INTERNATIONAL BUSINESS MACHINES CORP
Form SC 13G/A
February 13, 2017

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

Schedule 13G

Under the Securities Exchange Act of 1934

(Amendment No.: 3)*

Name of issuer: International Business Machines Corp

Title of Class of Securities: Common Stock

CUSIP Number: 459200101

Date of Event Which Requires Filing of this Statement: **December 31, 2016**

Check the appropriate box to designate the rule pursuant to which this Schedule is filed:

(X) Rule 13d-1(b)

( ) Rule 13d-1(c)

( ) Rule 13d-1(d)

*The remainder of this cover page shall be filled out for a reporting person's initial filing on this form with respect to the subject class of securities, and for any subsequent amendment containing information which would alter the disclosures provided in a prior cover page.

The information required in the remainder of this cover page shall not be deemed to be "filed" for the purpose of Section 18 of the Securities Exchange Act of 1934 ("Act") or otherwise subject to the liabilities of that section of the Act but shall be subject to all other provisions of the Act (however, see the Notes).

(Continued on the following page(s))

13G

CUSIP No.: 459200101

1. NAME OF REPORTING PERSON

S.S. OR I.R.S. IDENTIFICATION NO. OF ABOVE PERSON

The Vanguard Group - 23-1945930

2. CHECK THE APPROPRIATE [LINE] IF A MEMBER OF A GROUP

A. B. X

3. SEC USE ONLY

4. CITIZENSHIP OF PLACE OF ORGANIZATION

Pennsylvania

(For questions 5-8, report the number of shares beneficially owned by each reporting person with:)

5. SOLE VOTING POWER

1,375,277

6. SHARED VOTING POWER

175,870

7. SOLE DISPOSITIVE POWER

56,326,506

8. SHARED DISPOSITIVE POWER

1,535,731

9. AGGREGATE AMOUNT BENEFICIALLY OWNED BY EACH REPORTING PERSON

57,862,237

10. CHECK BOX IF THE AGGREGATE AMOUNT IN ROW (9) EXCLUDES CERTAIN SHARES

N/A

11. PERCENT OF CLASS REPRESENTED BY AMOUNT IN ROW 9

6.08%

12. TYPE OF REPORTING PERSON

IA

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

SCHEDULE 13G

Under the Securities Act of 1934

Check the following [line] if a fee is being paid with this statement N/A

Item 1(a) - Name of Issuer:

International Business Machines Corp

Item 1(b) - Address of Issuer's Principal Executive Offices:

1 New Orchard Road

Armonk, New York 10504

Item 2(a) - Name of Person Filing:

The Vanguard Group - 23-1945930

Item 2(b) – Address of Principal Business Office or, if none, residence:

100 Vanguard Blvd.

Malvern, PA 19355

Item 2(c) – Citizenship:

Pennsylvania

Item 2(d) - Title of Class of Securities:

Common Stock

Item 2(e) - CUSIP Number

459200101

Item 3 - Type of Filing:

This statement is being filed pursuant to Rule 13d-1. An investment adviser in accordance with §240.13d-1(b)(1)(ii)(E).

Item 4 - Ownership:

(a) Amount Beneficially Owned:

57,862,237

(b) Percent of Class:

6.08%

(c) Number of shares as to which such person has:

(i) sole power to vote or direct to vote: 1,375,277

(ii) shared power to vote or direct to vote: 175,870

(iii) sole power to dispose of or to direct the disposition of: 56,326,506

(iv) shared power to dispose or to direct the disposition of: 1,535,731

Comments:

Item 5 - Ownership of Five Percent or Less of a Class:

Not Applicable

Item 6 - Ownership of More Than Five Percent on Behalf of Another Person:

Not applicable

Item 7 - Identification and Classification of the Subsidiary Which Acquired The Security Being Reported on by the Parent Holding Company:

See Attached Appendix A

Item 8 - Identification and Classification of Members of Group:

Not applicable

Item 9 - Notice of Dissolution of Group:

Not applicable

Item 10 - Certification:

By signing below I certify that, to the best of my knowledge and belief, the securities referred to above were acquired in the ordinary course of business and were not acquired for the purpose of and do not have the effect of changing or influencing the control of the issuer of such securities and were not acquired in connection with or as a participant in any transaction having such purpose or effect.

Signature

After reasonable inquiry and to the best of my knowledge and belief, I certify that the information set forth in this statement is true, complete and correct.

Date: 02/09/2017

By /s/ F. William McNabb III*

F. William McNabb III

President and Chief Executive Officer

*By: /s/ Glenn Booraem

Glenn Booraem, pursuant to a Power of Attorney filed September 9, 2013, see File Number 005-56905, Incorporated by Reference

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Appendix A

Vanguard Fiduciary Trust Company ("VFTC"), a wholly-owned subsidiary of The Vanguard Group, Inc., is the beneficial owner of 1,115,201 shares or .11% of the Common Stock outstanding of the Company as a result of its serving as investment manager of collective trust accounts.

Vanguard Investments Australia, Ltd. ("VIA"), a wholly-owned subsidiary of The Vanguard Group, Inc., is the beneficial owner of 680,606 shares or .07% of the Common Stock outstanding of the Company as a result of its serving as investment manager of Australian investment offerings.

By /s/ F. William McNabb III*

F. William McNabb III

President and Chief Executive Officer

*By: /s/ Glenn Booraem

Glenn Booraem, pursuant to a Power of Attorney filed September 9, 2013, see File Number 005-56905, Incorporated by Reference

ign="bottom" BGCOLOR="#FFFFFF" style="padding-left:0pt;padding-Right:0.75pt;padding-Top:0.75pt;padding-Bottom:0pt;width:1%;">

States and

Loans and

Real Estate Loans

Commercial

Political

Lines of

Other

Residential

Construction

Commercial

Loans

Subdivisions

Credit

Auto Loans

Loans

Unallocated

Total

Individually
evaluated for
impairment

$

154

$

—

$

—

$

—

$

—

$

8

$

164

$

—

$

—

$

326

Collectively
evaluated for
impairment

3,591

43

3,496

1,704

295

290

1,530

26

920

11,895

ALL balance at December 31, 2018

$

3,745

$

43

$

3,496

$

1,704

$

295

$

298

$

1,694

$

26

$

920

$

12,221

Individually

evaluated for

impairment

$

149

$

—

$

—

$

—

$

—

$

—

$

164

$

—

$

—

$

313

Collectively
evaluated for
impairment

3,456

35

3,458

1,462

323

296

1,695

23

627

11,375

ALL balance at September 30, 2018

$

3,605

$

35

$

3,458

$

1,462

$

323

$

296

$

1,859

$

23

$

627

$

11,688

The allowance for loan losses is based on estimates, and actual losses will vary from current estimates. Management believes that the granularity of the homogeneous pools and the related historical loss ratios and other qualitative factors, as well as the consistency in the application of assumptions, result in an ALL that is representative of the risk

found in the components of the portfolio at any given date. Despite the above allocations, the allowance for loan losses is general in nature and is available to absorb losses from any loan segment.

The following is a summary of troubled debt restructuring granted during the three months ended December 31, 2018 and 2017 (dollars in thousands):

	For the Three Months Ended December 31, 2018		
	Number of Contracts	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment
Troubled Debt Restructurings			
Real estate loans:			
Residential	2	$ 95	$ 95
Construction	—	—	—
Commercial	—	—	—
Commercial	—	—	—
Obligations of states and political subdivisions	—	—	—
Home equity loans and lines of credit	2	159	159
Auto loans	1	21	21
Other	—	—	—
Total	5	$ 275	$ 275

	For the Three Months Ended December 31, 2017		
	Number of Contracts	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment
Troubled Debt Restructurings			
Real estate loans:			
Residential	2	$ 243	$ 240
Construction	—	—	—
Commercial	—	—	—
Commercial	—	—	—
Obligations of states and political subdivisions	—	—	—
Home equity loans and lines of credit	—	—	—
Auto loans	—	—	—
Other	—	—	—
Total	2	$ 243	$ 240

Of the five new troubled debt restructurings granted for the three months ended December 31, 2018, one loan totaling $14,000 was granted terms concessions, one loan totaling $81,000 was granted an interest rate concession, and three loans totaling $180,000 were granted term and rate concessions.

The two new troubled debt restructurings granted for the three months ended December 31, 2017, totaled $240,000 and were granted interest rate and principal concessions.

For the three months ended December 31, 2018, no loans defaulted on a restructuring agreement within one year of modification.

For the three months ended December 31, 2017, two loans totaling $95,000 defaulted on a restructuring agreement within one year of modification.

Foreclosed assets acquired in settlement of loans are carried at fair value, less estimated costs to sell, and are included in the Consolidated Balance Sheet. As of December 31, 2018, included within the foreclosed assets is $795,000 of consumer residential mortgages that were foreclosed on or received via a deed in lieu of foreclosure transaction prior to the period end. As of December 31, 2018, the Company has initiated formal foreclosure proceedings on $2.5 million of consumer residential mortgages which have not yet been transferred into foreclosed assets.

7. Deposits

Deposits consist of the following major classifications (in thousands):

	December 31, 2018	September 30, 2018
Non-interest bearing demand accounts	$162,129	$158,340
Interest bearing demand accounts	198,320	221,327
Money market accounts	317,828	296,078
Savings and club accounts	135,837	135,862
Certificates of deposit	493,803	525,248
Total	$1,307,917	$1,336,855

8. Net Periodic Benefit Cost-Defined Benefit Plan

For a detailed disclosure on the Bank's pension and employee benefits plans, please refer to Note 12 of the Company's Consolidated Financial Statements for the year ended September 30, 2018 included in the Company's Annual Report on Form 10-K.

The following table comprises the components of net periodic benefit cost for the three month period ended December 31, 2018 and 2017 (in thousands):

	For the Three Months Ended December 31,	
	2018	2017
Service Cost	$—	$—
Interest Cost	174	174
Expected return on plan assets	(293)	(298)
Amortization of unrecognized loss	—	—
Net periodic benefit cost	$(119)	$(124)

The Company's board of directors adopted resolutions to freeze the status of the Defined Benefit Plan ("the plan") effective February 28, 2017 ("the freeze date"). Accordingly, no additional participants will enter the plan after February 28, 2017; no additional years of service for benefit accrual purposes will be credited after the freeze date under the plan; and compensation earned by participants after the freeze date will not be taken into account under the plan.

9. Equity Incentive Plan

The Company previously maintained the ESSA Bancorp, Inc. 2007 Equity Incentive Plan (the "Plan"). The Plan provided for a total of 2,377,326 shares of common stock for issuance upon the grant or exercise of awards. Of the shares that were available under the Plan, 1,698,090 were available to be issued in connection with the exercise of stock options and 679,236 were available to be issued as restricted stock. The Plan allowed for the granting of non-qualified stock options ("NSOs"), incentive stock options ("ISOs"), and restricted stock. Options granted under the plan were granted at no less than the fair value of the Company's common stock on the date of the grant. As of the effective date of the 2016 Equity Incentive Plan (detailed below), no further grants will be made under the Plan and forfeitures of outstanding awards under the Plan will be added to the shares available under the 2016 Equity Incentive Plan.

The Company replaced the 2007 Equity Incentive Plan with the ESSA Bancorp, Inc. 2016 Equity Incentive Plan (the "2016 Plan") which was approved by shareholders on March 3, 2016. The 2016 Plan provides for a total of 250,000 shares of common stock for issuance upon the grant or exercise of awards. The 2016 Plan allows for the granting of restricted stock, restricted stock units, ISOs and NSOs.

The Company classifies share-based compensation for employees and outside directors within "Compensation and employee benefits" in the Consolidated Statement of Income to correspond with the same line item as compensation paid.

Restricted stock shares outstanding at December 31, 2018 vest over periods ranging from 18 to 45 months. The product of the number of shares granted and the grant date market price of the Company's common stock determines

the fair value of restricted shares under the Company's restricted stock plan. The Company expenses the fair value of all share based compensation grants over the requisite service period.

For the three months ended December 31, 2018 and 2017, the Company recorded $252,000 and $80,000 of share-based compensation expense, respectively, comprised of restricted stock expense. Expected future compensation expense relating to the restricted shares outstanding at December 31, 2018 is $840,000 over the remaining vesting period of 3.75 years.

The following is a summary of the status of the Company's restricted stock as of December 31, 2018, and changes therein during the three month period then ended:

	Number of Restricted Stock	Weighted-average Grant Date Fair Value
Nonvested at September 30, 2018	35,072	$ 15.37
Granted	37,236	16.23
Vested	(625)	15.00
Forfeited	(3,937)	15.87
Nonvested at December 31, 2018	67,746	$ 15.94

10. Fair Value

The following disclosures show the hierarchal disclosure framework associated within the level of pricing observations utilized in measuring assets and liabilities at fair value. The definition of fair value maintains the exchange price notion in earlier definitions of fair value but focuses on the exit price of the asset or liability. The exit price is the price that would be received to sell the asset or paid to transfer the liability adjusted for certain inherent risks and restrictions. Expanded disclosures are also required about the use of fair value to measure assets and liabilities.

Assets and Liabilities Required to be Measured and Reported at Fair Value on a Recurring Basis

The following tables provide the fair value for assets required to be measured and reported at fair value on a recurring basis on the Consolidated Balance Sheet as of December 31, 2018 and September 30, 2018 by level within the fair value hierarchy.

Recurring Fair Value Measurements at Reporting Date

	December 31, 2018			
	Level I	Level II	Level III	Total
Investment securities available for sale:				
Mortgage backed securities	$—	$267,993	$—	$267,993
Obligations of states and political subdivisions	—	32,924	—	32,924
U.S. government agencies	—	9,789	—	9,789
Corporate obligations	—	39,202	7,642	46,844
Other debt securities	—	18,504	—	18,504
Total Debt Securities	$—	$368,412	$7,642	$376,054
Equity securities- financial services	$18	$—	$—	$18
Derivatives and hedging activities:	—	1,511	—	1,511

	September 30, 2018			
	Level I	Level II	Level III	Total
Investment securities available for sale:				
Mortgage backed securities	$—	$258,123	$—	$258,123
Obligations of states and political subdivisions	—	40,949	—	40,949
U.S. government agencies	—	5,558	—	5,558
Corporate obligations	—	39,677	7,738	47,415
Other debt securities	—	19,373	—	19,373
Equity securities-financial services	20	—	—	20
Total Securities	$20	$363,680	$7,738	$371,438
Derivatives and hedging activities:	—	2,452	—	2,452

The following tables present a summary of changes in the fair value of the Company’s Level III investments for the three month periods ended December 31, 2018 and 2017 (in thousands).

	Fair Value Measurement Using Significant Unobservable Inputs (Level III)	
	Three Months Ended December 31, 2018	December 31, 2017
Beginning balance	$7,738	$ 7,224
Purchases, sales, issuances, settlements, net	—	500
Total unrealized gain (loss):		
Included in other comprehensive (loss) income	(96)	102
Transfers in and/or out of Level III	—	—
	$7,642	$ 7,826

25

Each financial asset and liability is identified as having been valued according to a specified level of input, 1, 2 or 3. Level 1 inputs are quoted prices (unadjusted) in active markets for identical assets or liabilities that the Company has the ability to access at the measurement date. Fair values determined by Level 2 inputs utilize inputs other than quoted prices included in Level 1 that are observable for the asset, either directly or indirectly. Level 2 inputs include quoted prices for similar assets in active markets, and inputs other than quoted prices that are observable for the asset or liability. Level 3 inputs are unobservable inputs for the asset, and include situations where there is little, if any, market activity for the asset or liability. In certain cases, the inputs used to measure fair value may fall into different levels of the fair value hierarchy. In such cases, the level in the fair value hierarchy, within which the fair value measurement in its entirety falls, has been determined based on the lowest level input that is significant to the fair value measurement in its entirety. The Company's assessment of the significance of a particular input to the fair value measurement in its entirety requires judgment, and considers factors specific to the asset.

The measurement of fair value should be consistent with one of the following valuation techniques: market approach, income approach, and/or cost approach. The market approach uses prices and other relevant information generated by market transactions involving identical or comparable assets or liabilities (including a business). For example, valuation techniques consistent with the market approach often use market multiples derived from a set of comparable. Multiples might lie in ranges with a different multiple for each comparable. The selection of where within the range the appropriate multiple falls requires judgment, considering factors specific to the measurement (qualitative and quantitative). Valuation techniques consistent with the market approach include matrix pricing. Matrix pricing is a mathematical technique used principally to value debt securities without relying exclusively on quoted prices for the specific securities, but rather by relying on a security's relationship to other benchmark quoted securities. Most of the securities classified as available for sale are reported at fair value utilizing Level 2 inputs. For these securities, the Company obtains fair value measurements from an independent pricing service. The fair value measurements consider observable data that may include dealer quoted market spreads, cash flows, the U.S. Treasury yield curve, live trading levels, trade execution data, market consensus prepayment speeds, credit information and the bond's terms and conditions, among other things. Securities reported at fair value utilizing Level 1 inputs are limited to actively traded equity securities whose market price is readily available from the New York Stock Exchange or the NASDAQ exchange. A few securities are valued using Level 3 inputs, all of these are classified as available for sale and are reported at fair value using Level 3 inputs.

Assets and Liabilities Required to be Measured and Reported on a Non-Recurring Basis

The following tables provide the fair value for assets required to be measured and reported at fair value on a non recurring basis on the Consolidated Balance Sheet as of December 31, 2018 and September 30, 2018 by level within the fair value hierarchy:

Non-Recurring Fair Value Measurements at Reporting Date (in thousands)				
	December 31, 2018			
	Level I	Level II	Level III	Total
Foreclosed real estate	$—	$ —	$876	$876
Impaired loans	—	—	7,570	7,570
	September 30, 2018			
				Total

	Level I	Level II	Level III	
Foreclosed real estate	$—	$ —	$1,141	$1,141
Impaired loans	—	—	11,557	11,557

The following tables present additional quantitative information about assets measured at fair value on a nonrecurring basis and for which the Company has utilized Level 3 inputs to determine fair value:

	Quantitative Information about Level 3 Fair Value Measurements			
(in thousands)	Fair Value Estimate	Valuation Techniques	Unobservable Input	Range
December 31, 2018				
Impaired loans	$7,570	Appraisal of collateral (1)	Appraisal adjustments (2)	0% to 35% (21.0%)
Foreclosed real estate owned	876	Appraisal of collateral (1), (3)	Appraisal adjustments (2)	20% to 46% (26.1%)

	Quantitative Information about Level 3 Fair Value Measurements			
(in thousands)	Fair Value Estimate	Valuation Techniques	Unobservable Input	Range
September 30, 2018				
Impaired loans	$ 11,557	Appraisal of collateral (1)	Appraisal adjustments (2)	0% to 35% (25.3%)
Foreclosed real estate owned	1,141	Appraisal of collateral (1), (3)	Appraisal adjustments (2)	20% to 46% (22.1%)

(1) Fair value is generally determined through independent appraisals of the underlying collateral, which generally include various level 3 inputs which are not identifiable.
(2) Appraisals may be adjusted by management for qualitative factors such as economic conditions and estimated liquidation expenses. The range of liquidation expenses and other appraisal adjustments are presented as a percent of the appraisal.

Foreclosed real estate is measured at fair value, less cost to sell at the date of foreclosure, valuations are periodically performed by management and the assets are carried at the lower of carrying amount or fair value, less cost to sell. Income and expenses from operations and changes in valuation allowance are included in the net expenses from foreclosed real estate. Impaired loans are reported at fair value utilizing level three inputs. For these loans, a review of the collateral is conducted and an appropriate allowance for loan losses is allocated to the loan. At December 31, 2018, 137 impaired loans with a carrying value of $7.9 million were reduced by specific valuation allowance totaling $326,000 resulting in a net fair value of $7.6 million based on Level 3 inputs. At September 30, 2018, 133 impaired loans with a carrying value of $11.9 million were reduced by a specific valuation totaling $313,000 resulting in a net fair value of $11.6 million based on Level 3 inputs.

Assets and Liabilities not Required to be Measured and Reported at Fair Value

The methods and assumptions used by the Company in estimating fair values of financial instruments at December 31, 2018 is in accordance with ASC Topic 825, Financial Instruments, as amended by ASU 2016-01 which requires public entities to use exit pricing in the calculations of the tables below. Prior period fair value calculations were run on the assumption of entry pricing and therefore the comparability between the periods below are diminished.

	December 31, 2018				
	Carrying Value	Level I	Level II	Level III	Total Fair Value

Financial assets:					
Cash and cash equivalents	$39,650	$39,650	$ —	$—	$39,650
Certificates of deposit	500	—	—	500	500
Loans receivable, net	1,334,304	—	—	1,297,473	1,297,473
Accrued interest receivable	6,261	6,261	—	—	6,261
Regulatory stock	15,121	15,121	—	—	15,121
Mortgage servicing rights	200	—	—	336	336
Bank owned life insurance	38,874	38,874	—	—	38,874
Financial liabilities:					
Deposits	$1,307,917	$814,114	$ —	$490,194	$1,304,308
Short-term borrowings	239,824	239,824	—	—	239,824
Other borrowings	112,373	—	—	111,904	111,904
Advances by borrowers for taxes and insurance	8,435	8,435	—	—	8,435
Accrued interest payable	1,488	1,488	—	—	1,488

	September 30, 2018				
	Carrying Value	Level I	Level II	Level III	Total Fair Value
Financial assets:					
Cash and cash equivalents	$43,539	$43,539	$ —	$—	$43,539
Certificates of deposit	500	—	—	505	505
Loans receivable, net	1,305,071	—	—	1,269,127	1,269,127
Accrued interest receivable	6,640	6,640	—	—	6,640
Regulatory stock	12,973	12,973	—	—	12,973
Mortgage servicing rights	206	—	—	340	340
Bank owned life insurance	38,630	38,630	—	—	38,630
Financial liabilities:					
Deposits	$1,336,855	$811,607	$ —	$520,861	$1,332,468
Short-term borrowings	179,773	179,773	—	—	179,773
Other borrowings	118,723	—	—	117,920	117,920
Advances by borrowers for taxes and insurance	6,826	6,826	—	—	6,826
Accrued interest payable	1,369	1,369	—	—	1,369

11. Accumulated Other Comprehensive Loss

The activity in accumulated other comprehensive loss for the three month periods ended December 31, 2018 and 2017 is as follows (in thousands):

	Accumulated Other Comprehensive Loss			
	Defined Benefit Pension Plan	Unrealized Gains (Losses) on Securities Available for Sale	Derivatives	Total
Balance at September 30, 2018	$(477)	$ (11,369)	$ 1,936	(9,910)
Other comprehensive income (loss) before reclassifications	—	3,991	(573)	3,418
Amounts reclassified from accumulated other comprehensive loss	—	(3)	(171)	(174)
Change in accounting principal for adoption of ASU 2016-01	—	4	—	4
Period change	—	3,992	(744)	3,248
Balance at December 31, 2018	$(477)	$ (7,377)	$ 1,192	$(6,662)
Balance at September 30, 2017	$(628)	$ (927)	$ 801	$(754)

Other comprehensive (loss) income before reclassifications	—	(1,288)	301	(987)
Amounts reclassified from accumulated other comprehensive loss, net of tax	—	—	(15)	(15)
Period change	—	(1,288)	286	(1,002)
Balance at December 31, 2017	$(628)	$ (2,215)	$ 1,087	$(1,756)

The following table presents significant amounts reclassified out of each component of accumulated other comprehensive loss for the three month periods ended December 31, 2018 and 2017 (in thousands):

Details About Accumulated Other Comprehensive Loss Components	Amount Reclassified from Accumulated Other Comprehensive Loss Accumulated Other Comprehensive Loss for the Three Months Ended December 31, 2018		Affected Line Item in the Consolidated Statement of Income
	2018	2017	
Securities available for sale			
Net securities gains reclassified into earnings	$4	$ —	Gain on sale of investments, net
Related income tax expense	(1)	—	Income taxes
Net effect on accumulated other comprehensive loss for the period	3	—	
Derivatives and hedging activities:			
Interest expense, effective portion	217	23	Interest expense
Related income tax expense	(46)	(8)	Income taxes
Net effect on accumulated other comprehensive loss for the period	171	15	
Total reclassification for the period	$174	$ 15	

12. Derivatives and Hedging Activities

Risk Management Objective of Using Derivatives

The Company is exposed to certain risks arising from both its business operations and economic conditions. The Company principally manages its exposures to a wide variety of business and operational risks through management of its core business activities. The Company manages economic risks, including interest rate, liquidity, and credit risk, primarily by managing the amount, sources, and duration of its assets and liabilities and through the use of derivative financial instruments. Specifically, the Company enters into derivative financial instruments to manage exposures that arise from business activities that result in the receipt or payment of future known and uncertain cash amounts, the value of which are determined by interest rates. The Company’s derivative financial instruments are used to manage differences in the amount, timing, and duration of the Company’s known or expected cash receipts and its known or expected cash payments principally related to certain variable rate borrowings.

Fair Values of Derivative Instruments on the Consolidated Balance Sheet

The table below presents the fair value of the Company's derivative financial instruments as well as their classification on the Consolidated Balance Sheet as of December 31, 2018 and September 30, 2017 (in thousands).

		Fair Values of Derivative Instruments Asset Derivatives					Fair Values of Derivative Instruments Liability Derivatives			
		As of December 31, 2018		As of September 30, 2018			As of December 31, 2018		As of Septenber 30, 2018	
	Notional Amount	Balance Sheet Location	Fair Value	Balance Sheet Location	Fair Value		Balance Sheet Location	Fair Value	Balance Sheet Location	Fair Value
Derivatives designated as hedging instruments						Derivatives designated as hedging instruments				
Interest Rate Products	$ 100,000	Other Assets	$ 1,832	Other Assets	$ 2,595	Interest Rate Products	Other Liabilities	$ 145	Other Liabilities	$ -
Total derivatives designated as hedging instruments			$ 1,832		$ 2,595	Total derivatives designated as hedging instruments		$ 145		$ -

Cash Flow Hedges of Interest Rate Risk

The Company's objectives in using interest rate derivatives are to add stability to interest income and expense and to manage its exposure to interest rate movements. To accomplish this objective, the Company has entered into interest rate swaps as part of its interest rate risk management strategy. These interest rate swaps are designated as cash flow hedges and involve the receipt of variable rate amounts from a counterparty in exchange for the Company making fixed payments. As of December 31, 2018, the Company had four interest rate swaps with a notional principal amount of $100.0 million associated with the Company's cash outflows associated with various FHLB advances.

For derivatives designated as cash flow hedges, the effective portion of changes in the fair value of the derivative is initially reported in other comprehensive income (outside of earnings), net of tax, and subsequently reclassified to earnings when the hedged transaction affects earnings, and the ineffective portion of changes in the fair value of the derivative is recognized directly in earnings. The Company assesses the effectiveness of each hedging relationship by comparing the changes in cash flows of the derivative hedging instrument with the changes in cash flows of the designated hedged transactions. The Company did not recognize any hedge ineffectiveness in earnings during the periods ended December 31, 2018 and September 30, 2018.

Amounts reported in accumulated other comprehensive loss related to derivatives that will be reclassified to interest income/expense as interest payments are made/received on the Company's variable-rate assets/liabilities. During the three months ended December 31, 2018 and 2017, the Company had $217,000 and $23,000 respectively, of gains reclassified to interest expense. During the next twelve months, the Company estimates that $967,000 will be reclassified as a decrease in interest expense.

The tables below presents the effect of the Company's cash flow hedge accounting on Accumulated Other Comprehensive Income for the three month period ended December 31, 2018 and 2017 (in thousands).

The Effect of Fair Value and Cash Flow Hedge Accounting on Accumulated Other Comprehensive Income

Derivatives in Hedging Relationships	Amount of (Loss) Gain Recognized in OCI on Derivative		Location of Gain Reclassified from Accumulated OCI	Amount of Gain Reclassified from Accumulated OCI into Income	
Derivatives in Cash Flow Hedging Relationships	2018	2017	into Income	2018	2017
Interest Rate Products	$(941)	$457	Interest expense	$ 217	$ 23
Total	$(941)	$457		$ 217	$ 23

The table below presents the effect of the Company's derivative financial instruments on Consolidated Statement of Operations for the three months ended December 31, 2018 and 2017.

	Location and Amount of Gain Recognized in Income on Fair Value and Cash Flow Hedging Relationships			
	Three months ended December 31, 2018		Three months ended December 31, 2017	
	Interest Income (Expense)	Other Income (Expense)	Interest Income (Expense)	Other Income (Expense)
Total amounts of income and expense line items presented in the statement of financial performance in which the effects of fair value or cash flow hedges are recorded	$217	$ -	$ 23	$ -
The effects of fair value and cash flow hedging:				
Gain in cash flow hedging relationships				
Interest contracts				
Amount of gain reclassified from accumulated other comprehensive income into income	$217	$ -	$ 23	$ -

30

The table below presents a gross presentation, the effects of offsetting, and a net presentation of the Company's derivatives for the periods ended December 31, 2018 and 2017. The net amounts of derivative assets or liabilities can be reconciled on the tabular disclosure of fair value. The tabular disclosure of fair value provides the location the derivative assets and liabilities are presented on the Consolidated Balance Sheet. There were no derivative liabilities for the periods ended December 31, 2018 and September 30, 2018.

Offsetting of Derivative Assets as of December 31, 2018

				Gross Amounts Not Offset in the Statement of Financial Position		
	Gross Amounts of Recognized Assets	Gross Amounts Offset in the Statement of Financial Position	Net Amounts of Assets presented in the Statement of Financial Position	Financial Instruments	Cash Collateral Received	Net Amount
Derivatives	$ 1,832	$ -	$ 1,832	$(145)	$ 1,687	$ -

Offsetting of Derivative Liabilities as of December 31, 2018

				Gross Amounts Not Offset in the Statement of Financial Position		
	Gross Amounts of Recognized Assets	Gross Amounts Offset in the Statement of Financial Position	Net Amounts of Liabilities presented in the Statement of	Financial Instruments	Cash Collateral Received	Net Amount

			Financial Position			
Derivatives	$ 145	$ -	$ 145	$(145)	$ -	$ -

Offsetting of Derivative Assets
as of September 30, 2018

				Gross Amounts Not Offset in the Statement of Financial Position		
	Gross Amounts of Recognized Assets	Gross Amounts Offset in the Statement of Financial Position	Net Amounts of Assets presented in the Statement of Financial Position	Financial Instruments	Cash Collateral Received	Net Amount
Derivatives	$ 2,595	$ -	$ 2,595	$-	$ 2,540	$ 55

Credit-risk-related Contingent Features

The Company has agreements with its derivative counterparties that contain a provision where if the Company defaults on any of its indebtedness, including default where repayment of the indebtedness has not been accelerated by the lender, then the Company could also be declared in default on its derivative obligations.

The Company also has agreements with certain of its derivative counterparties that contain a provision where if the Company fails to maintain its status as a well / adequately capitalized institution, then the counterparty could terminate the derivative positions and the Company would be required to settle its obligations under the agreements.

As of December 31, 2018 and September 30, 2018, the Company had no derivatives in a net liability position and was not required to post collateral against its obligations under these agreements. If the Company had breached any of these provisions at December 31, 2018, it could have been required to settle its obligations under the agreements at the termination value.

13. Contingent Liabilities
Legal Proceedings

The Company and its subsidiaries are subject to various legal actions arising in the normal course of business. In the opinion of Management, the resolution of these legal actions is not expected to have a material adverse effect on the Company's results of operations.

The Bank was named as a defendant in an action commenced on December 8, 2016 by one plaintiff who will also seek to pursue this action as a class action on behalf of the entire class of people similarly situated. The plaintiff alleges that a bank previously acquired by ESSA Bancorp in the process of making loans, received unearned fees and kickbacks in violation of the Real Estate Settlement Procedures Act. In an order dated January 29, 2018, the court granted the Bank's motion to dismiss the case. The plaintiff appealed the court's ruling. The plaintiff submitted her brief in support of her appeal in May 2018, and the Bank submitted its opposition brief in July 2018. The appellate court heard oral arguments in December 2018. To the extent that pending or threatened litigation could result in exposure to the Bank, the amount of such exposure is not currently estimable.

14. Revenue Recognition

Effective October 1, 2018, the Company adopted ASU 2014-09 Revenue from Contracts with Customers- Topic 606 and all subsequent ASC's that modified ASC 606. The Company has elected to apply the standard utilizing the modified retrospective approach with a cumulative effect of adoption for the impact from uncompleted contracts as of the date of adoption. The implementation of the new standard had no material impact on the measurement or recognition of revenue of prior periods.

Management determined that since the guidance does not apply to revenue associated with financial instruments, including loans and securities that are accounted for under other GAAP, the new guidance did not have a material impact on revenue most closely associated with financial instruments including interest income and expense along with non interest revenue resulting from non interest security gains, loan servicing, commitment fees and fees from financial guarantees. As a result, no changes were made during the period related to these sources of revenue which cumulatively comprise 90.3% of the total revenue of the Company.

The main types of non interest income within the scope of the standard are:

Trust and Investment Fees

Trust and asset management income is primarily comprised of fees earned from the management and administration of trusts and other customer assets. The Company's performance obligation is generally satisfied over time and the resulting fees are recognized monthly, based upon the month-end market value of the assets under management and the applicable fee rate. Payment is generally received a few days after month end through a direct charge to customer's accounts. The Company does not earn performance-based incentives. Optional services such as real estate sales and tax return preparation services are also available to existing trust and asset management customers. The Company's performance obligation for these transactional-based services is generally satisfied, and related revenue recognized, at a point in time (i.e. as incurred). Payment is received shortly after services are rendered.

Service Charges on Deposit Accounts

Service charges on deposit accounts consist of account analysis fees (i.e. net fees earned on analyzed business and public checking accounts), monthly service fees, check orders, and other deposit account related fees. The Company's performance obligation for account analysis fees and monthly service fees is generally satisfied, and the related revenue recognized, over the period in which the service is provided. Check orders and other deposit account related fees are largely transactional based, and therefore, the Company's performance obligation is satisfied, and related revenue recognized, at a point in time. Payment for service charges on deposit accounts is primarily received immediately or in the following month through a direct charge to customers' accounts.

Fees, Exchange, and Other Service Charges

Fees, interchange, and other service charges are primarily comprised of debit card income, ATM fees, cash management income, and other services charges. Debit card income is primarily comprised of interchange fees earned whenever the Company's debit cards are processed through card payment networks such as Mastercard. ATM fees are primarily generated when a Company cardholder uses a non-Company ATM or a non-Company cardholder uses a company ATM. Other service charges include revenue from processing wire transfers, bill pay service, cashier's checks, and other services. The Company's performance obligation for fees, exchange, and other service charges are largely satisfied, and related revenue recognized when the services are rendered or upon completion., Payment is typically received immediately or in the following month.

Insurance Commissions

Insurance income primarily consists of commissions received on product sales. The Company acts as an intermediary between the Company's customer and the insurance carrier. The Company's performance obligation is generally satisfied upon the issuance of the policy. Shortly after the policy is issued, the carrier remits the commission payment to the Company, and the Company recognizes the revenue.

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations
Forward Looking Statements

This Quarterly Report on Form 10-Q contains forward-looking statements, which can be identified by the use of such words as estimate, project, believe, intend, anticipate, plan, seek, expect and similar expressions. These forward-looking statements include:

- statements of our goals, intentions and expectations;
- statements regarding our business plans and prospects and growth and operating strategies;
- statements regarding the asset quality of our loan and investment portfolios; and
- estimates of our risks and future costs and benefits.

By identifying these forward-looking statements for you in this manner, we are alerting you to the possibility that our actual results and financial condition may differ, possibly materially, from the anticipated results and financial condition indicated in these forward-looking statements. Important factors that could cause our actual results and financial condition to differ from those indicated in the forward-looking statements include, among others, those discussed under "Risk Factors" in Part I, Item 1A of the Company's Annual Report on Form 10-K and Part II, Item 1A of this Quarterly Report on Form 10-Q, as well as the following factors:

- significantly increased competition among depository and other financial institutions;
- inflation and changes in the interest rate environment that reduce our margins or reduce the fair value of financial instruments;
- general economic conditions, either nationally or in our market areas, that are worse than expected;
- adverse changes in the securities markets;
- legislative or regulatory changes that adversely affect our business;
- our ability to enter new markets successfully and take advantage of growth opportunities, and the possible short-term dilutive effect of potential acquisitions or de novo branches, if any;
- changes in consumer spending, borrowing and savings habits;
- changes in accounting policies and practices, as may be adopted by the bank regulatory agencies and the FASB; and
- changes in our organization, compensation and benefit plans.

These risks and uncertainties should be considered in evaluating forward-looking statements and undue reliance should not be placed on such statements.

Comparison of Financial Condition at December 31, 2018 and September 30, 2018

Total Assets. Total assets increased by $29.1 million, or 1.6%, to $1.86 billion at December 31, 2018 from $1.83 billion at September 30, 2018 due primarily to growth in loans receivable.

Total Cash and Cash Equivalents. Total cash and cash equivalents decreased $3.9 million, or 8.9%, to $39.7 million at December 31, 2018 from $43.5 million at September 30, 2018. Decreases in interest bearing deposits with other institutions of $541,000, and cash and due from banks of $3.3 million, were the reasons for the net decrease.

Net Loans. Net loans increased $29.2 million, or 2.2%, to $1.33 billion at December 31, 2018 from $1.31 billion at September 30, 2018. During this period, residential loans increased $20.0 million to $600.6 million, construction loans increased $835,000 to $4.8 million, commercial real estate loans increased $17.9 million to $434.4 million, commercial loans increased $7.9 million to $57.4 million, obligations of states and political subdivisions increased $1.7 million to $75.0 million, home equity loans and lines of credit decreased $691,000 to $43.3 million, auto loans decreased $18.0 million to $128.2 million, and other loans increased $188,000 to $2.9 million.

Investment Securities Available for Sale. Investment securities available for sale increased $4.7 million, or 1.3%, to $376.1 million at December 31, 2018 from $371.4 million at September 30, 2018. The increase was due primarily to increases in mortgage backed securities of $7.8 million and U.S. government securities of $4.2 million, which were partially offset by decreases in obligations of states and political subdivisions of $8.0 million, corporate obligations of $571,000 and other debt securities of $869,000. The Company realized a net gain of $4,000 on the sale of investment securities totaling $9.9 million for the three months ended December 31, 2018.

Deposits. Deposits decreased $28.9 million, or 2.2%, to $1.31 billion at December 31, 2018 from $1.34 billion at September 30, 2018 due primarily to a decrease in municipal deposits. A decrease in interest bearing demand accounts of $23.0 million was offset in part by increases in non interest bearing demand accounts of $3.8 million and money market accounts of $21.8 million. The decrease in certificates of deposit, which decreased to $493.8 million at December 31, 2018, included a decrease in brokered certificates of deposit of $10.1 million to $158.6 million.

Borrowed Funds. Borrowed funds increased by $53.7 million, or 18.0%, to $352.2 million at December 31, 2018, from $298.5 million at September 30, 2018. The increase in borrowed funds was due to an increase in short term borrowings of $60.1 million offset in part by a decrease in other borrowings of $6.4 million. Short term borrowings increased due to asset growth and the decline in deposits. All borrowings at December 31, 2018 represent advances from the Federal Home Loan Bank of Pittsburgh (the “FHLB”).

Stockholders’ Equity. Stockholders’ equity increased by $5.0 million, or 3.1%, to $184.8 million at December 31, 2018 from $179.2 million at September 30, 2018. The increase in stockholders’ equity was primarily due to a decrease in accumulated other comprehensive loss of $3.2 million together with net income of $3.0 million.

Average Balance Sheets for the Three Months Ended December 31, 2018 and 2017

The following tables set forth average balance sheets, average yields and costs, and certain other information for the periods indicated. All average balances are daily average balances, the yields set forth below include the effect of deferred fees and discounts and premiums that are amortized or accreted to interest income.

	For the Three Months Ended December 31,					
	2018			2017		
	Average Balance (dollars in thousands)	Interest Income/ Expense	Yield/Cost	Average Balance	Interest Income/ Expense	Yield/Cost
Interest-earning assets:						
Loans[1]	$1,320,053	$ 13,907	4.18 %	$1,267,613	$ 12,783	4.00 %
Investment Securities						
Taxable[2]	68,190	676	3.93 %	80,745	656	3.22 %
Exempt from federal income tax[2][3]	25,377	136	2.69 %	50,017	288	3.02 %
Total investment securities	93,567	812	3.60 %	130,762	944	3.14 %
Mortgage-backed securities	278,425	1,806	2.57 %	258,354	1,403	2.15 %
Federal Home Loan Bank stock	13,464	222	6.54 %	14,258	175	4.87 %
Other	24,386	122	1.98 %	5,742	71	4.91 %
Total interest-earning assets	1,729,895	16,869	3.88 %	1,676,729	15,376	3.66 %
Allowance for loan losses	(11,864)			(9,505)		
Noninterest-earning assets	114,591			135,157		
Total assets	$1,832,622			$1,802,381		
Interest-bearing liabilities:						
NOW accounts	$209,035	$ 188	0.36 %	$205,532	$ 139	0.27 %
Money market accounts	315,439	821	1.03 %	249,639	332	0.53 %
Savings and club accounts	131,181	18	0.05 %	135,086	18	0.05 %
Certificates of deposit	512,533	2,361	1.83 %	526,263	1,888	1.42 %
Borrowed funds	307,102	1,596	2.06 %	328,465	1,231	1.49 %
Total interest-bearing liabilities	1,475,290	4,984	1.34 %	1,444,985	3,608	0.99 %
Non-interest-bearing NOW accounts	157,993			152,596		
Non-interest-bearing liabilities	18,171			20,612		
Total liabilities	1,651,454			1,618,193		
Equity	181,168			184,188		
Total liabilities and equity	$1,832,622			$1,802,381		
Net interest income		$ 11,885			$ 11,767	
Interest rate spread			2.54 %			2.67 %
Net interest-earning assets	$254,605			$231,744		
Net interest margin[4]			2.73 %			2.78 %
Average interest-earning assets to		117.26 %			116.04 %	

average interest-bearing
liabilities

(1) Non-accruing loans are included in the outstanding loan balances.
(2) Available for sale securities are reported at fair value.
(3) Yields on tax exempt securities have been calculated on a fully tax equivalent basis assuming a tax rate of 21.00% for the three months ended December 31, 2018 and 24.25% for the three months ended December 31, 2017.
(4) Represents the difference between interest earned and interest paid, divided by average total interest earning assets.

Comparison of Operating Results for the Three Months Ended December 31, 2018 and December 31, 2017

Net Income. Net income increased $4.6 million, or 283.7%, to $3.0 million for the three months ended December 31, 2018 compared to a net loss of $1.6 million for the comparable period in 2017. The increase was due to an increase in net interest income and non interest income combined with a decrease in noninterest expenses, loan loss provision and income taxes. The net loss for the three month period ended December 31, 2017 was primarily a result of a one time charge to income tax expense of $3.7 million related to the reduction in the carrying value of the Company’s deferred tax assets, which resulted from the reduction in the federal corporate income tax rate under the Tax Cuts and Jobs Act of 2017.

Net Interest Income. Net interest income increased $117,000, or 1.0%, to $11.9 million for the three months ended December 31, 2018 from $11.8 million for the comparable period in 2017. The increase was primarily attributable to a $22.9 million increase in the average balance of the Company’s net interest earning assets for the three months ended December 31, 2018 partially offset by a decrease of thirteen basis points in the Company’s interest rate spread to 2.54% for the three months ended December 31, 2018 from 2.67% for the comparable period in 2017.

Interest Income. Interest income increased $1.5 million, or 9.7%, to $16.9 million for the three months ended December 31, 2018 from $15.4 million for the comparable 2017 period. The increase resulted primarily from an increase in the average yield on interest earning assets of 22 basis points to 3.88% for the three months ended December 31, 2018 from 3.66% in the comparable 2017 period and an increase in the average balance of interest earning assets of $53.2 million. The average balance of loans increased $52.4 million between the two periods. In addition between the two periods, the average balance of investment securities decreased $37.2 million, mortgage-backed securities increased $20.1 million, FHLB stock decreased $794,000 and other interest earning assets increased $18.6 million.

Interest Expense. Interest expense increased $1.4 million, or 38.1%, to $5.0 million for the three months ended December 31, 2018 from $3.6 million for the comparable 2017 period. The increase resulted from an increase in the cost of interest bearing liabilities of 35 basis points and an increase in the average balance of interest bearing liabilities of $30.3 million between the two periods. The Federal Reserve increased the Fed Funds interest rate by a total of 100 basis points between December 31, 2017 and December 31, 2018. This increase was the primary reason for increases in the Company’s cost of borrowed funds to 2.06% for the three months ended December 31, 2018 from 1.49% for the comparable period in 2017 and cost of certificates of deposit to 1.83% from 1.42% for the same comparative periods. For the three months ended December 31, 2018 and 2017 the average cost of interest bearing liabilities was 1.34% and 0.99%, respectively.

Provision for Loan Losses. In evaluating the level of the allowance for loan losses, management considers historical loss experience, the types of loans and the amount of loans in the loan portfolio, adverse situations that may affect a borrower’s ability to repay, the estimated value of any underlying collateral, peer group information and prevailing economic conditions. This evaluation is inherently subjective as it requires estimates that are subject to interpretation and revision as more information becomes available or as future events occur. After an evaluation of these factors, management made a provision for loan losses of $876,000 for the three month period ended December 31, 2018 compared to $1.0 million for the three month period ended December 31, 2017. The allowance for loan losses was $12.2 million, or 0.91% of loans outstanding, at December 31, 2018, compared to $11.7 million, or 0.89% of loans outstanding, at September 30, 2018.

Non-interest Income. Non-interest income increased $157,000, or 8.0%, to $2.1 million for the three months ended December 31, 2018 from $2.0 million for the comparable period in 2017. Increases in other income of $195,000, gain on sale of investments, net of $4,000 and insurance commissions of $30,000 were partially offset by decreases in service fees on deposit accounts of $20,000, service charges and fees on loans of $39,000, trusted investment fees of

$1,000 and earnings on bank owned life insurance of $11,000. Other income increased primarily due to a recovery of $226,000 of previously expensed professional fees related to the settlement of a non-performing loan.

Non-interest Expense. Non-interest expense decreased $630,000, or 6.1%, to $9.7 million for the three months ended December 31, 2018 from $10.3 million for the comparable period in 2017. The primary reasons for the decrease were decreases in professional fees of $42,000, occupancy and equipment expenses of $159,000, data processing expenses of $26,000, amortization of intangible assets of $60,000, other expense of $375,000 and an increase in gain on foreclosed real estate of $79,000 which were offset in part by an increase of $116,000 in compensation and employee benefits.

Income Taxes. Income tax expense decreased $3.6 million to $474,000 for the three months ended December 31, 2018 from $4.1 million for the comparable 2017 period. The decrease was primarily a result of a one time charge to income tax expense of $3.7 million in the three months ended December 31, 2017 related to the reduction in the carrying value of the Company’s deferred tax assets, which resulted from the reduction in the federal corporate income tax rate under the Tax Cuts and Jobs Act of 2017. The effective tax rate for the three months ended December 31, 2018 was 13.6% compared to 166.7% for the 2017 period.

36

The following table provides information with respect to the Bank's non-performing assets at the dates indicated (dollars in thousands).

	December 31, 2018		September 30, 2018	
Non-performing assets:				
Non-accruing loans	$ 9,416		$ 8,964	
Non-accruing purchased credit impaired loans	1,273		1,547	
Total non-performing loans	10,689		10,511	
Foreclosed real estate	876		1,141	
Other repossessed assets	16		16	
Total non-performing assets	$ 11,581		$ 11,668	
Ratio of non-performing loans to total loans	0.79	%	0.80	%
Ratio of non-performing loans to total assets	0.57	%	0.57	%
Ratio of non-performing assets to total assets	0.62	%	0.64	%
Ratio of allowance for loan losses to total loans	0.91	%	0.85	%

Loans are reviewed on a regular basis and are placed on non-accrual status when they become more than 90 days delinquent. When loans are placed on non-accrual status, unpaid accrued interest is fully reserved, and further income is recognized only to the extent received. Non-performing assets decreased $88,000 from September 30, 2018 to December 31, 2018. The number of nonperforming residential loans was 59 at December 31, 2018 compared to 58 at September 30, 2018. The $10.7 million of non-accruing loans at December 31, 2018 included 59 residential loans with an aggregate outstanding balance of $5.7 million, 23 commercial and commercial real estate loans with aggregate outstanding balances of $3.9 million and 90 consumer loans with aggregate balances of $1.1 million. Within the residential loan balance are $3.0 million of loans less than 90 days past due. In the quarter ended December 31, 2018, the Company identified 28 residential loans which, although paying as agreed, have a high probability of default. Foreclosed real estate decreased $265,000 to $876,000 at December 31, 2018. Foreclosed real estate consists of 13 residential properties, one building lot and two commercial properties.

At December 31, 2018, the principal balance of troubled debt restructures ("TDRs") was $4.5 million compared to $4.4 million at September 30, 2018. Of the $4.5 million of troubled debt restructures at December 31, 2018, $192,000 are performing loans and $4.3 million are non-accrual loans.

As of December 31, 2018, TDRs were comprised of 30 residential loans totaling $3.3 million, six commercial and commercial real estate loans totaling $937,000 and eight consumer (home equity loans, home equity lines and credit, indirect auto and other) loans totaling $270,000.

For the three month period ended December 31, 2018, three loans were removed from non-performing TDR status.

Liquidity and Capital Resources

We maintain liquid assets at levels we consider adequate to meet both our short-term and long-term liquidity needs. We adjust our liquidity levels to fund deposit outflows, repay our borrowings and to fund loan commitments. We also adjust liquidity as appropriate to meet asset and liability management objectives.

Our primary sources of liquidity are deposits, prepayment and repayment of loans and mortgage-backed securities, maturities of investment securities and other short-term investments, and earnings and funds provided from operations, as well as access to FHLB advances and other borrowing sources. While scheduled principal repayments on loans and mortgage-backed securities are a relatively predictable source of funds, deposit flows and loan prepayments are greatly influenced by market interest rates, economic conditions, and rates offered by our competition. We set the interest rates on our deposits to maintain a desired level of total deposits.

A portion of our liquidity consists of cash and cash equivalents and borrowings, which are a product of our operating, investing and financing activities. At December 31, 2018, $39.7 million of our assets were invested in cash and cash equivalents. Our primary sources of cash are principal repayments on loans, proceeds from the maturities of investment securities, principal repayments of mortgage-backed securities and increases in deposit accounts. As of December 31, 2018, we had $352.2 million in borrowings outstanding from the Pittsburgh FHLB. We have access to total FHLB advances of up to approximately $650.2 million.

At December 31, 2018, we had $208.2 million in loan commitments outstanding, which included, in part, $57.0 million in undisbursed construction loans and land development loans, $37.3 million in unused home equity lines of credit, $106.1 million in commercial lines of credit and commitments to originate commercial loans, $4.8 million in performance standby letters of credit and $3.0 million in other unused commitments which are primarily to originate residential mortgage loans and multifamily loans. Certificates of deposit due within one year of December 31, 2018 totaled $338.7 million, or 68.6% of certificates of deposit. If these maturing deposits do not remain with us, we will be required to seek other sources of funds, including other certificates of deposit and borrowings. Depending on market conditions, we may be required to pay higher rates on such deposits or other borrowings than we currently pay on the certificates of deposit due on or before December 31, 2019. We believe, however, based on past experience that a significant portion of our certificates of deposit will remain with us. We have the ability to attract and retain deposits by adjusting the interest rates offered.

As reported in the Consolidated Statements of Cash Flow, our cash flows are classified for financial reporting purposes as operating, investing or financing cash flows. Net cash provided by operating activities was $3.2 million and $5.9 million for the three months ended December 31, 2018 and 2017, respectively. These amounts differ from our net income because of a variety of cash receipts and disbursements that did not affect net income for the respective periods. Net cash used for investing activities was $32.4 million and $47.4 million for the three months ended December 31, 2018 and 2017, respectively, principally reflecting our loan and investment security activities. Deposit and borrowing cash flows have comprised most of our financing activities, which resulted in net cash provided by $25.3 million and $38.6 million for the three months ended December 31, 2018 and 2017, respectively.

Critical Accounting Policies

We consider accounting policies that require management to exercise significant judgment or discretion or make significant assumptions that have, or could have, a material impact on the carrying value of certain assets or on income, to be critical accounting policies. We consider the following to be our critical accounting policies:

Allowance for Loan Losses. The allowance for loan losses is the estimated amount considered necessary to cover credit losses inherent in the loan portfolio at the balance sheet date. The allowance is established through the provision for loan losses which is charged against income. In determining the allowance for loan losses, management makes significant estimates and has identified this policy as one of our most critical. The methodology for determining the allowance for loan losses is considered a critical accounting policy by management due to the high degree of judgment involved, the subjectivity of the assumptions utilized and the potential for changes in the economic environment that could result in changes to the amount of the recorded allowance for loan losses.

As a substantial amount of our loan portfolio is collateralized by real estate, appraisals of the underlying value of property securing loans and discounted cash flow valuations of properties are critical in determining the amount of the allowance required for specific loans. Assumptions for appraisals and discounted cash flow valuations are instrumental in determining the value of properties. Overly optimistic assumptions or negative changes to assumptions could significantly impact the valuation of a property securing a loan and the related allowance determined. The assumptions supporting such appraisals and discounted cash flow valuations are carefully reviewed by management to determine that the resulting values reasonably reflect amounts realizable on the related loans.

Management performs a quarterly evaluation of the adequacy of the allowance for loan losses. Consideration is given to a variety of factors in establishing this estimate including, but not limited to, current economic conditions, delinquency statistics, geographic and industry concentrations, the adequacy of the underlying collateral, the financial strength of the borrower, results of internal and external loan reviews and other relevant factors. This evaluation is inherently subjective, as it requires material estimates that may be susceptible to significant revision based on changes in economic and real estate market conditions.

The analysis of the allowance for loan losses has two components: specific and general allocations. Specific allocations are made for loans that are determined to be impaired. Impairment is measured by determining the present value of expected future cash flows or, for collateral-dependent loans, the fair value of the collateral adjusted for market conditions and selling expenses. The general allocation is determined by segregating the remaining loans by type of loan, risk weighting (if applicable) and payment history. We also analyze historical loss experience, delinquency trends, general economic conditions and geographic and industry concentrations. This analysis establishes factors that are applied to the loan groups to determine the amount of the general allocations. Actual loan losses may be significantly more than the allowance for loan losses we have established which could have a material negative effect on our financial results.

Goodwill and Intangible Assets. Goodwill is not amortized, but it is tested at least annually for impairment in the fourth quarter, or more frequently if indicators of impairment are present. If the estimated current fair value of a reporting unit exceeds its carrying value, no additional testing is required and an impairment loss is not recorded. The Company uses market capitalization and multiples of tangible book value methods to determine the estimated current fair value of its reporting unit. Based on this analysis, no impairment was recorded in 2018 or 2017.

The other intangibles assets are assigned useful lives, which are amortized on an accelerated basis over their weighted-average lives. The Company periodically reviews the intangible assets for impairment as events or changes in circumstances indicate that the carrying amount of such asset may not be recoverable. Based on these reviews, no impairment was recorded in 2018 and 2017.

Derivative Instruments and Hedging Activities. The Company records all derivatives on the balance sheet at fair value. The accounting for changes in the fair value of derivatives depends on the intended use of the derivative, whether the Company has elected to designate a derivative in a hedging relationship and apply hedge accounting and whether the hedging relationship has satisfied the criteria necessary to apply hedge accounting. Derivatives designated and qualifying as a hedge of the exposure to changes in the fair value of an asset, liability, or firm commitment attributable to a particular risk, such as interest rate risk, are considered fair value hedges. Derivatives designated and qualifying as a hedge of the exposure to variability in expected future cash flows, or other types of forecasted transactions, are considered cash flow hedges. Derivatives may also be designated as hedges of the foreign currency exposure of a net investment in a foreign operation. Hedge accounting generally provides for the matching of the timing of gain or loss recognition on the hedging instrument with the recognition of the changes in the fair value of the hedged asset or liability that are attributable to the hedged risk in a fair value hedge or the earnings effect of the hedged forecasted transactions in a cash flow hedge. The Company may enter into derivative contracts that are intended to economically hedge certain of its risk, even though hedge accounting does not apply or the Company elects not to apply hedge accounting.

Fair Value Measurements. We group our assets at fair value in three levels, based on the markets in which the assets are traded and the reliability of the assumptions used to determine fair value. These levels are:

- Level I – Valuation is based upon quoted prices for identical instruments traded in active markets.
- Level II – Valuation is based upon quoted prices for similar instruments in active markets, quoted prices for identical or similar instruments in markets that are not active, and model-based valuation techniques for which all significant assumptions are observable in the market.
- Level III – Valuation is generated from model-based techniques that use significant assumptions not observable in the market. These unobservable assumptions reflect the Company’s own estimates of assumptions that market participants would use in pricing the asset.

We base our fair values on 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. It is our policy to maximize the use of observable inputs and minimize the use of unobservable inputs when developing fair value measurements, in accordance with the fair value hierarchy in generally accepted accounting principles.

Fair value measurements for most of our assets are obtained from independent pricing services that we have engaged for this purpose. When available, we, or our independent pricing service, use quoted market prices to measure fair value. If market prices are not available, fair value measurement is based upon models that incorporate available trade, bid, and other market information. Subsequently, all of our financial instruments use either of the foregoing methodologies to determine fair value adjustments recorded to our financial statements. In certain cases, however, when market observable inputs for model-based valuation techniques may not be readily available, we are required to make judgments about assumptions market participants would use in estimating the fair value of financial instruments. The degree of management judgment involved in determining the fair value of a financial instrument is dependent upon the availability of quoted market prices or observable market parameters. For financial instruments that trade actively and have quoted market prices or observable market parameters, there is minimal subjectivity involved in measuring fair value. When observable market prices and parameters are not fully available, management judgment is necessary to estimate fair value. In addition, changes in the market conditions may reduce the availability of quoted prices or observable data. When market data is not available, we use valuation techniques requiring more management judgment to estimate the appropriate fair value measurement. Therefore, the results cannot be determined with

precision and may not be realized in an actual sale or immediate settlement of the asset. Additionally, there may be inherent weaknesses in any calculation technique, and changes in the underlying assumptions used, including discount rates and estimates of future cash flows, that could significantly affect the results of current or future valuations.

Other-than-Temporary Investment Security Impairment. Securities are evaluated periodically to determine whether a decline in their value is other-than-temporary. Management utilizes criteria such as the magnitude and duration of the decline, in addition to the reasons underlying the decline, to determine whether the loss in value is other-than-temporary. The term “other-than-temporary” is not intended to indicate that the decline is permanent, but indicates that the prospect for a near-term recovery of value is not necessarily favorable, or that there is a lack of evidence to support a realizable value equal to or greater than the carrying value of the investment. Once a decline in value is determined to be other-than-temporary, the value of the security is reduced and a corresponding charge to earnings is recognized.

Deferred Income Taxes. We use the asset and liability method of accounting for income taxes. Under this method, deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. If current available information raises doubt as to the realization of the deferred tax assets, a valuation allowance is established. We consider the determination of this valuation allowance to be a critical accounting policy because of the need to exercise significant judgment in evaluating the amount and timing of recognition of deferred tax liabilities and assets, including projections of future taxable income. These judgments and estimates are reviewed on a continual basis as regulatory and business factors change. A valuation allowance for deferred tax assets may be required if the amount of taxes recoverable through loss carryback declines, or if we project lower levels of future taxable income. Such a valuation allowance would be established through a charge to income tax expense that would adversely affect our operating results.

Off-Balance Sheet Arrangements

We do not have any off-balance sheet arrangements (as such term is defined in applicable Securities and Exchange Commission rules) that are reasonably likely to have a current or future material effect on our financial condition, results of operations, liquidity, capital expenditures or capital resources.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

The majority of our assets and liabilities are monetary in nature. Consequently, our most significant form of market risk is interest rate risk. Our assets, consisting primarily of mortgage loans, have longer maturities than our liabilities, consisting primarily of deposits and borrowings. As a result, a principal part of our business strategy is to manage interest rate risk and reduce the exposure of our net interest income to changes in market interest rates. Accordingly, our Board of Directors has approved guidelines for managing the interest rate risk inherent in our assets and liabilities, given our business strategy, operating environment, capital, liquidity and performance objectives. Senior management monitors the level of interest rate risk on a regular basis and the asset/liability committee meets quarterly to review our asset/liability policies and interest rate risk position.

We have sought to manage our interest rate risk in order to minimize the exposure of our earnings and capital to changes in interest rates. The net proceeds from the Company’s stock offering increased our capital and provided management with greater flexibility to manage our interest rate risk. In particular, management used the majority of the capital we received to increase our interest-earning assets. There have been no material changes in our interest rate risk since September 30, 2018.

Item 4. Controls and Procedures

Under the supervision and with the participation of our management, including our Principal Executive Officer and Principal Financial Officer, we evaluated the effectiveness of the design and operation of our disclosure controls and procedures (as defined in Rule 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934) as of the end of the period covered by this Report. Based upon that evaluation, the Principal Executive Officer and Principal Financial Officer concluded that, as of the end of the period covered by this Report, our disclosure controls and procedures were effective.

There were no changes made in the Company’s internal controls over financial reporting (as defined by rule 13a-15(f) and 15d-15(f) under the Securities Exchange Act of 1934) or in other factors that have materially affected, or are reasonably likely to materially affect, the Company’s internal controls over financial reporting during the period covered by this Report.

Part II – Other Information

Item 1. Legal Proceedings

The Company and its subsidiaries are subject to various legal actions arising in the normal course of business. In the opinion of Management, the resolution of these legal actions is not expected to have a material adverse effect on the Company's results of operations.

The Bank was named as a defendant in an action commenced on December 8, 2016 by one plaintiff who will also seek to pursue this action as a class action on behalf of the entire class of people similarly situated. The plaintiff alleges that a bank previously acquired by ESSA Bancorp in the process of making loans, received unearned fees and kickbacks in violation of the Real Estate Settlement Procedures Act. In an order dated January 29, 2018, the court granted the Bank's motion to dismiss the case. The plaintiff appealed the court's ruling. The plaintiff submitted her brief in support of her appeal in May 2018, and the Bank submitted its opposition brief in July 2018. The appellate court heard oral arguments in December 2018. To the extent that pending or threatened litigation could result in exposure to the Bank, the amount of such exposure is not currently estimable.

Item 1A. Risk Factors

There have been no material changes in the "Risk Factors" as disclosed in the Company's response to Item 1A in Part 1 of its Annual Report on Form 10-K for the year ended September 30, 2018, filed on December 14, 2018.

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

Not applicable.

Item 3. Defaults Upon Senior Securities

Not applicable.

Item 4. Mine Safety Disclosures

Not applicable.

Item 5. Other Information

Not applicable.

Item 6. Exhibits

The following exhibits are either filed as part of this Report or are incorporated herein by reference:

3.1	Articles of Incorporation of ESSA Bancorp, Inc. (incorporated by reference to the Registration Statement on Form S-1 of ESSA Bancorp, Inc. (file no. 333-139157), originally filed with the Securities and Exchange Commission on December 7, 2006)
3.2	Bylaws of ESSA Bancorp, Inc. (incorporated by reference to the Registration Statement on Form S-1 of ESSA Bancorp, Inc. (file no. 333-139157), originally filed with the Securities and Exchange Commission on December 7, 2006)
4	Form of Common Stock Certificate of ESSA Bancorp, Inc. (incorporated by reference to the Registration Statement on Form S-1 of ESSA Bancorp, Inc. (file no. 333-139157), originally filed with the Securities and Exchange Commission on December 7, 2006)
31.1	Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
31.2	Certification of Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
32	Certification of Chief Executive Officer and Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
101	Interactive data files pursuant to Rule 405 of Regulation S-T: (i) the Consolidated Statements of Condition; (ii) the Consolidated Statement of Income; (iii) the Consolidated Statement of Changes in Stockholder Equity; the Consolidated Statement of Cash Flows; and (iv) the Notes to Consolidated Financial Statements.

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has duly caused this Report to be signed on its behalf by the undersigned, thereunto duly authorized.

	ESSA BANCORP, INC.
Date: February 11, 2019	/s/ Gary S. Olson Gary S. Olson President and Chief Executive Officer
Date: February 11, 2019	/s/ Allan A. Muto Allan A. Muto Executive Vice President and Chief Financial Officer

43