
HARLEYSVILLE FINANCIAL CORPORATION

2018
Annual Report

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2018 ANNUAL REPORT

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CORPORATE PROFILE

Harleysville Financial Corporation, formerly Harleysville Savings Financial Corporation, (the “Company”) is a Pennsylvania corporation headquartered in Harleysville, Pennsylvania. The Company became the bank holding company for Harleysville Bank, formerly Harleysville Savings Bank, in connection with the holding company reorganization of the Bank in February 2000 (the “Reorganization”). In August 1987, the Bank’s predecessor, Harleysville Savings Association, converted to the stock form of organization. The Bank, whose predecessor was originally, incorporated in 1915, converted from a Pennsylvania chartered, permanent reserve fund savings association to a Pennsylvania chartered stock savings bank in June 1991. The Bank operates from six full-service offices located in Montgomery County and one office located in Bucks County, Pennsylvania. The Bank’s primary market area includes Montgomery County, which has the third largest population and the second highest per capita income in the Commonwealth of Pennsylvania, and, to a lesser extent, Bucks County. As of September 30, 2018, the Company had \$768.9 million of total assets, \$582.1 million of deposits and \$71.8 million of stockholders’ equity. The Company’s stockholders’ equity constituted 9.3% of total assets as of September 30, 2018.

The Bank’s primary business consists of attracting deposits from the general public and business customers through a variety of deposit programs and investing such deposits principally in first mortgage loans secured by residential properties in the Bank’s primary market area. The Bank also originates a variety of consumer loans, predominately home equity loans and lines of credit also secured by residential properties in the Bank’s primary lending area. The Bank is also engaged in the general commercial banking business, and provides a full range of commercial loans and commercial real estate loans to customers in the Bank’s primary market area. The Bank serves its customers through its full-service branch network, the internet, telephone and mobile banking.

Deposits with the Bank are insured to the maximum extent provided by law through the Deposit Insurance Fund administered by the Federal Deposit Insurance Corporation (“FDIC”). The Bank is subject to examination and comprehensive regulation by the FDIC and the Pennsylvania Department of Banking (“Department”). It is also a member of the Federal Home Loan Bank of Pittsburgh (“FHLB of Pittsburgh” or “FHLB”), which is one of the 11 regional banks comprising the Federal Home Loan Bank System (“FHLB System”). The Bank is also subject to regulations of the Board of Governors of the Federal Reserve System (“Federal Reserve Board”) governing reserves required to be maintained against deposits and certain other matters.

The Company’s principal executive offices are located at 271 Main Street, Harleysville, Pennsylvania 19438 and its telephone number is (215) 256-8828.

Competition

The Company faces significant competition in attracting deposits. Its most direct competition for deposits has historically come from commercial banks and savings institutions located in its market area. The Company faces additional significant competition for investors’ funds from other financial intermediaries. The Company competes for deposits principally by offering depositors a variety of deposit programs, convenient branch locations, hours and other services. The Company does not rely upon any individual group or entity for a material portion of its deposits.

The Company’s competition for real estate loans comes principally from mortgage banking companies, other savings institutions, commercial banks and credit unions. The Bank competes for loan originations primarily through the interest rates and loan fees it charges, the efficiency and quality of services it provides borrowers, referrals from real estate brokers and builders, and the variety of its products. Factors which affect competition include the general and local economic conditions, current interest rate levels and volatility in the mortgage markets.

STOCK MARKET INFORMATION

Harleysville Financial Corporation's common stock trades on the OTC Bulletin Board under the symbol "HARL". Prices shown below reflect the prices reported on the OTC Bulletin Board during the indicated periods. The closing price of the common stock on September 30, 2018 was \$25.00 per share. There were 3,744,046 shares of common stock outstanding as of September 30, 2018, held by approximately 1,000 stockholders of record, not including the number of persons or entities whose stock is held in nominee or "street" name through various brokerage firms and banks.

For The Quarter Ended	High	Low	Close	Cash Dividends Declared
September 30, 2018	\$25.20	\$22.81	\$25.00	\$0.23
June 30, 2018	24.25	23.50	24.00	0.23
March 31, 2018	23.55	22.34	23.55	0.23
December 31, 2017	23.00	21.85	23.00	0.22
September 30, 2017	\$23.85	\$22.25	\$22.75	\$0.22
June 30, 2017	24.00	21.50	21.70	0.22
March 31, 2017	24.00	20.01	20.11	0.22
December 31, 2016	22.25	18.20	18.45	0.21

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

The following discussion is intended to assist in understanding our financial condition, and the results of operations for Harleysville Financial Corporation, and its subsidiary Harleysville Bank, for the fiscal years ended September 30, 2018 and 2017. The information in this section should be read in conjunction with the Company's financial statements and the accompanying notes included elsewhere herein.

Overview

Harleysville Financial Corporation, a bank holding company, of which Harleysville Bank (the "Bank"), is a wholly owned subsidiary, was formed in February 2000. For purposes of this discussion, the Company, including its wholly owned subsidiary, will be referred to as the "Company." The Company's earnings are primarily dependent upon its net interest income, which is determined by (i) the difference between yields earned on interest-earning assets and rates paid on interest-bearing liabilities ("interest rate spread") and (ii) the relative amounts of interest-earning assets and interest-bearing liabilities outstanding. The Company's interest rate spread is affected by regulatory, economic, and competitive factors that influence interest rates, loan demand and deposit flows. The Company, like other institutions, is vulnerable to an increase in interest rates to the extent that interest-bearing liabilities mature or reprice more rapidly than interest-earning assets. To reduce the effect of adverse changes in interest rates on its operations, the Company has adopted certain asset and liability management strategies, described below. The Company's earnings are also affected by, among other factors, other non-interest income, other expenses, and income taxes.

The Company's total assets at September 30, 2018 amounted to \$768.9 million compared to \$762.9 million as of September 30, 2017. The increase in assets was primarily due to an increase in loans receivable of \$31.5 million. The increase in loans receivable was partially offset by a decrease in investments and mortgage-backed securities of \$24.9 million. Total liabilities at September 30, 2018 were \$697.0 million compared to \$694.0 million at September 30, 2017. The increase in liabilities was due to an increase in total deposits of \$33.3 million. The increase in total deposits was partially offset by a decrease in borrowings of \$28.4 million. Stockholders' equity totaled \$71.8 million at September 30, 2018 compared to \$68.9 million at September 30, 2017.

During fiscal 2018, net interest income increased \$2.5 million or 11.9% from the prior fiscal year. This increase was primarily due to an increase in the interest rate spread to 3.0% in fiscal year 2018 from 2.7% in fiscal year 2017. There was a 1.4% increase in the average interest-earning assets and a 0.4% increase in average interest-bearing liabilities. Net income for fiscal 2018 was \$7.1 million compared to \$5.7 million for the fiscal year ended 2017. The Company's return on average assets (net income divided by average total assets) was 0.9% during fiscal 2018 compared to 0.7% during fiscal 2017. Return on average equity (net income divided by average equity) was 10.2% during fiscal 2018 compared to 8.4% during fiscal 2017.

Results of Operations

The following table sets forth as of the periods indicated, information regarding: (i) the total dollar amounts of interest income from interest-earning assets and the resulting average yields; (ii) the total dollar amount of interest expense on interest-bearing liabilities and the resulting average costs; (iii) net interest income; (iv) interest rate spread; (v) net interest-earning assets; (vi) the net yield earned on interest-earning assets; and (vii) the ratio of total interest-earning assets to total interest-bearing liabilities. Average balances are calculated on a monthly basis. Yields on tax-exempt assets have not been calculated on a fully tax-exempt basis.

For The Year Ended September 30,						
	2018			2017		
	Average Balance	Interest	Yield/Rate	Average Balance	Interest	Yield/Rate
Interest-earning assets:						
Mortgage loans (2)(3)	\$319,370	\$ 14,316	4.48%	\$303,253	\$ 13,861	4.57%
Mortgage-backed securities	100,431	2,219	2.21%	125,127	2,641	2.11%
Commercial loans (3)	194,142	8,712	4.49%	165,747	7,322	4.42%
Consumer and other loans (3)	103,480	3,994	3.86%	105,083	3,665	3.49%
Investments	36,273	1,088	3.00%	44,379	1,071	2.41%
Total interest-earning assets	753,696	30,329	4.02%	743,589	28,560	3.84%
Interest-bearing liabilities:						
Savings and money market	227,653	1,400	0.61%	232,903	1,270	0.55%
Checking	123,174	29	0.02%	136,030	38	0.03%
Certificates of deposit	167,998	2,210	1.32%	121,910	1,092	0.90%
Total deposits	518,825	3,639	0.70%	490,843	2,400	0.49%
Borrowings	112,994	3,128	2.77%	138,436	5,096	3.68%
Total interest-bearing liabilities	631,819	6,767	1.07%	629,279	7,496	1.19%
Net interest income/interest rate spread		\$ 23,562	2.95%		\$ 21,064	2.65%
Net interest-earning assets/net yield on interest-earning assets(1)	\$ 121,877		3.13%	\$ 114,310		2.84%
Ratio of average interest-earning assets to average interest-bearing liabilities			119.3%			118.2%

(1) Net interest income divided by average interest-earning assets.

(2) Loan fee income is immaterial to this analysis.

(3) There were 46 non-accruing loans totaling \$9.6 million at September 30, 2018 and 48 non-accruing loans totaling \$11.5 million at September 30, 2017.

Net Interest Income

Net interest income increased by \$2.5 million or 11.9% in fiscal 2018, over the prior year. The increase in the net interest income in fiscal 2018 was due to an increase in the interest rate spread between interest earning assets and interest bearing liabilities due to the transformation of the balance sheet from wholesale to retail. The driving factors are further explained below under “- Interest Income” and “- Interest Expense.”

Interest Income

Interest income on mortgage loans increased by \$455,000 or 3.3% in fiscal 2018 from the prior year. During fiscal 2018, the average balance of mortgage loans increased \$16.1 million or 5.3% and the yield decreased by 9 basis points. The majority of loans during the year were fixed rate mortgages. The decrease in interest on mortgage-backed securities reflects an increase in the yield of 10 basis points, with a decrease in the average balance of \$24.7 million in fiscal 2018. During fiscal 2018, the consumer and other loan average balance decreased \$1.6 million or 1.5% and the yield increased by 37 basis points. The increase in interest income on commercial loans during fiscal 2018 reflected an increase in average balance of \$28.4 million, and an increase in yield of 7 basis points.

Interest and dividends on investments increased by \$16,000 or 1.5% in fiscal 2018 from fiscal 2017. During fiscal 2018, the increase in income resulted from an increase in the yield of 59 basis points. This was partially offset by a decrease in the average balance of \$8.1 million or 18.3%.

Interest Expense

Interest expense on deposits increased \$1.2 million or 51.6% in fiscal 2018 as compared to the prior year. In fiscal 2018, the average balance of deposits increased by \$28.0 million. The average rate paid on deposits increased to 0.7% for the year ended September 30, 2018 compared to 0.5% for year ended September 30, 2017. The increase in the average rate paid on deposits in fiscal 2018 was due to an increase in the average balance of certificates of deposits of \$46.1 million and an increase in interest expense on certificates of deposits of \$1.1 million attributable to promotional rate offerings.

Interest expense on borrowings decreased by \$2.0 million or 38.6% in fiscal 2018 compared to the prior year. The decrease in fiscal 2018 was primarily the result of a decrease in the average balance of borrowings of \$25.4 million or 18.4%. This decrease in the average balance of borrowings was offset by an increase in deposits and a direct result of the transformation of the balance sheet from wholesale to retail.

Provision for Loan Losses

Management establishes reserves for losses on loans when it determines that losses are probable. The adequacy of loan loss reserves is based upon a regular monthly review of loan delinquencies and “classified assets”, as well as local and national economic trends. The allowance for loan losses totaled \$3.9 million at September 30, 2018, compared to \$4.1 million for fiscal year ended September 30, 2017 or 0.6% and 0.7% of total loans at September 30, 2018 and 2017 respectively. The Company recorded a provision for loan losses of \$1.0 million in fiscal 2018 compared to \$664,000 in fiscal 2017. The provision for loan loss reflects the Company’s analysis and review of its loan portfolio and assessment of the underlying risks associated with delinquent loans as well as loans classified for regulatory purposes. For additional analysis of the allowance refer to Note 4 – Loans Receivable in the Consolidated Financial Statements.

Other Income

The Company’s total other income increased to \$2.9 million in fiscal 2018 compared to \$2.6 million in fiscal 2017. The increase in other income is primarily due to an increase in gain on sale of foreclosed real estate of \$304,000 in fiscal 2018 compared to \$55,000 in fiscal 2017. In fiscal 2018 there was no gain on sales of mortgage-backed securities compared to \$173,000 in fiscal 2017.

Customer service fees and debit card income were \$1.3 million in fiscal 2018 and 2017.

Other, which consists primarily of loan servicing fees, the sale of non-deposit products, and insurance commissions, increased by \$126,000 or 18.1% during fiscal 2018. The fees, which comprise other income, are set by the Company at a level that is intended to cover the cost of providing the related services and expenses to customers.

Other Expenses

Salaries and employee benefits increased by \$277,000 or 3.4% in fiscal 2018 as compared to fiscal 2017. The increased expenses of salaries and employee benefits during the periods are attributable to an increase in staffing and normal salary increases.

Occupancy and equipment expense increased \$23,000 or 1.7% in fiscal year 2018 as compared to fiscal 2017. Data processing costs increased by \$229,000 in fiscal 2018. The increase in data processing expenses in fiscal 2018 was attributable to the replacement of automated teller machines at all locations.

Other expenses, which consist primarily of advertising expenses, directors' fees, ATM network fees, professional fees, checking account costs, rewards expenses, REO expenses and stockholders expense increased by \$178,000 or 4.9% in fiscal 2018 compared to fiscal 2017. The increase in other expenses in 2018 was attributable to an increase in commercial loan expense, REO expense, legal expense and an increase in automated teller machine processing expense.

Deposit insurance premiums for the fiscal year 2018 increased \$81,000 or 37.0% from fiscal 2017 due to an increase in the assessment base.

Income Taxes

The Company recorded income tax provisions of \$2.9 million in fiscal year 2018 and \$2.7 million in 2017. The effective tax rate was 28.8% in fiscal 2018 compared to 32.7% in fiscal 2017. Under the 2017 Tax Reform Act, the corporate income tax rate was reduced from 34% to 21%. The Bank recorded \$355,000 in additional tax expense reflecting the revaluation of its net deferred tax assets from 34% to 21% at December 31, 2017. See Note 8 of the Consolidated Financial Statements which provides an analysis of the provision for income taxes.

INDEPENDENT AUDITOR'S REPORT

Audit Committee
Harleysville Financial Corporation
Harleysville, Pennsylvania

Report on the Financial Statements

We have audited the accompanying consolidated financial statements of Harleysville Financial Corporation and subsidiaries, which comprise the consolidated statements of financial condition as of September 30, 2018 and 2017; the related consolidated statements of income, comprehensive income, stockholders' equity, and cash flows for the years then ended; and the related notes to the consolidated financial statements.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these consolidated financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of consolidated financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's Responsibility

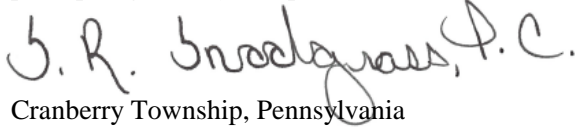
Our responsibility is to express an opinion on these consolidated financial statements based on our audits. We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the consolidated financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the consolidated financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the consolidated financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Harleysville Financial Corporation and subsidiaries as of September 30, 2018 and 2017, and the results of their operations and their cash flows for the years then ended in accordance with accounting principles generally accepted in the United States of America.


Cranberry Township, Pennsylvania

November 30, 2018

Consolidated Statements of Financial Condition

(In thousands, except share data)	September 30,	
	2018	2017
Assets		
Cash and amounts due from depository institutions	\$ 2,867	\$ 2,852
Interest-bearing demand deposits	<u>5,209</u>	<u>5,983</u>
Total cash and cash equivalents	8,076	8,835
Investments and mortgage-backed securities:		
Available for sale (amortized cost – 2018, \$859; 2017, \$875)	876	896
Held to maturity (fair value – 2018, \$103,946; 2017, \$132,861)	<u>107,042</u>	<u>131,885</u>
Loans receivable (net of allowance for loan losses - 2018, \$3,922; 2017, \$4,063)	615,899	584,443
Accrued interest receivable	2,239	2,078
Federal Home Loan Bank stock - at cost	5,286	5,384
Foreclosed real estate	1,043	829
Office properties and equipment, net	10,631	10,942
Bank-owned life insurance	16,464	16,071
Prepaid expenses and other assets	<u>1,309</u>	<u>1,531</u>
TOTAL ASSETS	<u>\$ 768,865</u>	<u>\$ 762,894</u>
Liabilities and Stockholders' Equity		
Liabilities:		
Deposits	\$ 582,078	\$ 548,755
Short-term borrowings	17,207	14,337
Long-term debt	91,309	122,621
Accrued interest payable	179	456
Advances from borrowers for taxes and insurance	1,473	1,467
Other liabilities	<u>4,781</u>	<u>6,358</u>
Total liabilities	<u>697,027</u>	<u>693,994</u>
Commitments and contingencies (Notes 13 & 14)	-	-
Stockholders' Equity:		
Preferred Stock: \$.01 par value; 7,500,000 shares authorized; none issued	-	-
Common stock: \$.01 par value; 15,000,000 shares authorized; 3,921,177 shares issued: shares outstanding 2018, 3,744,046; 2017, 3,759,637	39	39
Additional paid-in capital	8,208	8,261
Treasury stock, at cost (2018, 177,131 shares; 2017, 161,540 shares)	(3,359)	(2,670)
Retained earnings - partially restricted	66,939	63,257
Accumulated other comprehensive income	<u>11</u>	<u>13</u>
Total stockholders' equity	<u>71,838</u>	<u>68,900</u>
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	<u>\$ 768,865</u>	<u>\$ 762,894</u>

See notes to consolidated financial statements.

Consolidated Statements of Income

(In thousands, except share and per share data)	Year Ended September 30,	
	2018	2017
Interest and Dividend Income:		
Interest and fees on mortgage loans	\$ 14,316	\$ 13,861
Interest on commercial loans	8,712	7,322
Interest on consumer and other loans	3,994	3,665
Interest on mortgage-backed securities	2,219	2,641
Interest on taxable investments	655	599
Interest on tax-exempt investments	430	472
Dividends on investment securities	<u>3</u>	<u>-</u>
Total interest and dividend income	<u>30,329</u>	<u>28,560</u>
Interest Expense:		
Interest on deposits	3,639	2,400
Interest on short-term borrowings	106	46
Interest on long-term debt	<u>3,022</u>	<u>5,050</u>
Total interest expense	<u>6,767</u>	<u>7,496</u>
Net Interest Income	23,562	21,064
Provision for Loan Losses	<u>1,040</u>	<u>664</u>
Net Interest Income, after Provision for Loan Losses	<u>22,522</u>	<u>20,400</u>
Other Income:		
Customer service fees and debit card income	1,348	1,286
Realized gains on securities	-	173
Realized gains on sale of foreclosed real estate, net	304	55
Income on bank-owned life insurance	393	392
Other income	<u>821</u>	<u>695</u>
Total other income	<u>2,866</u>	<u>2,601</u>
Other Expenses:		
Salaries and employee benefits	8,525	8,248
Occupancy and equipment	1,344	1,321
Deposit insurance premiums	300	219
Data processing	1,451	1,222
Other	<u>3,779</u>	<u>3,601</u>
Total other expenses	<u>15,399</u>	<u>14,611</u>
Income before Income Tax Expense	9,989	8,390
Income tax expense	<u>2,879</u>	<u>2,740</u>
Net Income	<u>\$ 7,110</u>	<u>\$ 5,650</u>
Earnings Per Share:		
Basic	\$ <u>1.89</u>	\$ <u>1.51</u>
Diluted	\$ <u>1.85</u>	\$ <u>1.48</u>
Weighted Average Shares Outstanding:		
Basic	<u>3,759,817</u>	<u>3,730,021</u>
Diluted	<u>3,844,533</u>	<u>3,818,833</u>

See notes to consolidated financial statements.

Consolidated Statements of Comprehensive Income

(In thousands)	Year Ended September 30,	
	2018	2017
Net Income	\$ 7,110	\$ 5,650
Other Comprehensive Loss:		
Unrealized losses on available-for-sale-securities	(4)	(6)
Income tax effect	=	<u>1</u>
Other comprehensive loss, net of tax	<u>(4)</u>	<u>(5)</u>
Comprehensive income	<u>\$ 7,106</u>	<u>\$ 5,645</u>

See notes to consolidated financial statements.

Consolidated Statements of Stockholders' Equity

(In thousands, except share and per share data)

	Common Stock Shares Outstanding	Common Stock	Additional Paid-in Capital	Retained Earnings- Partially Restricted	Accumulated Other Comprehensive Income (Loss)	Treasury Stock	Total Stockholders' Equity
Balance at September 30, 2016	3,686,890	\$ 39	\$ 8,765	\$ 60,852	\$ 18	\$ (3,999)	\$ 65,675
Net income				5,650			5,650
Dividends - \$.87 per share				(3,245)			(3,245)
Restricted stock awards	4,511		(80)			80	-
Stock based compensation			159				159
Treasury stock delivered under 401k	2,013		9			29	38
Treasury stock sold	6,738					153	153
Treasury stock delivered under dividend reinvestment plan	10,370		33			185	218
Employee options exercised	49,115		(625)			882	257
Other comprehensive loss					(5)		(5)
Balance at September 30, 2017	3,759,637	39	8,261	63,257	13	(2,670)	68,900
Reclassification of certain income tax effects from accumulated other comprehensive income				(2)	2		-
Net income				7,110			7,110
Dividends - \$.91 per share				(3,426)			(3,426)
Restricted stock awards	4,806		(86)			86	-
Stock based compensation			258				258
Treasury stock delivered under 401k	2,684		19			45	64
Treasury stock purchase	(60,816)					(1,461)	(1,461)
Treasury stock delivered under dividend reinvestment plan	8,449		42			155	197
Employee options exercised	29,286		(286)			486	200
Other comprehensive loss					(4)		(4)
Balance at September 30, 2018	<u>3,744,046</u>	<u>\$ 39</u>	<u>\$ 8,208</u>	<u>\$ 66,939</u>	<u>\$ 11</u>	<u>\$ (3,359)</u>	<u>\$ 71,838</u>

See notes to consolidated financial statements.

Consolidated Statements of Cash Flows

(In thousands)

	Year Ended September 30,	
	2018	2017
Operating Activities:		
Net Income	\$ 7,110	\$ 5,650
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation	739	610
Provision for loan losses	1,040	664
Deferred income taxes	(18)	50
Change in corporate tax rate	355	-
Gains on sales of securities	-	(173)
Gain on sale of foreclosed real estate	(304)	(55)
Amortization of deferred fees	(80)	(40)
Increase in cash surrender value of bank owned life insurance	(393)	(392)
Stock based compensation	258	159
Changes in assets and liabilities which provided (used) cash:		
(Decrease) increase in other liabilities	(1,577)	2,291
(Decrease) increase in prepaid expenses and other assets	(115)	13
Increase in accrued interest receivable	(161)	(120)
Decrease in accrued interest payable	(277)	(100)
Net cash provided by operating activities	<u>6,577</u>	<u>8,557</u>
Investing Activities:		
Purchase of mortgage-backed securities held to maturity	-	(19,396)
Purchase of investment securities held to maturity	-	(5,000)
Purchase of investment securities available-for-sale	(18,650)	(42,974)
Purchase of FHLB stock	(2,882)	(2,313)
Redemption of FHLB stock	2,980	2,442
Proceeds from the redemption of investment securities available-for-sale	18,666	47,161
Proceeds from maturities of investment securities held to maturity	935	3,020
Proceeds from sales of mortgage-backed securities held to maturity	-	1,824
Principal collected on mortgage-backed securities held to maturity	23,908	28,816
Proceeds from sale of foreclosed real estate	1,069	263
Increase in loans, net	(33,395)	(42,974)
Purchase of premises and equipment	(428)	(963)
Net cash used in investing activities	<u>(7,797)</u>	<u>(30,094)</u>
Financing Activities:		
Net (decrease) increase in demand deposits, NOW accounts and savings accounts	(9,657)	17,893
Net increase in certificates of deposit	42,980	7,442
Cash dividends	(3,426)	(3,245)
Increase in short term borrowings	2,870	5,692
Proceeds from long-term debt	46,000	26,000
Repayment of long-term debt	(77,312)	(46,502)
(Acquisition) Sale of treasury stock	(1,461)	153
Sale of treasury stock delivered under employee stock plans	461	513
Net increase (decrease) in advances from borrowers for taxes and insurance	<u>6</u>	<u>(221)</u>
Net cash provided by financing activities	<u>461</u>	<u>7,725</u>
DECREASE IN CASH AND CASH EQUIVALENTS	(759)	(13,812)
CASH AND CASH EQUIVALENTS AT BEGINNING OF YEAR	<u>8,835</u>	<u>22,647</u>
CASH AND CASH EQUIVALENTS AT END OF YEAR	\$ <u>8,076</u>	\$ <u>8,835</u>
Supplemental Disclosure of Cash Flow Information		
Cash paid during the period for:		
Interest	\$ 7,044	\$ 7,596
Income taxes	2,110	2,210
Non-cash transfer of loans to foreclosed real estate	979	829
<i>See notes to consolidated financial statements</i>		

Notes to Consolidated Financial Statements

1. Nature of Operations and Organizational Structure

Harleysville Financial Corporation, formerly Harleysville Savings Financial Corporation, (the “Company”) is a bank holding company that is regulated by the Federal Reserve Bank of Philadelphia. Harleysville Bank, formerly Harleysville Savings Bank, (the Bank) is a wholly owned subsidiary and is regulated by the FDIC and the Pennsylvania Department of Banking. The Bank is principally in the business of attracting deposits through its branch offices and investing those deposits, together with funds from borrowings and operations, primarily in single family residential, commercial, consumer loans and investments. The Bank’s customers are primarily in southeastern Pennsylvania.

2. Summary of Significant Accounting Policies

Principles of Consolidation - The accompanying consolidated financial statements include the accounts of the Company, the Bank, and the Bank’s wholly owned subsidiary, HSB Inc., a Delaware subsidiary which was formed in order to accommodate the transfer of certain assets, Freedom Financial Solutions LLC that allows the Company to offer non-deposit products and HARL, LLC that allows the Bank to invest in equity investments. All significant intercompany accounts and transactions have been eliminated in consolidation.

Use of Estimates in Preparation of the Consolidated Financial Statements - The preparation of consolidated financial statements in conformity with accounting principles generally accepted in the United States of America requires 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 Consolidated Statement of Financial Condition and the reported amounts of income and expenses during the reporting period. The most significant of these estimates and assumptions in the Company’s consolidated financial statements is the allowance for loan losses and other-than-temporary impairment of investments. Actual results could differ from those estimates.

Significant Group Concentrations of Credit Risk - Most of the Company’s activities are with customers located within the southeastern region of Pennsylvania. Note 3 discusses the types of securities that the Company invests in. Note 4 discusses the types of lending that the Company engages in. The Company does not have any significant concentrations to any one industry or customer.

Cash and Cash Equivalents - For purposes of the Consolidated Statements of Cash Flows, cash and cash equivalents include cash and amounts due from depository institutions, including interest-bearing demand deposits in banks with original maturities of less than 90 days.

Investment and Mortgage-Backed Securities - The Company classifies and accounts for debt and equity securities as follows:

Held to Maturity - Debt securities that management has the positive intent and ability to hold until maturity are classified as held to maturity and are carried at their remaining unpaid principal balance, net of unamortized premiums or unaccreted discounts. Premiums are amortized and discounts are accreted using the interest method over the estimated remaining term of the underlying security.

Available for Sale - Debt and equity securities that will be held for indefinite periods of time, including securities that may be sold in response to changes in market interest or prepayment rates, needs for liquidity and changes in the availability of and the yield of alternative investments are classified as available for sale. These assets are carried at fair value. Unrealized gains and losses are excluded from earnings and are reported net of tax in other comprehensive income. Realized gains and losses on the sale of investment securities are recorded as of the trade date, reported in the Consolidated Statements of Income and determined using the amortized cost of the specific security sold.

For all securities that are in an unrealized loss position for an extended period of time and for all securities whose fair value is significantly below amortized cost, the Company performs an evaluation of the specific

events attributable to the market decline of the security. The Company considers the length of time and extent to which the security's fair value has been below cost as well as the general market conditions, industry characteristics, and the fundamental operating results of the issuer to determine if the decline is other-than-temporary. The Company also considers as part of the evaluation its intent and ability to hold the security and whether it is more likely than not that it will be required to sell the security before its fair value has recovered to a level at least equal to the amortized cost.

For debt securities, accounting guidance specifies that (a) if a company does not have the intent to sell a debt security prior to recovery and (b) it is more likely than not that it will not have to sell the debt security prior to recovery, the security would not be considered other-than-temporarily impaired unless there is a credit loss. When an entity does not intend to sell the security, and it is more likely than not, the entity will not have to sell the security before recovery of its cost basis, it will recognize the credit component of an other-than-temporary impairment of a debt security in earnings and the remaining portion in other comprehensive income. For held to maturity debt securities, the amount of an other-than-temporary impairment recorded in other comprehensive income for the noncredit portion of a previous other-than-temporary impairment should be amortized prospectively over the remaining life of the security on the basis of the timing of future estimated cash flows of the security.

When the Company determines that a security's unrealized loss is other-than-temporary, an impairment loss is recognized in the period in which the decline in value is determined to be other-than-temporary.

Loans - The Company grants commercial, mortgage and consumer loans to customers. A substantial portion of the loan portfolio is represented by mortgage loans throughout southeastern Pennsylvania. The ability of the Company's debtors to honor their contracts is dependent upon the general economic conditions in this area.

Loans that management has the intent and ability to hold for the foreseeable future or until maturity or pay-off are reported at their outstanding unpaid principal balances adjusted for charge-offs, the allowance for loan losses, and any deferred fees or costs on originated loans.

Interest Income on Loans - Interest income is accrued on the unpaid principal balance. Interest on loans is recognized as income when earned. The accrual of interest on loans is discontinued at the time the loan is 90 days delinquent unless the credit is well-secured and in process of collection. In all cases, loans are placed on nonaccrual or charged-off at an earlier date if collection of principal or interest is considered doubtful.

All interest accrued but not collected for loans that are placed on nonaccrual or charged off are reversed against interest income. The interest on these loans is accounted for on the cash-basis or cost-recovery method, until qualifying for return to accrual. Loans are returned to accrual status when all the principal and interest amounts contractually due are brought current and future payments are reasonably assured.

Deferred Loan Fees - Loan origination fees, net of certain direct origination costs, are deferred and the balance is amortized to income as an adjustment over the life of the loan using the interest method.

Allowance for Loan Losses - The allowance for loan losses is established as losses are estimated to have occurred through a provision for loan losses charged to earnings. Loan losses are charged against the allowance when management believes the uncollectibility of a loan balance is confirmed. Subsequent recoveries, if any, are credited to the allowance. An allowance for loan losses is maintained at a level that management considers adequate to provide for losses based upon evaluation of known and inherent risks in the loan portfolio. The loan loss reserves are established as an allowance for estimated losses based on the probable losses of the loan portfolio. In assessing risk, management considers historical experience, volume and composition of lending conducted by the Company, industry standards, and status of nonperforming loans, general economic conditions as they relate to the Company's market area, and other factors related to the collectibility of the Company's loan portfolio.

The allowance for loan losses consists of three elements: (1) specific allowances for impaired loans; (2) a general valuation allowance on all classified loans which are not impaired; and (3) a general valuation allowance on the remainder of the loan portfolio. This is consistent with the regulatory method of classifying reserves. Although the amount of each element of the allowance is determined separately, the entire allowance for loan losses is available for the entire portfolio. An allowance for impaired loans is established in the amounts by which the discounted cash flows (or collateral value or observable market price) are lower than the carrying value of the loan. A general allowance is established for classified loans that are not impaired. These loans are segregated by loan category, and allowance percentages are assigned to each category based on inherent losses associated with each type of lending and consideration that these loans, in the aggregate, represent an above-average credit risk and that more of these loans will prove to be uncollectible compared to loans in the general portfolio.

Foreclosed Real Estate - Real estate acquired through, or in lieu of, loan foreclosures are carried at the lesser of cost or fair value of the property, based on an appraisal less cost to sell. Costs relating to the development and improvement of the property are capitalized, and those relating to holding the property are charged to expense. The Company had foreclosed real estate of \$1.0 million and \$829,000 as of September 30, 2018 and 2017, respectively.

Office Properties and Equipment - Land is carried at cost. Office properties and equipment are recorded at cost, less accumulated depreciation. Depreciation is computed using the straight-line method over the expected useful lives of the assets that range from four to forty years. The costs of maintenance and repairs are expensed as they are incurred, and renewals and betterments are capitalized.

Federal Home Loan Bank Stock - Federal law requires a member institution of the Federal Home Loan Bank (FHLB) to hold stock of its district FHLB according to a predetermined formula. The restricted stock is carried at cost.

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

Cash Surrender Value of Bank-Owned Life Insurance (BOLI) - The Bank funded the purchase of insurance policies on the lives of officers and employees of the Bank. The Company has recognized any increase in cash surrender value of life insurance, net of insurance costs, in the Consolidated Statements of Income as income on BOLI. The cash surrender value of the insurance policies is recorded as an asset in other assets in the Consolidated Statements of Financial Condition and amounted to \$16.5 million and \$16.1 million at September 30, 2018 and 2017, respectively.

Income Taxes - Deferred income taxes are recognized for the tax consequences of "temporary differences" by applying enacted statutory tax rates applicable to future years to differences between the financial statement carrying amounts and the tax bases of existing assets and liabilities. The effect on deferred taxes of a change in tax rates is recognized in income in the period that includes the enactment date. The Company and its subsidiary file a consolidated federal income tax return.

The Company analyzes each tax position taken in its tax returns and determines the likelihood that the position will be realized. Only tax positions that are "more likely than not" to be realized can be recognized in the Company's financial statements. For tax positions that do not meet this recognition threshold, the Company will record an unrecognized tax benefit for the difference between the position taken on the tax return and the amount recognized in the financial statements. The Company does not have any material unrecognized tax

benefits or accrued interest or penalties at September 30, 2018 and 2017, or during the years then ended. No unrecognized tax benefits are expected to arise within the next twelve months. The Company's policy is to account for interest as a component of interest expense and penalties as a component of other expenses. The Company and its subsidiaries are subject to U.S. Federal income tax as well as income tax of the Commonwealth of Pennsylvania. The Company is no longer subject to examination by taxing authorities for the years before October 1, 2014.

On December 22, 2017, federal tax reform legislation, commonly referred to as the Tax Cuts and Jobs Act of 2017 (the "Tax Act"), was enacted. The Tax Act makes broad and complex changes to the U.S. tax code that affected our income tax rate in 2017. The Tax Act reduced the U.S. federal corporate income tax rate from 34% to 21%. As a result, the Company was required to re-measure, through income tax expense, the deferred tax assets and liabilities using the enacted rate at which they are expected to be recovered or settled. The re-measurement of the net deferred tax asset resulted in additional income tax expense of \$355,000 for the year ended September 30, 2018.

Transfers of Financial Assets - Transfers of financial assets are accounted for as sales, when control over the assets has been surrendered. Control over transferred assets is deemed to be surrendered when (1) the assets have been isolated from the Company (2) the transferee obtains the right (free of conditions that constrain it from taking advantage of that right) to pledge or exchange the transferred assets, and (3) the Company does not maintain effective control over the transferred assets through an agreement to repurchase them before their maturity.

Treasury Stock - The Company records treasury stock purchases at cost. Gains and losses on subsequent reissuance of shares are credited or charged to additional paid-in capital using the average-cost method.

Stock Based Compensation - The Company currently has several stock based compensation plans in place for employees and directors of the Company. The Company recognizes the cost of employee services received in exchange for an award of equity investment based on grant-date fair value of the award. That cost will be recognized over the period during which an employee is required to provide service in exchange for the award. Stock-based compensation expense for the years ended September 30, 2018 and 2017 was \$258,000 and \$159,000, respectively. The tax benefit recognized related to the compensation expense for the years ended September 30, 2018 and 2017 was \$19,000 and \$12,000, respectively.

Earnings Per Share - Basic earnings per common share is computed based on the weighted average number of shares outstanding. Diluted earnings per share is computed based on the weighted average number of shares outstanding, increased by additional common shares that would have been outstanding if dilutive potential common shares had been issued. Potential common shares that may be issued by the Company relate to outstanding stock options and unvested stock awards, and are determined using the treasury stock method. The number of anti-dilutive options that are excluded from the earnings per share calculation for the years ended September 30, 2018 and 2017 were 101,264 and 86,117, respectively. For the year ended September 30, 2018, the exercise price for the options representing anti-dilutive shares ranged from \$18.66 to \$24.55. For the year ended September 30, 2017, the exercise price for the options representing anti-dilutive shares was \$16.95 to \$18.66. The weighted average shares outstanding used to calculate earnings per share were as follows:

	Year Ended September 30,	
	2018	2017
Weighted average shares outstanding – basic	3,759,817	3,730,021
Increase in shares due to dilutive potential common shares	<u>84,716</u>	<u>88,812</u>
Weighted average shares outstanding – diluted	<u>3,844,533</u>	<u>3,818,833</u>

Other Comprehensive Income - The Company presents, as a component of comprehensive income, amounts from transactions and other events, which are currently excluded from the Consolidated Statements of Income and are recorded directly to stockholders' equity. The Company's other comprehensive income consists of net unrealized holding gains or losses on securities available-for-sale, net of income taxes.

Reclassifications - Certain amounts in the prior period's financial statements have been reclassified to conform with the current year classifications. The reclassifications had no effect on net income.

Adoption of New Accounting Standards

On February 14, 2018, the Financial Accounting Standards Board finalized ASU 2018-02 - *Income Statement-Reporting Comprehensive Income (Topic 220)*. This accounting standard allows Companies to reclassify the "stranded" tax effect in accumulated other comprehensive income (loss) that resulted from the Tax Cuts and Jobs Act which was enacted in December 2017 and requires deferred tax liabilities and assets to be adjusted for the effect of a change in tax laws.

The Company adopted this accounting standard, which provides a benefit to the financial statements by more accurately aligning the impacts of the items carried in accumulated other comprehensive income (loss) with the associate tax effect. The adoption resulted in a one-time cumulative effect adjustment of \$2,000 between Retained Earnings and Accumulated Other Comprehensive Income (Loss) on the Consolidated Statement of Financial Condition. The adjustment had no impact on net income or any other financial metrics in any prior periods presented.

Recently Issued Accounting Standards - In May 2014, the FASB issued ASU 2014-09, Revenue from Contracts with Customers (a new revenue recognition standard). The Update's core principle is that a company will recognize revenue to depict the transfer of goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. In addition, this Update specifies the accounting for certain costs to obtain or fulfill a contract with a customer and expands disclosure requirements for revenue recognition. Subsequently, the FASB issued ASU 2015-14, *Revenue from Contracts with Customers (Topic 606)*. The amendments in this Update defer the effective date of ASU 2014-09 for all entities by one year. Public business entities, certain not-for-profit entities, and certain employee benefit plans should apply the guidance in ASU 2014-09 to annual reporting periods beginning after December 15, 2017, including interim reporting periods within that reporting period. All other entities should apply the guidance in ASU 2014-09 to annual reporting periods beginning after December 15, 2018, and interim reporting periods within annual reporting periods beginning after December 15, 2019. Because the guidance does not apply to revenue associated with financial instruments, including loans and securities, we do not expect the new standard, or any of the amendments, to result in a material change from our current accounting for revenue because the majority of the Company's financial instruments are not within the scope of Topic 606. However, we do expect that the standard will result in new disclosure requirements, which are currently being evaluated.

In January 2016, the FASB issued ASU 2016-01, *Financial Instruments – Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities*. This Update applies to all entities that hold financial assets or owe financial liabilities and is intended to provide more useful information on the recognition, measurement, presentation, and disclosure of financial instruments. Among other things, this Update (a) requires equity investments (except those accounted for under the equity method of accounting or those that result in consolidation of the investee) to be measured at fair value with changes in fair value recognized in net income; (b) simplifies the impairment assessment of equity investments without readily determinable fair values by requiring a qualitative assessment to identify impairment; (c) eliminates the requirement to disclose the fair value of financial instruments measured at amortized cost for entities that are not public business entities; (d) eliminates the requirement for public business entities to disclose the method(s) and significant assumptions used to estimate the fair value that is required to be disclosed for financial

instruments measured at amortized cost on the balance sheet; (e) requires public business entities to use the exit price notion when measuring the fair value of financial instruments for disclosure purposes; (f) requires separate presentation of financial assets and financial liabilities by measurement category and form of financial asset (that is, securities or loans and receivables) on the balance sheet or the accompanying notes to the financial statements; and (g) clarifies that an entity should evaluate the need for a valuation allowance on a deferred tax asset related to available-for-sale securities in combination with the entity's other deferred tax assets. For public business entities, the amendments in this Update are effective for fiscal years beginning after December 15, 2017, including interim periods within those fiscal years. For all other entities, including not-for-profit entities and employee benefit plans within the scope of Topics 960 through 965 on plan accounting, the amendments in this Update are effective for fiscal years beginning after December 15, 2018, and interim periods within fiscal years beginning after December 15, 2019. All entities that are not public business entities may adopt the amendments in this Update earlier as of the fiscal years beginning after December 15, 2017, including interim periods within those fiscal years. The Company is currently evaluating the impact the adoption of the standard will have on the Company's financial position or results of operations.

In February 2016, the FASB issued ASU 2016-02, *Leases (Topic 842)*. The standard requires lessees to recognize the assets and liabilities that arise from leases on the balance sheet. A lessee should recognize in the statement of financial position a liability to make lease payments (the lease liability) and a right-of-use asset representing its right to use the underlying asset for the lease term. A short-term lease is defined as one in which (a) the lease term is 12 months or less and (b) there is not an option to purchase the underlying asset that the lessee is reasonably certain to exercise. For short-term leases, lessees may elect to recognize lease payments over the lease term on a straight-line basis. For public business entities, the amendments in this Update are effective for fiscal years beginning after December 15, 2018, and interim periods within those years. For all other entities, the amendments in this Update are effective for fiscal years beginning after December 15, 2019, and for interim periods within fiscal years beginning after December 15, 2020. The amendments should be applied at the beginning of the earliest period presented using a modified retrospective approach with earlier application permitted as of the beginning of an interim or annual reporting period. The Company is currently assessing the practical expedients it may elect at adoption, but does not anticipate the amendments will have a significant impact on the financial statements. Based on the Company's preliminary analysis of its current portfolio, the impact to the Company's balance sheet is estimated to result in less than a 1 percent increase in assets and liabilities.

In March 2016, the FASB issued ASU 2016-08, *Revenue from Contracts with Customers (Topic 606)*. The amendments in this Update affect entities with transactions included within the scope of Topic 606, which includes entities that enter into contracts with customers to transfer goods or services (that are an output of the entity's ordinary activities) in exchange for consideration. The amendments in this Update do not change the core principle of the guidance in Topic 606; they simply clarify the implementation guidance on principal versus agent considerations. The amendments in this Update are intended to improve the operability and understandability of the implementation guidance on principal versus agent considerations. The amendments in this Update affect the guidance in ASU 2014-09, *Revenue from Contracts with Customers (Topic 606)*, which is not yet effective. The effective date and transition requirements for the amendments in this Update are the same as the effective date and transition requirements of Update 2014-09. ASU 2015-14, *Revenue from Contracts with Customers (Topic 606): Deferral of the Effective Date*, defers the effective date of Update 2014-09 by one year. The Company is currently evaluating the impact the adoption of the standard will have on the Company's financial position or results of operations.

In April 2016, the FASB issued ASU 2016-10, *Revenue from Contracts with Customers (Topic 606)*. The amendments in this Update affect entities with transactions included within the scope of Topic 606, which includes entities that enter into contracts with customers to transfer goods or services in exchange for consideration. The amendments in this Update do not change the core principle for revenue recognition in Topic 606. Instead, the amendments provide (1) more detailed guidance in a few areas and (2) additional implementation guidance and examples based on feedback the FASB received from its stakeholders. The

amendments are expected to reduce the degree of judgment necessary to comply with Topic 606, which the FASB expects will reduce the potential for diversity arising in practice and reduce the cost and complexity of applying the guidance. The amendments in this Update affect the guidance in ASU 2014-09, *Revenue from Contracts with Customers (Topic 606)*, which is not yet effective. The effective date and transition requirements for the amendments in this Update are the same as the effective date and transition requirements in Topic 606 (and any other Topic amended by Update 2014-09). ASU 2015-14, *Revenue from Contracts with Customers (Topic 606): Deferral of the Effective Date*, defers the effective date of Update 2014-09 by one year. The Company is currently evaluating the impact the adoption of the standard will have on the Company's financial position or results of operations.

In May 2016, the FASB issued ASU 2016-12, *Revenue from Contracts with Customers (Topic 606)*, which among other things clarifies the objective of the collectability criterion in Topic 606, as well as certain narrow aspects of Topic 606. The amendments in this Update affect the guidance in ASU 2014-09, *Revenue from Contracts with Customers (Topic 606)*, which is not yet effective. The effective date and transition requirements for the amendments in this Update are the same as the effective date and transition requirements for Topic 606 (and any other Topic amended by Update 2014-09). ASU 2015-14, *Revenue from Contracts with Customers (Topic 606): Deferral of the Effective Date*, defers the effective date of Update 2014-09 by one year. This Update is not expected to have a significant impact on the Company's financial statements.

In June 2016, the FASB issued ASU 2016-13, *Financial Instruments - Credit Losses: Measurement of Credit Losses on Financial Instruments*, which changes the impairment model for most financial assets. This Update is intended to improve financial reporting by requiring timelier recording of credit losses on loans and other financial instruments held by financial institutions and other organizations. The underlying premise of the Update is that financial assets measured at amortized cost should be presented at the net amount expected to be collected, through an allowance for credit losses that is deducted from the amortized cost basis. The allowance for credit losses should reflect management's current estimate of credit losses that are expected to occur over the remaining life of a financial asset. The income statement will be effected for the measurement of credit losses for newly recognized financial assets, as well as the expected increases or decreases of expected credit losses that have taken place during the period. ASU 2016-13 is effective for annual and interim periods beginning after December 15, 2019, and early adoption is permitted for annual and interim periods beginning after December 15, 2018. With certain exceptions, transition to the new requirements will be through a cumulative effect adjustment to opening retained earnings as of the beginning of the first reporting period in which the guidance is adopted. We expect to recognize a one-time cumulative effect adjustment to the allowance for loan losses as of the beginning of the first reporting period in which the new standard is effective, but cannot yet determine the magnitude of any such one-time adjustment or the overall impact of the new guidance on the consolidated financial statements.

In January 2018, the FASB issued ASU 2018-01, *Leases (Topic 842)*, which provides an optional transition practical expedient to not evaluate under Topic 842 existing or expired land easements that were not previously accounted for as leases under the current lease guidance in Topic 840. An entity that elects this practical expedient should evaluate new or modified land easements under Topic 842 beginning at the date the entity adopts Topic 842; otherwise, an entity should evaluate all existing or expired land easements in connection with the adoption of the new lease requirements in Topic 842 to assess whether they meet the definition of a lease. The effective date and transition requirements for the amendments are the same as the effective date and transition requirements in ASU 2016-02. This Update is not expected to have a significant impact on the Company's financial statements.

In February 2018, the FASB issued ASU 2018-03, *Technical Corrections and Improvements to Financial Instruments—Overall (Subtopic 825-10)*, to clarify certain aspects of the guidance issued in ASU 2016-01.

(1) An entity measuring an equity security using the measurement alternative may change its measurement approach to a fair value method in accordance with Topic 820, *Fair Value Measurement*, through an irrevocable election that would apply to that security and all identical or similar investments of the same

issuer. Once an entity makes this election, the entity should measure all future purchases of identical or similar investments of the same issuer using a fair value method in accordance with Topic 820. (2) Adjustments made under the measurement alternative are intended to reflect the fair value of the security as of the date that the observable transaction for a similar security took place. (3) Remeasuring the entire value of forward contracts and purchased options is required when observable transactions occur on the underlying equity securities. (4) When the fair value option is elected for a financial liability, the guidance in paragraph 825-10-45-5 should be applied, regardless of whether the fair value option was elected under either Subtopic 815-15, *Derivatives and Hedging—Embedded Derivatives*, or 825-10, *Financial Instruments—Overall*. (5) Financial liabilities for which the fair value option is elected, the amount of change in fair value that relates to the instrument specific credit risk should first be measured in the currency of denomination when presented separately from the total change in fair value of the financial liability. Then, both components of the change in the fair value of the liability should be remeasured into the functional currency of the reporting entity using end-of-period spot rates. (6) The prospective transition approach for equity securities without a readily determinable fair value in the amendments in Update 2016-01 is meant only for instances in which the measurement alternative is applied. An insurance entity subject to the guidance in Topic 944, *Financial Services—Insurance*, should apply a prospective transition method when applying the amendments related to equity securities without readily determinable fair values. An insurance entity should apply the selected prospective transition method consistently to the entity's entire population of equity securities for which the measurement alternative is elected. For public business entities, the amendments in this Update are effective for fiscal years beginning after December 15, 2017, and interim periods within those fiscal years beginning after June 15, 2018. Public business entities with fiscal years beginning between December 15, 2017, and June 15, 2018, are not required to adopt these amendments until the interim period beginning after June 15, 2018, and public business entities with fiscal years beginning between June 15, 2018, and December 15, 2018, are not required to adopt these amendments before adopting the amendments in Update 2016-01. For all other entities, the effective date is the same as the effective date in Update 2016-01. All entities may early adopt these amendments for fiscal years beginning after December 15, 2017, including interim periods within those fiscal years, as long as they have adopted Update 2016-01. This Update is not expected to have a significant impact on the Company's financial statements.

In July 2018, the FASB issued ASU 2018-10, *Codification Improvements to Topic 842, Leases*, represents changes to clarify, correct errors in, or make minor improvements to the Codification. The amendments in this ASU affect the amendments in ASU 2016-02, which are not yet effective, but for which early adoption upon issuance is permitted. For entities that early adopted Topic 842, the amendments are effective upon issuance of this ASU, and the transition requirements are the same as those in Topic 842. For entities that have not adopted Topic 842, the effective date and transition requirements will be the same as the effective date and transition requirements in Topic 842. This Update is not expected to have a significant impact on the Company's financial statements.

In July 2018, the FASB issued ASU 2018-11, *Leases (Topic 842): Targeted Improvements*. This Update provides another transition method which allows entities to initially apply ASC 842 at the adoption date and recognize a cumulative-effect adjustment to the opening balance of retained earnings in the period of adoption. Entities that elect this approach should report comparative periods in accordance with ASC 840, *Leases*. In addition, this Update provides a practical expedient under which lessors may elect, by class of underlying assets, to not separate nonlease components from the associated lease component, similar to the expedient provided for lessees. However, the lessor practical expedient is limited to circumstances in which the nonlease component or components otherwise would be accounted for under the new revenue guidance and both (a) the timing and pattern of transfer are the same for the nonlease component(s) and associated lease component and (b) the lease component, if accounted for separately, would be classified as an operating lease. If the nonlease component or components associated with the lease component are the predominant component of the combined component, an entity should account for the combined component in accordance with ASC 606, *Revenue from Contracts with Customers*. Otherwise, the entity should account for the combined component as an operating lease in accordance with ASC 842. If a lessor elects the practical expedient, certain disclosures are

required. This Update is effective for public business entities for fiscal years beginning after December 15, 2018, and interim periods within those fiscal years, with early adoption permitted. For all other entities, the amendments are effective for fiscal years beginning after December 15, 2019, and interim periods within fiscal years beginning after December 15, 2020. This Update is not expected to have a significant impact on the Company's financial statements.

In August 2018, the FASB issued ASU 2018-13, *Fair Value Measurement (Topic 820): Disclosure Framework – Changes the Disclosure Requirements for Fair Value Measurements*. The Update removes the requirement to disclose the amount of and reasons for transfers between Level I and Level II of the fair value hierarchy; the policy for timing of transfers between levels; and the valuation processes for Level III fair value measurements. The Update requires disclosure of changes in unrealized gains and losses for the period included in other comprehensive income (loss) for recurring Level III fair value measurements held at the end of the reporting period and the range and weighted average of significant unobservable inputs used to develop Level III fair value measurements. This Update is effective for all entities for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2019. The Company is currently evaluating the impact the adoption of the standard will have on the Company's financial position or results of operations.

3. INVESTMENT AND MORTGAGE-BACKED SECURITIES

The amortized cost and fair value of the Company's securities with gross unrealized gains and losses, as of September 30, 2018 and 2017 are as follows:

Available for sale securities:

	September 30, 2018			
(In thousands)	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Collateralized mortgage obligations	\$ 785	\$ 17	\$ -	\$ 802
U.S. Government money market funds	<u>74</u>	<u>-</u>	<u>-</u>	<u>74</u>
Total Available for Sale Securities	<u>\$ 859</u>	<u>\$ 17</u>	<u>\$ -</u>	<u>\$ 876</u>

	September 30, 2017			
(In thousands)	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Collateralized mortgage obligations	\$ 785	\$ 21	\$ -	\$ 806
U.S. Government money market funds	<u>90</u>	<u>-</u>	<u>-</u>	<u>90</u>
Total Available for Sale Securities	<u>\$ 875</u>	<u>\$ 21</u>	<u>\$ -</u>	<u>\$ 896</u>

Held to maturity securities:

	September 30, 2018			
(In thousands)	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Mortgage-backed securities- U.S. Government Sponsored Enterprises (GSE'S)	\$ 86,723	\$ 203	\$ (2,564)	\$ 84,362
Collateralized mortgage obligations	1,173	38	-	1,211
Municipal bonds	9,955	296	(157)	10,094
U.S. Government Agencies	<u>9,191</u>	<u>-</u>	<u>(912)</u>	<u>8,279</u>
Total Held to Maturity Securities	<u>\$ 107,042</u>	<u>\$ 537</u>	<u>\$ (3,633)</u>	<u>\$ 103,946</u>

	September 30, 2017			
(In thousands)	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Mortgage-backed securities- U.S. Government Sponsored Enterprises (GSE'S)	\$ 110,351	\$ 1,178	\$ (490)	\$ 111,039
Collateralized mortgage obligations	1,542	43	-	1,585
Municipal bonds	10,803	551	(7)	11,347
U.S. Government Agencies	<u>9,189</u>	<u>-</u>	<u>(299)</u>	<u>8,890</u>
Total Held to Maturity Securities	<u>\$ 131,885</u>	<u>\$ 1,772</u>	<u>\$ (796)</u>	<u>\$ 132,861</u>

All the Company's mortgage-backed securities and collateralized mortgage obligations are residential. At September 30, 2018, the Bank held \$1.2 million in Collateralized Mortgage Obligations (CMOs) of which all were issued by Government Sponsored Enterprises and none were privately issued.

There were no sales of securities during the year ended September 30, 2018.

Proceeds from the sales of held-to-maturity mortgage-backed securities during the year ended September 30, 2017 were \$1.8 million with a related gross realized gain of \$173,000. At the time of sale, all of the mortgage-backed securities had been paid down at least 85% of their original par.

A summary of securities with unrealized losses, aggregated by category, as of September 30, 2018 and September 30, 2017 is as follows:

	September 30, 2018					
	Less than 12 Months		12 Months or Longer			
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Total Fair Value	Total Unrealized Losses
(In thousands)						
Mortgage-backed securities	\$ 44,496	\$ (991)	\$ 32,912	\$ (1,573)	\$ 77,408	\$ (2,564)
Municipal bonds	2,943	(113)	662	(44)	3,605	(157)
U.S. Government Agencies	1,146	(48)	7,133	(864)	8,279	(912)
Total temporarily impaired securities	<u>\$ 48,585</u>	<u>\$ (1,152)</u>	<u>\$ 40,707</u>	<u>\$ (2,481)</u>	<u>\$ 89,292</u>	<u>\$ (3,633)</u>

	September 30, 2017					
	Less than 12 Months		12 Months or Longer			
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Total Fair Value	Total Unrealized Losses
(In thousands)						
Mortgage-backed securities	\$ 41,432	\$ (490)	\$ -	\$ -	\$ 41,432	\$ (490)
Municipal bonds	1,353	(7)	-	-	1,353	(7)
U.S. Government Agencies	8,890	(299)	-	-	8,890	(299)
Total temporarily impaired securities	<u>\$ 51,675</u>	<u>\$ (796)</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 51,675</u>	<u>\$ (796)</u>

At September 30, 2018, debt securities in a gross unrealized loss position consisted of 86 securities that at such date had an aggregate depreciation of 3.9% from the Company's amortized cost basis. Management believes that the estimated fair value of the securities disclosed above is primarily dependent upon the movement in market interest rates. Management evaluated the length of time and the extent to which the fair value has been less than cost; the financial condition and near term prospects of the issuer, including any specific events which may influence the operations of the issuer. The Company has the ability and intent to hold these securities until maturity and the Company does not believe it will be required to sell such securities prior to the recovery of the amortized cost basis. Management does not believe any individual unrealized loss on debt securities as of September 30, 2018 represents other-than-temporary impairment.

The following table sets forth the stated maturities of the investment and mortgage-backed securities at September 30, 2018. Money market funds are not included in the table based on lack of maturity.

	September 30, 2018	
	Amortized Cost	Fair Value
(In thousands)		
Available for sale:		
Due after ten years	\$ 785	\$ 802
Total	<u>\$ 785</u>	<u>\$ 802</u>
Held to maturity:		
Due in one year or less	\$ 626	\$ 630
Due after one year through five years	21,887	21,590
Due after five years through ten years	42,464	41,450
Due after ten years	42,065	40,276
Total	<u>\$ 107,042</u>	<u>\$ 103,946</u>

Certain of the Company's investment securities, totaling \$41.0 million and \$47.1 million at September 30, 2018 and 2017, respectively, were pledged or restricted for deposit sweep accounts, public deposits, or other purposes as required or permitted by law.

Other securities totaling \$33.9 million at September 30, 2017, were pledged for long-term advances of \$25 million as described in Note 7. Due to the maturities of these advances during the year, there were no additional securities pledged.

4. LOANS RECEIVABLE

Loans receivable consists of the following:

(In thousands)	September 30,	
	2018	2017
Residential Mortgages	\$ 327,587	\$ 313,691
Construction	7,767	10,744
Home Equity	85,749	87,963
Commercial Mortgages	197,373	174,353
Commercial Business Loans	5,128	6,505
Consumer Non-Real Estate	<u>385</u>	<u>382</u>
Total	623,989	593,638
Undisbursed portion of loans in process	(4,226)	(5,069)
Deferred loan fees	58	(63)
Allowance for loan losses	<u>(3,922)</u>	<u>(4,063)</u>
Loans Receivable - net	\$ <u>615,899</u>	\$ <u>584,442</u>

At September 30, 2018 and 2017, the Company was servicing residential mortgage loans for others amounting to approximately \$13.0 million and \$14.7 million, respectively. Servicing loans for others generally consists of collecting mortgage payments, maintaining escrow accounts, disbursing payments to investors and foreclosure processing. Loan servicing income is recognized over the life of the loan. The Company receives a servicing fee of 0.25% on sold loans, which totaled \$40,000 as of September 30, 2018. These servicing fees are included in prepaid expenses and other assets on the Consolidated Statements of Financial Condition. In connection with the loans serviced for others, the Company held borrowers' escrow balances of approximately \$51,000 and \$53,000 at September 30, 2018 and 2017, respectively.

The Bank has had, and may be expected to have in the future, loan transactions in the ordinary course of business with directors, officers, principal stockholders, their immediate families and affiliated companies (commonly referred to as related parties), on the same terms including interest rates and collateral, as those prevailing at the time for comparable transactions with others. Loans to related parties at September 30, 2018 and 2017, were approximately \$14.1 million and \$2.3 million, respectively. Additional loans and repayments, net, for the year ended September 30, 2018 were \$11.8 million compared to \$179,000 for the year ended September 30, 2017.

The loans receivable portfolio is segmented into consumer and commercial loans. Consumer loans consist of the following classes: residential mortgage loans, construction loans, home equity loans and non-real estate consumer loans. Commercial loans consist of the following classes: commercial mortgages and commercial business loans. For all classes of loans receivable, the accrual of interest is discontinued when the contractual payment of principal or interest has become 90 days past due or management has serious doubts about further collectability of principal or interest, even though the loan is currently performing. A loan may remain on accrual status if it is in the process of collection and is either guaranteed or well secured. When a loan is placed on nonaccrual status, unpaid interest credited to income in the current year is reversed and unpaid interest accrued in prior years is charged against the allowance for loan losses. Interest received on nonaccrual loans including impaired loans generally are either applied against principal or reported as interest income, according to management's judgment as to the collectability of principal. Generally, loans are restored to accrual status when the obligation is brought current, has performed in accordance with the contractual terms for a reasonable period of time (generally six months) and the ultimate collectability of the total contractual principal and interest is no longer in doubt. The past due status of all classes of loans receivable is determined based on

contractual due dates for loan payments.

The allowance for loan losses represents management's estimate of losses inherent in the loan portfolio as of the Consolidated Statements of Financial Condition date and is recorded as a reduction to loans. The allowance for loan losses is increased by the provision for loan losses, and decreased by charge-offs, net of recoveries. Loans deemed to be uncollectible are charged against the allowance for loan losses, and subsequent recoveries, if any, are credited to the allowance. All, or part, of the principal balance of loans receivable are charged off to the allowance as soon as it is determined that the repayment of all, or part, of the principal balance is highly unlikely. Because all identified losses are immediately charged off, no portion of the allowance for loan losses is restricted to any individual loan or groups of loans, and the entire allowance is available to absorb any and all loan losses.

The allowance for loan losses is maintained at a level considered adequate to provide for losses that can be reasonably anticipated. Management performs a monthly evaluation of the adequacy of the allowance. The allowance is based on the Company's past loan loss experience, known and inherent risks in the portfolio, adverse situations that may affect the borrower's ability to repay, the estimated value of any underlying collateral, composition of the loan portfolio, current economic conditions and other relevant factors. This evaluation is inherently subjective as it requires material estimates that may be susceptible to significant revision as more information becomes available.

The allowance consists of specific, general and unallocated components. The specific component relates to loans that are classified as impaired. For loans that are classified as impaired, an allowance is established when the discounted cash flows (or collateral value or observable market price) of the impaired loan is lower than the carrying value of that loan. The general component covers pools of loans by loan class. These pools of loans are evaluated for loss exposure based upon historical loss rates for each of these categories of loans, adjusted for qualitative factors. These significant factors may include changes in lending policies and procedures, changes in existing general economic and business conditions affecting our primary lending areas, credit quality trends, collateral value, loan volumes and concentrations, seasoning of the loan portfolio, recent loss experience in particular segments of the portfolio, duration of the current business cycle and bank regulatory examination results. The applied loss factors are reevaluated quarterly to ensure their relevance in the current economic environment.

Residential mortgage lending generally entails a lower risk of default than other types of lending. Other consumer loans and commercial real estate loans generally involve more risk of collectability because of the type and nature of the collateral and, in certain cases, the absence of collateral. It is the Company's policy to establish specific reserves for losses on delinquent commercial loans when it determines that losses are probable.

An unallocated component is maintained to cover uncertainties that could affect management's estimate of probable losses. The unallocated component of the allowance reflects the margin of imprecision inherent in the underlying assumptions used in the methodologies for estimating specific and general losses in the portfolio.

A loan is considered impaired when, based on current information and events, it is probable that the Company will be unable to collect the scheduled payments of principal or interest when due according to the contractual terms of the loan agreement. Additionally, all loans modified in a troubled debt restructuring are considered impaired. Factors considered by management in determining impairment include payment status, collateral value and the probability of collecting scheduled principal and interest payments when due. Loans that experience insignificant payment delays and payment shortfalls generally are not classified as impaired. Management determines the significance of payment delays and payment shortfalls on a case-by-case basis, taking into consideration all of the circumstances surrounding the loan and the borrower, including the length of the delay, the reasons for the delay, the borrower's prior payment record and the amount of the shortfall in relation to the principal and interest owed. Impairment is measured on a loan by loan basis for loans by either

the present value of expected future cash flows discounted at the loan's effective interest rate or the fair value of the collateral if the loan is collateral dependent.

An allowance for loan losses is established for an impaired loan if its carrying value exceeds its estimated fair value. The estimated fair values of substantially all of the Company's impaired loans are measured based on the estimated fair value of the loan's collateral. Interest payments on impaired loans and non-accrual loans are applied to principal unless the ability to collect the principal amount is fully secured, in which case interest is recognized on the cash basis.

For residential mortgage loans, home equity loans and commercial loans secured by real estate, estimated fair values are determined primarily through third-party appraisals. When a real estate secured loan becomes impaired, a decision is made regarding whether an updated certified appraisal of the real estate is necessary. This decision is based on various considerations, including the age of the most recent appraisal, the loan-to-value ratio based on the original appraisal and the condition of the property. Appraised values are discounted to arrive at the estimated selling price of the collateral, which is considered to be the estimated fair value. The discounts also include estimated costs to sell the property.

For commercial business loans secured by non-real estate collateral, such as accounts receivable, inventory and equipment, estimated fair values are determined based on the borrower's financial statements, inventory reports, accounts receivable aging or equipment appraisals or invoices. Indications of value from these sources are generally discounted based on the age of the financial information or the quality of the assets.

The allowance calculation methodology includes further segregation of loan classes into risk rating categories. The borrower's overall financial condition, repayment sources, guarantors and value of collateral, if appropriate, are evaluated annually for commercial loans or when credit deficiencies arise, such as delinquent loan payments, for commercial and consumer loans. Credit quality risk ratings include regulatory classifications of special mention, substandard, doubtful and loss. Loans criticized special mention have potential weaknesses that deserve management's close attention. If uncorrected, the potential weaknesses may result in deterioration of the repayment prospects. Loans classified substandard have a well-defined weakness or weaknesses that jeopardize the liquidation of the debt. They include loans that are inadequately protected by the current sound net worth and paying capacity of the obligor or of the collateral pledged, if any. Loans classified doubtful have all the weaknesses inherent in loans classified substandard with the added characteristic that collection or liquidation in full, on the basis of current conditions and facts, is highly improbable. Loans classified as a loss are considered uncollectible and are charged to the allowance for loan losses. Loans not classified are rated pass.

In addition, federal regulatory agencies, as an integral part of their examination process, periodically review the Company's allowance for loan losses and may require the Company to recognize additions to the allowance based on their judgments about information available to them at the time of their examination, which may not be currently available to management. Based on management's comprehensive analysis of the loan portfolio, management believes the current level of the allowance for loan losses is adequate.

The following table presents the classes of the loan portfolio summarized by the aggregate pass rating and the classified ratings of special mention, substandard and doubtful within the Company's internal risk rating system as of September 30, 2018 and 2017:

September 30, 2018

(In thousands)	Pass	Special Mention	Substandard	Doubtful	Total
Residential Mortgages	\$ 322,342	\$ 182	\$ 4,283	\$ 780	\$ 327,587
Construction	7,767	-	-	-	7,767
Home Equity	85,327	16	271	135	85,749
Commercial Mortgages	191,678	1,177	4,518	-	197,373
Commercial Business Loans	4,833	92	203	-	5,128
Consumer Non-Real Estate	385	-	-	-	385
Total	<u>\$ 612,332</u>	<u>\$ 1,467</u>	<u>\$ 9,275</u>	<u>\$ 915</u>	<u>\$ 623,989</u>

September 30, 2017

(In thousands)	Pass	Special Mention	Substandard	Doubtful	Total
Residential Mortgages	\$ 309,083	\$ 213	\$ 3,859	\$ 536	\$ 313,691
Construction	10,744	-	-	-	10,744
Home Equity	86,525	237	1,201	-	87,963
Commercial Mortgages	166,802	1,542	5,805	204	174,353
Commercial Business Loans	6,345	107	53	-	6,505
Consumer Non-Real Estate	382	-	-	-	382
Total	<u>\$ 579,881</u>	<u>\$ 2,099</u>	<u>\$ 10,918</u>	<u>\$ 740</u>	<u>\$ 593,638</u>

The following table summarizes information in regards to impaired loans by loan portfolio class as of September 30, 2018 and for the year then ended:

(In thousands)	Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Recorded Investment	Interest Income Recognized
With no related allowance recorded:					
Residential Mortgages	\$ 4,530	\$ 4,591	\$ -	\$ 4,461	\$ 165
Construction	-	-	-	-	-
Home Equity	212	367	-	260	11
Commercial Mortgages	4,518	4,726	-	4,549	96
Commercial Business Loans	150	150	-	150	8
Consumer Non-Real Estate	-	-	-	-	-
Subtotal:	<u>9,410</u>	<u>9,834</u>	<u>-</u>	<u>9,420</u>	<u>280</u>
With an allowance recorded:					
Residential Mortgages	533	533	(24)	539	25
Construction	-	-	-	-	-
Home Equity	194	194	(124)	197	9
Commercial Mortgages	-	-	-	-	-
Commercial Business Loans	53	274	(12)	275	-
Consumer Non-Real Estate	-	-	-	-	-
Subtotal:	<u>780</u>	<u>1,001</u>	<u>(160)</u>	<u>1,011</u>	<u>34</u>
Total:					
Residential Mortgages	5,063	5,124	(24)	5,000	190
Construction	-	-	-	-	-
Home Equity	406	561	(124)	457	20
Commercial Mortgages	4,518	4,726	-	4,549	96
Commercial Business Loans	203	424	(12)	425	8
Consumer Non-Real Estate	-	-	-	-	-
Totals:	<u>\$ 10,190</u>	<u>\$ 10,835</u>	<u>\$ (160)</u>	<u>\$ 10,431</u>	<u>\$ 314</u>

The following table summarizes information in regards to impaired loans by loan portfolio class as of September 30, 2017 and for the year then ended:

(In thousands)	<u>Recorded Investment</u>	<u>Unpaid Principal Balance</u>	<u>Related Allowance</u>	<u>Average Recorded Investment</u>	<u>Interest Income Recognized</u>
With no related allowance recorded:					
Residential Mortgages	\$ 4,314	\$ 4,346	\$ -	\$ 4,367	\$ 150
Construction	-	-	-	-	-
Home Equity	1,047	1,215	-	1,053	16
Commercial Mortgages	4,096	4,304	-	4,121	77
Commercial Business Loans	53	275	-	55	-
Consumer Non-Real Estate	-	-	-	-	-
Subtotal:	<u>9,510</u>	<u>10,140</u>	<u>-</u>	<u>9,596</u>	<u>243</u>
With an allowance recorded:					
Residential Mortgages	82	82	(57)	101	1
Construction	-	-	-	-	-
Home Equity	153	153	(91)	154	6
Commercial Mortgages	1,913	1,913	(29)	1,920	-
Commercial Business Loans	-	-	-	-	-
Consumer Non-Real Estate	-	-	-	-	-
Subtotal:	<u>2,148</u>	<u>2,148</u>	<u>(177)</u>	<u>2,175</u>	<u>7</u>
Total:					
Residential Mortgages	4,396	4,428	(57)	4,468	151
Construction	-	-	-	-	-
Home Equity	1,200	1,368	(91)	1,207	22
Commercial Mortgages	6,009	6,217	(29)	6,041	77
Commercial Business Loans	53	275	-	55	-
Consumer Non-Real Estate	-	-	-	-	-
Totals:	<u>\$ 11,658</u>	<u>\$ 12,288</u>	<u>\$ (177)</u>	<u>\$ 11,771</u>	<u>\$ 250</u>

The performance and credit quality of the loan portfolio is also monitored by the analyzing the age of the loans receivable as determined by the length of time a recorded payment is past due. The following tables present the classes of the loan portfolio summarized by the past due status as of September 30, 2018 and 2017:

September 30, 2018

(In thousands)	<u>30-89 Days Past Due</u>	<u>Greater than 90 Days</u>	<u>Total Past Due</u>	<u>Current</u>	<u>Total Loans Receivable</u>	<u>Loans Receivable > 90 Days and Accruing</u>
Residential Mortgages	\$ 4,264	\$ 3,922	\$ 8,186	\$319,401	\$ 327,587	\$ -
Construction	-	-	-	7,767	7,767	-
Home Equity	911	361	1,272	84,477	85,749	-
Commercial Mortgages	-	4,518	4,518	192,855	197,373	-
Commercial Business Loans	25	203	228	4,900	5,128	-
Consumer Non-Real Estate	-	-	-	385	385	-
Total	<u>\$ 5,200</u>	<u>\$ 9,004</u>	<u>\$ 14,204</u>	<u>\$609,785</u>	<u>\$ 623,989</u>	<u>\$ -</u>

September 30, 2017

(In thousands)	30-89 Days Past Due	Greater than 90 Days	Total Past Due	Current	Total Loans Receivable	Loans Receivable > 90 Days and Accruing
Residential Mortgages	\$ 4,975	\$ 3,367	\$ 8,342	\$305,349	\$ 313,691	\$ -
Construction	-	-	-	10,744	10,744	-
Home Equity	832	991	1,823	86,140	87,963	-
Commercial Mortgages	-	6,009	6,009	168,344	174,353	-
Commercial Business Loans	-	53	53	6,452	6,505	-
Consumer Non-Real Estate	<u>3</u>	<u>7</u>	<u>10</u>	<u>372</u>	<u>382</u>	<u>7</u>
Total	<u>\$ 5,810</u>	<u>\$ 10,427</u>	<u>\$ 16,237</u>	<u>\$577,401</u>	<u>\$ 593,638</u>	<u>\$ 7</u>

The following table presents nonaccrual loans by classes of the loan portfolio for the years ended September 30, 2018 and 2017:

(In thousands)	September 30, 2018	September 30, 2017
Residential Mortgages	\$ 4,482	\$ 4,296
Construction	-	-
Home Equity	361	1,097
Commercial Mortgages	4,518	6,009
Commercial Business Loans	203	53
Consumer Non-Real Estate	<u>-</u>	<u>-</u>
Total	<u>\$ 9,564</u>	<u>\$ 11,455</u>

The following table provides the activity in the allowance for loan losses by loan class for the years ended September 30, 2018 and 2017 and the balance in the allowance for loan losses at September 30, 2018 and 2017 disaggregated on the basis of the Company's impairment method by loan class along with the balance of loans receivable by class disaggregated on the basis of the Company's impairment methodology.

September 30, 2018								
(In thousands)	<u>Residential Mortgages</u>	<u>Construction</u>	<u>Home Equity</u>	<u>Commercial Mortgages</u>	<u>Commercial Business Loans</u>	<u>Consumer Non-Real Estate</u>	<u>Unallocated</u>	<u>Totals</u>
Allowance for loan loss:								
Beginning Balance, September 30, 2017	\$ 1,235	\$ -	\$ 549	\$ 1,382	\$ 128	\$ 19	\$ 750	\$ 4,063
Charge-offs	(30)	-	-	(75)	(1,023)	(59)	-	(1,187)
Recoveries	-	-	-	-	-	6	-	6
Provisions	<u>(165)</u>	<u>-</u>	<u>(30)</u>	<u>262</u>	<u>1,065</u>	<u>58</u>	<u>(150)</u>	<u>1,040</u>
Ending balance, September 30, 2018	<u>\$ 1,040</u>	<u>\$ -</u>	<u>\$ 519</u>	<u>\$ 1,569</u>	<u>\$ 170</u>	<u>\$ 24</u>	<u>\$ 600</u>	<u>\$ 3,922</u>
Ending balance:								
Individually evaluated for impairment	\$ 24	\$ -	\$ 124	\$ -	\$ 12	\$ -	\$ -	\$ 160
Ending balance:								
Collectively evaluated for impairment	\$ 1,016	\$ -	\$ 395	\$ 1,569	\$ 158	\$ 24	\$ 600	\$ 3,762
Loans:								
Ending balance:	\$ 327,587	\$ 7,767	\$ 85,749	\$ 197,373	\$ 5,128	\$ 385	\$ -	\$623,989
Ending balance:								
Individually evaluated for impairment	\$ 5,063	\$ -	\$ 406	\$ 4,518	\$ 203	\$ -	\$ -	\$ 10,190
Ending balance:								
Collectively evaluated for impairment	\$ 322,524	\$ 7,767	\$ 85,343	\$ 192,855	\$ 4,925	\$ 385	\$ -	\$613,799

During the fiscal year ended September 30, 2018 a credit provision was recorded in the residential mortgage and home equity portfolios while the commercial mortgage, commercial business loan and consumer non-real-estate portfolios required provision expense. The credit provision in the residential mortgage and home equity portfolios was the result of decreased qualitative factors. The provision expense recorded for the commercial mortgage, commercial business loan and consumer non-real-estate portfolios was the result of increased historical loss factors and qualitative factors.

September 30, 2017

(In thousands)	<u>Residential Mortgages</u>	<u>Construction</u>	<u>Home Equity</u>	<u>Commercial Mortgages</u>	<u>Commercial Business Loans</u>	<u>Consumer Non-Real Estate</u>	<u>Unallocated</u>	<u>Totals</u>
Allowance for loan loss:								
Beginning Balance, September 30, 2016	\$ 1,272	\$ -	\$ 675	\$ 1,398	\$ 136	\$ 24	\$ 445	\$ 3,950
Charge-offs	(179)	-	-	(157)	(221)	(10)	-	(567)
Recoveries	2	-	6	-	-	8	-	16
Provisions	<u>140</u>	<u>-</u>	<u>(132)</u>	<u>141</u>	<u>213</u>	<u>(3)</u>	<u>305</u>	<u>664</u>
Ending balance, September 30, 2017	<u>\$ 1,235</u>	<u>\$ -</u>	<u>\$ 549</u>	<u>\$ 1,382</u>	<u>\$ 128</u>	<u>\$ 19</u>	<u>\$ 750</u>	<u>\$ 4,063</u>
Ending balance:								
Individually evaluated for impairment	\$ 57	\$ -	\$ 91	\$ 29	\$ -	\$ -	\$ -	\$ 177
Ending balance:								
Collectively evaluated for impairment	\$ 1,178	\$ -	\$ 458	\$ 1,353	\$ 128	\$ 19	\$ 750	\$ 3,886
Loans:								
Ending balance:	\$ 313,691	\$ 10,744	\$ 87,963	\$ 174,353	\$ 6,505	\$ 382	\$ -	\$593,638
Ending balance:								
Individually evaluated for impairment	\$ 4,396	\$ -	\$ 1,200	\$ 6,009	\$ 53	\$ -	\$ -	\$ 11,658
Ending balance:								
Collectively evaluated for impairment	\$ 309,295	\$ 10,744	\$ 86,763	\$ 168,344	\$ 6,452	\$ 382	\$ -	\$581,980

During the fiscal year ended September 30, 2017 a credit provision was recorded in the home equity and consumer non-real estate portfolios while the residential mortgage, commercial mortgage, commercial business loan portfolios required provision expense. The credit provision in the home equity and consumer non-real-estate portfolio was the result of increased qualitative factors. The provision expense recorded for the residential mortgage, commercial mortgage and commercial business loan portfolios was the result of increased historical loss factors and qualitative factors.

Foreclosed assets acquired in settlement of loans are carried at fair value, less estimated costs to sell, and are included in other assets on the Consolidated Balance Sheet. As of September 30, 2018, included within the foreclosed assets are no consumer residential mortgages and \$1.0 million of commercial loans that were foreclosed on or received via a deed in lieu transaction prior to the period end. As of September 30, 2018, the Company has initiated formal foreclosure proceeds on \$974,000 of consumer residential mortgages and commercial loans, which have not yet been transferred into foreclosed assets.

A troubled debt restructuring (“TDR”) is a formal restructure of a loan when the lender, for economic or legal reasons related to the borrower’s financial difficulties, grants a concession to the borrower. The concessions may be granted in various forms, including reduction in the stated interest rate, reduction in the loan balance or accrued interest, or extension of the maturity date.

The following table summarizes information in regards to troubled debt restructurings for the twelve months ended September 30, 2018 (in thousands):

	Number of Contracts	Pre-Modification Outstanding Recorded Investments	Post-Modification Outstanding Recorded Investments
Troubled Debt Restructurings			
Home equity	<u>1</u>	<u>46</u>	<u>46</u>
Totals	<u>1</u>	<u>\$ 46</u>	<u>\$ 46</u>

As indicated in the table above, the Company modified one home equity loan with a recorded investment of \$46,000 during the twelve months ended September 30, 2018. As a result of the modification the Company added uncollected overdue amounts to the principal balance of the loan, which are due at maturity.

For the year ended September 30, 2018 there were no loan modifications classified as troubled debt restructuring that subsequently defaulted within one year of modification.

The following table summarizes information in regards to troubled debt restructurings for the twelve months ended September 30, 2017 (in thousands):

	Number of Contracts	Pre-Modification Outstanding Recorded Investments	Post-Modification Outstanding Recorded Investments
Troubled Debt Restructurings			
Residential mortgages	1	90	90
Home equity	<u>1</u>	<u>50</u>	<u>48</u>
Totals	<u>2</u>	<u>\$ 140</u>	<u>\$138</u>

As indicated in the table above, the Company modified one mortgage loan and one home equity loan with a recorded investment of \$138,000 during the twelve months ended September 30, 2017. As a result of the modified terms of the new loans, the Company modified the principal payment amount over a specific time period.

For the year ended September 30, 2017 there were no loan modifications classified as troubled debt restructuring that subsequently defaulted within one year of modification.

5. OFFICE PROPERTIES AND EQUIPMENT

Office properties and equipment are summarized by major classifications as follows:

(In thousands)	September 30,	
	2018	2017
Land	\$ 3,277	\$ 3,277
Buildings	10,562	10,384
Fixed assets suspense	-	57
Furniture, fixtures and equipment	5,908	5,892
Data processing	2,021	1,730
Automobiles	<u>82</u>	<u>141</u>
Total	21,850	21,481
Less accumulated depreciation	<u>(11,219)</u>	<u>(10,539)</u>
Net	<u>\$10,631</u>	<u>\$ 10,942</u>

Depreciation expense for the years ended September 30, 2018 and 2017 amounted to approximately \$739,000 and \$610,000, respectively.

6. DEPOSITS

Deposits are summarized as follows:

(In thousands)	September 30,			
	2018		2017	
	Amount	Weighted Average Interest Rate	Amount	Weighted Average Interest Rate
Non-interest-bearing checking accounts	\$ 55,537	0.00%	\$ 52,069	0.00%
NOW accounts	41,553	0.04	44,897	0.04
Interest-bearing checking accounts	75,341	0.63	70,134	0.69
Money market deposit accounts	217,177	0.30	231,402	0.30
Passbook and club accounts	2,982	0.71	3,745	0.70
Certificate of deposit accounts	<u>189,488</u>	<u>1.57</u>	<u>146,508</u>	<u>1.11</u>
Total Deposits	<u>\$582,078</u>	<u>0.71%</u>	<u>\$548,755</u>	<u>0.52%</u>

At September 30, 2018, the amounts of scheduled maturities of certificate of deposit accounts were as follows (in thousands):

For the year ended September 30,	2019	\$ 55,547
	2020	73,738
	2021	18,781
	2022	35,767
	2023	5,647
	2024	<u>8</u>
Total		<u>\$ 189,488</u>

The aggregate amount of certificate accounts in denominations of \$250,000 or more at September 30, 2018 and 2017 amounted to approximately \$16.8 million and \$7.4 million, respectively.

7. SHORT-TERM BORROWINGS AND LONG-TERM DEBT

The Bank's short-term borrowings activities are summarized as follows:

<u>FHLB RepoPlus Advance</u>	<u>2018</u>	<u>2017</u>
	(Dollar in thousands)	
Balance at year-end	\$ 17,207	\$14,337
Maximum amount of outstanding at any month-end	18,099	14,337
Average balance outstanding during the year	14,773	10,120
Weighted-average interest rate:		
As of year-end	0.61%	0.33%
Paid during the year	0.72%	0.46%

Average amounts outstanding during the year represent daily average balances, while weighted-average interest rates represent interest expense divided by the related average balance for the period indicated.

The Bank maintains the Repo Plus Advance credit arrangement, which is renewable annually, with the FHLB. The line maintains a variable rate of interest that may be reset daily at the FHLB's discretion. The Bank's maximum borrowing capacity under the credit arrangement with the FHLB as of September 30, 2018, is approximately \$385.0 million. FHLB advances are secured by a blanket security agreement that includes the Company's FHLB stock as well as certain residential mortgage loans and investments.

Long-term debt consists of the following (in thousands):

<u>Description</u>	<u>Maturity Range</u>		<u>Weighted Average Interest Rate</u>	<u>Stated Interest Rate Range</u>		<u>2018</u>	<u>2017</u>
	<u>From</u>	<u>To</u>		<u>From</u>	<u>To</u>		
Fixed rate	12/16/2019	01/31/2025	2.31%	1.64%	2.93%	\$ 78,309	\$ 38,621
Convertible	03/23/2020	10/19/2020	1.86%	1.73%	2.01%	13,000	59,000
Other long-term debt	02/02/2018	11/15/2018	4.05%	3.29%	4.55%	-	25,000
						<u>\$91,309</u>	<u>\$122,621</u>

Maturities of long-term advances as of September 30, 2018 are summarized as follows:

	<u>Amount</u>	<u>Weighted Average Rate</u>
	(In thousands)	
FHLB long-term debt:		
2019	\$ 1,014	1.91%
2020	14,034	1.85%
2021	21,261	2.12%
2022	12,000	2.20%
2023	31,000	2.31%
Thereafter	<u>12,000</u>	<u>2.83%</u>
Total FHLB long-term debt	<u>91,309</u>	<u>2.24%</u>

8. INCOME TAXES

The Company computes its reserve for bad debts under the specific charge-off method. The bad debt deduction allowable under this method is available to large banks with assets greater than \$500 million. Generally, this method allows the Company to deduct an annual addition to the reserve for bad debts equal to its net charge-offs. Retained earnings at September 30, 2018 and 2017 includes approximately \$1,325,000 representing bad debt deductions for which no deferred income taxes have been provided.

The expense for income taxes differs from that computed at the statutory federal corporate tax rate as follows:

	Year Ended September 30,			
	2018		2017	
(In thousands)	<u>Amount</u>	<u>Percentage of Pretax Income</u>	<u>Amount</u>	<u>Percentage of Pretax Income</u>
At statutory rate	\$ 2,422	24.3%	\$ 2,852	34.0%
Adjustments resulting from:				
Tax-exempt income	(196)	(2.0)	(287)	(3.4)
State tax-net of federal tax benefit	395	4.0	194	2.3
Change in corporate rate tax	355	3.6	-	-
Other	<u>(98)</u>	<u>(1.0)</u>	<u>(19)</u>	<u>(0.2)</u>
Expense per consolidated statements of income	<u>\$ 2,879</u>	<u>28.8%</u>	<u>\$ 2,740</u>	<u>32.7%</u>

The Tax Cuts and Job Act, enacted on December 22, 2017, lowered the federal corporate income tax rate from 35% to 21% effective January 1, 2018. As a result, the carrying value of net deferred tax assets was reduced which increased income tax expense by \$355,000.

Income tax expense is summarized as follows:

(In thousands)	Year Ended September 30,	
	2018	2017
Current	\$ 2,542	\$ 2,690
Deferred	(18)	50
Change in corporate tax rate	<u>355</u>	<u>-</u>
Total Income Tax Expense	\$ <u>2,879</u>	\$ <u>2,740</u>

Items that gave rise to significant portions of the deferred tax accounts are as follows:

(In thousands)	September 30,	
	2018	2017
Deferred Tax Assets:		
Deferred Loan Fees	\$ 12	\$ 1
Allowance for Loan Losses	824	1,381
Non-deductible capital losses	-	16
Other	<u>389</u>	<u>563</u>
Sub-Total	<u>1,225</u>	<u>1,961</u>
Deferred Tax Liabilities:		
Unrealized gain on investment securities	(4)	(7)
Properties and equipment	<u>(634)</u>	<u>(1,033)</u>
Sub-Total	<u>(638)</u>	<u>(1,040)</u>
Total	\$ <u>587</u>	\$ <u>921</u>

9. 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 direct material effect on the Bank'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 U.S. GAAP, regulatory reporting requirements, and regulatory capital standards. The Bank's capital amounts and classification are also subject to qualitative judgments by the regulators about components, risk weightings, and other factors.

Quantitative measures established by regulatory capital standards to ensure capital adequacy require the Bank to maintain minimum amounts and ratios (set forth in the following table) of total and Tier 1 capital to risk-weighted assets, common equity Tier 1 capital to total risk-weighted assets, and of Tier 1 capital to average assets. Management believes, as of September 30, 2018, that the Bank meets all capital adequacy requirements to which it is subject.

As of September 30, 2018, and September 30, 2017, the most recent notification from the Federal Deposit Insurance Corporation 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 total risk-based

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

The Bank's actual capital amounts and ratios are also presented in the table.

	Actual		For Capital Adequacy Purposes		To Be Considered Well Capitalized Under Prompt Corrective Action Provisions	
(In thousands)	Amount	Ratio	Amount	Ratio	Amount	Ratio
At September 30, 2018						
Tier 1 Capital (to assets)	\$71,901	9.26%	\$31,072	4.00%	\$38,840	5.00%
Common Equity Tier 1 Capital (to risk weighted assets)	71,901	13.02%	24,846	4.50%	35,889	6.50%
Tier 1 Capital (to risk weighted assets)	71,901	13.02%	33,128	6.00%	44,171	8.00%
Total Capital (to risk weighted assets)	75,907	13.75%	44,171	8.00%	55,214	10.00%
At September 30, 2017						
Tier 1 Capital (to assets)	\$68,845	8.92%	\$30,885	4.00%	\$38,606	5.00%
Common Equity Tier 1 Capital (to risk weighted assets)	68,845	12.86%	24,083	4.50%	34,787	6.50%
Tier 1 Capital (to risk weighted assets)	68,845	12.86%	32,111	6.00%	42,815	8.00%
Total Capital (to risk weighted assets)	72,993	13.64%	42,815	8.00%	53,519	10.00%

The Company's capital ratios are not significantly different than the Bank's disclosed above.

10. RETIREMENT SAVINGS PLANS

The Company has a qualified 401 (k) retirement savings plan covering all full-time employees meeting certain eligibility requirements. Contributions for the plan are at the discretion of the Company's Board of Directors. Compensation expense related to the plan was \$536,000 and \$524,000 for the years ended September 30, 2018 and 2017, respectively.

11. STOCK BASED COMPENSATION AND EMPLOYEE STOCK PURCHASE PLAN

In January 2016, the stockholders approved the 2015 Stock Incentive Plan which provides 300,000 shares for the granting of incentive stock options, compensatory stock options, stock appreciation rights and share awards of restrictive stock. The number of shares available to be issued as share awards will not exceed 75,000 shares. There are 176,325 shares remaining for grant under this plan.

The life of the options under the above plan is ten years. The vesting period for the options is between one and five years.

A summary of stock option transactions under these plans follows:

	2018		2017	
	Options	Weighted Average Price	Options	Weighted Average Price
Outstanding, beginning of year	334,848	\$ 16.17	397,852	\$ 15.43
Exercised	(55,812)	13.59	(109,419)	14.56
Forfeited	(2,400)	19.77	(6,350)	17.92
Expired	-	-	-	-
Granted	80,599	23.20	52,765	18.66
Outstanding, end of year	357,235	\$ 18.13	334,848	\$ 16.17
Options exercisable, end of year	181,513	\$ 15.89	194,740	\$ 14.74

A summary of the exercise price ranges at September 30, 2018 and 2017 is as follows:

2018			
Number of Option Shares	Exercise Price Range	Weighted Average Remaining Contractual Life	Weighted Average Exercise Price per Share
76,196	\$ 11.85-14.84	2.10	\$ 13.93
116,519	14.85-18.50	4.50	16.98
164,520	18.51-24.55	8.42	20.90
357,235	\$ 11.85-24.55	5.79	\$ 18.13

2017			
Number of Option Shares	Exercise Price Range	Weighted Average Remaining Contractual Life	Weighted Average Exercise Price per Share
79,440	\$ 11.85-13.42	1.62	\$ 12.86
107,726	13.43-17.16	4.73	15.56
147,682	17.17-19.13	7.41	18.40
334,848	\$ 11.85-19.13	5.17	\$ 16.17

At September 30, 2018 and 2017, the aggregate intrinsic value of options outstanding was \$2.0 million and \$2.2 million, respectively. At September 30, 2018 and 2017, the aggregate intrinsic value of options exercisable was \$1.4 million and \$1.6 million, respectively. For the years ended September 30, 2018 and 2017, the aggregate intrinsic value of options exercised was \$437,000 and \$781,000, respectively.

The aggregate intrinsic value of a stock option represents the total pre-tax intrinsic value (the amount by which the current market value of the underlying stock exceeds the exercise price of the option) that would have been received by the option holder had all option holders exercised their options on September 30, 2018. This amount changes based on changes in the market value of the Company's common stock.

The weighted average fair value of stock options granted in the years ended September 30, 2018 and 2017 was \$4.34 and \$1.72, respectively, and was estimated at the date of grant using a Binomial Option Pricing Model with the following weighted-average assumptions while the market price of the Company's common stock at the date of grant is used for restricted stock awards:

	Year Ended September 30,	
	2018	2017
Risk free interest rate of return	2.49%	1.92%
Expected option life	84 months	84 months
Expected volatility	23.50%	18.00%
Expected dividends	3.8%	4.53%

The expected volatility is based on historic volatility. The risk-free interest rates for periods within the contractual life of the awards are based on the U.S. Treasury yield curve in effect at the time of the grant. The expected life is based on historical exercise experience. The dividend yield assumption is based on the Company's history and expectation of dividend payouts.

Stock based compensation expense related to stock options for the years ended September 30, 2018 and 2017 was \$156,000 or \$147,000 net of tax, and \$71,000 or \$67,000 net of tax, respectively. As of September 30, 2018, there was approximately \$104,000 of total unrecognized compensation cost related to non-vested stock options under the plans.

On November 10, 2015, 4,637 shares of restricted stock were awarded. The restricted shares awarded had a grant date fair value of \$18.80 per share. The restricted stock awarded vests 33% annually beginning November 10, 2016. On November 8, 2016, 4,802 shares of restricted stock were awarded. The restricted shares awarded had a grant date fair value of \$18.66 per share. The restricted stock awarded vests 33% annually beginning November 8, 2017. On November 7, 2017, 4,474 shares of restricted stock were awarded. The restricted shares awarded had a grant date fair value of \$22.00 per share. The restricted stock awarded vests 33% annually beginning November 7, 2018. On August 15, 2018, 3,085 shares of restricted stock were awarded. The restricted shares awarded had a grant date fair value of \$24.55 per share. The restricted stock awarded vests 33% annually beginning August 15, 2019. During the years ended September 30, 2018 and 2017, \$102,000 and \$88,000, respectively in compensation expense was recognized in regard to these restricted stock awards. At September 30, 2018, there was \$124,000 of unrecognized compensation expense related to the restricted stock awards which is expected to be recognized over a period of three years.

Restricted stock award activity for the year ended September 30, 2018 was as follows:

	Number of shares	Weighted Average Grant Date Fair Value
Unvested restricted stock, beginning of year	9,558	\$ 18.41
Granted	7,559	23.04
Forfeited	-	-
Vested	(4,806)	18.11
Unvested restricted stock, end of year	<u>12,311</u>	<u>\$ 21.37</u>

Restricted stock award activity for the year ended September 30, 2017 was as follows:

	Number of shares	Weighted Average Grant Date Fair Value
Unvested restricted stock, beginning of year	9,267	\$ 18.00
Granted	4,802	18.66
Forfeited	-	-
Vested	<u>(4,511)</u>	<u>17.83</u>
Unvested restricted stock, end of year	<u>9,558</u>	<u>\$ 18.41</u>

The Company also has established an Employee Stock Purchase Plan (the “Purchase Plan”) whereby employees may elect to make contributions to the Purchase Plan in an aggregate amount not less than 2% or more than 10% of such employee’s total compensation. These contributions would then be used to purchase stock during an offering period determined by the Company’s Salary and Benefits Committee. The purchase price of the stock would be the lesser of 85% of the market price on the first day or the last day of the offering period. At September 30, 2018 and 2017, there were 53,583 shares available for future purchase. The Company suspended participation in the Purchase Plan in March 2005 and the plan is not currently active.

12. ACCUMULATED OTHER COMPREHENSIVE INCOME

The following table presents the changes in accumulated other comprehensive income by component net of tax for the years ended September 30, 2018 and 2017.

	Unrealized gains on available for sale securities (a)
	(In thousands)
Balance as of September 30, 2017	\$ 13
Other comprehensive loss before reclassification	(4)
Amount reclassified from accumulated other comprehensive income	-
Reclassification of certain income tax effects from accumulated other comprehensive income	<u>2</u>
Total other comprehensive loss	<u>(2)</u>
Balance as of September 30, 2018	<u>\$ 11</u>

(a) All amounts are net of tax. Amounts in parentheses indicate debits.

	Unrealized gains on available for sale securities (a)
	(In thousands)
Balance as of September 30, 2016	\$ 18
Other comprehensive loss before reclassification	(5)
Amount reclassified from accumulated other comprehensive income	-
Total other comprehensive loss	<u>(5)</u>
Balance as of September 30, 2017	<u>\$ 13</u>

(a) All amounts are net of tax. Amounts in parentheses indicate debits.

There were no items that were reclassified from accumulated other comprehensive income for the years ended September 30, 2018 and 2017.

13. COMMITMENTS

At September 30, 2018, the Company had approximately \$7.5 million in outstanding commitments to originate mortgage loans, of which \$5.9 million were fixed rates ranging from 3.50% to 5.75% and \$1.6 million were adjustable rates ranging from 4.00% to 4.75%. The unfunded home equity line of credit commitments at September 30, 2018 were \$65.9 million. The Company had \$4.1 million and \$2.5 million of committed commercial and consumer loans, respectively, at September 30, 2018. In addition, the Company had \$20.9 million of unused commercial lines of credit at September 30, 2018. The amounts of undisbursed portions of loans in process at September 30, 2018 were \$4.2 million. The Company had a total of \$700,000 in standby letters of credit. Also, at September 30, 2018, the Company had no outstanding futures or options positions.

Outstanding letters of credit written are conditional commitments issued by the Company to guarantee the performance of a customer to a third party. The majority of these standby letters of credit expire within the next twelve months. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending other loan commitments. The Company requires collateral supporting these letters of credit as deemed necessary. Management believes that the proceeds obtained through a liquidation of such collateral would be sufficient to cover the maximum potential amount of future payments required under the corresponding guarantees. The current amount of the liability as of September 30, 2018 for guarantees under standby letters of credit issued is not material.

The Company leases land for two of its branch offices. The Company leases office space for three remote offices. Rent expense amounted to \$150,000 and \$144,000 for the years ended September 30, 2018 and 2017. Minimum rental commitments for the next five years at September 30, 2017, are summarized below:

<u>Fiscal Year</u>	<u>Rental Amount</u>
	(In thousands)
2019	\$ 158
2020	161
2021	163
2022	169
2023	<u>178</u>
Total	<u>\$ 829</u>

The Company is required to maintain reserve funds in cash or on deposit with the Federal Reserve Bank. The required reserve was \$554,000 for the year ended September 30, 2018.

14. LEGAL CONTINGENCIES

Various legal claims also arise from time to time in the normal course of business which, in the opinion of management, will have no material effect on the Company's consolidated financial statements.

15. RESTRICTED RETAINED EARNINGS

At the time of conversion to a stock savings bank, in 1987, the Bank established a liquidation account in an amount equal to the Bank's net worth as reflected in the latest Consolidated Statements of Financial Condition of the Bank contained in the offering circular utilized in the conversion. The function of the liquidation account is to establish a priority on liquidation and, except with respect to the payment of cash dividends on, or the re-purchase of, any of the common stock by the Bank, the existence of the liquidation account will not operate to restrict the use or application of any of the net worth accounts of the Bank. In the event of a complete liquidation of the Bank (and only in such event), each eligible account holder will be entitled to receive a pro rata distribution from the liquidation account, based on such holder's proportionate amount of the total current adjusted balances from deposit accounts then held by all eligible account holders, before any

liquidation distribution may be made with respect to stockholders. The liquidation account was approximately \$2,300,000 at September 30, 2018. Furthermore, the Company may not repurchase any of its stock if the effect thereof would cause the Company's net worth to be reduced below (i) the amount required for the liquidation account or (ii) the regulatory capital requirements.

16. FAIR VALUE MEASUREMENTS AND DISCLOSURES

The Company uses fair value measurements to record fair value adjustments to certain assets and liabilities and to determine fair value disclosures. In accordance with accounting guidance, the fair value of a financial instrument is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. Fair value is best determined based upon quoted market prices. However, in many instances, there are no quoted market prices for the Company's various financial instruments. In cases where quoted market prices are not available, fair values are based on estimates using present value or other valuation techniques. Those techniques are significantly affected by the assumption used, including the discount rate and estimates of future cash flows. Accordingly, the fair value estimates may not be realized in an immediate settlement of the instrument.

The fair value guidance provides a consistent definition of fair value, which focuses on exit price in an orderly transaction (that is, not a forced liquidation or distressed sale) between market participants at the measurement date under current market conditions. If there has been a significant decrease in the volume and level of activity for the asset or liability, a change in valuation technique or the use of multiple valuation techniques may be appropriate. In such instances, determining the price at which willing market participants would transact at the measurement date under current market conditions depends on the facts and circumstances and requires the use of significant judgment. The fair value is determined at a reasonable point within the range that is most representative of fair value under current market conditions.

The guidance establishes a fair value hierarchy that prioritizes the inputs to valuation methods used to measure fair value. The hierarchy gives the highest priority to unadjusted quoted prices in active markets for identical assets or liabilities (Level 1 measurements) and the lowest priority to unobservable inputs (Level 3 measurements). The three levels of the fair value hierarchy under are as follows:

Level 1: Unadjusted quoted prices in active markets that are accessible at the measurement date for identical, unrestricted assets or liabilities.

Level 2: Quoted prices in markets that are not active, or inputs that are observable either directly or indirectly, for substantially the full term of the asset or liability.

Level 3: Prices or valuation techniques that require inputs that are both significant to the fair value measurement and unobservable (i.e., supported with little or no market activity).

An asset's or liability's level within the fair value hierarchy is based on the lowest level of input that is significant to the fair value measurement.

For financial assets measured at fair value on a recurring basis, the fair value measurements by level within the fair value hierarchy used at September 30, 2018 and 2017 are as follows (in thousands):

Description	Total	(Level 1) Quoted Prices in Active Markets for Identical Assets	(Level 2) Significant Other Observable Inputs	(Level 3) Significant Unobservable Inputs
September 30, 2018				
Available for sale securities:				
Collateralized mortgage obligations	\$ 802	\$ -	\$ 802	\$ -
U.S. Government money market funds	<u>74</u>	<u>74</u>	<u>-</u>	<u>-</u>
Totals	<u>\$ 876</u>	<u>\$ 74</u>	<u>\$ 802</u>	<u>\$ -</u>

Description	Total	(Level 1) Quoted Prices in Active Markets for Identical Assets	(Level 2) Significant Other Observable Inputs	(Level 3) Significant Unobservable Inputs
September 30, 2017				
Available for sale securities:				
Collateralized mortgage obligations	\$ 806	\$ -	\$ 806	\$ -
U.S. Government money market funds	<u>90</u>	<u>90</u>	<u>-</u>	<u>-</u>
Totals	<u>\$ 896</u>	<u>\$ 90</u>	<u>\$ 806</u>	<u>\$ -</u>

There were no transfers in and out of Level 1 and Level 2 fair value measurements for the year ended September 30, 2018.

For assets measured at fair value on a non recurring basis, the fair value measurements by level within the fair value hierarchy used at September 30, 2018 and 2017 are as follows (in thousands):

Description	September 30, 2018	(Level 1) Quoted Prices in Active Markets for Identical Assets	(Level 2) Significant Other Observable Inputs	(Level 3) Significant Unobservable Inputs
Impaired Loans	\$ 10,169	\$ -	\$ -	\$ 10,169
Foreclosed Real Estate	<u>1,043</u>	<u>-</u>	<u>-</u>	<u>1,043</u>
Totals	<u>\$ 11,212</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 11,212</u>

Description	September 30, 2017	(Level 1) Quoted Prices in Active Markets for Identical Assets	(Level 2) Significant Other Observable Inputs	(Level 3) Significant Unobservable Inputs
Impaired Loans	\$ 11,481	\$ -	\$ -	\$ 11,481
Foreclosed Real Estate	<u>829</u>	<u>-</u>	<u>-</u>	<u>829</u>
Totals	<u>\$ 12,310</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 12,310</u>

Quantitative Information about Level 3 Fair Value Measurements

September 30, 2018

Description	Fair Value	Valuation Technique	Unobservable Input	Range (Weighted Average) (3)
Impaired loans	\$ 10,169	Fair Value of Collateral (1)	Appraised Value (2)	17% - 27% (18%)
Foreclosed Real Estate	1,043	Appraised Value (2)	Appraised Value (2)	17%

Quantitative Information about Level 3 Fair Value Measurements

September 30, 2017

Description	Fair Value	Valuation Technique	Unobservable Input	Range (Weighted Average) (3)
Impaired loans	\$ 11,481	Fair Value of Collateral (1)	Appraised Value (2)	17% - 27% (18%)
Foreclosed Real Estate	829	Appraised Value (2)	Appraised Value (2)	17%

- (1) Fair value is generally determined through independent appraisals of the underlying collateral, which include Level 3 inputs that are not identifiable.
- (2) Appraisals may be adjusted by management for qualitative factors such as economic conditions and estimated liquidation expenses.

The significant unobservable inputs for impaired loans are the appraised value or an agreed upon sales price. These values are adjusted for estimated costs to sell which are incremental direct costs to transact a sale such as broker commission, legal fees, closing costs and title transfer fees. The costs must be considered essential to the sale and would not have been incurred if the decision to sell had not been made. The costs to sell are based on costs associated with the Company's actual sales of other real estate owned which are assessed annually.

Other real estate owned is measured at fair value, less costs to sell at the date of foreclosure, establishing a new cost basis. Subsequent to foreclosure, valuations are periodically performed by management and the assets are carried at the lower of the carrying amount or fair value, less costs to sell.

The following information should not be interpreted as an estimate of the fair value of the entire Company since a fair value calculation is only provided for a limited portion of the Company's assets and liabilities. Due to a wide range of valuation techniques and the degree of subjectivity used in making the estimates, comparisons between the Company's disclosures and those of other companies may not be meaningful. The following methods and assumptions were used to estimate the fair values of the Company's financial instruments at September 30, 2018 and 2017.

Cash and Cash Equivalents (Carried at Cost)

The carrying amounts reported in the Consolidated Statements of Financial Condition for cash and short-term instruments approximate those assets' fair values.

Securities

The fair value of securities available for sale (carried at fair value) and held to maturity (carried at amortized cost) are determined by obtaining quoted market prices on nationally recognized securities exchanges (Level 1), or matrix pricing (Level 2), which is a mathematical technique used widely in the industry to value debt securities without relying exclusively on quoted prices for the specific securities but rather by relying on the securities' relationship to other benchmark quoted prices. The Company currently holds U.S. Government money market funds which are classified as Level 1, because quoted prices are available for these securities in an active market.

The Bank's investment portfolio is maintained by a third-party which utilizes Interactive Data Corporation (IDC) as its primary source for security valuations. IDC is not affiliated with or owned by a securities broker, dealer or underwriter, nor is it actively involved in the business of investment management or securities trading. Some of the major asset classes that IDC provides pricing and market inputs are as follows: U.S. Agency/Government Sponsored Enterprise (GSE) issues, U.S. high grade municipal issues, and U.S. Structured Securities Agency/GSE Collateralized Mortgage Obligation issues. The methodology used to price the above asset classes include: broker quotes, proprietary models, vast descriptive terms and conditions databases, as well as extensive quality control programs. Market inputs used to help determine the fair value hierarchy include but not limited to: security characteristics, ratings updates, prepayment schedules; cash flows and yield to maturity. Based on these methodologies employed by IDC; the Company considers these evaluations Level 2 in reference to ASC 820 with the exception of inactive markets. There are no securities in an inactive environment.

Loans Receivable (Carried at Cost)

The fair values of loans, excluding impaired loans are estimated using discounted cash flow analyses, using market rates at the Consolidated Statements of Financial Condition date that reflect the credit and interest rate-risk inherent in the loans. Projected future cash flows are calculated based upon contractual maturity or call dates, projected repayments and prepayments of principal. Generally, for variable rate loans that repriced frequently and with no significant change in credit risk, fair values are based on carrying values.

Impaired loans are those loans which the Company has measured impairment generally based on the fair value of the loan's collateral. Fair value is generally determined based upon independent third-party appraisals of the properties, or discounted cash flows based upon the expected proceeds. These assets are included as Level 3 values, based upon the lowest level of input that is significant to the fair value measurements.

Federal Home Loan Bank Stock (Carried at Cost)

The carrying amount of this restricted investment in bank stock approximates fair value, and considers the limited marketability of this security.

Bank Owned Life Insurance

Fair value is equal to the cash surrender value of the life insurance policies.

Accrued Interest Receivable and Payable (Carried at Cost)

The carrying amount of accrued interest receivable and accrued interest payable approximates their fair value.

Deposit Liabilities (Carried at Cost)

The fair values disclosed for demand deposits (e.g., interest and noninterest checking, passbook savings and money market accounts) are, by definition, equal to the amount payable on demand at the reporting date (i.e., their carrying amounts). Fair values for fixed-rate certificates of deposit are estimated using a discounted cash flow calculation that applies interest rates currently being offered in the market on certificates to a schedule of an aggregated expected monthly maturities on time deposits.

Borrowings (Carried at Cost)

The fair value of short-term borrowings approximates the current book value. Fair values of long-term borrowings are estimated using discounted cash flow analysis, based on quoted prices for new advances with similar credit risk characteristics, terms and remaining maturity. These prices obtained from this active market represent a market value that is deemed to represent the transfer price if the liability were assumed by a third party.

Off-Balance Sheet financial Instruments (Disclosed at Cost)

Fair values for the Company's off-balance sheet financial instruments (lending commitments and letters of credit) are based on fees currently charged in the market to enter into similar agreements, taking into account, the remain terms of the agreements and the counterparties' credit standing. The fair value of these off-balance sheet financial instruments are not considered material as of September 30, 2018 and 2017.

The fair value amounts have been determined by the Company using available market information appropriate valuation methodologies. However, considerable judgment is necessarily required to interpret the data to develop the estimates.

The carrying amounts and fair values of all the Company's financial instruments as of September 30, 2018 and 2017 are as follows:

			Fair Value Measurements at September 30, 2018		
(In thousands)	Carrying Amount	Estimated Fair Value	Quoted Prices in Active Markets For Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Assets:					
Cash and cash equivalents	\$ 8,076	\$ 8,076	\$ 8,076	\$ -	\$ -
Securities held to maturity	107,042	103,946	-	103,946	-
Securities available-for-sale	876	876	74	802	-
Loans receivable - net	615,899	611,279	-	-	611,279
Federal Home Loan Bank stock	5,286	5,286	5,286	-	-
Bank-owned life insurance	16,464	16,464	16,464	-	-
Accrued interest receivable	2,239	2,239	2,239	-	-
Liabilities:					
Checking, passbook, club and NOW deposit accounts	175,413	175,413	175,413	-	-
Money Market deposit accounts	217,177	217,177	217,177	-	-
Certificate of deposit accounts	189,488	185,809	-	-	185,809
Short-term borrowings	17,207	17,207	17,207	-	-
Long-term borrowings	91,309	88,578	-	-	88,578
Accrued interest payable	179	179	179	-	-
Off-balance sheet financial instruments	-	-	-	-	-

			Fair Value Measurements at September 30, 2017		
			Quoted Prices in Active Markets For Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
(In thousands)	Carrying Amount	Estimated Fair Value			
Assets:					
Cash and cash equivalents	\$ 8,835	\$ 8,835	\$ 8,835	\$ -	\$ -
Securities held to maturity	131,885	132,861	-	132,861	-
Securities available-for-sale	896	896	90	806	-
Loans receivable - net	584,443	593,144	-	-	593,144
Federal Home Loan Bank stock	5,384	5,384	5,384	-	-
Bank-owned life insurance	16,071	16,071	16,071	-	-
Accrued interest receivable	2,078	2,078	2,078	-	-
Liabilities:					
Checking, passbook, club and NOW deposit accounts	170,845	170,845	170,845	-	-
Money Market deposit accounts	231,402	231,402	231,402	-	-
Certificate of deposit accounts	146,508	145,456	-	-	145,456
Short-term borrowings	14,337	14,337	14,337	-	-
Long-term borrowings	122,621	123,692	-	-	123,692
Accrued interest payable	456	456	456	-	-
Off-balance sheet financial instruments	-	-	-	-	-

17. PARENT COMPANY ONLY CONDENSED FINANCIAL INFORMATION

Condensed financial statements of Harleysville Financial Corporation are as follows:

(In thousands)		September 30,	
Condensed Statements of Financial Condition		2018	2017
Assets			
Cash	\$ 5	\$ 113	
Investment in subsidiary	<u>71,914</u>	<u>68,863</u>	
Total Assets	\$ <u>71,919</u>	\$ <u>68,976</u>	
Liabilities and Stockholders' Equity			
Other liabilities	\$ 81	\$ 76	
Stockholders' equity	<u>71,838</u>	<u>68,900</u>	
Total Liabilities and Stockholders' Equity	\$ <u>71,919</u>	\$ <u>68,976</u>	
		For the Year Ended September 30,	
Condensed Statements of Income:		2018	2017
Equity in income of subsidiary	\$ 3,054	\$ 3,288	
Distributed earnings of subsidiary	<u>4,750</u>	<u>2,950</u>	
Other expense	<u>694</u>	<u>588</u>	
Net income	\$ <u>7,110</u>	\$ <u>5,650</u>	
		For the Year Ended September 30,	
Condensed Statements of Cash Flows		2018	2017
Net income	\$ 7,110	\$ 5,650	
Increase in other liabilities	4	6	
Stock based compensation	258	159	
Equity in undistributed earnings of subsidiary	<u>(3,054)</u>	<u>(3,288)</u>	
Net cash provided by operating activities	<u>4,318</u>	<u>2,527</u>	
Financing activities:			
(Acquisition) sale of treasury stock	(1,461)	153	
Sale of treasury stock delivered under employee stock plans	461	512	
Dividends paid	<u>(3,426)</u>	<u>(3,245)</u>	
Net cash used in financing activities	<u>(4,426)</u>	<u>(2,580)</u>	
Decrease in cash and cash equivalents	(108)	(53)	
Cash and cash equivalents at the beginning of the period	<u>113</u>	<u>166</u>	
Cash and cash equivalents at the end of the period	\$ <u>5</u>	\$ <u>113</u>	

18. SUBSEQUENT EVENTS

Management has reviewed events occurring through November 30, 2018, the date the financial statements were issued, and no subsequent events occurred requiring accrual or disclosures.