SMARTHEAT INC.
Form 10-Q/A
April 13, 2012

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q
(Amendment No. 1)

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

For the quarterly period ended September 30, 2011

OR

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

Commission file number: 001-34246

SMARTHEAT INC.
(Exact name of registrant as specified in its charter)

Nevada (State or other jurisdiction of incorporation or organization)	98-0514768 (IRS Employer Identification No.)
A-1, 10, Street 7 Shenyang Economic and Technological Development Zone Shenyang, China (Address of principal executive offices)	110141 (Zip Code)

+86 (24) 2519-7699
(Registrant's telephone number, including area code)

Indicate by checkmark 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 last 90 days.

YES x NO ¨

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

YES x NO ¨

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

Large accelerated filer ¨ Accelerated filer x
Non-accelerated filer ¨ Smaller reporting company x
(do not check if a 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 x

Indicate the number of shares outstanding of each of the issuer’s classes of common stock, as of the latest practicable date: 38,601,939 shares of common stock outstanding as of November 4, 2011.

EXPLANATORY NOTE

We are filing this Amendment No. 1, or the First Amendment, to our Quarterly Report on Form 10-Q for the quarterly period ended September 30, 2011, to amend the “Item 4. Controls and Procedures” of the Quarterly Report originally filed on November 8, 2011, or the Original Report. This First Amendment is being made to address certain comments received from the Staff of the Securities and Exchange Commission, or the SEC.

Except as stated herein, this First Amendment does not reflect events occurring after the filing of the Original Report on November 8, 2011, and no attempt has been made in this First Amendment to modify or update other disclosures as presented in the Original Report. Accordingly, this First Amendment should be read in conjunction with the Original Report and our filings with the SEC subsequent to the filing of the Original Report.

Table of Contents

SmartHeat Inc.

Table of Contents

		Page
	PART I. FINANCIAL INFORMATION	
Item 1.	Financial Statements	1
Item 2.	Management's Discussion and Analysis of Financial Condition and Results of Operations	23
Item 3.	Quantitative and Qualitative Disclosures about Market Risk	35
Item 4.	Controls and Procedures	35
	PART II. OTHER INFORMATION	
Item 1.	Legal Proceedings	35
Item 1A.	Risk Factors	35
Item 2.	Unregistered Sales of Equity Securities and Use of Proceeds	37
Item 3.	Defaults Upon Senior Securities	37
Item 4.	(Removed and Reserved)	37
Item 5.	Other Information	37
Item 6.	Exhibits	37
	Signatures	38
	Exhibit Index	39

Table of Contents

PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

SMARTHEAT INC. AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS

	September 30, 2011 (Unaudited)	December 31, 2010
ASSETS		
CURRENT ASSETS		
Cash & equivalents	$ 12,257,202	$ 56,806,471
Restricted cash	2,075,969	1,949,742
Accounts receivable, net	35,435,963	47,224,476
Retentions receivable	2,914,986	2,548,401
Advances to suppliers	21,791,588	8,351,579
Other receivables, prepayments and deposits	9,538,520	6,301,772
Tax receivables	1,391,304	-
Inventories	58,207,965	26,585,362
Deferred tax asset	-	380,232
Notes receivable - bank acceptances	802,075	1,457,457
Total current assets	144,415,572	151,605,492
NONCURRENT ASSETS		
Restricted cash	155,254	502,672
Retentions receivable	1,084,696	1,062,167
Advance for construction and equipment	977,463	-
Construction in progress	518,433	81,204
Property and equipment, net	11,429,832	8,381,019
Intangible assets, net	15,399,192	14,243,734
Goodwill	11,151,957	-
Deferred tax asset	-	22,266
Other noncurrent asset	14,939	-
Total noncurrent assets	40,731,766	24,293,062
TOTAL ASSETS	$ 185,147,338	$ 175,898,554
LIABILITIES AND STOCKHOLDERS' EQUITY		
CURRENT LIABILITIES		
Accounts payable	$ 9,767,193	$ 4,490,333
Advance from customers	7,843,587	1,131,193
Taxes payable	26,357	2,000,456
Accrued liabilities and other payables	2,223,938	3,039,701
Notes payable - bank acceptances	1,510,985	2,207,280
Loans payable	16,837,401	9,059,749

Total current liabilities		38,209,461		21,928,712
DEFERRED TAX LIABILITY		212,475		-
LONG-TERM PAYABLE		371,483		-
COMMITMENTS AND CONTINGENCIES				
STOCKHOLDERS' EQUITY				
Common stock, $0.001 par value; 75,000,000 shares authorized, 38,601,939 and 38,551,939 shares issued and outstanding at September 30, 2011, and December 31, 2010		38,602		38,552
Paid-in capital		102,523,424		102,251,027
Statutory reserve		4,962,052		5,301,918
Accumulated other comprehensive income		9,969,280		4,252,261
Retained earnings		27,470,582		41,500,015
Total Company stockholders' equity		144,963,940		153,343,773
NONCONTROLLING INTEREST		1,389,979		626,069
TOTAL EQUITY		146,353,919		153,969,842
TOTAL LIABILITIES AND EQUITY	$	185,147,338	$	175,898,554

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

Table of Contents

SMARTHEAT INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF INCOME AND COMPREHENSIVE INCOME (LOSS)
(UNAUDITED)

	NINE MONTHS ENDED SEPTEMBER 30,		THREE MONTHS ENDED SEPTEMBER 30,	
	2011	2010	2011	2010
Net sales	$ 31,543,940	$ 83,613,250	$ 16,573,890	$ 51,476,821
Cost of goods sold	21,025,243	54,177,914	11,263,003	33,061,854
Gross profit	10,518,697	29,435,336	5,310,887	18,414,967
Operating expenses				
Selling	6,611,522	5,972,651	2,409,435	3,335,303
General and administrative				
R&D	598,117	480,572	85,250	259,879
Bad debt	8,913,261	15,744	3,107,589	(38,484)
G&A expenses	8,550,170	4,126,152	2,244,025	1,840,058
Total operating expenses	24,673,070	10,595,119	7,846,299	5,396,756
Income (loss) from operations	(14,154,373)	18,840,217	(2,535,412)	13,018,211
Non-operating income (expenses)				
Interest income	166,419	322,462	33,925	117,853
Interest expense	(590,242)	(41,871)	(297,007)	(41,871)
Financial income (expense)	(54,999)	(36,430)	22,285	(17,427)
Foreign exchange transaction gain (loss)	(439,983)	24,652	(137,779)	68,323
Other income, net	548,995	134,446	224,766	52,060
Total non-operating income (expenses), net	(369,810)	403,259	(153,810)	178,938
Income (loss) before income tax	(14,524,183)	19,243,476	(2,689,222)	13,197,149
Income tax expense (benefit)	(5,159)	3,059,182	1,322,900	2,092,876
Net income (loss) before noncontrolling interest	(14,519,024)	16,184,294	(4,012,122)	11,104,273
Less: Income (loss) attributable to noncontrolling interest	(149,727)	(16,962)	(15,003)	(2,232)
Net income (loss) to SmartHeat Inc.	(14,369,297)	16,201,256	(3,997,119)	11,106,505
Other comprehensive item				
	5,717,019	1,931,721	2,091,719	1,418,870

Foreign currency translation gain										
Comprehensive Income (Loss)	$	(8,652,278	)	$	18,132,977	$	(1,905,400	)	$	12,525,375
Basic weighted average shares outstanding		38,582,342			32,804,292		38,601,939			32,811,125
Diluted weighted average shares outstanding		38,582,342			32,846,171		38,601,939			32,817,520
Basic earnings (loss) per share	$	(0.37	)	$	0.49	$	(0.10	)	$	0.34
Diluted earnings (loss) per share	$	(0.37	)	$	0.49	$	(0.10	)	$	0.34

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

2

Table of Contents

SMARTHEAT INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS
(UNAUDITED)

	NINE MONTHS ENDED SEPTEMBER 30,	
	2011	2010
CASH FLOWS FROM OPERATING ACTIVITIES:		
Income (loss) including noncontrolling interest	$(14,519,024)	$16,184,294
Adjustments to reconcile income (loss) including noncontrolling interest to net cash used in operating activities:		
Depreciation and amortization	1,252,981	709,544
Provision for bad debt	8,913,261	15,744
Unearned interest on accounts receivable	(71,118)	(74,520)
Stock compensation	272,447	160,959
Loss on disposal of fixed assets	9,548	-
Changes in deferred tax	(58,098)	(23,160)
(Increase) decrease in current assets:		
Accounts receivable	5,854,356	(17,807,291)
Retentions receivable	(232,191)	(1,547,759)
Advances to suppliers	(12,764,507)	(4,761,889)
Other receivables, prepayments and deposits	3,198,367	1,995,914
Inventories	(27,931,844)	(20,659,166)
Increase (decrease) in current liabilities:		
Accounts payable	3,807,969	3,635,847
Advance from customers	6,521,146	2,079,159
Taxes payable	(2,975,398)	608,861
Accrued liabilities and other payables	(2,700,390)	128,354
Net cash used in operating activities	(31,422,495)	(19,355,109)
CASH FLOWS FROM INVESTING ACTIVITIES:		
Change in restricted cash	317,415	(12,593)
Acquisition of property & equipment	(2,453,889)	(3,277,320)
Advance for construction and equipment	(977,463)	-
Disposal of fixed assets	39,418	-
Acquisition of intangible asset	(106,971)	(170,689)
Deposit for land use right	-	(9,448,356)
Notes receivable	701,069	(404,449)
Other receivables-advance to third parties	(5,293,224)	-
Cash acquired from acquisition	448,849	-
Cash paid at acquisition	(13,588,207)	-
Construction in progress	(424,286)	(79,008)
Net cash used in investing activities	(21,337,289)	(13,392,415)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Warrants exercised	-	85,500

Proceeds from short-term loans	6,461,314	4,407,357
Repayment to short-term loans	-	(4,407,357)
Other payables-advance from third parties	802,606	-
Cash contribution from noncontrolling interest	754,332	-
Payment on notes payable	(771,988)	(1,812,243)
Net cash provided by (used in) financing activities	7,246,264	(1,726,743)
EFFECT OF EXCHANGE RATE CHANGE ON CASH & EQUIVALENTS	964,251	230,366
NET DECREASE IN CASH & EQUIVALENTS	(44,549,269)	(34,243,901)
CASH & EQUIVALENTS, BEGINNING OF PERIOD	56,806,471	48,967,992
CASH & EQUIVALENTS, END OF PERIOD	$12,257,202	$14,724,091
Supplemental cash flow data:		
Income tax paid	$1,661,821	$1,634,509
Interest paid	$563,269	$137,787

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

Table of Contents

SMARTHEAT INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
SEPTEMBER 30, 2011 (UNAUDITED) AND 2010

1. ORGANIZATION AND DESCRIPTION OF BUSINESS

SmartHeat Inc., formerly known as Pacific Goldrim Resources, Inc. (the “Company” or “SmartHeat”), was incorporated on August 4, 2006, in the State of Nevada. The Company, through its operating subsidiaries in China and Germany, designs, manufactures, sells and services plate heat exchangers (“PHEs”), PHE Units, which combine PHEs with various pumps, temperature sensors, valves and automated control systems, heat meters and heat pumps for use in commercial and residential buildings.

On April 14, 2008, the Company entered into a Share Exchange Agreement (the “Share Exchange Agreement”) with Shenyang Taiyu Machinery and Electronic Equipment Co., Ltd. (“Taiyu”) and the Taiyu Shareholders. Pursuant to the Share Exchange Agreement, all of the equitable and legal rights, title and interests in and to Taiyu’s share capital of Yuan 25,000,000 were exchanged for 18,500,000 shares of SmartHeat’s common stock (the “Share Exchange”). Concurrent with the Share Exchange, one of SmartHeat’s shareholders cancelled 2,500,000 shares of the 6,549,900 issued and outstanding shares of SmartHeat common stock pursuant to a split-off agreement dated April 14, 2008. As a result of the Share Exchange, Taiyu became a wholly owned subsidiary of SmartHeat.

Prior to the acquisition of Taiyu, the Company was a non-operating public shell. Pursuant to Securities and Exchange Commission (“SEC”) rules, the merger or acquisition of a private operating company into or by a non-operating public shell with nominal net assets was considered a capital transaction rather than a business combination. Accordingly, for accounting purposes the transaction was treated as a reverse acquisition and recapitalization and pro-forma information was not presented. Transaction costs incurred in the reverse acquisition were expensed.

Taiyu was incorporated in Liaoning Province, China in July 2002. Taiyu manufactures and sells PHEs, PHE Units and heat meters. The Company is an authorized dealer of Sondex brand PHEs; Sondex is the second largest PHE plate manufacturer in the world.

On September 25, 2008, the Company entered into a Share Exchange Agreement (the “SanDeKe Agreement”) with Asialink (Far East) Limited (“Asialink”) to acquire all of the outstanding capital stock of SanDeKe Co., Ltd., a Shanghai-based manufacturer of PHEs (“SanDeKe”). The purchase price for SanDeKe was $741,516. Under the terms of the SanDeKe Agreement, two shareholders of SanDeKe agreed not to compete with SanDeKe’s business for four years after SanDeKe was purchased.

On June 12, 2009, the Company incorporated a new subsidiary, SmartHeat Siping Beifang Energy Technology Co., Ltd. (“SmartHeat Siping”), to manufacture PHEs.

On June 16, 2009, Taiyu closed an asset purchase transaction with Siping Beifang Heat Exchanger Manufacture Co., Ltd. (“Siping Beifang”), a company organized under the laws of the People’s Republic of China (“PRC”), to purchase certain assets consisting of the plant, equipment and certain land use rights for RMB 54,000,000 ($7,906,296). Taiyu then transferred all the acquired assets to SmartHeat Siping, the newly incorporated subsidiary. The Company paid RMB 7,250,000 ($1,061,500) upon the completion of inventory inspection, with the remaining purchase consideration paid in full as of June 30, 2011.

On August 14, 2009, the Company formed Beijing SmartHeat Jinhui Energy Technology Co., Ltd. (“Jinhui”), a joint venture in Beijing with registered capital of RMB 10 million ($1.46 million), to provide consulting services and expand the Company’s sales of PHEs into new industries and regions of China. SmartHeat owns 52% of Jinhui and

invested approximately $765,000.

On April 7, 2010, the Company formed SmartHeat (China) Investment Co., Ltd. (“SmartHeat Investment”), an investment holding company and wholly owned subsidiary in Shenyang with registered capital of $70 million.

On April 12, 2010, SmartHeat Investment formed SmartHeat (Shenyang) Energy Equipment Co., Ltd. (“SmartHeat Energy”), a wholly owned subsidiary in Shenyang with registered capital of $30 million, for the research, development, manufacturing and sales of energy products.

SMARTHEAT INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
SEPTEMBER 30, 2011 (UNAUDITED) AND 2010

On May 6, 2010, the Company formed SmartHeat (Shanghai) Trading Co., Ltd. (“SmartHeat Trading”) through a nominee to market and expand sales of the Company’s Taiyu-branded products. The Company made a capital contribution of $1.5 million, and controls and is entitled to 100% of the profit or loss of SmartHeat Trading pursuant to an investment agreement dated February 1, 2010.

On January 7, 2011, the Company invested $771,658 for 51% of the equity interest in Hohhot Ruicheng Technology Co., Ltd. (“Ruicheng”), a joint venture formed on December 2, 2010, in Hohhot City, China, for the design and manufacture of heat meters.

On March 3, 2011, the Company completed the acquisition of Gustrower Warmepumpen GmbH (“GWP”), a designer and manufacturer of high efficiency heat pumps in Germany, from Conergy AG for EUR 4,248,082 ($5,898,887) paid at closing. This acquisition will extend the Company’s clean technology heating solutions into the rapidly growing heat pump markets in Europe and China, enabling its customers to purchase technologically advanced heat pumps at competitive prices.

On March 1, 2011, the Company entered into a purchase agreement with Shenyang Bingchuan Refrigerating Machine Limited Company, a Shenyang-based state-owned heat pump manufacturer and designer, which was renamed SmartHeat (Shenyang) Heat Pump Technology Co., Ltd. (“SmartHeat Pump”). The Company paid RMB 50 million ($7.6 million) to acquire 95% of the equity interest in SmartHeat Pump, with the local government retaining the remaining 5% equity interest.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Principles of Consolidation

The accompanying consolidated financial statements include the accounts of SmartHeat’s U.S. parent, Taiyu, SanDeKe, SmartHeat Siping, Jinhui, SmartHeat Investment, SmartHeat Energy, SmartHeat Trading, Ruicheng, GWP and SmartHeat Pump. The “Company” refers collectively to SmartHeat’s U.S. parent, Taiyu, SanDeKe, SmartHeat Siping, Jinhui, SmartHeat Investment, SmartHeat Energy, SmartHeat Trading, Ruicheng, GWP and SmartHeat Pump. All significant intercompany accounts and transactions were eliminated in consolidation.

Noncontrolling Interest

The Company follows Financial Accounting Standards Board’s (“FASB”) Accounting Standards Codification (“ASC”) Topic 810, “Consolidation,” which established new standards governing the accounting for and reporting of noncontrolling interests (“NCIs”) in partially owned consolidated subsidiaries and the loss of control of subsidiaries. Certain provisions of this standard indicate, among other things, that NCIs, previously referred to as minority interests, be treated as a separate component of equity, not as a liability, as was previously the case, that increases and decreases in the parent’s ownership interest that leave control intact be treated as equity transactions rather than as step acquisitions or dilution gains or losses and that losses of a partially owned consolidated subsidiary be allocated to the NCI even when such allocation might result in a deficit balance. This standard also required changes to certain presentation and disclosure requirements. Losses attributable to the NCI in a subsidiary may exceed the NCI’s interests in the subsidiary’s equity. The excess attributable to the NCI is attributed to those interests. The NCI shall continue to be attributed its share of losses even if that attribution results in a deficit NCI balance.

Use of Estimates

In preparing the financial statements in conformity with U.S. generally accepted accounting principles ("U.S. GAAP"), management makes estimates and assumptions that affect the reported amounts of assets and liabilities and disclosures of contingent assets and liabilities at the dates of the financial statements, as well as the reported amounts of revenues and expenses during the reporting period. Significant estimates, required by management, include the recoverability of long-lived assets, allowance for doubtful accounts and the reserve for obsolete and slow-moving inventories. Actual results could differ from those estimates.

Table of Contents

SMARTHEAT INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
SEPTEMBER 30, 2011 (UNAUDITED) AND 2010

Cash and Equivalents

For purposes of the statement of cash flows, the Company considers all highly liquid investments with an original maturity of three months or less to be cash equivalents. As of September 30, 2011, the Company maintained restricted cash of $2.23 million in several bank accounts, of which $1.46 million was cash deposits from customers for securing payment from such customers no later than the warranty period expiration and approximately $0.77 million was deposits the Company paid to a commercial bank for the bank issuing bank acceptances to the Company's vendors. Of the total restricted cash at September 30, 2011, $2.08 million will be released to the Company within one year. As of December 31, 2010, the Company maintained restricted cash of $2.5 million in several bank accounts, of which $1.05 million was cash deposits from customers for securing payment from such customers no later than the warranty period expiration and approximately $1.40 million was deposits the Company paid to a commercial bank for the bank issuing bank acceptances to the Company's vendors. Of the total restricted cash at December 31, 2010, $1.9 million will be released to the Company within one year.

The following table presents in U.S. dollars ("USD") the amount of cash and cash equivalents held by the Company as of September 30, 2011, and December 31, 2010, based on the jurisdiction where it is deposited. The Company's U.S. parent holds cash and cash equivalents in U.S. bank accounts denominated in USD.

As of September 30, 2011	United States	China	Germany	Total
Cash in bank	$217,465	$9,725,393	$2,300,060	$12,242,918
Cash on hand	-	14,284	-	14,284
Total cash	$217,465	$10,139,677	$2,300,060	$12,257,202
As of December 31, 2010				
Cash in bank	$33,299,040	$23,500,804	$-	$56,799,844
Cash on hand	-	6,627	-	6,627
Total cash	$33,299,040	$23,507,431	$-	$56,806,471

Accounts and Retentions Receivable

The Company maintains reserves for potential credit losses on accounts receivable. Management reviews the composition of accounts receivable and analyzes historical bad debts, customer concentrations, customer credit worthiness, current economic trends and changes in customer payment patterns to evaluate the adequacy of these reserves. Based on historical collection activity, the Company had allowances of $11.8 million and $2.3 million at September 30, 2011, and December 31, 2010, respectively.

At September 30, 2011, and December 31, 2010, the Company had retentions receivable from customers for product quality assurance of $4.0 million and $3.6 million, respectively. The retention rate varies from 5% to 20% of the sales price with variable terms from 3 to 24 months depending on the shipping date, and for PHE Units, the customer acceptance date, of the products and the number of heating seasons that the warranty period covers.

Accounts receivable is net of unearned interest of $11,742 and $81,041 at September 30, 2011, and December 31, 2010, respectively. Unearned interest is imputed interest on accounts receivable with due dates over 1 year from the invoice date discounted at the Company's borrowing rate, which was 6.56% at September 30, 2011, and 5.81% at December 31, 2010.

Advance to Suppliers

The Company makes advances to certain vendors to purchase its material and equipment. The advances are interest-free and unsecured.

Inventories

Inventories are valued at the lower of cost or market, with cost determined on a moving weighted average basis. Cost of work in progress and finished goods comprises direct material, direct labor and an allocated portion of production overheads.

Table of Contents

SMARTHEAT INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
SEPTEMBER 30, 2011 (UNAUDITED) AND 2010

Property and Equipment

Property and equipment are stated at cost, net of accumulated depreciation. Expenditures for maintenance and repairs are expensed as incurred; additions, renewals and betterments are capitalized. When property and equipment are retired or otherwise disposed of, the related cost and accumulated depreciation are removed from the respective accounts and any gain or loss is included in operations. Depreciation of property and equipment is provided using the straight-line method with a 10% salvage value and estimated lives as follows:

Building	20 years
Vehicles	5 years
Office Equipment	5 years
Production Equipment	5-10 years

Land Use Rights

Right to use land is stated at cost less accumulated amortization. Amortization is provided using the straight-line method over 50 years.

Impairment of Long-Lived Assets

Long-lived assets, which include property, plant and equipment and intangible assets, are reviewed for impairment whenever events or changes in circumstances indicate the carrying amount of an asset may not be recoverable.

Recoverability of long-lived assets to be held and used is measured by comparing the carrying amount of an asset to the estimated undiscounted future cash flows expected to be generated by the asset. If the carrying amount of an asset exceeds its estimated undiscounted future cash flows, an impairment charge is recognized based on the excess of the carrying amount over the fair value of the assets. Fair value generally is determined using the asset's expected future discounted cash flows or market value, if readily determinable. Based on its review, the Company believes that, as of September 30, 2011, and December 31, 2010, there were no significant impairments of its long-lived assets.

Warranties

The Company offers to all customers standard warranties on its products for one or two heating seasons depending on the terms negotiated. The Company accrues for warranty costs based on estimates of the costs that may be incurred under its warranty obligations. The warranty expense and related accrual is included in the Company's selling expenses and other payables respectively, and is recorded when revenue is recognized. Factors that affect the Company's warranty liability include the number of units sold, its estimates of anticipated rates of warranty claims, costs per claim and estimated support labor costs and the associated overhead. The Company periodically assesses the adequacy of its recorded warranty liabilities and adjusts the amounts as necessary.

Activity in the Company's warranty reserve as of and during the period ended September 30, 2011, and as of and during the year ended December 31, 2010, is as follows:

	2011	2010
Beginning balance	$ 398,292	$ 675,562

Provisions made or adjusted		(137,000)		(277,270)
Actual costs incurred		(164,851)		-
Ending balance in current liabilities	$	96,441	$	398,292

7

SMARTHEAT INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
SEPTEMBER 30, 2011 (UNAUDITED) AND 2010

Research and Development Costs

Research and development costs are expensed as incurred and included in general and administrative expenses. These costs primarily consist of cost of materials used and salaries paid for the development department of the Company and fees paid to third parties. Research and development costs for the nine months ended September 30, 2011 and 2010, were $598,117 and $480,572, respectively. Research and development costs for the three months ended September 30, 2011 and 2010, were $85,250 and $260,000, respectively.

Income Taxes

The Company utilizes Statement of Financial Accounting Standards ("SFAS") No. 109, "Accounting for Income Taxes" (codified in FASB ASC Topic 740), which requires recognition of deferred tax assets and liabilities for expected future tax consequences of events included in the financial statements or tax returns. Under this method, deferred income taxes are recognized for the tax consequences in future years of differences between the tax bases of assets and liabilities and their financial reporting amounts at each period end based on enacted tax laws and statutory tax rates applicable to the periods in which the differences are expected to affect taxable income. Valuation allowances are established, when necessary, to reduce deferred tax assets to the amount expected to be realized.

The Company follows the provisions of FASB Interpretation No. 48, "Accounting for Uncertainty in Income Taxes" (codified in FASB ASC Topic 740). When tax returns are filed, it is likely that some positions taken would be sustained upon examination by the taxing authorities, while others are subject to uncertainty about the merits of the position taken or the amount of the position that would be ultimately sustained. The benefit of a tax position is recognized in the financial statements in the period during which, based on all available evidence, management believes it is more likely than not that the position will be sustained upon examination, including the resolution of appeals or litigation processes, if any. Tax positions taken are not offset or aggregated with other positions. Tax positions that meet the more-likely-than-not recognition threshold are measured as the largest amount of tax benefit that is more than 50 percent likely of being realized upon settlement with the applicable taxing authority. The portion of the benefits associated with tax positions taken that exceeds the amount measured as described above is reflected as a liability for unrecognized tax benefits in the accompanying balance sheets along with any associated interest and penalties that would be payable to the taxing authorities upon examination.

Interest associated with unrecognized tax benefits is classified as interest expense and penalties are classified as selling, general and administrative expense in the statements of income. At September 30, 2011, and December 31, 2010, the Company had not taken any significant uncertain tax position on its tax return for 2010 and prior years or in computing its tax provision for 2010.

Revenue Recognition

The Company's revenue recognition policies are in compliance with SEC Staff Accounting Bulletin ("SAB") 104 (codified in FASB ASC Topic 605). Sales revenue is recognized when PHEs, heat meters and heat pumps are delivered, and for PHE Units when customer acceptance occurs, the price is fixed or determinable, no other significant obligations of the Company exist and collectability is reasonably assured. Payments received before all of the relevant criteria for revenue recognition met are recorded as unearned revenue.

The Company's sales generally provide for 30% of the purchase price on placement of an order, 30% on delivery, 30% upon installation and acceptance of the equipment after customer testing and 10% no later than the termination of the standard warranty period, which ranges from 3 to 24 months from the acceptance date.

Sales revenue is the invoiced value of goods, net of value-added tax ("VAT"). All of the Company's products sold in the PRC are subject to a VAT of 17% of the gross sales price. This VAT may be offset by the VAT paid by the Company on raw materials and other materials purchased in China and included in the cost of producing the Company's finished product. The Company recorded VAT payable and VAT receivable net of payments in the financial statements. The VAT tax return is filed offsetting the payables against the receivables. GWP, the Company's German subsidiary, is subject to 19% VAT.

Sales and purchases are recorded net of VAT collected and paid as the Company acts as an agent for the government. VAT taxes are not affected by the income tax holiday.

SMARTHEAT INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
SEPTEMBER 30, 2011 (UNAUDITED) AND 2010

At September 30, 2011, the Company had VAT receivable of $1,355,642 for its subsidiaries in China, which the Company anticipates collecting within one year. The Company does not experience credit losses with respect to its VAT receivable because it is owed to the Company by the PRC government. The Company classifies its VAT receivable as a current asset because it is an asset that is reasonably expected to be realized (or sold or consumed) within one year or within the Company's normal operating cycle.

Sales returns and allowances were $0 for the nine months ended September 30, 2011 and 2010. Sales returns and allowances were $0 for the three months ended September 30, 2011 and 2010. The Company does not provide a right of return, price protection or any other concessions to its customers.

The Company provides a standard warranty to all customers, which is not considered an additional service; rather, an integral part of the product's sale. The Company believes the existence of its standard product warranty in a sales contract does not constitute a deliverable in the arrangement and thus there is no need to apply the EITF 00-21 (codified in FASB ASC Topic 605-25) separation and allocation model for a multiple deliverable arrangement. SFAS 5 (codified in FASB ASC Topic 450) specifically addresses the accounting for standard warranties and neither SAB 104 nor EITF 00-21 supersedes SFAS 5. The Company believes that accounting for its standard warranty pursuant to SFAS 5 does not impact revenue recognition because the cost of honoring the warranty can be reliably estimated.

The Company charges for after-sales services provided after the expiration of the warranty period, with after-sales services mainly consisting of cleaning PHEs and repairing and exchanging parts. The Company recognizes such revenue when service is provided. For the nine months ended September 30, 2011 and 2010, revenue from after-sales services after the expiration of the warranty period was $349,300 and 74,000, respectively. For the three months ended September 30, 2011 and 2010, revenue from after-sales services after the expiration of the warranty period was $209,100 and $34,500, respectively.

Cost of Goods Sold

Cost of goods sold consists primarily of material costs and direct labor and manufacturing overhead that are directly attributable to the products. Write-down of inventories to the lower of cost or market is also recorded in cost of goods sold.

Advance from Customers

The Company records payments received from customers in advance of their future orders to advance account. Those orders normally are delivered within a reasonable period of time based upon contract terms with the customers.

Concentration of Credit Risk

Cash includes cash on hand and demand deposits in accounts maintained within China. Balances at financial institutions within China are not covered by insurance. The Company has not experienced any losses in such accounts.

Certain other financial instruments, which subject the Company to concentration of credit risk, consist of accounts and other receivables. The Company does not require collateral or other security to support these receivables. The Company conducts periodic reviews of its customers' financial condition and customer payment practices to minimize collection risk on accounts receivable.

The operations of the Company are located primarily in China. Accordingly, the Company's business, financial condition and results of operations may be influenced by the political, economic and legal environments in China, as well as by the general state of the PRC economy.

SMARTHEAT INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
SEPTEMBER 30, 2011 (UNAUDITED) AND 2010

Goodwill

Goodwill is the excess of purchase price and related costs over the value assigned to the net tangible and identifiable intangible assets of businesses acquired. In accordance with SFAS No. 142, “Goodwill and Other Intangible Assets” (“Statement No. 142”), codified in ASC Topic 350, goodwill is not amortized but is tested for impairment, annually or when circumstances indicate a possible impairment may exist. Impairment testing is performed at a reporting unit level. An impairment loss generally would be recognized when the carrying amount of the reporting unit exceeds its fair value, with the fair value of the reporting unit determined using discounted cash flow (“DCF”) analysis. A number of significant assumptions and estimates are involved in the application of the DCF analysis to forecast operating cash flows, including the discount rate, the internal rate of return and projections of realizations and costs to produce. Management considers historical experience and all available information at the time the fair values of its reporting units are estimated.

The excess of the purchase price for GWP over the fair value of the net assets acquired of $5.1 million was recorded as goodwill. The excess of the purchase price for SmartHeat Pump over the fair value of the net assets acquired of $5.6 million was recorded as goodwill. As of September 30, 2011, the Company concluded there was no impairment of goodwill for the following reasons: (1) the losses of the acquired businesses are temporary because the Company acquired GWP and SmartHeat Pump in March 2011 and is in the transition process of integrating operations and adjusting business strategies; (2) the Company expects the return on investment from the acquired businesses within three years and believes that its overall market share will be expanded with the contribution of sales and marketing resources from the acquired businesses; and (3) sales contracts for the products of the acquired businesses typically are entered into in the third and fourth calendar quarters.

Statement of Cash Flows

In accordance with SFAS No. 95, “Statement of Cash Flows,” codified in FASB ASC Topic 230, cash flows from the Company’s operations are calculated based upon the local currencies. As a result, amounts shown on the statement of cash flows may not necessarily agree with changes in the corresponding asset and liability on the balance sheet.

Basic and Diluted Earnings (Loss) per Share (EPS)

Basic EPS is computed by dividing income available to common shareholders by the weighted average number of common shares outstanding for the period. Diluted EPS is computed similarly, except that the denominator is increased to include the number of additional common shares that would have been outstanding if the potential common shares had been issued and if the additional common shares were dilutive. Diluted EPS are based on the assumption that all dilutive convertible shares and stock options were converted or exercised. Dilution is computed by applying the treasury stock method. Under this method, options and warrants are assumed to have been exercised at the beginning of the period (or at the time of issuance, if later), and as if funds obtained thereby were used to purchase common stock at the average market price during the period.

The following table presents a reconciliation of basic and diluted earnings (loss) per share for the nine and three months ended September 30, 2011 and 2010:

	Nine months ended September 30,	Three months ended September 30,

	2011	2010	2011	2010
Net income (loss)	$ (14,369,297)	$ 16,201,256	$ (3,997,119)	$ 11,106,505
Weighted average shares outstanding - basic	38,582,342	32,804,292	38,601,939	32,811,125
Effect of dilutive securities:				
Unexercised warrants and options	-	41,879	-	6,395
Weighted average shares outstanding - diluted	38,582,342	32,846,171	38,601,939	32,817,520
Earnings (loss) per share - basic	$ (0.37)	$ 0.49	$ (0.10)	$ 0.34
Earnings (loss) per share - diluted	$ (0.37)	$ 0.49	$ (0.10)	$ 0.34

Basic and diluted earnings (loss) per share are the same for the nine and three months ended September 30, 2011 and 2010, because the common stock equivalent of the convertible securities outstanding, consisting of unexercised warrants issued to investors and options issued to the Company's directors and an officer, are antidilutive and, accordingly, were excluded from the computation of diluted earnings (loss) per share. At September 30, 2011 and 2010, options to purchase 35,000 and 6,666 shares of common stock were outstanding and exercisable, respectively, and warrants to purchase 0 and 96,775 shares of common stock were outstanding and exercisable, respectively (see Note 16).

SMARTHEAT INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
SEPTEMBER 30, 2011 (UNAUDITED) AND 2010

Fair Value of Financial Instruments

For certain of the Company's financial instruments, including cash and equivalents, restricted cash, accounts receivable, accounts payable, accrued liabilities and short-term debt, the carrying amounts approximate their fair values due to their short maturities. ASC Topic 820, "Fair Value Measurements and Disclosures," requires disclosure of the fair value of financial instruments held by the Company. ASC Topic 825, "Financial Instruments," defines fair value, and establishes a three-level valuation hierarchy for disclosures of fair value measurement that enhances disclosure requirements for fair value measures. The carrying amounts reported in the consolidated balance sheets for receivables and current liabilities each qualify as financial instruments and are a reasonable estimate of their fair values because of the short period of time between the origination of such instruments and their expected realization and their current market rate of interest. The three levels of valuation hierarchy are defined as follows:

§ Level 1 inputs to the valuation methodology are quoted prices for identical assets or liabilities in active markets.

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

§ Level 3 inputs to the valuation methodology are unobservable and significant to the fair value measurement.

The Company analyzes all financial instruments with features of both liabilities and equity under ASC 480, "Distinguishing Liabilities from Equity," and ASC 815.

As of September 30, 2011, and December 31, 2010, the Company did not identify any assets and liabilities that are required to be presented on the balance sheet at fair value.

Foreign Currency Translation and Comprehensive Income (Loss)

The accounts of the U.S. parent company are maintained in USD. The functional currency of the Company's China subsidiaries is the Chinese Yuan Renminbi ("RMB") and the functional currency of GWP, the Company's subsidiary in Germany, is the Euro ("EUR"). The accounts of the China subsidiaries and German subsidiary were translated into USD in accordance with SFAS No. 52, "Foreign Currency Translation" (codified in FASB ASC Topic 830). According to SFAS No. 52, all assets and liabilities were translated at the exchange rate on the balance sheet date, stockholders' equity was translated at the historical rates and statement of operations items were translated at the weighted average exchange rate for the year. The resulting translation adjustments are reported under other comprehensive income in accordance with SFAS No. 130, "Reporting Comprehensive Income" (codified in FASB ASC Topic 220).

The RMB to USD exchange rates in effect as of September 30, 2011, and December 31, 2010, were USD$1 = RMB6.3549 and USD$1 = RMB6.6227, respectively. The weighted average RMB to USD exchange rates in effect for the nine months ended September 30, 2011 and 2010, were USD$1 = RMB6.4975 and USD$1 = RMB6.8068, respectively. The exchange rates used in translation from RMB to USD were published by the People's Bank of the People's Republic of China.

The EUR to USD exchange rate in effect as of September 30, 2011, was USD$1 = EUR0.7354. The weighted average EUR to USD exchange rate in effect for the nine months ended September 30, 2011, was USD$1 = EUR0.7027. The exchange rates used in translation from EUR to USD were published by OANDA Rates.

Table of Contents

SMARTHEAT INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
SEPTEMBER 30, 2011 (UNAUDITED) AND 2010

Stock-Based Compensation

The Company accounts for its stock-based compensation in accordance with SFAS No. 123R, "Share-Based Payment, an Amendment of FASB Statement No. 123" (codified in FASB ASC Topics 718 and 505). The Company recognizes in the income statement the grant date fair value of stock options and other equity-based compensation issued to employees and non-employees.

Segment Reporting

SFAS No. 131, "Disclosures about Segments of an Enterprise and Related Information" (codified in FASB ASC Topic 280), requires use of the "management approach" model for segment reporting. The management approach model is based on the way a company's management organizes segments within the company for making operating decisions and assessing performance. Reportable segments are based on products and services, geography, legal structure, management structure, or any other manner in which management disaggregates a company.

SFAS No. 131 has no effect on the Company's financial statements as management determined that substantially all of the Company's operations are conducted in one industry segment.

The following table sets forth a summary of sales by product line for the nine and three months ended September 30, 2011 and 2010:

	Nine months ended September 30,		Three months ended September 30,	
	2011	2010	2011	2010
	(in millions)			
PHEs	$ 14.19	$ 40.89	$ 7.12	$ 23.68
PHE Units	13.23	33.81	7.95	19.98
Heat meters	2.45	8.91	0.75	7.82
Heat pumps	1.67	-	0.75	-
	$ 31.54	$ 83.61	$ 16.57	$ 51.48

Reclassifications

Certain prior year amounts were reclassified to conform to the manner of presentation in the current period.

New Accounting Pronouncements

In June 2011, FASB issued ASU 2011-05, "Comprehensive Income (ASC Topic 220): Presentation of Comprehensive Income." Under the amendments in this update, an entity has the option to present the total of comprehensive income, the components of net income and the components of other comprehensive income either in a single continuous statement of comprehensive income or in two separate but consecutive statements. Under both options, an entity is required to present each component of net income along with total net income, each component of other comprehensive income along with a total for other comprehensive income and a total amount for comprehensive income. In a single continuous statement, the entity is required to present the components of net income and total net income, the components of other comprehensive income and a total for other comprehensive income, along with the

total of comprehensive income in that statement. In the two-statement approach, an entity is required to present components of net income and total net income in the statement of net income. The statement of other comprehensive income should immediately follow the statement of net income and include the components of other comprehensive income and a total for other comprehensive income, along with a total for comprehensive income. In addition, the entity is required to present on the face of the financial statements reclassification adjustments for items that are reclassified from other comprehensive income to net income in the statement(s) where the components of net income and the components of other comprehensive income are presented. The amendments in this update should be applied retrospectively and are effective for fiscal years, and interim periods within those years, beginning after December 15, 2011. The Company is currently assessing the effect that the adoption of this pronouncement will have on its financial statements.

Table of Contents

SMARTHEAT INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
SEPTEMBER 30, 2011 (UNAUDITED) AND 2010

3. INVENTORIES

Inventories at September 30, 2011, and December 31, 2010, were as follows:

	2011	2010
Raw materials	$ 34,946,366	$ 15,803,040
Work in process	1,675,221	3,157,799
Finished goods	21,586,378	7,624,523
Total	$ 58,207,965	$ 26,585,362

4. NOTES RECEIVABLE – BANK ACCEPTANCES

The Company sold goods to its customers and received commercial notes (bank acceptance) from them in lieu of payments for accounts receivable. The Company discounted the commercial notes with the bank or endorsed the commercial notes to vendors for payment of their own obligations or to get cash from third parties. Most of the commercial notes have a maturity of less than six months. At September 30, 2011, and December 31, 2010, the Company had notes receivable of $802,075 and $1,457,457, respectively. As of September 30, 2011, the Company is contingently liable for the notes endorsed to vendors in the amount of $423,000.

5. PROPERTY AND EQUIPMENT, NET

Property and equipment consisted of the following at September 30, 2011, and December 31, 2010:

	2011	2010
Building	$ 4,748,457	$ 4,556,445
Production equipment	7,234,813	3,923,521
Office equipment	966,0078	794,816
Vehicles	946,547	711,798
Total	13,895,825	9,986,580
Less: Accumulated depreciation	(2,465,993)	(1,605,561)
Net	$ 11,429,832	$ 8,381,019

Depreciation for the nine months ended September 30, 2011 and 2010, was $821,800 and $518,700, respectively. Depreciation for the three months ended September 30, 2011 and 2010, was $300,200 and $119,600, respectively.

6. OTHER RECEIVABLES, PREPAYMENTS AND DEPOSITS

Other receivables, prepayments and deposits consisted of the following at September 30, 2011, and December 31, 2010, respectively:

	2011	2010
Advanced to third parties	$ 5,293,224	$ 2,076,862
Deposit for public bids of sales contracts	1,196,958	846,739
Deposit for acquisition of SmartHeat Pump	-	1,834,600
	611,391	115,542

Prepayment for freight and related insurance expenses			
Other deposits		87,957	53,289
Advance to employees		1,197,462	600,427
Other		1,151,528	774,313
Total	$	9,538,520	6,301,772

Advanced to third parties were short-term advances to unrelated parties with payment usually due within a year and includes advance to Siping Beifang Heat Exchanger Manufacture Co., Ltd. ("Siping Beifang", see Note 1) of RMB 22 million ($3.5 million), non-interest bearing and due on December 9, 2011. Deposits for public bidding represented the deposits for bidding on expected contracts, which will be returned to the Company after the bidding process is completed, usually within three to four months from the payment date. Prepayment for freight and related insurance expenses represented prepaid shipping and freight insurance expenses for customers and is generally repaid upon customer receipt of products. Deposits mainly consisted of deposits for rents, payroll expense and utilities. Advanced to employees represented short-term loans to employees and advances for business trips and related expenses. Other receivables, prepayments and deposits are reimbursed or settled within 12 months.

Table of Contents

SMARTHEAT INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
SEPTEMBER 30, 2011 (UNAUDITED) AND 2010

7. INTANGIBLE ASSETS

Intangible assets consisted mainly of land use rights, trademark, computer software, know-how technology, customer list and covenant not to compete. All land in the PRC is government-owned and cannot be sold to any individual or company. However, the government grants the user a “land use right” to use the land. The Company acquired land use rights during 2005 for $440,000 (RMB 3,549,682). In June 2009, the Company acquired land use rights for $3.1 million from Siping Beifang. In November 2010, the Company’s subsidiary, SmartHeat Energy, acquired land use rights for $10.1 million. The Company has the right to use the land for 50 years and is amortizing such rights on a straight-line basis for 50 years.

Intangible assets consisted of the following at September 30, 2011, and December 31, 2010, respectively:

	2011	2010
Land use rights	$ 14,507,293	$ 13,884,020
Know-how technology	874,421	275,345
Customer list	206,119	197,784
Covenant not to compete	112,128	107,593
Software	513,566	403,680
Trademark	286,429	-
Total	16,499,956	14,868,422
Less: Accumulated amortization	(1,100,764)	(624,688)
Net	$ 15,399,192	$ 14,243,734

Amortization of intangible assets for the nine months ended September 30, 2011 and 2010, was $430,600 and $191,000, respectively. Amortization of intangible assets for the three months ended September 30, 2011 and 2010, was $151,300 and $67,000, respectively. Annual amortization expense for the next five years from September 30, 2011, is expected to be $588,000, $566,000, $440,000, $421,000 and $405,000.

8. CONSTRUCTION IN PROGRESS

The Company had construction in progress of $518,433 at September 30, 2011, with two ongoing projects. SmartHeat Energy is building a factory with a total estimated cost of $9 million, of which the Company has paid $451,000 as of September 30, 2011, and expects this construction to be completed by June 2012. SmartHeat Siping has a construction project of $68,000 for the laying of a foundation for its machinery installation. This foundation project will be completed in 2011, with remaining cost to complete of $20,000.

9. TAXES PAYABLE

Taxes payable consisted of the following at September 30, 2011, and December 31, 2010:

	2011	2010
Income tax payable	$ -	$ 1,866,569
Value-added tax payable	-	117,779
Other taxes payable	26,357	16,108
Total taxes payable	$ 26,357	$ 2,000,456

14

Table of Contents

SMARTHEAT INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
SEPTEMBER 30, 2011 (UNAUDITED) AND 2010

10. ACCRUED LIABILITIES AND OTHER PAYABLES

Accrued liabilities and other payables consisted of the following at September 30, 2011, and December 31, 2010:

	2011	2010
Advance from third parties	$ 802,606	$ 132,890
Payable to Siping Beifang	-	1,238,166
Other payables	1,211,577	952,593
Warranty reserve (See Note 2)	96,441	398,292
Accrued expenses	113,314	317,840
Total	$ 2,223,938	$ 3,039,701

Advance from third parties were short-term, non-interest-bearing advances from third parties. Other payables consisted of payables for the Company's miscellaneous expenses including postage, business insurance, employee benefits, bidding fee, etc. Accrued expenses mainly consisted of accrued purchases, interest and utility.

11. NOTES PAYABLE – BANK ACCEPTANCES

Notes payable represented the conversion of accounts payable into notes payable, which were issued by a bank. The Company deposited a portion of the acceptance amount into the bank. The terms of the notes range from 3-6 months and bear no interest. At September 30, 2011, and December 31, 2010, the Company deposited $1.5 million and $2.2 million with the bank as restricted cash for the bank issuing the notes. The restricted cash is refundable when the notes are repaid.

12. LOANS PAYABLE - BANK

The Company was obligated for the following short-term loans as of September 30, 2011, and December 31, 2010:

	2011	2010
From a commercial bank in the PRC for RMB 5,000,000 entered into on October 19, 2010. The loan bore interest at 6.94% with maturity on October 18, 2011 but was repaid in September 2011. The loan was pledged by bank deposit.	$-	$754,979
From a commercial bank in the PRC for RMB 17,000,000 entered into on June 1, 2010. The loan bore interest at 5.31% with maturity on June 30, 2011. The loan was guaranteed by a third party. The loan was paid in full when it matured.	-	2,566,929
From a commercial bank in the PRC for RMB 13,000,000 entered into on August 9, 2010. The loan bore interest at 5.31% with maturity on June 30, 2011. The Company pledged its building and land use rights for this loan. The loan was paid in full when it matured.	-	1,962,946
From a commercial bank in the PRC for RMB 25,000,000 entered into on September 14, 2010. The loan currently bears interest at 7.22% with maturity on September 13, 2011, and was renewed until September 13, 2012. The loan was pledged by bank deposit.	3,933,972	3,774,895
From a commercial bank in the PRC for RMB 10,000,000 entered into on June 27, 2011. The loan currently bears interest at 7.57% with maturity on June 27, 2012.	1,573,589	-

The loan was pledged by bank deposit.		
From a commercial bank in the PRC for RMB 50,000,000 entered into on June 29, 2011. The loan currently bears interest at 6.94% with maturity on January 27, 2012. The loan was guaranteed by SanDeKe.	7,867,944	-
From a commercial bank in the PRC for RMB 3,000,000 entered into on June 30, 2011. The loan currently bears interest at 6.63% with maturity on June 29, 2012. The loan was guaranteed by a third party.	472,077	-
From a commercial bank in the PRC for RMB 5,000,000 entered into on July 6, 2011. The loan currently bears interest at 6.63% with maturity on July 5, 2012. The loan was guaranteed by a third party.	786,795	-
From a commercial bank in the PRC for RMB 3,000,000 entered into on July 15, 2011. The loan currently bears interest at 6.89% with maturity on July 14, 2012. The loan was guaranteed by a third party.	472,077	-
From a commercial bank in the PRC for RMB 1,600,000 entered into on August 1, 2011. The loan currently bears interest at 6.89% with maturity on July 31, 2012. The loan was guaranteed by a third party.	251,774	-
From a commercial bank in the PRC for RMB 3,300,000 entered into August 16, 2011. The loan currently bears interest at 6.89% with maturity on August15, 2012. The loan was guaranteed by a third party.	519,284	-
From a commercial bank in the PRC for RMB 1,100,000 entered into on August 23, 2011. The loan currently bears interest at 6.89% with maturity on August 22, 2012. The loan was guaranteed by a third party.	173,095	-
From a commercial bank in the PRC for RMB 5,000,000 entered into on September 21, 2011. The loan currently bears interest at 7.22% with maturity on September 20, 2012. The loan was pledged by bank deposit.	786,794	-
	$16,837,401	$9,059,749

Of the loans listed above that are guaranteed by a third party, the guarantees were provided by the same third party company, the guarantee term is one year and the Company is not required to pay for this guarantee service as the Company provides the same guarantee service to loans of the third party company in return. As of September 30, 2011, the Company has signed a contract to provide guarantee of up to RMB 30 million ($4.7 million) in loans for this third party company.

Table of Contents

SMARTHEAT INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
SEPTEMBER 30, 2011 (UNAUDITED) AND 2010

13. DEFERRED TAX ASSET (LIABILITY)

Deferred tax asset (liability) represented differences between the tax bases and book bases of property and equipment and intangible assets arising from the acquisition of SanDeKe and SmartHeat Pump, and bad debt allowance booked by the Company which was not allowed per tax purpose. As of September 30, 2011, and December 31, 2010, deferred tax asset (liability) consisted of the following:

	2011	2010
Deferred tax asset — current (bad debt allowance)	$ 1,844,905	$ 380,232
Less: valuation allowance	(1,844,905)	-
Deferred tax asset current, net	-	380,232
Deferred tax asset — noncurrent (depreciation of fixed assets)	-	22,266
Deferred tax liability — noncurrent (depreciation of fixed assets)	$ 212,475	$ -

14. INCOME TAXES

The Company is subject to income taxes by entity on income arising in or derived from the tax jurisdiction in which each entity is domiciled.

SmartHeat, the parent company, was incorporated in the U.S. and has net operating losses (“NOL”) for income tax purposes, which can be carried forward for up to 20 years from the year the loss is incurred. SmartHeat has net operating loss carry forwards for income taxes of approximately $2.54 million at September 30, 2011, which may be available to reduce future years’ taxable income. Management believes the realization of benefits from these losses remains uncertain due to SmartHeat’s limited operating history and continuing losses. Accordingly, a 100% deferred tax asset valuation allowance has been provided.

Table of Contents

SMARTHEAT INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
SEPTEMBER 30, 2011 (UNAUDITED) AND 2010

Taiyu and SanDeKe are governed by the Income Tax Law of the PRC concerning privately-run enterprises, which are generally subject to tax at a statutory rate of 25% on income reported in the statutory financial statements after appropriated tax adjustments. According to the new income tax law that became effective January 1, 2008, new high-tech enterprises given special support by the PRC government are subject to an income tax rate of 15%. Taiyu was recognized as a new high-tech enterprise and registered its status with the tax bureau, providing it with an income tax rate of 15% from 2009 through 2011. Taiyu currently is in the process of renewing its high-tech enterprise status, which is reviewed annually by the local PRC government. SanDeKe is exempt from income tax for two years starting from its first profitable year and is entitled to a 50% discount on the income tax rate from 2010 through 2012. The income tax rate for SanDeKe is 12% and 11% for 2011 and 2010, respectively.

SmartHeat Siping, Jinhui, SmartHeat Investment, SmartHeat Energy, SmartHeat Pump, Ruicheng and SmartHeat Trading are subject to the regular 25% PRC income tax rate. GWP is subject to a 15% corporate income tax in Germany.

The following table reconciles the U.S. statutory rates to the Company's effective tax (benefit) rate for the nine and three months ended September 30, 2011 and 2010:

	Nine months ended September 30,		Three months ended September 30,	
	2011	2010	2011	2010
U.S. statutory rates	(34.0)%	34.0 %	(34.0)%	34.0 %
Tax rate difference	8.57 %	(9.4)%	9.36 %	(9.2)%
Effect of tax holiday	6.91 %	(10.7)%	4.70 %	(10.2)%
Others	(0.37)%	0.3 %	(1.30)%	0.2 %
Valuation allowance	18.85 %	1.7 %	70.43 %	1.1 %
Tax (benefit) per financial statements	(0.04)%	15.9 %	49.19 %	15.9 %

The provision for income tax (benefit) for the nine and three months ended September 30, 2011 and 2010, consisted of the following:

	Nine months ended September 30,		Three months ended September 30,	
	2011	2010	2011	2010
Income tax expense - current	$ 93,430	$ 3,082,342	$ 125,019	$ 2,101,004
Income tax benefit - deferred	(98,589)	(23,160)	1,197,881	(8,128)
Total income tax expense (benefit)	$ (5,159)	$ 3,059,182	$ 1,322,900	$ 2,092,876

15. STATUTORY RESERVES AND RESTRICTED NET ASSETS

The Company's ability to pay dividends is primarily dependent on the Company receiving distributions of funds from its subsidiaries. Relevant PRC statutory laws and regulations permit payments of dividends by the Company's PRC

subsidiaries only out of the subsidiary's retained earnings, if any, as determined in accordance with PRC accounting standards and regulations. The results of operations reflected in the financial statements prepared in accordance with U.S. GAAP differ from those reflected in the statutory financial statements of the Company's PRC subsidiaries.

In accordance with the PRC Regulations on Enterprises with Foreign Investment and their articles of association, a foreign invested enterprise ("FIE") established in the PRC is required to provide certain statutory reserves, which are appropriated from net profit as reported in the FIE's PRC statutory accounts. An FIE is required to allocate at least 10% of its annual after-tax profit to the surplus reserve until such reserve has reached 50% of its respective registered capital based on the FIE's PRC statutory accounts. Appropriations to other funds are at the discretion of the board of directors for all FIEs. The aforementioned reserves can only be used for specific purposes and are not distributable as cash dividends. Additionally, shareholders of an FIE are required to contribute capital to satisfy the registered capital requirement of the FIE. Until such contribution of capital is satisfied, the FIE is not allowed to repatriate profits to its shareholders, unless otherwise approved by the State Administration of Foreign Exchange. Taiyu, SanDeKe, SmartHeat Siping, Jinhui, SmartHeat Investment, and Ruicheng were established as FIEs and therefore are subject to the above-mandated restrictions on distributable profits. As of September 30, 2011, the Company has met all registered capital requirements for its FIEs except for SmartHeat Investment, for which the Company is committed to contribute an additional $40 million in registered capital by April 2015 (see Note 17).

Table of Contents

SMARTHEAT INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
SEPTEMBER 30, 2011 (UNAUDITED) AND 2010

Additionally, in accordance with the Company Law of the PRC, a domestic enterprise is required to provide surplus reserve at least 10% of its annual after-tax profit until such reserve has reached 50% of its respective registered capital based on the enterprise’s PRC statutory accounts. A domestic enterprise is also required to provide discretionary surplus reserve, at the discretion of the board of directors, from the profits determined in accordance with the enterprise’s PRC statutory accounts. The aforementioned reserves can only be used for specific purposes and are not distributable as cash dividends. SmartHeat Energy, SmartHeat Trading and SmartHeat Pump were established as domestic enterprises and therefore are subject to the above-mentioned restrictions on distributable profits.

As a result of these PRC laws and regulations that require annual appropriations of 10% of after-tax income to be set aside prior to payment of dividends as general reserve fund, the Company’s PRC subsidiaries are restricted in their ability to transfer a portion of their net assets to the Company as a dividend.

16. STOCKHOLDERS’ EQUITY

Common Stock with Warrants Issued for Cash

In August 2008, the Company sold 1,630,000 units consisting of one share of the Company’s common stock and a 3-year warrant to purchase 15% of one share of the Company’s common stock for $6.00 per share, at $3.50 per unit, for approximately $5.7 million. The Company issued warrants to purchase 244,500 shares of its common stock. In connection with the private placement, the Company paid commissions of $340,000 and issued warrants to purchase 148,500 shares of its common stock to placement agents. The warrants are immediately exercisable and expire on the third anniversary of their issuance. The warrants require the Company to settle in its own shares. There is no provision for cash settlement, except in lieu of fractional shares. Net proceeds of approximately $5.1 million were received by the Company. The value of warrants was determined by using the Black-Scholes pricing model with the following assumptions: discount rate – 2.76%; dividend yield – 0%; expected volatility – 15%; and term of 3 years. The value of the warrants was $70,246. During 2009, warrants to purchase 281,975 shares were exercised at $6.00 per share for $1,691,850. During 2010, warrants to purchase 14,250 shares were exercised at $6.00 per share for $85,500. All outstanding warrants expired unexercised on August 22, 2011.

Following is a summary of the warrant activity:

	Number of Shares	Average Exercise Price per Share	Weighted Average Remaining Contractual Term in Years
Outstanding at December 31, 2010	96,775	$ 6.00	0.51
Exercisable at December 31, 2010	96,775	$ 6.00	0.51
Granted	-	-	-
Exercised	-	-	-
Forfeited	-	-	-
Expired	(96,775)	-	-
	-	$ -	-

Outstanding at September 30, 2011				
Exercisable at September 30, 2011	-	$	-	-

Table of Contents

SMARTHEAT INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
SEPTEMBER 30, 2011 (UNAUDITED) AND 2010

Stock Options to Independent Directors and Employee

On July 17, 2008, the Company granted non-statutory stock options to each of its two independent U.S. directors. The terms of each option are 10,000 shares at an exercise price per share of $4.60, with a life of five years and vesting over three years as follows: 3,333 shares vest on July 17, 2009; 3,333 shares vest on July 17, 2010; and 3,334 shares vest on July 17, 2011, subject in each case to the director continuing to be associated with the Company as a director. The options were valued using a volatility of 15%, risk-free interest rate of 2.76%, and dividend yield of 0%. No estimate of forfeitures was made as the Company has a short history of granting options.

On July 31, 2009, one of the Company's independent U.S. directors voluntarily retired. As such, he forfeited his right to his unvested options to purchase 6,667 shares. Upon his termination as director, any vested portion of the grant remained exercisable for 90 days following termination under the terms of the option grant. Accordingly, the 3,333 vested options expired unexercised as of October 29, 2009.

On February 1, 2010, the Company issued stock options to an employee. The terms of the options are 50,000 shares at an exercise price per share of $11.85, with a life of five years and vesting over two years as follows: 25,000 shares vest on June 30, 2011 and 25,000 shares vest on June 29, 2012. The options were valued using a volatility of 74%, risk free interest rate of 2.76%, and dividend yield of 0%. The grant-date fair value of the options was $367,107.

Based on the fair value method under SFAS No. 123 (Revised), "Share Based Payment" ("SFAS 123(R)") (codified in FASB ASC Financial Instruments, Topic 718 & 505), the fair value of each stock option granted is estimated on the date of the grant using the Black-Scholes option pricing model. The Black-Scholes option pricing model has assumptions for risk-free interest rates, dividends, stock volatility and expected life of an option grant. The risk-free interest rate is based upon market yields for U.S. Treasury debt securities at a maturity near the term remaining on the option. Dividend rates are based on the Company's dividend history. The stock volatility factor is based on the historical volatility of the Company's stock price. The expected life of an option grant is based on management's estimate. The fair value of each option grant to independent directors is calculated by the Black-Scholes method and is recognized as compensation expense over the vesting period of each stock option award.

Following is a summary of the option activity:

	Number of Shares	Average Exercise Price per Share	Weighted Average Remaining Contractual Term in Years
Outstanding at December 31, 2010	60,000	$ 10.32	3.76
Exercisable at December 31, 2010	6,666	$ 4.60	2.54
Granted	-	-	-
Exercised	-	-	-
Forfeited	-	-	-
Outstanding at September 30, 2011	60,000	$ 10.32	3.01

Exercisable at September 30, 2011	35,000	$	4.60	1.79

There were no options exercised during the nine months ended September 30, 2011 and 2010. The Company recorded $121,946 and $142,869 as compensation expense for stock options during the nine months ended September 30, 2011 and 2010, respectively. There were no options exercised during the three months ended September 30, 2011 and 2010. The Company recorded $19,215 and $87,895 as compensation expense for stock options during the three months ended September 30, 2011 and 2010, respectively.

On April 18, 2011, the Company issued 50,000 shares of stock to an employee as a bonus. The Company recorded $150,500 as stock compensation expense during the nine months ended September 30, 2011.

Stock Issued for Consulting Service

On January 1, 2010, the Company entered into a one-year service agreement with a consultant to provide business development assistance and engineering advice regarding the sales and marketing of the Company’s products. On July 16, 2010, the Company and consultant amended the compensation terms under the consulting agreement. The Company compensated the consultant on a quarterly basis at $6,250 and 500 restricted shares of the Company’s common stock in 2010. Starting from 2011, the Company compensated the consultant on a quarterly basis at $6,250.

Table of Contents

SMARTHEAT INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
SEPTEMBER 30, 2011 (UNAUDITED) AND 2010

17. COMMITMENTS

Employment Agreements

On January 1, 2008, Taiyu entered into a 3-year employment agreement with Jun Wang, the Company’s Chief Executive Officer, which agreement was renewed on the same terms through December 31, 2013, upon mutual agreement between Mr. Wang and Taiyu. Pursuant to the terms of his employment agreement, Mr. Wang shall receive a salary not less than the lowest minimum wage per month paid in Shenyang and shall be based on the uniform wage and incentive system in Shenyang. Effective on February 1, 2010, the Compensation Committee approved an increase in Mr. Wang’s annual compensation to a base salary of $150,000 per year.

On January 1, 2008, Taiyu entered into a 3-year employment agreement with Zhijuan Guo, the Company’s Chief Financial Officer, which agreement was renewed on the same terms through December 31, 2013, upon mutual agreement between Ms. Guo and Taiyu. Pursuant to the terms of her employment agreement, Ms. Guo shall receive a salary not less than the lowest minimum wage per month paid in Shenyang and shall be based on the uniform wage and incentive system in Shenyang. In addition, Ms. Guo shall be entitled to overtime pay in accordance with the applicable law.

On February 1, 2010, SmartHeat entered into an employment agreement with Xudong Wang, the Company’s Vice President of Strategy and Development, for a term ending on June 30, 2013. Mr. Wang is compensated at RMB 70,000 ($10,648) per month and eligible for annual cash bonuses at the sole discretion of the Board of Directors.

Lease Agreements

The Company leased offices for its sales representative in several different cities in China under various one-year, non-cancellable and renewable operating lease agreements. Rental expense for the nine months ended September 30, 2011 and 2010, was approximately $325,200 and $142,000, respectively. Rental expense for the three months ended September 30, 2011 and 2010, was approximately $72,800 and $71,000, respectively.

Capital Contribution

The Company formed SmartHeat Investment on April 7, 2010, as an investment holding company with registered capital of $70 million to enable its establishment and investment in new businesses in China. Under PRC company law, registered capital must be used in the operations of the domestic company within its approved business scope. SmartHeat Investment was established as a separate subsidiary of the Company to allow for the allocation of capital to new businesses in China separate from its existing subsidiaries and operations. The Company contributed $30 million in capital to SmartHeat Investment on April 15, 2010, from proceeds of its underwritten public offering that closed on September 22, 2009. On April 12, 2010, SmartHeat Investment formed SmartHeat Energy, a wholly owned subsidiary in Shenyang with registered capital of $30 million, subsequently satisfied out of the registered capital of SmartHeat Investment, for the research, development, manufacturing and sale of energy products. As of September 30, 2011, the Company is committed to contribute the remaining $40 million in registered capital to SmartHeat Investment by April 2015. The Company plans to satisfy this contribution through cash flow provided by operations and funds raised through offerings of its securities, if and when the Company determines such offerings are required, and at such time that the Company identifies a new acquisition, investment or business opportunity to be financed through SmartHeat Investment, although no specific investment candidate has been identified to date. If the Company is unable to make

the required capital contribution to registered capital, the Company may be subject to a negotiated penalty related to the unsatisfied portion of registered capital. If the Company chooses to pay the penalty, the Company can request that its registered capital be reduced to the amount already paid or to another amount that can be completed by a new due date. The Company may also apply for a grace period, or may apply to reduce its registered capital prior to the payment becoming due.

Table of Contents

SMARTHEAT INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
SEPTEMBER 30, 2011 (UNAUDITED) AND 2010

18. CONTINGENCIES

The Company's operations in the PRC are subject to specific considerations and significant risks not typically associated with companies in North America and Western Europe. These include risks associated with, among others, the political, economic and legal environments in China and foreign currency exchange. The Company's results may be adversely affected by changes in PRC government policies with respect to laws and regulations, anti-inflationary measures, currency conversion and remittance abroad and rates and methods of taxation, among other things.

The Company's sales, purchases and expense transactions in China are denominated in RMB and all of the Company's assets and liabilities in China are also denominated in RMB. The RMB is not freely convertible into foreign currencies under the current PRC law. In China, foreign exchange transactions are required by law to be transacted only by authorized financial institutions. Remittances in currencies other than RMB may require certain supporting documentation in order to affect the remittance.

19. ACQUISITION AND UNAUDITED PRO FORMA INFORMATION

On March 3, 2011, the Company completed the acquisition of GWP, a designer and manufacturer of high efficiency heat pumps. This acquisition will extend the Company's clean technology heating solutions into the rapidly growing heat pump markets in Europe and China, enabling its customers to purchase technologically advanced heat pumps at competitive prices. The purchase price was EUR 4,248,082 ($5,898,887), which was negotiated based on a two-times multiple of GWP's projected net income over the three years following the acquisition, and was paid at closing.

The following table summarizes the preliminary fair values of the assets acquired and liabilities assumed at the date of acquisition. The fair values of the assets acquired and liabilities assumed at agreement date were used for the purpose of purchase price allocation. The Company determined that little or no identifiable intangible assets, consisting of outstanding patents, technology and customer lists, were acquired with GWP based on the Company's due diligence and discussions with the seller. Accordingly, the excess of the purchase price over the fair value of the net assets acquired of $5,134,627 was recorded as goodwill.

Cash	$	239,686
Accounts receivable		137,185
Other receivables		24,254
Inventory		667,412
Property and equipment		350,382
Goodwill		5,134,627
Accounts payable		(536,907)
Other payables		(117,752)
Purchase price	$	5,898,887

On March 1, 2011, the Company entered into a purchase agreement with SmartHeat Pump, a Shenyang-based state-owned heat pump manufacturer and designer. The Company paid RMB 50 million ($7.6 million) to acquire 95% of the equity interests in SmartHeat Pump, with the local government retaining the remaining 5% equity interest. The purchase price was negotiated based on a two-times multiple of the projected net income of SmartHeat Pump over the three years following the acquisition.

The following table summarizes the preliminary fair values of the assets acquired and liabilities assumed at the date of the SmartHeat Pump acquisition. The fair values of the assets acquired and liabilities assumed at the agreement date were used for the purpose of purchase price allocation. The Company determined that little or no identifiable intangible assets, consisting of outstanding patents, technology and customer lists, were acquired with SmartHeat Pump based on the Company's due diligence and discussions with the seller. Accordingly, the excess of the purchase price over the fair value of the net assets acquired of $5,629,951 was recorded as goodwill.

Cash	$	189,438
Accounts receivable		920,463
Other receivable		263,220
Inventory		1,265,455
Property and equipment		759,341
Intangible assets		858,409
Goodwill		5,629,951
Accounts payable		(446,334)
Other payable and accrued expenses		(686,195)
Short-term loan		(760,433)
Deferred tax liability		(285,069)
Noncontrolling interest		(103,915)
Purchase price	$	7,604,331

Table of Contents

SMARTHEAT INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
SEPTEMBER 30, 2011 (UNAUDITED) AND 2010

The amounts of revenue and earnings (loss) of GWP and SmartHeat Pump since their respective acquisition dates included in the consolidated income statement for the nine months ended September 30, 2011, are $1,245,558 and $(955,266) for GWP, and $1,605,701 and $(1,080,012) for SmartHeat Pump, respectively.

The following unaudited pro forma consolidated results of operations for SmartHeat for the nine months ended September 30, 2011 and 2010, presents the operations of SmartHeat, GWP and SmartHeat Pump as if the acquisitions occurred at January 1, 2011 and 2010, respectively. The pro forma results are not necessarily indicative of the actual results that would have occurred had the acquisitions been completed as of the beginning of the periods presented, nor are they necessarily indicative of future consolidated results.

	2011	2010
Net sales	$ 31,941,435	$ 88,074,205
Cost of goods sold	21,333,437	57,277,335
Gross profit	10,607,998	30,796,870
Total operating expenses	25,172,723	12,675,369
Income (loss) from operations	(14,564,725)	18,121,501
Total non-operating income (expenses)	(397,771)	425,108
Income (loss) before income tax	(14,962,496)	18,546,609
Income tax expense	(5,151)	(3,059,436)
Net income (loss) before noncontrolling interest	(14,957,345)	15,487,174
Less:Loss attributable to noncontrolling interest	160,113	29,578
Net income (loss) to SmartHeat Inc.	$ (14,797,232)	$ 15,516,752
Weighted average shares outstanding	38,582,342	32,804,292
Earnings (loss) per share	$ (0.38)	$ 0.47

Table of Contents

CAUTIONARY STATEMENT FOR FORWARD-LOOKING STATEMENTS

This Quarterly Report on Form 10-Q includes forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended (the “Securities Act”), and Section 21E of the Securities Exchange Act of 1934, as amended (the “Exchange Act”). We have based these forward-looking statements on our current expectations and projections about future events. These forward-looking statements are subject to known and unknown risks, uncertainties and assumptions about us that may cause our actual results, levels of activity, performance or achievements to be materially different from any future results, levels of activity, performance or achievements expressed or implied by such forward-looking statements. In some cases, you can identify forward-looking statements by terminology such as “may,” “will,” “should,” “could,” “would,” “expect,” “plan,” “anticipate,” “believe,” “estimate,” “conti negative of such terms or other similar expressions. Factors that might cause or contribute to such a discrepancy include, but are not limited to, those listed under the heading “Risk Factors” and those listed in our other Securities and Exchange Commission filings. The following discussion should be read in conjunction with our Financial Statements and related Notes thereto included elsewhere in this report. Throughout this Quarterly Report, we will refer to SmartHeat Inc. as “SmartHeat,” the “Company,” “we,” “us,” and “our.”

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

Overview

We are a designer, manufacturer and seller of clean technology plate heat exchangers and related systems in the People’s Republic of China (“China” or the “PRC”). Our products are used by our customers in the industrial, residential and commercial markets in China to improve energy utilization and efficiencies and reduce pollution by reducing the need for coal fired boilers. We design, manufacture, sell and service plate heat exchangers (“PHEs”), PHE Units, which combine PHEs with various pumps, temperature sensors, valves and automated control systems, heat meters and heat pumps for use in commercial and residential buildings. We also design, manufacture and sell spiral heat exchangers and tube heat exchangers. Our products and systems are an increasingly important element in providing a clean technology, mission-critical solution to energy consumption and air pollution problems in China and are commonly used in a wide variety of industrial processes where heat transfer is required. Common applications include energy conversion for heating, ventilation and air conditioning (“HVAC”) and industrial use in petroleum refining, petrochemicals, metallurgy, food and beverage and chemical processing. Our PHE Units are custom designed by our own in-house engineers and sold under our Taiyu brand name, while our PHEs are sold under both our Taiyu brand as well as the Sondex brand name. We are an authorized dealer of Sondex PHEs in China.

We were incorporated in the State of Nevada on August 4, 2006, under the name Pacific Goldrim Resources, Inc., as an exploration stage corporation that intended to engage in exploration for silver, lead and zinc. On April 14, 2008, we changed our name to SmartHeat Inc. and acquired all of the equity interests in Shenyang Taiyu Machinery & Electronic Equipment Co., Ltd. (“Taiyu”), a privately held company formed under the laws of the PRC engaged in the design, manufacture, sale and servicing of PHE products in China. After the relevant PRC government agency approved our subscription of 71.6% of the registered capital increase of Taiyu on July 29, 2008, PRC approval of Taiyu becoming our wholly owned subsidiary was obtained on June 3, 2009, when the transfer by the three original owners of Taiyu of their remaining 28.4% ownership of Taiyu to us was officially recognized.

As an expansion of our business, we acquired SanDeKe Co., Ltd. (“SanDeKe”), a Shanghai-based manufacturer of PHEs, on September 25, 2008. On June 16, 2009, we completed an asset purchase transaction with Siping Beifang Heat Exchanger Manufacture Co., Ltd. (“Siping Beifang”) to set up a new manufacturing facility under our newly incorporated subsidiary, SmartHeat Siping Beifang Energy Technology Co., Ltd. (“SmartHeat Siping”). On August 14, 2009, we formed Beijing SmartHeat Jinhui Energy Technology Co., Ltd. (“Jinhui”), a joint venture in Beijing of which we own 52% with total registered capital of RMB 10 million ($1.46 million), to provide consulting services and

expand our sales of PHEs into new industries and regions of China. On April 7, 2010, we formed SmartHeat (China) Investment Co., Ltd. (“SmartHeat Investment”), an investment holding company and wholly owned subsidiary in Shenyang with registered capital of $70 million for our investment in and establishment of new companies and businesses in China. On April 12, 2010, SmartHeat Investment formed SmartHeat (Shenyang) Energy Equipment Co., Ltd. (“SmartHeat Energy”), a wholly owned subsidiary with registered capital of $30 million for the research, development, manufacturing and sales of energy products. On May 6, 2010, we formed SmartHeat (Shanghai) Trading Co., Ltd. (“SmartHeat Trading”) through a nominee to market and expand sales of our Taiyu-branded products in China. On December 2, 2010, we formed Hohhot Ruicheng Technology Co., Ltd. (“Ruicheng”), a joint venture in Hohhot City, China, for the design and manufacture of heat meters, of which we acquired 51% of the equity interest for our investment of $771,658 on January 7, 2011. On March 3, 2011, we completed the acquisition of Gustrower Warmepumpen GmbH (“GWP”), a designer and manufacturer of high efficiency heat pumps in Germany, for EUR 4,248,082 ($5,898,887) paid at closing. The acquisition of GWP will extend our clean technology heating solutions into the rapidly growing heat pump markets in Europe and China, enabling our customers to purchase technologically advanced heat pump technology at competitive prices. On March 1, 2011, we entered into a purchase agreement with Shenyang Bingchuan Refrigerating Machine Limited Company, a Shenyang-based state-owned heat pump manufacturer and designer renamed SmartHeat (Shenyang) Heat Pump Technology Co., Ltd. (“SmartHeat Pump”). We paid RMB 50 million ($7.6 million) to acquire 95% of the equity interest in SmartHeat Pump, with the local government retaining the remaining 5% equity interest.

Table of Contents

Our Corporate Structure

We are a U.S. holding company with no material assets other than the ownership interests of our subsidiaries through which we design, manufacture and sell our clean technology PHEs and related systems. Taiyu, SanDeKe, SmartHeat Siping and SmartHeat Investment are our wholly foreign-owned enterprises (“WFOEs”) authorized by their respective business licenses to operate our businesses in China. GWP is our wholly owned subsidiary in Germany. We own 52% and 51%, respectively, of the equity interests of our PRC-based joint ventures, Jinhui and Ruicheng. SmartHeat Energy is a wholly owned subsidiary of SmartHeat Investment. Taiyu owns 95% of the equity interests of SmartHeat Pump. We control SmartHeat Trading through an investment agreement, dated February 1, 2010 (the “SmartHeat Trading Agreement”), entered into with the nominee owner of SmartHeat Trading, Cleantech Holdings Inc., a British Virgin Islands company (“Cleantech Holdings”). We have no direct ownership interest in SmartHeat Trading or Cleantech Holdings; instead, pursuant to the SmartHeat Trading Agreement, we invested $1.5 million as the registered capital of SmartHeat Trading in exchange for our right to control 100% of the shareholder rights in SmartHeat Trading and our rights to 100% of its profit or loss.

Our corporate structure as of the date of this report is set forth in the following diagram:

(1) We control and are entitled to 100% of the profit or loss of SmartHeat Trading pursuant to contractual arrangements between SmartHeat and the nominee owner of SmartHeat Trading. We have no direct ownership interest in SmartHeat Trading.

Table of Contents

Principal Factors Affecting Our Financial Performance

Our revenues are subject to fluctuations due to the timing of sales of high-value products, the impact of seasonal spending patterns, the timing and size of projects our customers perform, changes in overall spending levels in the industry, changes in PRC government fiscal policies, inflation in China and other unpredictable factors that may affect customer ordering patterns. Our revenues may fluctuate significantly due to the seasonal nature of central heating services in the PRC because the equipment used in residential buildings must be delivered and installed prior to the beginning of the heating season in late fall, which occurs during the third and fourth calendar quarters in China. Additionally, any significant delays in the commercial launch or any lack or delay of commercial acceptance of new products, unfavorable sales trends in existing product lines or impacts from the other factors mentioned above, could adversely affect our revenue growth or cause a sequential decline in quarterly revenue.

In response to inflationary concerns, the PRC government instituted tightened fiscal policies in 2011 that have contributed to a general slowdown in many sectors of China's economy and restricted bank lending practices. Historically, approximately 40% of our customers, representing the majority of our total sales, consist of state-owned enterprises in China. Many of these customers, the majority of whom are real estate developers, have encountered difficulties in 2011 in obtaining grants from the PRC government and faced an extended bank loan application process, both of which typically are used to finance the purchase of our products. Accordingly, the deflationary policy of the PRC government affected the number of new sales of our PHE Units and PHEs as certain state-owned enterprises deferred the bidding for new projects in the first half of 2011 because of their working capital difficulties or abandoned existing projects. The decline in new projects among state-owned enterprises and increased peer competition contributed to a decline in sales of our PHE Units and PHEs in 2011. We also canceled contracts with certain of these state-owned customers that were unable to make payments or that had requested adjustments to their payment terms in response to their financial difficulties. Although these events caused a decrease in our sales in 2011, we expect that a portion of the canceled PHE Unit and PHE orders will be reinstated and contracts that have been partially delayed will be performed within this fiscal year or 2012, reducing the impact of the drop in our sales over the long term. Furthermore, we plan to diversify our reliance on the PRC market as we integrate the European business of GWP, which we acquired in March 2011.

Our revenues also may fluctuate significantly due to material costs, which normally account for approximately 80% of our cost of sales. We have experienced and anticipate continued fluctuation in raw material costs as a result of world economic conditions, such as the price of stainless steel used to produce plates for our PHEs and PHE Units. We monitor the commodities markets for pricing trends and changes, but we do not engage in hedging transactions to protect against raw material fluctuations. Instead, we attempt to mitigate the short-term risks of price swings by purchasing raw materials in advance based on production needs and projected sales. We typically experience significantly stronger sales during the second half of the year, which is the start of the fall and winter seasons in China, during which we historically generate approximately 74% of our revenue. Accordingly, we have increased our inventory and advances to suppliers during the first three quarters of 2011 in anticipation of our historical high season for production. Although we currently are able to obtain adequate supplies of raw materials, it is impossible to predict future availability or cost. Unfavorable fluctuations in the price, quality or availability of required raw materials could negatively affect our cash flows and ability to meet the demands of our customers, which could result in the loss of future sales.

Our profitability generally depends upon the margin between the cost to us of certain goods used in the manufacturing process, such as plates, pumps, water tanks, sensors, controlling systems and other raw materials, as well as our fabrication costs associated with converting such goods and raw materials compared to the selling price of our products, and the overall supply of raw materials. It is our intention to base the selling prices of our products upon the associated raw materials costs to us, which typically make up approximately 80% of total cost. We may not be able to pass all increases in raw material costs and ancillary acquisition costs associated with taking possession of raw

materials through to our customers, however, and there may be a time lag as we bid on new projects and renegotiate pricing with our existing customers.

Significant Accounting Policies

While our significant accounting policies are more fully described in Note 2 to our consolidated financial statements, we believe the following accounting policies are the most critical to aid you in fully understanding and evaluating this management discussion and analysis.

Basis of Presentation

Our financial statements are prepared in accordance with generally accepted accounting principles in the U.S. ("U.S. GAAP").

Principle of Consolidation

The accompanying consolidated financial statements include the accounts of SmartHeat's U.S. parent and its subsidiaries, Taiyu, SanDeKe, SmartHeat Siping, Jinhui, SmartHeat Investment, SmartHeat Energy, SmartHeat Trading, Ruicheng, GWP and SmartHeat Pump. The "Company" refers collectively to SmartHeat's U.S. parent, Taiyu, SanDeKe, SmartHeat Siping, Jinhui, SmartHeat Investment, SmartHeat Energy, SmartHeat Trading, Ruicheng, GWP and SmartHeat Pump. All significant inter-company accounts and transactions were eliminated in consolidation.

Use of Estimates

In preparing the financial statements in conformity with U.S. GAAP, management makes estimates and assumptions that affect the reported amounts of assets and liabilities and disclosures of contingent assets and liabilities at the dates of the financial statements, as well as the reported amounts of revenues and expenses during the reporting period. Significant estimates, required by management, include the recoverability of long-lived assets, allowance for doubtful accounts, and the reserve for obsolete and slow-moving inventories. Actual results could differ from those estimates.

Accounts Receivable

Our policy is to maintain reserves for potential credit losses on accounts receivable. Management reviews the composition of accounts receivable and analyzes historical bad debts, customer concentrations, customer credit worthiness, current economic trends and changes in customer payment patterns to evaluate the adequacy of these reserves. Accounts receivable are net of unearned interest. Unearned interest represents imputed interest on accounts receivable with due dates over one year from the invoice date discounted at our borrowing rate for the year.

Impairment of Long-Lived Assets

We assess the impairment of long-lived assets, which include property, plant and equipment and intangible assets, whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. The following are indicators management considers in determining whether it is necessary to test assets for impairment in accordance with ASC 360-10-35-21:

- Significant decrease in the market price of a long-lived asset or asset group;
- Significant adverse change in the extent or manner in which a long-lived asset (asset group) is being used or in its physical condition;
- Significant adverse change in legal factors or in the business climate that could affect the value of a long-lived asset or asset group, including an adverse action or assessment by a regulator;
- Accumulation of costs significantly in excess of the amount originally expected for the acquisition or construction of a long-lived asset or asset group;

- Current-period operating or cash flow loss combined with a history of operating or cash flow losses, or a projection or forecast that demonstrates continuing losses associated with the use of a long-lived asset or asset group; and
- Current expectation that, more likely than not, a long-lived asset or asset group will be sold or otherwise disposed of significantly before the end of its previously estimated useful life.

Recoverability of long-lived assets to be held and used is measured by comparing the carrying amount of an asset to the estimated undiscounted future cash flows expected to be generated by the asset. If the carrying amount of an asset exceeds its estimated undiscounted future cash flows, an impairment charge is recognized based on the excess of the carrying amount over the fair value of the assets. Fair value generally is determined using the asset's expected future discounted cash flows or market value, if readily determinable. We believe at this time that the carrying amounts and useful lives of our long-lived assets continue to be appropriate; there can be no assurance, however, that there will not be significant changes from our current forecasts, which could result in future impairment charges.

Table of Contents

Revenue Recognition

Our revenue recognition policies are in compliance with SEC Staff Accounting Bulletin (“SAB”) 104 (codified in Financial Accounting Standards Board (“FASB”) Accounting Standards Codification (“ASC”) Topic 605). Sales revenue is recognized when PHEs heat meters, and heat pumps are delivered, and for PHE Units when customer acceptance occurs, the price is fixed or determinable, no other significant obligations of ours exist and collectibility is reasonably assured. Payments received before all of the relevant criteria for revenue recognition are recorded as unearned revenue.

Our agreements with our customers generally provide that 30% of the purchase price is due upon placement of an order, 30% upon delivery and 30% upon installation and acceptance of the equipment after customer testing. As a common practice in the heating manufacturing business in China, payment of the final 10% of the purchase price is due no later than the termination date of the standard warranty period, which ranges from 3 to 24 months from the acceptance date.

Our standard warranty is provided to all customers and is not considered an additional service; rather, it is an integral part of the product sale. We believe the existence of the standard product warranty in a sales contract does not constitute a deliverable in the arrangement and thus there is no need to apply the EITF 00-21 (codified in FASB ASC Topic 605-25) separation and allocation model for a multiple deliverable arrangement. SFAS 5 (codified in FASB ASC Topic 450) specifically addresses the accounting for standard warranties and neither SAB 104 nor EITF 00-21 supersedes SFAS 5. We believe accounting for our standard warranty pursuant to SFAS 5 does not impact revenue recognition because the cost of honoring the warranty can be reliably estimated.

We charge for after-sales services provided after the expiration of the warranty period, with after-sales services mainly consisting of cleaning PHEs and repairing and exchanging parts. We recognize such revenue when service is provided. The revenue earned from these services was not material.

Foreign Currency Translation and Comprehensive Income (Loss)

The functional currency of our subsidiaries in China is the Chinese Yuan Renminbi (“RMB”). The functional currency of GWP, our German subsidiary, is the Euro (“EUR”). For financial reporting purposes, RMB and EUR were translated into United States dollars (“USD”) as the reporting currency. Assets and liabilities are translated at the exchange rate in effect at the balance sheet date. Revenues and expenses are translated at the average rate of exchange prevailing during the reporting period. Translation adjustments arising from the use of different exchange rates from period to period are included as a component of stockholders’ equity as “Accumulated other comprehensive income.” Gains and losses resulting from foreign currency transactions are included in income. There has been no significant fluctuation in exchange rate for the conversion of RMB to USD after the balance sheet date.

We use Statement of Financial Accounting Standards (“SFAS”) No. 130, “Reporting Comprehensive Income” (codified in FASB ASC Topic 220). Comprehensive income is comprised of net income and all changes to the statements of stockholders’ equity, except those due to investments by shareholders, changes in paid-in capital and distributions to shareholders.

Table of Contents

Recent Accounting Pronouncements

In June 2011, FASB issued ASU 2011-05, "Comprehensive Income (ASC Topic 220): Presentation of Comprehensive Income." Under the amendments in this update, an entity has the option to present the total of comprehensive income, the components of net income and the components of other comprehensive income either in a single continuous statement of comprehensive income or in two separate but consecutive statements. Under both options, an entity is required to present each component of net income along with total net income, each component of other comprehensive income along with a total for other comprehensive income and a total amount for comprehensive income. In a single continuous statement, the entity is required to present the components of net income and total net income, the components of other comprehensive income and a total for other comprehensive income, along with the total of comprehensive income in that statement. In the two-statement approach, an entity is required to present components of net income and total net income in the statement of net income. The statement of other comprehensive income should immediately follow the statement of net income and include the components of other comprehensive income and a total for other comprehensive income, along with a total for comprehensive income. In addition, the entity is required to present on the face of the financial statements reclassification adjustments for items that are reclassified from other comprehensive income to net income in the statement(s) where the components of net income and the components of other comprehensive income are presented. The amendments in this update should be applied retrospectively and are effective for fiscal years, and interim periods within those years, beginning after December 15, 2011. We are currently assessing the effect that the adoption of this pronouncement will have on our financial statements.

Results of Operations

Nine Months Ended September 30, 2011, Compared to the Nine Months Ended September 30, 2010

The following table sets forth the results of our operations for the years indicated as a percentage of net sales:

	2011		2010	
	$	% of Sales	$	% of Sales
Sales	$ 31,543,940		$ 83,613,250	
Cost of sales	21,025,243	66.7%	54,177,914	64.8%
Gross profit	10,518,697	33.3%	29,435,336	35.2%
Operating expenses	24,673,070	78.2%	10,595,119	12.7%
Income (loss) from operations	(14,154,373)	(44.9)%	18,840,217	22.5%
Other income (expenses), net	(369,810)	(1.2)%	403,259	0.5%
Income tax expense (benefit)	(5,159)	(0)%	3,059,182	3.7%
Noncontrolling interest	(149,727)	(0.5)%	(16,962)	0%
Net income (loss) to the Company	$ (14,369,297)	(45.6)%	$ 16,201,256	19.4%

Sales. Net sales in the nine months ended September 30, 2011, were $31.54 million, consisting of $13.23 million for PHE Units, $14.19 million for PHEs, $2.45 million for heat meters and $1.67 million for heat pumps, while our net sales in the same period of 2010 were $83.61 million, consisting of $33.81 million for PHE Units, $40.89 million for PHEs and $8.91 million for heat meters, an overall decrease of $52.07 million or 62%. The decrease in sales was due

primarily to a 49% decrease in sales volume for the nine months ended September 30, 2011, compared to the same period in 2010. The sales volume of PHE Units decreased 50% compared to the same period of 2010, PHEs decreased 38% and heat meters decreased 62%. We began sales of heat pumps in 2011. The decrease in sales volume resulted from tightened fiscal policy in China, which has contributed to a general slowdown in many sectors of the Chinese economy and caused the abandonment of certain projects by customers. Most of our customers are real estate developers that encountered difficulties in obtaining loans typically used to finance the purchase of our products, which resulted in an unexpected cancelation of orders and delays in the performance of PHE Unit and PHE contracts. In addition, we re-evaluated the credit and payment history of our customers and determined to give up certain customers based on our review.

We have a strict review process for approving each sales contract, especially with respect to the determination of a sales price. The sales price is determined under each contract in proportion to our estimated cost in order to ensure our gross profit. Our sales price varies according to each sale depending mainly on each customer’s specific requirements and our negotiation of the contract amount and term. We believe our marketing policy remains successful and have maintained the same program as last year, but we adjusted our pricing policy in 2011 in order to obtain more contracts. The decrease of average selling price, in addition to decreased sales volume, resulted in a decrease of sales across product lines for the nine months ended September 30, 2011, compared to the same period of 2010.

Table of Contents

Cost of Sales. Cost of sales for the nine months ended September 30, 2011, was $21.03 million, while our cost of sales for the same period of 2010 was $54.18 million, a decrease of $33.15 million or 61%. Cost of sales mainly consisted of the cost of materials and labor, as well as factory overhead. Materials cost is normally 80% of total cost, while factory overhead cost is about 15% and labor cost is about 5%. The decrease in cost of sales is attributable to the decrease in production and sales volume in the nine months ended September 30, 2011. Cost of sales as a percentage of sales was 66.7% for the nine months ended September 30, 2011, and 64.8% for the same period of 2010, an increase of 1.9%. The slight increase in cost of sales as a percentage of sales was due to overall inflation in China, which resulted in a 3% pricing increase of our raw material purchases and a nearly 10% increase of labor cost. Also, due to significant decreased production volume, the overhead cost absorbed by individual products increased for the nine months ended September 30, 2011, compared to the same period in 2010. The gross profit margin of SmartHeat Pump, our subsidiary acquired in March 2011, was break even due to low production, high research and development expense and adjusted marketing strategy. In order to ease the pressure from inflation, we implemented new controls over our purchasing process and raw material pricing by adopting a new budgetary control system to monitor our fixed costs and continued improvements to our manufacturing process to decrease labor cost and improve manufacturing efficiency.

Gross Profit. Gross profit was $10.52 million for the nine months ended September 30, 2011, compared to $29.44 million in the same period of 2010, or gross profit margins of 33.3% and 35.2%, respectively. The decreased gross profit was due primarily to inflation-related increases to our production costs, including increased prices for raw material, increased labor cost and decreased production volume.

Operating Expenses. Operating expenses consisting of selling, general and administrative expenses totaled $24.67 million for the nine months ended September 30, 2011, compared to $10.60 million for the same period of 2010, an increase of $14.08 million or 133%. Operating expenses as a percentage of sales were 78.2% in the nine months ended September 30, 2011, compared to 12.7% in the same period of 2010. The increase in operating expenses mainly resulted from increased bad debt allowance of approximately $8.91 million and expansion of our business, which included additional costs of hiring more sales personnel, higher depreciation expense, training our marketing team and establishing new sales offices in more regions of China.

We recorded a bad debt allowance of $8.91 million for the nine months ended September 30, 2011, primarily attributed to payment delays caused by the working capital difficulties of many of our state-owned customers. Due to the current deflationary fiscal policy of the PRC government, some of our state-owned customers encountered difficulties in obtaining grants from the government and loans from state-owned banks, both of which typically are used to finance the purchase of our products, which resulted in unexpected delays in paying our accounts receivable in a timely manner. Generally, we account for 50% of the amount of accounts receivable with aging over 180 days and 100% of the amount of accounts receivable with aging over 360 days as bad debt allowance. We do not expect a significant risk with respect to the overdue accounts receivable for which we took the bad debt allowance and believe that a substantial portion of the bad debt will be repaid as the Chinese government restores grants and credit policies. We believe the government’s stringent fiscal policy impacting our customers will be temporary and the expansion and training of our marketing team and other employees to date will increase sales and improve the efficiency of our operations. Nevertheless, we will institute a rigorous program of cost cutting to continue to tightly control our budget and implement additional cost control measures, including a review of the staffing levels of our employees in response to the decrease in revenue.

As part of our strategy to expand market share in China, consolidate management and reduce reliance on our current state-owned customers that have encountered financial difficulties in 2011, we increased sales personnel and management. This strategy includes the opening of additional branch offices and centralizing management over sales and marketing across subsidiaries, which increased costs for personnel, training and rent in the nine months ended September 30, 2011. We hired 270 more employees in the nine months ended September 30, 2011, resulting in an

increase of employee compensation and employee welfare and benefit expenses of $2.10 million. Our after-sales service cost increased $0.16 million, rental expenses increased $0.15 million, technology consulting fees increased $0.46 million, R&D expense increased $0.13 million and new plant expenses increased $0.35 million in the nine months ended September 30, 2011 over the same period in 2010. Our legal, audit and related expenses were approximately $662,000 in the nine months ended September 30, 2011, in connection with the acquisitions of GWP and SmartHeat Pump in March 2011. In addition, we canceled certain contracts with some of our state-owned customers that have experienced financial difficulties attributed to the current deflationary policy in China.

Table of Contents

Other income (expenses), net. Our other expense for the nine months ended September 30, 2011, was $369,810 compared to net other income of $403,259 for the same period of 2010, a decrease of $773,069 or 192%. The decrease was due mainly to increased interest expenses of $0.55 million from increased short-term loans and increased foreign exchange transaction loss of $0.46 million.

Income tax expense (benefit). We had income tax benefit of $5,159 for the nine months ended September 30, 2011, compared to income tax expense of $3.06 million for the same period of 2010. The effective income tax rate for the nine months ended September 30, 2011, was 0% compared to 15.9% for the same period of 2010 as a result of our loss.

Taiyu and SanDeKe are governed by the Income Tax Law of the PRC concerning privately-run enterprises, which are generally subject to tax at a statutory rate of 25% on income reported in the statutory financial statements after appropriated tax adjustments. According to the new income tax law that became effective January 1, 2008, new high-tech enterprises given special support by the PRC government are subject to an income tax rate of 15%. Taiyu was recognized as a new high-tech enterprise and registered its status with the tax bureau, providing it with an income tax rate of 15%. The local PRC government reviews the high-tech status of such enterprises annually. SanDeKe is exempt from income tax for two years starting from its first profitable year and is entitled to a 50% discount on the income tax rate from 2010 through 2012. The income tax rate for SanDeKe is 12% and 11% for 2011 and 2010, respectively.

SmartHeat Siping, Jinhui, SmartHeat Investment, SmartHeat Energy, SmartHeat Pump, Ruicheng and SmartHeat Trading are subject to the regular 25% PRC income tax rate. GWP is subject to a 15% corporate income tax in Germany.

Net Income (Loss). Our net loss for the nine months ended September 30, 2011, was $14.37 million compared to net income of $16.20 million for the same period of 2010, a decrease of $30.57 million or 189%. Net loss as a percentage of sales was 45.6% in the nine months ended September 30, 2011, and net income as a percentage of sales was 19.4% in the 2010 period. This decrease in net income was attributable to the decrease of net sales and increased bad debt allowance reserve and other operating expenses.

Three Months Ended September 30, 2011, Compared to the Three Months Ended September 30, 2010

The following table sets forth the results of our operations for the years indicated as a percentage of net sales:

	2011		2010	
	$	% of Sales	$	% of Sales
Sales	$ 16,573,890		$ 51,476,821	
Cost of sales	11,263,003	68.0%	33,061,854	64.2%
Gross profit	5,310,887	32.0%	18,414,967	35.8%
Operating expenses	7,846,299	47.3%	5,396,756	10.5%
Income (loss) from operations	(2,535,412)	(15.3)%	13,018,211	25.3%
Other income (expenses), net	(153,810)	(0.9)%	178,938	0.3%
Income tax expense (benefit)	1,322,900	8%	2,092,876	4.0%
Noncontrolling interest	(15,003)	(0.1)%	(2,232)	-%

Net income (loss)	$	(3,997,119)	(24.1)%	$	11,106,505	21.6%

Sales. Net sales in the three months ended September 30, 2011, were $16.57 million, consisting of $7.95 million for PHE Units, $7.12 million for PHEs, $0.75 million for heat meters and $0.75 million for heat pumps, while our net sales in the same period of 2010 were $51.48 million, consisting of $19.98 million for PHE Units, $23.68 million for PHEs and $7.82 million for heat meters, an overall decrease of $34.90 million or 68%. The decrease in sales was due primarily to a 64% decrease in sales volume for the nine months ended September 30, 2011, compared to the same period in 2010. The sales volume of PHE Units decreased 61% compared to the same period of 2010, PHEs decreased 59% and heat meters decreased 65%. We began sales of heat pumps in 2011. The decrease in sales volume resulted from tightened fiscal policy in China, which has contributed to a general slowdown in many sectors of the Chinese economy and caused the abandonment of certain projects by customers. Most of our customers are real estate developers that encountered difficulties in obtaining loans typically used to finance the purchase of our products, which resulted in an unexpected cancelation of orders and delays in the performance of PHE Unit and PHE contracts. In addition, we re-evaluated the credit and payment history of our customers and determined to give up certain customers based on our review.

Table of Contents

We have a strict review process for approving each sales contract, especially with respect to the determination of a sales price. The sales price is determined under each contract in proportion to our estimated cost in order to ensure our gross profit. Our sales price varies according to each sale depending mainly on each customer's specific requirements and our negotiation of the contract amount and term. We believe our marketing policy remains successful and have maintained the same program as last year, but we adjusted our pricing policy in 2011 in order to obtain more contracts. The decrease of average selling price, in addition to decreased sales volume, resulted in a decrease of sales across product lines for the three months ended September 30, 2011, compared to the same period of 2010.

Cost of Sales. Cost of sales for the three months ended September 30, 2011, was $11.26 million, while our cost of sales for the same period of 2010 was $33.06 million, a decrease of $21.80 million or 66%. Cost of sales mainly consisted of the cost of materials and labor, as well as factory overhead. Materials cost is normally 80% of total cost, while factory overhead cost is about 15% and labor cost is about 5%. The decrease in cost of sales is attributable to the decrease in production and sales volume in the three months ended September 30, 2011. Cost of sales as a percentage of sales was 68.0% for the three months ended September 30, 2011, and 64.2% for the same period of 2010, an increase of 3.8%. The slight increase in cost of sales as a percentage of sales was due to overall inflation in China, which resulted in a 3% pricing increase of our raw material purchases and a nearly 10% increase of labor cost. Also, due to significant decreased production volume, the overhead cost absorbed by individual products increased for the three months ended September 30, 2011, compared to the same period in 2010. The gross profit margin of SmartHeat Pump, our subsidiary acquired in March 2011, was break even due to low production, high research and development expense and adjusted marketing strategy. In order to ease the pressure from inflation, we implemented new controls over our purchasing process and raw material pricing by adopting a new budgetary control system to monitor our fixed costs and continued improvements to our manufacturing process to decrease labor cost and improve manufacturing efficiency.

Gross Profit. Gross profit was $5.31 million for the three months ended September 30, 2011, compared to $33.06 million in the same period of 2010, or gross profit margins of 32.0% and 35.8%, respectively. The decrease in our gross profit margin was due to the increase of cost of sales as a percentage of sales, caused primarily by inflation-related increases to our production costs, including increased prices for raw material, increased labor cost and decreased production volume.

Operating Expenses. Operating expenses consisting of selling, general and administrative expenses totaled $7.85 million for the three months ended September 30, 2011, compared to $5.40 million for the same period of 2010, an increase of $2.45 million or 45%. Operating expenses as a percentage of sales were 47.3% in the three months ended September 30, 2011, compared to 10.5% in the same period of 2010. The increase in operating expenses mainly resulted from increased bad debt allowance of approximately $3.11 million and expansion of our business, which included additional costs of hiring more sales personnel, higher depreciation expense, training our marketing team and establishing new sales offices in more regions of China.

We recorded a bad debt allowance of $3.11 million for the three months ended September 30, 2011, primarily attributed to payment delays caused by the working capital difficulties of many of our state-owned customers. Due to the current deflationary fiscal policy of the PRC government, some of our state-owned customers encountered difficulties in obtaining grants from the government and loans from state-owned banks, both of which typically are used to finance the purchase of our products, which resulted in unexpected delays in paying our accounts receivable in a timely manner. Generally, we account for 50% of the amount of accounts receivable with aging over 180 days and 100% of the amount of accounts receivable with aging over 360 days as bad debt allowance. We do not expect a significant risk with respect to the overdue accounts receivable for which we took the bad debt allowance and believe that a substantial portion of the bad debt will be repaid as the Chinese government restores grants and credit policies. We believe the government's stringent fiscal policy impacting our customers will be temporary and the expansion and training of our marketing team and other employees to date will increase sales and improve the efficiency of our

operations. Nevertheless, we will institute a rigorous program of cost cutting to continue to tightly control our budget and implement additional cost control measures, including a review of the staffing levels of our employees in response to the decrease in revenue.

Table of Contents

Other income (expenses), net. Our other expense for the three months ended September 30, 2011, was $153,810 compared to net other income of $178,938 for the same period of 2010, a decrease of $332,748 or 186%. The decrease was due mainly to increased interest expenses of $0.26 million from increased short-term loans and increased foreign exchange transaction loss of $0.21 million.

Income tax expense (benefit). We had income tax expense of $1.32 million for the three months ended September 30, 2011, compared to income tax expense of $2.09 million for the same period of 2010. The effective income tax rate for the three months ended September 30, 2011, was 49.2% compared to 15.9% for the same period of 2010. During the six months ended June 30, 2011, we recorded a $1.33 million tax benefit resulting primarily from provision of bad debt allowance. During the quarter ended September 30, 2011, management believed the realization of deferred tax benefits from these losses remains uncertain due to our continuing losses. Accordingly, a 100% deferred tax asset valuation allowance has been provided during the quarter and the $1.33 million tax benefit recorded previously was reversed in the third quarter of 2011.

Taiyu and SanDeKe are governed by the Income Tax Law of the PRC concerning privately-run enterprises, which are generally subject to tax at a statutory rate of 25% on income reported in the statutory financial statements after appropriated tax adjustments. According to the new income tax law that became effective January 1, 2008, new high-tech enterprises given special support by the PRC government are subject to an income tax rate of 15%. Taiyu was recognized as a new high-tech enterprise and registered its status with the tax bureau, providing it with an income tax rate of 15%. The local PRC government reviews the high-tech status of such enterprises annually. SanDeKe is exempt from income tax for two years starting from its first profitable year and is entitled to a 50% discount on the income tax rate from 2010 through 2012. The income tax rate for SanDeKe is 12% and 11% for 2011 and 2010, respectively.

SmartHeat Siping, Jinhui, SmartHeat Investment, SmartHeat Energy, SmartHeat Pump, Ruicheng and SmartHeat Trading are subject to the regular 25% PRC income tax rate. GWP is subject to a 15% corporate income tax in Germany.

Net Income (Loss). Our net loss for the three months ended September 30, 2011, was $4.0 million compared to net income of $11.11 million for the same period of 2010, a decrease of $15.10 million or 136%. Net loss as a percentage of sales was 24.1% in the three months ended September 30, 2011, and net income as a percentage of sales was 21.6% in the 2010 period. This decrease in net income was attributable to the significant decrease of net sales and increased bad debt allowance reserve and other operating expenses.

Liquidity and Capital Resources

On November 23, 2010, we closed a public offering of 5,740,814 shares of our common stock at $5.00 per share, which includes 740,814 shares sold as a result of the underwriters exercising their over-allotment option. After underwriting discounts and commissions and related expenses, we received net proceeds of $27,040,741.

As of September 30, 2011, we had cash and equivalents of $12.28 million. Working capital was $106.21 million at September 30, 2011. The ratio of current assets to current liabilities was 3.78:1 at September 30, 2011.

The following is a summary of cash provided by or used in each of the indicated types of activities during the nine months ended September 30, 2011 and 2010:

	2011	2010
Cash provided by (used in):		
Operating activities	$ (31,422,495)	$ (19,355,109)

Investing activities	$	(21,337,289)	$	(13,392,415)
Financing activities	$	7,246,264	$	(1,726,743)

Table of Contents

Net cash flow used in operating activities was $31.42 million in the nine months ended September 30, 2011, compared to net cash flow used in operating activities of $19.36 million in the same period of 2010. The increase in net cash outflow in operating activities was due mainly to decreased net income, increased payment of advance to suppliers, inventory and payment made for income tax and value-added tax (“VAT”). We typically experience significantly stronger sales during the second half of the calendar year, which is the fall and winter season in China, during which we historically generate approximately 74% of our sales. Accordingly, we increased inventory and advances to suppliers in the nine months ended September 30, 2011, in advance of anticipated production needs.

Net cash flow used in investing activities was $21.34 million in the nine months ended September 30, 2011, compared to net cash used in investing activities of $13.39 million in the same period of 2010. The increase of net cash flow used in investing activities was due mainly to the acquisition of SmartHeat Pump and GWP for $13.59 million, purchase of property and equipment of $2.45 million, advance to third party of $5.29 million and $0.42 million on construction in progress, partially offset by cash acquired from acquisition of $0.45 million and proceeds from note receivables of $0.70 million.

Net cash flow provided by financing activities was $7.25 million in the nine months ended September 30, 2011, compared to net cash used in financing activities of $1.73 million in the same period of 2010. The cash inflow was mainly from the proceeds from a short-term loan of $6.46 million, cash advance from third party of $0.80 million and capital contribution from noncontrolling interest of $0.75 million, partially offset by payment on notes payable of $0.77 million, while in the 2010 period, we had $0.09 million cash inflow from warrants exercised, but repaid $1.81 million on notes payable.

Our agreements with our customers generally provide that 30% of the purchase price is due upon the placement of an order, 30% upon delivery and 30% upon installation and acceptance of the equipment after customer testing. As a common practice in the heating manufacturing business in China, payment of the final 10% of the purchase price is due no later than the termination date of the standard warranty period, which ranges from 3 to 24 months from the acceptance date, or up to 2 heating seasons. Our receipts for payment on our products depend on the complexity of the equipment ordered, which impacts manufacturing, delivery, installation, testing times and warranty periods. For example, PHEs are less complex than PHE Units and therefore have a shorter manufacturing, acceptance, warranty and payment schedule. We may experience payment delays from time to time, which historically have been from 1 to 3 months from the due date, but given the temporary financial difficulties of some of our state-owned customers in China during the first half of 2011, we have experienced longer payment delays from these customers. Our accounts receivable and inventory turnover are relatively low and days sales outstanding ratio relatively high. Consequently, collection on our sales is slow and capital is tied up in inventories, which may result in pressure on cash flows. For the nine months ended September 30, 2011, we had accounts receivable turnover of 1.77 on an annualized basis, with days sales outstanding of 206 and inventory turnover of 1.12 on an annualized basis. For the nine months ended September 30, 2010, we had accounts receivable turnover of 2.68 on an annualized basis, with days sales outstanding of 136 and inventory turnover of 3.25 on an annualized basis. The low accounts receivable turnover and high days outstanding was due to the temporary financial difficulties of some of our state-owned customers that resulted in a delay in their making payments to us. The low inventory turnover rate was due to our decreased sales volume as a result of our state-owned customers’ temporary financial difficulty.

As of September 30, 2011, we had accounts receivable of $51,296,381, of which $4,369,178 was with aging within 30 days, $6,690,544 was with aging over 30 days and within 90 days, $8,280,705 was with aging over 90 days and within 180 days, $29,966,228 was with aging over 180 days and within 360 days and $1,989,726 was with aging over 360 days. At September 30, 2011, net accounts receivable was $35,435,963, or gross accounts receivable of $51,296,381 less bad debt allowance of $11,848,994, unearned interest of $11,742 and current and noncurrent retention receivables of $3,999,682. As of October 31, 2011, we have collected $3.5 million of the accounts receivable outstanding as of September 30, 2011.

33

Table of Contents

Our accounts receivable typically remain outstanding for a significant period of time based on the standard payment terms with our customers described above. The increase in amount of accounts receivable outstanding for more than 180 days in 2011 was due mainly to payment delays from certain state-owned customers that experienced working capital difficulties in the first half of 2011 because of the current deflationary fiscal policy of the PRC government. We do not expect a significant risk with respect to these overdue accounts receivable. We took the bad debt allowance against some of these customers and believe that a substantial portion of the bad debt will be repaid in 2011 and first quarter of 2012 as the PRC government restores grants and credit policies.

We recognize the final 5-10% of the purchase price as a retention receivable, which is due no later than the termination of our warranty period. The deferral of the final payment is a common practice in the heating manufacturing business in China. Sometimes our customers are required to deposit 5-10% of the sales price on high value products, like an assembled heat exchanger unit or the main part of a PHE, into designated bank accounts as restricted cash for securing the payment after such period expires. Based on our historical experience, there have been no defaults on such deferrals. Therefore, we believe the potential risks and uncertainty associated with defaults on such receivables are not material.

Dividend Distribution

We are a U.S. holding company that conducts substantially all of our business through our wholly owned and other consolidated operating entities in China and Germany. We will of necessity rely in part on dividends paid by our subsidiaries in China and Germany for our cash needs, including the funds necessary to pay dividends and other cash distributions to our shareholders, to service any debt we may incur and to pay our operating expenses. The payment of dividends by entities organized in China is subject to limitations. In particular, PRC regulations currently permit payment of dividends only out of accumulated profits as determined in accordance with accounting standards and regulations in China. Our PRC subsidiaries also are required to set aside at least 10% of their after-tax profit based on PRC accounting standards each year to a statutory surplus reserve fund until the accumulative amount of such reserve reaches 50% of registered capital. These reserves are not distributable as cash dividends. In addition, our PRC subsidiaries, at their discretion, may allocate a portion of their after-tax profit to their staff welfare and bonus fund, which may not be distributed to equity owners except in the event of liquidation. Moreover, if any of our subsidiaries in China or Germany incur debt on its own behalf in the future, the instruments governing the debt may restrict such subsidiary’s ability to pay dividends or make other distributions to us. Any limitation on the ability of one of our subsidiaries to distribute dividends and other distributions to us could materially and adversely limit our ability to make investments or acquisitions that could be beneficial to our businesses, pay dividends or otherwise fund and conduct our business.

Off-Balance Sheet Arrangements

We have not entered into any other financial guarantees or other commitments to guarantee the payment obligations of any third parties. We have not entered into any derivative contracts that are indexed to our shares and classified as stockholders’ equity or that are not reflected in our consolidated financial statements. Furthermore, we do not have any retained or contingent interest in assets transferred to an unconsolidated entity that serves as credit, liquidity or market risk support to such entity. We do not have any variable interest in any unconsolidated entity that provides financing, liquidity, market risk or credit support to us or engages in leasing, hedging or research and development services with us.

Contractual Obligations

We were obligated for the following short-term loans as of September 30, 2011, and December 31, 2010:

	2011	2010
From a commercial bank in the PRC for RMB 5,000,000 entered into on October 19, 2010. The loan bore interest at 6.94% with maturity on October 18, 2011, but was repaid in September 2011. The loan was pledged by bank deposit.	$ -	$ 754,979
From a commercial bank in the PRC for RMB 17,000,000 entered into on June 1, 2010. The loan currently bore interest at 5.31% with maturity on June 30, 2011. The loan was guaranteed by a third party. The loan was paid in full when it matured.	-	2,566,929
From a commercial bank in the PRC for RMB 13,000,000 entered into on August 9, 2010. The loan bore interest at 5.31% with maturity on June 30, 2011. The Company pledged its building and land use rights for this loan. The loan was paid in full when it matured.	-	1,962,946
From a commercial bank in the PRC for RMB 25,000,000 entered into on September 14, 2010. The loan currently bears interest at 7.22% with maturity on September 13, 2011, and was renewed until September 13, 2012. The loan was pledged by bank deposit.	3,933,972	3,774,895
From a commercial bank in the PRC for RMB 10,000,000 entered into on June 27, 2011. The loan currently bears interest at 7.57% with maturity on June 27, 2012. The loan was pledged by bank deposit.	1,573,589	-
From a commercial bank in the PRC for RMB 50,000,000 entered into on June 29, 2011. The loan currently bears interest at 6.94% with maturity on January 27, 2012. The loan was guaranteed by SanDeKe.	7,867,944	-
From a commercial bank in the PRC for RMB 3,000,000 entered into on June 30, 2011. The loan currently bears interest at 6.63% with maturity on June 29, 2012. The loan was guaranteed by a third party.	472,077	-
From a commercial bank in the PRC for RMB 5,000,000 entered into on July 6, 2011. The loan currently bears interest at 6.63% with maturity on July 5, 2012. The loan was guaranteed by a third party.	786,795	-
From a commercial bank in the PRC for RMB 3,000,000 entered into on July 15, 2011. The loan currently bears interest at 6.89% with maturity on July 14, 2012. The loan was guaranteed by a third party.	472,077	-
From a commercial bank in the PRC for RMB 1,600,000 entered into on August 1, 2011. The loan currently bears interest at 6.89% with maturity on July 31, 2012. The loan was guaranteed by a third party.	251,774	-
From a commercial bank in the PRC for RMB 3,300,000 entered into August 16, 2011. The loan currently bears interest at 6.89% with maturity on August15, 2012. The loan was guaranteed by a third party.	519,284	-
From a commercial bank in the PRC for RMB 1,100,000 entered into on August 23, 2011. The loan currently bears interest at 6.89% with maturity on August 22, 2012. The loan was guaranteed by a third party.	173,095	-
From a commercial bank in the PRC for RMB 5,000,000 entered into on September 21, 2011. The loan currently bears interest at 7.22% with maturity on September 20, 2012. The loan was pledged by bank deposit.	786,794	-
	$ 16,837,401	$ 9,059,749

Of the loans listed above that are guaranteed by a third party, the guarantees were provided by the same third party company, the guarantee term is one year and we not required to pay for this guarantee service as we provide the same guarantee service to loans of the third party company in return. As of September 30, 2011, we have signed a contract to provide guarantee of up to RMB 30 million ($4.7 million) in loans for this third party company.

Table of Contents

Item 3. Quantitative and Qualitative Disclosures about Market Risk

We are exposed to market risks related to fluctuations in currency exchange rates and commodity prices for certain of our raw materials. We currently do not engage in forward foreign exchange agreements or other hedging transactions in an effort to reduce our exposure to foreign currency exchange risk. We do not engage in hedging transactions to protect against raw material pricing fluctuations; instead, we attempt to mitigate the short-term risks of price swings by purchasing raw materials in advance.

Our Annual Report on Form 10-K for the year ended December 31, 2010, as amended, contains information about our exposure to market risks under "Item 7A. Quantitative and Qualitative Disclosures about Market Risk." There has been no material change in our exposure to market risks during the nine months ended September 30, 2011.

Item 4. Controls and Procedures

Disclosure Controls and Procedures

Our management, with the participation of our Chief Executive Officer and Chief Financial Officer, our principal executive officer and principal financial officer, respectively, evaluated the effectiveness of our disclosure controls and procedures as defined in Rules 13a-15(e) and 15d-15(e) under the Exchange Act as of the end of the period covered by this report. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed by us in the reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms, and that such information is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosure. Based on this evaluation, our Chief Executive Officer and Chief Financial Officer concluded that, as of September 30, 2011, our disclosure controls and procedures were not effective as of such date because of a material weakness identified in our internal control over financial reporting related to our internal level of U.S. GAAP expertise. We lack sufficient personnel with the appropriate level of knowledge, experience and training in U.S. GAAP for the preparation of financial statements in accordance with U.S. GAAP. None of our internal accounting staff, including our Chief Financial Officer, that are primarily responsible for the preparation of our books and records and financial statements in compliance with U.S. GAAP holds a license such as Certified Public Accountant in the U.S., nor have any attended U.S. institutions or extended educational programs that would provide enough of the relevant education relating to U.S. GAAP. Our Board of Directors and management have implemented measures to mitigate this material weakness and are evaluating remediation measures that we will undertake to address this material weakness, and will continue this evaluation in order to implement a comprehensive remediation plan. Until such time as we hire qualified accounting staff and train our current accounting staff with the requisite U.S. GAAP experience, however, it is unlikely we will be able to remediate this material weakness in our internal control over financial reporting. Notwithstanding this material weakness, our management has concluded that our consolidated financial statements for the periods covered by and included in this report are prepared in accordance with U.S. GAAP and fairly present, in all material respects, our financial position, results of operations and cash flows for each of the periods presented herein.

Changes in Internal Control over Financial Reporting

There were no changes in our internal control over financial reporting (as such term is defined in Rules 13a-15(f) and 15d-15(f) of the Exchange Act) during our most recently completed fiscal quarter that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting. In designing and evaluating the disclosure controls and procedures, management recognizes that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving the desired control objectives. In addition,

the design of disclosure controls and procedures must reflect the fact that there are resource constraints and that management is required to apply its judgment in evaluating the benefits of possible controls and procedures relative to their costs.

PART II. OTHER INFORMATION

Item 1. Legal Proceedings

We may become involved in various lawsuits and legal proceedings arising in the ordinary course of business. Litigation is subject to inherent uncertainties and an adverse result in these or other matters may arise from time to time that may have an adverse effect on our business, financial conditions or operating results. We are currently not aware of any such legal proceedings or claims that will have, individually or in the aggregate, a material adverse effect on our business, financial condition or operating results.

Item 1A. Risk Factors

In addition to the following new risk factors, you should consider carefully the factors discussed in the “Risk Factors” in our Annual Report on Form 10-K for the year ended December 31, 2010, as amended, which could materially affect our business.

Table of Contents

Risks Related to Doing Business in China

PRC labor laws may adversely affect our results of operations.

On June 29, 2007, the PRC government promulgated a new labor law, namely, the Labor Contract Law of the PRC (the “Labor Contract Law”), which became effective on January 1, 2008. The Labor Contract Law imposes greater liabilities on employers and significantly affects the cost of an employer’s decision to reduce its workforce. It additionally requires that employers base certain termination decisions on seniority and not merit. In the event we decide to significantly change or decrease our workforce in China, the Labor Contract Law could adversely affect our ability to effect such changes in a manner that is most advantageous to our business or in a timely and cost-effective manner, thus materially and adversely affecting our financial condition and results of operations.

Under the Enterprise Income Tax Law, we may be classified as a “resident enterprise” of China. Such classification will likely result in unfavorable tax consequences to us and our non-PRC resident shareholders.

We are a U.S. holding company that conducts substantially all of our business through our wholly owned and other consolidated entities in China, and we derive substantially all of our income from these entities. Prior to January 1, 2008, dividends derived by foreign enterprises from business operations in China were not subject to PRC enterprise income tax. Under the PRC Enterprise Income Tax Law (the “EIT Law”) and its implementing rules, both of which became effective on January 1, 2008, an enterprise established outside of China with “de facto management bodies” within China is considered a “resident enterprise,” meaning that it must be treated as a PRC domestic enterprise for enterprise income tax purposes. The implementing rules of the EIT Law define de facto management as “substantial and overall management and control over the production and operations, personnel, accounting, and properties” of the enterprise.

On April 22, 2009, the State Administration of Taxation issued the Notice Concerning Relevant Issues Regarding Cognizance of Chinese Investment Controlled Enterprises Incorporated Offshore as Resident Enterprises pursuant to Criteria of de facto Management Bodies (the “Notice”), which further interprets the application of the EIT Law and its implementation regarding non-PRC enterprise or group controlled offshore entities. Pursuant to the Notice, an enterprise incorporated in an off-shore jurisdiction and controlled by a PRC enterprise or group will be classified as a “non-domestically incorporated resident enterprise” if: (i) its senior management in charge of daily operations reside or perform their duties mainly in China; (ii) its financial or personnel decisions are made or approved by bodies or persons in China; (iii) its substantial assets and properties, accounting books, corporate chops, board and shareholder minutes are kept in China; and (iv) at least half of its directors with voting rights or senior management often reside in China. A “resident enterprise” would be subject to an enterprise income tax rate of 25% on its worldwide income and must pay a withholding tax at a rate of 10% when paying dividends to its non-PRC shareholders. However, detailed measures on imposition of tax from non-domestically incorporated resident enterprises are not yet available. Therefore, it is unclear how tax authorities will determine tax residency based on the facts of each case.

We may be deemed to be a “resident enterprise” by PRC tax authorities because substantially all members of our senior management team are located in China. If the PRC tax authorities determine that we are a “resident enterprise” for PRC enterprise income tax purposes, a number of unfavorable PRC tax consequences could follow. First, we may be subject to the enterprise income tax at a rate of 25% on our worldwide taxable income as well as PRC enterprise income tax reporting obligations. In our case, this would mean that income such as interest on financing proceeds and non-PRC source income would be subject to PRC enterprise income tax at a rate of 25%. Second, although under the EIT Law and its implementing rules dividends paid to us from our PRC subsidaries would qualify as “tax-exempt income,” we cannot guarantee that such dividends will not be subject to a 10% withholding tax, as the PRC foreign exchange control authorities, which enforce the withholding tax, have not yet issued guidance with respect to the processing of outbound remittances to entities that are treated as “resident enterprises” for PRC enterprise income tax

purposes. Finally, it is possible that future guidance issued with respect to the new "resident enterprise" classification could result in a situation in which a 10% withholding tax is imposed on dividends we pay to our non-PRC shareholders and with respect to gains derived by our non-PRC shareholders from transferring our shares. If we were treated as a "resident enterprise" by PRC tax authorities, we would be subject to taxation in both the U.S. and China, and our PRC tax may not be creditable against our U.S. tax.

Risks Related to our Securities

If we are unable to regain compliance with the minimum bid requirements of the NASDAQ Global Select Market, our stock may be delisted, which could limit investors' ability to effect transactions in our common stock and subject our common stock to additional trading restrictions.

Our common stock currently is listed on the NASDAQ Global Select Market. On September 29, 2011, we received notice from the Listing Qualifications Department of the NASDAQ Stock Market LLC indicating that, for the last 30 consecutive business days, the bid price for our common stock had closed below the minimum $1.00 per share bid closing price required for continued inclusion on the NASDAQ Global Select Market under NASDAQ Listing Rule 5450(a)(1). Under the NASDAQ Listing Rules, we are provided 180 calendar days, or until March 27, 2012, to regain compliance with the minimum bid price requirement. In order to regain compliance, shares of our common stock must maintain a minimum bid closing price of at least $1.00 per share for a minimum of ten consecutive business days. If we are unable to regain compliance with the minimum bid price requirements of the NASDAQ Global Select Market, we may apply to transfer our common stock to the NASDAQ Capital Market if we meet certain listing requirements for such market under the NASDAQ Listing Rules, whereby we may be provided with an additional period of time to regain compliance with the minimum bid price requirement.

Table of Contents

We cannot assure you that we will be able to solve the deficiency and regain compliance with the NASDAQ minimum bid price requirements, however. If our common stock is delisted from trading on the NASDAQ markets, we could face significant material adverse consequences, including:

- a limited availability of market quotations for our common stock;
- a reduced liquidity with respect to our common stock;
- a determination that our common stock is a "penny stock," which would require brokers trading in our common stock to adhere to more stringent rules, possibly resulting in a reduced level of trading activity in the secondary trading market for our common stock;
- a limited amount of news and analyst coverage for our company; and
- a decreased ability to issue additional securities or obtain additional financing in the future.

We intend to actively monitor the bid price for our common stock through March 27, 2012, and will consider all available options, including a reverse stock split, to resolve the deficiency and regain compliance with the NASDAQ minimum bid price requirements.

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

None.

Item 3. Defaults Upon Senior Securities

None.

Item 4. (Removed and Reserved)

Item 5. Other Information

None.

Item 6. Exhibits

See the Exhibit Index following the signature page to this Quarterly Report on Form 10-Q for a list of exhibits filed or furnished with this report, which Exhibit Index is incorporated herein by reference.

Table of Contents

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.

		SMARTHEAT INC.
		(Registrant)
Date: April 13, 2012	By:	/s/ Jun Wang
		Jun Wang
		Chief Executive Officer
		(Principal Executive Officer)

Table of Contents

EXHIBIT INDEX

Exhibit No.	Document Description
31.1 †	Certification of Chief Executive Officer pursuant to 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 Exchange Act Rules 13a-14(a) and 15d-14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
32.1 ‡	Certification pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, as signed by the Chief Executive Officer
32.2 ‡	Certification pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, as signed by the Chief Financial Officer
101.INS†	XBRL Instance Document
101.SCH†	XBRL Schema Document
101.CAL†	XBRL Calculation Linkbase Document
101.DEF†	XBRL Definition Linkbase Document
101.LAB†	XBRL Label Linkbase Document
101.PRE†	XBRL Presentation Linkbase Document

† Filed herewith
‡ Furnished herewith

="font-family:inherit;font-size:10pt;font-weight:bold;">Announced Plans

Under the Plan
July 1, 2014 through

July 31, 2014
451,700

$
11.96

451,700

$
57,897,467

August 1, 2014 through

August 31, 2014
491,900

11.89

491,900

52,048,818

September 1, 2014 through

September 30, 2014
470,000

11.96

470,000

46,427,061

Total
1,413,600

11.94

1,413,600

46,427,061

36

Stockholders and General Inquiries
Copies of our Annual Report on Form 10-K for the fiscal year ended September 30, 2014 are available at no charge to stockholders upon request. Please direct requests or inquiries to: James D. Wempe, Vice President, Investor Relations, 700 South Kansas Avenue, Topeka, KS 66603, (785) 270-6055, or jwempe@capfed.com.

Stockholder Return Performance Presentation
The line graph below compares the cumulative total stockholder return on the Company's common stock to the cumulative total return of a broad index of the NASDAQ Stock Market and the SNL Midcap Bank and Thrift industry index for the period September 30, 2009 through September 30, 2014. The information presented below assumes $100 invested on September 30, 2009 in the Company's common stock and in each of the indices, and assumes the reinvestment of all dividends. Historical stock price performance is not necessarily indicative of future stock price performance.

	Period Ending					
Index	9/30/2009	9/30/2010	9/30/2011	9/30/2012	9/30/2013	9/30/2014
Capitol Federal Financial, Inc.	100.00	80.50	86.27	101.18	114.37	117.86
NASDAQ Composite	100.00	112.74	116.12	151.70	186.60	225.17
SNL Midcap Bank & Thrift Index	100.00	105.20	85.66	115.18	147.22	157.17

Restrictions on the Payments of Dividends
The Company's ability to pay dividends is dependent, in part, upon its ability to obtain capital distributions from the Bank. The dividend policy of the Company is subject to the discretion of the Board of Directors and will depend upon a number of factors, including the Company's financial condition and results of operations, regulatory capital requirements, regulatory limitations on the Bank's ability to make capital distributions to the Company, and the amount of cash at the holding company level. See "Item 1. Business – Regulation and Supervision – Limitations on Dividends and Other Capital Distributions" for additional information regarding the Company's ability to pay dividends.

Item 6. Selected Financial Data

The summary information presented below under "Selected Balance Sheet Data" and "Selected Operations Data" for, and as of the end of, each of the years ended September 30 is derived from our audited consolidated financial statements. The following information is only a summary and should be read in conjunction with our consolidated financial statements. In December 2010, Capitol Federal Financial completed its conversion from a mutual holding company form of organization to a stock form of organization ("the corporate reorganization"). All share information prior to the corporate reorganization has been revised to reflect the 2.2637 exchange ratio.

	September 30,				
	2014	2013	2012	2011	2010
	(Dollars in thousands)				
Selected Balance Sheet Data:					
Total assets	$9,865,028	$9,186,449	$9,378,304	$9,450,799	$8,487,130
Loans receivable, net	6,233,170	5,958,868	5,608,083	5,149,734	5,168,202
Securities:					
AFS	840,790	1,069,967	1,406,844	1,486,439	1,060,366
HTM	1,552,699	1,718,023	1,887,947	2,370,117	1,880,154
FHLB stock	213,054	128,530	132,971	126,877	120,866
Deposits	4,655,272	4,611,446	4,550,643	4,495,173	4,386,310
FHLB borrowings	3,369,677	2,513,538	2,530,322	2,379,462	2,348,371
Other borrowings	220,000	320,000	365,000	515,000	668,609
Stockholders' equity	1,492,882	1,632,126	1,806,458	1,939,529	961,950

	For the Year Ended September 30,				
	2014	2013	2012	2011	2010
	(Dollars and counts in thousands, except per share amounts)				
Selected Operations Data:					
Total interest and dividend income	$290,246	$298,554	$328,051	$346,865	$374,051
Total interest expense	106,103	120,394	143,170	178,131	204,486
Net interest and dividend income	184,143	178,160	184,881	168,734	169,565
Provision for credit losses	1,409	(1,067)	2,040	4,060	8,881
Net interest and dividend income after provision for credit losses	182,734	179,227	182,841	164,674	160,684
Retail fees and charges	14,937	15,342	15,915	15,509	17,789
Other non-interest income	8,018	7,947	8,318	9,486	16,622
Total non-interest income	22,955	23,289	24,233	24,995	34,411
Salaries and employee benefits	43,757	49,152	44,235	44,913	42,666
Other non-interest expense	46,780	47,795	46,840	87,404	47,064
Total non-interest expense	90,537	96,947	91,075	132,317	89,730
Income before income tax expense	115,152	105,569	115,999	57,352	105,365
Income tax expense	37,458	36,229	41,486	18,949	37,525
Net income	$77,694	$69,340	$74,513	$38,403	$67,840
Basic earnings per share	$0.56	$0.48	$0.47	$0.24 [1]	$0.41
Average basic shares outstanding	139,440	144,847	157,913	162,625	165,862
Diluted earnings per share	0.56	0.48	0.47	0.24 [1]	0.41
Average diluted shares outstanding	139,442	144,848	157,916	162,633	165,899

	2014		2013		2012		2011		2010	
Selected Performance and Financial Ratios and Other Data:										
Performance Ratios:										
Return on average assets	0.82	%	0.75	%	0.79	%	0.41	% (1)	0.80	%
Return on average equity	5.00		4.14		3.93		2.20	(1)	7.09	
Dividends paid per share	$ 0.98		$ 1.00		$ 0.40		$ 1.63		$ 2.29	(2)
Dividend payout ratio	177.84	%	211.75	%	85.58	%	390.88	%	71.34	%
Operating expense ratio	0.96		1.05		0.97		1.40	(1)	1.06	
Efficiency ratio	43.72		48.13		43.55		68.30	(1)	43.99	
Ratio of average interest-earning assets to average interest-bearing liabilities	1.18x		1.21x		1.24x		1.22x		1.11x	
Net interest margin	2.00	%	1.97	%	2.01	%	1.84	%	2.06	%
Interest rate spread information:										
Average during period	1.79		1.70		1.64		1.42		1.78	
End of period	1.84		1.72		1.68		1.60		1.76	
Asset Quality Ratios:										
Non-performing assets to total assets	0.29		0.33		0.43		0.40		0.49	
Non-performing loans to total loans	0.40		0.44		0.57		0.51		0.62	
ACL to non-performing loans	37.04		33.36		34.88		58.34		46.60	
ACL to loans receivable, net	0.15		0.15		0.20		0.30		0.29	
Capital Ratios:										
Equity to total assets at end of period	15.13		17.77		19.26		20.52		11.33	
Average equity to average assets	16.45		18.12		20.11		18.50		11.30	
Regulatory Capital Ratios of Bank:										
Tier 1 leverage ratio	13.2		14.8		14.6		15.1		9.8	
Tier 1 risk-based capital	33.0		35.6		36.4		37.9		23.5	
Total risk-based capital	33.2		35.9		36.7		38.3		23.8	
Other Data:										
Number of traditional offices	37		36		36		35		35	
Number of in-store offices	10		10		10		10		11	

(1) Excluding the $40.0 million ($26.0 million, net of income tax benefit) contribution to the Capitol Federal Foundation (the "Foundation") in connection with the corporate reorganization, basic and diluted earnings per share would have been $0.40, return on average assets would have been 0.68%, return on average equity would have been 3.69%, the operating expense ratio would have been 0.98%, and the efficiency ratio would have been 47.65%. This adjusted financial data is not presented in accordance with accounting principles generally accepted in the United States of America ("GAAP"). Management believes it is important for comparability purposes to provide this adjusted financial data because of the magnitude and non-recurring nature of the contribution to the Foundation. Set forth below is a reconciliation of the adjusted financial data to the financial data calculated and presented in accordance with GAAP:

	For the Year Ended September 30, 2011					
	Actual (GAAP)		Contribution to Foundation		Adjusted (Non-GAAP)	
Return on average assets	0.41	%	(0.27	)%	0.68	%

Return on average equity	2.20	(1.49)	3.69
Operating expense ratio	1.40	0.42	0.98
Efficiency ratio	68.30	20.65	47.65

(2) For fiscal year 2010, Capitol Federal Savings Bank MHC ("MHC") owned a majority of the outstanding shares of Capitol Federal Financial common stock and waived its right to receive dividends paid on the common stock with the exception of the $0.50 per share dividend paid on 500,000 shares in February 2010. Public shares excluded shares held by MHC, as well as unallocated shares held in the Capitol Federal Financial Employee Stock Ownership Plan ("ESOP"). The ownership portion of MHC was sold in a public offering in conjunction with the corporate reorganization.

39

Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations
The following discussion and analysis is intended to assist in understanding the financial condition, results of operations, liquidity, and capital resources of the Company. The Bank comprises almost all of the consolidated assets and liabilities of the Company and the Company is dependent primarily upon the performance of the Bank for the results of its operations. Because of this relationship, references to management actions, strategies and results of actions apply to both the Bank and the Company.

Executive Summary
The Company completed its conversion from a mutual holding company form of organization to a stock form of organization in December 2010. The Company's common stock is traded on the Global Select tier of the NASDAQ Stock Market under the symbol "CFFN." The Company provides a full range of retail banking services through the Bank, which is a wholly-owned subsidiary headquartered in Topeka Kansas. The Bank has 37 traditional and 10 in-store banking offices serving primarily the metropolitan areas of Topeka, Wichita, Lawrence, Manhattan, Emporia and Salina, Kansas and portions of the metropolitan area of greater Kansas City.

We have been, and intend to continue to be, a community-oriented financial institution offering a variety of financial services to meet the needs of the communities we serve. We attract retail deposits from the general public and invest those funds primarily in permanent loans secured by first mortgages on owner-occupied, one- to four-family residences. We also originate consumer loans primarily secured by first mortgages on one- to four-family residences, commercial and multi-family real estate loans, and construction loans secured by residential, multi-family, or commercial real estate. While our primary business is the origination of one- to four-family mortgage loans funded through retail deposits, we also purchase whole one- to four-family mortgage loans from correspondent and nationwide lenders, participate in loans with other lenders that are secured by multi-family or commercial real estate, and invest in certain investment securities and MBS using funding from retail deposits, FHLB borrowings, and repurchase agreements.

The Company's results of operations are primarily dependent on net interest income, which is the difference between the interest earned on loans, MBS, investment securities, and cash, and the interest paid on deposits and borrowings. On a weekly basis, management reviews deposit flows, loan demand, cash levels, and changes in several market rates to assess all pricing strategies. The Bank's pricing strategy for first mortgage loan products includes setting interest rates based on secondary market prices and local competitor pricing for our local lending markets, and secondary market prices and national competitor pricing for our correspondent lending markets. Generally, deposit pricing is based upon a survey of competitors in the Bank's market areas, and the need to attract funding and retain maturing deposits. The majority of our loans are fixed-rate products with maturities up to 30 years, while the majority of our retail deposits have maturity or repricing dates of less than two years.

The Company is significantly affected by prevailing economic conditions, including federal monetary and fiscal policies and federal regulation of financial institutions. Retail deposit balances are influenced by a number of factors, including interest rates paid on competing investment products, the level of personal income, and the personal rate of savings within our market areas. Lending activities are influenced by the demand for housing and other loans, our loan underwriting guidelines compared to those of our competitors, as well as interest rate pricing competition from other lending institutions.

The Federal Open Market Committee of the Federal Reserve (the "FOMC") noted in their October 2014 statement that economic activity has expanded at a moderate pace. Labor market conditions further improved with solid job gains and lower unemployment as underutilization of labor resources gradually diminished. The FOMC stated that household spending and business fixed investment continued to advance, but recovery in the housing sector remained slow. Inflation continued to run below the FOMC's longer-run objective while longer-term inflationary expectations have remained stable. Given the substantial improvement in the outlook for the labor market since the inception of the FOMC's current asset purchase program, and the sufficient underlying strength it sees in the broader economy, the

FOMC decided to conclude its asset purchase program. The FOMC will continue its existing policy of reinvesting principal payments from its holdings of agency debt and agency MBS in agency MBS, and rolling over maturing Treasury securities at auction. The FOMC reaffirmed its view that the current 0% to 0.25% target range for the federal funds rate remains appropriate and that it will likely be so for a considerable time following the end of the asset purchase program, especially if projected inflation continues to run below the FOMC's 2% longer-run goal. If incoming information indicates faster progress toward the FOMC's employment and inflation objectives, then increases in the federal funds target range are likely to occur sooner than currently anticipated.

Conversely, if progress is restricted more than expected, then increases in the federal funds target range are likely to occur later than currently anticipated. Even after employment and inflation are near mandate-consistent levels, economic conditions may, for some time, warrant keeping the target federal funds rate below levels the FOMC views as normal in the long run. When the FOMC decides to begin to remove policy accommodation, they stated they will take a balanced approach consistent with their longer-run goals of maximum employment and inflation of 2%.

Economic conditions in the Bank's local market areas have a significant impact on the ability of borrowers to repay loans and the value of the collateral securing these loans. The industries in our market areas are very diversified, specifically in the Kansas City metropolitan statistical area which comprises the largest segment of our loan portfolio and deposit base. As of October 2014, the unemployment rate was 4.4% for Kansas and 5.9% for Missouri, compared to the national average of 5.8% based on information from the Bureau of Economic Analysis. The Kansas City market area has an average household income of approximately $74 thousand per annum, based on 2014 estimates from the American Community Survey, which is a statistical survey by the U.S. Census Bureau. The average household income in our combined market areas is approximately $69 thousand per annum, with 90% of the population at or above the poverty level, also based on the 2014 estimates from the American Community Survey. The FHFA price index for Kansas and Missouri has not experienced significant fluctuations during the past 10 years, unlike other market areas of the United States, which indicates relative stability in property values in our local market areas.

The structure of the Bank's retail branches is currently undergoing a transformation as more customers utilize electronic and other remote channels to conduct business. The physical footprint of the branch is being reduced. The last branch opened by the Bank occupies approximately 2,100 square feet and we anticipate that future retail branches will be even smaller, operating with three to five retail staff members. The interior layout of the branch also will transform, with future or remodeled branches designed without a teller counter and designed for more consultative interactions with less emphasis on transaction processing. To support this operating concept, the Bank has fully implemented a new branch staffing model that eliminates our traditional teller role, blending transaction processing and account servicing functions under Customer Service Associates and Customer Service Representatives. The expanded skill set of branch staff provides branch managers greater flexibility to manage customer flows within the branches. Also, the branch management ranks have been pared, with 32 of our 47 branches now operating under a manager responsible for either two or three offices. Currently, any future branch management reductions are expected to result from retirements and attrition. Management continues to monitor the role and functions of the branch staff and will adjust the branch management and overall branch staffing structure as necessary to achieve the Bank’s targets for deposit and loan production. Since 2010, the Bank has reduced retail branch staff by 24 full-time equivalent positions while adding four new branch locations. Additionally, lending staff have been deployed from regionally centralized locations to the branch network. By utilizing paperless electronic document technology, the Bank can better utilize staff resources regardless of their physical location. This promotes a more efficient loan process which benefits the customer and the loan operation. Having loan staff located in the branch network also provides them with more frequent opportunities to interact with customers and cross-sell additional products and services.

During the fourth quarter of fiscal year 2014, the Bank implemented the daily leverage strategy to increase earnings. The daily leverage strategy currently involves borrowing up to $2.10 billion on the Bank's FHLB line of credit in two leverage tiers. The first tier of $800.0 million is intended to remain borrowed on the FHLB line of credit for an extended period of time. The second tier of $1.30 billion is borrowed at the beginning of each quarter and paid off prior to each quarter end. The proceeds of the borrowings, net of the required FHLB stock holdings, are deposited at the Federal Reserve Bank of Kansas City. The daily leverage strategy was fully implemented beginning on August 1, 2014 and increased fiscal year 2014 net income by $501 thousand. The daily leverage strategy has had minimal impact on the Bank's interest rate risk and liquidity. The pre-tax yield of the daily leverage strategy, which is defined as the annualized pre-tax income resulting from the transaction as a percentage of the interest-earning assets associated with the transaction, was 0.21% for the period that the strategy was in place during fiscal year 2014. Management expects to continue this strategy and will monitor it on a continuous basis.

41

For fiscal year 2014, the Company recognized net income of $77.7 million, compared to net income of $69.3 million for fiscal year 2013. The $8.4 million, or 12.0%, increase in net income was due primarily to a $6.0 million increase in net interest income, and a $5.4 million decrease in salaries and employee benefits due primarily to a reduction in ESOP related expenses. The net interest margin increased three basis points, from 1.97% for the prior fiscal year to 2.00% for the current fiscal year. Excluding the effects of the daily leverage strategy, the net interest margin would have been 2.07% for the current fiscal year. Decreases in the cost of funds and a shift in the mix of interest-earning assets from relatively lower yielding securities to higher yielding loans were the primary drivers for the higher net interest margin in the current fiscal year.

Total assets were $9.87 billion at September 30, 2014 compared to $9.19 billion at September 30, 2013. The $678.6 million increase was due primarily to a $697.0 million increase in cash and cash equivalents resulting largely from the daily leverage strategy, a $274.3 million increase in loans receivable and an $84.5 million increase in FHLB stock, also due largely to the daily leverage strategy, partially offset by a $394.5 million decrease in the securities portfolio. Cash flows from the securities portfolio were used to fund loan growth, pay dividends, and repurchase stock. During the current fiscal year, the Bank originated and refinanced $566.9 million of loans with a weighted average rate of 3.91%, purchased $515.5 million of loans from correspondent lenders with a weighted average rate of 3.70%, and participated in $58.3 million of commercial real estate loans with a weighted average rate of 3.94%.

Total liabilities were $8.37 billion at September 30, 2014 compared to $7.55 billion at September 30, 2013. The $817.8 million increase was due primarily to an $856.1 million increase in FHLB borrowings, largely due to an $800.0 million increase in the FHLB line of credit resulting from the daily leverage strategy, as well as to a $43.8 million increase in deposits. Repurchase agreements decreased $100.0 million between periods as a result of an agreement that matured being replaced with a FHLB advance.

Stockholders' equity was $1.49 billion at September 30, 2014 compared to $1.63 billion at September 30, 2013. The $139.2 million decrease was due primarily to the payment of $138.2 million in dividends and the repurchase of $83.2 million of stock, partially offset by net income of $77.7 million.

Critical Accounting Policies

Our most critical accounting policies are the methodologies used to determine the ACL and fair value measurements. These policies are important to the presentation of our financial condition and results of operations, involve a high degree of complexity, and require management to make difficult and subjective judgments that may require assumptions or estimates about highly uncertain matters. The use of different judgments, assumptions, and estimates could cause reported results to differ materially. These critical accounting policies and their application are reviewed at least annually by our audit committee. The following is a description of our critical accounting policies and an explanation of the methods and assumptions underlying their application.

Allowance for Credit Losses. The Company maintains an ACL to absorb inherent losses in the loan portfolio based upon ongoing quarterly assessments of the loan portfolio. The ACL is maintained through provisions for credit losses which are either charged or credited to income. The methodology for determining the ACL is considered a critical accounting policy by management because of the high degree of judgment involved, the subjectivity of the assumptions used, and the potential for changes in economic conditions that could result in changes to the amount of the recorded ACL. Additionally, bank regulators have the ability to require the Bank, as they can require all institutions, to increase the ACL or recognize additional charge-offs based upon their judgment, which may differ from management's judgment. Although management believes that the Bank has established and maintained the ACL at appropriate levels, additions may be necessary if economic and other conditions worsen substantially from the current operating environment, and/or if bank regulators require the Bank to increase the ACL and/or recognize additional charge-offs.

42

Our primary lending emphasis is the origination and purchase of one- to four-family loans and, to a lesser extent, consumer loans secured by one- to four-family residential properties, resulting in a loan concentration in residential mortgage loans. As a result of our lending practices, we also have a concentration of loans secured by property located in Kansas and Missouri. At September 30, 2014, approximately 63% and 19% of the Bank's loans were secured by property located in Kansas and Missouri, respectively.

We believe the primary risks inherent in our one- to four-family and consumer loan portfolios are a decline in economic conditions, elevated levels of unemployment or underemployment, and declines in residential real estate values. Changes in any one or a combination of these events may adversely affect borrowers' ability to repay their loans, resulting in increased delinquencies, non-performing assets, loan losses, and future loan loss provisions. Although the multi-family and commercial loan portfolio is subject to the same risk of declines in economic conditions, the primary risk characteristics inherent in this portfolio include the ability of the borrower to sustain sufficient cash flows from leases and to control expenses to satisfy their contractual debt payments, and/or the ability to utilize personal and/or business resources to pay their contractual debt payments if the cash flows are not sufficient. Additionally, if the Bank were to repossess the secured collateral of a multi-family or commercial loan, the pool of potential buyers is limited more than that for a residential property. Therefore, the Bank could hold the property for an extended period of time and/or potentially be forced to sell at a discounted price, resulting in additional losses.

Generally, when a one- to four-family secured loan is 180 days delinquent, a new collateral value is obtained through an appraisal. If the estimated fair value of the collateral, less estimated costs to sell, is less than the current loan balance, the difference is charged-off. Anticipated PMI proceeds are taken into consideration when calculating the amount of the charge-off. An updated appraisal is requested, at a minimum, every 12 months thereafter if the loan remains 180 days or more delinquent or in foreclosure. If the Bank holds the first and second mortgage, both loans are combined when evaluating whether there is a potential loss on the loan. For multi-family and commercial loans, losses are charged-off when the collection of such amounts is determined to be unlikely. When a non-real estate secured loan, which includes consumer loans - other, is 120 days delinquent, any identified losses are charged-off. Charge-offs for any loan type may also occur at any time if the Bank has knowledge of the existence of a potential loss. Loans individually evaluated for loss are excluded from the formula analysis model.

Each quarter, we prepare a formula analysis which segregates our loan portfolio into categories based on certain risk characteristics such as loan type (one- to four-family, multi-family, etc.), interest payments (fixed-rate and adjustable-rate/interest-only), loan source (originated and correspondent purchased, or bulk purchased), LTV ratios, borrower's credit score and payment status (i.e. current or number of days delinquent). Consumer loans, such as second mortgages and home equity lines of credit, with the same underlying collateral as a one- to four-family loan are combined with the one- to four-family loan in the formula analysis to calculate a combined LTV ratio.

Quantitative loss factors are applied to each loan category in the formula analysis based on the historical net loss experience for each respective loan category. Each quarter management reviews the historical loss time periods and utilizes the historical loss time periods believed to be the most reflective of the current economic conditions. Additionally, qualitative loss factors that management believes impact the collectability of the loan portfolio as of the evaluation date are applied to certain loan categories. Loss factors increase as loans are classified or become delinquent. Additionally, TDRs that have not been individually evaluated for loss are included in a category within the formula analysis model with an overall higher qualitative loss factor than corresponding performing loans, for the life of the loan.

The factors applied in the formula analysis are reviewed quarterly by management to assess whether the factors adequately cover probable and estimable losses inherent in the loan portfolio. Our ACL methodology permits modifications to the formula analysis in the event that, in management's judgment, significant factors which affect the collectability of the portfolio or any category of the loan portfolio, as of the evaluation date, have changed from the current formula analysis. Management's evaluation of the qualitative factors with respect to these conditions is subject

to a higher degree of uncertainty because they are not identified with a specific problem loan or portfolio segment.

43

Management utilizes the formula analysis, along with considering several other data elements, when evaluating the adequacy of the ACL. Such data elements include the trend and composition of delinquent loans, results of foreclosed property and short sale transactions, charge-off trends, the current status and trends of local and national economic conditions (particularly levels of unemployment), trends and current conditions in the real estate and housing markets, and loan portfolio growth and concentrations. Since our loan portfolio is primarily concentrated in one- to four-family real estate, management monitors residential real estate market value trends in the Bank's local market areas and geographic sections of the U.S. by reference to various industry and market reports, economic releases and surveys, and management's general and specific knowledge of the real estate markets in which we lend, in order to determine what impact, if any, such trends may have on the level of ACL. Reviewing these data elements assists management in evaluating the overall credit quality of the loan portfolio and the reasonableness of the ACL on an ongoing basis, and whether changes need to be made to our ACL methodology. In addition, the adequacy of the Company's ACL is reviewed during bank regulatory examinations. We consider any comments from our regulators when assessing the appropriateness of our ACL. We seek to apply ACL methodology in a consistent manner; however, the methodology can be modified in response to changing conditions.

Fair Value Measurements. The Company uses fair value measurements to record fair value adjustments to certain assets and to determine fair value disclosures in accordance with Accounting Standard Codification ("ASC") 820 and ASC 825. The Company groups its assets at fair value in three levels based on the markets in which the assets are traded and the reliability of the assumptions used to determine fair value, with Level 1 (quoted prices for identical assets in an active market) being considered the most reliable, and Level 3 having the most unobservable inputs and therefore being considered the least reliable. The Company bases its fair values on the price that would be received from the sale of an asset in an orderly transaction between market participants at the measurement date. The Company maximizes the use of observable inputs and minimizes the use of unobservable inputs when measuring fair value. The Company did not have any liabilities that were measured at fair value at September 30, 2014.

The Company's AFS securities are its most significant assets measured at fair value on a recurring basis. Changes in the fair value of AFS securities are recorded, net of tax, as accumulated other comprehensive income in stockholders' equity. The Company primarily uses prices obtained from third party pricing services to determine the fair value of its securities. Various modeling techniques are used to determine pricing for the Company's securities, including option pricing, discounted cash flow models, and similar techniques. The inputs to these models may include benchmark yields, reported trades, broker/dealer quotes, issuer spreads, benchmark securities, bids, offers and reference data. There is one security, with a balance of $2.3 million at September 30, 2014, in the AFS portfolio that has significant unobservable inputs requiring the independent pricing services to use some judgment in pricing the related securities. This AFS security is classified as Level 3. All other AFS securities are classified as Level 2.

Loans individually evaluated for impairment and OREO are the Company's significant assets measured at fair value on a non-recurring basis. These non-recurring fair value adjustments involve the application of lower-of-cost-or-fair value accounting or write-downs of individual assets. Fair values of loan individually evaluated for impairment are estimated through current appraisals or analyzed based on market indicators. OREO fair values are estimated using current appraisals or listing prices. Fair values may be adjusted by management to reflect current economic and market conditions and, as such, are classified as Level 3.

Recent Accounting Pronouncements. For a discussion of Recent Accounting Pronouncements, see "Item 8. Financial Statements and Supplementary Data – Notes to Financial Statements – Note 1 – Summary of Significant Accounting Policies."

Management Strategy

We are a community-oriented financial institution dedicated to serving the needs of customers in our market areas. Our commitment is to provide qualified borrowers the broadest possible access to home ownership through our mortgage lending programs and to offer a complete set of personal banking products and services to our customers. We strive to enhance stockholder value while maintaining a strong capital position. To achieve these goals, we focus on the following strategies:

- Residential Portfolio Lending. We are one of the leading originators of one- to four-family loans in the state of Kansas. We originate these loans primarily for our own portfolio, and we service the loans we originate. We also purchase one- to four-family loans from correspondent and nationwide lenders. We offer both fixed- and adjustable-rate products with various terms to maturity and pricing options. We maintain strong relationships with local real estate agents to attract mortgage loan business. We rely on our marketing efforts and customer service reputation to attract mortgage business from walk-in customers, customers that apply online, and existing customers.
- Retail Financial Services. We offer a wide array of deposit products and retail services. These products include checking, savings, money market, certificates of deposit, and retirement accounts. They are provided through a branch network of 47 locations, including traditional branches and retail in-store locations, our call center which operates on extended hours, mobile banking, telephone banking and bill payment services, and online banking and bill payment services.
- Cost Control. We generally are very effective at controlling our costs of operations. By using technology, we are able to centralize our lending and deposit support functions for efficient processing. We have located our branches to serve a broad range of customers through relatively few branch locations. Our average deposit base per traditional branch at September 30, 2014 was approximately $111.2 million. This large average deposit base per branch helps to control costs. Our one- to four-family lending strategy and our effective management of credit risk allows us to service a large portfolio of loans at efficient levels because it costs less to service a portfolio of performing loans.
- Asset Quality. We utilize underwriting standards for our lending products that are designed to limit our exposure to credit risk. We require complete documentation for both originated and purchased loans, and make credit decisions based on our assessment of the borrower's ability to repay the loan in accordance with its terms.
- Capital Position. Our policy has always been to protect the safety and soundness of the Bank through credit and operational risk management, balance sheet strength, and sound operations. The end result of these activities has been a capital ratio in excess of the well-capitalized standards set by the OCC. We believe that maintaining a strong capital position safeguards the long-term interests of the Bank, the Company, and our stockholders.
- Stockholder Value. We strive to enhance stockholder value while maintaining a strong capital position. One way that we continue to provide returns to stockholders is through our dividend payments. Total dividends declared and paid during fiscal year 2014 were $138.2 million. The Company's cash dividend payout policy is reviewed quarterly by management and the Board of Directors, and the ability to pay dividends under the policy depends upon a number of factors, including the Company's financial condition and results of operations, regulatory capital requirements, regulatory limitations on the Bank's ability to make capital distributions to the Company, and the amount of cash at the holding company level. It is the intent of the Board of Directors to continue to pay regular quarterly and special cash dividends each year, and for fiscal year 2015, it is the intent of the Board of Directors and management to continue with the payout of 100% of the Company's earnings to its stockholders. Another way we have provided returns to stockholders is through our share repurchase programs. During fiscal year 2014, the Company repurchased 6,947,065 shares of common stock at an average price of $11.98 per share, or $83.2 million.
- Interest Rate Risk Management. Changes in interest rates are our primary market risk as our balance sheet is almost entirely comprised of interest-earning assets and interest-bearing liabilities. As such, fluctuations in interest rates have a significant impact not only upon our net income but also upon the cash flows related to those assets and liabilities and the market value of our assets and liabilities. In order to maintain what we believe to be acceptable levels of net interest income in varying interest rate environments, we actively manage our interest rate risk and assume a moderate amount of interest rate risk consistent with board policies.

45

Financial Condition

Assets. Total assets were $9.87 billion at September 30, 2014 compared to $9.19 billion at September 30, 2013. The $678.6 million increase was due primarily to a $697.0 million increase in cash and cash equivalents, a $274.3 million increase in loans receivable, and an $84.5 million increase in FHLB stock, partially offset by a $394.5 million decrease in the securities portfolio.

Loans Receivable. The loans receivable portfolio, net, increased $274.3 million, or 4.6%, to $6.23 billion at September 30, 2014, from $5.96 billion at September 30, 2013. The increase in the portfolio was due primarily to correspondent one- to four-family loan purchases outpacing principal repayments between periods. The growth in the loan portfolio was primarily funded with cash flows from the securities portfolio.

The following table presents information related to the composition of our loan portfolio (before deductions for undisbursed loan funds, unearned loan fees and deferred costs, and ACL) as of the dates indicated. The weighted average rate of the loan portfolio decreased six basis points from 3.82% at September 30, 2013 to 3.76% at September 30, 2014. The decrease in the rate was due primarily to adjustable-rate loans repricing to lower rates and repayments of loans with rates greater than the weighted average rate of the existing portfolio. Within the one- to four-family loan portfolio at September 30, 2014, 67% of the loans had a balance at origination of less than $417 thousand.

	September 30, 2014		September 30, 2013	
	Amount	Average Rate	Amount	Average Rate
	(Dollars in thousands)			
Real estate loans:				
One-to four-family	$5,972,031	3.72 %	$5,743,047	3.77 %
Multi-family and commercial	75,677	4.39	50,358	5.22
Construction:				
One- to four-family	72,113	3.66	63,208	3.51
Multi-family and commercial	34,677	4.01	14,535	4.17
Total real estate loans	6,154,498	3.73	5,871,148	3.78
Consumer loans:				
Home equity	130,484	5.14	135,028	5.26
Other	4,537	4.16	5,623	4.41
Total consumer loans	135,021	5.11	140,651	5.23
Total loans receivable	6,289,519	3.76	6,011,799	3.82
Less:				
Undisbursed loan funds	52,001		42,807	
ACL	9,227		8,822	
Discounts/unearned loan fees	23,687		23,057	
Premiums/deferred costs	(28,566)		(21,755)	
Total loans receivable, net	$6,233,170		$5,958,868	

46

The following table presents, for our portfolio of one- to four-family loans, the balance, percentage of total, weighted average credit score, weighted average LTV ratio, and the average balance per loan at the dates presented. Credit scores are updated at least semiannually, with the last update in September 2014, from a nationally recognized consumer rating agency. The LTV ratios were based on the current loan balance and either the lesser of the purchase price or original appraisal, or the most recent Bank appraisal, if available. In most cases, the most recent appraisal was obtained at the time of origination.

	September 30, 2014					September 30, 2013				
	Amount	% of Total	Credit Score	LTV	Average Balance	Amount	% of Total	Credit Score	LTV	Average Balance
	(Dollars in thousands)									
Originated	$3,978,396	66.6 %	764	64 %	$127	$4,054,436	70.6 %	763	65 %	$127
Correspondent purchased	1,431,745	24.0	764	68	332	1,044,127	18.2	761	67	341
Bulk purchased	561,890	9.4	749	67	311	644,484	11.2	747	67	316
	$5,972,031	100.0 %	763	65	159	$5,743,047	100.0 %	761	65	155

Included in the loan portfolio at September 30, 2014 were $96.2 million, or 1.5% of the total loan portfolio, of ARM loans that were originated as interest-only. Of these interest-only loans, $81.1 million were purchased in bulk loan packages from nationwide lenders, primarily during fiscal year 2005. Interest-only ARM loans do not typically require principal payments during their initial term, and have initial interest-only terms of either 5 or 10 years. The $81.1 million of bulk purchased interest-only ARM loans had a weighted average credit score of 724 and a weighted average LTV ratio of 70% at September 30, 2014. At September 30, 2014, $52.8 million, or 55%, of the interest-only loans were still in their interest-only payment term and $4.2 million, or 17% of non-performing loans, were interest-only ARMs.

The following tables summarize activity in the loan portfolio, along with weighted average rates where applicable, for the periods indicated, excluding changes in undisbursed loan funds, ACL, discounts/unearned loan fees, and premiums/deferred costs. Loans that were paid-off as a result of refinances are included in repayments. Purchased loans include purchases from correspondent and nationwide lenders. There were no loan purchases from nationwide lenders during the periods presented. Loan endorsements are not included in the activity in the following table because a new loan is not generated at the time of the endorsement. The endorsed balance and rate are included in the ending loan portfolio balance and rate. During the fiscal years ended September 30, 2014 and 2013, the Bank endorsed $36.4 million and $487.0 million, respectively, of one- to four-family loans, reducing the average rate on those loans by 113 basis points and 112 basis points, respectively.

	For the Three Months Ended							
	September 30, 2014		June 30, 2014		March 31, 2014		December 31, 2013	
	Amount	Rate	Amount	Rate	Amount	Rate	Amount	Rate
	(Dollars in thousands)							
Beginning balance	$6,197,114	3.78 %	$6,117,440	3.79 %	$6,095,089	3.80 %	$6,011,799	3.82 %
Originated and refinanced:								
Fixed	116,296	3.88	98,668	4.11	63,921	4.09	108,829	3.95
Adjustable	47,025	3.67	48,106	3.75	38,790	3.76	45,273	3.76
Purchased and participations:								
Fixed	127,814	3.75	122,407	4.03	65,793	4.00	94,535	4.00
Adjustable	44,417	3.07	40,344	3.12	32,932	3.27	45,541	3.34
Repayments	(241,320)		(228,911)		(177,411)		(209,931)	
Principal charge-offs, net	(282)		(192)		(112)		(418)	
Other	(1,545)		(748)		(1,562)		(539)	
Ending balance	$6,289,519	3.76	$6,197,114	3.78	$6,117,440	3.79	$6,095,089	3.80

	For the Year Ended September 30,			
	2014		2013	
	Amount	Rate	Amount	Rate
	(Dollars in thousands)			
Beginning balance	$6,011,799	3.82 %	$5,649,156	4.15 %
Originations and refinances:				
Fixed	387,714	4.00	789,206	3.40
Adjustable	179,194	3.74	138,443	3.76
Purchases and participations:				
Fixed	410,549	3.93	507,978	3.43
Adjustable	163,234	3.20	105,557	2.72
Repayments	(857,573)		(1,170,625)	
Principal charge-offs, net	(1,004)		(1,211)	
Other	(4,394)		(6,705)	
Ending balance	$6,289,519	3.76	$6,011,799	3.82

The following table presents loan origination, refinance, and purchase activity for the periods indicated, excluding endorsement activity, along with associated weighted average rates and percent of total. Loan originations, purchases and refinances are reported together. The fixed-rate one- to four-family loans less than or equal to 15 years have an original maturity at origination of less than or equal to 15 years, while fixed-rate one- to four-family loans greater than 15 years have an original maturity at origination of greater than 15 years. The adjustable-rate one- to four-family loans less than or equal to 36 months have a term to first reset of less than or equal to 36 months at origination and adjustable-rate one- to four-family loans greater than 36 months have a term to first reset of greater than 36 months at origination.

	For the Year Ended					
	September 30, 2014			September 30, 2013		
	Amount	Rate	% of Total	Amount	Rate	% of Total
	(Dollars in thousands)					
Fixed-rate:						
One- to four-family:						
<= 15 years	$ 191,563	3.27 %	16.8 %	$ 405,229	2.86 %	26.3 %
> 15 years	551,696	4.19	48.4	860,520	3.62	55.8
Multi-family and commercial real estate	51,000	3.85	4.5	27,237	4.34	1.8
Home equity	2,863	6.16	0.2	3,179	6.18	0.2
Other	1,141	7.44	0.1	1,019	8.97	0.1
Total fixed-rate	798,263	3.96	70.0	1,297,184	3.41	84.2
Adjustable-rate:						
One- to four-family:						
<= 36 months	7,984	2.76	0.7	6,560	2.32	0.4
> 36 months	248,551	3.13	21.8	162,572	2.75	10.5
Multi-family and commercial real estate	14,358	4.34	1.3	4,770	3.40	0.3
Home equity	70,066	4.64	6.1	68,660	4.73	4.5
Other	1,469	3.17	0.1	1,438	3.02	0.1
Total adjustable-rate	342,428	3.48	30.0	244,000	3.31	15.8
Total originated, refinanced and purchased	$ 1,140,691	3.82	100.0 %	$ 1,541,184	3.39	100.0 %
Purchased and participation loans included above:						
Fixed-rate:						
Correspondent - one- to four-family	$ 366,599	3.95		$ 484,238	3.38	
Participations - commercial real estate	43,950	3.81		23,740	4.37	
Total fixed-rate purchased/participations	410,549	3.93		507,978	3.43	
Adjustable-rate:						
Correspondent - one- to four-family	148,876	3.09		100,787	2.69	
Participations - commercial real estate	14,358	4.34		4,770	3.40	
Total adjustable-rate purchased/participations	163,234	3.20		105,557	2.72	
Total purchased/participation loans	$ 573,783	3.72		$ 613,535	3.31	

The following table presents originated, refinanced, correspondent activity in our one- to four-family loan portfolio, excluding endorsement activity, along with associated weighted average LTVs and weighted average credit scores for the periods indicated.

	For the Year Ended September 30, 2014			September 30, 2013		
	Amount	LTV	Credit Score	Amount	LTV	Credit Score
	(Dollars in thousands)					
Originated	$421,120	78 %	768	$551,265	77 %	765
Refinanced by Bank customers	63,199	68	763	298,591	67	768
Correspondent purchased	515,475	75	762	585,025	70	765
	$999,794	76	765	$1,434,881	72	765

The following table presents the amount, percent of total, and weighted average rate, by state, for one- to four-family loan originations and correspondent purchases where originations and purchases in the state exceeded 1% of the total amount originated and purchased during the year ended September 30, 2014.

State	Amount	% of Total	Rate
	(Dollars in thousands)		
Kansas	$477,708	47.8 %	3.78 %
Missouri	280,960	28.1	3.75
Texas	94,277	9.4	3.71
Tennessee	42,359	4.2	3.67
Alabama	25,144	2.5	3.48
Oklahoma	19,674	2.0	3.95
North Carolina	16,157	1.6	3.36
Massachusetts	12,587	1.3	3.55
Other states	30,928	3.1	3.68
	$999,794	100.0 %	3.74

The following table summarizes our one- to four-family loan origination, refinance, and correspondent purchase commitments as of September 30, 2014, along with associated weighted average rates. Commitments generally have fixed expiration dates or other termination clauses and may require the payment of a rate lock fee. A percentage of the commitments are expected to expire unfunded, so the amounts reflected in the table below are not necessarily indicative of future cash requirements.

	Fixed-Rate 15 years or less	More than 15 years	Adjustable-Rate	Total Amount	Rate
	(Dollars in thousands)				
Originate/refinance	$13,712	$36,975	$16,041	$66,728	3.70 %
Correspondent	18,116	33,270	18,575	69,961	3.63
	$31,828	$70,245	$34,616	$136,689	3.67
Rate	3.16 %	4.13 %	3.19 %		

Securities. The following table presents the distribution of our MBS and investment securities portfolios, at amortized cost, at the dates indicated. Overall, fixed-rate securities comprised 79% of these portfolios at September 30, 2014. The WAL is the estimated remaining maturity (in years) after three-month historical prepayment speeds and projected call option assumptions have been applied. Weighted average yields on tax-exempt securities are not calculated on a fully taxable equivalent basis.

	September 30, 2014			September 30, 2013		
	Amount	Yield	WAL	Amount	Yield	WAL
	(Dollars in thousands)					
Fixed-rate securities:						
MBS	$1,279,990	2.35 %	3.7	$1,427,648	2.44 %	3.5
GSE debentures	554,811	1.06	2.9	709,118	1.04	2.8
Municipal bonds	38,874	2.29	2.8	35,587	3.02	1.5
Total fixed-rate securities	1,873,675	1.97	3.4	2,172,353	1.99	3.3
Adjustable-rate securities:						
MBS	506,089	2.24	5.4	601,359	2.32	4.9
TRUPs	2,493	1.49	22.7	2,594	1.51	23.7
Total adjustable-rate securities	508,582	2.24	5.5	603,953	2.31	4.9
Total securities portfolio	$2,382,257	2.02	3.9	$2,776,306	2.06	3.7

The following table presents the carrying value of MBS in our portfolio by issuer at the dates presented.

	At September 30,	
	2014	2013
	(Dollars in thousands)	
FNMA	$1,052,464	$1,250,948
FHLMC	598,153	629,216
Government National Mortgage Association	151,930	167,544
	$1,802,547	$2,047,708

51

Mortgage-Backed Securities - The balance of MBS, which primarily consists of securities of U.S. GSEs, decreased $245.2 million from $2.05 billion at September 30, 2013 to $1.80 billion at September 30, 2014. Repayments from the MBS portfolio not reinvested in the portfolio were used to fund loan growth, pay dividends, and repurchase Company stock. The following table provides a summary of the activity in our portfolio of MBS for the periods presented. The weighted average yields and WALs for purchases are presented as recorded at the time of purchase. The weighted average yields for the beginning balances are as of the last day of the period previous to the period presented and the weighted average yield for the ending balances are as of the last day of the period presented and are generally derived from recent prepayment activity on the securities in the portfolio as of the dates presented. The weighted average yield of the MBS portfolio decreased from September 30, 2013 to September 30, 2014 primarily as a result of purchases of MBS between periods with yields less than the average yield on the existing portfolio, and to repayments of MBS with yields greater than the average yield on the existing portfolio. The beginning and ending WAL is the estimated remaining maturity (in years) after three-month historical prepayment speeds have been applied. The increase in the WAL between September 30, 2013 and September 30, 2014 was due primarily to an increase in market interest rates between periods, which resulted in a decrease in realized prepayments.

	For the Three Months Ended											
	September 30, 2014			June 30, 2014			March 31, 2014			December 31, 2013		
	Amount	Yield	WAL	Amount	Yield	WAL	Amount	Yield	WAL	Amount	Yield	WAL
	(Dollars in thousands)											
Beginning balance - carrying value	$1,904,010	2.32%	4.4	$2,005,138	2.37%	4.7	$1,975,164	2.42%	4.7	$2,047,708	2.40%	3.9
Maturities and repayments	(100,521)			(99,000)			(92,609)			(95,864)		
Net amortization of (premiums)/discounts	(1,464)			(1,542)			(1,271)			(1,397)		
Purchases:												
Fixed	—	—	—	—	—	—	103,730	1.74	3.9	25,272	1.72	3.7
Adjustable	—	—	—	—	—	—	21,737	1.92	5.2	—	—	—
Change in valuation on AFS securities	522			(586)			(1,613)			(555)		
Ending balance - carrying value	$1,802,547	2.32	4.2	$1,904,010	2.32	4.4	$2,005,138	2.37	4.7	$1,975,164	2.42	4.7

	For the Year Ended September 30,					
	2014			2013		
	Amount	Yield	WAL	Amount	Yield	WAL
	(Dollars in thousands)					
Beginning balance - carrying value	$2,047,708	2.40 %	3.9	$2,332,942	2.78 %	4.0
Maturities and repayments	(387,994)			(703,331)		
Net amortization of (premiums)/discounts	(5,674)			(7,985)		
Purchases:						
Fixed	129,002	1.74	3.8	420,272	1.24	3.9
Adjustable	21,737	1.92	5.2	22,246	1.80	5.1
Change in valuation on AFS securities	(2,232)			(16,436)		
Ending balance - carrying value	$1,802,547	2.32	4.2	$2,047,708	2.40	3.9

Investment Securities - Investment securities, which consist of U.S. GSE debentures (primarily issued by FNMA, FHLMC, or Federal Home Loan Banks) and municipal investments, decreased $149.4 million, from $740.3 million at September 30, 2013 to $590.9 million at September 30, 2014. The cash flows not reinvested in the portfolio were used to fund loan growth, pay dividends, and repurchase Company stock. The following tables provide a summary of the activity of investment securities for the periods presented. The weighted average yields and WALs for purchases are presented as recorded at the time of purchase. The weighted average yields for the beginning balances are as of the last day of the period previous to the period presented and the weighted average yields for the ending balances are as of the last day of the period presented. The beginning and ending WALs represent the estimated remaining maturity (in years) of the securities after projected call dates have been considered, based upon market rates at each date presented. Of the $138.9 million of fixed-rate investment securities purchased during the fiscal year ended September 30, 2014, $125.6 million are callable.

	For the Three Months Ended											
	September 30, 2014			June 30, 2014			March 31, 2014			December 31, 2013		
	Amount	Yield	WAL	Amount	Yield	WAL	Amount	Yield	WAL	Amount	Yield	WAL
	(Dollars in thousands)											
Beginning balance - carrying value	$590,405	1.15%	3.4	$610,768	1.13%	3.5	$686,913	1.11%	3.3	$740,282	1.14%	2.9
Maturities and calls	(3,374)			(28,610)			(177,805)			(79,860)		
Net amortization of (premiums)/discounts	(87)			(94)			(84)			(114)		
Purchases:												
Fixed	4,702	1.57	5.2	4,421	1.53	6.3	99,393	0.91	2.0	30,392	1.29	4.4
Change in valuation on AFS securities	(704)			3,920			2,351			(3,787)		
Ending balance - carrying value	$590,942	1.15	3.0	$590,405	1.15	3.4	$610,768	1.13	3.5	$686,913	1.11	3.3

	For the Year Ended September 30,					
	2014			2013		
	Amount	Yield	WAL	Amount	Yield	WAL
	(Dollars in thousands)					
Beginning balance - carrying value	$740,282	1.14 %	2.9	$961,849	1.23 %	1.0
Maturities and calls	(289,649)			(619,034)		
Net amortization of (premiums)/discounts	(379)			(460)		
Purchases:						
Fixed	138,908	1.04	2.8	408,726	1.00	2.1
Change in valuation on AFS securities	1,780			(10,799)		
Ending balance - carrying value	$590,942	1.15	3.0	$740,282	1.14	2.9

53

Liabilities. Total liabilities were $8.37 billion at September 30, 2014 compared to $7.55 billion at September 30, 2013. The $817.8 million increase was due primarily to an $856.1 million increase in FHLB borrowings, largely due to an $800.0 million increase in the FHLB line of credit resulting from the daily leverage strategy, partially offset by a $100.0 million decrease in repurchase agreements.

Deposits - Deposits were $4.66 billion at September 30, 2014 compared to $4.61 billion at September 30, 2013. The $43.8 million increase was due primarily to a $35.1 million increase in the checking portfolio, a $13.0 million increase in the savings portfolio, and a $7.3 million increase in the money market portfolio, partially offset by an $11.2 million decrease in the retail certificate of deposit portfolio. We continue to be competitive on deposit rates and, in some cases, our offer rates for certificates of deposit have been higher than peers. If interest rates were to rise, it is possible that our customers may move the funds from their checking, savings and money market accounts to higher yielding deposit products within the Bank or withdraw their funds from these accounts, including certificates of deposit, to invest in higher yielding investments outside of the Bank.

The following table presents the amount, weighted average rate and percentage of total for the components of our deposit portfolio at the dates presented.

	At September 30,					
	2014			2013		
	Amount	Rate	% of Total	Amount	Rate	% of Total
	(Dollars in thousands)					
Noninterest-bearing checking	$ 167,045	— %	3.6 %	$ 150,171	— %	3.2 %
Interest-bearing checking	523,959	0.05	11.2	505,762	0.05	11.0
Savings	296,187	0.15	6.4	283,169	0.13	6.1
Money market	1,135,915	0.23	24.4	1,128,604	0.23	24.5
Retail certificates of deposit	2,231,737	1.22	47.9	2,242,909	1.27	48.7
Public units/brokered deposits	300,429	0.63	6.5	300,831	0.80	6.5
	$ 4,655,272	0.70	100.0 %	$ 4,611,446	0.74	100.0 %

At September 30, 2014, brokered deposits were $41.9 million compared to $63.7 million at September 30, 2013, and had a weighted average rate of 2.93% and a remaining term to maturity of seven months. The Bank monitors the cost of brokered deposits and considers them as a potential source of funding, provided that investment opportunities are balanced with the funding cost. At September 30, 2014, public unit deposits were $258.6 million compared to $237.1 million of public unit deposits at September 30, 2013, and had a weighted average rate of 0.26% and an average remaining term to maturity of seven months. Management will continue to monitor the wholesale deposit market for attractive opportunities relative to the use of proceeds for investments.

The following tables set forth scheduled maturity information for our certificates of deposit, along with associated weighted average rates, at September 30, 2014.

	Amount Due					
Rate range	1 year or less	More than 1 year to 2 years	More than 2 to 3 years	More than 3 years	Total Amount	Rate
	(Dollars in thousands)					
0.00 – 0.99%	$ 776,165	$ 280,116	$ 30,917	$ 63	$ 1,087,261	0.49 %
1.00 – 1.99%	238,851	252,931	320,705	336,574	1,149,061	1.41
2.00 – 2.99%	236,839	39,051	—	1,896	277,786	2.51
3.00 – 3.99%	17,287	188	317	—	17,792	3.03
4.00 – 4.99%	189	77	—	—	266	4.40
	$ 1,269,331	$ 572,363	$ 351,939	$ 338,533	$ 2,532,166	1.15
Percent of total	50.1 %	22.6 %	13.9 %	13.4 %		
Weighted average rate	1.03	1.09	1.37	1.45		
Weighted average maturity (in years)	0.5	1.5	2.5	3.6	1.4	
Weighted average maturity for the retail certificate of deposit portfolio (in years)					1.5	

	Amount Due				
	3 months or less	Over 3 to 6 months	Over 6 to 12 months	Over 12 months	Total
	(Dollars in thousands)				
Retail certificates of deposit less than $100,000	$ 181,863	$ 182,345	$ 356,697	$ 784,898	$ 1,505,803
Retail certificates of deposit of $100,000 or more	76,414	68,085	157,097	424,338	725,934
Brokered deposits less than $100,000	—	—	41,853	—	41,853
Public unit deposits of $100,000 or more	112,909	51,831	40,237	53,599	258,576
	$ 371,186	$ 302,261	$ 595,884	$ 1,262,835	$ 2,532,166

Borrowings - The following tables present term borrowing activity for the periods shown, which includes FHLB advances, at par, and repurchase agreements. Line of credit activity is excluded from the following tables. At September 30, 2014, the Bank had $800.0 million outstanding on the FHLB line of credit, at a rate of 0.24%, in conjunction with the daily leverage strategy. The weighted average effective rate includes the net impact of the amortization of deferred prepayment penalties resulting from the prepayment of certain FHLB advances and deferred gains related to interest rate swaps previously terminated. Rates on new borrowings are fixed-rate. The weighted average maturity ("WAM") is the remaining weighted average contractual term in years. The beginning and ending WAMs represent the remaining maturity at each date presented. For new borrowings, the WAMs presented are as of the date of issue.

	For the Three Months Ended											
	September 30, 2014			June 30, 2014			March 31, 2014			December 31, 2013		
	Amount	Effective Rate	WAM	Amount	Effective Rate	WAM	Amount	Effective Rate	WAM	Amount	Effective Rate	WAM
	(Dollars in thousands)											
Beginning balance	$2,795,000	2.53 %	2.9	$2,795,000	2.54 %	2.9	$2,845,000	2.71 %	2.7	$2,845,000	2.75 %	2.6
Maturities and prepayments:												
FHLB advances	—	—		(100,000)	2.80		(200,000)	5.01		(150,000)	3.16	
Repurchase agreements	(100,000)	4.20		—	—		—	—		—	—	
New borrowings:												
FHLB advances	100,000	1.96	5.0	100,000	2.45	7.0	150,000	2.59	7.0	150,000	2.32	6.0
Ending balance	$2,795,000	2.45	2.8	$2,795,000	2.53	2.9	$2,795,000	2.54	2.9	$2,845,000	2.71	2.7

	For the Year Ended September 30,					
	2014			2013		
	Amount	Effective Rate	WAM	Amount	Effective Rate	WAM
	(Dollars in thousands)					
Beginning balance	$2,845,000	2.75 %	2.6	$2,915,000	3.13 %	2.7
Maturities and prepayments:						
FHLB advances	(450,000)	3.90		(325,000)	4.17	
Repurchase agreements	(100,000)	4.20		(145,000)	3.81	
New borrowings:						
FHLB advances	500,000	2.36	6.3	300,000	1.23	5.7
Repurchase agreements	—	—	—	100,000	2.53	7.0
Ending balance	$2,795,000	2.45	2.8	$2,845,000	2.75	2.6

Maturities - The following table presents the maturity of FHLB advances, at par, and repurchase agreements, along with associated weighted average contractual and effective rates as of September 30, 2014. At September 30, 2014, the Bank also had $800.0 million outstanding against the FHLB line of credit, at a rate of 0.24%, in conjunction with the daily leverage strategy, which is not included in the following table.

Maturity by Fiscal year	FHLB Advances Amount	Repurchase Agreements Amount	Total Amount	Contractual Rate	Effective Rate[(1)]
	(Dollars in thousands)				
2015	$ 600,000	$ 20,000	$ 620,000	1.73 %	1.96 %
2016	575,000	—	575,000	2.29	2.91
2017	500,000	—	500,000	2.69	2.72
2018	200,000	100,000	300,000	2.90	2.90
2019	200,000	—	200,000	1.63	1.63
2020	250,000	100,000	350,000	2.18	2.18
2021	250,000	—	250,000	2.53	2.53
	$ 2,575,000	$ 220,000	$ 2,795,000	2.26	2.45

(1) The effective rate includes the net impact of the amortization of deferred prepayment penalties resulting from the prepayment of certain FHLB advances and deferred gains related to terminated interest rate swaps.

The following table presents the maturity and weighted average repricing rate, which is also the weighted average effective rate, of term borrowings and certificates of deposit, split between retail and public unit/brokered deposits, for the next four quarters as of September 30, 2014.

Maturity by Quarter End	Term Borrowings Amount	Repricing Rate	Retail Certificate Amount	Repricing Rate	Public Unit/ Brokered Deposit Amount	Repricing Rate	Total	Repricing Rate
	(Dollars in thousands)							
December 31, 2014	$ 250,000	0.84 %	$ 258,277	0.99 %	$ 112,909	0.16 %	$ 621,186	0.78 %
March 31, 2015	250,000	2.47	250,430	1.07	51,831	0.19	552,261	1.62
June 30, 2015	100,000	3.01	256,207	1.14	67,557	1.89	423,764	1.70
September 30, 2015	20,000	4.45	257,587	1.27	14,533	0.35	292,120	1.44
	$ 620,000	1.96	$ 1,022,501	1.12	$ 246,830	0.65	$ 1,889,331	1.33

57

Stockholders' Equity. Stockholders' equity was $1.49 billion at September 30, 2014 compared to $1.63 billion at September 30, 2013. The $139.2 million decrease was due primarily to the payment of $138.2 million in dividends and the repurchase of $83.2 million of stock, partially offset by net income of $77.7 million. The $138.2 million in dividends paid during the current fiscal year consisted of: (1) two $0.25 per share True Blue dividends, totaling $0.50 per share, or $70.4 million; (2) an $0.18 per share, or $25.8 million, dividend related to fiscal year 2013 earnings per the Company's dividend policy; and (3) four regular quarterly dividends of $0.075 per share each quarter, totaling $0.30 per share, or $42.0 million. The $70.4 million in True Blue dividends were funded by $72.0 million in capital distributions from the Bank to the holding company.

On October 17, 2014, the Company declared a regular quarterly cash dividend of $0.075 per share, or approximately $10.2 million, payable on November 21, 2014 to stockholders of record as of the close of business on November 7, 2014. On October 28, 2014, the Company's Board of Directors approved a special year-end dividend of $0.26 per share, or approximately $35.5 million, payable on December 5, 2014 to stockholders of record as of the close of business on November 21, 2014. The $0.26 per share special year-end dividend was determined by taking the difference between total earnings for fiscal year 2014 and total regular quarterly dividends paid during fiscal year 2014, divided by the number of shares outstanding as of October 28, 2014. The special year-end dividend is the result of the Board of Directors' commitment to distribute to stockholders 100% of the annual earnings of Capitol Federal Financial, Inc. for fiscal year 2014.

At September 30, 2014, Capitol Federal Financial, Inc., at the holding company level, had $139.5 million on deposit at the Bank. For fiscal year 2015, it is the intent of the Board of Directors and management to continue with the payout of 100% of the Company's earnings to its stockholders. The payout is expected to be in the form of regular quarterly cash dividends of $0.075 per share, totaling $0.30 for the year, and a special year-end cash dividend equal to fiscal year 2015 earnings in excess of the amount paid as regular quarterly cash dividends during fiscal year 2015. It is anticipated that the fiscal year 2015 special year-end cash dividend will be paid in December 2015. Dividend payments depend upon a number of factors including the Company's financial condition and results of operations, regulatory capital requirements, regulatory limitations on the Bank's ability to make capital distributions to the Company, and the amount of cash at the holding company.

The following table presents regular quarterly dividends and special dividends paid in calendar years 2014, 2013, and 2012. The amounts represent cash dividends paid during each period. The 2014 true-up dividend amount is management's estimate of the dividend payout as of November 17, 2014, based on the number of shares outstanding on that date and the dividend announced on October 29, 2014 of $0.26 per share.

	Calendar Year		
	2014	2013	2012
	(Dollars in thousands)		
Quarter ended March 31			
Regular quarterly dividends paid	$ 10,513	$ 11,023	$ 12,145
Quarter ended June 30			
Regular quarterly dividends paid	10,399	10,796	11,883
Quarter ended September 30			
Regular quarterly dividends paid	10,318	10,703	11,402
Quarter ended December 31			
Regular quarterly dividends paid	10,226	10,754	11,223
True-up dividends paid	35,450	25,815	26,585
True Blue dividends paid	34,663	35,710	76,494
Calendar year-to-date dividends paid	$ 111,569	$ 104,801	$ 149,732

58

In November 2012, the Company announced that its Board of Directors approved the repurchase of up to $175.0 million of the Company's common stock. The Company began repurchasing common stock under this plan during the second quarter of fiscal year 2013 and, as of September 30, 2014, had repurchased 10,773,709 shares at an average price of $11.93 per share, at a total cost of $128.6 million. During fiscal year 2014, the Company repurchased 6,947,065 shares of common stock at an average price of $11.98 per share, or $83.2 million. Subsequent to September 30, 2014 through November 17, 2014, the Company repurchased an additional 302,145 shares at an average price of $11.99 per share. This plan, under which $42.8 million remained available as of November 17, 2014, has no expiration date.

Weighted Average Yields and Rates. The following table presents the weighted average yields on interest-earning assets, the weighted average rates paid on interest-bearing liabilities, and the resultant interest rate spreads at the dates indicated. The weighted average yields and rates include amortization of fees, costs, premiums and discounts, which are considered adjustments to yields/rates. Weighted average yields on tax-exempt securities are not calculated on a fully taxable equivalent basis.

	At September 30,					
	2014		2013		2012	
Yield on:						
Loans receivable	3.75	%	3.82	%	4.16	%
MBS	2.32		2.40		2.78	
Investment securities	1.15		1.14		1.23	
FHLB stock	5.99		3.46		3.40	
Cash and cash equivalents	0.25		0.25		0.25	
Combined yield on interest-earning assets	3.08		3.23		3.44	
Rate paid on:						
Checking deposits	0.04		0.04		0.04	
Savings deposits	0.15		0.13		0.11	
Money market deposits	0.23		0.23		0.25	
Retail certificates	1.22		1.27		1.49	
Wholesale certificates	0.63		0.80		0.98	
Total deposits	0.70		0.74		0.89	
FHLB advances	2.39		2.67		3.03	
FHLB line of credit	0.24		—		—	
FHLB borrowings	1.88		2.67		3.03	
Repurchase agreements	3.08		3.43		3.83	
Total borrowings	1.96		2.75		3.13	
Combined rate paid on interest-bearing liabilities	1.24		1.51		1.76	
Net interest rate spread	1.84		1.72		1.68	

Average Balance Sheets. The following table presents the average balances of our assets, liabilities, and stockholders' equity, and the related weighted average yields and rates on our interest-earning assets and interest-bearing liabilities for the periods indicated. Weighted average yields are derived by dividing annual income by the average balance of the related assets, and weighted average rates are derived by dividing annual expense by the average balance of the related liabilities, for the periods shown. Average outstanding balances are derived from average daily balances. The yields and rates include amortization of fees, costs, premiums and discounts which are considered adjustments to yields/rates. Yields on tax-exempt securities were not calculated on a fully taxable equivalent basis.

59

	Year Ended September 30,								
	2014			2013			2012		
	Average Outstanding Amount	Interest Earned/ Paid	Yield/ Rate	Average Outstanding Amount	Interest Earned/ Paid	Yield/ Rate	Average Outstanding Amount	Interest Earned/ Paid	Yield/ Rate
Assets:	(Dollars in thousands)								
Interest-earning assets:									
Loans receivable[1]	$6,082,505	$229,944	3.78 %	$5,740,435	$228,455	3.98 %	$5,259,007	$236,225	4.49 %
MBS[2]	1,931,477	45,300	2.35	2,247,927	55,424	2.47	2,445,953	71,156	2.91
Investment securities[2][3]	648,939	7,385	1.14	842,335	10,012	1.19	1,243,073	15,944	1.28
FHLB stock	139,197	6,555	4.71	132,516	4,515	3.41	129,687	4,446	3.43
Cash and cash equivalents	420,194	1,062	0.25	61,899	148	0.24	113,120	280	0.25
Total interest-earning assets[1][2]	9,222,312	290,246	3.15	9,025,112	298,554	3.31	9,190,840	328,051	3.57
Other noninterest-earning assets	221,229			226,850			235,852		
Total assets	$9,443,541			$9,251,962			$9,426,692		
Liabilities and stockholders' equity:									
Interest-bearing liabilities:									
Checking	$676,773	259	0.04	$633,182	244	0.04	$568,262	421	0.07
Savings	291,957	353	0.12	275,146	284	0.10	258,626	408	0.16
Money market	1,137,734	2,635	0.23	1,138,055	2,446	0.21	1,096,133	3,457	0.32
Retail certificates	2,220,436	27,205	1.23	2,251,591	31,198	1.39	2,364,405	39,247	1.66
Wholesale certificates	303,528	2,152	0.71	287,068	2,644	0.92	245,799	2,637	1.07
Total deposits	4,630,428	32,604	0.70	4,585,042	36,816	0.80	4,533,225	46,170	1.02
FHLB advances[4]	2,499,888	62,348	2.49	2,529,298	70,766	2.80	2,503,833	82,032	3.28
FHLB line of credit	356,890	869	0.24	25,709	50	0.19	3,815	12	0.30
FHLB borrowings	2,856,778	63,217	2.21	2,555,007	70,816	2.77	2,507,648	82,044	3.28
Repurchase agreements	300,274	10,282	3.38	332,411	12,762	3.79	382,350	14,956	3.85
Total borrowings	3,157,052	73,499	2.32	2,887,418	83,578	2.89	2,889,998	97,000	3.35
Total interest-bearing liabilities	7,787,480	106,103	1.36	7,472,460	120,394	1.61	7,423,223	143,170	1.93
Other noninterest-bearing liabilities	102,638			103,159			108,142		
Stockholders' equity	1,553,423			1,676,343			1,895,327		
Total liabilities and stockholders' equity	$9,443,541			$9,251,962			$9,426,692		
Net interest income[5]		$184,143			$178,160			$184,881	
			1.79			1.70			1.64

Net interest rate spread[6]				
Net interest-earning assets	$1,434,832	$1,552,652	$1,767,617	
Net interest margin[7]	2.00		1.97	2.01
Ratio of interest-earning assets to interest-bearing liabilities	1.18x		1.21x	1.24x

60

(1) Calculated net of unearned loan fees, deferred costs, and undisbursed loan funds. Loans that are 90 or more days delinquent are included in the loans receivable average balance with a yield of zero percent. Balances include loans receivable held-for-sale.
(2) MBS and investment securities classified as AFS are stated at amortized cost, adjusted for unamortized purchase premiums or discounts.
(3) The average balance of investment securities includes an average balance of non-taxable securities of $36.8 million, $41.5 million, and $54.5 million for the years ended September 30, 2014, 2013, and 2012, respectively.
(4) The balance and rate of FHLB advances are stated net of deferred gains and deferred prepayment penalties.
(5) Net interest income represents the difference between interest income earned on interest-earning assets and interest paid on interest-bearing liabilities. Net interest income depends on the balance of interest-earning assets and interest-bearing liabilities, and the interest rates earned or paid on them.
(6) Net interest rate spread represents the difference between the average yield on interest-earning assets and the average cost of interest-bearing liabilities.
(7) Net interest margin represents net interest income as a percentage of average interest-earning assets.

Rate/Volume Analysis. The table below presents the amount of changes in interest income and interest expense for major components of our interest-earning assets and interest-bearing liabilities, comparing fiscal years 2014 to 2013 and fiscal years 2013 to 2012. For each category of interest-earning assets and interest-bearing liabilities, information is provided on changes attributable to (1) changes in volume, which are changes in the average balance multiplied by the previous year's average rate, and (2) changes in rate, which are changes in the average rate multiplied by the average balance from the previous year. The net changes attributable to the combined impact of both rate and volume have been allocated proportionately to the changes due to volume and the changes due to rate.

	For the Year Ended September 30,					
	2014 vs. 2013			2013 vs. 2012		
	Increase (Decrease) Due to			Increase (Decrease) Due to		
	Volume	Rate	Total	Volume	Rate	Total
	(Dollars in thousands)					
Interest-earning assets:						
Loans receivable	$13,013	$(11,524)	$1,489	$20,168	$(27,938)	$(7,770)
MBS	(7,519)	(2,605)	(10,124)	(5,456)	(10,276)	(15,732)
Investment securities	(2,216)	(411)	(2,627)	(4,833)	(1,099)	(5,932)
FHLB stock	237	1,803	2,040	86	(17)	69
Cash and cash equivalents	907	7	914	(123)	(9)	(132)
Total interest-earning assets	4,422	(12,730)	(8,308)	9,842	(39,339)	(29,497)
Interest-bearing liabilities:						
Checking	17	(2)	15	43	(220)	(177)
Savings	18	51	69	24	(149)	(125)
Money market	(1)	190	189	126	(1,137)	(1,011)
Certificates of deposit	(195)	(4,290)	(4,485)	(1,133)	(6,908)	(8,041)
FHLB borrowings	(97)	(7,502)	(7,599)	588	(11,816)	(11,228)
Repurchase agreements	(1,171)	(1,309)	(2,480)	(1,957)	(237)	(2,194)
Total interest-bearing liabilities	(1,429)	(12,862)	(14,291)	(2,309)	(20,467)	(22,776)
Net change in net interest and dividend income	$5,851	$132	$5,983	$12,151	$(18,872)	$(6,721)

Comparison of Operating Results for the Years Ended September 30, 2014 and 2013

For fiscal year 2014, the Company recognized net income of $77.7 million, compared to net income of $69.3 million for fiscal year 2013. The $8.4 million, or 12.0%, increase in net income was due primarily to a $6.0 million increase in net interest income, and a $5.4 million decrease in salaries and employee benefits due primarily to a reduction in ESOP-related expenses. The net interest margin increased three basis points, from 1.97% for the prior fiscal year to 2.00% for the current fiscal year. Decreases in the cost of funds and a shift in the mix of interest-earning assets from relatively lower yielding securities to higher yielding loans were the primary drivers for the higher net interest margin in the current fiscal year.

As discussed in "Executive Summary", during the fourth quarter of fiscal year 2014, the Bank implemented a daily leverage strategy which increased fiscal year 2014 net income by $501 thousand. The pre-tax yield of the daily leverage strategy, which is defined as the annualized pre-tax income resulting from the transaction as a percentage of the interest-earning assets associated with the transaction, was 0.21% for the period that the strategy was in place during fiscal year 2014. Excluding the effects of the daily leverage strategy, the net interest margin would have been 2.07% for the current fiscal year.

Interest and Dividend Income

The weighted average yield on total interest-earning assets decreased 16 basis points from 3.31% for the prior fiscal year to 3.15% for the current fiscal year, while the average balance of interest-earning assets increased $197.2 million from the prior fiscal year due to the daily leverage strategy. The following table presents the components of interest and dividend income for the time periods presented along with the change measured in dollars and percent.

	For the Year Ended September 30,		Change Expressed in:	
	2014	2013	Dollars	Percent
	(Dollars in thousands)			
INTEREST AND DIVIDEND INCOME:				
Loans receivable	$229,944	$228,455	$1,489	0.7 %
MBS	45,300	55,424	(10,124)	(18.3)
Investment securities	7,385	10,012	(2,627)	(26.2)
FHLB stock	6,555	4,515	2,040	45.2
Cash and cash equivalents	1,062	148	914	617.6
Total interest and dividend income	$290,246	$298,554	$(8,308)	(2.8)

The increase in interest income on loans receivable was due to an increase in the average balance of the portfolio, partially offset by a decrease in the weighted average yield on the portfolio. The weighted average yield on the loans receivable portfolio decreased 20 basis points, from 3.98% for the prior fiscal year to 3.78% for the current fiscal year. The downward repricing of the loan portfolio was due largely to adjustable-rate loans repricing to lower rates, to loans being purchased at market rates less than or equal to the weighted average rate of the existing portfolio, and to the current fiscal year reflecting the full impact of the large volume of refinances and endorsements that occurred during the prior fiscal year.

The decrease in interest income on MBS and investment securities was due largely to a decrease in the average balance of each portfolio as cash flows not reinvested in the portfolios were used to fund loan growth, pay dividends, and repurchase stock. The average balance of the MBS portfolio decreased $316.4 million between the two periods and the average yield on the MBS portfolio decreased 12 basis points, from 2.47% during the prior fiscal year to 2.35% for the current fiscal year. The decrease in the average yield on the MBS portfolio was due primarily to purchases of MBS between periods with yields less than the average yield on the existing portfolio, and to repayments of MBS with yields greater than the average yield on the existing portfolio. Included in interest income on MBS for the current fiscal year was $5.7 million from the net amortization of premiums and the accretion of discounts, decreasing the average yield on the portfolio by 29 basis points. During the prior fiscal year, $8.0 million of net

premiums were amortized and decreased the average yield on the portfolio by 35 basis points. At September 30, 2014, the net balance of premiums/(discounts) on our portfolio of MBS was $18.6 million. The decrease in interest income on investment securities was due primarily to a $193.4 million decrease in the average balance of the portfolio, along with a five basis point decrease in the yield, from 1.19% during the prior fiscal year, to 1.14% for the current fiscal year.

The increase in dividends on FHLB stock was due to an increase in the FHLB dividend rate between the two periods and, to a lesser extent, a $6.7 million increase in the average balance of the portfolio due to the purchase of additional shares of FHLB stock in conjunction with the daily leverage strategy. Similarly, the increase in interest income on cash and cash equivalents was due primarily to a $358.3 million increase in the average balance due to the daily leverage strategy, which was $336.8 million of the increase in the average balance during the current fiscal year.

Interest Expense

The weighted average rate paid on total interest-bearing liabilities decreased 25 basis points from 1.61% for the prior fiscal year to 1.36% for the current fiscal year, while the average balance of interest-bearing liabilities increased $315.0 million from the prior fiscal year due primarily to an increase in borrowings against the FHLB line of credit in conjunction with the daily leverage strategy. The following table presents the components of interest expense for the time periods presented, along with the change measured in dollars and percent. The decrease in interest expense was due primarily to a decrease in the weighted average rate paid on the portfolios between the two periods.

	For the Year Ended September 30,		Change Expressed in:	
	2014	2013	Dollars	Percent
	(Dollars in thousands)			
INTEREST EXPENSE:				
FHLB borrowings	$63,217	$70,816	$(7,599)	(10.7)%
Deposits	32,604	36,816	(4,212)	(11.4)
Repurchase agreements	10,282	12,762	(2,480)	(19.4)
Total interest expense	$106,103	$120,394	$(14,291)	(11.9)

The weighted average rate paid on the FHLB borrowings portfolio decreased 56 basis points, from 2.77% for the prior fiscal year to 2.21% for the current fiscal year. The decrease in the average rate paid was due primarily to maturities and renewals of advances to lower market rates between periods, as well as to an increase in the use of the low-costing line of credit in conjunction with the daily leverage strategy. The average balance against the line of credit increased $331.2 million from the prior fiscal year, largely as a result of the daily leverage strategy. The average balance of FHLB advances decreased $29.4 million between periods, due primarily to some maturing advances not being renewed in their entirety. Absent the impact of the daily leverage strategy, the average rate paid on FHLB borrowings would have been 2.49% for the current fiscal year.

The decrease in the weighted average rate paid on the deposit portfolio was due primarily to a decrease in the weighted average rate paid on the retail certificate of deposit portfolio. The weighted average rate paid on the retail certificate of deposit portfolio decreased 16 basis points, from 1.39% for the prior fiscal year to 1.23% for the current fiscal year.

The weighted average rate paid on repurchase agreements decreased 41 basis points, from 3.79% for the prior fiscal year to 3.38% for the current fiscal year. The decrease in the average rate paid on repurchase agreements was due to maturities and a new agreement entered into between periods which had a rate less than the existing portfolio.

Provision for Credit Losses

The Bank recorded a provision for credit losses during the current fiscal year of $1.4 million, compared to a $1.1 million negative provision for credit losses for the prior fiscal year. The $1.4 million provision for credit losses in the current fiscal year takes into account net charge-offs of $1.0 million.

Non-Interest Income

The following table presents the components of non-interest income for the time periods presented, along with the change measured in dollars and percent.

	For the Year Ended September 30,		Change Expressed in:	
	2014	2013	Dollars	Percent
	(Dollars in thousands)			
NON-INTEREST INCOME:				
Retail fees and charges	$ 14,937	$ 15,342	$ (405)	(2.6)%
Insurance commissions	3,151	2,925	226	7.7
Loan fees	1,568	1,727	(159)	(9.2)
Income from bank-owned life insurance ("BOLI")	1,993	1,483	510	34.4
Other non-interest income	1,306	1,812	(506)	(27.9)
Total non-interest income	$ 22,955	$ 23,289	$ (334)	(1.4)

The decrease in retail fees and charges was due primarily to a decrease in service charges earned. The increase in income from BOLI was due primarily to the receipt of death benefits. The decrease in other non-interest income was due primarily to a decrease in premium income from CFMRC, as it is no longer writing new business, and to a decrease in gains on loans held-for-sale.

Non-Interest Expense

The following table presents the components of non-interest expense for the time periods presented, along with the change measured in dollars and percent.

	For the Year Ended September 30,		Change Expressed in:	
	2014	2013	Dollars	Percent
	(Dollars in thousands)			
NON-INTEREST EXPENSE:				
Salaries and employee benefits	$ 43,757	$ 49,152	$ (5,395)	(11.0)%
Occupancy	10,268	9,871	397	4.0
Information technology and communications	9,429	8,855	574	6.5
Regulatory and outside services	5,572	5,874	(302)	(5.1)
Deposit and loan transaction costs	5,329	5,547	(218)	(3.9)
Advertising and promotional	4,195	5,027	(832)	(16.6)
Federal insurance premium	4,536	4,462	74	1.7
Other non-interest expense	7,451	8,159	(708)	(8.7)
Total non-interest expense	$ 90,537	$ 96,947	$ (6,410)	(6.6)

The decrease in salaries and employee benefits was due primarily to a decrease in ESOP-related expenses resulting largely from the final allocation of ESOP shares acquired in our initial public offering (March 1999) being made at September 30, 2013. In fiscal year 2014, the only ESOP shares allocated were shares acquired in the Company's corporate reorganization in December 2010. The increase in occupancy expense was due largely to an increase in depreciation expense, which was primarily associated with the remodeling of our home office. The increase in information technology and communications expense was primarily related to continued upgrades to our information technology infrastructure. The decrease in regulatory and outside services was due largely to the timing of fees paid for our external audit. The decrease in advertising and promotional expense was due primarily to the timing of media campaigns in fiscal year 2013, which included campaigns delayed from fiscal year 2012, as well as to a general decrease in advertising and promotional campaigns during the current year, compared to the prior year. The decrease in other non-interest expense was due largely to a decrease in the amortization

64

of mortgage-servicing rights assets, a decrease in OREO operations expense, and a decrease in office supplies and related expenses, partially offset by an increase in amortization of low income housing partnerships.

Included in the $7.5 million of other non-interest expense for fiscal year 2014 was $2.4 million of amortization expense associated with our investments in low income housing partnerships. During the current fiscal year, the average balance of our investments in low income housing partnerships was $38.7 million. The Company will continue to recognize the amortization of these investments as an operating expense on its income statement because of the involvement two of the Bank's officers have with the operational management of the low income housing partnership investment group. Their participation provides the investment group with additional experience in evaluating housing-related investments and policy matters related to housing investment opportunities. We invest in low income housing partnerships because we receive an income tax credit in the amount of the original investment recognized over the lifetime of the investment. The Company will deduct $3.6 million of tax credits related to its investment in low income housing partnerships for fiscal year 2014. This amount reduced the fiscal year 2014 effective tax rate by 3.1%.

Management anticipates that in fiscal year 2015, retail fees and charges earned will decrease approximately $1.3 million. Additionally, management anticipates that non-interest expense will increase in fiscal year 2015 as a result of higher costs of compliance with regulations and certain on-going operations. It is anticipated that (1) occupancy expense may increase by $500 thousand as we continue to refurbish existing branch locations; (2) information technology and communications expense could increase $1.5 million as technology is added to facilitate compliance efforts, to upgrade our disaster recovery location, and to deliver customer friendly technology; (3) federal insurance premiums may increase by $1.1 million as a result of the daily leverage strategy because the premium is based on average total assets less average tangible equity, which will partially offset the related increase in net interest income; and (4) other non-interest expense may increase by $2.0 million related to amortization expense associated with our investments in low income housing partnerships, partially offset by a $1.0 million increase in low income housing tax credits which will be reflected in our effective income tax rate. Management anticipates the effective tax rate for fiscal year 2015 will be approximately 32% to 33%, based on current fiscal year 2015 estimates.

The Company's efficiency ratio was 43.72% for the current fiscal year compared to 48.13% for the prior fiscal year. The change in the efficiency ratio was due primarily to a decrease in total non-interest expense. The efficiency ratio is a measure of a financial institution's total non-interest expense as a percentage of the sum of net interest income (pre-provision for credit losses) and non-interest income. A lower value indicates that the financial institution is generating revenue with a lower level of expense.

Income Tax Expense

Income tax expense was $37.5 million for the current fiscal year compared to $36.2 million for the prior fiscal year. The $1.3 million increase between periods was due largely to an increase in pre-tax income, partially offset by a decrease in the effective tax rate. The effective tax rate for the current fiscal year was 32.5% compared to 34.3% for the prior fiscal year. The decrease in the effective tax rate between periods was due largely to a lower amount of nondeductible ESOP-related expenses due to the final ESOP allocation on September 30, 2013, as discussed in the non-interest expense section above, along with higher tax credits related to our investments in low income housing partnerships.

Comparison of Operating Results for the Years Ended September 30, 2013 and 2012
For fiscal year 2013, the Company recognized net income of $69.3 million, compared to net income of $74.5 million for fiscal year 2012. The $5.2 million, or 6.9%, decrease in net income was due primarily to a decrease in net interest income and an increase in non-interest expense, partially offset by a decrease in income tax expense and provision for credit losses.

The net interest rate spread, which represents the difference between the average yield on interest-earning assets and the average cost of interest-bearing liabilities, increased six basis points, from 1.64% for fiscal year 2012 to 1.70% for fiscal year 2013. The increase in the net interest rate spread was due to cost of funds decreasing more than the yield on interest-earning assets.

The net interest margin, which is calculated as the difference between interest income and interest expense divided by average interest-earning assets, decreased four basis points, from 2.01% for fiscal year 2012 to 1.97% for fiscal year 2013. Decreases in the cost of funds and a shift in the mix of interest-earning assets from relatively lower yielding securities to higher yielding loans mitigated the decrease in the net interest margin, but were not enough to fully offset the impact of decreasing asset yields.

Interest and Dividend Income
The weighted average yield on total interest-earning assets decreased 26 basis points from fiscal year 2012 to 3.31% for fiscal year 2013 and the average balance of interest-earning assets decreased $165.7 million from fiscal year 2012. The decrease in the weighted average balance between the two periods was primarily in the lower yielding investment securities and MBS portfolios, while the average balance of the loan portfolio increased between the two periods.

The following table presents the components of interest and dividend income for the time periods presented, along with the change measured in dollars and percent. The decrease in interest income on MBS and loans receivable was due primarily to a decrease in the weighted average yield of each portfolio, while the decrease in interest income on investment securities was due primarily to a decrease in the average balance of the portfolio.

	For the Year Ended September 30,		Change Expressed in:	
	2013	2012	Dollars	Percent
	(Dollars in thousands)			
INTEREST AND DIVIDEND INCOME:				
Loans receivable	$228,455	$236,225	$(7,770)	(3.3)%
MBS	55,424	71,156	(15,732)	(22.1)
Investment securities	10,012	15,944	(5,932)	(37.2)
FHLB stock	4,515	4,446	69	1.6
Cash and cash equivalents	148	280	(132)	(47.1)
Total interest and dividend income	$298,554	$328,051	$(29,497)	(9.0)%

The average yield on the loans receivable portfolio decreased 51 basis points, from 4.49% for fiscal year 2012 to 3.98% for fiscal year 2013. The decrease in the weighted average yield was due to the continued downward repricing of the existing portfolio resulting primarily from endorsements and refinances, as well as to the origination and purchase of loans at rates less than the weighted average rate of the existing portfolio. The decrease in interest income on loans receivable resulting from the decrease in the average yield was partially offset by a $481.4 million increase in the average balance of the portfolio, which was primarily a result of loan purchases between periods.

The average yield on the MBS portfolio decreased 44 basis points, from 2.91% during fiscal year 2012 to 2.47% for fiscal year 2013. The decrease in the average yield was due primarily to maturities and principal repayments of higher yielding securities in the portfolio, with proceeds being reinvested into higher yielding loans or purchases of MBS with yields less than the average yield on the existing portfolio. The maturities and repayments also resulted in the

average balance of the MBS portfolio decreasing $198.0 million between the two periods.

The decrease in interest income on investment securities was due primarily to a $400.7 million decrease in the average balance of the portfolio, part of which was related to securities held at the holding company level. The cash flows from calls and maturities of investment securities that were not reinvested into the portfolio were used largely to fund loan growth, pay dividends to stockholders, and repurchase stock.

Interest Expense

The weighted average rate paid on total interest-bearing liabilities decreased 32 basis points from fiscal year 2012 to 1.61% for fiscal year 2013, and the average balance of interest-bearing liabilities increased $49.2 million from fiscal year 2012. The increase in the average balance of interest-bearing liabilities was largely in lower rate deposit products while the average balance of certificates of deposit decreased between the two periods.

The following table presents the components of interest expense for the time periods presented, along with the change measured in dollars and percent. The decrease in interest expense on FHLB borrowings and deposits was due primarily to a decrease in the weighted average rate paid on the portfolios, while the decrease in interest expense on repurchase agreements was due primarily to a decrease in the average balance between the two years.

	For the Year Ended September 30,		Change Expressed in:	
	2013	2012	Dollars	Percent
	(Dollars in thousands)			
INTEREST EXPENSE:				
FHLB borrowings	$ 70,816	$ 82,044	$ (11,228)	(13.7)%
Deposits	36,816	46,170	(9,354)	(20.3)
Repurchase agreements	12,762	14,956	(2,194)	(14.7)
Total interest expense	$ 120,394	$ 143,170	$ (22,776)	(15.9)%

The weighted average rate paid on the FHLB borrowings portfolio decreased 51 basis points, from 3.28% for fiscal year 2012 to 2.77% for fiscal year 2013. The decrease in the average rate paid was due largely to the renewal of maturing advances during the two periods to lower rates.

The weighted average rate paid on the deposit portfolio decreased 22 basis points, from 1.02% for fiscal year 2012 to 0.80% for fiscal year 2013. The decrease in the weighted average rate paid on the deposit portfolio was due largely to a decrease in the weighted average rate paid on the certificate of deposit and money market portfolios. The weighted average rate paid on the certificate of deposit portfolio decreased 27 basis points, from 1.60% for fiscal year 2012 to 1.33% for fiscal year 2013. The weighted average rate paid on the money market portfolio decreased 11 basis points, from 0.32% for fiscal year 2012 to 0.21% for fiscal year 2013.

The decrease in interest expense on repurchase agreements was due primarily to a $49.9 million decrease in the average balance between periods. The decrease in the average balance was due to the maturity of $145.0 million of agreements during the fiscal year 2013, some of which were replaced with FHLB borrowings. Decreases in the average balance resulting from maturities during fiscal year 2013 were partially offset by a new $100.0 million agreement during the fourth quarter of fiscal year 2013.

Provision for Credit Losses

The Bank recorded a negative provision for credit losses during fiscal year 2013 of $1.1 million, compared to a $2.0 million provision for credit losses for fiscal year 2012. The negative provision in fiscal year 2013 reflects the decrease in our net charge-offs from fiscal year 2012, specifically related to our bulk purchased loan portfolio where the majority of our charge-offs occurred in recent years, coupled with a decline in the historical loss balances utilized in the formula analysis model as older, larger losses roll off. The decrease in net charge-offs from fiscal year 2012 was due to a stabilization and/or increase in property values, specifically in some of the states where we have purchased loans, along with a decrease in the number of bulk purchased loans going 180 days delinquent, which is generally when a loan is evaluated for loss. Net charge-offs during fiscal year 2013 were $1.2 million, of which $381 thousand related to loans that were discharged primarily in a prior fiscal year under Chapter 7 bankruptcy that must be, pursuant to regulatory reporting requirements, evaluated for collateral value loss, even if they were current. Net charge-offs during fiscal year 2012 were $6.4 million, of which $3.5 million was related to the implementation of a new loan charge-off policy during January 2012 in accordance with regulatory reporting requirements. The OCC does not permit the use of SVAs, which the Bank was previously utilizing for potential loan losses, as permitted by the Bank's previous regulator.

Non-Interest Income

The following table presents the components of non-interest income for the time periods presented, along with the change measured in dollars and percent.

	For the Year Ended September 30,		Change Expressed in:	
	2013	2012	Dollars	Percent
	(Dollars in thousands)			
NON-INTEREST INCOME:				
Retail fees and charges	$ 15,342	$ 15,915	$ (573)	(3.6)%
Insurance commissions	2,925	2,772	153	5.5
Loan fees	1,727	2,113	(386)	(18.3)
BOLI	1,483	1,478	5	0.3
Other non-interest income	1,812	1,955	(143)	(7.3)
Total non-interest income	$ 23,289	$ 24,233	$ (944)	(3.9)%

The decrease in retail fees and charges was primarily a result of changes required by the Dodd-Frank Wall Street Reform and Consumer Protection Act that reduced debit card interchange fees and established limits to fees for overdrafts of debit card transactions. The decrease in loan fees was due primarily to a decrease in servicing fees received from sold loans as a result of a decrease in our sold loan portfolio.

Non-Interest Expense

The following table presents the components of non-interest expense for the time periods presented, along with the change measured in dollars and percent.

	For the Year Ended September 30,		Change Expressed in:	
	2013	2012	Dollars	Percent
	(Dollars in thousands)			
NON-INTEREST EXPENSE:				
Salaries and employee benefits	$49,152	$44,235	$4,917	11.1 %
Occupancy	9,871	8,751	1,120	12.8
Information technology and communications	8,855	7,583	1,272	16.8
Regulatory and outside services	5,874	5,291	583	11.0
Deposit and loan transaction costs	5,547	5,381	166	3.1
Advertising and promotional	5,027	3,931	1,096	27.9
Federal insurance premium	4,462	4,444	18	0.4
Other non-interest expense	8,159	11,459	(3,300)	(28.8)
Total non-interest expense	$96,947	$91,075	$5,872	6.4 %

The increase in salaries and employee benefits expense was due primarily to compensation expense on unallocated ESOP shares related to the $0.52 True Blue dividend paid in December 2012, stock option and restricted stock grants in May 2012 and September 2012, and an increase in payroll expense resulting from internal promotions and salary increases. The increase in information technology and communications expense was primarily related to continued upgrades and investments in our information technology infrastructure. The increase in occupancy expense was due largely to an increase in depreciation expense associated with the remodeling of our home office. The increase in advertising and promotional expense was due primarily to an increase in media campaigns that were delayed until fiscal year 2013. The increase in regulatory and outside services was due largely to the timing of fees paid for our external audit and an increase in fees associated with tax preparation services and professional services. The decrease in other non-interest expenses was due primarily to a decrease in OREO operations expense and to a recovery of valuation allowance expense on the mortgage-servicing rights asset compared to an impairment expense in fiscal year 2012.

Income Tax Expense

Income tax expense was $36.2 million for fiscal year 2013 compared to $41.5 million for fiscal year 2012. The $5.3 million decrease between periods was due largely to a decrease in pretax income. The effective tax rate for fiscal year 2013 was 34.3% compared to 35.8% for fiscal year 2012. The fiscal year 2013 rate is lower than the fiscal year 2012 rate due primarily to higher deductible expenses associated with the ESOP in fiscal year 2013, along with higher tax credits related to investments in our low income housing partnerships. Additionally, pre-tax income is lower than in fiscal year 2012, due primarily to the items outlined in the non-interest expense discussion above, which results in all items impacting the income tax rate having a larger impact on the overall effective tax rate than in fiscal year 2012.

Liquidity and Capital Resources

Liquidity refers to our ability to generate sufficient cash to fund ongoing operations, to repay maturing certificates of deposit and other deposit withdrawals, to repay maturing borrowings, and to fund loan commitments. Liquidity management is both a daily and long-term function of our business management. The Company's most available liquid assets are represented by cash and cash equivalents, AFS securities, and short-term investment securities. The Bank's primary sources of funds are deposits, FHLB borrowings, repurchase agreements, repayments and maturities of outstanding loans and MBS and other short-term investments, and funds provided by operations. The Bank's term borrowings primarily have been used to invest in debentures and MBS in an effort to manage the Bank's interest rate risk with the intent to improve the earnings of the Bank while maintaining capital ratios in excess of regulatory standards for well-capitalized financial institutions. In addition, the Bank's focus on managing risk has provided additional liquidity capacity by maintaining a balance of MBS and investment securities available as collateral for borrowings.

We generally intend to maintain cash reserves sufficient to meet short-term liquidity needs, which are routinely forecasted for 10, 30, and 365 days. Additionally, on a monthly basis, we perform a liquidity stress test in accordance with the Interagency Policy Statement on Funding and Liquidity Risk Management. The liquidity stress test incorporates both short-term and long-term liquidity scenarios in order to identify and to quantify liquidity risk. Management also continuously monitors key liquidity statistics related to items such as wholesale funding gaps, borrowings capacity, and available unpledged collateral, along with various liquidity ratios in an effort to further mitigate liquidity risk.

In the event short-term liquidity needs exceed available cash, the Bank has access to a line of credit at the FHLB and the Federal Reserve Bank discount window. Additionally, all or a portion of the borrowings against the FHLB line of credit in conjunction with the daily leverage strategy could be repaid at any point in time, if necessary. Per the FHLB's lending guidelines, total FHLB borrowings cannot exceed 40% of total Bank assets, as reported on the Bank's Call Report to the OCC, without pre-approval from the FHLB president. The amount that can be borrowed from the Federal Reserve Bank discount window is based upon the fair value of securities pledged as collateral and certain other characteristics of those securities, and is used only when other sources of short-term liquidity are unavailable. Management tests the Bank's access to the Federal Reserve Bank discount window annually with a nominal, one night borrowing.

If management observes a trend in the amount and frequency of line of credit utilization that is not in conjunction with a planned management strategy, such as the daily leverage strategy, the Bank will likely utilize long-term wholesale borrowing sources such as FHLB advances and/or repurchase agreements to provide permanent fixed-rate funding. The maturity of these borrowings is generally structured in such a way as to stagger maturities in order to reduce the risk of a highly negative cash flow position at maturity.

The outstanding amount of FHLB advances was $2.58 billion at September 30, 2014, of which $600.0 million was scheduled to mature in the next 12 months. Additionally, in conjunction with the daily leverage strategy, there was $800.0 million against the FHLB line of credit at September 30, 2014. The FHLB borrowings are secured by certain qualifying loans pursuant to a blanket collateral agreement with the FHLB along with certain securities. The Bank pledged securities with an estimated fair value of $488.4 million as collateral for FHLB borrowings at September 30, 2014. At September 30, 2014, the Bank's ratio of the par value of FHLB borrowings to total assets, as reported to the OCC, was 34%. As a result of the implementation of the daily leverage strategy, FHLB borrowings to the Bank's total assets were in excess of 40% at certain times during the fourth quarter of fiscal year 2014, and are expected to be in excess of 40% at certain times during fiscal year 2015, as long as the Bank continues its daily leverage strategy. In July 2014, the president of the FHLB approved an increase in the Bank's borrowing limit to 55% of total assets for one year.

At September 30, 2014, the Bank had repurchase agreements of $220.0 million, or approximately 2% of total assets, of which $20.0 million was scheduled to mature in the next 12 months. The Bank may enter into additional repurchase agreements as management deems appropriate, not to exceed 15% of total assets, and subject to a total borrowings limit of 55% as discussed below. The Bank has pledged securities with an estimated fair value of $247.3 million as collateral for repurchase agreements as of September 30, 2014. The securities pledged for the repurchase agreements will be delivered back to the Bank when the repurchase agreements mature.

The Bank's internal policy limits total borrowings to 55% of total assets. At September 30, 2014, the Bank had term borrowings, at par, of $2.80 billion and $800.0 million against a line of credit, for a total of $3.60 billion, or approximately 36% of total assets. Additionally, the Bank could utilize the repayment and maturity of outstanding loans, MBS, and other investments for liquidity needs rather than reinvesting such funds into the related portfolios. At September 30, 2014, the Bank had $659.9 million of securities that were eligible but unused as collateral for borrowing or other liquidity needs. This collateral amount is comprised of AFS and HTM securities with individual fair values greater than $10.0 million, which is then reduced by a collateralization ratio of 10% to account for potential market value fluctuations.

The Bank has access to and utilizes other sources for liquidity purposes, such as brokered deposits and public unit deposits. As of September 30, 2014, the Bank's policy allows for combined brokered and public unit deposits up to 15% of total deposits. At September 30, 2014, the Bank had brokered and public unit deposits totaling $300.4 million, or approximately 6% of total deposits. Management continuously monitors the wholesale deposit market for opportunities to obtain brokered and public unit deposits at attractive rates. The Bank has pledged securities with an estimated fair value of $284.3 million as collateral for public unit deposits. The securities pledged as collateral for public unit deposits are held under joint custody by the FHLB and generally will be released upon deposit maturity.

At September 30, 2014, $1.27 billion of the Bank's $2.53 billion of certificates of deposit was scheduled to mature within one year. Included in the $1.27 billion was $246.8 million of public unit and brokered deposits. Based on our deposit retention experience and our current pricing strategy, we anticipate the majority of the maturing retail certificates of deposit will renew or transfer to other deposit products at the prevailing rate, although no assurance can be given in this regard. We also anticipate the majority of the $205.0 million of maturing public unit deposits will be replaced with similar wholesale funding products.

While scheduled payments from the amortization of loans and MBS and payments on short-term investments are relatively predictable sources of funds, deposit flows, prepayments on loans and MBS, and calls of investment securities are greatly influenced by general interest rates, economic conditions, and competition, and are less predictable sources of funds. To the extent possible, the Bank manages the cash flows of its loan and deposit portfolios by the rates it offers customers.

At September 30, 2014, cash and cash equivalents totaled $810.8 million, an increase of $697.0 million from September 30, 2013. The increase in cash and cash equivalents was a result of the implementation of the daily leverage strategy during the fourth quarter of fiscal year 2014. During fiscal year 2014, loan originations and purchases, net of principal repayments and related loan activity, resulted in a cash outflow of $280.1 million. See additional discussion regarding loan activity in "Financial Condition – Loans Receivable." During fiscal year 2014, principal payments on MBS were $388.0 million and proceeds from called or matured investment securities were $289.6 million. During fiscal year 2014, the Bank purchased $138.9 million of investment securities and $150.7 million of MBS. Cash flows from the securities portfolio which were not reinvested in the portfolio were used to fund loan growth, pay dividends, and repurchase stock.

At September 30, 2014, Capitol Federal Financial, Inc., at the holding company level, had $139.5 million on deposit at the Bank. During the year ended September 30, 2014, the Company paid $138.2 million in cash dividends and repurchased 6,947,065 shares at a total cost of $83.2 million. See additional discussion regarding dividends and stock repurchases in "Financial Condition - Stockholders' Equity."

As of September 30, 2014, the Bank had entered into $10.4 million of agreements in connection with the remodeling of the Bank’s Kansas City market area operations center. The existing building was constructed in 1968. The project scope includes replacement of all mechanical and electrical systems, interior finishes, and exterior building components, along with an upgrade to our disaster recovery location. The completed project will result in a more energy efficient building which is expected to lower our utility and maintenance expenses. There may be additional

agreements and expenses related to the project through early fiscal year 2017, which is when the project is expected to be completed. Costs related to the project will be capitalized and depreciated according to the estimated useful life of the assets as they are placed in service.

The following table presents the contractual maturities of our loan, MBS, and investment securities portfolios at September 30, 2014, along with associated weighted average yields. Loans and securities which have adjustable interest rates are shown as maturing in the period during which the contract is due. The table does not reflect the effects of possible prepayments or enforcement of due on sale clauses. As of September 30, 2014, the amortized cost of investment securities in our portfolio which are callable or have pre-refunding dates within one year was $488.2 million.

	Loans[1]		MBS		Investment Securities		Total	
	Amount	Yield	Amount	Yield	Amount	Yield	Amount	Yield
	(Dollars in thousands)							
Amounts due:								
Within one year	$77,403	3.89 %	$—	— %	$3,353	2.69 %	$80,756	3.84 %
After one year:								
Over one to two years	54,030	3.79	430	5.70	31,363	1.56	85,823	2.99
Over two to three years	12,602	5.35	—	—	82,907	0.98	95,509	1.55
Over three to five years	74,345	4.94	64,436	4.42	408,255	1.11	547,036	2.02
Over five to ten years	363,879	4.13	505,574	2.10	62,768	1.31	932,221	2.84
Over ten to fifteen years	1,406,826	3.48	711,647	2.28	—	—	2,118,473	3.07
After fifteen years	4,300,434	3.78	520,460	2.33	2,296	1.49	4,823,190	3.62
Total due after one year	6,212,116	3.75	1,802,547	2.32	587,589	1.14	8,602,252	3.27
	$6,289,519	3.75	$1,802,547	2.32	$590,942	1.15	$8,683,008	3.27

(1) Demand loans, loans having no stated maturity, and overdraft loans are included in the amounts due within one year. Construction loans are presented based on the term to complete construction. The maturity date for home equity loans assumes the customer always makes the required minimum payment.

Limitations on Dividends and Other Capital Distributions

Although savings and loan holding companies are not currently subject to regulatory capital requirements or specific restrictions on the payment of dividends or other capital distributions, the OCC does prescribe such restrictions on subsidiary savings associations. The OCC regulations impose restrictions on savings institutions with respect to their ability to make distributions of capital, which include dividends, stock redemptions or repurchases, cash-out mergers, and other transactions charged to the capital account.

Generally, savings institutions, such as the Bank, may make capital distributions during any calendar year equal to earnings of the previous two calendar years and current year-to-date earnings under the FRB and OCC safe harbor regulations. It is generally required that the Bank remain well capitalized before and after a proposed distribution; however, an institution deemed to be in need of more than normal supervision by the OCC may have its capital distribution authority restricted. A savings institution, such as the Bank, that is a subsidiary of a savings and loan holding company and that proposes to make a capital distribution must submit written notice to the OCC and FRB 30 days prior to such distribution. The OCC and FRB may object to the distribution during that 30-day period based on safety and soundness or other concerns. Savings institutions that desire to make a larger capital distribution, are under special restrictions, or are not, or would not be, well capitalized following a proposed capital distribution, however, must obtain regulatory non-objection prior to making such distribution.

The long-term ability of the Company to pay dividends to its stockholders is based primarily upon the ability of the Bank to make capital distributions to the Company. So long as the Bank continues to remain well capitalized after each capital distribution and operates in a safe and sound manner, it is management's belief that the OCC and FRB will continue to allow the Bank to distribute its net income to the Company, although no assurance can be given in this regard.

The Company paid cash dividends of $138.2 million during the year ended September 30, 2014. Dividend payments depend upon a number of factors including the Company's financial condition and results of operations, regulatory capital requirements, regulatory limitations on the Bank's ability to make capital distributions to the Company, and the amount of cash at the holding company level.

Off-Balance Sheet Arrangements, Commitments and Contractual Obligations

The Company, in the normal course of business, makes commitments to buy or sell assets or to incur or fund liabilities. Commitments may include, but are not limited to:

- the origination, purchase, participation, or sale of loans;
- the purchase or sale of investment securities and MBS;
- extensions of credit on home equity loans, construction loans, and commercial loans;
- terms and conditions of operating leases; and
- funding withdrawals of deposit accounts at maturity.

The following table summarizes our contractual obligations and other material commitments, along with associated weighted average rates as of September 30, 2014.

	Maturity Range				
		Less than	1 to 3	3 to 5	More than
	Total	1 year	years	years	5 years
	(Dollars in thousands)				
Operating leases	$7,989	$995	$1,702	$1,531	$3,761
Certificates of deposit	$2,532,166	$1,269,331	$924,302	$337,981	$552
Rate	1.15 %	1.03 %	1.20 %	1.45 %	1.55 %
FHLB advances	$2,575,000	$600,000	$1,075,000	$400,000	$500,000
Rate	2.19 %	1.64 %	2.48 %	2.15 %	2.29 %
FHLB line of credit	$800,000	$800,000	$—	$—	$—
Rate	0.24 %	0.24 %	— %	— %	— %
Repurchase agreements	$220,000	$20,000	$—	$100,000	$100,000
Rate	3.08 %	4.45 %	— %	3.35 %	2.53 %
Commitments to originate and purchase/participate in loans	$137,641	$137,641	$—	$—	$—
Rate	3.70 %	3.70 %	— %	— %	— %
Commitments to fund unused home equity lines of credit and unadvanced commercial loans	$260,393	$260,393	$—	$—	$—
Rate	4.50 %	4.50 %	— %	— %	— %
Unadvanced portion of construction loans	$52,001	$52,001	$—	$—	$—
Rate	3.67 %	3.67 %	— %	— %	— %

Excluded from the table above are immaterial amounts of income tax liabilities related to uncertain income tax positions. The amounts are excluded as management is unable to estimate the period of cash settlement as it is contingent on the statute of limitations expiring without examination by the respective taxing authority.

A percentage of commitments to originate and purchase/participate in loans are expected to expire unfunded; therefore, the amounts reflected in the table above are not necessarily indicative of future liquidity requirements. Additionally, the Bank is not obligated to honor commitments to fund unused home equity lines of credit if a customer is delinquent or otherwise in violation of the loan agreement.

We anticipate we will continue to have sufficient funds, through repayments and maturities of loans and securities, deposits and borrowings, to meet our current commitments.

We had no material off-balance sheet arrangements as of September 30, 2014.

Contingencies

In the normal course of business, the Company and its subsidiary are named defendants in various lawsuits and counter claims. In the opinion of management, after consultation with legal counsel, none of the currently pending suits are expected to have a materially adverse effect on the Company's consolidated financial statements for the year ended September 30, 2014, or future periods.

Capital

Consistent with our goal to operate a sound and profitable financial organization, we actively seek to maintain a "well-capitalized" status for the Bank in accordance with regulatory standards. As of September 30, 2014, the Bank exceeded all regulatory capital requirements. The Company currently does not have any regulatory capital requirements. The following table presents the Bank's regulatory capital ratios at September 30, 2014 based upon regulatory guidelines.

	Bank Ratios	Regulatory Requirement For "Well-Capitalized" Status
Tier 1 leverage ratio	13.2 %	5.0 %
Tier 1 risk-based capital	33.0	6.0
Total risk-based capital	33.2	10.0

A reconciliation of the Bank's equity under GAAP to regulatory capital amounts as of September 30, 2014 is as follows (dollars in thousands):

Total Bank equity as reported under GAAP	$ 1,306,351
Unrealized gains on AFS securities	(6,986)
Total Tier 1 capital	1,299,365
ACL	9,227
Total risk-based capital	$ 1,308,592

75

Item 7A. Quantitative and Qualitative Disclosure about Market Risk
Asset and Liability Management and Market Risk

The risk associated with changes in interest rates on the earnings of the Bank and the market value of its financial assets and liabilities is known as interest rate risk. Interest rate risk is our most significant market risk, and our ability to adapt to changes in interest rates is known as interest rate risk management. The rates of interest the Bank earns on its assets and pays on its liabilities are generally established contractually for a period of time. Fluctuations in interest rates have a significant impact not only upon our net income, but also upon the cash flows and market values of our assets and liabilities. Our results of operations, like those of other financial institutions, are impacted by changes in interest rates and the interest rate sensitivity of our interest-earning assets and interest-bearing liabilities. The analysis presented in the tables within this section reflect the level of market risk at the Bank.

The general objective of our interest rate risk management program is to determine and manage an appropriate level of interest rate risk while maximizing net interest income in a manner consistent with our policy to reduce, to the extent practicable, the exposure of net interest income to changes in market interest rates. The ALCO regularly reviews the interest rate risk exposure of the Bank by forecasting the impact of hypothetical, alternative interest rate environments on net interest income and the market value of portfolio equity ("MVPE") at various dates. The MVPE is defined as the net of the present value of cash flows from existing assets, liabilities, and off-balance sheet instruments. The present values are determined based upon market conditions as of the date of the analysis, as well as in alternative interest rate environments providing potential changes in the MVPE under those alternative interest rate environments. Net interest income is projected in the same alternative interest rate environments with both a static balance sheet and with management strategies considered. The MVPE and net interest income analysis are also conducted to estimate our sensitivity to rates for future time horizons based upon market conditions as of the date of the analysis. In addition to the interest rate environments presented below, management also reviews the impact of non-parallel rate shock scenarios on a quarterly basis. These scenarios consist of flattening and steepening the yield curve by changing short-term and long-term interest rates independent of each other, and simulating cash flows and determining valuations as a result of these hypothetical changes in interest rates to identify rate environments that pose the greatest risk to the Bank. This analysis helps management quantify the Bank's exposure to changes in the shape of the yield curve.

Based upon management's recommendations, the Board of Directors sets the asset and liability management policies of the Bank. These policies are implemented by ALCO. The purpose of ALCO is to communicate, coordinate, and control asset and liability management consistent with board-approved policies. ALCO's objectives are to manage assets and funding sources to produce the highest profitability balanced against liquidity, capital adequacy, and risk management objectives. At each monthly meeting, ALCO recommends appropriate strategy changes, if necessary. The Chief Financial Officer, or his designee, is responsible for executing, reviewing, and reporting on the results of the policy recommendations and strategies to the Board of Directors, generally on a monthly basis.

The ability to maximize net interest income is dependent largely upon the achievement of a positive interest rate spread that can be sustained despite fluctuations in prevailing interest rates. The asset and liability repricing gap is a measure of the difference between the amount of interest-earning assets and interest-bearing liabilities which either reprice or mature within a given period of time. The difference provides an indication of the extent to which an institution's interest rate spread will be affected by changes in interest rates. A gap is considered positive when the amount of interest-earning assets exceeds the amount of interest-bearing liabilities maturing or repricing during the same period. A gap is considered negative when the amount of interest-bearing liabilities exceeds the amount of interest-earning assets maturing or repricing during the same period. Generally, during a period of rising interest rates, a negative gap within shorter repricing periods adversely affects net interest income, while a positive gap within shorter repricing periods positively affects net interest income. During a period of falling interest rates, the opposite would generally be true.

At September 30, 2014, the Bank's one-year gap between interest-earning assets and interest-bearing liabilities was negative $(81.2) million, or (0.8)% of total assets. Interest-bearing liabilities repricing to higher rates at a faster pace than interest-earning assets will generally result in net interest margin compression. The majority of the Bank's interest-bearing liabilities (borrowings and certificate of deposit portfolios) are contractual and generally cannot be terminated early without penalty; therefore, the amount expected to reprice in a given period is not usually impacted by changes in market interest rates. The majority of interest-earning assets anticipated to reprice in fiscal year 2015 are mortgages and MBS, both of which have characteristics that change projected cash flows as interest rates change. As interest rates rise, the amount of interest-earning

76

assets expected to reprice will likely decrease from estimated levels as borrowers and agency debt issuers will have less economic incentive to modify their cost of borrowings. This would likely result in a decrease in the Bank's net interest margin due to the interest-bearing liabilities repricing to higher interest rates faster than the interest-earning assets. If rates were to increase 200 basis points, as of September 30, 2014, the Bank's one-year gap is projected to be negative $(472.8) million, or (4.8)% of total assets.

Management recognizes that dramatic changes in interest rates within a short period of time can cause an increase in our interest rate risk. At times, ALCO may recommend increasing our interest rate risk exposure in an effort to increase our net interest margin, while maintaining compliance with established board limits for interest rate risk sensitivity. Management believes that maintaining and improving earnings is the best way to preserve a strong capital position. Management recognizes the need, in certain interest rate environments, to limit the Bank's exposure to changing interest rates and may implement strategies to reduce our interest rate risk which could, as a result, reduce earnings in the short-term. To minimize the potential for adverse effects of material and prolonged changes in interest rates on our results of operations, we have adopted asset and liability management policies to better balance the maturities and repricing terms of our interest-earning assets and interest-bearing liabilities based on existing local and national interest rates.

During periods of economic uncertainty, rising interest rates, or extreme competition for loans, the Bank's ability to originate or purchase loans may be adversely affected. In such situations, the Bank alternatively may invest its funds in investment securities or MBS. These investments may have rates of interest lower than rates we could receive on loans, if we were able to originate or purchase them, potentially reducing the Bank's interest income.

As mentioned above, the shape of the yield curve also has an impact on our net interest income and, therefore, the Bank's net interest margin. Historically, the Bank has benefited from a steeper yield curve as the Bank's mortgage loans are generally priced off of long-term rates while deposits are priced off of short-term rates. A steeper yield curve (one with a greater difference between short-term rates and long-term rates) allows the Bank to receive a higher rate of interest on its mortgage-related assets relative to the rate paid for the funding of those assets, which generally results in a higher net interest margin. As the yield curve flattens, the spread between rates received on assets and paid on liabilities becomes compressed, which generally leads to a decrease in net interest margin.

General assumptions used by management to evaluate the sensitivity of our financial performance to changes in interest rates presented in the tables below are utilized in, and set forth under, the gap table and related notes. Although management finds these assumptions reasonable given the constraints described above, the interest rate sensitivity of our assets and liabilities and the estimated effects of changes in interest rates on our net interest income and MVPE indicated in the below tables could vary substantially if different assumptions were used or actual experience differs from these assumptions. To illustrate this point, the projected cumulative excess (deficiency) of interest-earning assets over interest-bearing liabilities within the next 12 months as a percent of total assets ("one-year gap") is also provided for an up 200 basis point scenario, as of September 30, 2014.

Qualitative Disclosure about Market Risk

Percentage Change in Net Interest Income. The Bank's net interest income projections are a reflection of the response to interest rates of the assets and liabilities that are expected to mature or reprice over the next year. Repricing can occur as a result of variable interest rate characteristics of the Bank's assets or liabilities as a result of cash flows that are received or paid on assets or due on liabilities which would be replaced at then current market interest rates. The Bank's borrowings and certificate of deposit portfolios have stated maturities and the cash flows related to the Bank's liabilities do not generally fluctuate as a result of changes in interest rates. Cash flows from mortgage-related assets and callable agency debentures can vary significantly as a result of changes in interest rates. As interest rates decrease, borrowers have an economic incentive to lower their cost of debt by refinancing or endorsing their mortgage to a lower interest rate. Similarly, agency debt issuers are more likely to exercise embedded call options for agency

securities and issue new securities at a lower interest rate.

For each period presented in the following table, the estimated percentage change in the Bank's net interest income based on the indicated instantaneous, parallel and permanent change in interest rates is presented. The percentage change in each interest rate environment represents the difference between estimated net interest income in the 0 basis point interest rate environment ("base case," assumes the forward market and product interest rates implied by the yield curve are realized) and the estimated net interest income in each alternative interest rate environment (assumes market and product interest rates have a parallel shift in rates across all maturities by the indicated change in rates). Estimations of net interest income used in preparing the table below were based upon the assumptions that the total composition of interest-earning assets and interest-bearing liabilities do not change materially and that any repricing of assets or liabilities occurs at anticipated product and market rates for the alternative rate environments as of the dates presented. The estimation of net interest income does not include any projected gains or losses related to the sale of loans or securities, or income derived from non-interest income sources, but does include the use of different prepayment assumptions in the alternative interest rate environments. It is important to consider that estimated changes in net interest income are for a cumulative four-quarter period. These do not reflect the earnings expectations of management.

Change (in Basis Points) in Interest Rates[(1)]	Percentage Change in Net Interest Income At September 30,			
	2014		2013	
-100 bp	N/A		N/A	
000 bp	—		—	
+100 bp	(2.32	)%	(2.29	)%
+200 bp	(5.54	)	(4.76	)
+300 bp	(9.67	)	(7.89	)

(1) Assumes an instantaneous, permanent, and parallel change in interest rates at all maturities.

The projected percentage change in net interest income was more adversely impacted by higher interest rates at September 30, 2014 than at September 30, 2013. This was largely driven by a change from a positive gap position in the base case rate scenario at September 30, 2013 to a negative gap position at September 30, 2014. Due to the change in gap position, it is expected that liabilities will reprice higher and at a faster pace in a rising interest rate scenario at September 30, 2014 as compared to September 30, 2013. The change to a negative gap position at September 30, 2014 was caused by a decrease in the amount of anticipated cash flows from the investment securities portfolio in the 12-month horizon, compared to September 30, 2013, due to a decrease in the overall balance of the investment securities portfolio, as well as to an increase in interest rates in the front-to-middle part of the yield curve compared to the previous year. Interest rates in the 2- to 5-year points of the yield curve have a greater impact on the Bank's investment securities portfolio, compared to the Bank's mortgage loan portfolio, because of the short-term nature of these assets. Cash flow projections from the mortgage loan portfolio are impacted to a greater degree by longer-term interest rates, which decreased year-over-year. Since the interest rates in the front-to-middle part of the yield curve were higher, prepayment expectations on the Bank's shorter-term MBS and call projections on the Bank's callable agency debentures decreased, which reduced the projected cash flows from these assets. This was somewhat offset by lower mortgage interest rates, which increased the projected cash flows on mortgage loans, particularly the Bank's 30-year mortgage loans. Additionally, the amount of liabilities expected to reprice over the 12-month horizon at September 30, 2014 increased from the projections at September 30, 2013 due primarily to an increase in the contractual maturities of certificates of deposit and term borrowings. See the Gap Table below for additional information.

Percentage Change in MVPE. Changes in the estimated market values of our financial assets and liabilities drive changes in estimates of MVPE. The market value of an asset or liability reflects the present value of all the projected cash flows over its remaining life, discounted at current market interest rates. As interest rates rise, generally the market value for both financial assets and liabilities decrease. The opposite is generally true as interest rates fall. The

MVPE represents the theoretical market value of capital that is calculated by netting the market value of assets, liabilities, and off-balance sheet instruments. If the market values of financial assets increase at a faster pace than the market values of financial liabilities, or if the market values of financial liabilities decrease at a faster pace than the market values of financial assets, the MVPE will increase. The magnitude of the changes in the Bank's MVPE represents the Bank's interest rate risk. The market value of shorter term-to-maturity financial instruments is less sensitive to changes in interest rates than are longer term-to-maturity financial instruments. Because of this, the market values of our certificates of deposit (which generally have relatively shorter average lives) tend to display less sensitivity to changes in interest rates than do our mortgage-related assets (which

generally have relatively longer average lives). The average life expected on our mortgage-related assets varies under different interest rate environments because borrowers have the ability to prepay their mortgage loans. Therefore, as interest rates decrease, the WAL of mortgage-related assets decrease as well. As interest rates increase, the WAL would be expected to increase, as well as increasing the sensitivity of these assets in higher rate environments.

The following table sets forth the estimated percentage change in the MVPE for each period presented based on the indicated instantaneous, parallel and permanent change in interest rates. The percentage change in each interest rate environment represents the difference between the MVPE in the base case (assumes the forward market interest rates implied by the yield curve are realized) and the MVPE in each alternative interest rate environment (assumes market interest rates have a parallel shift in rates). The estimations of the MVPE used in preparing the table below were based upon the assumptions that the total composition of interest-earning assets and interest-bearing liabilities do not change, that any repricing of assets or liabilities occurs at current product or market rates for the alternative rate environments as of the dates presented, and that different prepayment rates were used in each alternative interest rate environment. The estimated MVPE results from the valuation of cash flows from financial assets and liabilities over the anticipated lives of each for each interest rate environment. The table below presents the effects of the changes in interest rates on our assets and liabilities as they mature, repay, or reprice, as shown by the change in the MVPE for alternative interest rates.

Change	Percentage Change in MVPE			
(in Basis Points)	At September 30,			
in Interest Rates[1]	2014		2013	
-100 bp	N/A		N/A	
000 bp	—		—	
+100 bp	(9.51	)%	(11.44	)%
+200 bp	(21.00	)	(23.86	)
+300 bp	(32.96	)	(36.36	)

(1) Assumes an instantaneous, permanent, and parallel change in interest rates at all maturities.

The percentage change in the Bank's MVPE was adversely impacted by rising interest rates at both September 30, 2013 and September 30, 2014. This was due primarily to the Bank's mortgage-related assets and callable investment securities. Prepayments on mortgage-related assets in the higher interest rate environments will likely only be realized through changes in borrowers' lives such as divorce, death, job-related relocations, or other life changing events, resulting in an increase in the average life of mortgage-related assets. Similarly, call projections for the Bank's callable agency debentures decrease as interest rates rise, which results in their cash flows moving towards their contractual maturity dates. The longer expected average lives of these assets, relative to the assumptions in the base case interest rate environment, increased the sensitivity of their market value to changes in interest rates. As a result, the market value of the Bank's financial assets decreased more than the decrease in the market value of its financial liabilities, resulting in a decrease in the MVPE in all interest rate environments. However, the percentage change in the Bank's MVPE at September 30, 2014 was less adversely impacted by higher interest rates than at September 30, 2013 due primarily to lower long-term interest rates, particularly lower mortgage interest rates, at September 30, 2014 than at September 30, 2013. The decrease in long-term interest rates primarily occurred at the end of fiscal year 2014; therefore, most of the loans originated and purchased during the current fiscal year were at rates higher than the rates at the September 30, 2014. Since interest rates were lower at September 30, 2014, projected prepayments increased because borrowers had more of an economic incentive to refinance or endorse their mortgages to a lower interest rate. This results in shorter WALs and, thus, less sensitivity to rising interest rates, compared to September 30, 2013.

Gap Table. The gap table summarizes the anticipated maturities or repricing periods of the Bank's interest-earning assets and interest-bearing liabilities as of September 30, 2014, based on the information and assumptions set forth in the notes below.

	Within Three Months	Three to Twelve Months	More Than One Year to Three Years	More Than Three Years to Five Years	Over Five Years	Total
Interest-earning assets:	(Dollars in thousands)					
Loans receivable:[1]						
Mortgage loans:						
Fixed-rate	$246,680	$643,061	$1,141,939	$748,644	$2,130,738	$4,911,062
Adjustable-rate	93,444	640,765	332,256	112,151	49,187	1,227,803
Other loans	114,403	11,123	5,251	2,149	1,609	134,535
Investment securities[2]	8,258	4,861	113,062	436,735	33,262	596,178
MBS[3]	176,462	498,419	495,276	280,585	335,337	1,786,079
Other interest-earning assets	797,385	—	—	—	—	797,385
Total interest-earning assets	1,436,632	1,798,229	2,087,784	1,580,264	2,550,133	9,453,042
Interest-bearing liabilities:						
Deposits:						
Checking[4]	130,694	47,680	109,609	82,434	320,587	691,004
Savings[4]	71,380	14,981	34,542	26,791	148,493	296,187
Money market[4]	161,836	197,247	272,109	158,730	485,533	1,275,455
Certificates	382,794	889,474	923,249	336,320	329	2,532,166
Borrowings[5]	1,050,000	370,000	1,075,000	500,000	646,140	3,641,140
Total interest-bearing liabilities	1,796,704	1,519,382	2,414,509	1,104,275	1,601,082	8,435,952
Excess (deficiency) of interest-earning assets over interest-bearing liabilities	$(360,072)	$278,847	$(326,725)	$475,989	$949,051	$1,017,090
Cumulative excess (deficiency) of interest-earning assets over interest-bearing liabilities	$(360,072)	$(81,225)	$(407,950)	$68,039	$1,017,090	
Cumulative excess (deficiency) of interest-earning assets over interest-bearing liabilities as a percent of total Bank assets at September 30, 2014	(3.65)%	(0.82)%	(4.14)%	0.69%	10.31%	
Cumulative one-year gap - interest rates +200 bp at September 30, 2014		(4.79)				
Cumulative one-year gap at September 30, 2013		4.04				
Cumulative one-year gap at September 30, 2012		22.82				

80

---

(1) ARM loans are included in the period in which the rate is next scheduled to adjust or in the period in which repayments are expected to occur, or prepayments are expected to be received, prior to their next rate adjustment, rather than in the period in which the loans are due. Fixed-rate loans are included in the periods in which they are scheduled to be repaid, based on scheduled amortization and prepayment assumptions. Balances are net of deferred fees and exclude loans 90 or more days delinquent or in foreclosure.

(2) Based on contractual maturities, term to call dates or pre-refunding dates as of September 30, 2014, at amortized cost.

(3) Reflects projected prepayments of MBS, at amortized cost.

(4) Although the Bank's checking, savings, and money market accounts are subject to immediate withdrawal, management considers a substantial amount of these accounts to be core deposits having significantly longer effective maturities. The decay rates (the assumed rates at which the balances of existing accounts decline) used on these accounts is based on assumptions developed from our actual experiences with these accounts. If all of the Bank's checking, savings, and money market accounts had been assumed to be subject to repricing within one year, interest-bearing liabilities which were estimated to mature or reprice within one year would have exceeded interest-earning assets with comparable characteristics by $1.72 billion, for a cumulative one-year gap of (17.4)% of total assets.

(5) Borrowings exclude deferred prepayment penalty costs and deferred gains on terminated interest rate swap agreements.

The decrease in the one-year gap from 4.04% at September 30, 2013, to negative (0.82)% at September 30, 2014, was largely driven by the decrease in the amount of cash flows from the investment securities portfolio expected to reprice in the next 12 months due to a decrease in the overall balance of the investment securities portfolio, as well as to an increase in interest rates in the front-to-middle part of the yield curve compared to September 30, 2013. Additionally, the amount of liabilities expected to reprice over the 12-month horizon at September 30, 2014 increased from the projections at September 30, 2013 due primarily to an increase in the contractual maturities of certificates of deposit and borrowings. See additional information regarding the change in the gap position year-over-year in "Percentage Change in Net Interest Income."

If interest rates were to increase 200 basis points at September 30, 2014, the Bank's one-year gap would become more negative. The +200 basis point gap in this scenario would be negative (4.79)% of total assets at September 30, 2014. This indicates that the projected cash flows from the Bank's mortgage-related assets and callable investment securities would decrease over the next 12 months, if interest rates were to increase 200 basis points, as a result of the diminished economic incentive to prepay mortgages or exercise embedded call options for the debtor.

The following table presents the weighted average yields/rates and WALs (in years), after applying prepayment, call assumptions, and decay rates for our interest-earning assets and interest-bearing liabilities as of the date presented. Yields presented for interest-earning assets include the amortization of fees, costs, premiums and discounts which are considered adjustments to the yield. The interest rate presented for term borrowings is the effective rate, which includes the net impact of the amortization of deferred prepayment penalties resulting from the prepayment of certain FHLB advances and deferred gains related to interest rate swaps previously terminated. The loan terms presented for one- to four-family loans represent the contractual terms of the loan.

	September 30, 2014				
	Amount	Yield/Rate	WAL	% of Category	% of Total
	(Dollars in thousands)				
Investment securities	$590,942	1.15 %	3.0	24.7 %	6.1 %
MBS - fixed	1,287,051	2.35	3.7	53.8	13.3
MBS - adjustable	515,496	2.24	5.4	21.5	5.3
Total investment securities and MBS	2,393,489	2.03	3.9	100.0 %	24.7
Loans receivable:					
Fixed-rate one- to four-family:					
<= 15 years	1,151,351	3.43	4.1	18.3 %	11.9
> 15 years	3,639,596	4.13	6.3	57.9	37.4
All other fixed-rate loans	151,164	4.66	3.7	2.4	1.6
Total fixed-rate loans	4,942,111	3.98	5.7	78.6	50.9
Adjustable-rate one- to four-family:					
<= 36 months	369,579	2.15	3.9	5.9	3.8
> 36 months	811,505	2.92	3.2	12.9	8.4
All other adjustable-rate loans	166,324	4.32	1.3	2.6	1.7
Total adjustable-rate loans	1,347,408	2.88	3.2	21.4	13.9
Total loans receivable	6,289,519	3.75	5.1	100.0 %	64.8
FHLB stock	213,054	5.99	2.0		2.2
Cash and cash equivalents	810,840	0.25	—		8.3
Total interest-earning assets	$9,706,902	3.08	4.3		100.0 %
Transaction deposits	$2,123,106	0.16	6.8	45.6 %	25.7 %
Certificates of deposit	2,532,166	1.15	1.4	54.4	30.7
Total deposits	4,655,272	0.70	3.9	100.0 %	56.4
Term borrowings	2,795,000	2.45	2.8	77.7 %	33.9
FHLB line of credit	800,000	0.24	—	22.3	9.7
Total borrowings	3,595,000	1.96	2.2	100.0 %	43.6
Total interest-bearing liabilities	$8,250,272	1.24	3.1		100.0 %

Item 8. Financial Statements and Supplementary Data

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Stockholders of
Capitol Federal Financial, Inc. and subsidiary
Topeka, Kansas

We have audited the internal control over financial reporting of Capitol Federal Financial, Inc. and subsidiary (the "Company") as of September 30, 2014, based on criteria established in Internal Control - Integrated Framework (1992) issued by the Committee of Sponsoring Organizations of the Treadway Commission. The Company's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying Management's Report on Internal Control over Financial Reporting. Our responsibility is to express an opinion on the Company's internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, testing and evaluating the design and operating effectiveness of internal control based on the assessed risk, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company's internal control over financial reporting is a process designed by, or under the supervision of, the company's principal executive and principal financial officers, or persons performing similar functions, and effected by the company's Board of Directors, management, and other personnel to provide reasonable assurance regarding the reliability of financial reporting and the preparation of consolidated financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of consolidated financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the consolidated financial statements.

Because of the inherent limitations of internal control over financial reporting, including the possibility of collusion or improper management override of controls, material misstatements due to error or fraud may not be prevented or detected on a timely basis. Also, projections of any evaluation of the effectiveness of the internal control over financial reporting to future periods are subject to the risk that the controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of September 30, 2014, based on the criteria established in Internal Control - Integrated Framework (1992) issued by the Committee of Sponsoring Organizations of the Treadway Commission.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated financial statements as of and for the year ended September 30, 2014 of the Company and our report dated November 26, 2014 expressed an unqualified opinion on those consolidated financial statements.
Kansas City, Missouri
November 26, 2014

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Stockholders of
Capitol Federal Financial, Inc. and subsidiary
Topeka, Kansas

We have audited the accompanying consolidated balance sheets of Capitol Federal Financial, Inc. and subsidiary (the "Company") as of September 30, 2014 and 2013, and the related consolidated statements of income, comprehensive income, stockholders' equity, and cash flows for each of the three years in the period ended September 30, 2014. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall consolidated financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, such consolidated financial statements present fairly, in all material respects, the financial position of Capitol Federal Financial, Inc. and subsidiary as of September 30, 2014 and 2013, and the results of its operations and its cash flows for each of the three years in the period ended September 30, 2014, in conformity with accounting principles generally accepted in the United States of America.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the Company's internal control over financial reporting as of September 30, 2014, based on the criteria established in Internal Control - Integrated Framework (1992) issued by the Committee of Sponsoring Organizations of the Treadway Commission, and our report dated November 26, 2014 expressed an unqualified opinion on the Company's internal control over financial reporting.
Kansas City, Missouri
November 26, 2014

CAPITOL FEDERAL FINANCIAL, INC. AND SUBSIDIARY
CONSOLIDATED BALANCE SHEETS
SEPTEMBER 30, 2014 and 2013 (Dollars in thousands, except per share amounts)

	2014	2013
ASSETS:		
Cash and cash equivalents (includes interest-earning deposits of $799,340 and $99,735)	$ 810,840	$ 113,886
Securities:		
Available-for-sale ("AFS"), at estimated fair value (amortized cost of $829,558 and $1,058,283)	840,790	1,069,967
Held-to-maturity ("HTM"), at amortized cost (estimated fair value of $1,571,524 and $1,741,846)	1,552,699	1,718,023
Loans receivable, net (allowance for credit losses ("ACL") of $9,227 and $8,822)	6,233,170	5,958,868
Federal Home Loan Bank Topeka ("FHLB") stock, at cost	213,054	128,530
Premises and equipment, net	70,530	70,112
Other assets	143,945	127,063
TOTAL ASSETS	$ 9,865,028	$ 9,186,449
LIABILITIES:		
Deposits	$ 4,655,272	$ 4,611,446
FHLB borrowings	3,369,677	2,513,538
Repurchase agreements	220,000	320,000
Advance payments by borrowers for taxes and insurance	58,105	57,392
Income taxes payable	368	108
Deferred income tax liabilities, net	22,367	20,437
Accounts payable and accrued expenses	46,357	31,402
Total liabilities	8,372,146	7,554,323
STOCKHOLDERS' EQUITY:		
Preferred stock, $.01 par value; 100,000,000 shares authorized, no shares issued or outstanding	—	—
Common stock, $.01 par value; 1,400,000,000 shares authorized, 140,951,203 and 147,840,268 shares issued and outstanding as of September 30, 2014 and 2013, respectively	1,410	1,478
Additional paid-in capital	1,180,732	1,235,781
Unearned compensation, Employee Stock Ownership Plan ("ESOP")	(42,951)	(44,603)
Retained earnings	346,705	432,203
Accumulated other comprehensive income ("AOCI"), net of tax	6,986	7,267
Total stockholders' equity	1,492,882	1,632,126
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	$ 9,865,028	$ 9,186,449

See notes to consolidated financial statements

CAPITOL FEDERAL FINANCIAL, INC. AND SUBSIDIARY
CONSOLIDATED STATEMENTS OF INCOME
YEARS ENDED SEPTEMBER 30, 2014, 2013, and 2012 (Dollars in thousands, except per share amounts)

	2014	2013	2012
INTEREST AND DIVIDEND INCOME:			
Loans receivable	$229,944	$228,455	$236,225
Mortgage-backed securities ("MBS")	45,300	55,424	71,156
Investment securities	7,385	10,012	15,944
FHLB stock	6,555	4,515	4,446
Cash and cash equivalents	1,062	148	280
Total interest and dividend income	290,246	298,554	328,051
INTEREST EXPENSE:			
FHLB borrowings	63,217	70,816	82,044
Deposits	32,604	36,816	46,170
Repurchase agreements	10,282	12,762	14,956
Total interest expense	106,103	120,394	143,170
NET INTEREST INCOME	184,143	178,160	184,881
PROVISION FOR CREDIT LOSSES	1,409	(1,067)	2,040
NET INTEREST INCOME AFTER PROVISION FOR CREDIT LOSSES	182,734	179,227	182,841
NON-INTEREST INCOME:			
Retail fees and charges	14,937	15,342	15,915
Insurance commissions	3,151	2,925	2,772
Loan fees	1,568	1,727	2,113
Income from bank-owned life insurance ("BOLI")	1,993	1,483	1,478
Other non-interest income	1,306	1,812	1,955
Total non-interest income	22,955	23,289	24,233
NON-INTEREST EXPENSE:			
Salaries and employee benefits	43,757	49,152	44,235
Occupancy	10,268	9,871	8,751
Information technology and communications	9,429	8,855	7,583
Regulatory and outside services	5,572	5,874	5,291
Deposit and loan transaction costs	5,329	5,547	5,381
Federal insurance premium	4,536	4,462	4,444
Advertising and promotional	4,195	5,027	3,931
Other non-interest expense	7,451	8,159	11,459
Total non-interest expense	90,537	96,947	91,075
INCOME BEFORE INCOME TAX EXPENSE	115,152	105,569	115,999
INCOME TAX EXPENSE	37,458	36,229	41,486
NET INCOME	$77,694	$69,340	$74,513
Basic earnings per share	$0.56	$0.48	$0.47
Diluted earnings per share	$0.56	$0.48	$0.47
Dividends declared per share	$0.98	$1.00	$0.40

See notes to consolidated financial statements

CAPITOL FEDERAL FINANCIAL, INC. AND SUBSIDIARY
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
YEARS ENDED SEPTEMBER 30, 2014, 2013, and 2012 (Dollars in thousands)

	2014	2013	2012
Net income	$77,694	$69,340	$74,513
Other comprehensive income (loss), net of tax:			
Changes in unrealized holding losses on AFS securities, net of deferred income taxes of $171, $10,295, and $1,491 for the years ended September 30, 2014, 2013, and 2012, respectively	(281)	(16,940)	(2,500)
Comprehensive income	$77,413	$52,400	$72,013

88

CAPITOL FEDERAL FINANCIAL, INC. AND SUBSIDIARY
CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY
YEARS ENDED SEPTEMBER 30, 2014, 2013, and 2012 (Dollars in thousands, except per share amounts)

	Common Stock	Additional Paid-In Capital	Unearned Compensation ESOP	Retained Earnings	AOCI	Total Stockholders' Equity
Balance at October 1, 2011	$1,675	$1,392,567	$(50,547)	$569,127	$26,707	$1,939,529
Net income, fiscal year 2012				74,513		74,513
Other comprehensive loss, net of tax					(2,500)	(2,500)
ESOP activity, net		3,434	2,972			6,406
Restricted stock activity, net	5	(5)				—
Stock-based compensation		1,196				1,196
Repurchase of common stock	(126)	(105,131)		(43,722)		(148,979)
Stock options exercised		61				61
Dividends on common stock to stockholders ($0.40 per share)				(63,768)		(63,768)
Balance at September 30, 2012	1,554	1,292,122	(47,575)	536,150	24,207	1,806,458
Net income, fiscal year 2013				69,340		69,340
Other comprehensive loss, net of tax					(16,940)	(16,940)
ESOP activity, net		3,678	2,972			6,650
Restricted stock activity, net		172				172
Stock-based compensation		2,633				2,633
Repurchase of common stock	(76)	(62,836)		(26,463)		(89,375)
Stock options exercised		12				12
Dividends on common stock to stockholders ($1.00 per share)				(146,824)		(146,824)
Balance at September 30, 2013	1,478	1,235,781	(44,603)	432,203	7,267	1,632,126
Net income, fiscal year 2014				77,694		77,694
Other comprehensive loss, net of tax					(281)	(281)
ESOP activity, net		362	1,652			2,014
Restricted stock activity, net		127				127
Stock-based compensation		2,134				2,134
Repurchase of common stock	(69)	(58,129)		(25,020)		(83,218)
Stock options exercised	1	457				458
Dividends on common stock to stockholders ($0.98 per share)				(138,172)		(138,172)
Balance at September 30, 2014	$1,410	$1,180,732	$(42,951)	$346,705	$6,986	$1,492,882

See notes to consolidated financial statements

CAPITOL FEDERAL FINANCIAL, INC. AND SUBSIDIARY
CONSOLIDATED STATEMENTS OF CASH FLOWS
YEARS ENDED SEPTEMBER 30, 2014, 2013, and 2012 (Dollars in thousands)

	2014	2013	2012
CASH FLOWS FROM OPERATING ACTIVITIES:			
Net income	$77,694	$69,340	$74,513
Adjustments to reconcile net income to net cash provided by operating activities:			
FHLB stock dividends	(6,555)	(4,515)	(4,446)
Provision for credit losses	1,409	(1,067)	2,040
Originations of loans receivable held-for-sale ("LHFS")	(1,325)	(7,098)	(6,008)
Proceeds from sales of LHFS	1,998	7,156	6,524
Amortization and accretion of premiums and discounts on securities	6,053	8,445	8,662
Depreciation and amortization of premises and equipment	6,316	5,447	4,951
Amortization of deferred amounts related to FHLB advances, net	6,139	8,216	8,797
Common stock committed to be released for allocation - ESOP	2,014	6,650	6,406
Stock-based compensation	2,134	2,633	1,196
Provision for deferred income taxes	2,106	5,696	6,089
Changes in:			
Prepaid federal insurance premium	—	11,802	3,927
Other assets, net	1,606	(936)	5,717
Income taxes payable/receivable	382	(644)	(1,398)
Accounts payable and accrued expenses	(8,184)	(9,403)	(10,732)
Net cash provided by operating activities	91,787	101,722	106,238
CASH FLOWS FROM INVESTING ACTIVITIES:			
Purchase of AFS securities	(120,817)	(408,497)	(688,520)
Purchase of HTM securities	(168,830)	(442,747)	(560,024)
Proceeds from calls, maturities and principal reductions of AFS securities	349,210	717,545	761,535
Proceeds from calls, maturities and principal reductions of HTM securities	328,433	604,820	1,036,121
Proceeds from the redemption of FHLB stock	22,387	11,347	4,048
Purchases of FHLB stock	(100,356)	(2,391)	(5,696)
Net increase in loans receivable	(280,105)	(355,694)	(471,144)
Purchases of premises and equipment	(7,227)	(18,769)	(12,617)
Proceeds from sales of other real estate owned ("OREO")	4,875	10,677	13,145
Proceeds from BOLI death benefit	405	—	—
Net cash provided by investing activities	27,975	116,291	76,848

(Continued)

CAPITOL FEDERAL FINANCIAL, INC. AND SUBSIDIARY
CONSOLIDATED STATEMENTS OF CASH FLOWS
YEARS ENDED SEPTEMBER 30, 2014, 2013, and 2012 (Dollars in thousands)

	2014	2013	2012
CASH FLOWS FROM FINANCING ACTIVITIES:			
Dividends paid	(138,172)	(146,824)	(63,768)
Deposits, net of withdrawals	43,826	60,803	55,470
Proceeds from borrowings	2,944,577	1,003,115	957,768
Repayments on borrowings	(2,194,577)	(1,073,115)	(957,768)
Deferred FHLB prepayment penalty	—	—	(7,937)
Change in advance payments by borrowers for taxes and insurance	713	1,750	504
Repurchase of common stock	(79,633)	(91,573)	(146,781)
Stock options exercised	458	12	36
Excess tax benefits from stock options	—	—	25
Net cash provided by (used in) financing activities	577,192	(245,832)	(162,451)
NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	696,954	(27,819)	20,635
CASH AND CASH EQUIVALENTS:			
Beginning of year	113,886	141,705	121,070
End of year	$ 810,840	$ 113,886	$ 141,705
SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION:			
Income tax payments	$ 34,969	$ 31,175	$ 36,791
Interest payments	$ 100,581	$ 112,950	$ 135,444
SUPPLEMENTAL DISCLOSURE OF NONCASH INVESTING AND FINANCING ACTIVITIES:			
Loans transferred to OREO	$ 4,694	$ 6,705	$ 11,296

See notes to consolidated financial statements (Concluded)

CAPITOL FEDERAL FINANCIAL, INC. AND SUBSIDIARY
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
YEARS ENDED SEPTEMBER 30, 2014, 2013, and 2012

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES
Description of Business - Capitol Federal Financial, Inc. (the "Company") provides a full range of retail banking services through its wholly-owned subsidiary, Capitol Federal Savings Bank (the "Bank"), a federal savings bank, which has 37 traditional and 10 in-store banking offices serving primarily the metropolitan areas of Topeka, Wichita, Lawrence, Manhattan, Emporia and Salina, Kansas and portions of the metropolitan area of greater Kansas City. The Bank emphasizes mortgage lending, primarily originating and purchasing one- to four-family mortgage loans, and providing personal retail financial services. The Bank is subject to competition from other financial institutions and other companies that provide financial services.

Basis of Presentation - The consolidated financial statements include the accounts of the Company and its wholly owned subsidiary, the Bank. The Bank has a wholly owned subsidiary, Capitol Funds, Inc. Capitol Funds, Inc. has a wholly owned subsidiary, Capitol Federal Mortgage Reinsurance Company ("CFMRC"). All intercompany accounts and transactions have been eliminated in consolidation. These consolidated financial statements have been prepared in conformity with accounting principles generally accepted in the United States of America ("GAAP"), and require management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting periods.

The Bank has an expense sharing agreement with the Company that covers the reimbursement of certain expenses that are allocable to the Company. These expenses include compensation, rent for leased office space, and general overhead expenses.

The Company, Bank, Capitol Funds, Inc. and CFMRC have a tax allocation agreement. The Bank is the paying agent to the taxing authorities for the group for all periods presented. Each company is liable for taxes as if separate tax returns were filed and reimburses the Bank for its pro rata share of the tax liability. If any entity has a tax benefit, the Bank reimburses the entity for its tax benefit.

Cash and Cash Equivalents - Cash and cash equivalents include cash on hand and amounts due from banks. Regulations of the Board of Governors of the Federal Reserve System ("FRB") require federally chartered savings banks to maintain cash reserves against their transaction accounts. Required reserves must be maintained in the form of vault cash, an account at a Federal Reserve Bank, or a pass-through account as defined by the FRB. The amount of interest-earning deposits held at the Federal Reserve Bank of Kansas City as of September 30, 2014 and 2013 was $797.3 million and $98.7 million, respectively. The Bank is in compliance with the FRB requirements. For the years ended September 30, 2014 and 2013, the average daily balance of required reserves at the Federal Reserve Bank was $9.1 million and $9.0 million, respectively.

Securities - Securities include mortgage-backed and agency securities issued primarily by United States Government-Sponsored Enterprises ("GSE"), including Federal National Mortgage Association, Federal Home Loan Mortgage Corporation and the Federal Home Loan Banks, United States Government agencies, including Government National Mortgage Association, and municipal bonds. Securities are classified as HTM, AFS, or trading based on management's intention for holding the securities on the date of purchase. Generally, classifications are made in response to liquidity needs, asset/liability management strategies, and the market interest rate environment at the time of purchase.

Securities that management has the intent and ability to hold to maturity are classified as HTM and reported at amortized cost. Such securities are adjusted for the amortization of premiums and discounts which are recognized as

adjustments to interest income over the life of the securities using the level-yield method.

Securities that management may sell if necessary for liquidity or asset management purposes are classified as AFS and reported at fair value, with unrealized gains and losses reported as a component of AOCI within stockholders' equity, net of deferred income taxes. The amortization of premiums and discounts are recognized as adjustments to interest income over the life of the securities using the level-yield method. Gains or losses on the disposition of AFS securities are recognized using the specific identification method. The Company primarily uses prices obtained from third party pricing services to

92

determine the fair value of securities. See additional discussion of fair value of AFS securities in "Note 12 – Fair Value of Financial Instruments."

Securities that are purchased and held principally for resale in the near future are classified as trading securities and are reported at fair value, with unrealized gains and losses included in non-interest income in the consolidated statements of income. During the fiscal years ended September 30, 2014 and 2013, neither the Company nor the Bank maintained a trading securities portfolio.

Management monitors the securities portfolio for impairment on an ongoing basis and performs a formal review quarterly. The process involves monitoring market events and other items that could impact issuers. The evaluation includes, but is not limited to, such factors as: the nature of the investment, the length of time the security has had a fair value less than the amortized cost basis, the cause(s) and severity of the loss, expectation of an anticipated recovery period, recent events specific to the issuer or industry including the issuer's financial condition and current ability to make future payments in a timely manner, external credit ratings and recent downgrades in such ratings, management's intent to sell and whether it is more likely than not management would be required to sell prior to recovery for debt securities. Management determines whether other-than-temporary losses should be recognized for impaired securities by assessing all known facts and circumstances surrounding the securities. If management intends to sell an impaired security or if it is more likely than not that management will be required to sell an impaired security before recovery of its amortized cost basis, an other-than-temporary impairment has occurred and the difference between amortized cost and fair value will be recognized as a loss in earnings and the security will be written down to fair value. Such losses would be included in non-interest income in the consolidated statements of income.

Loans Receivable - Loans receivable that management has the intent and ability to hold for the foreseeable future are carried at the amount of unpaid principal, net of ACL, undisbursed loan funds, unamortized premiums and discounts, and deferred loan origination fees and costs. Net loan origination fees and costs, and premiums and discounts are amortized as yield adjustments to interest income using the level-yield method, adjusted for the estimated prepayment speeds of the related loans when applicable. Interest on loans is credited to income as earned and accrued only if deemed collectible.

Troubled debt restructurings ("TDRs") - For borrowers experiencing financial difficulties, the Bank may grant a concession to the borrower. Generally, the Bank grants a short-term payment concession to borrowers who are experiencing a temporary cash flow problem. The most frequently used concession is to reduce the monthly payment amount for a period of 6 to 12 months, often by requiring payments of only interest and escrow during this period, resulting in an extension of the maturity date of the loan. For more severe situations requiring long-term solutions, the Bank also offers interest rate reductions to currently-offered rates and the capitalization of delinquent interest and/or escrow resulting in an extension of the maturity date of the loan. The Bank does not forgive principal or interest nor does it commit to lend additional funds, except for situations generally involving the capitalization of delinquent interest and/or escrow not to exceed the original loan balance, to these borrowers.

Endorsed loans are classified as TDRs when certain guidelines for soft credit scores and/or estimated loan-to-value ("LTV") ratios are not met. These guidelines are intended to identify changes in the borrower's credit condition since origination, signifying the borrower could be experiencing financial difficulties even though the borrower has not been delinquent on his contractual loan payment in the previous 12 months.

The TDRs discussed above will be reported as such until paid-off, unless the loan has been restructured to an interest rate equal to or greater than the rate the Bank was willing to accept at the time of the restructuring for a new loan with comparable risk, and has performed under the new terms of the restructuring agreement for at least 12 consecutive months.

Additionally, loans that have been discharged under Chapter 7 bankruptcy proceedings where the borrower has not reaffirmed the debt owed to the lender ("Chapter 7 loans") are reported as TDRs, regardless of their delinquency status, pursuant to regulatory reporting requirements. These loans will be reported as TDRs until the borrower has made 48 consecutive monthly loan payments after the Chapter 7 discharge date.

Delinquent loans - A loan is considered delinquent when payment has not been received within 30 days of its contractual due date.

Nonaccrual loans - The accrual of income on loans is discontinued when interest or principal payments are 90 days in arrears or for certain TDR loans that are required to be reported as such pursuant to regulatory reporting requirements. Loans on which the accrual of income has been discontinued are designated as nonaccrual and outstanding interest previously credited beyond 90 days delinquent is reversed. A nonaccrual loan is returned to accrual status once the contractual payments have been made to bring the loan less than 90 days past due or, in the case of a TDR loan, the borrower has made the required consecutive loan payments.

Impaired loans - A loan is considered impaired when, based on current information and events, it is probable that the Bank will be unable to collect all amounts due, including principal and interest, according to the contractual terms of the loan agreement. Interest income on impaired loans is recognized in the period collected unless the ultimate collection of principal is considered doubtful. The following types of loans are reported as impaired loans: all nonaccrual loans, loans classified as substandard, loans partially charged-off, Chapter 7 loans, and all TDRs except those that have been restructured to an interest rate equal to or greater than the rate the Bank was willing to accept at the time of the restructuring for a new loan with comparable risk, and has performed under the new terms of the restructuring agreement for at least 12 consecutive months.

The majority of the Bank's impaired loans are related to one- to four-family properties. Impaired loans related to one- to four-family properties are individually evaluated for loss when the loan becomes 180 days delinquent or at any time management has knowledge of the existence of a potential loss to ensure that the carrying value of the loan is not in excess of the fair value of the collateral, less estimated selling costs.

Allowance for Credit Losses - The ACL represents management's best estimate of the amount of inherent losses in the loan portfolio as of the balance sheet date, involves a high degree of complexity, and requires management to make difficult and subjective judgments and assumptions about highly uncertain matters. Management's methodology for assessing the appropriateness of the ACL consists of a formula analysis model, along with analyzing several other factors. The use of different judgments and assumptions could cause reported results to differ significantly. Management maintains the ACL through provisions for credit losses that are either charged to or credited to income.

One- to four-family loans, including home equity loans, are individually evaluated for loss when the loan is generally 180 days delinquent and any losses are charged-off. Losses are based on new collateral values obtained through appraisals, less estimated costs to sell. Anticipated private mortgage insurance proceeds are taken into consideration when calculating the loss amount. An updated appraisal is requested, at a minimum, every 12 months thereafter if the loan is 180 days or more delinquent or in foreclosure. If the Bank holds the first and second mortgage, both loans are combined when evaluating whether there is a potential loss on the loan. For multi-family and commercial loans, losses are charged-off when the collection of such amounts is determined to be unlikely. When a non-real estate secured loan, which includes consumer loans - other, is 120 days delinquent, any identified losses are charged-off. Charge-offs for any loan type may also occur at any time if the Bank has knowledge of the existence of a potential loss. Loans individually evaluated for loss are excluded from the formula analysis model.

The Bank's primary lending emphasis is the origination and purchase of one- to four-family loans and, to a lesser extent, consumer loans secured by one- to four-family residential properties, resulting in a loan concentration in residential mortgage loans. The Bank has a concentration of loans secured by residential property located in Kansas and Missouri. Based on the composition of the Bank's loan portfolio, the primary risk characteristics inherent in the one- to four-family and consumer loan portfolios are a decline in economic conditions, elevated levels of unemployment or underemployment, and declines in residential real estate values. Any one or a combination of these events may adversely affect borrowers' ability to repay their loans, resulting in increased delinquencies, non-performing assets, loan losses, and future loan loss provisions. Although the multi-family and commercial loan portfolio is subject to the same risk of declines in economic conditions, the primary risk characteristics inherent in this portfolio include the ability of the borrower to sustain sufficient cash flows from leases and to control expenses to satisfy their contractual debt payments, and/or the ability to utilize personal and/or business resources to pay their

contractual debt payments if the cash flows are not sufficient. Additionally, if the Bank were to repossess the secured collateral of a multi-family or commercial loan, the pool of potential buyers is typically limited more than that for a residential property. This increases the risk that the Bank could hold the property for an extended period of time and/or potentially be forced to sell at a discounted price, resulting in additional losses.

Each quarter, a formula analysis is prepared which segregates the loan portfolio into categories based on certain risk characteristics. The categories include the following: one- to four-family loans; multi-family and commercial loans; consumer home equity loans; and other consumer loans. Home equity loans with the same underlying collateral as a one- to four-family loan are combined with the one- to four-family loan in the formula analysis model to calculate a combined LTV ratio. The one- to four-family loan portfolio and related home equity loans are segregated into additional categories based on the following risk characteristics: originated and correspondent purchased, or bulk purchased; interest payments (fixed-rate and adjustable-rate/interest-only); LTV ratios; borrower's credit scores; and certain geographic locations. The categories were derived by management based on reviewing the historical performance of the one- to four-family loan portfolio and taking into consideration current economic conditions, such as trends in residential real estate values in certain areas of the U.S. and unemployment rates.

Quantitative loss factors are applied to each loan category in the formula analysis model based on the historical loss experience for each respective loan category. Each quarter, management reviews the historical loss time periods and utilizes the historical loss time periods believed to be the most reflective of the current economic conditions.

Qualitative loss factors are applied to each loan category in the formula analysis model. The qualitative loss factors that are applied in the formula analysis model for one- to four-family and consumer loan portfolios are: unemployment rate trends; collateral value trends; credit score trends; delinquent loan trends; and a factor based on management's judgment of certain segments of the portfolio and related loan product mix. The qualitative loss factors that are applied in the formula analysis model for multi-family and commercial loan portfolio are: delinquent loan trends and a factor based on management's judgment due to the higher risk nature of these loans, compared to one- to four-family loans. As loans are classified or become delinquent, the qualitative loss factors increase for each respective loan category. Additionally, TDRs that have not been individually evaluated for loss are included in a category within the formula analysis model with an overall higher qualitative loss factor than corresponding performing loans, for the life of the loan. The qualitative factors were derived by management based on a review of the historical performance of the respective loan portfolios and consideration of current economic conditions and their likely impact to the loan portfolio.

Management utilizes the formula analysis, along with considering several other data elements when evaluating the adequacy of the ACL. Such data elements include the trend and composition of delinquent loans, trends in foreclosed property and short sale transactions and charge-off activity, the current status and trends of local and national economies (particularly levels of unemployment), trends and current conditions in the real estate and housing markets, loan portfolio growth and concentrations, and certain ACL ratios such as ACL to loans receivable, net and annualized historical losses to ACL. Since the Bank's loan portfolio is primarily concentrated in one- to four-family real estate, management monitors residential real estate market value trends in the Bank's local market areas and geographic sections of the U.S. by reference to various industry and market reports, economic releases and surveys, and management's general and specific knowledge of the real estate markets in which the Bank lends, in order to determine what impact, if any, such trends may have on the level of ACL. Reviewing these qualitative factors assists management in evaluating the overall credit quality of the loan portfolio and the reasonableness of the ACL on an ongoing basis, and whether changes need to be made to the Bank's ACL methodology. Management seeks to apply the ACL methodology in a consistent manner; however, the methodology can be modified in response to changing conditions. Although management believes the ACL was at a level adequate to absorb inherent losses in the loan portfolio at September 30, 2014, the level of the ACL remains an estimate that is subject to significant judgment and short-term changes.

Federal Home Loan Bank Stock - As a member of FHLB Topeka, the Bank is required to acquire and hold shares of FHLB stock. The Bank's holding requirement varies based on the Bank's activities, primarily the Bank's outstanding borrowings, with the FHLB. FHLB stock is carried at cost and is considered a restricted asset because it cannot be pledged as collateral or bought or sold on the open market and it also has certain redemption restrictions. Management conducts a quarterly evaluation to determine if any FHLB stock impairment exists. The quarterly impairment

evaluation focuses primarily on the capital adequacy and liquidity of the FHLB, while also considering the impact that legislative and regulatory developments may have on the FHLB. Stock and cash dividends received on FHLB stock are reflected as dividend income in the consolidated statements of income.

Premises and Equipment - Land is carried at cost. Buildings, leasehold improvements, and furniture, fixtures and equipment are carried at cost less accumulated depreciation and leasehold amortization. Buildings, furniture, fixtures and equipment are depreciated over their estimated useful lives using the straight-line method. Buildings have an estimated useful life of 39 years. Structural components of the buildings generally have an estimated life of 15 years. Furniture, fixtures and equipment have an estimated useful life of three to seven years. Leasehold improvements are amortized over the shorter of their estimated useful lives or the term of the respective leases, which is generally three to 15 years. The costs for major improvements and renovations are capitalized, while maintenance, repairs and minor improvements are charged to operating expenses as incurred. Gains and losses on dispositions are recorded as non-interest income or non-interest expense as incurred.

Income Taxes - The Company utilizes the asset and liability method of accounting for income taxes. Under this method, deferred income tax assets and liabilities are recognized for the tax consequences of temporary differences between the financial statement carrying amounts and the tax basis of existing assets and liabilities. Deferred income taxes expense (benefit) represents the change in deferred income tax assets and liabilities excluding the tax effects of the change in net unrealized gain (loss) on AFS securities and changes in the market value of restricted stock between the grant date and vesting date. Income tax related penalties and interest are included in income tax expenses in the consolidated statements of income.

Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date. Certain tax benefits attributable to stock options and restricted stock are credited to additional paid-in capital. To the extent that management considers it more likely than not that a deferred tax asset will not be recovered, a valuation allowance is recorded. All positive and negative evidence is reviewed in determining how much of a valuation allowance is recognized on a quarterly basis.

Certain accounting literature prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of an uncertain tax position taken, or expected to be taken, in a tax return. Interest and penalties related to unrecognized tax benefits are recognized in income tax expense in the consolidated statements of income. Accrued interest and penalties related to unrecognized tax benefits are included within the related tax liabilities line in the consolidated balance sheet.

Employee Stock Ownership Plan - The funds borrowed by the ESOP from the Company to purchase the Company's common stock are being repaid from dividends paid on unallocated ESOP shares and, if necessary, contributions by the Bank. The shares pledged as collateral are reported as a reduction of stockholders' equity at cost. As ESOP shares are committed to be released from collateral each quarter, the Company records compensation expense based on the average market price of the Company's stock during the quarter. Additionally, the shares become outstanding for earnings per share ("EPS") computations once they are committed to be released. The eligibility criteria for participation in the Company's ESOP is a minimum of one year of service, at least age 21, and at least 1,000 hours of employment in each plan year.

Stock-based Compensation - The Company has share-based plans under which stock options and restricted stock awards have been granted. Compensation expense is recognized over the service period of the share-based payment award. The Company utilizes a fair-value-based measurement method in accounting for the share-based payment transactions with employees, except for equity instruments held by the ESOP. The Company applies the modified prospective method in which compensation cost is recognized over the service period for all awards granted.

Borrowed Funds - The Bank enters into repurchase agreements, which are sales of securities under agreements to repurchase, with approved counterparties. These agreements are recorded as financing transactions, and thereby reported as liabilities on the consolidated balance sheet, as the Bank maintains effective control over the transferred

securities and the securities continue to be carried in the Bank's securities portfolio. The securities are delivered to the party with whom each transaction is executed and they agree to resell to the Bank the same securities at the maturity of the agreement. The Bank retains the right to substitute similar or like securities throughout the terms of the agreements. The collateral is subject to valuation at current market levels and the Bank may ask for the return of excess collateral or be required to post additional collateral due to market value changes or as a result of principal payments received.

The Bank has obtained borrowings from the FHLB in the form of advances and a line of credit. Total FHLB borrowings are secured by certain qualifying loans pursuant to a blanket collateral agreement with the FHLB and certain securities. Per the FHLB's lending guidelines, total FHLB borrowings cannot exceed 40% of total Bank assets, as reported on the Bank's Call Report to the Office of the Comptroller of the Currency ("OCC"), without pre-approval from the FHLB president. In July 2014, the president of the FHLB approved an increase in the Bank's borrowing limit to 55% of total assets for one year. During the fourth quarter of fiscal year 2014, the Bank's FHLB borrowings to the Bank's total assets was in excess of 40%. See additional discussion in "Note 6 - Deposits and Borrowed Funds - FHLB Borrowings." Additionally, the Bank is authorized to borrow from the Federal Reserve Bank's "discount window."

Segment Information - As a community-oriented financial institution, substantially all of the Bank's operations involve the delivery of loan and deposit products to customers. Management makes operating decisions and assesses performance based on an ongoing review of these community banking operations, which constitute the Company's only operating segment for financial reporting purposes.

Earnings Per Share - Basic EPS is computed by dividing income available to common stockholders by the weighted average number of shares outstanding for the period. Diluted EPS reflects the potential dilution that could occur if securities or other contracts to issue common stock (such as stock options) were exercised or resulted in the issuance of common stock. These potentially dilutive shares would then be included in the weighted average number of shares outstanding for the period using the treasury stock method. Shares issued and shares reacquired during any period are weighted for the portion of the period that they were outstanding.

In computing both basic and diluted EPS, the weighted average number of common shares outstanding includes the ESOP shares previously allocated to participants and shares committed to be released for allocation to participants and restricted stock shares which have vested or have been allocated to participants. ESOP shares that have not been committed to be released are excluded from the computation of basic and diluted EPS. Unvested restricted stock awards contain nonforfeitable rights to dividends and are treated as participating securities in the computation of EPS pursuant to the two-class method.

Recent Accounting Pronouncements - In December 2011, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") 2011-11, Balance Sheet (Topic 210): Disclosures about Offsetting Assets and Liabilities. The ASU requires new disclosures regarding the nature of an entity's rights of setoff and related arrangements associated with its financial instruments and derivative instruments. The new disclosures are designed to make GAAP financial statements more comparable to those prepared under International Financial Reporting Standards. The new disclosures entail presenting information about both gross and net exposures. The new disclosure requirements were effective for annual reporting periods beginning on or after January 1, 2013, which was October 1, 2013 for the Company, and interim periods therein; retrospective application is required. The adoption of this ASU was disclosure-related and therefore did not have an impact on the Company's consolidated financial condition or results of operations when adopted on October 1, 2013.

In January 2013, the FASB issued ASU 2013-01, Clarifying the Scope of Disclosures about Offsetting Assets and Liabilities. The ASU clarifies the scope of the offsetting disclosure requirements in ASU 2011-11, Disclosures about Offsetting Assets and Liabilities. These standards were effective for fiscal years beginning on or after January 1, 2013, which was October 1, 2013 for the Company. The standards are disclosure-related and therefore, their adoption did not have an impact on the Company's consolidated financial condition or results of operations when adopted on October 1, 2013.

In February 2013, the FASB issued ASU 2013-02, Reporting of Amounts Reclassified Out of Accumulated Other Comprehensive Income, which is intended to improve the transparency of changes in other comprehensive income and items reclassified out of AOCI. The standard requires entities to disaggregate the total change of each component of other comprehensive income and separately present reclassification adjustments and current period other

comprehensive income. Additionally, the standard requires that significant items reclassified out of AOCI be presented by component either on the face of the statement where net income is presented or as a separate disclosure in the notes to the financial statements. ASU 2013-02 was effective for fiscal years beginning after December 15, 2012, which was October 1, 2013 for the Company, and should be applied prospectively. The adoption of this ASU is disclosure-related and therefore did not have an impact on the Company's consolidated financial condition or results of operations when adopted on October 1, 2013.

In February 2013, the FASB issued ASU 2013-04, Obligations Resulting from Joint and Several Liability Arrangements for Which the Total Amount of the Obligation Is Fixed at the Reporting Date. The ASU provides recognition, measurement, and disclosure guidance for certain obligations resulting from joint and several liability arrangements for which the total amount of the obligation is fixed at the reporting date. ASU 2013-04 is effective for fiscal years beginning after December 15, 2013, which is October 1, 2014 for the Company, and should be applied retrospectively. The ASU is not expected to have a material impact on the Company's consolidated financial condition or result of operations when adopted on October 1, 2014.

In January 2014, the FASB issued ASU 2014-01, Accounting for Investments in Qualified Affordable Housing Projects. The ASU revised the conditions that an entity must meet to elect to use the effective yield method when accounting for qualified affordable housing project investments. Per current accounting guidance, an entity that invests in a qualified affordable housing project may elect to account for that investment using the effective yield method if all required conditions are met. For those investments that are not accounted for using the effective yield method, current accounting guidance requires that the investments be accounted for under either the equity method or the cost method. Certain existing conditions required to be met to use the effective yield method are restrictive and thus prevent many such investments from qualifying for the use of the effective yield method. The ASU replaces the effective yield method with the proportional amortization method and modifies the conditions that an entity must meet to be eligible to use a method other than the equity or cost methods to account for qualified affordable housing project investments. If the modified conditions are met, the ASU permits an entity to use the proportional amortization method to amortize the initial cost of the investment in proportion to the amount of tax credits and other tax benefits received and recognize the net investment performance in the income statement as a component of income tax expense. Additionally, the ASU requires new disclosures about all investments in qualified affordable housing projects irrespective of the method used to account for the investments. ASU 2014-01 is effective for fiscal years beginning after December 15, 2014, which is October 1, 2015 for the Company, and should be applied retrospectively. The ASU is not expected to have a material impact on the Company's consolidated financial condition or result of operations when adopted.

In January 2014, the FASB issued ASU 2014-04, Reclassification of Residential Real Estate Collateralized Consumer Mortgage Loans upon Foreclosure. The ASU clarifies when an in substance repossession or foreclosure occurs, that is, when a creditor should be considered to have received physical possession of residential real estate property collateralizing a consumer mortgage loan such that the loan receivable should be derecognized and the real estate property recognized. The ASU also requires disclosure of both (1) the amount of foreclosed residential real estate property held by a creditor and (2) the recorded investment in consumer mortgage loans collateralized by residential real estate property that are in the process of foreclosure according to local requirements of the applicable jurisdiction. ASU 2014-04 is effective for fiscal years beginning after December 15, 2014, which is October 1, 2015 for the Company, and can be applied using either a modified retrospective transition method or a prospective transition method. The ASU is not expected to have a material impact on the Company's consolidated financial condition or result of operations when adopted.

In May 2014, the FASB issued ASU 2014-09, Revenue from Contracts with Customers. The ASU clarifies principles for recognizing revenue and provides a common revenue standard for GAAP and International Financial Reporting Standards. Additionally, the ASU provides implementation guidance on several topics and requires entities to disclose both quantitative and qualitative information regarding contracts with customers. ASU 2014-09 is effective for fiscal years beginning after December 15, 2016, which is October 1, 2017 for the Company, and can be applied using either a retrospective or cumulative-effect transition method. Early adoption is not permitted. The Company has not yet completed its evaluation of this ASU.

In June 2014, the FASB issued ASU 2014-11, Repurchase-to-Maturity Transactions, Repurchase Financings, and Disclosures. The ASU makes limited amendments to the current guidance on accounting for certain repurchase agreements. The ASU also expands disclosure requirements for certain transfers of financial assets accounted for as

sales or as secured borrowings. The accounting changes in ASU 2014-11 are effective for the first quarterly period or fiscal year beginning after December 15, 2014, which is January 1, 2015 for the Company, and should be applied using a cumulative-effect transition method. The expanded disclosure requirements for ASU 2014-11 are effective for fiscal years beginning after December 15, 2014, and for quarterly periods beginning after March 15, 2015, which is April 1, 2015 for the Company. The Company accounts for its repurchase agreements as secured borrowings; therefore, the accounting requirements of ASU 2014-11 are not expected to have an impact on its financial condition or results of operations when adopted.

2. EARNINGS PER SHARE

Shares acquired by the ESOP are not considered in the basic average shares outstanding until the shares are committed for allocation or vested to an employee's individual account. Unvested shares awarded pursuant to the Company's restricted stock benefit plans are treated as participating securities in the computation of EPS pursuant to the two-class method as they contain nonforfeitable rights to dividends. The two-class method is an earnings allocation that determines EPS for each class of common stock and participating security.

	For the Year Ended September 30,		
	2014	2013	2012
	(Dollars in thousands, except per share amounts)		
Net income	$77,694	$69,340	$74,513
Income allocated to participating securities	(176)	(205)	(69)
Net income available to common stockholders	$77,518	$69,135	$74,444
Average common shares outstanding	139,377,615	144,638,458	157,704,473
Average committed ESOP shares outstanding	62,458	208,698	208,505
Total basic average common shares outstanding	139,440,073	144,847,156	157,912,978
Effect of dilutive stock options	1,891	853	3,422
Total diluted average common shares outstanding	139,441,964	144,848,009	157,916,400
Net EPS:			
Basic	$0.56	$0.48	$0.47
Diluted	$0.56	$0.48	$0.47
Antidilutive stock options, excluded from the diluted average common shares outstanding calculation	2,060,748	2,430,629	1,308,925

99

3. SECURITIES

The following tables reflect the amortized cost, estimated fair value, and gross unrealized gains and losses of AFS and HTM securities at the dates presented. The majority of the MBS and investment securities portfolios are composed of securities issued by GSEs.

	September 30, 2014			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
	(Dollars in thousands)			
AFS:				
GSE debentures	$ 554,811	$ 413	$ 5,469	$ 549,755
MBS	271,138	16,640	172	287,606
Trust preferred securities	2,493	—	197	2,296
Municipal bonds	1,116	17	—	1,133
	829,558	17,070	5,838	840,790
HTM:				
MBS	1,514,941	31,130	12,935	1,533,136
Municipal bonds	37,758	654	24	38,388
	1,552,699	31,784	12,959	1,571,524
	$ 2,382,257	$ 48,854	$ 18,797	$ 2,412,314

	September 30, 2013			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
	(Dollars in thousands)			
AFS:				
GSE debentures	$ 709,118	$ 996	$ 7,886	$ 702,228
MBS	345,263	18,701	—	363,964
Trust preferred securities	2,594	—	171	2,423
Municipal bonds	1,308	44	—	1,352
	1,058,283	19,741	8,057	1,069,967
HTM:				
MBS	1,683,744	39,878	16,984	1,706,638
Municipal bonds	34,279	943	14	35,208
	1,718,023	40,821	16,998	1,741,846
	$ 2,776,306	$ 60,562	$ 25,055	$ 2,811,813

The following tables summarize the estimated fair value and gross unrealized losses of those securities on which an unrealized loss at the dates presented was reported and the continuous unrealized loss position for less than 12 months and equal to or greater than 12 months as of the dates presented.

	September 30, 2014					
	Less Than 12 Months			Equal to or Greater Than 12 Months		
	Count	Estimated Fair Value	Unrealized Losses	Count	Estimated Fair Value	Unrealized Losses
	(Dollars in thousands)					
AFS:						
GSE debentures	3	$ 70,666	$ 209	18	$ 403,389	$ 5,260
MBS	63	18,571	172	—	—	—
Trust preferred securities	—	—	—	1	2,296	197
	66	$ 89,237	$ 381	19	$ 405,685	$ 5,457
HTM:						
MBS	24	$ 353,344	$ 2,194	25	$ 409,275	$ 10,741
Municipal bonds	9	4,688	19	1	739	5
	33	$ 358,032	$ 2,213	26	$ 410,014	$ 10,746

	September 30, 2013					
	Less Than 12 Months			Equal to or Greater Than 12 Months		
	Count	Estimated Fair Value	Unrealized Losses	Count	Estimated Fair Value	Unrealized Losses
	(Dollars in thousands)					
AFS:						
GSE debentures	19	$ 426,482	$ 7,213	1	$ 24,327	$ 673
Trust preferred securities	—	—	—	1	2,423	171
	19	$ 426,482	$ 7,213	2	$ 26,750	$ 844
HTM:						
MBS	40	$ 710,291	$ 16,984	—	$ —	$ —
Municipal bonds	3	1,299	14	—	—	—
	43	$ 711,590	$ 16,998	—	$ —	$ —

The unrealized losses at September 30, 2014 were primarily a result of an increase in market yields from the time the securities were purchased. In general, as market yields rise, the fair value of securities will decrease; as market yields fall, the fair value of securities will increase. Management generally views changes in fair value caused by changes in interest rates as temporary; therefore, these securities have not been classified as other-than-temporarily impaired. Additionally, the impairment is also considered temporary because scheduled coupon payments have been made, it is anticipated that the entire principal balance will be collected as scheduled, and management neither intends to sell the securities, nor is it more likely than not that the Company will be required to sell the securities before the recovery of the remaining amortized cost amount, which could be at maturity. As a result of the analysis, management does not believe any other-than-temporary impairments existed at September 30, 2014. See "Note 1 - Summary of Significant Accounting Policies - Securities" for additional information regarding our impairment review and classification process for securities.

The amortized cost and estimated fair value of debt securities as of September 30, 2014, by contractual maturity, are shown below. Actual maturities may differ from contractual maturities due to prepayment or early call privileges by the issuer.

	AFS		HTM	
	Amortized Cost	Estimated Fair Value	Amortized Cost	Estimated Fair Value
	(Dollars in thousands)			
One year or less	$ 200	$ 200	$ 3,153	$ 3,178
One year through five years	501,577	497,891	24,634	25,215
Five years through ten years	54,150	52,797	9,971	9,995
Ten years and thereafter	2,493	2,296	—	—
	558,420	553,184	37,758	38,388
MBS	271,138	287,606	1,514,941	1,533,136
	$ 829,558	$ 840,790	$ 1,552,699	$ 1,571,524

The following table presents the taxable and non-taxable components of interest income on investment securities for the periods presented.

	For the Year Ended September 30,		
	2014	2013	2012
	(Dollars in thousands)		
Taxable	$ 6,440	$ 8,796	$ 14,309
Non-taxable	945	1,216	1,635
	$ 7,385	$ 10,012	$ 15,944

The following table summarizes the amortized cost and estimated fair value of securities pledged as collateral as of the dates presented.

	September 30, 2014		2013	
	Amortized Cost	Estimated Fair Value	Amortized Cost	Estimated Fair Value
	(Dollars in thousands)			
FHLB borrowings	$ 487,736	$ 488,368	$ —	$ —
Public unit deposits	282,464	284,251	272,016	274,917
Repurchase agreements	239,922	247,306	353,648	364,593
Federal Reserve Bank	25,969	27,067	34,261	35,477
	$ 1,036,091	$ 1,046,992	$ 659,925	$ 674,987

All dispositions of securities during fiscal years 2014, 2013, and 2012 were the result of principal repayments, calls, or maturities.

4. LOANS RECEIVABLE and ALLOWANCE FOR CREDIT LOSSES

Loans receivable, net at September 30, 2014 and 2013 is summarized as follows:

	2014	2013
	(Dollars in thousands)	
Real estate loans:		
One- to four-family	$ 5,972,031	$ 5,743,047
Multi-family and commercial	75,677	50,358
Construction	106,790	77,743
Total real estate loans	6,154,498	5,871,148
Consumer loans:		
Home equity	130,484	135,028
Other	4,537	5,623
Total consumer loans	135,021	140,651
Total loans receivable	6,289,519	6,011,799
Less:		
Undisbursed loan funds	52,001	42,807
ACL	9,227	8,822
Discounts/unearned loan fees	23,687	23,057
Premiums/deferred costs	(28,566)	(21,755)
	$ 6,233,170	$ 5,958,868

As of September 30, 2014 and 2013, the Bank serviced loans for others aggregating approximately $195.0 million and $237.7 million, respectively. Such loans are not included in the accompanying consolidated balance sheets. Servicing loans for others generally consists of collecting mortgage payments, maintaining escrow accounts, disbursing payments to investors and foreclosure processing. Loan servicing income includes servicing fees withheld from investors and certain charges collected from borrowers, such as late payment fees. The Bank held borrowers' escrow balances on loans serviced for others of $3.4 million and $4.1 million as of September 30, 2014 and 2013, respectively.

Lending Practices and Underwriting Standards - Originating and purchasing one- to four-family loans is the Bank's primary lending business, resulting in a loan concentration in residential first mortgage loans. The Bank purchases one- to four-family loans, on a loan-by-loan basis, from a select group of correspondent lenders, and also originates consumer loans, commercial and multi-family real estate loans, and construction loans secured by residential, multi-family or commercial real estate. As a result of our one- to four-family lending activities, the Bank has a concentration of loans secured by real property located in Kansas and Missouri.

One- to four-family loans - Full documentation to support an applicant's credit and income, and sufficient funds to cover all applicable fees and reserves at closing, are required on all loans. Loans are underwritten according to the "ability to repay" and "qualified mortgage" standards, as issued by the Consumer Financial Protection Bureau, with total debt-to-income ratios not exceeding 43% of a borrower's verified income. Properties securing one- to four-family loans are appraised by either staff appraisers or fee appraisers, both of which are independent of the loan origination function and approved by our Board of Directors.

The underwriting standards for loans purchased from correspondent and nationwide lenders are generally similar to the Bank's internal underwriting standards. The underwriting of correspondent loans is performed by the Bank's underwriters. For the tables within this Note, correspondent purchased loans are included with originated loans, and bulk purchased loans are reported as purchased loans.
The Bank also originates construction-to-permanent loans secured by one- to four-family residential real estate. Construction loans are obtained by homeowners who will occupy the property when construction is complete. Construction loans to builders for speculative purposes are not permitted. All construction loans are manually underwritten using the Bank's internal underwriting standards. Construction draw requests and the supporting documentation are reviewed and approved by management. The Bank also performs regular documented inspections of the construction project to ensure the funds are being used for the intended purpose and the project is being completed according to the plans and specifications provided.

Multi-family and commercial loans - The Bank's multi-family, commercial real estate, and related construction loans are originated by the Bank or are in participation with a lead bank. These loans are granted based on the income producing potential of the property and the financial strength of the borrower and/or guarantor. At the time of origination, LTV ratios on multi-family, commercial real estate, and related construction loans cannot exceed 80% of the appraised value of the property securing the loans. The net operating income, which is the income derived from the operation of the property less all operating expenses, must be in excess of the required payments related to the outstanding debt at the time of origination. The Bank generally requires personal guarantees from the borrowers covering a portion of the debt in addition to the security property as collateral for these loans. Appraisals on properties securing these loans are performed by independent state certified fee appraisers.

Consumer loans - The Bank offers a variety of secured consumer loans, including home equity loans and lines of credit, home improvement loans, auto loans, and loans secured by savings deposits. The Bank also originates a very limited amount of unsecured loans. The Bank does not originate any consumer loans on an indirect basis, such as contracts purchased from retailers of goods or services which have extended credit to their customers. The majority of the consumer loan portfolio is comprised of home equity lines of credit for which the Bank also has the first mortgage or the home equity line of credit is in the first lien position.

The underwriting standards for consumer loans include a determination of an applicant's payment history on other debts and an assessment of an applicant's ability to meet existing obligations and payments on the proposed loan. Although creditworthiness of an applicant is a primary consideration, the underwriting process also includes a comparison of the value of the security in relation to the proposed loan amount.

Credit Quality Indicators - Based on the Bank's lending emphasis and underwriting standards, management has segmented the loan portfolio into three segments: (1) one- to four-family loans; (2) consumer loans; and (3) multi-family and commercial loans. The one- to four-family and consumer segments are further segmented into classes for purposes of providing disaggregated information about the credit quality of the loan portfolio. The classes are: one- to four-family loans - originated, one- to four-family loans - purchased, consumer loans - home equity, and consumer loans - other.

The Bank's primary credit quality indicators for the one- to four-family loan and consumer - home equity loan portfolios are delinquency status, asset classifications, LTV ratios, and borrower credit scores. The Bank's primary credit quality indicators for the multi-family and commercial loan and consumer - other loan portfolios are delinquency status and asset classifications.

The following tables present the recorded investment, by class, in loans 30 to 89 days delinquent, loans 90 or more days delinquent or in foreclosure, total delinquent loans, total current loans, and total recorded investment at the dates presented. The recorded investment in loans is defined as the unpaid principal balance of a loan (net of unadvanced funds related to loans in process), less charge-offs and inclusive of unearned loan fees and deferred costs. At September 30, 2014 and September 30, 2013, all loans 90 or more days delinquent were on nonaccrual status.

	September 30, 2014				
	30 to 89 Days Delinquent	90 or More Days Delinquent or in Foreclosure	Total Delinquent Loans	Current Loans	Total Recorded Investment
	(Dollars in thousands)				
One- to four-family loans - originated	$ 15,396	$ 8,566	$ 23,962	$ 5,421,112	$ 5,445,074
One- to four-family loans - purchased	7,937	7,190	15,127	550,229	565,356
Multi-family and commercial loans	—	—	—	96,946	96,946
Consumer - home equity	770	397	1,167	129,317	130,484
Consumer - other	69	13	82	4,455	4,537
	$ 24,172	$ 16,166	$ 40,338	$ 6,202,059	$ 6,242,397

	September 30, 2013				
	30 to 89 Days Delinquent	90 or More Days Delinquent or in Foreclosure	Total Delinquent Loans	Current Loans	Total Recorded Investment
	(Dollars in thousands)				
One- to four-family loans - originated	$ 18,889	$ 9,379	$ 28,268	$ 5,092,581	$ 5,120,849
One- to four-family loans - purchased	7,842	9,695	17,537	631,050	648,587
Multi-family and commercial loans	—	—	—	57,603	57,603
Consumer - home equity	848	485	1,333	133,695	135,028
Consumer - other	35	5	40	5,583	5,623
	$ 27,614	$ 19,564	$ 47,178	$ 5,920,512	$ 5,967,690

The following table presents the recorded investment, by class, in loans classified as nonaccrual at the dates presented.

	September 30,	
	2014	2013
	(Dollars in thousands)	
One- to four-family loans - originated	$ 16,546	$ 15,939
One- to four-family loans - purchased	7,940	9,985
Multi-family and commercial loans	—	—
Consumer - home equity	442	586
Consumer - other	13	5
	$ 24,941	$ 26,515

In accordance with the Bank's asset classification policy, management regularly reviews the problem loans in the Bank's portfolio to determine whether any loans require classification. Loan classifications are defined as follows:

- Special mention - These loans are performing loans on which known information about the collateral pledged or the possible credit problems of the borrower(s) have caused management to have doubts as to the ability of the borrower(s) to comply with present loan repayment terms and which may result in the future inclusion of such loans in the non-performing loan categories.
- Substandard - A loan is considered substandard if it is inadequately protected by the current net worth and paying capacity of the obligor or of the collateral pledged, if any. Substandard loans include those characterized by the distinct possibility the Bank will sustain some loss if the deficiencies are not corrected.
- Doubtful - Loans classified as doubtful have all the weaknesses inherent in those classified as substandard, with the added characteristic that the weaknesses present make collection or liquidation in full on the basis of currently existing facts and conditions and values highly questionable and improbable.
- Loss - Loans classified as loss are considered uncollectible and of such little value that their continuance as assets on the books is not warranted.

The following table sets forth the recorded investment in loans classified as special mention or substandard, by class, at the dates presented. Special mention and substandard loans are included in the formula analysis model if the loan is not individually evaluated for loss. Loans classified as doubtful or loss are individually evaluated for loss. At the dates presented, there were no loans classified as doubtful, and all loans classified as loss were fully charged-off.

	September 30,			
	2014		2013	
	Special Mention	Substandard	Special Mention	Substandard
	(Dollars in thousands)			
One- to four-family - originated	$20,068	$29,151	$29,359	$27,761
One- to four-family - purchased	2,738	11,470	1,871	14,195
Multi-family and commercial	—	—	1,976	—
Consumer - home equity	146	887	87	819
Consumer - other	5	13	—	13
	$22,957	$41,521	$33,293	$42,788

The following table shows the weighted average credit score and weighted average LTV for originated and purchased one- to four-family loans and originated consumer home equity loans at the dates presented. Borrower credit scores are intended to provide an indication as to the likelihood that a borrower will repay their debts. Credit scores are updated at least semiannually, with the last update in September 2014, from a nationally recognized consumer rating agency. The LTV ratios provide an estimate of the extent to which the Bank may incur a loss on any given loan that may go into foreclosure. The LTV ratios were based on the current loan balance and either the lesser of the purchase price or original appraisal, or the most recent Bank appraisal, if available. In most cases, the most recent appraisal was obtained at the time of origination.

	September 30,					
	2014			2013		
	Credit Score	LTV		Credit Score	LTV	
One- to four-family - originated	764	65	%	762	65	%
One- to four-family - purchased	749	66		747	67	
Consumer - home equity	751	18		746	19	
	762	64		760	64	

TDRs - The following tables present the recorded investment prior to restructuring and immediately after restructuring in all loans restructured during the periods presented. These tables do not reflect the recorded investment at the end of the periods indicated. Any increase in the recorded investment at the time of the restructuring was generally due to the capitalization of delinquent interest and/or escrow balances.

	For the Year Ended September 30, 2014		
	Number of Contracts	Pre- Restructured Outstanding	Post- Restructured Outstanding
	(Dollars in thousands)		
One- to four-family loans - originated	145	$ 17,721	$ 17,785
One- to four-family loans - purchased	7	1,054	1,056
Multi-family and commercial loans	—	—	—
Consumer - home equity	6	100	101
Consumer - other	—	—	—
	158	$ 18,875	$ 18,942

	For the Year Ended September 30, 2013		
	Number of Contracts	Pre- Restructured Outstanding	Post- Restructured Outstanding
	(Dollars in thousands)		
One- to four-family loans - originated	178	$ 30,707	$ 30,900
One- to four-family loans - purchased	9	2,324	2,366
Multi-family and commercial loans	2	82	79
Consumer - home equity	14	297	305
Consumer - other	—	—	—
	203	$ 33,410	$ 33,650

	For the Year Ended September 30, 2012		
	Number of Contracts	Pre- Restructured Outstanding	Post- Restructured Outstanding
	(Dollars in thousands)		
One- to four-family loans - originated	232	$ 33,683	$ 33,815
One- to four-family loans - purchased	14	3,878	3,877
Multi-family and commercial loans	—	—	—
Consumer - home equity	23	466	475
Consumer - other	1	12	12
	270	$ 38,039	$ 38,179

The following table provides information on TDRs restructured within the last 12 months that became delinquent during the periods presented.

	For the Years Ended September 30, 2014		September 30, 2013		September 30, 2012	
	Number of Contracts	Recorded Investment	Number of Contracts	Recorded Investment	Number of Contracts	Recorded Investment
	(Dollars in thousands)					
One- to four-family loans - originated	38	$4,112	38	$3,341	14	$2,340
One- to four-family loans - purchased	3	780	6	1,270	—	—
Multi-family and commercial loans	—	—	—	—	—	—
Consumer - home equity	2	56	3	22	—	—
Consumer - other	—	—	1	10	—	—
	43	$4,948	48	$4,643	14	$2,340

Impaired loans - The following information pertains to impaired loans, by class, as of the dates presented. A loan is considered impaired when, based on current information and events, it is probable that the Bank will be unable to collect all amounts due, including principal and interest, according to the contractual terms of the loan agreement.

	September 30, 2014			September 30, 2013		
	Recorded Investment	Unpaid Principal Balance	Related ACL	Recorded Investment	Unpaid Principal Balance	Related ACL
	(Dollars in thousands)					
With no related allowance recorded						
One- to four-family - originated	$13,871	$14,507	$—	$12,950	$13,543	$—
One- to four-family - purchased	12,405	14,896	—	13,882	16,645	—
Multi-family and commercial	—	—	—	—	—	—
Consumer - home equity	605	892	—	577	980	—
Consumer - other	13	22	—	2	7	—
	26,894	30,317	—	27,411	31,175	—
With an allowance recorded						
One- to four-family - originated	23,675	23,767	107	35,520	35,619	209
One- to four-family - purchased	1,820	1,791	56	2,034	2,015	29
Multi-family and commercial	—	—	—	73	74	2
Consumer - home equity	464	464	39	492	492	78
Consumer - other	—	—	—	11	11	1
	25,959	26,022	202	38,130	38,211	319
Total						
One- to four-family - originated	37,546	38,274	107	48,470	49,162	209
One- to four-family - purchased	14,225	16,687	56	15,916	18,660	29
Multi-family and commercial	—	—	—	73	74	2
Consumer - home equity	1,069	1,356	39	1,069	1,472	78
Consumer - other	13	22	—	13	18	1
	$52,853	$56,339	$202	$65,541	$69,386	$319

The following information pertains to impaired loans, by class, for the periods presented.

	For the Years Ended					
	September 30, 2014		September 30, 2013		September 30, 2012	
	Average Recorded Investment	Interest Income Recognized	Average Recorded Investment	Interest Income Recognized	Average Recorded Investment	Interest Income Recognized
	(Dollars in thousands)					
With no related allowance recorded						
One- to four-family - originated	$13,455	$416	$9,763	$321	$41,396	$176
One- to four-family - purchased	13,305	212	14,730	186	12,296	126
Multi-family and commercial	—	—	—	—	223	—
Consumer - home equity	567	33	567	39	543	6
Consumer - other	6	—	19	—	11	—
	27,333	661	25,079	546	54,469	308
With an allowance recorded						
One- to four-family - originated	28,171	1,117	40,590	1,651	10,886	1,330
One- to four-family - purchased	2,334	53	2,052	74	6,138	51
Multi-family and commercial	17	1	58	3	—	—
Consumer - home equity	558	22	534	23	226	4
Consumer - other	12	—	23	1	6	—
	31,092	1,193	43,257	1,752	17,256	1,385
Total						
One- to four-family - originated	41,626	1,533	50,353	1,972	52,282	1,506
One- to four-family - purchased	15,639	265	16,782	260	18,434	177
Multi-family and commercial	17	1	58	3	223	—
Consumer - home equity	1,125	55	1,101	62	769	10
Consumer - other	18	—	42	1	17	—
	$58,425	$1,854	$68,336	$2,298	$71,725	$1,693

Allowance for Credit Losses - The following is a summary of ACL activity, by segment, for the periods presented, and the ending balance of ACL based on the Company's impairment methodology. Of the $1.2 million of net charge-offs during the year ended September 30, 2013, $381 thousand was due to loans that were primarily discharged in a prior fiscal year under Chapter 7 bankruptcy that had to be, pursuant to regulatory reporting requirements, evaluated for collateral value loss, even if they were current. In January 2012, management implemented a new loan charge-off policy in accordance with regulatory reporting requirements, which resulted in $3.5 million of specific valuation allowances being charged-off during fiscal year 2012.

	For the Year Ended September 30, 2014					
	One- to Four-Family - Originated	One- to Four-Family - Purchased	One- to Four-Family - Total	Multi-family and Commercial	Consumer	Total
	(Dollars in thousands)					
Beginning balance	$5,771	$2,486	$8,257	$185	$380	$8,822
Charge-offs	(380)	(653)	(1,033)	—	(109)	(1,142)
Recoveries	1	64	65	—	73	138
Provision for credit losses	871	426	1,297	215	(103)	1,409
Ending balance	$6,263	$2,323	$8,586	$400	$241	$9,227

	For the Year Ended September 30, 2013					
	One- to Four-Family - Originated	One- to Four-Family - Purchased	One- to Four-Family - Total	Multi-family and Commercial	Consumer	Total
	(Dollars in thousands)					
Beginning balance	$6,074	$4,453	$10,527	$219	$354	$11,100
Charge-offs	(637)	(761)	(1,398)	—	(259)	(1,657)
Recoveries	14	398	412	—	34	446
Provision for credit losses	320	(1,604)	(1,284)	(34)	251	(1,067)
Ending balance	$5,771	$2,486	$8,257	$185	$380	$8,822

	For the Year Ended September 30, 2012					
	One- to Four-Family - Originated	One- to Four-Family - Purchased	One- to Four-Family - Total	Multi-family and Commercial	Consumer	Total
	(Dollars in thousands)					
Beginning balance	$4,915	$9,901	$14,816	$254	$395	$15,465
Charge-offs	(892)	(5,186)	(6,078)	—	(357)	(6,435)
Recoveries	16	8	24	—	6	30
Provision for credit losses	2,035	(270)	1,765	(35)	310	2,040
Ending balance	$6,074	$4,453	$10,527	$219	$354	$11,100

The following is a summary of the loan portfolio and related ACL balances, at the dates presented, by loan portfolio segment disaggregated by the Company's impairment method. There was no ACL for loans individually evaluated for impairment at either date as all potential losses were charged-off.

	September 30, 2014					
	One- to Four-Family - Originated	One- to Four-Family - Purchased	One- to Four-Family - Total	Multi-family and Commercial	Consumer	Total
	(Dollars in thousands)					
Recorded investment in loans collectively evaluated for impairment	$5,431,203	$552,951	$5,984,154	$96,946	$134,403	$6,215,503
Recorded investment in loans individually evaluated for impairment	13,871	12,405	26,276	—	618	26,894
	$5,445,074	$565,356	$6,010,430	$96,946	$135,021	$6,242,397
ACL for loans collectively evaluated for impairment	$6,263	$2,323	$8,586	$400	$241	$9,227

	September 30, 2013					
	One- to Four-Family - Originated	One- to Four-Family - Purchased	One- to Four-Family - Total	Multi-family and Commercial	Consumer	Total
	(Dollars in thousands)					
Recorded investment in loans collectively evaluated for impairment	$5,107,899	$634,705	$5,742,604	$57,603	$140,072	$5,940,279
Recorded investment in loans individually evaluated for impairment	12,950	13,882	26,832	—	579	27,411
	$5,120,849	$648,587	$5,769,436	$57,603	$140,651	$5,967,690
ACL for loans collectively evaluated for impairment	$5,771	$2,486	$8,257	$185	$380	$8,822

5. PREMISES AND EQUIPMENT, Net

A summary of the net carrying value of premises and equipment at September 30, 2014 and 2013 was as follows:

	2014	2013
	(Dollars in thousands)	
Land	$ 11,041	$ 11,029
Building and improvements	76,029	73,199
Furniture, fixtures and equipment	41,365	43,268
	128,435	127,496
Less accumulated depreciation	57,905	57,384
	$ 70,530	$ 70,112

The Bank has entered into non-cancelable operating lease agreements with respect to banking premises and equipment. It is expected that many agreements will be renewed at expiration in the normal course of business. Rental expense was $1.1 million, $1.2 million, and $1.3 million for the years ended September 30, 2014, 2013, and 2012, respectively.

As of September 30, 2014, future minimum rental commitments, rounded to the nearest thousand, required under operating leases that have initial or remaining non-cancelable lease terms in excess of one year were as follows:

2015	$ 995
2016	888
2017	814
2018	813
2019	718
Thereafter	3,761
	$ 7,989

112

6. DEPOSITS and BORROWED FUNDS

Deposits - The amount of noninterest-bearing deposits was $167.0 million and $150.2 million as of September 30, 2014 and 2013, respectively. Certificates of deposit with a minimum denomination of $250 thousand were $402.1 million and $363.8 million as of September 30, 2014 and 2013, respectively. Deposits in excess of $250 thousand may not be fully insured by the Federal Deposit Insurance Corporation.

FHLB Borrowings - FHLB borrowings at September 30, 2014 consisted of $2.57 billion in fixed-rate FHLB advances and $800.0 million against the variable-rate FHLB line of credit. The line of credit is set to expire on November 20, 2015, at which time it is expected to be renewed automatically by the FHLB for a one year period. FHLB borrowings at September 30, 2013 consisted of $2.51 billion in fixed-rate FHLB advances.

During the fourth quarter of fiscal year 2014, the Bank implemented a leverage strategy ("daily leverage strategy") to increase earnings. The daily leverage strategy involves borrowing up to $2.10 billion against the Bank's FHLB line of credit and currently consists of two leverage tiers. The first tier of $800.0 million is intended to remain borrowed against the line of credit for an extended period of time. The second tier of $1.30 billion is borrowed in the first days of each quarter and paid off prior to each quarter end. The proceeds of the borrowings, net of the required FHLB stock holdings, is deposited at the Federal Reserve Bank of Kansas City.

FHLB advances at September 30, 2014 and 2013 were comprised of the following:

	2014		2013	
	(Dollars in thousands)			
Fixed-rate FHLB advances	$ 2,575,000		$ 2,525,000	
Deferred prepayment penalty	(5,350	)	(11,575	)
Deferred gain on terminated interest rate swaps	27		113	
	$ 2,569,677		$ 2,513,538	
Weighted average contractual interest rate on FHLB advances	2.19	%	2.33	%
Weighted average effective interest rate on FHLB advances[1]	2.39		2.67	

(1) The effective rate includes the net impact of the amortization of deferred prepayment penalties related to the prepayment of certain FHLB advances and deferred gains related to the termination of interest rate swaps.

FHLB borrowings are secured by certain qualifying loans pursuant to a blanket collateral agreement with the FHLB and certain securities. Per the FHLB's lending guidelines, total FHLB borrowings cannot exceed 40% of total Bank assets without the pre-approval of the FHLB president. In July 2014, the president of the FHLB approved an increase in the Bank's borrowing limit to 55% of total assets for one year. At September 30, 2014, the ratio of the par value of the Bank's FHLB borrowings to the Bank's total assets, as reported to the OCC, was 34%. During the fourth quarter of fiscal year 2014, the Bank's FHLB borrowings to the Bank's total assets was in excess of 40% due to the daily leverage strategy.

Repurchase Agreements - At September 30, 2014 and 2013, the Company had repurchase agreements outstanding in the amounts of $220.0 million and $320.0 million, with weighted average contractual rates of 3.08% and 3.43%, respectively. All of the Company's repurchase agreements at September 30, 2014 and 2013 were fixed-rate.

Maturity of Borrowed Funds and Certificates of Deposit - The following table presents the scheduled maturity of FHLB advances, at par, repurchase agreements, and certificates of deposit as of September 30, 2014:

	FHLB Advances Amount	Repurchase Agreements Amount	Certificates of Deposit Amount
	(Dollars in thousands)		
2015	$600,000	$20,000	$1,269,331
2016	575,000	—	572,363
2017	500,000	—	351,939
2018	200,000	100,000	281,154
2019	200,000	—	56,827
Thereafter	500,000	100,000	552
	$2,575,000	$220,000	$2,532,166

7. INCOME TAXES

Income tax expense for the years ended September 30, 2014, 2013, and 2012 consisted of the following:

	2014	2013	2012
	(Dollars in thousands)		
Current:			
Federal	$32,137	$27,570	$32,353
State	3,215	2,963	3,044
	35,352	30,533	35,397
Deferred:			
Federal	2,121	5,586	5,638
State	(15)	110	451
	2,106	5,696	6,089
	$37,458	$36,229	$41,486

The Company's effective tax rates were 32.5%, 34.3%, and 35.8% for the years ended September 30, 2014, 2013, and 2012, respectively. The differences between such effective rates and the statutory Federal income tax rate computed on income before income tax expense result from the following:

	2014 Amount	2014 %	2013 Amount	2013 %	2012 Amount	2012 %
	(Dollars in thousands)					
Federal income tax expense computed at statutory Federal rate	$40,303	35.0 %	$36,949	35.0 %	$40,600	35.0 %
Increases (decreases) in taxes resulting from:						
State taxes, net of Federal tax effect	3,200	2.8	3,073	2.9	3,495	3.0
Low income housing tax credits	(3,580)	(3.1)	(2,675)	(2.5)	(2,081)	(1.8)
ESOP related expenses, net	(1,550)	(1.4)	(347)	(0.3)	591	0.5
BOLI income	(698)	(0.6)	(519)	(0.5)	(517)	(0.4)
Other	(217)	(0.2)	(252)	(0.3)	(602)	(0.5)
	$37,458	32.5 %	$36,229	34.3 %	$41,486	35.8 %

114

Deferred income taxes expense represents the change in deferred income tax assets and liabilities excluding the tax effects of the change in net unrealized gain (loss) on AFS securities and changes in the market value of restricted stock between the grant date and vesting date. The sources of these differences and the tax effect of each as of September 30, 2014, 2013, and 2012 were as follows:

	2014	2013	2012
	(Dollars in thousands)		
Capitol Federal Foundation contribution	$3,768	$3,216	$5,422
ACL	(37)	982	1,617
Premises and equipment	(388)	1,365	629
FHLB stock dividends	(832)	866	1,650
Other, net	(405)	(733)	(3,229)
	$2,106	$5,696	$6,089

The components of the net deferred income tax liabilities as of September 30, 2014 and 2013 were as follows:

	2014	2013
	(Dollars in thousands)	
Deferred income tax assets:		
Capitol Federal Foundation contribution	$418	$4,186
ACL	1,301	1,264
Salaries and employee benefits	2,202	2,071
ESOP compensation	1,205	1,004
Other	4,252	4,179
Gross deferred income tax assets	9,378	12,704
Valuation allowance	(1,810)	(1,824)
Gross deferred income tax asset, net of valuation allowance	7,568	10,880
Deferred income tax liabilities:		
FHLB stock dividends	20,512	21,344
Premises and equipment	4,627	5,015
Unrealized gain on AFS securities	4,246	4,417
Other	550	541
Gross deferred income tax liabilities	29,935	31,317
Net deferred tax liabilities	$22,367	$20,437

The Company assesses the available positive and negative evidence surrounding the recoverability of its deferred tax assets and applies its judgment in estimating the amount of valuation allowance necessary under the circumstances. At both September 30, 2014 and 2013, the Company had a valuation allowance of $1.8 million related to the net operating losses generated by the Company's consolidated Kansas corporate income tax return. The companies included in the consolidated Kansas corporate income tax return are the holding company and Capitol Funds, Inc., as the Bank files a Kansas privilege tax return. Based on the nature of the operations of the holding company and Capitol Funds, Inc., management believes there will not be sufficient taxable income to fully utilize the deferred tax assets noted above; therefore, a valuation allowance has been recorded for the related amounts at September 30, 2014 and 2013.

Accounting Standard Codification ("ASC") 740 Income Taxes prescribes a process by which a tax position taken, or expected to be taken, on an income tax return is determined based upon the technical merits of the position, along with whether the tax position meets a more-likely-than-not-recognition threshold, to determine the amount, if any, of unrecognized tax benefits to recognize in the financial statements. Estimated penalties and interest related to unrecognized tax benefits are included in income tax expense in the consolidated statements of income. For the years ended September 30, 2014, 2013, and 2012, the Company's unrecognized tax benefits, estimated penalties and interest, and related activities were insignificant. The Company does not anticipate the total amount of unrecognized tax benefits to significantly change within the next 12 months.

The Company files income tax returns in the U.S. federal jurisdiction and the state of Kansas, as well as other states where it has either established nexus under an economic nexus theory or has exceeded enumerated nexus thresholds based on the amount of interest income derived from sources within the state. In many cases, uncertain tax positions are related to tax years that remain subject to examination by the relevant taxing authorities. With few exceptions, the Company is no longer subject to U.S. federal and state examinations by tax authorities for fiscal years before 2011.

In September 2013, the Internal Revenue Service enacted final guidance regarding the deduction and capitalization of expenditures related to tangible property ("tangible property regulations"). The tangible property regulations clarify and expand sections 162(a) and 263(a) of the Internal Revenue Code which relate to amounts paid to acquire produce, or improve tangible property. Additionally, the tangible property regulations provide final guidance under section 167 regarding accounting for and retirement of depreciable property and regulations under section 168 relating to the accounting for property under the Modified Accelerated Cost Recovery System. The tangible property regulations affect all taxpayers that acquire, produce, or improve tangible property, which includes the Company, and generally apply to taxable years beginning on or after January 1, 2014, which will impact the fiscal year ending September 30, 2015 for the Company. The Company has evaluated the tangible property regulations and has determined the regulations will not have a material impact on the Company's financial condition or results of operations.

8. ESOP

The ESOP trust acquired 3,024,574 shares (6,846,728 shares post-corporate reorganization) of common stock in the Company's initial public offering and 4,726,000 shares of common stock in the Company's corporate reorganization in December of 2010. Both acquisitions of common stock were made with proceeds from loans from the Company. The loans are secured by shares of the Company's stock purchased in each offering. The Bank has agreed to make cash contributions to the ESOP trust on an annual basis sufficient to enable the ESOP trust to make the required annual loan payments to the Company on September 30 of each year. The loan for the shares acquired in the initial public offering matured on September 30, 2013. The loan for the shares acquired in the corporate reorganization matures on September 30, 2040.

As annual loan payments are made on September 30, shares are released from collateral and allocated to qualified employees based on the proportion of their qualifying compensation to total qualifying compensation. On September 30, 2014, 165,198 shares were released from collateral. On September 30, 2015, 165,198 shares will be released from collateral. As ESOP shares are committed to be released from collateral, the Company records compensation expense. Dividends on unallocated ESOP shares are applied to the debt service payments of the loan secured by the unallocated shares. Dividends on unallocated ESOP shares in excess of the debt service payment are recorded as compensation expense and distributed to participants or participants' ESOP accounts. Compensation expense related to the ESOP was $3.8 million for the year ended September 30, 2014, $9.7 million for the year ended September 30, 2013, and $6.7 million for the year ended September 30, 2012. Of these amounts, $362 thousand, $3.7 million, and $3.4 million related to the difference between the market price of the Company's stock when the shares were acquired by the ESOP trust and the average market price of the Company's stock during the years ended September 30, 2014, 2013, and 2012, respectively. The amount included in compensation expense for dividends on unallocated ESOP shares in excess of the debt service payments was $1.7 million, $3.0 million, and $325 thousand for the years ended September 30, 2014, 2013, and 2012, respectively, which was related to the loan for the shares acquired in the corporate reorganization.

Shares may be withdrawn from the ESOP trust due to retirement, termination, or death of the participant. Additionally, a participant may begin to diversify at least 25% of their ESOP shares at age 50. The following is a summary of shares held in the ESOP trust as of September 30, 2014 and 2013:

	2014	2013
	(Dollars in thousands)	
Allocated ESOP shares	4,923,349	4,892,642
Unreleased ESOP shares	4,295,148	4,460,346
Total ESOP shares	9,218,497	9,352,988
Fair value of unreleased ESOP shares	$ 50,769	$ 55,442

9. STOCK-BASED COMPENSATION

The Company has a Stock Option Plan, a Restricted Stock Plan, and an Equity Incentive Plan, all of which are considered share-based plans.

Stock Option Plans – The Company currently has two plans outstanding which provide for the granting of stock option awards, the 2000 Stock Option Plan and the 2012 Equity Incentive Plan. The objective of both plans is to provide additional incentive to certain officers, directors and key employees by facilitating their purchase of a stock interest in the Company. The total number of shares originally eligible to be granted as stock options under the 2000 Stock Option Plan was 8,558,411. At September 30, 2014, the 2000 Stock Option Plan still had 2,965,349 shares available for future grant; however the Company will not issue any additional stock option grants from this plan. The 2000 Stock Option Plan will expire in April 2015 and no additional grants may be made after expiration, but outstanding grants continue until they are individually vested, forfeited, or expire. All future grants will be awarded from the 2012 Equity Incentive Plan, which had 5,907,500 shares originally eligible to be granted as stock options. At September 30, 2014, the Company had 4,265,900 shares still available for future grants of stock options under the 2012 Equity Incentive Plan. This plan will expire in January 2027 and no additional grants may be made after expiration, but outstanding grants continue until they are individually vested, forfeited, or expire.

The Company may issue incentive and nonqualified stock options under the 2012 Equity Incentive Plan. The Company may also award stock appreciation rights, although to date no stock appreciation rights have been awarded. The incentive stock options expire no later than 10 years and the nonqualified stock options expire no later than 15 years from the date of grant. The vesting period of the options under the 2012 Equity Incentive Plan generally has ranged from three to five years. The option price cannot be less than the market value at the date of the grant as defined by each plan. The fair value of stock option grants is estimated on the date of the grant using the Black-Scholes option pricing model.

At September 30, 2014, the Company had 2,394,502 options outstanding with a weighted average exercise price of $13.02 per option and a weighted average contractual life of 7.6 years, and 1,520,863 options exercisable with a weighted average exercise price of $13.63 per option and a weighted average contractual life of 6.9 years. The exercise price may be paid in cash, shares of common stock, or a combination of both. New shares are issued by the Company upon the exercise of stock options.

Compensation expense attributable to stock option awards during the years ended September 30, 2014, 2013, and 2012 totaled $633 thousand, $792 thousand, and $369 thousand, respectively. The fair value of stock options vested during the years ended September 30, 2014, 2013, and 2012 was $646 thousand, $689 thousand, and $141 thousand, respectively. As of September 30, 2014, the total future compensation cost related to non-vested stock options not yet recognized in the consolidated statements of income was $976 thousand, net of estimated forfeitures, and the weighted average period over which these awards are expected to be recognized was 1.9 years.

117

Restricted Stock Plans – The Company currently has two plans outstanding which provide for the granting of restricted stock awards, the 2000 Recognition and Retention Plan and the 2012 Equity Incentive Plan. The objective of both plans is to enable the Company to retain personnel of experience and ability in key positions of responsibility. The total number of shares originally eligible to be granted as restricted stock under the 2000 Recognition and Retention Plan was 3,423,364. At September 30, 2014, the 2000 Recognition and Retention Plan still had 358,767 shares available for future restricted stock grants; however, the Company will not award any additional grants from this plan. The 2000 Recognition and Retention Plan will expire in April 2015 and no additional grants may be made after expiration, but outstanding grants continue until they are individually vested or forfeited. All future grants of restricted stock will be awarded from the 2012 Equity Incentive Plan, which had 2,363,000 shares originally eligible to be granted as restricted stock. At September 30, 2014, the Company had 1,823,850 shares available for future grants of restricted stock under the 2012 Equity Incentive Plan. This plan will expire in January 2027 and no additional grants may be made after expiration, but outstanding grants continue until they are individually vested or forfeited. The vesting period of the restricted stock awards under the 2012 Equity Incentive Plan generally has ranged from three to five years. At September 30, 2014, the Company had 280,625 unvested restricted stock shares with a weighted average grant date fair value of $11.95 per share.

Compensation expense is calculated based on the fair market value of the common stock at the date of the grant, as defined by the plans, and is recognized over the vesting time period. Compensation expense attributable to restricted stock awards during the years ended September 30, 2014, 2013, and 2012 totaled $1.5 million, $1.8 million, and $827 thousand, respectively. The fair value of restricted stock that vested during the years ended September 30, 2014, 2013, and 2012 totaled $1.5 million, $1.5 million, and $212 thousand, respectively. As of September 30, 2014 there was $2.4 million of unrecognized compensation cost related to unvested restricted stock to be recognized over a weighted average period of 1.9 years.

10. COMMITMENTS AND CONTINGENCIES

The following table summarizes the Bank's loan commitments as of September 30, 2014 and 2013:

	2014	2013
	(Dollars in thousands)	
Originate fixed-rate	$ 48,475	$ 77,085
Originate adjustable-rate	15,937	17,997
Purchase/participate fixed-rate	54,752	95,247
Purchase/participate adjustable-rate	18,477	40,528
	$ 137,641	$ 230,857

Commitments to originate loans are commitments to lend to a customer. Commitments to purchase/participate in loans primarily represent commitments to purchase loans from correspondent lenders on a loan-by-loan basis. The Bank evaluates each borrower's creditworthiness on a case-by-case basis. Commitments generally have fixed expiration dates or other termination clauses and may require the payment of a rate lock fee. Some of the commitments are expected to expire without being fully drawn upon; therefore, the amount of total commitments disclosed above does not necessarily represent future cash requirements. As of September 30, 2014 and 2013, there were no significant loan-related commitments that met the definition of derivatives or commitments to sell mortgage loans. As of September 30, 2014 and 2013, the Bank had approved but unadvanced home equity lines of credit of $260.4 million and $262.7 million, respectively.

At September 30, 2014, the Bank had $10.4 million of agreements outstanding in connection with the remodeling of its Kansas City market area operations center.

In the normal course of business, the Company and its subsidiary are named defendants in various lawsuits and counterclaims. In the opinion of management, after consultation with legal counsel, none of the currently pending suits are expected to have a materially adverse effect on the Company's consolidated financial statements for the year

ended September 30, 2014 or future periods.

11. REGULATORY CAPITAL REQUIREMENTS

The Bank is subject to various regulatory capital requirements administered by the federal banking agencies. Failure to meet minimum capital requirements can initiate certain mandatory and, possibly additional discretionary, actions by regulators that, if undertaken, could have a material adverse effect on the Company's financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the Bank must meet specific capital guidelines that involve quantitative measures of the Bank's assets, liabilities, and certain off-balance sheet items as calculated under regulatory accounting practices. The Bank's capital amounts and classifications are also subject to qualitative judgments by regulators about components, risk weightings, and other factors.

As of September 30, 2014 and 2013, the most recent regulatory guidelines categorized the Bank as "well capitalized" under the regulatory framework for prompt corrective action. To be categorized as "well capitalized," the Bank must maintain minimum capital ratios as set forth in the table below. Management believes, as of September 30, 2014, that the Bank meets all capital adequacy requirements to which it is subject and there were no conditions or events subsequent to September 30, 2014 that would change the Bank's category. There are currently no regulatory capital requirements at the Company level.

	Actual			For Capital Adequacy Purposes			To Be Well Capitalized Under Prompt Corrective Action Provisions		
	Amount	Ratio		Amount	Ratio		Amount	Ratio	
	(Dollars in thousands)								
As of September 30, 2014									
Tier 1 leverage ratio	$ 1,299,365	13.2	%	$ 394,945	4.0	%	$ 493,682	5.0	%
Tier 1 risk-based capital	1,299,365	33.0		157,674	4.0		236,511	6.0	
Total risk-based capital	1,308,592	33.2		315,348	8.0		394,185	10.0	
As of September 30, 2013									
Tier 1 leverage ratio	$ 1,363,103	14.8	%	$ 368,028	4.0	%	$ 460,034	5.0	%
Tier 1 risk-based capital	1,363,103	35.6		153,015	4.0		229,523	6.0	
Total risk-based capital	1,371,925	35.9		306,030	8.0		382,538	10.0	

Generally, savings institutions, such as the Bank, may make capital distributions during any calendar year equal to the earnings of the previous two calendar years and current year-to-date earnings. It is generally required that the Bank remain well capitalized before and after the proposed distribution. The Company's ability to pay dividends is dependent, in part, upon its ability to obtain capital distributions from the Bank. So long as the Bank continues to remain "well capitalized" after each capital distribution and operates in a safe and sound manner, it is management's belief that the regulators will continue to allow the Bank to distribute its net income to the Company, although no assurance can be given in this regard.

In conjunction with the Company's corporate reorganization in December 2010, a "liquidation account" was established for the benefit of certain depositors of the Bank in an amount equal to Capitol Federal Savings Bank MHC's ownership interest in the retained earnings of Capitol Federal Financial as of June 30, 2010. As of September 30, 2014, the balance of this liquidation account was $247.2 million. Under applicable federal banking regulations, neither the Company nor the Bank is permitted to pay dividends on its capital stock to its stockholders if stockholders' equity would be reduced below the amount of the liquidation account at that time.

12. FAIR VALUE OF FINANCIAL INSTRUMENTS

Fair Value Measurements – The Company uses fair value measurements to record fair value adjustments to certain assets and to determine fair value disclosures in accordance with ASC 820 and ASC 825. The Company did not have any liabilities that were measured at fair value at September 30, 2014 or 2013. The Company's AFS securities are recorded at fair value on a recurring basis. Additionally, from time to time, the Company may be required to record at fair value other assets or liabilities on a non-recurring basis, such as OREO and loans individually evaluated for impairment. These non-recurring fair value adjustments involve the application of lower-of-cost-or-fair value accounting or write-downs of individual assets.

The Company groups its assets at fair value in three levels based on the markets in which the assets are traded and the reliability of the assumptions used to determine fair value. These levels are:

- Level 1 - Valuation is based upon quoted prices for identical instruments traded in active markets.
- Level 2 - Valuation is based upon quoted prices for similar instruments in active markets, quoted prices for identical or similar instruments in markets that are not active, and model-based valuation techniques for which all significant assumptions are observable in the market.
- Level 3 - Valuation is generated from model-based techniques that use significant assumptions not observable in the market. These unobservable assumptions reflect the Company's own estimates of assumptions that market participants would use in pricing the asset or liability. Valuation techniques include the use of option pricing models, discounted cash flow models, and similar techniques. The results cannot be determined with precision and may not be realized in an actual sale or immediate settlement of the asset or liability.

The Company bases its fair values on the price that would be received from the sale of an asset in an orderly transaction between market participants at the measurement date. The Company maximizes the use of observable inputs and minimizes the use of unobservable inputs when measuring fair value.

The following is a description of valuation methodologies used for assets measured at fair value on a recurring basis.

AFS Securities - The Company's AFS securities portfolio is carried at estimated fair value, with any unrealized gains and losses, net of taxes, reported as AOCI in stockholders' equity. The majority of the securities within the AFS portfolio were issued by GSEs. The Company primarily uses prices obtained from third party pricing services to determine the fair value of its securities. On a quarterly basis, management corroborates a sample of prices obtained from the third party pricing service for Level 2 securities by comparing them to an independent source. If the price provided by the independent source varies by more than a predetermined percentage from the price received from the third party pricing service, then the variance is researched by management. The Company did not have to adjust prices obtained from the third party pricing service when determining the fair value of its securities during the years ended September 30, 2014 and 2013. The Company's major security types, based on the nature and risks of the securities, are:

- GSE Debentures - Estimated fair values are based on a discounted cash flow method. Cash flows are determined by taking any embedded options into consideration and are discounted using current market yields for similar securities. (Level 2)
- MBS - Estimated fair values are based on a discounted cash flow method. Cash flows are determined based on prepayment projections of the underlying mortgages and are discounted using current market yields for benchmark securities. (Level 2)
- Municipal Bonds - Estimated fair values are based on a discounted cash flow method. Cash flows are determined by taking any embedded options into consideration and are discounted using current market yields for securities with similar credit profiles. (Level 2)
- Trust Preferred Securities - Estimated fair values are based on a discounted cash flow method. Cash flows are determined by taking prepayment and underlying credit considerations into account. The discount rates are derived

from secondary trades and bid/offer prices. (Level 3)

120

The following tables provide the level of valuation assumption used to determine the carrying value of the Company's assets measured at fair value on a recurring basis at the dates presented.

	September 30, 2014			
	Carrying Value	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)(1)
	(Dollars in thousands)			
AFS Securities:				
GSE debentures	$ 549,755	$—	$ 549,755	$—
MBS	287,606	—	287,606	—
Municipal bonds	1,133	—	1,133	—
Trust preferred securities	2,296	—	—	2,296
	$ 840,790	$—	$ 838,494	$ 2,296

	September 30, 2013			
	Carrying Value	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)(2)
	(Dollars in thousands)			
AFS Securities:				
GSE debentures	$ 702,228	$—	$ 702,228	$—
MBS	363,964	—	363,964	—
Municipal bonds	1,352	—	1,352	—
Trust preferred securities	2,423	—	—	2,423
	$ 1,069,967	$—	$ 1,067,544	$ 2,423

(1) The Company's Level 3 AFS securities had no activity during the year ended September 30, 2014, except for principal repayments of $150 thousand and increases in net unrealized losses recognized in other comprehensive income. Increases in net unrealized losses included in other comprehensive income for the year ended September 30, 2014 were $16 thousand.

(2) The Company's Level 3 AFS securities had no activity during the year ended September 30, 2013, except for principal repayments of $424 thousand and reductions in net unrealized losses recognized in other comprehensive income. Reductions in net unrealized losses included in other comprehensive income for the year ended September 30, 2013 were $276 thousand.

The following is a description of valuation methodologies used for significant assets measured at fair value on a non-recurring basis.

Loans Receivable – The balance of loans individually evaluated for impairment at September 30, 2014 and 2013 was $26.8 million and $27.3 million, respectively. Substantially all of these loans were secured by residential real estate and were individually evaluated to ensure that the carrying value of the loan was not in excess of the fair value of the collateral, less estimated selling costs. When no impairment is indicated, the carrying amount is considered to approximate fair value. Fair values were estimated through current appraisals or analyzed based on market indicators. Fair values may be adjusted by management to reflect current economic and market conditions and, as such, are classified as Level 3. Based on this evaluation, the Bank charged-off any loss amounts as of September 30, 2014 and 2013; therefore, there was no ACL related to these loans.

OREO – OREO primarily represents real estate acquired as a result of foreclosure or by deed in lieu of foreclosure and is carried at lower-of-cost or fair value. Fair value is estimated through current appraisals or listing prices, less estimated selling costs. As these properties are actively marketed, estimated fair values may be adjusted by management to reflect current economic and market conditions and, as such, are classified as Level 3. The fair value of OREO at September 30, 2014 and 2013 was $4.1 million and $3.9 million, respectively.

The following tables provide the level of valuation assumptions used to determine the carrying value of the Company's assets measured at fair value on a non-recurring basis at the dates presented.

	September 30, 2014			
	Carrying Value	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
	(Dollars in thousands)			
Loans individually evaluated for impairment	$26,828	$—	$—	$26,828
OREO	4,094	—	—	4,094
	$30,922	$—	$—	$30,922

	September 30, 2013			
	Carrying Value	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
	(Dollars in thousands)			
Loans individually evaluated for impairment	$27,327	$—	$—	$27,327
OREO	3,882	—	—	3,882
	$31,209	$—	$—	$31,209

Fair Value Disclosures – The Company determined estimated fair value amounts using available market information and from a variety of valuation methodologies. However, considerable judgment is required to interpret market data to develop the estimates of fair value. Accordingly, the estimates presented are not necessarily indicative of the amount the Company could realize in a current market exchange. The use of different market assumptions and estimation methodologies may have a material impact on the estimated fair value amounts. The fair value estimates presented herein were based on pertinent information available to management as of the dates presented.

The carrying amounts and estimated fair values of the Company's financial instruments at September 30, 2014 and 2013 were as follows:

	2014		2013	
	Carrying Amount	Estimated Fair Value	Carrying Amount	Estimated Fair Value
	(Dollars in thousands)			
Assets:				
Cash and cash equivalents	$ 810,840	$ 810,840	$ 113,886	$ 113,886
AFS securities	840,790	840,790	1,069,967	1,069,967
HTM securities	1,552,699	1,571,524	1,718,023	1,741,846
Loans receivable	6,233,170	6,429,840	5,958,868	6,132,239
FHLB stock	213,054	213,054	128,530	128,530
Liabilities:				
Deposits	4,655,272	4,674,268	4,611,446	4,646,263
FHLB borrowings	3,369,677	3,423,547	2,513,538	2,599,749
Repurchase agreements	220,000	227,539	320,000	333,749

The following methods and assumptions were used to estimate the fair value of the financial instruments:

Cash and Cash Equivalents - The carrying amounts of cash and cash equivalents are considered to approximate their fair value due to the nature of the financial assets. (Level 1)

HTM Securities - Estimated fair values of securities are based on one of three methods: (1) quoted market prices where available; (2) quoted market prices for similar instruments if quoted market prices are not available; (3) unobservable data that represents the Bank's assumptions about items that market participants would consider in determining fair value where no market data is available. HTM securities are carried at amortized cost. (Level 2)

Loans Receivable - The fair value of one- to four-family mortgages and home equity loans are generally estimated using the present value of expected future cash flows, assuming future prepayments and using discount factors determined by prices obtained from securitization markets, less a discount for the cost of servicing and lack of liquidity. The estimated fair value of the Bank's multi-family, commercial, and consumer loans are based on the expected future cash flows assuming future prepayments and discount factors based on current offering rates. (Level 3)

FHLB stock - The carrying value and estimated fair value of FHLB stock equals cost, which is based on redemption at par value. (Level 1)

Deposits - The estimated fair value of demand deposits, savings, and money market accounts is the amount payable on demand at the reporting date. The estimated fair value of these deposits at September 30, 2014 and 2013 was $2.12 billion and $2.07 billion, respectively. (Level 1) The fair value of certificates of deposit is estimated by discounting future cash flows using current London Interbank Offered Rates ("LIBOR"). The estimated fair value of certificates of deposit at September 30, 2014 and 2013 was $2.55 billion and $2.58 billion, respectively. (Level 2)

FHLB borrowings and Repurchase Agreements - The fair value of fixed-maturity borrowed funds is estimated by discounting estimated future cash flows using current offer rates. (Level 2) The carrying value of FHLB line of credit is considered to approximate its fair value due to the nature of the financial liability. (Level 1)

13. SUBSEQUENT EVENTS

In preparing these financial statements, management has evaluated events occurring subsequent to September 30, 2014, for potential recognition and disclosure. There have been no material events or transactions which would require adjustments to the consolidated financial statements at September 30, 2014.

14. SELECTED QUARTERLY FINANCIAL DATA (UNAUDITED)

The following table presents summarized quarterly data for each of the years indicated for the Company.

	First Quarter	Second Quarter	Third Quarter	Fourth Quarter	Total
	(Dollars and counts in thousands, except per share amounts)				
2014					
Total interest and dividend income	$72,234	$71,857	$71,921	$74,234	$290,246
Net interest and dividend income	44,245	45,727	46,198	47,973	184,143
Provision for credit losses	515	160	307	427	1,409
Net income	17,813	19,688	19,983	20,210	77,694
Basic EPS	0.12	0.14	0.14	0.15	0.56
Diluted EPS	0.12	0.14	0.14	0.15	0.56
Dividends declared per share	0.505	0.075	0.325	0.075	0.98
Average number of basic shares outstanding	142,882	139,489	138,332	137,047	139,440
Average number of diluted shares outstanding	142,883	139,489	138,334	137,051	139,442
2013					
Total interest and dividend income	$77,676	$74,980	$73,675	$72,223	$298,554
Net interest and dividend income	45,630	44,320	44,404	43,806	178,160
Provision for credit losses	233	—	(800)	(500)	(1,067)
Net income	17,563	17,715	17,995	16,067	69,340
Basic EPS	0.12	0.12	0.13	0.11	0.48
Diluted EPS	0.12	0.12	0.13	0.11	0.48
Dividends declared per share	0.775	0.075	0.075	0.075	1.00
Average number of basic shares outstanding	147,883	145,382	143,263	142,856	144,847
Average number of diluted shares outstanding	147,883	145,382	143,263	142,858	144,848

15. PARENT COMPANY FINANCIAL INFORMATION (PARENT COMPANY ONLY)
The Company serves as the holding company for the Bank (see "Note 1 – Summary of Significant Accounting Policies"). The Company's (parent company only) balance sheets at the dates presented, and the related statements of income and cash flows for each of the years presented are as follows:
BALANCE SHEETS
September 30, 2014 and 2013
(Dollars in thousands, except per share amounts)

	2014	2013
ASSETS:		
Cash and cash equivalents	$ 139,540	$ 207,012
Investment in the Bank	1,306,351	1,370,426
Note receivable - ESOP	46,140	47,260
Other assets	484	282
Income taxes receivable	3,618	3,031
Deferred income tax assets	393	4,186
TOTAL ASSETS	$ 1,496,526	$ 1,632,197
LIABILITIES:		
Accounts payable and accrued expenses	$ 3,644	$ 71
STOCKHOLDERS' EQUITY:		
Preferred stock, $.01 par value; 100,000,000 shares authorized, no shares issued or outstanding	—	—
Common stock, $.01 par value; 1,400,000,000 shares authorized, 140,951,203 and 147,840,268		
shares issued and outstanding as of September 30, 2014 and 2013, respectively	1,410	1,478
Additional paid-in capital	1,180,732	1,235,781
Unearned compensation - ESOP	(42,951)	(44,603)
Retained earnings	346,705	432,203
AOCI, net of tax	6,986	7,267
Total stockholders' equity	1,492,882	1,632,126
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	$ 1,496,526	$ 1,632,197

125

STATEMENTS OF INCOME
YEARS ENDED SEPTEMBER 30, 2014, 2013 and 2012
(Dollars in thousands)

	2014	2013	2012
INTEREST AND DIVIDEND INCOME:			
Dividend income from the Bank	$ 145,276	$ 70,512	$ 88,871
Interest income from other investments	2,004	2,328	2,835
Interest income from securities	—	62	1,062
Total interest and dividend income	147,280	72,902	92,768
NON-INTEREST EXPENSE:			
Salaries and employee benefits	774	857	838
Regulatory and outside services	248	473	276
Other non-interest expense	606	648	694
Total non-interest expense	1,628	1,978	1,808
INCOME BEFORE INCOME TAX EXPENSE AND EQUITY IN EXCESS OF DISTRIBUTION OVER EARNINGS OF SUBSIDIARY	145,652	70,924	90,960
INCOME TAX EXPENSE	132	144	731
INCOME BEFORE EQUITY IN EXCESS OF DISTRIBUTION OVER EARNINGS OF SUBSIDIARY	145,520	70,780	90,229
EQUITY IN EXCESS OF DISTRIBUTION OVER EARNINGS OF SUBSIDIARY	(67,826)	(1,440)	(15,716)
NET INCOME	$ 77,694	$ 69,340	$ 74,513

126

STATEMENTS OF CASH FLOWS
YEARS ENDED SEPTEMBER 30, 2014, 2013 and 2012
(Dollars in thousands)

	2014	2013	2012
CASH FLOWS FROM OPERATING ACTIVITIES:			
Net income	$77,694	$69,340	$74,513
Adjustments to reconcile net income to net cash provided by operating activities:			
Equity in excess of distribution over earnings of subsidiary	67,826	1,440	15,716
Depreciation of equipment	2	—	—
Amortization/accretion of premiums/discounts	—	74	2,196
Other, net	—	263	1,549
Provision for deferred income taxes	3,768	3,216	5,422
Changes in:			
Other assets	166	(198)	(9)
Income taxes receivable/payable	(562)	(220)	(2,160)
Accounts payable and accrued expenses	(12)	(27)	33
Net cash flows provided by operating activities	148,882	73,888	97,260
CASH FLOWS FROM INVESTING ACTIVITIES:			
Proceeds from maturities of AFS securities	—	60,000	300,000
Principal collected on notes receivable from ESOP	1,120	2,827	2,672
Purchase of equipment	(370)	—	—
Net cash flows provided by investing activities	750	62,827	302,672
CASH FLOWS FROM FINANCING ACTIVITIES:			
Net payment from subsidiary related to restricted stock awards	243	34	6,128
Dividends paid	(138,172)	(146,824)	(63,768)
Repurchase of common stock	(79,633)	(91,573)	(146,781)
Stock options exercised	458	12	36
Net cash flows used in financing activities	(217,104)	(238,351)	(204,385)
NET (DECREASE) INCREASE IN CASH AND CASH EQUIVALENTS	(67,472)	(101,636)	195,547
CASH AND CASH EQUIVALENTS:			
Beginning of year	207,012	308,648	113,101
End of year	$139,540	$207,012	$308,648

Item 9. Changes in and Disagreements with Accountants on Accounting and Financial Disclosure
None.

Item 9A. Controls and Procedures
Evaluation of Disclosure Controls and Procedures
Our management, with the participation of our Chief Executive Officer and our Chief Financial Officer, evaluated the Company's disclosure controls and procedures (as defined in Rule 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended, the "Act") as of September 30, 2014. Based upon this evaluation, our Chief Executive Officer and our Chief Financial Officer have concluded that as of September 30, 2014, such disclosure controls and procedures were effective to ensure that information required to be disclosed by the Company in the reports it files or submits under the Act is accumulated and communicated to the Company's management (including the Chief Executive Officer and Chief Financial Officer) to allow timely decisions regarding required disclosure, and is recorded, processed, summarized, and reported within the time periods specified in the SEC's rules and forms.

Internal Controls Over Financial Reporting
Management of the Company is responsible for establishing and maintaining adequate internal control over financial reporting (as defined in Rule 13a-15(e) and 15(d)-15(e) under the Securities Exchange Act of 1934, as amended, the "Act"). The Company's internal control system is a process designed to provide reasonable assurance to the Company's management and Board of Directors regarding the preparation and fair presentation of published financial statements.

The Company's internal control over financial reporting includes policies and procedures that pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect transactions and dispositions of assets; provide reasonable assurances that transactions are recorded as necessary to permit preparation of financial statements in accordance with GAAP, and that receipts and expenditures are being made only in accordance with authorizations of management and the directors of the Company; and provide reasonable assurance regarding prevention or untimely detection of unauthorized acquisition, use, or disposition of the Company's assets that could have a material effect on the Company's financial statements.

All internal control systems, no matter how well designed, have inherent limitations. Therefore, even those systems determined to be effective can provide only reasonable assurance with respect to financial reporting. Further, because of changes in conditions, the effectiveness of any system of internal control may vary over time. The design of any internal control system also factors in resource constraints and consideration for the benefit of the control relative to the cost of implementing the control. Because of these inherent limitations in any system of internal control, management cannot provide absolute assurance that all control issues and instances of fraud within the Company have been detected.

Management assessed the effectiveness of the Company's internal control over financial reporting as of September 30, 2014. In making this assessment, management used the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission in Internal Control - Integrated Framework (1992). Management has concluded that the Company maintained an effective system of internal control over financial reporting based on these criteria as of September 30, 2014.

The Company's independent registered public accounting firm, Deloitte & Touche LLP, who audited the consolidated financial statements included in the Company's annual report, has issued an audit report on the Company's internal control over financial reporting as of September 30, 2014 and it is included in Item 8.

Changes in Internal Control Over Financial Reporting
There have been no changes in the Company's internal control over financial reporting (as defined in Rule 13a-15(f) and 15d-15(f) under the Act) that occurred during the Company's quarter ended September 30, 2014 that have

materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

Item 9B. Other Information

None.

PART III

Item 10. Directors, Executive Officers, and Corporate Governance

Information required by this item concerning the Company's directors and compliance with Section 16(a) of the Act is incorporated herein by reference from the definitive proxy statement for the Annual Meeting of Stockholders to be held in January 2015, a copy of which will be filed not later than 120 days after the close of the fiscal year.
Pursuant to General Instruction G(3), information concerning executive officers of the Company is included in Part I, under the caption "Executive Officers of the Registrant" of this Form 10-K.

Information required by this item regarding the audit committee of the Company's Board of Directors, including information regarding the audit committee financial experts serving on the committee, is incorporated herein by reference from the definitive proxy statement for the Annual Meeting of Stockholders to be held in January 2015, a copy of which will be filed not later than 120 days after the close of the fiscal year.

Code of Ethics

We have adopted a written code of ethics within the meaning of Item 406 of SEC Regulation S-K that applies to our principal executive officer and senior financial officers, and to all of our other employees and our directors, a copy of which is available free of charge by contacting James Wempe, Investor Relations Officer, at (785) 270-6055, or from our internet website (www.capfed.com).

Item 11. Executive Compensation

Information required by this item concerning compensation is incorporated herein by reference from the definitive proxy statement for the Annual Meeting of Stockholders to be held in January 2015, a copy of which will be filed not later than 120 days after the close of the fiscal year.

Item 12. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters

Information required by this item concerning security ownership of certain beneficial owners and management is incorporated herein by reference from the definitive proxy statement for the Annual Meeting of Stockholders to be held in January 2015, a copy of which will be filed not later than 120 days after the close of the fiscal year.

The following table sets forth information as of September 30, 2014 with respect to compensation plans under which shares of our common stock may be issued.

Equity Compensation Plan Information

Plan Category	Number of Shares to be issued upon Exercise of Outstanding Options, Warrants and Rights	Weighted Average Exercise Price of Outstanding Options, Warrants and Rights	Number of Shares Remaining Available for Future Issuance Under Equity Compensation Plans (Excluding Shares Reflected in the First Column)	
Equity compensation plans approved by stockholders	2,394,502	$ 13.02	9,413,866	(1)
Equity compensation plans not approved by stockholders	N/A	N/A	N/A	
	2,394,502	$ 13.02	9,413,866	

(1) This amount includes 358,767 shares available for future grants of restricted stock under the 2000 Recognition and Retention Plan, and 1,823,850 shares available for future grants of restricted stock under the 2012 Equity Incentive Plan. The Company intends to award all future grants of restricted stock from the 2012 Equity Incentive Plan.

Item 13. Certain Relationships and Related Transactions, and Director Independence

Information required by this item concerning certain relationships, related transactions and director independence is incorporated herein by reference from the definitive proxy statement for the Annual Meeting of Stockholders to be held in January 2015, a copy of which will be filed not later than 120 days after the close of the fiscal year.

Item 14. Principal Accountant Fees and Services

Information required by this item concerning principal accountant fees and services is incorporated herein by reference from the definitive proxy statement for the Annual Meeting of Stockholders to be held in January 2015, a copy of which will be filed not later than 120 days after the close of the fiscal year.

PART IV

Item 15. Exhibits and Financial Statement Schedules

(a) The following is a list of documents filed as part of this report:

(1) Financial Statements:

The following financial statements are included under Part II, Item 8 of this Form 10-K:

1. Report of Independent Registered Public Accounting Firm.
2. Consolidated Balance Sheets as of September 30, 2014 and 2013.
3. Consolidated Statements of Income for the Years Ended September 30, 2014, 2013, and 2012.
4. Consolidated Statements of Comprehensive Income for the Years Ended September 30, 2014, 2013, and 2012.
5. Consolidated Statements of Stockholders' Equity for the Years Ended September 30, 2014, 2013, and 2012.
6. Consolidated Statements of Cash Flows for the Years Ended September 30, 2014, 2013, and 2012.
7. Notes to Consolidated Financial Statements for the Years Ended September 30, 2014, 2013, and 2012.

(2) Financial Statement Schedules:

All financial statement schedules have been omitted as the information is not required under the related instructions or is not applicable.

(3) Exhibits:

See "Index to Exhibits."

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) 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.

CAPITOL FEDERAL FINANCIAL, INC.

Date: November 26, 2014	By:	/s/ John B. Dicus John B. Dicus, Chairman, President and Chief Executive Officer (Principal Executive Officer)

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the Registrant and in the capacities and on the date indicated.

By: /s/ John B. Dicus
John B. Dicus, Chairman, President and Chief Executive Officer
(Principal Executive Officer)
Date: November 26, 2014

By: /s/ Kent G. Townsend
Kent G. Townsend, Executive Vice President, Chief Financial Officer and Treasurer
(Principal Financial Officer)
Date: November 26, 2014

By: /s/ Jeffrey R. Thompson
Jeffrey R. Thompson, Director
Date: November 26, 2014

By: /s/ Jeffrey M. Johnson
Jeffrey M. Johnson, Director
Date: November 26, 2014

By: /s/ Morris J. Huey II
Morris J. Huey II, Director
Date: November 26, 2014

By: /s/ Reginald L. Robinson
Reginald L. Robinson, Director
Date: November 26, 2014

By: /s/ Michael T. McCoy, M.D.
Michael T. McCoy, M.D., Director
Date: November 26, 2014

By: /s/ James G. Morris
James G. Morris, Director
Date: November 26, 2014

By: /s/ Marilyn S. Ward
Marilyn S. Ward, Director
Date: November 26, 2014

By: /s/ Tara D. Van Houweling
Tara D. Van Houweling, First Vice President and Reporting Director
(Principal Accounting Officer)
Date: November 26, 2014

INDEX TO EXHIBITS

Exhibit Number	Document
3(i)	Charter of Capitol Federal Financial, Inc., as filed on May 6, 2010, as Exhibit 3(i) to Capitol Federal Financial, Inc.'s Registration Statement on Form S-1 (File No. 333-166578) and incorporated herein by reference
3(ii)	Bylaws of Capitol Federal Financial, Inc. as filed on May 6, 2010, as Exhibit 3(ii) to Capitol Federal Financial Inc.'s Registration Statement on Form S-1 (File No. 333-166578) and incorporated herein by reference
10.1(i)	Capitol Federal Financial, Inc.'s Employee Stock Ownership Plan, as amended, filed on May 10, 2011 as Exhibit 10.1(ii) to the March 31, 2011 Form 10-Q for Capitol Federal Financial, Inc., and incorporated herein by reference
10.1(ii)	Form of Change of Control Agreement with each of John B. Dicus, Kent G. Townsend, and Rick C. Jackson filed on January 20, 2011 as Exhibit 10.1 to the Registrant's Current Report on Form 8-K and incorporated herein by reference
10.1(iii)	Form of Change of Control Agreement with each of Natalie G. Haag and Carlton A. Ricketts filed on November 29, 2012 as Exhibit 10.1(iv) to the Registrant's Annual Report on Form 10-K and incorporated herein by reference
10.1(iv)	Form of Change of Control Agreement with Frank H. Wright filed on November 29, 2013 as Exhibit 10.1(v) to the Registrant's Annual Report on Form 10-K and incorporated herein by reference
10.2	Capitol Federal Financial's 2000 Stock Option and Incentive Plan (the "Stock Option Plan") filed on April 13, 2000 as Appendix A to Capitol Federal Financial's Revised Proxy Statement (File No. 000-25391) and incorporated herein by reference
10.3	Capitol Federal Financial's 2000 Recognition and Retention Plan filed on April 13, 2000 as Appendix B to Capitol Federal Financial's Revised Proxy Statement (File No. 000-25391) and incorporated herein by reference
10.4	Capitol Federal Financial Deferred Incentive Bonus Plan, as amended, filed on May 5, 2009 as Exhibit 10.4 to the March 31, 2009 Form 10-Q for Capitol Federal Financial and incorporated herein by reference
10.5	Form of Incentive Stock Option Agreement under the Stock Option Plan filed on February 4, 2005 as Exhibit 10.5 to the December 31, 2004 Form 10-Q for Capitol Federal Financial and incorporated herein by reference
10.6	Form of Non-Qualified Stock Option Agreement under the Stock Option Plan filed on February 4, 2005 as Exhibit 10.6 to the December 31, 2004 Form 10-Q for Capitol Federal Financial and incorporated herein by reference
10.7	Form of Restricted Stock Agreement under the Recognition and Retention Plan filed on February 4, 2005 as Exhibit 10.7 to the December 31, 2004 Form 10-Q for Capitol Federal Financial and incorporated herein by reference
10.8	Description of Named Executive Officer Salary and Bonus Arrangements
10.9	Description of Director Fee Arrangements filed on August 1, 2014 as Exhibit 10.9 to the Registrant's June 30, 2014 Form 10-Q and incorporated herein by reference
10.10	Short-term Performance Plan filed on August 4, 2011 as Exhibit 10.10 to the Registrant's June 30, 2011 Form 10-Q and incorporated herein by reference
10.11	Capitol Federal Financial, Inc. 2012 Equity Incentive Plan (the "Equity Incentive Plan") filed on December 22, 2011 as Appendix A to Capitol Federal Financial, Inc.'s Proxy Statement (File No. 001-34814) and incorporated herein by reference
10.12	Form of Incentive Stock Option Agreement under the Equity Incentive Plan filed on February 6, 2012 as Exhibit 10.12 to the Registrant's December 31, 2011 Form 10-Q and incorporated herein by reference
10.13	

	Form of Non-Qualified Stock Option Agreement under the Equity Incentive Plan filed on February 6, 2012 as Exhibit 10.13 to the Registrant's December 31, 2011 Form 10-Q and incorporated herein by reference
10.14	Form of Stock Appreciation Right Agreement under the Equity Incentive Plan filed on February 6, 2012 as Exhibit 10.14 to the Registrant's December 31, 2011 Form 10-Q and incorporated herein by reference
10.15	Form of Restricted Stock Agreement under the Equity Incentive Plan filed on February 6, 2012 as Exhibit 10.15 to the Registrant's December 31, 2011 Form 10-Q and incorporated herein by reference
11	Calculations of Basic and Diluted EPS (See "Part II, Item 8. Financial Statements and Supplementary Data – Notes to Consolidated Financial Statements – Note 2 – Earnings Per Share")

14	Code of Ethics*
21	Subsidiaries of the Registrant
23	Consent of Independent Registered Public Accounting Firm
31.1	Certification pursuant to section 302 of the Sarbanes-Oxley Act of 2002 made by John B. Dicus, Chairman, President and Chief Executive Officer
31.2	Certification pursuant to section 302 of the Sarbanes-Oxley Act of 2002 made by Kent G. Townsend, Executive Vice President, Chief Financial Officer and Treasurer
32	Certification pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 made by John B. Dicus, Chairman, President and Chief Executive Officer, and Kent G. Townsend, Executive Vice President, Chief Financial Officer and Treasurer
101	The following information from the Company's Annual Report on Form 10-K for the fiscal year ended September 30, 2014, filed with the SEC on November 26, 2014, has been formatted in eXtensible Business Reporting Language: (i) Consolidated Balance Sheets at September 30, 2014 and 2013, (ii) Consolidated Statements of Income for the fiscal years ended September 30, 2014, 2013, and 2012, (iii) Consolidated Statements of Comprehensive Income for the fiscal years ended September 30, 2014, 2013, and 2012, (iv) Consolidated Statement of Stockholders' Equity for the fiscal years ended September 30, 2014, 2013, and 2012, (v) Consolidated Statements of Cash Flows for the fiscal years ended September 30, 2014, 2013, and 2012, and (vi) Notes to the Unaudited Consolidated Financial Statements

*May be obtained free of charge from the Registrant's Investor Relations Officer by calling (785) 270-6055 or from the Registrant's internet website at www.capfed.com.