PRUDENTIAL BANCORP INC OF PENNSYLVANIA
Form 10-Q
May 17, 2010

## UNITED STATES <br> SECURITIES AND EXCHANGE COMMISSION

Washington, DC 20549
FORM 10-Q
(Mark One)
x QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended March 31, 2010
OR
o TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the transition period from to
Commission file number: 000-51214
Prudential Bancorp, Inc. of Pennsylvania
(Exact Name of Registrant as Specified in Its Charter)
Pennsylvania
(State or Other Jurisdiction of Incorporation or
Organization)
(I.R.S. Employer Identification

1834 Oregon Avenue
Philadelphia, Pennsylvania
19145
(Address of Principal Executive Offices)
(215) 755-1500
(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 x No o
Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T
( $\$ 232.405$ of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).
o Yes o No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or 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
Accelerated filer o
filer o
Non-accelerated filer o (Do not check if a smaller reporting company)
company x Smaller reporting

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

Indicate the number of shares outstanding of each of the issuer's classes of common stock as of the latest practical date: as of May $5,2010,10,031,472$ shares were issued and outstanding.

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## PRUDENTIAL BANCORP, INC. OF PENNSYLVANIA

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## PRUDENTIAL BANCORP, INC. OF PENNSYLVANIA AND SUBSIDIARIES

UNAUDITED CONSOLIDATED STATEMENTS OF FINANCIAL CONDITION

|  | September |
| :---: | :---: |
| March 31, | 30, |
| 2010 | 2009 |
| (Dollars in Thousands) |  |

## ASSETS

| Cash and amounts due from depository institutions | $\$ 5,036$ | $\$ 4,088$ |
| :--- | :---: | :---: |
| Interest-bearing deposits | 16,448 | 9,581 |
| Total cash and cash equivalents |  |  |
|  | 21,484 | 13,669 |
| Investment and mortgage-backed securities held to maturity (estimated fair value-- |  |  |
| March 31, 2010, \$141,967; September 30, 2009, $\$ 161,968$ ) | 140,450 | 160,126 |
| Investment and mortgage-backed securities available for sale (amortized cost- |  |  |
| March 31, 2010, $\$ 67,118 ;$ September 30, 2009, $\$ 63,000$ ) | 66,982 | 62,407 |
| Loans receivable-net of allowance for loan losses (March 31, 2010, $\$ 2,426 ;$ |  | 253,831 |
| September 30, 2009, $\$ 2,732$ ) |  | 256,694 |
| Accrued interest receivable: | 1,474 | 1,419 |
| Loans receivable | 368 | 390 |
| Mortgage-backed securities | 1,383 | 1,496 |
| Investment securities | 5,297 | 3,622 |
| Real estate owned | 3,545 | 3,545 |
| Federal Home Loan Bank stock-at cost | 1,981 | 1,992 |
| Office properties and equipment-net | 5,888 | 5,786 |
| Bank owned life insurance | 3,515 | 1,272 |
| Prepaid expenses and other assets | 2,041 | 2,343 |
| Deferred tax asset-net | $\$ 508,239$ | $\$ 514,761$ |

## LIABILITIES AND STOCKHOLDERS' EQUITY

| LIABILITIES: |  |  |
| :--- | :---: | :---: |
| Deposits: | $\$ 2,102$ | $\$ 2,848$ |
| Noninterest-bearing | 434,214 | 429,526 |
| Interest-bearing | 436,316 | 432,374 |
| $\quad$ Total deposits | 13,637 | 19,659 |
| Advances from Federal Home Loan Bank | 1,374 | 3,463 |
| Accrued interest payable | 1,186 | 1,214 |
| Advances from borrowers for taxes and insurance | 1,019 | 1,703 |
| Accounts payable and accrued expenses | 501 | 491 |
| Accrued dividend payable | 454,033 | 458,904 |

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## STOCKHOLDERS' EQUITY:

$\left.\begin{array}{lll}\text { Preferred stock, \$.01 par value, 10,000,000 shares authorized, none issued } & - & - \\ \text { Common stock, \$.01 par value, 40,000,000 shares authorized, issued 12,563,750; } & & \\ \text { outstanding - 10,031,472 at March 31, 2010; 10,331,866 at September 30, 2009 } & 126 & 126 \\ \begin{array}{l}\text { Additional paid-in capital } \\ \text { Unearned ESOP shares }\end{array} & 53,246 & 52,938 \\ \text { Treasury stock, at cost: 2,532,278 shares at March 31, 2010; 2,231,884 shares at } & (3,346 \quad) & (3,457\end{array}\right)$

See notes to unaudited consolidated financial statements.

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## PRUDENTIAL BANCORP, INC. OF PENNSYLVANIA AND SUBSIDIARIES

## UNAUDITED CONSOLIDATED STATEMENTS OF OPERATIONS

|  | Three Months Ended March 31, |  |  | Six Months Ended March 31, |  |  |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: |
|  | 2010 | 2009 |  | 2010 |  | 2009 |
|  | (Dollars in Thousands |  |  | (Dollars in Thousands |  |  |
|  | Except Per Share |  |  | Except |  |  |
|  | Amounts) |  |  | Per Share Amounts) |  |  |
| INTEREST INCOME: |  |  |  |  |  |  |
| Interest on loans | \$3,719 | \$3,863 |  | \$7,470 |  | \$7,590 |
| Interest on mortgage-backed securities | 1,188 | 1,562 |  | 2,411 |  | 3,318 |
| Interest and dividends on investments | 1,404 | 1,480 |  | 2,896 |  | 3,224 |
| Total interest income | 6,311 | 6,905 |  | 12,777 |  | 14,132 |
| INTEREST EXPENSE: |  |  |  |  |  |  |
| Interest on deposits | 2,086 | 3,202 |  | 4,357 |  | 6,361 |
| Interest on borrowings | 200 | 224 |  | 417 |  | 527 |
| Total interest expense | 2,286 | 3,426 |  | 4,774 |  | 6,888 |
| NET INTEREST INCOME | 4,025 | 3,479 |  | 8,003 |  | 7,244 |
| PROVISION FOR LOAN LOSSES | 250 | 50 |  | 385 |  | 363 |
| NET INTEREST INCOME AFTER |  |  |  |  |  |  |
| PROVISION FOR LOAN LOSSES | 3,775 | 3,429 |  | 7,618 |  | 6,881 |
| NON-INTEREST INCOME (LOSS): |  |  |  |  |  |  |
| Fees and other service charges | 118 | 131 |  | 243 |  | 256 |
| Total other-than-temporary impairment losses | $(43$ | ) $(3,156$ | ) | (375 | ) | (5,310 |
| Portion of loss recognized in other comprehensive |  |  |  |  |  |  |
| income, before taxes | (90 | ) 2,509 |  | 38 |  | 2,509 |
| Net impairment losses recognized in earnings | (133 | ) (647 | ) | (337 | ) | (2,801 |
| Other | 77 | 82 |  | 176 |  | 164 |
| Total non-interest income (loss) | 62 | (434 | ) | 82 |  | (2,381 |
| NON-INTEREST EXPENSE: |  |  |  |  |  |  |
| Salaries and employee benefits | 1,324 | 1,262 |  | 2,685 |  | 2,330 |
| Data processing | 122 | 136 |  | 260 |  | 301 |
| Professional services | 143 | 204 |  | 285 |  | 420 |
| Office occupancy | 110 | 109 |  | 203 |  | 204 |
| Depreciation | 89 | 81 |  | 177 |  | 166 |
| Payroll taxes | 95 | 78 |  | 162 |  | 141 |

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| Director compensation | 88 | 64 |  | 150 | 121 |  |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: |
| Deposit insurance | 155 | 88 |  | 337 | 296 |  |
| Real estate owned expense | 58 | 209 |  | 74 | 220 |  |
| Advertising | 114 | 110 |  | 212 | 207 |  |
| Other | 363 | 337 |  | 671 | 726 |  |
| Total non-interest expense | 2,661 | 2,678 |  | 5,216 | 5,132 |  |
| INCOME (LOSS) BEFORE INCOME TAXES | 1,176 | 317 |  | 2,484 | (632 | ) |
| INCOME TAXES: |  |  |  |  |  |  |
| Current expense | 214 | 350 |  | 808 | 853 |  |
| Deferred expense (benefit) | 119 | 15 |  | 147 | (444 | ) |
| Total income tax expense | 333 | 365 |  | 955 | 409 |  |
| NET INCOME (LOSS) | \$843 | \$(48 | ) | \$1,529 | \$(1,041 | ) |
| BASIC INCOME (LOSS) PER SHARE | \$0.09 | \$(0.004 | ) | \$0.16 | \$(0.10 | ) |
| DILUTED INCOME (LOSS) PER SHARE | \$0.09 | \$(0.004 | ) | \$0.15 | \$(0.10 | ) |

See notes to unaudited consolidated financial statements.

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PRUDENTIAL BANCORP, INC. OF PENNSYLVANIA AND SUBSIDIARIES
UNAUDITED CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY AND COMPREHENSIVE INCOME (LOSS)

| Common | AdditionalPaid-In | Unearned <br> ESOP | Treasury | Retained | Accumulated |  |  |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: |
|  |  |  |  |  | Other TotalComprehensSiteck |  | Comprehensive |
|  |  |  |  |  |  |  |  |
| Stock | Capital | Shares | Stock | Earnings | Income (Loss) | Equity | Income (Loss) |
| (Dollars | in Thousan | s except per | share amo |  |  |  |  |
| \$ 126 | \$ 52,938 | \$ $(3,457)$ | \$ (28,652 | \$ 35,293 | \$ (391 | \$ 55,8 |  |

Comprehensive income:

Net income
1,529
1,529
1,529
Net unrealized holding gain on available for sale securities arising during the period, net of $\begin{array}{llll}\text { income tax of } \$ 41 & 79 & 79 & 79\end{array}$

Reclassification adjustment for other than temporary impairment recognized in earnings net of tax of $\$ 115 \quad 222 \quad 222 \quad 222$
Comprehensive income \$ 1,830

Cash dividends declared (\$.10 per share) (976 ) (976 )

Treasury stock purchased
(300,394 shares) (2,924 )

[^0]compensation

benefit of $\$ 928$

| Reclassification adjustment for other than temporary impairment recognized in earnings net of tax of \$953 Comprehensive loss |  |  |  |  |  | 1,848 | 1,848 | $\begin{aligned} & 1,848 \\ \$ & (995 \end{aligned}$ |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: |
| Cash dividends declared (\$.10 per share) |  |  |  |  | (1,068) |  | (1,068) |  |
| Excess tax benefit and stock compensation |  | 35 |  |  |  |  | 35 |  |
| Stock option expense |  | 52 |  |  |  |  | 52 |  |
| Recognition and Retention Plan expense |  | 57 |  |  |  |  | 57 |  |
| Acquisition of restricted stock plan shares (226,148 shares) |  | (2,465 ) |  |  |  |  | (2,465 ) |  |
| ESOP shares committed to be released (11,310 shares) | - | 4 | 111 | - | - | - | 115 |  |
| BALANCE, March 31, 2009 | \$ 126 | \$ 52,608 | \$ $(3,569)$ | \$ $(19,481)$ | \$ 36,071 | \$ (1,403 ) | \$ 64,352 |  |

See notes to unuadited consolidated financial statements

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## PRUDENTIAL BANCORP, INC. OF PENNSYLVANIA AND SUBSIDIARIES

## UNAUDITED CONSOLIDATED STATEMENTS OF CASH FLOWS

| OPERATING ACTIVITIES: | Six Months Ended March 31, |  |  |
| :---: | :---: | :---: | :---: |
|  | 2010 |  | 2009 |
|  | (Dollars in Thousands) |  |  |
| Net income (loss) | \$1,529 |  | \$(1,041 |
| Adjustments to reconcile net income (loss) to net cash used in operating activities: |  |  |  |
| Provision for loan losses | 385 |  | 363 |
| Depreciation | 177 |  | 166 |
| Net accretion of premiums/discounts | (154 | ) | (922 |
| Net accretion of deferred loan fees and costs | (30 | ) | (76 |
| Impairment charge on investment and mortgage-backed securities | 337 |  | 2,801 |
| Share-based compensation expense | 312 |  | 144 |
| Real estate owned writedown | 18 |  | 186 |
| Amortization of ESOP | 107 |  | 115 |
| Income from bank owned life insurance | (102 | ) | (104 |
| Deferred income tax expense (benefit) | 147 |  | (444 |
| Excess tax benefit related to stock compensation | (31 | ) | (35 |
| Changes in assets and liabilities which used cash: |  |  |  |
| Accrued interest receivable | 80 |  | 245 |
| Prepaid expenses and other assets | (2,244 | ) | 71 |
| Accrued interest payable | (2,089 | ) | (962 |
| Accounts payable and accrued expenses | (685 | ) | (640 |
| Net cash used in operating activities | (2,243 | ) | (133 |
| INVESTING ACTIVITIES: |  |  |  |
| Purchase of investment and mortgage-backed securities held to maturity | (15,990 | ) | (49,994 |
| Purchase of investment and mortgage-backed securities available for sale | (9,909 | ) | (8,770 |
| Loans originated or acquired | (24,224 | ) | (35,654 |
| Principal collected on loans | 25,040 |  | 23,206 |
| Principal payments received on investment and mortgage-backed securities: |  |  |  |
| held-to-maturity | 35,688 |  | 58,589 |
| available-for-sale | 5,586 |  | 3,899 |
| Acquisition of FHLB stock, net | - |  | (925 |
| Purchases of equipment | (166 | ) | (8) |
| Net cash provided by (used in) investing activities | 16,025 |  | (9,657 |
| FINANCING ACTIVITIES: |  |  |  |
| Net increase in demand deposits, NOW accounts, and savings accounts | 4,946 |  | 505 |
| Net (decrease) increase in certificates of deposit | (1,004 | ) | 41,928 |
| Net repayment of advances from Federal Home Loan Bank | (6,022 | ) | (12,021 |
| (Decreases) increase in advances from borrowers for taxes and insurance | (28 | ) | 54 |
| Excess tax benefit related to stock compensation | 31 |  | 35 |
| Acquisition of stock for Recognition and Retention Plan | - |  | (2,465 |
| Purchase of treasury stock | (2,924 | ) | - |
| Cash dividend paid | (966 | ) | (1,063 |
| Net cash (used in) provided by financing activities | (5,967 | ) | 26,973 |


| NET INCREASE IN CASH AND CASH EQUIVALENTS | 7,815 | 17,183 |
| :---: | :---: | :---: |
| CASH AND CASH EQUIVALENTS—Beginning of period | 13,669 | 9,454 |
| CASH AND CASH EQUIVALENTS-End of period | \$21,484 | \$26,637 |
| SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION: |  |  |
| Interest paid on deposits and advances from Federal |  |  |
| Home Loan Bank | \$6,864 | \$7,850 |
| Income taxes paid | \$1,431 | \$2,782 |
| SUPPLEMENTAL DISCLOSURES OF NONCASH ITEMS: |  |  |
| Real estate acquired in settlement of loans | \$1,692 | \$- |

See notes to unaudited consolidated financial statements.

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## PRUDENTIAL BANCORP, INC. OF PENNSYLVANIA AND SUBSIDIARIES

## NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

1. 

## SIGNIFICANT ACCOUNTING POLICIES

Basis of presentation -The accompanying unaudited consolidated financial statements were prepared pursuant to the rules and regulations of the United States Securities and Exchange Commission ("SEC") for interim information and therefore do not include all the information or footnotes necessary for a complete presentation of financial condition, results of operations, changes in equity and cash flows in conformity with accounting principles generally accepted in the United States of America ("GAAP"). However, all normal recurring adjustments that, in the opinion of management, are necessary for a fair presentation of the financial statements have been included. The results for the three and six months ended March 31, 2010 are not necessarily indicative of the results that may be expected for the fiscal year ending September 30, 2010, or any other period. These financial statements should be read in conjunction with the audited consolidated financial statements of Prudential Bancorp, Inc. of Pennsylvania (the "Company") and the accompanying notes thereto for the year ended September 30, 2009 included in the Company's Annual Report on Form 10-K for the fiscal year ended September 30, 2009.

Use of Estimates in the Preparation of Financial Statements-The preparation of financial statements in conformity with GAAP in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of income and expenses during the reporting period. The most significant estimates and assumptions in the Company's consolidated financial statements are recorded in the allowance for loan losses, deferred income taxes, and the fair value measurement for investment securities available for sale. Actual results could differ from those estimates.

Dividend Payable - On March 17, 2010, the Company's Board of Directors declared a quarterly cash dividend of \$. 05 on the common stock of the Company payable on April 30, 2010 to the shareholders of record at the close of business on April 16, 2010 which resulted in a payable of $\$ 501,000$ at March 31, 2010. A portion of the cash dividend was payable to Prudential Mutual Holding Company (the "MHC") due to its ownership of shares of the Company's common stock and totaled $\$ 369,000$.

Employee Stock Ownership Plan - The Company maintains an employee stock ownership plan ("ESOP") for substantially all of its full-time employees. Using a loan from the Company, the ESOP purchased 452,295 shares of the Company's common stock for an aggregate cost of approximately $\$ 4.5$ million in fiscal 2005. Shares of the Company's common stock purchased by the ESOP are held in a suspense account until released for allocation to participants. Shares are allocated to each eligible participant based on the ratio of each such participant's compensation, as defined in the ESOP, to the total compensation of all eligible plan participants for a given plan year. As the unearned shares are released from the suspense account as the loan is repaid, the Company recognizes compensation expense equal to the fair value of the ESOP shares during the periods in which they become committed to be released. To the extent that the fair value of the ESOP shares released differs from the cost of such shares, the difference is charged or credited to equity as additional paid-in capital. As of March 31, 2010, the Company had allocated a total of 107,445 shares from the suspense account to participants and committed to release an additional 5,655 shares. In addition, at such date the total number of shares of Company common stock held by the ESOP was 450,200 . For the six months ended March 31, 2010, the Company recognized $\$ 100,000$ in compensation expense.

Share-Based Compensation - The Company accounts for stock-based compensation issued to employees, and where appropriate non-employees, in a fair value. Under fair value provisions, stock-based compensation cost is measured at the grant date based on the fair value of the award and is recognized as expense over the appropriate vesting period

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using the straight-line method. The amount of stock-based compensation recognized at any date must at least equal the portion of the grant date fair value of the award that is vested at that date and as a result it may be necessary to recognize the expense using a ratable method. Determining the fair value of stock-based awards at the date of grant requires judgment, including estimating the expected term of the stock options and the expected volatility of the Company's stock. In addition, judgment is required in estimating the amount of stock-based awards that are expected to be forfeited. If actual results differ significantly from these estimates or different key assumptions were used, it could have a material effect on the Company's Consolidated Financial Statements.

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Dividends with respect to non-vested share awards granted pursuant to the Company's Recognition and Retention Plan ("Plan") Trust (the "Trust") are held by the Trust for the benefit of the recipients and will be paid out proportionately by the Trust to the recipients of stock awards granted pursuant to the Plan as soon as practicable after the stock awards are earned.

Treasury Stock - Stock held in treasury by the Company is accounted for using the cost method, which treats stock held in treasury as a reduction to total stockholders' equity. During February 2010, the Company completed its seventh stock repurchase program. Additionally, the Company repurchased an additional 271,000 shares during March 2010 in a separate transaction. The average cost per share of the approximately 2.5 million shares which have been repurchased by the Company through March 31, 2010 was $\$ 12.47$. The repurchased shares are available for general corporate purposes. In addition, the MHC completed its third stock purchase plan during February 2010. As of March 31, 2010, the MHC had purchased 468,000 shares at an average cost of $\$ 11.03$ per share.

Comprehensive Income (Loss) -The Company presents in the unaudited consolidated statement of changes in stockholders' equity and comprehensive income those amounts arising from transactions and other events which currently are excluded from the statements of operations and are recorded directly to stockholders' equity. For the six months ended March 31, 2010 and 2009, the only components of comprehensive income were net income (loss), unrealized holding gains and losses, net of income tax expense and benefit, on available for sale securities and reclassifications related to realized loss due to other than temporary impairment, net of tax.

FHLB Stock - Federal Home Loan Bank ("FHLB") stock is classified as a restricted equity security because ownership is restricted and there is not an established market for its resale. FHLB stock is carried at cost and is evaluated for impairment when certain conditions warrant further consideration. While the FHLB has recognized losses in recent periods, it is currently not probable that the Company will not realize its cost basis since the FHLB has maintained capital levels in excess of regulatory requirements. Management concluded that no impairment existed as of March 31, 2010.

Recent Accounting Pronouncements - In December 2009, the Financial Accounting Standards Board ("FASB") issued ASU 2009-16, Accounting for Transfer of Financial Assets. ASU 2009-16 provides guidance to improve the relevance, representational faithfulness, and comparability of the information that an entity provides in its financial statements about a transfer of financial assets; the effects of a transfer on its financial position, financial performance, and cash flows; and a transferor's continuing involvement, if any, in transferred financial assets. ASU 2009-16 is effective for annual periods beginning after November 15, 2009 and for interim periods within those fiscal years. The adoption of this guidance is not expected to have a significant impact on the Company's financial statements.

In September 2009, the FASB issued new guidance impacting Topic 820 "Fair Value Measurement and Disclosures". This creates a practical expedient to measure the fair value of an alternative investment that does not have a readily determinable fair value. This guidance also requires certain additional disclosures. This guidance is effective for interim and annual periods ending after December 15, 2009. The adoption of this guidance did not have a material impact on the Company's financial position or results of operation.

In January 2010, the FASB issued ASU 2010-04, Accounting for Various Topics - Technical Corrections to SEC Paragraphs. ASU 2010-04 makes technical corrections to existing SEC guidance including the following topics: accounting for subsequent investments, termination of an interest rate swap, issuance of financial statements subsequent events, use of residential method to value acquired assets other than goodwill, adjustments in assets and liabilities for holding gains and losses, and selections of discount rate used for measuring defined benefit obligation. ASU 2010-04 is effective January 15, 2010. The adoption of this guidance did not have a material impact on the Company's financial position or results of operation.

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In January 2010, the FASB issued ASU 2010-06, Fair Value Measurements and Disclosures (Topic 820): Improving Disclosures about Fair Value Measurements, that describes amendments that require some new disclosures and clarifies some existing disclosure requirements about fair value measurement as set forth in ASC Topic 820-10. The FASB's objective is to improve these disclosures and, thus, increase the transparency in financial reporting. The amendments are effective for interim and annual reporting periods beginning after December 15, 2009, except for the disclosures about purchases, sales, issuances, and settlements in the roll forward of activity in Level 3 fair value measurements. Those disclosures are effective for fiscal years beginning after December 15, 2010, and for interim periods within those fiscal years. Early adoption is permitted. The adoption of this standard is not expected to have a material effect on the Company's results of operations or financial position.

In April 2010, the FASB issued ASU 2010-13, Compensation - Stock Compensation (Topic 718): Effect of Denominating the Exercise Price of a Share-Based Payment Award in the Currency of the Market in Which the Underlying Equity Security Trades. ASU 2010-13 provides guidance on the classification of a share-based payment award as either equity or a liability. A share-based payment that contains a condition that is not a market, performance, or service condition is required to be classified as a liability. ASU 2010-13 is effective for fiscal years and interim periods within those fiscal years, beginning on or after December 15, 2010 and is not expected to have a significant impact on the Company's financial statements.
2.

## EARNINGS PER SHARE

Basic earnings per common share is computed by dividing net income available to common shareholders by the weighted average number of shares of common stock outstanding, net of any treasury shares, during the period. Diluted earnings per share is calculated by dividing net income available to common shareholders by the weighted average number of shares of common stock outstanding, net of any treasury shares, after consideration of the potential dilutive effect of common stock equivalents ("CSEs"), based upon the treasury stock method using an average market price for the period.

The calculated basic and diluted earnings per share are as follows:
Quarter Ended March 31,

|  | 2010 |  |  |  | 2009 |  |  |  |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: |
|  | (Dollars in Thousands Except Per Share Data) |  |  |  |  |  |  |  |
| Net income (loss) | \$ | 843 | \$ | 843 | \$ | (48 | \$ | (48 ) |
| Weighted average shares outstanding |  | 9,685,542 |  | 9,685,542 |  | 10,772,473 |  | 10,772,473 |
| Effect of common stock equivalents |  | - |  | 128,338 |  | - |  | 49,987 |
| Adjusted weighted average shares used in earnings per share computation | \$ | 9,685,542 | \$ | 9,813,880 | \$ | 10,772,473 | \$ | 10,822,460 |
| Income (loss) per share - basic and diluted | \$ | 0.09 | \$ | 0.09 | \$ | (0.004 | \$ | (0.004 ) |

Six Months Ended March 31,

|  | 2010 |  |  |
| :---: | :---: | :---: | :---: |
| Basic | Diluted | Basic | Diluted |
|  | (Dollars in Thousands Except Per Share Data) |  |  |


| Net income (loss) | \$ | 1,529 | \$ | 1,529 | \$ | (1,041 | \$ | (1,041 |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: |
| Weighted average shares outstanding |  | 9,721,744 |  | 9,721,744 |  | 10,676,401 |  | 10,676,401 |
| Effect of common stock equivalents |  | - |  | 143,599 |  | - |  | 24,568 |
| Adjusted weighted average shares used in earnings per share |  |  |  |  |  |  |  |  |
| computation | \$ | 9,721,744 | \$ | 9,865,343 | \$ | 10,676,401 | \$ | 10,700,969 |
| Income (loss) per share - basic and diluted | \$ | 0.16 | \$ | 0.15 | \$ | (0.10 ) | \$ | (0.10 |

## 3. <br> INVESTMENT AND MORTGAGE-BACKED SECURITIES

The amortized cost and fair value of investment and mortgage-backed securities, with gross unrealized gains and losses, are as follows:

|  | March 31, 2010 |  |  |  |  |  |  |  |  |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: |
|  | Amortized Cost |  | Gross Unrealized Gains |  |  | Unrealized Losses |  | Fair <br> Value |  |
| U.S. Government agency obligations | \$ | 109,694 | \$ | 615 | \$ | (582 | ) | \$ | 109,727 |
| Municipal obligations |  | 914 |  | 1 |  | - |  |  | 915 |
| Mortgage-backed securities - U.S. |  |  |  |  |  |  |  |  |  |
| Government agencies |  | 29,842 |  | 1,483 |  | - |  |  | 31,325 |
| Total securities held to maturity | \$ | 140,450 | , | 2,099 | \$ | (582 | ) | \$ | 141,967 |
| Securities available for sale: |  |  |  |  |  |  |  |  |  |
| U.S. Government agency obligations | \$ | 4,999 | \$ | 19 | \$ | (13 | ) | \$ | 5,005 |
| Mortgage-backed securities - U.S. |  |  |  |  |  |  |  |  |  |
| Government agencies |  | 52,982 |  | 1,937 |  | (222 | ) |  | 54,697 |
| Mortgage-backed securities - Non-agency |  | 9,121 |  | 70 |  | (1,945 | ) |  | 7,246 |
| Total debt securities |  | 67,102 |  | 2,026 |  | (2,180 | ) |  | 66,948 |
| FHLMC preferred stock |  | 16 |  | 18 |  | - |  |  | 34 |
| Total securities available for sale | \$ | 67,118 | \$ | 2,044 | \$ | (2,180 | ) | \$ | 66,982 |


|  | Amortized Cost |  | September 30, 2009 |  |  |  |  | Fair <br> Value |  |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: |
|  |  |  | Gross <br> Unrealized <br> Gains <br> (Dollars |  | Unrealized Losses |  |  |  |  |
| Securities Held to Maturity: |  |  |  |  |  |  |  |  |  |
| U.S. Government agency obligations | \$ | 123,923 | \$ | 881 | \$ | (645 | ) | \$ | 124,159 |
| Municipal obligations |  | 1,970 |  | 6 |  | - |  |  | 1,976 |
| Mortgage-backed securities - U.S. |  |  |  |  |  |  |  |  |  |
| Government agencies |  | 34,233 |  | 1,600 |  | - |  |  | 35,833 |
| Total securities held to maturity | \$ | 160,126 | \$ | 2,487 | \$ | (645 | ) | \$ | 161,968 |
| Securities Available for Sale: |  |  |  |  |  |  |  |  |  |
| U.S. Government agency obligations | \$ | 2,000 | \$ | - | \$ | (18 | ) | \$ | 1,982 |
| Mortgage-backed securities - U.S. |  |  |  |  |  |  |  |  |  |
| Government agencies |  | 50,659 |  | 2,009 |  | (57 | ) |  | 52,611 |
| Mortgage-backed securities - Non-agency |  | 10,325 |  | 6 |  | (2,564 | ) |  | 7,767 |
| Total debt securities |  | 62,984 |  | 2,015 |  | (2,639 | ) |  | 62,360 |
| FHLMC preferred stock |  | 16 |  | 31 |  | - |  |  | 47 |
| Total securities available for sale | \$ | 63,000 | \$ | 2,046 | \$ | (2,639 | ) | \$ | 62,407 |

The following table shows the gross unrealized losses and related fair values of the Company's investment securities, aggregated by investment category and length of time that individual securities had been in a continuous loss position at March 31, 2010:


Mortgage-backed securities -

| Non-agency | $(603$ | ) | 772 | $(1,342)$ | 4,399 | $(1,945$ | $)$ | 5,171 |
| :--- | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: |
| Total securities <br> available for sale | $(817$ | $)$ | 11,595 | $(1,363)$ | 7,243 | $(2,180$ | $)$ | 18,838 |
| Total | $\$(1,293)$ | $\$$ | 54,068 | $\$(1,363)$ | $\$ 7,243$ | $\$$ | $(2,762)$ | $\$$ |

All equity securities, municipal bonds and mortgage-backed securities held to maturity were in an unrealized gain position as of March 31, 2010.

The following table shows the gross unrealized losses and related fair values of the Company's investment securities, aggregated by investment category and length of time that individual securities had been in a continuous loss position at September 30, 2009:

| Less than 12 months |  |
| :---: | :---: |
| Gross |  |
| Unrealized | Fair |
| Losses | Value |


| More than 12 months | Total |  |  |
| :--- | :---: | :---: | :---: |
| Gross | Gross |  |  |
| Unrealized | Fair | Unrealized | Fair |
| Losses | Value | Losses | Value |



All equity securities, municipal bonds and mortgage-backed securities held to maturity were in an unrealized gain position as of September 30, 2009.

Management has reviewed its investment securities and determined that for the six months ended March 31, 2010 unrealized losses of $\$ 375,000$ on a pre-tax basis for certain securities in the non-agency mortgage-backed portfolio classified as available for sale were deemed other than temporary.

Management evaluates securities for other-than-temporary impairment ("OTTI") at least on a quarterly basis, and more frequently when economic or market concerns warrant such evaluation. The Company determines whether the unrealized losses are temporary. The evaluation is based upon factors such as the creditworthiness of the issuers/guarantors, the underlying collateral, if applicable, and the continuing performance of the securities.
Management also evaluates other facts and circumstances that may be indicative of an OTTI condition. This includes, but is not limited to, an evaluation of the type of security, length of time and extent to which the fair value has been
less than cost, and near-term prospects of the issuer.
The Company assesses whether the credit loss existed by considering whether (1) the Company has the intent to sell the security, (2) it is more likely than not that it will be required to sell the security before recovery, or (3) it does not expect to recover the entire amortized cost basis of the security. The Company bifurcates the OTTI impact on impaired securities where impairment in value was deemed to be other than temporary between the component representing credit loss and the component representing loss related to other factors. The portion of the fair value decline attributable to credit loss must be recognized through a charge to earnings. The credit component is determined by comparing the present value of the cash flows expected to be collected, discounted at the rate in effect before recognizing any OTTI with the amortized cost basis of the debt security. The Company uses the cash flow expected to be realized from the security, which includes assumptions about interest rates, timing and severity of defaults, estimates of potential recoveries, the cash flow distribution from the bond indenture and other factors, then applies a discount rate equal to the effective yield of the security. The difference between the present value of the expected cash flows and the amortized book value is considered a credit loss. The fair market value of the security is determined using the same expected cash flows; the discount rate is a rate the Company determines from the open market and other sources as appropriate for the security. The difference between the fair market value and the security's remaining amortized cost is recognized in other comprehensive income.

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The following is a rollforward for the six months ended March 31, 2010 of the amounts recognized in earnings related to credit losses on securities which the Company has recorded OTTI charges through earnings and other comprehensive income.

Credit component of OTTI as of October 1, 2009
Additions for credit-related OTTI charges on previously unimpaired securities

Reduction for securities liquidated
Additional increases as a result of impairment charges recognized on investments for which an OTTI charge was previously recognized

Credit component of OTTI as of March 31, 2010
(Dollars in thousands)
\$ 2,859

7
(106
) 330
\$ 3,090

United States Treasury and Government Sponsored Enterprise and Agency Notes - The Company's investments in the preceding table in United States Government sponsored enterprise notes consist of debt obligations of the Federal Home Loan Bank ("FHLB"), Federal Home Loan Mortgage Corporation ("FHLMC"), Federal National Mortgage Association ("FNMA"), and Federal Farm Credit System ("FFCS"). FHLB debt securities are rated by both Moody's and Standard \& Poor's. All long-term debt issued by the FHLB banks is rated Aaa by Moody's and AAA by Standard and Poor's. All short-term debt is rated "Prime-1" by Moody's and A-1+ by Standard \& Poor's. FNMA and FHLMC senior debt securities are also currently rated "Aaa" by Moody's, short-term debt is rated "Prime-1", subordinated debt is rated "Aa2" and preferred stock ratings are currently "Aa3" with "Stable" outlooks. Farm Credit Designated Bonds are high credit quality, liquid and callable securities. The securities are Aaa rated by Moody's, AAA by Standard \& Poor's, and AAA by Fitch. At March 31, 2010, securities in a gross unrealized loss for less than twelve months consist of 26 securities having an aggregate depreciation of $1.1 \%$ from the Company's amortized cost basis. Securities in a gross unrealized loss for more than twelve months consisted of seven securities having an aggregate depreciation of $0.8 \%$ from the Company's amortized cost basis. The unrealized losses on these debt securities relates principally to the changes in market interest rates and a lack of liquidity currently in the financial markets and are not as a result of projected shortfall of cash flows. In addition, the Company does not intend to sell these securities and it is more likely than not that the Company will not be required to sell the securities. As such, the Company anticipates it will recover the entire amortized cost basis of the securities. As a result, the Company does not consider these investments to be other-than-temporarily impaired at March 31, 2010.

State and Municipal Obligations - The municipal bonds consist of obligations of entities located in Pennsylvania. None of the municipal bonds were in an unrealized loss position as of March 31, 2010.

US Agency Issued Mortgage-Backed Securities - At March 31, 2010, the gross unrealized loss in U.S. agency issued mortgage-backed securities in the category of less than 12 months was $\$ 214,000$ or $1.9 \%$ from the Company's amortized cost basis and consisted of nine securities. The gross unrealized loss in the category of more than 12 months was $\$ 8,000$ or $0.9 \%$ of the Company's amortized cost basis and consisted of one security. These securities represent asset-backed issues that are issued or guaranteed by a U.S. Government sponsored agency or carry the full faith and credit of the United States through a government agency and are currently rated AAA by at least one bond credit rating agency. In September 2008, the U.S. Department of the Treasury announced the establishment of the Government-Sponsored Enterprise Credit Facility to ensure credit availability to FNMA and FHLMC. The Treasury also entered into senior preferred stock purchase agreements, which ensure that each entity maintains a positive net

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worth and effectively support the holders of debt and mortgage-backed securities ("MBS") issued or guaranteed by FNMA and FHLMC. The Agreements enhance market stability by providing additional security to debt holders, senior and subordinated, thereby alleviating the concern of the credit driven impairment of the securities. The unrealized loss on these debt securities relates principally to the changes in market interest rates and a lack of liquidity currently in the financial markets and are not as a result of projected shortfall in cash flows. In addition, the Company does not intend to sell the securities and it is more likely than not that the Company will not be required to sell the securities. As such, the Company expects to recover the entire amortized cost basis of the securities. As a result, the Company does not consider these investments to be other-than-temporarily impaired at March 31, 2010.

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Non-Agency Issued Mortgage-Backed Securities and Collateralized Mortgage Obligations - This portfolio was acquired through the redemption-in-kind of a mutual fund during 2008 and includes 72 collateralized mortgage obligations ("CMO") and MBS securities issued by large commercial financial institutions. For the six months ended March 31, 2010 management recognized an other than temporary impairment charge related to a portion of the portfolio securities in the amount of $\$ 375,000$ on a pre-tax basis due to the fact that, in management's judgment, the credit quality of the collateral pool underlying such securities had deteriorated during recent periods to the point that full recovery of the entire amortized cost of the investment was considered to be uncertain. This portfolio consists primarily of securities with underlying collateral consisting primarily of Alt-A loans, home equity lines of credit and other receivables as well as whole loans. With respect to the securities collateralized by whole loans, such collateral is in many cases located in markets that have been subject to significant declines in market values. For the overall portfolio of the securities, the Company's exposure to the declining real estate markets such as California, Nevada, Arizona and Florida is approximately $48.7 \%$. Consequently, an additional OTTI charge was deemed to be warranted as of March 31, 2010. Of the recorded charge, a total of $\$ 337,000$ was concluded to be credit related and recognized currently in earnings and $\$ 38,000$ was concluded to be attributable to other factors and recognized in other accumulated comprehensive income.

As of March 31, 2010, with the exception of securities discussed above, there are no securities for which the Company currently believes it is not probable that it will collect all amounts due according to the contractual terms of the investment. Management concluded that an other-than-temporary impairment did not exist and the decline in value was attributed to the illiquidity in the financial markets. In addition, the Company does not intend to sell these securities and it is more likely than not that the Company will not be required to sell these securities.

The amortized cost and fair value of debt 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 call or prepayment penalties.

March 31, 2010
Held to Maturity
Available for Sale

|  | Amortized Cost |  | Fair $\quad$ AmortizedValue $\quad$ Cost(Dollars in thousands) |  |  |  | Fair <br> Value |  |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: |
| Due within one year | \$ | 1,000 | \$ | 1,010 | \$ | - | \$ | - |
| Due after one through five years |  | 440 |  | 440 |  | - |  | - |
| Due after five through ten years |  | 35,734 |  | 35,881 |  | 2,999 |  | 3,018 |
| Due after ten years |  | 73,434 |  | 73,311 |  | 2,000 |  | 1,987 |
| Total | \$ | 110,608 | \$ | 110,642 | \$ | 4,999 | \$ | 5,005 |

The maturity table above excludes mortgage-backed securities because the contractual maturities are not indicative of actual maturities due to significant prepayments.

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Loans receivable consist of the following:

|  | $\begin{gathered} \text { March 31, } \\ 2010 \end{gathered}$ |  | September |  |
| :---: | :---: | :---: | :---: | :---: |
|  |  |  |  | 30, |
|  |  |  |  | 2009 |
|  | (Dollars in Thousands) |  |  |  |
| One-to-four family residential | \$ | 197,088 | \$ | 201,396 |
| Multi-family residential |  | 4,117 |  | 4,178 |
| Commercial real estate |  | 20,183 |  | 19,907 |
| Construction and land development |  | 37,878 |  | 36,764 |
| Commercial business |  | 2,383 |  | 2,232 |
| Consumer |  | 518 |  | 586 |
| Total loans |  | 262,167 |  | 265,063 |
| Undisbursed portion of loans-in-process |  | (6,518 |  | (6,281 |
| Deferred loan costs, net |  | 608 |  | 644 |
| Allowance for loan losses |  | (2,426 |  | (2,732 |
| Net | \$ | 253,831 | \$ | 256,694 |

The following schedule summarizes the changes in the allowance for loan losses:

> Six Months Ended March
> 31,
> 20102009
> (Dollars in Thousands)

| Balance, beginning of period | $\$ 2,732$ | $\$$ | 1,591 |  |
| :--- | :--- | :--- | :--- | :--- |
| Provision for loan losses |  | 385 |  | 363 |
| Charge-offs | $(691$ |  | $(217$ | $)$ |
| Recoveries | - |  | - |  |
|  |  |  |  |  |
| Balance, end of period | $\$ 2,426$ | $\$ 1,737$ |  |  |

The Company established a provision for loan losses of $\$ 250,000$ for the quarter ended March 31, 2010 and $\$ 385,000$ for the six month period ended March 31, 2010 as compared to $\$ 50,000$ and $\$ 363,000$ for the comparable periods in 2009. The increased level of provisions in the 2010 periods reflected the higher level of non-performing assets resulting from the continued weakness in the economy experienced during these periods. At March 31, 2010, the Company's non-performing assets totaled $\$ 7.8$ million or $1.5 \%$ of total assets as compared to $\$ 5.6$ million or $1.1 \%$ of total assets at September 30, 2009. At March 31, 2010, non-performing assets consisted of five commercial real estate loans totaling $\$ 927,000$, 13 one-to four-family residential mortgage loans totaling $\$ 1.6$ million and seven real estate owned properties totaling $\$ 5.3$ million. The allowance for loan losses totaled $\$ 2.4$ million, or $0.9 \%$ of total loans and $96.1 \%$ of non-performing loans at March 31, 2010. The allowance for loan losses totaled $\$ 2.7$ million, or $1.0 \%$ of total loans, and $137.8 \%$ of non-performing loans at September 30, 2009.

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An impaired loan generally is one for which it is probable, based on current information, that the lender will not collect all the amounts due under the contractual terms of the loan. Large groups of smaller balance, homogeneous loans are collectively evaluated for impairment. Loans collectively evaluated for impairment include smaller balance commercial real estate loans, residential real estate loans and consumer loans. These loans are evaluated as a group because they have similar characteristics and performance experience. Larger commercial real estate, construction and commercial business loans are individually evaluated for impairment.

As of March 31, 2010 and September 30, 2009, the recorded investment in loans that are considered to be impaired was as follows:

|  | $\begin{gathered} \text { March 31, } \\ 2010 \end{gathered}$ |  | September |  |
| :---: | :---: | :---: | :---: | :---: |
|  |  |  |  | 30, |
|  |  |  |  | 2009 |
|  | (Dollars in thousands) |  |  |  |
| Impaired loans with related allowance | \$ | 1,014 | \$ | 1,661 |
| Impaired loans without related allowance | \$ |  | \$ | - |
| Related allowance for loan losses | \$ | 172 | \$ | 873 |

Other data for impaired loans as of March 31, 2010 and 2009 is as follow:
For the Six Months Ended March 31, 20102009
(Dollars in thousands)
Average impaired loans

| $\$$ | 1,340 | $\$$ | 4,698 |
| :--- | :--- | :--- | :--- |
| $\$$ | 15 | $\$$ | 54 |

5. 

DEPOSITS

Deposits consist of the following major classifications:

March 31,
2010

September 30, 2009

|  | Amount |  | Percent Amount(Dollars in Thousands) |  |  |  | Percent |  |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: |
| Money market deposit accounts | \$ | 76,056 | 17.4 | \% | \$ | 75,349 | 17.4 | \% |
| NOW accounts |  | 30,761 | 7.1 |  |  | 29,869 | 6.9 |  |
| Passbook, club and statement savings |  | 70,316 | 16.1 |  |  | 66,968 | 15.5 |  |
| Certificates maturing in six months or |  |  |  |  |  |  |  |  |
| less |  | 77,215 | 17.7 |  |  | 120,636 | 27.9 |  |
| Certificates maturing in more than six months |  | 181,968 | 41.7 |  |  | 139,552 | 32.3 |  |
| Total | \$ | 436,316 | 100.0 | \% | \$ | 432,374 | 100.0 | \% |

Certificates of \$100,000 and over totaled $\$ 94.0$ million as of March 31, 2010 and $\$ 91.9$ million as of September 30, 2009.

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## 6. INCOME TAXES

Items that gave rise to significant portions of deferred income taxes are as follows:

|  |  | $\begin{aligned} & \text { arch 31, } \\ & 2010 \end{aligned}$ |  | $\begin{aligned} & \text { ember 30, } \\ & 2009 \end{aligned}$ |
| :---: | :---: | :---: | :---: | :---: |
| Deferred tax assets: | (Dollars in thousands) |  |  |  |
| Unrealized loss on available for sale securities | \$ | 46 | \$ | 201 |
| Deposit premium |  | 143 |  | 167 |
| Allowance for loan losses |  | 871 |  | 974 |
| Real estate owned expenses |  | 494 |  | 469 |
| Nonaccrual interest |  | - |  | 15 |
| Accrued vacation |  | 51 |  | 44 |
| Capital loss carryforward |  | 1,873 |  | 1,873 |
| Impairment loss |  | 1,477 |  | 1,363 |
| Split dollar life insurance |  | 81 |  | 84 |
| Post-retirement benefits |  | 151 |  | 154 |
| Employee benefit plans |  | 206 |  | 246 |
| Total deferred tax assets |  | 5,393 |  | 5,590 |
| Valuation allowance |  | (2,661 ) |  | (2,551 |
| Total deferred tax assets, net of valuation allowance |  | 2,732 |  | 3,039 |
| Deferred tax liabilities: |  |  |  |  |
| Property |  | 483 |  | 480 |
| Mortgage servicing rights |  | 2 |  | 4 |
| Deferred loan fees |  | 206 |  | 212 |
| Total deferred tax liabilities |  | 691 |  | 696 |
| Net deferred tax asset | \$ | 2,041 | \$ | 2,343 |

The Company establishes a valuation allowance for deferred tax assets when management believes that the deferred tax assets are not likely to be realized either through a carry back to taxable income in prior years, future reversals of existing taxable temporary differences, and, to a lesser extent, future taxable income. The tax deduction generated by the redemption in kind of the shares of the mutual fund and the subsequent impairment charge on the assets acquired through the redemption in kind are considered a capital loss and can only be utilized to the extent of capital gains over a five year period, resulting in the establishment of a valuation allowance for the carryforward period which expires beginning in 2013. The valuation allowance totaled $\$ 2.7$ million at March 31, 2010. The gross deferred asset related to impairment losses increased by $\$ 114,000$ during the six months ended March 31, 2010 while the corresponding valuation allowance increased by $\$ 110,000$, resulting in an additional income tax benefit of $\$ 4,000$ corresponding to the increase in value of available for sale mortgage-backed securities which may be sold in the future to generate capital gains.

There is currently no liability for uncertain tax positions and no known unrecognized tax benefits. The Company recognizes, when applicable, interest and penalties related to unrecognized tax benefits in the provision for income taxes in the Unaudited Consolidated Statement of Operations. During 2009, the Internal Revenue Service concluded an audit of the Company's tax returns for the year ended September 30, 2007 in which there was no change necessary
to the Company's tax liability. The Company's federal and state income tax returns for taxable years through September 30, 2005 have been closed for purposes of examination by the Internal Revenue Service and the Pennsylvania Department of Revenue.

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## 7. STOCK COMPENSATION PLANS

The Company maintains a Recognition and Retention Plan ("RRP") which is administered by a committee of the Board of Directors. The RRP provides for the grant of shares of common stock of the Company to certain officers, employees and directors of the Company. In order to fund the grant of shares under the RRP, the RRP Trust purchased 226,148 shares of the Company's common stock in the open market for approximately $\$ 2.5$ million, at an average price per share of $\$ 10.85$. The Company made sufficient contributions to the RRP Trust to fund these purchases. No additional purchases are expected to be made by the RRP Trust under this plan. Grants covering 178,882 shares have been awarded as part of the RRP. The remaining shares in the RRP Trust will be available for future awards. Shares subject to awards under the RRP will generally vest at the rate of $20 \%$ per year over five years. As of March 31, 2010, awards covering 34,646 shares were vested and no awards had been forfeited.

Compensation expense related to the shares subject to awards granted is recognized ratably over the five-year vesting period in an amount which totals the share price at the grant date. During the three months and six months ended March 31, 2010, $\$ 97,000$ and $\$ 192,000$, respectively, was recognized in compensation expense for the RRP. Tax expense of $\$ 12,000$ was recognized during the three months ended March 31, 2010 while a $\$ 20,000$ tax benefit was recognized during the six months ended March 31, 2010. During the three and six months ended March 31, 2009, approximately $\$ 87,000$ was recognized in compensation expense for the RRP. A tax benefit of $\$ 30,000$ was recognized during these periods. At March 31, 2010, approximately $\$ 1.5$ million in additional compensation expense for the shares awarded related to the RRP remained unrecognized which is expected to be recongnized over approximately the next 3.75 years.

A summary of the Company's non-vested stock award activity for the six months ended March 31, 2010 is presented in the following table:

Nonvested stock awards at beginning of fiscal year Issued Vested
Nonvested stock awards at the end of the period

Six Months Ended
March 31, 2010
March 31, 2010
Weighted
Average Weighted
Grant Date

| Number of | Fair |
| :--- | :--- |
| Shares | Value |


| 173,228 | $\$$ | 11.17 |
| :--- | :--- | :--- |
| 5,654 |  | 9.53 |
| $(34,646)$ |  | 11.17 |
|  |  |  |
|  | 144,236 | $\$$ |

Six Months Ended
March 31, 2009

|  | Weighted |
| :--- | :--- |
| Average Grant |  |
| Number of | Date Fair |
| Shares | Value |

The Company also maintains a Stock Option Plan. The Stock Option Plan authorizes the grant of stock options to officers, employees and directors of the Company to acquire shares of common stock with an exercise price at least equal to the market value of the common stock on the grant date. Options will generally become vested and exercisable at the rate of $20 \%$ per year over five years and are generally exercisable for a period of ten years after the grant date. A total of 565,369 shares of common stock are available for future issuance pursuant to the Stock Option Plan. To date, 315,194 incentive stock options and 127,206 non-qualified stock options have been awarded under the plan. As of March 31, 2010, options covering 85,653 shares were vested, while none have been forfeited.

A summary of the status of the Company' stock options under the Stock Option Plan as of March 31, 2010 and changes during the six month period ended March 31, 2010 are presented below:

Six Months Ended<br>March 31, 2010<br>Number of Weighted Average<br>Shares Exercise Price

| Outstanding at beginning of |  |  |  |
| :---: | :---: | :---: | :---: |
| fiscal year | 428,266 | \$ | 11.17 |
| Granted | 14,134 |  | 9.53 |
| Exercised | - |  | - |
| Forfeited | - |  | - |
| Outstanding at the end of the period | 442,400 | \$ | 11.12 |
| Exercisable at the end of the period | 85,653 | \$ | 11.17 |

The weighted average remaining contractual term was approximately 8.75 years for options outstanding as of March 31, 2010. Options covering 85,653 shares were exercisable as of March 31, 2010.

The estimated fair value of options granted during fiscal 2010 was $\$ 2.76$ per share. The fair value was estimated on the date of grant in accordance with FASB ASC Topic 718 using the Black-Scholes pricing model with the following weighted average assumptions used:

March 31, 2010

| Dividend <br> yield | $2.10 \%$ |
| :--- | :--- |
| Expected |  |
| volatility <br> Risk-free <br> interest | $28.95 \%$ |
| rate | $3.10 \%$ |
| Expected <br> life of <br> options | 6.5 years |

Compensation expense related to the Stock Option Plan is recognized ratably over the five-year vesting period in an amount which totals the fair value at the date of grant. During the three months and six months ended March 31, $2010, \$ 61,000$ and $\$ 120,000$, respectively, was recognized in compensation expense. A tax benefit of $\$ 6,000$ and $\$ 11,000$, respectively, was recognized during the three and six months ended March 31, 2010. During the three and six months ended March 31, 2009, approximately $\$ 56,000$ was recognized in compensation expense. A tax benefit of $\$ 5,000$ was recognized during these periods. At March 31, 2010, approximately $\$ 923,000$ in additional compensation expense for awarded options remained unrecognized. The weighted average period over which this expense will be recognized is approximately 3.75 years.

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At March 31, 2010, the Company had $\$ 15.9$ million in outstanding commitments to originate fixed and variable-rate loans with market interest rates ranging from $5.00 \%$ to $6.50 \%$. At September 30, 2009, the Company had $\$ 11.0$ million in outstanding commitments to originate fixed and variable-rate loans with market interest rates ranging from $5.00 \%$ to $6.50 \%$.

The aggregate undisbursed portion of loans-in-process amounted to $\$ 6.5$ million and $\$ 6.3$ million, respectively, at March 31, 2010 and September 30, 2009.

The Company also had commitments under unused lines of credit of $\$ 7.4$ million and $\$ 7.7$ million at March 31 , 2010 and September 30, 2009, respectively, and letters of credit outstanding of \$621,000 at both March 31, 2010 and September 30, 2009.

Among the Company's contingent liabilities are exposures to limited recourse arrangements with respect to the Company's sales of whole loans and participation interests. At March 31, 2010, the exposure, which represents a portion of credit risk associated with the interests sold, amounted to $\$ 64,000$. This exposure is for the life of the related loans and payables, on our proportionate share, as actual losses are incurred.

The Company is involved in various legal proceedings occurring in the ordinary course of business. Management of the Company, based on discussions with litigation counsel, believes that such proceedings will not have a material adverse effect on the financial condition, operations or cash flows of the Company. There can be no assurance that any of the outstanding legal proceedings to which the Company is a party will not be decided adversely to the Company's interests and have a material adverse effect on the financial condition and operations of the Company.
9.

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

Accordingly, the estimates presented herein are not necessarily indicative of the amounts the Company could realize in a current market exchange. The use of different market assumptions and/or estimation methodologies may have a material effect on the estimated fair value amounts.

|  | $\begin{gathered} \text { March 31, } \\ 2010 \end{gathered}$ |  |  |  | September 30, 2009 |  |  |  |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: |
|  | Carrying <br> Amount (Dollars in thousands) |  |  | Fair Value |  | Carrying <br> Amount |  | Fair Value |
| Assets: |  |  |  |  |  |  |  |  |
| Cash and cash equivalents | \$ | 21,484 | \$ | 21,484 | \$ | 13,669 | \$ | 13,669 |
| Investment and mortgage-backed securities held to maturity |  | 140,450 |  | 141,967 |  | 160,126 |  | 161,968 |
| Investment securities and mortgagebacked securities available for sale |  | 66,982 |  | 66,982 |  | 62,407 |  | 62,407 |
| Loans receivable, net |  | 253,831 |  | 259,555 |  | 256,694 |  | 262,000 |
| Accrued interest receivable: |  |  |  |  |  |  |  |  |
| Loans receivable |  | 1,474 |  | 1,474 |  | 1,419 |  | 1,419 |
| Mortgage-backed securities |  | 368 |  | 368 |  | 390 |  | 390 |
| Investment securities |  | 1,383 |  | 1,383 |  | 1,496 |  | 1,496 |
| Federal Home Loan Bank stock |  | 3,545 |  | 3,545 |  | 3,545 |  | 3,545 |
| Liabilities: |  |  |  |  |  |  |  |  |
| NOW accounts |  | 30,761 |  | 30,761 |  | 29,869 |  | 29,869 |
| Money market deposit accounts |  | 76,056 |  | 76,056 |  | 75,349 |  | 75,349 |
| Passbook, club and statement savings accounts |  | 70,316 |  | 70,316 |  | 66,968 |  | 66,968 |
| Certificates of deposit |  | 259,183 |  | 265,149 |  | 260,188 |  | 266,192 |
| Advances from Federal Home |  |  |  |  |  |  |  |  |
| Loan Bank |  | 13,637 |  | 13,935 |  | 19,659 |  | 20,294 |
| Accrued interest payable |  | 1,374 |  | 1,374 |  | 3,463 |  | 3,463 |

Cash and Cash Equivalents-For cash and cash equivalents, the carrying amount is a reasonable estimate of fair value.
Investments and Mortgage-Backed Securities-The fair value of investment securities and mortgage-backed securities is based on quoted market prices, dealer quotes, and prices obtained from independent pricing services that may be derivable from observable and unobservable market inputs.

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Loans Receivable-The fair value of loans is estimated based on present value using the current rates at which similar loans would be made to borrowers with similar credit ratings and for the same remaining maturities.

Accrued Interest Receivable - For accrued interest receivable, the carrying amount is a reasonable estimate of fair value.

Federal Home Loan Bank (FHLB) Stock-Although FHLB stock is an equity interest in an FHLB, it is carried at cost because it does not have a readily determinable fair value as its ownership is restricted and it lacks a market. The estimated fair value approximates the carrying amount.

NOW Accounts, Money Market Deposit Accounts, Passbook Accounts, Club Accounts, Statement Savings Accounts, and Certificates of Deposit-The fair value of passbook accounts, club accounts, statement savings accounts, NOW accounts, and money market deposit accounts is the amount reported in the financial statements. The fair value of certificates of deposit is based on a present value estimate using rates currently offered for deposits of similar remaining maturity.

Advances from Federal Home Loan Bank-The fair value of advances from FHLB is the amount payable on demand at the reporting date.

Accrued Interest Payable - For accrued interest payable, the carrying amount is a reasonable estimate of fair value.
Commitments to Extend Credit and Letters of Credit-The majority of the Bank's commitments to extend credit and letters of credit carry current market interest rates if converted to loans. Because commitments to extend credit and letters of credit are generally unassignable by either the Bank or the borrower, they only have value to the Bank and the borrower. The estimated fair value approximates the recorded deferred fee amounts, which are not significant.
10.

FAIR VALUE MEASUREMENT
The fair value estimates presented herein are based on pertinent information available to management as of March 31, 2010 and September 30, 2009, respectively. Although management is not aware of any factors that would significantly affect the fair value amounts, such amounts have not been comprehensively revalued for purposes of these financial statements since that date and, therefore, current estimates of fair value may differ significantly from the amounts presented herein.

The Company adopted FASB ASC Topic 820 "Fair Value Measurement and Disclosures" effective October 1, 2008, which provides a frame work for measuring fair value under generally accepted accounting principles. FASB ASC Topic 820 establishes a fair value hierarchy which requires an entity to maximize the use of observable inputs and minimizes the use of unobservable inputs when measuring fair value. The standard describes three levels of inputs that may be used to measure fair value.

The three broad levels defined by FASB ASC Topic 820 hierarchy are as follows:
Level 1 Quoted prices in active markets for identical assets or liabilities.
Level 2 Observable inputs other than Level 1 prices, such as quoted prices for similar assets or liabilities; quoted prices in markets that are not active; or other inputs that are observable or can be corroborated by observable market data for substantially the full term of the assets or liabilities.
Level 3 Unobservable inputs that are supported by little or no market activity and that are significant to the fair value of the assets or liabilities. Level 3 assets and liabilities include financial instruments whose value is determined using pricing models, discounted cash flow methodologies, or similar techniques, as well as
instruments for which the determination of fair value requires significant management judgment or estimation.

Those assets which will continue to be measured at fair value on a recurring basis as of March 31, 2010 are as follows:

|  | Category Used for Fair Value Measurement |  |
| :---: | :---: | :---: |
| Level 1 | Level 2 | Level 3 |
|  | (Dollars in Thousands) | Total |
|  |  |  |

Assets:
Securities available for sale:

| U.S. Government agency obligations | \$ | - | \$ | 5,005 | \$ | - | \$ | 5,005 |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: |
| Mortgage-backed securities - U.S. vernment agencies |  | - |  | 54,697 |  | - | \$ | 54,697 |
| Mortgage-backed securities -on-agency |  | - |  | 7,169 |  | 77 |  | 7,246 |
| FNMA and FHLMC preferred stock |  | 34 |  |  |  | - |  | 34 |
| Total | \$ | 34 | \$ | 66,871 | \$ | 77 | \$ | 66,982 |

Those assets which continued to be measured at fair value on a recurring basis as of September 30, 2009 are as follows:

|  | Category Used for Fair Value Measurement |  |
| :---: | :---: | :---: |
| Level 1 | Level 2 | Level 3 |$\quad$ Total

Assets:
Securities available for sale:

| U.S. Government agency obligations | \$ | - | \$ | 1,982 | \$ | - | \$ | 1,982 |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: |
| Mortgage-backed securities - U.S. |  |  |  |  |  |  |  |  |
| vernment agencies |  | - |  | 52,611 |  | - | \$ | 52,611 |
| Mortgage-backed securities - |  |  |  |  |  |  |  |  |
| on-agency |  | - |  | 7,685 |  | 82 |  | 7,767 |
| FNMA and FHLMC preferred stock |  | 47 |  | - |  | - |  | 47 |
| Total | \$ | 47 | \$ | 62,278 | \$ | 82 | \$ | 62,407 |

As a result of general market conditions and the illiquidity in the market for certain non-agency mortgage-backed securities, management deemed it necessary to classify certain securities as Level 3 assets. These securities were priced by a third party specialist utilizing recent prices for similar securities as inputs in the standard discounted cash flow model, adjusted for assumptions unobservable in the market.

The following provides details of the fair value measurement activity for Level 3 assets during the three months ended March 31, 2010:

```
Measurements
Using Significant
Unobservable
Inputs (Level 3)
    Non-agency
mortgage-backed
        securities
        (Dollars in
    Thousands)
$ 78 \$ 77
```

Balance, January 1, 2010:

Total losses, realized/unrealized Included in earnings
Included in accumulated other comprehensive loss

Purchases, maturities, prepayments and calls, net

Transfers from Level 3, net Balance, March 31, 2010:

The following provides details of the fair value measurement activity for Level 3 assets during the six months ended March 31, 2010:

> Measurements
> Using Significant
> Unobservable
> Inputs (Level 3)
> Non-agency
> mortgage-backed
> securities
> (Dollars in
> Thousands)

Balance, October 1, 2009: \$ 82
Total losses, realized/unrealized
Included in earnings (6)
Included in accumulated
other comprehensive loss
16
Purchases, maturities, prepayments and calls, net

Transfers from Level 3, net
Balance, March 31, 2010:
\$ 77

Certain assets are measured at fair value on a nonrecurring basis; that is, the instruments are not measured at fair value on an ongoing basis but are subject to fair value adjustments in certain circumstances (for example, when there is evidence of impairment). The Company measures impaired loans and loans or bank properties transferred into real estate owned at fair value on a non-recurring basis.

The Company considers loans to be impaired when it becomes probable that the Company will be unable to collect all amounts due in accordance with the contractual terms of the loan agreement. UnderASC 310-10-35 Receivables-Subsequent Measurement, collateral dependent impaired loans are based on the fair value of the collateral which is based on appraisals. In some cases, adjustments are made to the appraised values for various factors including age of the appraisal, age of the comparables included in the appraisal, and known changes in the market and in the collateral These adjustments are based upon unobservable inputs, and therefore, the fair value measurement has been categorized as a Level 2 measurement. Specific reserves were calculated for impaired loans with carrying amounts totaling $\$ 1.0$ million at March 31, 2010. The collateral underlying these loans had a fair value of $\$ 842,000$, resulting in specific reserves in the allowance for loan losses of $\$ 172,000$.

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## Transfer of Impaired Loans into Real Estate Owned

Once an asset is determined to be uncollectible, the underlying collateral is repossessed and reclassified to foreclosed real estate and repossessed assets. These assets are carried at lower of cost or fair value of the collateral, less cost to sell. In some cases, adjustments are made to the appraised values for various factors including age of the appraisal, age of the comparables included in the appraisal, and known changes in the market and in the collateral These adjustments are based upon unobservable inputs, and therefore, the fair value measurement has been categorized as a Level 2 measurement.

Summary of Non-Recurring Fair Value Measurements


## ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following discussion should be read in conjunction with our unaudited consolidated financial statements included elsewhere in this Form 10-Q and with our Annual Report on Form 10-K for the year ended September 30, 2009.

Overview. Prudential Bancorp, Inc. of Pennsylvania (the "Company") was formed by Prudential Savings Bank (the "Bank") in connection with the Bank's reorganization into the mutual holding company form of organization. The Company's results of operations are primarily dependent on the results of the Bank, which is a wholly owned subsidiary of the Company. The Company's results of operations depend to a large extent on net interest income, which primarily is the difference between the income earned on its loan and securities portfolios and the cost of funds, which is the interest paid on deposits and borrowings. Results of operations are also affected by our provisions for loan losses, non-interest income (which includes impairment charges) and non-interest expense. Non-interest expense principally consists of salaries and employee benefits, office occupancy, depreciation, data processing expense, payroll taxes and other expense. Our results of operations are also significantly affected by general economic and competitive conditions, particularly changes in interest rates, government policies and actions of regulatory authorities. Future changes in applicable laws, regulations or government policies may materially impact our financial condition and results of operations. The Bank is subject to regulation by the Federal Deposit Insurance Corporation ("FDIC") and the Pennsylvania Department of Banking (the "Department"). The Bank's main office is in Philadelphia, Pennsylvania, with six additional banking offices located in Philadelphia and Delaware Counties in Pennsylvania. The Bank's primary business consists of attracting deposits from the general public and using those funds together with borrowings to originate loans and to invest primarily in U.S. Government and agency securities and mortgage-backed
securities. In November 2005, the Bank formed PSB Delaware, Inc., a Delaware corporation, as a subsidiary of the Bank. In March 2006, all mortgage-backed securities owned by the Company were transferred to PSB Delaware, Inc. PSB Delaware, Inc.'s. activities are included as part of the consolidated financial statements.

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Critical Accounting Policies. In reviewing and understanding financial information for the Company, you are encouraged to read and understand the significant accounting policies used in preparing our financial statements. These policies are described in Note 2 of the Notes to Consolidated Financial Statements included in the Annual Report filed on Form 10-K for the year ended September 30, 2009. The accounting and financial reporting policies of the Company conform to accounting principles generally accepted in the United States of America and to general practices within the banking industry. The preparation of the Company's consolidated financial statements requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of income and expenses during the reporting period. Management evaluates these estimates and assumptions on an ongoing basis. The following accounting policies comprise those that management believes are the most critical to aid in fully understanding and evaluating our reported financial results. These policies require numerous estimates or economic assumptions that may prove inaccurate or may be subject to variations which may significantly affect our reported results and financial condition for the period or in future periods.

Allowance for Loan Losses. The allowance for loan losses is established through a provision for loan losses charged to expense. Loans are charged against the allowance for loan losses when management believes that the collectibility of the principal is unlikely. Subsequent recoveries are added to the allowance. The allowance for loan losses is maintained at a level that management considers adequate to provide for estimated losses and impairment based upon an evaluation of known and inherent risk in the loan portfolio. Loan impairment is evaluated based on the fair value of collateral or estimated net realizable value. It is the policy of management to provide for losses on unidentified loans in its portfolio in addition to classified loans.

Management monitors its allowance for loan losses at least quarterly and makes adjustments to the allowance through the provision for loan losses as economic conditions and other pertinent factors indicate. The quarterly review and adjustment of the qualitative factors employed in the allowance methodology and the updating of historic loss experience allow for timely reaction to emerging conditions and trends. In this context, a series of qualitative factors are used in a methodology as a measurement of how current circumstances are affecting the loan portfolio. Included in these qualitative factors are:

Levels of past due, classified and non-accrual loans, troubled debt restructurings and modifications
Nature and volume of loans
Changes in lending policies and procedures, underwriting standards, collections, charge-offs and recoveries and for commercial loans, the level of loans being approved with exceptions to lending policy Experience, ability and depth of management and staff
National and local economic and business conditions, including various market segments
Quality of the Company's loan review system and degree of Board oversight
Concentrations of credit and changes in levels of such concentrations
Effect of external factors on the level of estimated credit losses in the current portfolio
In determining the allowance for loan losses, management has established both specific and general pooled allowances. Values assigned to the qualitative factors and those developed from historic loss experience provide a dynamic basis for the calculation of reserve factors for both pass-rated loans (general pooled allowance) and those criticized and classified loans. Larger commercial real estate, construction and commercial business loans are individually evaluated for impairment. Loans not individually reviewed are evaluated as a group using reserve factor percentages based on historic loss experience and the qualitative factors described above. In determining the appropriate level of the general pooled allowance, management makes estimates based on internal risk ratings, which take into account such factors as debt service coverage, loan-to-value ratios, and external factors. Estimates are periodically measured against actual loss experience.

This evaluation is inherently subjective as it requires material estimates including, among others, exposure at default, the amount and timing of expected future cash flows on impaired loans, value of collateral, estimated losses on our commercial, construction and residential loan portfolios and historical loss experience. All of these estimates may be susceptible to significant change.

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While management uses the best information available to make loan loss allowance evaluations, adjustments to the allowance may be necessary based on changes in economic and other conditions or changes in accounting guidance. Historically, our estimates of the allowance for loan loss have not required significant adjustments from management's initial estimates. In addition, the Pennsylvania Department of Banking and the Federal Deposit Insurance Corporation, as an integral part of their examination processes, periodically review our allowance for loan losses. The Pennsylvania Department of Banking and the Federal Deposit Insurance Corporation may require the recognition of adjustments to the allowance for loan losses based on their judgment of information available to them at the time of their examinations. To the extent that actual outcomes differ from management's estimates, additional provisions to the allowance for loan losses may be required that would adversely impact earnings in future periods.

Fair Value Measurements. Where quoted prices are available in an active market, securities are classified within Level 1 of the valuation hierarchy. If quoted market prices are not available, then fair values are estimated using quoted prices of securities with similar characteristics or discounted cash flows and are classified within Level 2 of the fair value hierarchy. In certain cases where there is limited activity or less transparency around inputs to the valuation, securities are classified within Level 3 of the valuation hierarchy. At March 31, 2009, the Company's investment in certain non-agency mortgage-backed securities were shifted from a Level 2 market value measurement to a Level 3 market value measurement. This Level 3 market value measurement included an internally developed discounted cash flow model combined with using market data points of similar securities with comparable credit ratings in addition to market yield curves with similar maturities in determining the discount rate.

Management evaluates securities for other-than-temporary impairment at least on a quarterly basis, and more frequently when economic or market concerns warrant such evaluation. The Company determines whether the unrealized losses are temporary in accordance with United States Generally Accepted Accounting Principles ("U.S. GAAP"). The evaluation is based upon factors such as the creditworthiness of the issuers/guarantors, the underlying collateral, if applicable, and the continuing performance of the securities. In addition, the Company also considers the likelihood that the security will be required to be sold by a regulatory agency, our internal intent not to dispose of the security prior to maturity and whether the entire cost basis of the security is expected to be recovered. In determining whether the cost basis will be recovered, management evaluates other facts and circumstances that may be indicative of an other-than-temporary impairment condition. This includes, but is not limited to, an evaluation of the type of security, length of time and extent to which the fair value has been less than cost, and near-term prospects of the issuer.

In addition, certain assets are measured at fair value on a non-recurring basis; that is, the instruments are not measured at fair value on an ongoing basis but are subject to fair value adjustments in certain circumstances (for example, when there is evidence of impairment). The Company measures impaired loans, FHLB stock and loans or properties transferred into real estate owned at fair value on a non-recurring basis.

Valuation techniques and models utilized for measuring financial assets and liabilities are reviewed and validated by the Company at least quarterly.

Income Taxes. The Company accounts for income taxes in accordance with U.S. GAAP. The Company records deferred income taxes that reflect the net tax effects of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for income tax purposes. Management exercises significant judgment in the evaluation of the amount and timing of the recognition of the resulting tax assets and liabilities. The judgments and estimates required for the evaluation are updated based upon changes in business factors and the tax laws. If actual results differ from the assumptions and other considerations used in estimating the amount and timing of tax recognized, there can be no assurance that additional expenses will not be required in future periods.

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In evaluating our ability to recover deferred tax assets, we consider all available positive and negative evidence, including our past operating results and our forecast of future taxable income. In determining future taxable income, we make assumptions for the amount of taxable income, the reversal of temporary differences and the implementation of feasible and prudent tax planning strategies. These assumptions require us to make judgments about our future taxable income and are consistent with the plans and estimates we use to manage our business. Any reduction in estimated future taxable income may require us to record an additional valuation allowance against our deferred tax assets. An increase in the valuation allowance would result in additional income tax expense in the period and could have a significant impact on our future earnings.
U.S. GAAP prescribes a minimum probability threshold that a tax position must meet before a financial statement benefit is recognized. The Company recognizes, when applicable, interest and penalties related to unrecognized tax benefits in the provision for income taxes in the consolidated income statement. Assessment of uncertain tax positions requires careful consideration of the technical merits of a position based on management's analysis of tax regulations and interpretations. Significant judgment may be involved in the assessment of the tax position.

Forward-looking Statements. In addition to historical information, this Quarterly Report on Form 10-Q includes certain "forward-looking statements" based on management's current expectations. The Company's actual results could differ materially, as such term is defined in the Securities Act of 1933, as amended, and the Securities Exchange Act of 1934, as amended, from management's expectations. Such forward-looking statements include statements regarding management's current intentions, beliefs or expectations as well as the assumptions on which such statements are based. These forward-looking statements are subject to significant business, economic and competitive uncertainties and contingencies, many of which are not subject to the Company's control. You are cautioned that any such forward-looking statements are not guarantees of future performance and involve risks and uncertainties, and that actual results may differ materially from those contemplated by such forward-looking statements. Factors that could cause future results to vary from current management expectations include, but are not limited to, general economic conditions, legislative and regulatory changes, monetary and fiscal policies of the federal government, changes in tax policies, rates and regulations of federal, state and local tax authorities, changes in interest rates, deposit flows, the cost of funds, demand for loan products, demand for financial services, competition, changes in the quality or composition of the Company's loan and investment portfolios, changes in accounting principles, policies or guidelines and other economic, competitive, governmental and technological factors affecting the Company's operations, markets, products, services and fees.

The Company undertakes no obligation to update or revise any forward-looking statements to reflect changed assumptions, the occurrence of unanticipated events or changes to future operating results that occur subsequent to the date such forward-looking statements are made unless required by law or regulations.

Market Overview. The continued turbulence in the economy and the current financial crisis, which began in mid-2007, resulting in housing-related credit decline, combined with a capital markets liquidity crisis that has affected the liquidity and valuation of many investment vehicles, remains a concern for the Company. The severity of the downturn in the economic conditions deteriorated into a recession during 2008 which continued through calendar 2009. Although there is growing evidence the U.S. economy is starting to recover, economic conditions remained weak during the first quarter of calendar 2010. One of the primary concerns for the Company is the slump in the housing market. While the Philadelphia area has not suffered wholesale declines in the value of residential real estate as have other areas of the country, this downturn has rippled through many parts of the economy, including construction lending and lending to contractors. Such conditions increase our exposure to the risk of non-performance in our construction and commercial loan portfolios. The Company continues to focus on the credit quality of its customers - closely monitoring the financial status of borrowers throughout the Company's markets, gathering information, working on early detection of potential problems, taking pre-emptive steps where necessary and performing the analysis required to maintain adequate reserves. These declines in real estate market values has also
been a factor in determining the necessity to increase our allowance for loan losses through increased loan loss provisions.

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The decline in real estate market values and the increase in defaults on the underlying collateral have caused illiquidity in the financial markets which has led to the devaluation of certain non-agency securities. The Company continues to be impacted by continued pressure in the capital markets with respect to the value of our non-agency mortgage-backed securities and collateralized mortgage obligations, leading to the determination that the declines in the fair value were other-than-temporary resulting in the occurrence of other-than-temporary impairment charges.

Despite the current market and economic conditions, the Company continues to maintain a strong capital position.
The following discussion provides further details on the financial condition and results of operations of the Company at and for the periods ended March 31, 2010.

## COMPARISON OF FINANCIAL CONDITION AT MARCH 31, 2010 AND SEPTEMBER 30, 2009

At March 31, 2010, the Company's total assets were $\$ 508.2$ million, a decrease of $\$ 6.5$ million from $\$ 514.8$ million at September 30, 2009. The decrease was primarily attributable to net decreases in the investment and mortgage-backed securities portfolio of $\$ 15.1$ million. Partially offsetting the decrease was an increase in cash and cash equivalents of $\$ 7.8$ million as a result of the proceeds from the repayment or call of investment and mortgage-backed securities. The proceeds were held as cash pending future deployment or used to payoff borrowings.

Total liabilities decreased $\$ 4.9$ million to $\$ 454.0$ million at March 31, 2010 from $\$ 458.9$ million at September 30, 2009. The decrease was primarily the result of an $\$ 6.0$ million decrease in advances from the Federal Home Loan Bank which were paid down as proceeds were received from the call or repayment of investment and mortgage-backed securities. Partially offsetting the decrease in liabilities was a $\$ 3.9$ million increase in deposits.

Stockholders' equity decreased by $\$ 1.7$ million to $\$ 54.2$ million at March 31, 2010 from $\$ 55.9$ million at September 30, 2009. The largest component of change in equity during the six months ended March 31, 2010 reflected the cost of stock repurchases totaling $\$ 2.9$ million, partially offset by net income of $\$ 1.5$ million.

## COMPARISON OF RESULTS OF OPERATIONS FOR THE THREE AND SIX MONTHS ENDED MARCH 31, 2010 AND 2009

Net income. The Company reported net income of $\$ 843,000$ for the quarter ended March 31, 2010 as compared to a net loss of $\$ 48,000$ for the same period in 2009. For the six months ended March 31, 2010, the Company recognized net income of $\$ 1.5$ million compared to a net loss of $\$ 1.0$ million for the comparable period in 2009. The improved results of operations for the quarter and six month periods ended March 31, 2010 were primarily due to significantly reduced non-cash other than temporary impairment ("OTTI") charges in the 2010 periods as compared to the 2009 periods with respect to certain of the non-agency mortgage-backed securities received as a result of the redemption in kind of shares of a mutual fund during fiscal 2008.

Net interest income. Net interest income increased $\$ 546,000$ or $15.7 \%$ to $\$ 4.0$ million for the three months ended March 31, 2010 as compared to $\$ 3.5$ million for the same period in 2009. The increase reflected the effects of a $\$ 1.1$ million or $33.3 \%$ decrease in interest expense partially offset by a $\$ 594,000$ or $8.6 \%$ decrease in interest income. The decrease in interest expense resulted primarily from a 115 basis point decrease to $2.03 \%$ in the weighted average rate paid on interest-bearing liabilities, reflecting the repricing downward of interest-bearing liabilities during the year, partially offset by a $\$ 18.5$ million or $4.3 \%$ increase in the average balance of interest-bearing liabilities for the three months ended March 31, 2010, as compared to the same period in 2009. The decrease in interest income resulted from a 54 basis point decrease to $5.19 \%$ in the weighted average yield earned on interest-earning assets partially offset by a $\$ 4.0$ million or $0.8 \%$ increase in the average balance of interest-earning assets for the three months ended March 31, 2010, as compared to the same period in 2009.

For the six months ended March 31, 2010, net interest income increased $\$ 759,000$ or $10.5 \%$ to $\$ 8.0$ million as compared to $\$ 7.2$ million for the same period in 2009. The increase was due to a $\$ 2.1$ million or $30.7 \%$ decrease in interest expense partially offset by a 1.4 million or $9.6 \%$ decrease in interest income. The decrease in interest expense resulted primarily from a 109 basis point decrease to $2.14 \%$ in the weighted average rate paid on interest-bearing liabilities, reflecting the repricing downward of interest-bearing liabilities during the year, partially offset by a $\$ 18.6$ million or $4.4 \%$ increase in the average balance of interest-bearing liabilities, primarily in certificates of deposit, for the six months ended March 31, 2010, as compared to the same period in 2009. The decrease in interest income resulted primarily from a 59 basis point decrease to $5.28 \%$ in the weighted average yield earned on interest-earning assets partially offset by a $\$ 3.2$ million or $0.7 \%$ increase in the average balance of interest-earning assets for the six months ended March 31, 2010, as compared to the same period in 2009.

Average Balances, Net Interest Income, and Yields Earned and Rates Paid. The following table shows for the periods indicated the total dollar amount of interest from average interest-earning assets and the resulting yields, as well as the interest expense on average interest-bearing liabilities, expressed both in dollars and rates, and the net interest margin. Average yields and rates have been annualized. Tax-exempt income and yields have not been adjusted to a tax-equivalent basis. All average balances are based on monthly balances. Management does not believe that the monthly averages differ significantly from what the daily averages would be.

| Three Months Ended March 31, |  |  |  |  |  |
| :---: | :---: | :---: | :---: | :---: | :---: |
|  | 2010 |  |  | 2009 |  |
| Average |  | Average | Average |  | Average |
| Balance | Interest | Yield/Rate | Balance | Interest | Yield/Rate |

Interest-earning assets:
Investment securities
Mortgage-backed securities (1)
Loans receivable(2)
Other interest-earning assets (3)
Total interest-earning assets
Cash and non-interest-bearing balances
Other non-interest-earning assets Total assets
Interest-bearing liabilities:
Savings accounts
Money market deposit and NOW
accounts
Certificates of deposit
Total deposits
Advances from Federal Home Loan Bank
Advances from borrowers for taxes and insurance
Total interest-bearing liabilities

| $\$ 120,060$ | $\$ 1,401$ |
| :--- | :--- |
| 93,606 | 1,188 |
| 255,341 | 3,719 |
| 17,280 | 3 |
| 486,287 | 6,311 |


| 4.67 \% | \$ | 117,374 | \$ 1,466 | 5.00 |
| :---: | :---: | :---: | :---: | :---: |
| 5.08 |  | 92,376 | 1,562 | 6.76 |
| 5.83 |  | 254,793 | 3,863 | 6.06 |
| 0.07 |  | 17,709 | 14 | 0.32 |
| 5.19 |  | 482,252 | 6,905 | 5.73 |
|  |  | 6,308 |  |  |
|  |  | 13,668 |  |  |
|  | \$ | 502,228 |  |  |
| 1.90 | \$ | 64,722 | 431 | 2.66 |
| 1.07 |  | 93,806 | 536 | 2.29 |
| 2.37 |  | 243,819 | 2,233 | 3.66 |
| 1.96 |  | 402,347 | 3,200 | 3.18 |
| 3.45 |  | 26,573 | 224 | 3.37 |
| 0.45 |  | 1,950 | 2 | 0.41 |
| 2.03 |  | 430,870 | 3,426 | 3.18 |

Non-interest-bearing liabilities:
Non-interest-bearing demand accounts
Other liabilities
1,148
3,774
Total liabilities
2,194
452,712
2,278
56,397
436,922
Stockholders' equity
Total liabilities and stockholders'
equity
Net interest-earning assets
\$ 509,109 \$ 502,228
\$ 36,917
\$ 51,382
Net interest income; interest rate spread
Net interest margin(4)
\$ 4,025
3.16 \%
\$ 3,479
2.55 \%
2.89 \%

Average interest-earning assets to average
$\begin{array}{lll}\text { interest-bearing liabilities } \quad 108.22 \% & 111.93 \%\end{array}$
(1) The decrease in yield of the Company's mortgage-backed securities portfolio is primarily a result of changes in portfolio composition as well as in estimate of prepayment speed assumptions. The Company employs the effective yield method of accounting, which requires retrospective adjustments to the yield on the Company's assets, which in turn directly affects earnings. The Company estimates yield at the time of purchase of each asset. To the extent prepayment speeds assumptions differ from Company's estimates at the time of purchase, the Company is required to adjust the yield on that asset as well as the amortization of premium or discount taken to date on the asset. This cumulative "true up" of the amortization was taken through earnings in the 2009 period.
(2) Includes non-accrual loans. Calculated net of unamortized deferred fees, undisbursed portion of loans-in-process and allowance for loan losses.
(3) Yield substantially decreased due to declining overnight investment rates during the 2010 period as compared to the 2009 period.
(4) Equals net interest income divided by average interest-earning assets.

|  | Average Balance |  | 2010 |  | Six Months Ended March 31, |  |  | 2009 |  | Average <br> Yield/Rate |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: |
|  |  |  |  |  |  |  |  |  |
|  |  |  |  | Interest | Average Yield/Rate |  | Average Balance |  | Interest |  |
|  | (Dollars in Thousands) |  |  |  |  |  |  |  |  |  |
| Interest-earning assets: |  |  |  |  |  |  |  |  |  |  |
| Investment securities | \$ | 123,298 |  |  | \$ | 2,891 | 4.69 \% | \$ | 124,058 |  | 3,194 | 5.15 \% |
| Mortgage-backed securities (1) |  | 94,139 |  | 2,411 | 5.12 |  | 92,201 |  | 3,318 | 7.20 |
| Loans receivable(2) |  | 255,710 |  | 7,470 | 5.84 |  | 252,179 |  | 7,590 | 6.02 |
| Other interest-earning assets (3) |  | 11,190 |  | 5 | 0.09 |  | 12,726 |  | 30 | 0.47 |
| Total interest-earning assets |  | 484,337 |  | 12,777 | 5.28 |  | 481,164 |  | 14,132 | 5.87 |
| Cash and non-interest-bearing |  |  |  |  |  |  |  |  |  |  |
| balances |  | 2,922 |  |  |  |  | 4,923 |  |  |  |
| Other non-interest-earning assets |  | 19,583 |  |  |  |  | 13,838 |  |  |  |
| Total assets | \$ | 506,842 |  |  |  |  | 499,925 |  |  |  |
| Interest-bearing liabilities: |  |  |  |  |  |  |  |  |  |  |
| Savings accounts | \$ | 68,853 |  | 657 | 1.91 |  | 64,865 |  | 873 | 2.69 |
| Money market deposit and NOW accounts |  | 106,575 |  | 578 | 1.08 |  | 93,136 |  | 1,142 | 2.45 |
| Certificates of deposit |  | 247,108 |  | 3,119 | 2.52 |  | 232,542 |  | 4,342 | 3.73 |
| Total deposits |  | 422,536 |  | 4,354 | 2.06 |  | 390,543 |  | 6,357 | 3.26 |
| Advances from Federal Home |  |  |  |  |  |  |  |  |  |  |
| Loan Bank |  | 21,620 |  | 417 | 3.86 |  | 34,819 |  | 527 | 3.03 |
| Advances from borrowers for taxes and insurance |  | 1,619 |  | 3 | 0.37 |  | 1,770 |  | 4 | 0.45 |
| Total interest-bearing liabilities |  | 445,775 |  | 4,774 | 2.14 |  | 427,132 |  | 6,888 | 3.23 |
| Non-interest-bearing liabilities: |  |  |  |  |  |  |  |  |  |  |
| Non-interest-bearing demand accounts |  | 2,098 |  |  |  |  | 3,895 |  |  |  |
| Other liabilities |  | 4,820 |  |  |  |  | 2,591 |  |  |  |
| Total liabilities |  | 452,693 |  |  |  |  | 433,618 |  |  |  |
| Stockholders' equity |  | 56,149 |  |  |  |  | 66,307 |  |  |  |
| Total liabilities and stockholders' |  |  |  |  |  |  |  |  |  |  |
| Net interest-earning assets |  | 38,562 |  |  |  |  | 54,032 |  |  |  |
| Net interest income; interest rate |  |  |  |  |  |  |  |  |  |  |
| Net interest margin(4) |  |  |  |  | 3.30 \% |  |  |  |  | 3.01 \% |

Average interest-earning assets to average interest-bearing liabilities
(1) The decrease in yield of the Company's mortgage-backed securities portfolio is primarily a result of changes in portfolio composition as well as in estimate of prepayment speed assumptions. The Company employs the effective yield method of accounting, which requires retrospective adjustments to the yield on the Company's assets, which in turn directly affects earnings. The Company estimates yield at the time of purchase of each asset. To the extent prepayment speeds assumptions differ from Company's estimates at the time of purchase, the Company is required to adjust the yield on that asset as well as the amortization of premium or discount taken to date on the asset. This cumulative "true up" of the amortization was taken through earnings in the 2009 period.

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(2) Includes non-accrual loans. Calculated net of unamortized deferred fees, undisbursed portion of loans-in-process and allowance for loan losses.
(3) Yield substantially decreased due to declining overnight investment rates during the 2010 period as compared to the 2009 period.
(4) Equals net interest income divided by average interest-earning assets.

Provisions for loan losses. The allowance is maintained at a level sufficient to provide for estimated probable losses in the loan portfolio at each reporting date. At least quarterly, management performs an analysis to identify the inherent risk of loss in the Company's loan portfolio. This analysis includes a qualitative evaluation of concentrations of credit, past loss experience, current economic conditions, amount and composition of the loan portfolio (including loans being specifically monitored by management), estimated fair value of underlying collateral, delinquencies, and other factors.

Our methodology for assessing the adequacy of the allowance establishes both specific and general pooled allocations of the allowance. To determine the adequacy of the allowance and the need for potential changes to the allowance, we conduct a formal analysis quarterly to assess the risk within the loan portfolio. This assessment includes analyses of historical performance, past due trends, the level of nonperforming loans, reviews of certain impaired loans, loan activity since the last quarter, consideration of current economic conditions, and other pertinent information. Loans are assigned ratings, either individually for larger credits or in homogeneous pools, based on an internally developed grading system. The resulting conclusions are reviewed and approved by senior management.

The Company established a provision for loan losses of $\$ 250,000$ for the quarter ended March 31,2010 and $\$ 385,000$ for the six month period ended March 31,2010 as compared to $\$ 50,000$ and $\$ 363,000$ for the comparable periods in 2009. The increased level of provisions in the 2010 periods reflected the higher level of non-performing assets resulting from the continued weakness in the economy experienced during these periods. At March 31, 2010, the Company's non-performing assets totaled $\$ 7.8$ million or $1.5 \%$ of total assets as compared to $\$ 5.6$ million or $1.1 \%$ of total assets at September 30, 2009. The non-performing assets consisted of five commercial real estate loans totaling $\$ 927,000,13$ one-to four-family residential mortgage loans totaling $\$ 1.6$ million and seven real estate owned properties totaling $\$ 5.3$ million. The allowance for loan losses totaled $\$ 2.4$ million, or $0.9 \%$ of total loans and $96.1 \%$ of non-performing loans at March 31, 2010. The increase in non-performing assets was due to a $\$ 1.1$ million increase in loans delinquent greater than 90 days and the foreclosure of a four townhouse construction loan project.

Non-interest income (loss). Non-interest income amounted to $\$ 62,000$ and $\$ 82,000$ for the three and six month periods ended March 31, 2010, compared with losses of $\$ 434,000$ and $\$ 2.4$ million for the same periods in 2009 . The losses experienced in the 2009 periods were due to OTTI charges arising from the Company's investment in a mutual fund and the subsequent redemption in kind of such investment. The decline in the amount of losses recognized between the 2009 and 2010 periods reflected the decline in the amount of the OTTI charges from $\$ 647,000$ and $\$ 2.8$ million for the three and six months ended March 31, 2009 to $\$ 133,000$ and $\$ 337,000$ during the three and six months ended March 31, 2010 related to the non-agency mortgage-backed securities received as part of the June 2008 redemption in kind of the investment in the mutual fund as the markets for such securities began to stabilize in the 2010 periods.

Non-interest expenses. For the quarter ended March 31, 2010, non-interest expense decreased $\$ 17,000$ compared to the same period in the prior year, while non-interest expense increased $\$ 84,000$ for the six month period ended March 31,2010 compared to the same period in the prior year. The increase for the six month period was primarily due to expenses related to the implementation and expensing of awards granted under stock benefit plans which were $\$ 168,000$ higher than the amount incurred in the comparable period in 2009 as these expenses were only incurred for a

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portion of the 2009 period. Also contributing to the higher level of non-interest expense for the six months ended March 31, 2010 were increased costs related to an increase in actuarial computed contributions for the Company's defined benefit pension plan which were $\$ 128,000$ more than the amount recognized in the comparable period in 2009. These increases were partially offset by a decrease of real estate owned expenses of $\$ 146,000$ and a decrease of $\$ 135,000$ in professional services expenses for the six month period ended March 31, 2010 from the comparable period in 2009.

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Income tax expense. The Company recorded income tax expense for the quarter and six months ended March 31, 2010 of $\$ 333,000$ and $\$ 955,000$, respectively, compared to income tax expense of $\$ 365,000$ and $\$ 409,000$, respectively, for the quarter and six months ended March 31, 2009. Tax expense was recorded in the 2009 periods and was not fully offset by the capital losses incurred in connection with the writedown of certain of the mortgage-backed securities received in the redemption of the mutual fund. A valuation allowance was recorded against the deferred tax asset created as a result of such recognized capital losses as capital losses are only deductible to the extent of capital gains.

## LIQUIDITY AND CAPITAL RESOURCES

The Company's liquidity, represented by cash and cash equivalents, is a product of its operating, investing and financing activities. Our primary sources of funds are from deposits, scheduled principal and interest payments on loans, loan prepayments and the maturity of loans, mortgage-backed securities and other investments, and other funds provided from operations. While scheduled payments from the amortization of loans and mortgage-backed securities and maturing investment securities are relatively predictable sources of funds, deposit flows and loan and securities prepayments can be greatly influenced by market rates of interest, economic conditions and competition. We also maintain excess funds in short-term, interest-bearing assets that provide additional liquidity. At March 31, 2010, our cash and cash equivalents amounted to $\$ 21.5$ million. In addition, our available for sale investment and mortgage-backed securities amounted to an aggregate of $\$ 67.0$ million at such date.

We use our liquidity to fund existing and future loan commitments, to fund maturing certificates of deposit and demand deposit withdrawals, to invest in other interest-earning assets, and to meet operating expenses. At March 31, 2010, the Company had $\$ 15.9$ million in outstanding commitments to originate fixed and variable-rate loans, not including loans in process. The Company also had commitments under unused lines of credit of $\$ 7.4$ million and letters of credit outstanding of $\$ 621,000$ at March 31, 2010. Certificates of deposit at March 31, 2010 maturing in one year or less totaled $\$ 166.2$ million. Based upon historical experience, we anticipate that a significant portion of the maturing certificates of deposit will be redeposited with us.

In addition to cash flows from loan and securities payments and prepayments as well as from sales of available for sale securities, we have significant borrowing capacity available to fund liquidity needs should the need arise. Our borrowings consist solely of advances from the Federal Home Loan Bank of Pittsburgh, of which we are a member. Under terms of the collateral agreement with the Federal Home Loan Bank, we pledge residential mortgage loans and mortgage-backed securities as well as our stock in the Federal Home Loan Bank as collateral for such advances. However, use of FHLB advances has been modest. At March 31, 2010, we had $\$ 13.6$ million in outstanding FHLB advances and had the ability to obtain an additional $\$ 141.0$ million in FHLB advances.

We anticipate that we will continue to have sufficient funds and alternative funding sources to meet our current commitments.

The following table summarizes the Company's and Bank's regulatory capital ratios as of March 31, 2010 and September 30, 2009 and compares them to current regulatory guidelines.
$\left.\begin{array}{ccc} & \text { To Be } \\ & & \text { Well } \\ & & \text { Capitalized } \\ & \text { Required for } \\ \text { Capital } & \text { Under Prompt } \\ \text { Corrective }\end{array}\right\}$

March 31, 2010:
Tier 1 capital (to average assets)
The Company
The Bank
10.66 \%
4.0
\% N/A
9.77 \%
4.0
5.0 \%

Tier 1 capital (to risk weighted assets)

The Company
The Bank
21.86 \% 4.0 \% $\%$
$4.0 \quad \% \quad 6.0$

Total capital (to risk weighted assets)

The Company
The Bank
22.84 \% 8.0 \% $\%$
20.99 \% $\quad 8.0 \quad \% \quad 10.0 \quad \%$

September 30, 2009:
Tier 1 capital (to average assets)
The Company
The Bank
10.86 \%
4.0

N/A
9.99 \%
4.0
5.0

Tier 1 capital (to risk weighted assets)

The Company
The Bank
24.59 \% 4.0 \% $\%$
22.61 \%
$4.0 \quad \% \quad 6.0$

Total capital (to risk weighted assets)

The Company
The Bank
25.79 \% 8.0 \% $\%$
23.81 \%
8.0
10.0 \%

## IMPACT OF INFLATION AND CHANGING PRICES

The financial statements, accompanying notes, and related financial data of the Company presented herein have been prepared in accordance with generally accepted accounting principles which require the measurement of financial position and operating results in terms of historical dollars, without considering changes in the relative purchasing power of money over time due to inflation.

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Unlike most industrial companies, substantially all of the assets and liabilities of a financial institution are monetary in nature. As a result, interest rates have a more significant impact on a financial institution's performance than the effects of general levels of inflation. Interest rates do not necessarily move in the same direction or in the same magnitude as the price of goods and services, since such prices are affected by inflation to a larger extent than interest rates. In the current interest rate environment, liquidity and the maturity structure of the Company's assets and liabilities are critical to the maintenance of acceptable performance levels.

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How We Manage Market Risk. Market risk is the risk of loss from adverse changes in market prices and rates. Our market risk arises primarily from the interest rate risk which is inherent in our lending, investment and deposit gathering activities. To that end, management actively monitors and manages interest rate risk exposure. In addition to market risk, our primary risk is credit risk on our loan portfolio. We attempt to manage credit risk through our loan underwriting and oversight policies.

The principal objective of our interest rate risk management function is to evaluate the interest rate risk embedded in certain balance sheet accounts, determine the level of risk appropriate given our business strategy, operating environment, capital and liquidity requirements and performance objectives, and manage the risk consistent with approved guidelines. We seek to manage our exposure to risks from changes in interest rates while at the same time trying to improve our net interest spread. We monitor interest rate risk as such risk relates to our operating strategies. We have established an Asset/Liability Committee which is comprised of our President and Chief Executive Officer, Chief Financial Officer, Chief Lending Officer, Treasurer and Controller. The Asset/Liability Committee meets on a regular basis and is responsible for reviewing our asset/liability policies and interest rate risk position. Both the extent and direction of shifts in interest rates are uncertainties that could have a negative impact on future earnings.

In recent years, we primarily have reduced our exposure in callable agency bonds and increased our portfolio of agency issued mortgage-backed securities. However, notwithstanding the foregoing steps, we remain subject to a significant level of interest rate risk in a low interest rate environment due to the high proportion of our loan portfolio that consists of fixed-rate loans as well as our decision to invest a significant amount of our assets in long-term, fixed-rate investment and mortgage-backed securities.

Gap Analysis. The matching of assets and liabilities may be analyzed by examining the extent to which such assets and liabilities are "interest rate sensitive" and by monitoring a Company's interest rate sensitivity "gap." An asset or liability is said to be interest rate sensitive within a specific time period if it will mature or reprice within that time period. The interest rate sensitivity gap is defined as the difference between the amount of interest-earning assets maturing or repricing within a specific time period and the amount of interest-bearing liabilities maturing or repricing within that same time period. A gap is considered positive when the amount of interest rate sensitive assets exceeds the amount of interest rate sensitive liabilities. A gap is considered negative when the amount of interest rate sensitive liabilities exceeds the amount of interest rate sensitive assets. During a period of rising interest rates, a negative gap would tend to affect adversely net interest income while a positive gap would tend to result in an increase in net interest income. Conversely, during a period of falling interest rates, a negative gap would tend to result in an increase in net interest income while a positive gap would tend to affect adversely net interest income.

The following table sets forth the amounts of our interest-earning assets and interest-bearing liabilities outstanding at March 31, 2010, which we expect, based upon certain assumptions, to reprice or mature in each of the future time periods shown (the "GAP Table"). Except as stated below, the amounts of assets and liabilities shown which reprice or mature during a particular period were determined in accordance with the earlier of term to repricing or the contractual maturity of the asset or liability. The table sets forth an approximation of the projected repricing of assets and liabilities at March 31, 2010, on the basis of contractual maturities, anticipated prepayments, and scheduled rate adjustments within a three-month period and subsequent selected time intervals. The loan amounts in the table reflect principal balances expected to be redeployed and/or repriced as a result of contractual amortization and anticipated prepayments of adjustable-rate loans and fixed-rate loans, and as a result of contractual rate adjustments on adjustable-rate loans. Annual prepayment rates for adjustable-rate and fixed-rate single-family and multi-family residential and commercial mortgage loans are assumed to range from $6.7 \%$ to $29.0 \%$. The annual prepayment rate for mortgage-backed securities is assumed to range from $0.5 \%$ to $80.0 \%$. Money market deposit accounts, savings accounts and interest-bearing checking accounts are assumed to have annual rates of withdrawal, or "decay rates," based on information from the FDIC. For savings accounts and checking accounts, the decay rates are $60 \%$ in one to three
years, $20 \%$ in three to five years and $20 \%$ in five to 10 years. For money market accounts, the decay rates are $50 \%$ in three to 12 months and $50 \%$ in 13 to 36 months.

(1) Interest-earning assets are included in the period in which the balances are expected to be redeployed and/or repriced as a result of anticipated prepayments, scheduled rate adjustments and contractual maturities.
(2) For purposes of the gap analysis, investment securities are stated at amortized cost.
(3) For purposes of the gap analysis, loans receivable includes non-performing loans and is gross of the allowance for loan losses and unamortized deferred loan fees, but net of the undisbursed portion of loans-in-process.
(4) Includes FHLB stock.
(5) Cumulative interest-rate sensitivity gap represents the difference between interest-earning assets and interest-bearing liabilities.

Certain shortcomings are inherent in the method of analysis presented in the foregoing table. For example, although certain assets and liabilities may have similar maturities or periods to repricing, they may react in different degrees to changes in market interest rates. Also, the interest rates on certain types of assets and liabilities may fluctuate in advance of changes in market interest rates, while interest rates on other types may lag behind changes in market rates. Additionally, certain assets, such as adjustable-rate loans, have features which restrict changes in interest rates both on a short-term basis and over the life of the asset. Further, in the event of a change in interest rates, prepayment and early withdrawal levels would likely deviate significantly from those assumed in calculating the table. Finally, the ability of many borrowers to service their adjustable-rate loans may be adversely affected in the event of an interest rate increase.

Net Portfolio Value Analysis. Our interest rate sensitivity also is monitored by management through the use of a model which generates estimates of the changes in our net portfolio value ("NPV") over a range of interest rate scenarios. NPV is the present value of expected cash flows from assets, liabilities and off-balance sheet contracts. The NPV ratio, under any interest rate scenario, is defined as the NPV in that scenario divided by the market value of assets in the same scenario. The "Sensitivity Measure" is the decline in the NPV ratio, in basis points, caused by a $2 \%$ increase or decrease in rates, whichever produces a larger decline. The following table sets forth our NPV as of March 31, 2010 and reflects the changes to NPV as a result of immediate and sustained changes in interest rates as indicated.

| Change in Interest Rates In Basis Points | Net Portfolio Value |  |  | \% Change | NPV as \% of Portfolio Value of Assets |  |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: |
|  |  |  |  |  |  |
| (Rate Shock) | Amount | \$ Change |  |  | NPV <br> Ratio | Change |
| (Dollars in Thousands) |  |  |  |  |  |  |
| 300 | \$ 15,266 | \$ | $(47,306)$ |  | (75.60)\% | 3.40 \% | (8.73)\% |
| 200 | 29,620 |  | $(32,952)$ | (52.66)\% | 6.30 \% | (5.83)\% |
| 100 | 46,666 |  | $(15,906)$ | (25.42)\% | 9.46 \% | (2.67 )\% |
| Static | 62,572 |  | - | - | 12.13 \% | - |
| (100) | 68,222 |  | 5,650 | 9.03 \% | 12.92 \% | 0.79 \% |
| (200) | 71,703 |  | 9,131 | 14.59 \% | 13.39 \% | 1.26 \% |
| (300) | 76,502 |  | 13,930 | 22.26 \% | 14.12 \% | 1.99 \% |

At March 31, 2010, the Company's NPV was $\$ 62.6$ million or $12.13 \%$ of the market value of assets. Following a 200 basis point increase in interest rates, the Company's "post shock" NPV would be $\$ 29.6$ million or $6.30 \%$ of the market value of assets. The change in the NPV ratio or Company's sensitivity measure was a decline of 583 basis points.

As is the case with the GAP Table, certain shortcomings are inherent in the methodology used in the above interest rate risk measurements. Modeling changes in NPV requires the making of certain assumptions which may or may not reflect the manner in which actual yields and costs respond to changes in market interest rates. In this regard, the models presented assume that the composition of our interest sensitive assets and liabilities existing at the beginning of a period remains constant over the period being measured and also assumes that a particular change in interest rates is reflected uniformly across the yield curve regardless of the duration to maturity or repricing of specific assets and liabilities. Accordingly, although the NPV model provides an indication of interest rate risk exposure at a particular point in time, such model is not intended to and does not provide a precise forecast of the effect of changes in market interest rates on net interest income and will differ from actual results.

## ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Not applicable.

## ITEM 4T. CONTROLS AND PROCEDURES

Our management evaluated, with the participation of our Chief Executive Officer and Chief Financial Officer, the effectiveness of our disclosure controls and procedures (as defined in Rule 13a-15(e) or 15d-15(e) under the Securities Exchange Act of 1934) as of the end of the period covered by this report. Based on such evaluation, our Chief Executive Officer and Chief Financial Officer have concluded that our disclosure controls and procedures are designed to ensure that information required to be disclosed by us in the reports that we file or submit under the Securities Exchange Act of 1934 is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and regulations and are operating in an effective manner.

No change in our internal control over financial reporting (as defined in Rule 13a-15(f) or 15d-15(f) under the Securities Exchange Act of 1934) occurred during the most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

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## PART II

Item 1. Legal Proceedings
No material changes in the matters previously disclosed in Item 3 of the Company's Annual Report on Form 10-K for the year ended September 30, 2009 has occurred.

The Company is involved in various legal proceedings occurring in the ordinary course of business. Management of the Company, based on discussions with litigation counsel, does not believe that such proceedings will have a material adverse effect on the financial condition or operations of the Company. There can be no assurance that any of the outstanding legal proceedings to which the Company is a party will not be decided adversely to the Company's interests and have a material adverse effect on the financial condition and operations of the Company.

Item 1A. Risk Factors
Not applicable
Item 2. Unregistered Sales of Equity Securities and Use of Proceeds
(a) Not applicable
(b) Not applicable
(c) The Company's repurchases of its common stock made during the quarter are set forth in the following table:


Notes to the table:
(1) The seventh stock repurchase program was completed during February 2010.
(2) Reflects privately negotiated repurchase of shares from Stilwell Value Partners I.

Item 3. Defaults Upon Senior Securities
Not applicable
Item 4. (Removed and Reserved)
Item 5. Other Information
Not applicable
Item 6. Exhibits
Exhibit
No.
31.1 Rule 13a-14(a)/15d-14(a) Certification of Chief Executive Officer
31.2 Rule 13a-14(a)/15d-14(a) Certification of Chief Financial Officer
32.0 Section 1350 Certifications

## 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.

PRUDENTIAL BANCORP, INC. OF PENNSYLVANIA
Date: May 17, 2010
By: /s/ Thomas A. Vento
Thomas A. Vento
President and Chief Executive Officer
Date: May 17, 2010
By: /s/ Joseph R. Corrato
Joseph R. Corrato
Executive Vice President and Chief Financial Officer


[^0]:    Excess tax benefit 3131 from stock

