

SOUTHERN MISSOURI BANCORP, INC.
Form 10-Q
November 09, 2018

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, DC 20549

FORM 10-Q
(Mark One)

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

For the quarterly period ended September 30, 2018
OR

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

For the transition period from _____ to _____

Commission file number 0-23406
Southern Missouri Bancorp, Inc. (Exact name of registrant as specified in its charter)

Missouri 43-1665523
(State or jurisdiction of incorporation) (IRS employer id. no.)

2991 Oak Grove Road, Poplar Bluff, MO 63901
(Address of principal executive offices) (Zip code)

(573) 778-1800 Registrant's telephone number, including area code

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

Yes No

Indicate by check mark whether the registrant has submitted electronically every Interactive Data file required to be submitted pursuant to Rule 405 of regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

Yes No

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

Large accelerated filer Accelerated filer Non-accelerated filer Smaller reporting company

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12 b-2 of the Exchange Act)

Yes No X

Indicate the number of shares outstanding of each of the registrant's classes of common stock, as of the latest practicable date:

Class	Outstanding at November 8, 2018
Common Stock, Par Value \$.01	8,995,884 Shares

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PART I: Item 1: Condensed Consolidated Financial StatementsSOUTHERN MISSOURI BANCORP, INC.
CONDENSED CONSOLIDATED BALANCE SHEETS
SEPTEMBER 30, 2018 AND JUNE 30, 2018

(dollars in thousands)	September 30, 2018	June 30, 2018
<u>Assets</u>	(unaudited)	
Cash and cash equivalents	\$22,130	\$26,326
Interest-bearing time deposits	1,956	1,953
Available for sale securities	144,625	146,325
Stock in FHLB of Des Moines	7,441	5,661
Stock in Federal Reserve Bank of St. Louis	3,566	3,566
Loans receivable, net of allowance for loan losses of \$18,790 and \$18,214 at September 30, 2018 and June 30, 2018, respectively	1,624,156	1,563,380
Accrued interest receivable	9,612	7,992
Premises and equipment, net	54,669	54,832
Bank owned life insurance – cash surrender value	37,794	37,547
Goodwill	13,078	13,078
Other intangible assets, net	6,556	6,918
Prepaid expenses and other assets	18,045	18,537
Total assets	\$1,943,628	\$1,886,115
<u>Liabilities and Stockholders' Equity</u>		
Deposits	\$1,591,126	\$1,579,902
Securities sold under agreements to repurchase	3,631	3,267
Advances from FHLB of Des Moines	118,307	76,652
Note payable	3,000	3,000
Accounts payable and other liabilities	5,142	6,449
Accrued interest payable	1,391	1,206
Subordinated debt	14,969	14,945
Total liabilities	1,737,566	1,685,421
Common stock, \$.01 par value; 12,000,000 shares authorized; 8,995,884 and 8,996,584 shares issued, respectively, at September 30, 2018 and June 30, 2018	90	90
Additional paid-in capital	83,437	83,413
Retained earnings	125,167	119,536
Accumulated other comprehensive income (loss)	(2,632)	(2,345)
Total stockholders' equity	206,062	200,694
Total liabilities and stockholders' equity	\$1,943,628	\$1,886,115

See Notes to Condensed Consolidated Financial Statements

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SOUTHERN MISSOURI BANCORP, INC
CONDENSED CONSOLIDATED STATEMENTS OF INCOME
FOR THE THREE-MONTH PERIODS ENDED SEPTEMBER 30, 2018 AND 2017 (Unaudited)

	Three months ended September 30, 2018 2017	
(dollars in thousands except per share data)		
INTEREST INCOME:		
Loans	\$20,916	\$17,455
Investment securities	517	529
Mortgage-backed securities	584	417
Other interest-earning assets	25	10
Total interest income	22,042	18,411
INTEREST EXPENSE:		
Deposits	4,009	2,862
Securities sold under agreements to repurchase	8	14
Advances from FHLB of Des Moines	599	226
Note payable	35	28
Subordinated debt	224	178
Total interest expense	4,875	3,308
NET INTEREST INCOME	17,167	15,103
PROVISION FOR LOAN LOSSES	682	868
NET INTEREST INCOME AFTER PROVISION FOR LOAN LOSSES	16,485	14,235
NONINTEREST INCOME:		
Deposit account charges and related fees	1,224	1,168
Bank card interchange income	1,063	869
Loan late charges	94	113
Loan servicing fees	159	180
Other loan fees	337	388
Net realized gains on sale of loans	179	203
Earnings on bank owned life insurance	246	233
Other income	128	117
Total noninterest income	3,430	3,271
NONINTEREST EXPENSE:		
Compensation and benefits	6,047	5,932
Occupancy and equipment, net	2,470	2,309
Deposit insurance premiums	138	119
Legal and professional fees	256	252
Advertising	315	238
Postage and office supplies	152	197
Intangible amortization	396	348
Bank card network expense	495	367

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Other operating expense	1,180	993
Total noninterest expense	11,449	10,755
INCOME BEFORE INCOME TAXES	8,466	6,751
INCOME TAXES	1,666	1,889
NET INCOME	\$6,800	\$4,862
Basic earnings per common share	\$0.76	\$0.57
Diluted earnings per common share	\$0.76	\$0.56
Dividends per common share	\$0.13	\$0.11

See Notes to Condensed Consolidated Financial Statements

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SOUTHERN MISSOURI BANCORP, INC
 CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
 FOR THE THREE-MONTH PERIODS ENDED SEPTEMBER 30, 2018 AND 2017 (Unaudited)

	Three months ended September 30, 2018 2017	
(dollars in thousands)		
Net income	\$6,800	\$4,862
Other comprehensive income (loss):		
Unrealized gains (losses) on securities available-for-sale	(378)	23
Unrealized gains on available-for-sale securities for which a portion of an other-than-temporary impairment has been recognized in income	-	11
Tax benefit (expense)	91	(12)
Total other comprehensive income (loss)	(287)	22
Comprehensive income	\$6,513	\$4,884

See Notes to Condensed Consolidated Financial Statements

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SOUTHERN MISSOURI BANCORP, INC.
 CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
 FOR THE THREE-MONTH PERIODS ENDED SEPTEMBER 30, 2018 AND 2017 (Unaudited)

(dollars in thousands)	Three months ended September 30,	
	2018	2017
Cash Flows From Operating Activities:		
Net Income	\$6,800	\$4,862
Items not requiring (providing) cash:		
Depreciation	777	778
Loss (gain) on disposal of fixed assets	8	(4)
Stock option and stock grant expense	23	20
Loss (gain) on sale/write-down of REO	22	(28)
Amortization of intangible assets	396	348
Accretion of purchase accounting adjustments	(1,159)	(404)
Increase in cash surrender value of bank owned life insurance (BOLI)	(247)	(233)
Provision for loan losses	682	868
Net amortization of premiums and discounts on securities	230	272
Originations of loans held for sale	(7,420)	(6,876)
Proceeds from sales of loans held for sale	7,936	6,799
Gain on sales of loans held for sale	(179)	(203)
Changes in:		
Accrued interest receivable	(1,620)	(1,536)
Prepaid expenses and other assets	1,434	2,711
Accounts payable and other liabilities	(902)	(2,929)
Deferred income taxes	6	6
Accrued interest payable	185	77
Net cash provided by operating activities	6,972	4,528
Cash flows from investing activities:		
Net increase in loans	(62,129)	(52,814)
Net change in interest-bearing deposits	(4)	-
Proceeds from maturities of available for sale securities	5,748	4,224
Net purchases of Federal Home Loan Bank stock	(1,780)	(1,644)
Net purchases of Federal Reserve Bank of St. Louis stock	-	(836)
Purchases of available-for-sale securities	(4,655)	(7,726)
Purchases of premises and equipment	(622)	(1,383)
Investments in state & federal tax credits	(231)	(3,784)
Proceeds from sale of fixed assets	-	647
Proceeds from sale of foreclosed assets	421	431
Net cash used in investing activities	(63,252)	(62,885)
Cash flows from financing activities:		
Net (decrease) increase in demand deposits and savings accounts	(36,827)	24,271
Net increase (decrease) in certificates of deposits	48,067	(8,164)
Net increase (decrease) in securities sold under agreements to repurchase	364	(3,585)

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Proceeds from Federal Home Loan Bank advances	192,550	487,050
Repayments of Federal Home Loan Bank advances	(150,900)	(445,950)
Common stock issued	-	(4)
Dividends paid on common stock	(1,170)	(945)
Net cash provided by financing activities	52,084	52,673
Decrease in cash and cash equivalents	(4,196)	(5,684)
Cash and cash equivalents at beginning of period	26,326	30,786
Cash and cash equivalents at end of period	\$22,130	\$25,102
Supplemental disclosures of cash flow information:		
<u>Noncash investing and financing activities:</u>		
Conversion of loans to foreclosed real estate	\$1,495	\$701
Conversion of loans to repossessed assets	11	25
<u>Cash paid during the period for:</u>		
Interest (net of interest credited)	\$1,005	\$656
Income taxes	310	480
See Notes to Condensed Consolidated Financial Statements		

SOUTHERN MISSOURI BANCORP, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

Note 1: Basis of Presentation

The accompanying unaudited interim consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America for interim financial information and with the instructions to Form 10-Q and Rule 10-01 of Securities and Exchange Commission (SEC) Regulation S-X. Accordingly, they do not include all of the information and footnotes required by accounting principles generally accepted in the United States of America for complete financial statements. In the opinion of management, all material adjustments (consisting only of normal recurring accruals) considered necessary for a fair presentation have been included. The consolidated balance sheet of the Company as of June 30, 2018, has been derived from the audited consolidated balance sheet of the Company as of that date. Operating results for the three-month period ended September 30, 2018, are not necessarily indicative of the results that may be expected for the entire fiscal year. For additional information, refer to the audited consolidated financial statements included in the Company's June 30, 2018, Form 10-K, which was filed with the SEC.

The accompanying consolidated financial statements include the accounts of the Company and its wholly-owned subsidiary, Southern Bank. All significant intercompany accounts and transactions have been eliminated in consolidation.

Note 2: Organization and Summary of Significant Accounting Policies

Organization. Southern Missouri Bancorp, Inc., a Missouri corporation (the Company) was organized in 1994 and is the parent company of Southern Bank (the Bank). Substantially all of the Company's consolidated revenues are derived from the operations of the Bank, and the Bank represents substantially all of the Company's consolidated assets and liabilities. SB Real Estate Investments, LLC is a wholly-owned subsidiary of the Bank formed to hold Southern Bank Real Estate Investments, LLC. Southern Bank Real Estate Investments, LLC is a REIT which is controlled by SB Real Estate Investments, LLC, but which has other preferred shareholders in order to meet the requirements to be a REIT. At September 30, 2018, assets of the REIT were approximately \$615 million, and consisted primarily of loan participations acquired from the Bank.

The Bank is primarily engaged in providing a full range of banking and financial services to individuals and corporate customers in its market areas. The Bank and Company are subject to competition from other financial institutions. The Bank and Company are subject to regulation by certain federal and state agencies and undergo periodic examinations by those regulatory authorities.

Basis of Financial Statement Presentation. The financial statements of the Company have been prepared in conformity with accounting principles generally accepted in the United States of America and general practices within the banking industry. In the normal course of business, the Company encounters two significant types of risk: economic and regulatory. Economic risk is comprised of interest rate risk, credit risk, and market risk. The Company is subject to interest rate risk to the degree that its interest-bearing liabilities reprice on a different basis than its interest-earning assets. Credit risk is the risk of default on the Company's investment or loan portfolios resulting from the borrowers' inability or unwillingness to make contractually required payments. Market risk reflects changes in the value of the investment portfolio, collateral underlying loans receivable, and the value of the Company's investments in real estate.

Principles of Consolidation. The consolidated financial statements include the accounts of the Company and its wholly-owned subsidiary, the Bank. All significant intercompany accounts and transactions have been eliminated.

Use of Estimates. The preparation of 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 disclosures of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Material estimates that are particularly susceptible to significant change relate to the determination of the allowance for loan losses, estimated fair values of purchased loans, other-than-temporary impairments (OTTI), and fair value of financial instruments.

Cash and Cash Equivalents. For purposes of reporting cash flows, cash and cash equivalents includes cash, due from depository institutions and interest-bearing deposits in other depository institutions with original maturities of three months or less. Interest-bearing deposits in other depository institutions were \$1.3 million and \$3.4 million at September 30 and June 30, 2018, respectively. The deposits are held in various commercial banks in amounts not exceeding the FDIC's deposit insurance limits, as well as at the Federal Reserve and the Federal Home Loan Bank of Des Moines.

Interest-bearing Time Deposits. Interest bearing deposits in banks mature within seven years and are carried at cost.

Available for Sale Securities. Available for sale securities, which include any security for which the Company has no immediate plan to sell but which may be sold in the future, are carried at fair value. Unrealized gains and losses, net of tax, are reported in accumulated other comprehensive income (loss), a component of stockholders' equity. All securities have been classified as available for sale.

Premiums and discounts on debt securities are amortized or accreted as adjustments to income over the estimated life of the security using the level yield method. Realized gains or losses on the sale of securities is based on the specific identification method. The fair value of securities is based on quoted market prices or dealer quotes. If a quoted market price is not available, fair value is estimated using quoted market prices for similar securities.

The Company does not invest in collateralized mortgage obligations that are considered high risk.

When the Company does not intend to sell a debt security, and it is more likely than not the Company will not have to sell the security before recovery of its cost basis, it recognizes the credit component of an other-than-temporary impairment of a debt security in earnings and the remaining portion in other comprehensive income. As a result of this guidance, the Company's consolidated balance sheet as of the dates presented reflects the full impairment (that is, the difference between the security's amortized cost basis and fair value) on debt securities that the Company intends to sell or would more likely than not be required to sell before the expected recovery of the amortized cost basis. For available-for-sale debt securities that management has no intent to sell and believes that it more likely than not will not be required to sell prior to recovery, only the credit loss component of the impairment is recognized in earnings, while the noncredit loss is recognized in accumulated other comprehensive loss. The credit loss component recognized in earnings is identified as the amount of principal cash flows not expected to be received over the remaining term of the security as projected based on cash flow projections.

Federal Home Loan Bank and Federal Reserve Bank Stock. The Bank is a member of the Federal Home Loan Bank (FHLB) system, and the Federal Reserve Bank of St. Louis. Capital stock of the FHLB and the Federal Reserve is a required investment based upon a predetermined formula and is carried at cost.

Loans. Loans are generally stated at unpaid principal balances, less the allowance for loan losses and net deferred loan origination fees.

Interest on loans is accrued based upon the principal amount outstanding. The accrual of interest on loans is discontinued when, in management's judgment, the collectability of interest or principal in the normal course of business is doubtful. The Company complies with regulatory guidance which indicates that loans should be placed in nonaccrual status when 90 days past due, unless the loan is both well-secured and in the process of collection. A loan that is "in the process of collection" may be subject to legal action or, in appropriate circumstances, through other collection efforts reasonably expected to result in repayment or restoration to current status in the near future. A loan is considered delinquent when a payment has not been made by the contractual due date. Interest income previously

accrued but not collected at the date a loan is placed on nonaccrual status is reversed against interest income. Cash receipts on a nonaccrual loan are applied to principal and interest in accordance with its contractual terms unless full payment of principal is not expected, in which case cash receipts, whether designated as principal or interest, are applied as a reduction of the carrying value of the loan. A nonaccrual loan is generally returned to accrual status when principal and interest payments are current, full collectability of principal and interest is reasonably assured, and a consistent record of performance has been demonstrated.

The allowance for losses on loans represents management's best estimate of losses probable in the existing loan portfolio. The allowance for losses on loans is increased by the provision for losses on loans charged to expense and reduced by loans charged off, net of recoveries. Loans are charged off in the period deemed uncollectible, based on management's analysis of expected cash flows (for non-collateral dependent loans) or collateral value (for collateral-

dependent loans). Subsequent recoveries of loans previously charged off, if any, are credited to the allowance when received. The provision for losses on loans is determined based on management's assessment of several factors: reviews and evaluations of specific loans, changes in the nature and volume of the loan portfolio, current economic conditions and the related impact on specific borrowers and industry groups, historical loan loss experience, the level of classified and nonperforming loans and the results of regulatory examinations.

Loans are considered impaired if, 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. Depending on a particular loan's circumstances, we measure impairment of a loan based upon either the present value of expected future cash flows discounted at the loan's effective interest rate, the loan's observable market price, or the fair value of the collateral less estimated costs to sell if the loan is collateral dependent. Valuation allowances are established for collateral-dependent impaired loans for the difference between the loan amount and fair value of collateral less estimated selling costs. For impaired loans that are not collateral dependent, a valuation allowance is established for the difference between the loan amount and the present value of expected future cash flows discounted at the historical effective interest rate or the observable market price of the loan. Impairment losses are recognized through an increase in the required allowance for loan losses. Cash receipts on loans deemed impaired are recorded based on the loan's separate status as a nonaccrual loan or an accrual status loan.

Some loans are accounted for in accordance with ASC 310-30, Loans and Debt Securities Acquired with Deteriorated Credit Quality. For these loans ("purchased credit impaired loans"), the Company recorded a fair value discount and began carrying them at book value less their face amount (see Note 4). For these loans, we determined the contractual amount and timing of undiscounted principal and interest payments (the "undiscounted contractual cash flows"), and estimated the amount and timing of undiscounted expected principal and interest payments, including expected prepayments (the "undiscounted expected cash flows"). Under acquired impaired loan accounting, the difference between the undiscounted contractual cash flows and the undiscounted expected cash flows is the nonaccretable difference. The nonaccretable difference is an estimate of the loss exposure of principal and interest related to the purchased credit impaired loans, and the amount is subject to change over time based on the performance of the loans. The carrying value of purchased credit impaired loans is initially determined as the discounted expected cash flows. The excess of expected cash flows at acquisition over the initial fair value of the purchased credit impaired loans is referred to as the "accretable yield" and is recorded as interest income over the estimated life of the acquired loans using the level-yield method, if the timing and amount of the future cash flows is reasonably estimable. The carrying value of purchased credit impaired loans is reduced by payments received, both principal and interest, and increased by the portion of the accretable yield recognized as interest income. Subsequent to acquisition, the Company evaluates the purchased credit impaired loans on a quarterly basis. Increases in expected cash flows compared to those previously estimated increase the accretable yield and are recognized as interest income prospectively. Decreases in expected cash flows compared to those previously estimated decrease the accretable yield and may result in the establishment of an allowance for loan losses and a provision for loan losses. Purchased credit impaired loans are generally considered accruing and performing loans, as the loans accrete interest income over the estimated life of the loan when expected cash flows are reasonably estimable. Accordingly, purchased credit impaired loans that are contractually past due are still considered to be accruing and performing as long as there is an expectation that the estimated cash flows will be received. If the timing and amount of cash flows is not reasonably estimable, the loans may be classified as nonaccrual loans.

Loan fees and certain direct loan origination costs are deferred, and the net fee or cost is recognized as an adjustment to interest income using the interest method over the contractual life of the loans.

Foreclosed Real Estate. Real estate acquired by foreclosure or by deed in lieu of foreclosure is initially recorded at fair value less estimated selling costs. Costs for development and improvement of the property are capitalized.

Valuations are periodically performed by management, and an allowance for losses is established by a charge to operations if the carrying value of a property exceeds its estimated fair value, less estimated selling costs.

Loans to facilitate the sale of real estate acquired in foreclosure are discounted if made at less than market rates. Discounts are amortized over the fixed interest period of each loan using the interest method.

Premises and Equipment. Premises and equipment are stated at cost less accumulated depreciation and include expenditures for major betterments and renewals. Maintenance, repairs, and minor renewals are expensed as incurred. When property is retired or sold, the retired asset and related accumulated depreciation are removed from the accounts and the resulting gain or loss taken into income. The Company reviews property and equipment for

impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. If such assets are considered to be impaired, the impairment loss recognized is measured by the amount by which the carrying amount exceeds the fair value of the assets.

Depreciation is computed by use of straight-line and accelerated methods over the estimated useful lives of the assets. Estimated lives are generally seven to forty years for premises, three to seven years for equipment, and three years for software.

Bank Owned Life Insurance. Bank owned life insurance policies are reflected in the consolidated balance sheets at the estimated cash surrender value. Changes in the cash surrender value of these policies, as well as a portion of the insurance proceeds received, are recorded in noninterest income in the consolidated statements of income.

Goodwill. The Company's goodwill is evaluated annually for impairment or more frequently if impairment indicators are present. A qualitative assessment is performed to determine whether the existence of events or circumstances leads to a determination that it is more likely than not the fair value is less than the carrying amount, including goodwill. If, based on the evaluation, it is determined to be more likely than not that the fair value is less than the carrying value, then goodwill is tested further for impairment. If the implied fair value of goodwill is lower than its carrying amount, a goodwill impairment is indicated and goodwill is written down to its implied fair value. Subsequent increases in goodwill value are not recognized in the financial statements.

Intangible Assets. The Company's intangible assets at September 30, 2018 included gross core deposit intangibles of \$10.6 million with \$5.6 million accumulated amortization, gross other identifiable intangibles of \$3.8 million with accumulated amortization of \$3.8 million, and mortgage servicing rights of \$1.6 million. At June 30, 2018, the Company's intangible assets included gross core deposit intangibles of \$10.6 million with \$5.2 million accumulated amortization, gross other identifiable intangibles of \$3.8 million with accumulated amortization of \$3.8 million, and mortgage servicing rights of \$1.5 million. The Company's core deposit intangible assets are being amortized using the straight line method, over periods ranging from five to seven years, with amortization expense expected to be approximately \$932,000 in the remainder of fiscal 2019, \$1.2 million in fiscal 2020, \$716,000 in fiscal 2021, \$674,000 in fiscal 2022, \$674,000 in fiscal 2023, and \$802,000 thereafter.

Income Taxes. The Company accounts for income taxes in accordance with income tax accounting guidance (ASC 740, Income Taxes). The income tax accounting guidance results in two components of income tax expense: current and deferred. Current income tax expense reflects taxes to be paid or refunded for the current period by applying the provisions of the enacted tax law to the taxable income or excess of deductions over revenues. The Company determines deferred income taxes using the liability (or balance sheet) method. Under this method, the net deferred tax asset or liability is based on the tax effects of the differences between the book and tax bases of assets and liabilities, and enacted changes in tax rates and laws are recognized in the period in which they occur.

Deferred income tax expense results from changes in deferred tax assets and liabilities between periods. Deferred tax assets are recognized if it is more likely than not, based on the technical merits, that the tax position will be realized or sustained upon examination. The term more likely than not means a likelihood of more than 50 percent; the terms examined and upon examination also include resolution of the related appeals or litigation processes, if any. A tax position that meets the more-likely-than-not recognition threshold is initially and subsequently measured as the largest amount of tax benefit that has a greater than 50 percent likelihood of being realized upon settlement with a taxing authority that has full knowledge of all relevant information. The determination of whether or not a tax position has met the more-likely-than-not recognition threshold considers the facts, circumstances, and information available at the reporting date and is subject to management's judgment. Deferred tax assets are reduced by a valuation allowance if,

based on the weight of evidence available, it is more likely than not that some portion or all of a deferred tax asset will not be realized.

The Company recognizes interest and penalties on income taxes as a component of income tax expense.

The Company files consolidated income tax returns with its subsidiaries.

Incentive Plan. The Company accounts for its Management and Recognition Plan (MRP) and Equity Incentive Plan (EIP) in accordance with ASC 718, "Share-Based Payment." Compensation expense is based on the market price of the Company's stock on the date the shares are granted and is recorded over the vesting period. The difference between the aggregate purchase price and the fair value on the date the shares are considered earned represents a tax benefit to the Company that is recorded as an adjustment to income tax expense.

Outside Directors' Retirement. The Bank has entered into a retirement agreement with most outside directors since April 1994. The directors' retirement agreements provide that non-employee directors shall receive, upon termination of service on the Board on or after age 60, other than termination for cause, a benefit in equal annual installments over a five year period. The benefit will be based upon the product of the participant's vesting percentage and the total Board fees paid to the participant during the calendar year preceding termination of service on the Board. The vesting percentage shall be determined based upon the participant's years of service on the Board, whether before or after the reorganization date.

In the event that the participant dies before collecting any or all of the benefits, the Bank shall pay the participant's beneficiary. No benefits shall be payable to anyone other than the beneficiary, and shall terminate on the death of the beneficiary.

Stock Options. Compensation cost is measured based on the grant-date fair value of the equity instruments issued, and recognized over the vesting period during which an employee provides service in exchange for the award.

Earnings Per Share. Basic earnings per share available to common stockholders is computed using the weighted-average number of common shares outstanding. Diluted earnings per share available to common stockholders includes the effect of all weighted-average dilutive potential common shares (stock options) outstanding during each period.

Comprehensive Income. Comprehensive income consists of net income and other comprehensive income (loss), net of applicable income taxes. Other comprehensive income (loss) includes unrealized appreciation (depreciation) on available-for-sale securities, unrealized appreciation (depreciation) on available-for-sale securities for which a portion of an other-than-temporary impairment has been recognized in income, and changes in the funded status of defined benefit pension plans.

Transfers Between Fair Value Hierarchy Levels. Transfers in and out of Level 1 (quoted market prices), Level 2 (other significant observable inputs) and Level 3 (significant unobservable inputs) are recognized on the period ending date.

The following paragraphs summarize the impact of new accounting pronouncements:

In February 2018, the FASB issued ASU 2018-02, *Income Statement-Reporting Comprehensive Income (Topic 220): Reclassification of Certain Tax Effects from Accumulated Other Comprehensive Income*. This ASU provides financial statement preparers with an option to reclassify stranded tax effects within AOCI to retained earnings in each period in which the effect of the change in the U.S. federal corporate income tax rate in the Tax Cuts and Jobs Act (or portion thereof) are recorded. This standard is effective for all organizations for fiscal years beginning after December 15, 2018, and interim periods within those fiscal years. Early adoption is permitted. The Company elected to early adopt ASU 2018-02 and, as a result, reclassified \$65,497 from accumulated other comprehensive income to retained earnings as of December 31, 2017.

In May 2017, the FASB issued ASU 2017-09, *Compensation-Stock Compensation (Subtopic 718): Scope of Modification Accounting*. The amendments in ASU 2017-09 provide guidance about which changes to the terms or conditions of a share-based payment award require an entity to apply modification accounting in Topic 718. Under the new guidance, an entity should account for the effects of a modification unless all of the following are the same immediately before and after the change: (1) the fair value of the modified award, (2) the vesting conditions of the modified award, and (3) the classification of the modified award as either an equity or liability instrument. ASU

2017-09 was effective for the fiscal years, and interim periods within those fiscal years, beginning after December 15, 2017, and should be applied prospectively to awards modified on or after the adoption date. The adoption of this guidance in the first quarter of fiscal 2019 did not have a material impact on the Company's consolidated financial statements.

In August 2016, the FASB issued ASU 2016-15, Statement of Cash Flows (Topic 230), Classification of Certain Cash Receipts and Cash payments. The Update provides guidance on how certain cash receipts and payments are presented and classified in the statement of cash flows, with the objective of reducing the diversity in practice. The Update addresses eight specific cash flow issues. For public companies, the ASU was effective for fiscal years beginning after December 15, 2017, including interim periods within those fiscal years, and should be applied retrospectively. There has been no material impact on the Company's consolidated financial statements due to the adoption of this standard in the first quarter of fiscal 2019.

In June 2016, the FASB issued ASU 2016-13, Financial Instruments – Credit Losses (Topic 326). The Update amends guidance on reporting credit losses for assets held at amortized cost basis and available for sale debt securities. For assets held at amortized cost basis, Topic 326 eliminates the probable initial recognition threshold in current GAAP and, instead, requires an entity to reflect its current estimate of all expected credit losses. The Update affects loans, debt securities, trade receivables, net investments in leases, off balance sheet credit exposures, and any other financial assets not excluded from the scope that have the contractual right to receive cash. For public companies, the ASU is effective for fiscal years beginning after December 15, 2019, including interim periods within those fiscal years. Early adoption is available beginning after December 15, 2018, including interim periods within those fiscal years. Adoption will be applied on a modified retrospective basis, through a cumulative-effect adjustment to retained earnings. Management is evaluating the impact, if any, this new guidance will have on the Company's consolidated financial statements, but cannot yet reasonably estimate the impact of adoption. The Company has formed a working group of key personnel responsible for the allowance for loan losses estimate and has initiated its evaluation of the data and systems requirements of adoption of the Update. The group has determined that purchasing third party software will be the most effective method to comply with the requirements, and has evaluated several outside vendors. The group provided a recommendation to purchase Sageworks software, which was approved by the Board, and purchased in June 2018. Loan data files as of June 30, 2018 have been imported into the testing environment within the Sageworks software, and sample testing is complete. Training is expected to be completed by the end of the second quarter of fiscal 2019, with a goal to run parallel calculations shortly thereafter .

In February 2016, the FASB issued ASU 2016-02, "Leases," to revise the accounting related to lease accounting. Under the new guidance, a lessee is required to record a right-of-use (ROU) asset and a lease liability on the balance sheet for all leases with terms longer than 12 months. The ASU is effective for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years. Adoption of the standard requires the use of a modified retrospective transition approach for all periods presented at the time of adoption. Management is evaluating the impact of the new guidance, but does not expect the adoption of this guidance to have a material impact on the Company's consolidated financial statements.

In January 2016, the FASB issued ASU 2016-01, "Recognition and Measurement of Financial Assets and Financial Liabilities," to generally require equity investments be measured at fair value with changes in fair value recognized in net income, simplify the impairment assessment of equity investments without readily-determinable fair value, and change disclosure and presentation requirements regarding financial instruments and other comprehensive income, and clarify 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. In February 2018, the FASB issued ASU 2018-03, Technical Corrections and Improvements to Financial Instruments – Overall (Subtopic 825-10). The amendments in ASU 2018-03 make technical corrections to certain aspects of ASU 2016-01 on recognition of financial assets and financial liabilities. ASU 2016-01 became effective for the Company in the first quarter of fiscal 2019 and continues to have no material impact on the Company's consolidated financial statements.

In August 2015, the FASB issued ASU 2015-14, Revenue from Contracts with Customers (Topic 606): Deferral of the Effective Date, which deferred the effective date of ASU 2014-09. In May 2014, the FASB issued ASU 2014-09, Revenue from Contracts with Customers (Topic 606): Summary and Amendments that Create Revenue from Contracts with Customers (Topic 606) and Other Assets and Deferred Costs—Contracts with Customers (Subtopic 340-40). The guidance in ASU 2014-09 supersedes the revenue recognition requirements in ASC Topic 605, Revenue Recognition, and most industry-specific guidance throughout the industry topics of the codification. In April 2016, the FASB issued ASU 2016-10, Revenue from Contracts with Customers (Topic 606): Identifying Performance Obligations and Licensing, to clarify two aspects of Topic 606- performance obligations and the licensing

implementation guidance. Neither of the two updates changed the core principle of the guidance in Topic 606. In May 2016, the FASB issued ASU 2016-12, Revenue from Contracts with Customers (Topic 606), to provide narrow-scope improvements and practical expedients to ASU 2015-14. ASU 2015-04 became effective for the Company in the first quarter of fiscal 2019 and continues to have no material change to our accounting for revenue because the majority of our financial instruments are not within the scope of Topic 606.

Note 3: Securities

The amortized cost, gross unrealized gains, gross unrealized losses, and approximate fair value of securities available for sale consisted of the following:

(dollars in thousands)	September 30, 2018			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
Investment and mortgage backed securities:				
U.S. government-sponsored enterprises (GSEs)	\$8,269	\$ -	\$ (133)	\$8,136
State and political subdivisions	41,321	149	(626)	40,844
Other securities	5,278	33	(131)	5,180
Mortgage-backed GSE residential	93,177	1	(2,713)	90,465
Total investments and mortgage-backed securities	\$148,045	\$ 183	\$ (3,603)	\$144,625

(dollars in thousands)	June 30, 2018			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
Investment and mortgage backed securities:				
U.S. government-sponsored enterprises (GSEs)	\$9,513	\$ -	\$ (128)	\$9,385
State and political subdivisions	41,862	230	(480)	41,612
Other securities	5,284	61	(193)	5,152
Mortgage-backed GSE residential	92,708	1	(2,533)	90,176
Total investments and mortgage-backed securities	\$149,367	\$ 292	\$ (3,334)	\$146,325

The amortized cost and estimated fair value of investment and mortgage-backed securities, by contractual maturity, are shown below. Expected maturities will differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without penalties.

(dollars in thousands)	September 30, 2018	
	Amortized Cost	Estimated Fair Value
Within one year	\$4,145	\$4,122
After one year but less than five years	14,420	14,255
After five years but less than ten years	19,505	19,327
After ten years	16,798	16,456
Total investment securities	54,868	54,160
Mortgage-backed securities	93,177	90,465
Total investments and mortgage-backed securities	\$148,045	\$144,625

The carrying value of investment and mortgage-backed securities pledged as collateral to secure public deposits and securities sold under agreements to repurchase amounted to \$118.9 million at September 30, 2018 and \$124.2 million at June 30, 2018. The securities pledged consist of marketable securities, including \$6.1 million and \$8.4 million of

U.S. Government and Federal Agency Obligations, \$38.7 million and \$39.8 million of Mortgage-Backed Securities, \$39.6 million and \$41.5 million of Collateralized Mortgage Obligations, \$34.2 million and \$34.2 million of State and Political Subdivisions Obligations, and \$300,000 and \$300,000 of Other Securities at September 30 and June 30, 2018, respectively.

The following tables show our investments' gross unrealized losses and fair value, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position at September 30 and June 30, 2018:

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	September 30, 2018					
	Less than 12 months		12 months or more		Total	Unrealized
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	
(dollars in thousands)						
U.S. government-sponsored enterprises (GSEs)	\$4,710	\$ 61	\$3,426	\$ 72	\$8,136	\$ 133
Obligations of state and political subdivisions	18,087	307	9,317	319	27,404	626
Other securities	996	4	1,067	127	2,063	131
Mortgage-backed securities	67,495	1,672	22,906	1,041	90,401	2,713
Total investments and mortgage-backed securities	\$91,288	\$ 2,044	\$36,716	\$ 1,559	\$128,004	\$ 3,603
	June 30, 2018					
	Less than 12 months		12 months or more		Total	Unrealized
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	
(dollars in thousands)						
U.S. government-sponsored enterprises (GSEs)	\$5,957	\$ 58	\$3,427	\$ 70	\$9,384	\$ 128
Obligations of state and political subdivisions	14,861	224	8,526	256	23,387	480
Other securities	982	10	1,109	183	2,091	193
Mortgage-backed securities	65,863	1,513	24,187	1,020	90,050	2,533
Total investments and mortgage-backed securities	\$87,663	\$ 1,805	\$37,249	\$ 1,529	\$124,912	\$ 3,334

Other securities. At September 30, 2018, there were two pooled trust preferred securities with an estimated fair value of \$850,000 and unrealized losses of \$121,000 in a continuous unrealized loss position for twelve months or more. These unrealized losses were primarily due to the long-term nature of the pooled trust preferred securities and a reduced demand for these securities, and concerns regarding the financial institutions that issued the underlying trust preferred securities. Rules adopted by the federal banking agencies in December 2013 to implement Section 619 of the Dodd-Frank Act (the "Volcker Rule") generally prohibit banking entities from engaging in proprietary trading and from investing in, sponsoring, or having certain relationships with a hedge fund or private equity fund. The pooled trust preferred securities owned by the Company were included in a January 2014 listing of securities which the agencies considered to be grandfathered with regard to these prohibitions; as such, banking entities are permitted to retain their interest in these securities, provided the interest was acquired on or before December 10, 2013, unless acquired pursuant to a merger or acquisition.

The September 30, 2018, cash flow analysis for these two securities indicated it is probable the Company will receive all contracted principal and related interest projected. The cash flow analysis used in making this determination was based on anticipated default, recovery, and prepayment rates, and the resulting cash flows were discounted based on the yield spread anticipated at the time the securities were purchased. Other inputs include the actual collateral attributes, which include credit ratings and other performance indicators of the underlying financial institutions, including profitability, capital ratios, and asset quality. Assumptions for these two securities included prepayments averaging 1.4 percent, annually, annual defaults averaging 64 basis points, and a recovery rate averaging 6.9 percent

of gross defaults, lagged two years.

One of these two securities has continued to receive cash interest payments in full since our purchase; the other security received principal-in-kind (PIK), in lieu of cash interest, for a period of time following the recession and financial crisis which began in 2008, but resumed cash interest payments during fiscal 2014. Our cash flow analysis indicates that cash interest payments are expected to continue for the securities. Because the Company does not intend to sell these securities and it is not more-likely-than-not that the Company will be required to sell these securities prior to recovery of their amortized cost basis, which may be maturity, the Company does not consider these investments to be other-than-temporarily impaired at September 30, 2018.

The Company does not believe any other individual unrealized loss as of September 30, 2018, represents OTTI. However, the Company could be required to recognize OTTI losses in future periods with respect to its available for sale investment securities portfolio. The amount and timing of any required OTTI will depend on the decline in the underlying cash flows of the securities. Should the impairment of any of these securities become other-than-temporary, the cost basis of the investment will be reduced and the resulting loss recognized in the period the other-than-temporary impairment is identified.

Credit losses recognized on investments. During fiscal 2009, the Company adopted ASC 820, formerly FASB Staff Position 157-4, "Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly." The following table provides information about the security for which only a credit loss was recognized in income and other losses are recorded in other comprehensive income (loss) for the years ended September 30, 2018 and 2017.

(dollars in thousands)	Accumulated Credit Losses Three-Month Period Ended September 30, 2018 2017	
Credit losses on debt securities held		
Beginning of period	\$ -	\$ 340
Additions related to OTTI losses not previously recognized	-	-
Reductions due to sales	-	-
Reductions due to change in intent or likelihood of sale	-	-
Additions related to increases in previously-recognized OTTI losses	-	-
Reductions due to increases in expected cash flows	-	(3)
End of period	\$ -	\$ 337

Note 4: Loans and Allowance for Loan Losses

Classes of loans are summarized as follows:

(dollars in thousands)	September 30, 2018	June 30, 2018
Real Estate Loans:		
Residential	\$454,020	\$450,919
Construction	117,759	112,718
Commercial	728,082	704,647
Consumer loans	77,768	78,571
Commercial loans	310,587	281,272
	1,688,216	1,628,127
Loans in process	(45,268)	(46,533)
Deferred loan fees, net	(2)	-
Allowance for loan losses	(18,790)	(18,214)
Total loans	\$1,624,156	