LAKE SHORE BANCORP, INC.
Form 10-Q
November 13, 2018

United States
Securities and Exchange Commission
Washington, D.C. 20549
FORM 10-Q
(Mark One)

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

For the quarterly period ended September 30, 2018

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

Commission File No.: 000-51821

LAKE SHORE BANCORP, INC.
(Exact name of registrant as specified in its charter)

United States	20-4729288
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification Number)
31 East Fourth Street, Dunkirk, New York	14048

(Address(Zip code)
of
principal
executive
offices)

(716) 366-4070
(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, and (2) has been subject to such filing requirements for the past 90 days.

Yes [X]No [ ]

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

Yes [X]No [ ]

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

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

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act.

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

Yes [ ] No [X]

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

There were 6,019,919 shares of the registrant's common stock, $0.01 par value per share, outstanding at November 8, 2018.

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PART I Financial Information

Item 1. Financial Statements

Lake Shore Bancorp, Inc. and Subsidiary

Consolidated Statements of Financial Condition

	September 30, 2018 (Unaudited)	December 31, 2017
	(Dollars in thousands, except share data)	
Assets		
Cash and due from banks	$ 7,792	$ 7,709
Interest earning deposits	2,459	6,570
Federal funds sold	27,818	26,634
Cash and Cash Equivalents	38,069	40,913
Securities available for sale	83,147	80,421
Federal Home Loan Bank stock, at cost	1,545	1,631
Loans receivable, net of allowance for loan losses 2018 $3,388; 2017 $3,283	388,437	365,063
Premises and equipment, net	9,383	9,373
Accrued interest receivable	2,044	1,801
Bank owned life insurance	20,100	18,077
Other assets	3,428	1,698
Total Assets	$ 546,153	$ 518,977
Liabilities and Stockholders' Equity		
Liabilities		
Deposits:		
Interest bearing	$ 376,892	$ 350,535
Non-interest bearing	59,009	54,618
Total Deposits	435,901	405,153
Long-term debt	24,650	26,950
Advances from borrowers for taxes and insurance	1,625	3,000
Other liabilities	5,176	5,499
Total Liabilities	$ 467,352	$ 440,602
Stockholders' Equity		
Common stock, $0.01 par value per share, 25,000,000 shares authorized; 6,827,741 shares issued and 6,046,819 shares outstanding at September 30, 2018 and 6,827,741 shares issued and 6,098,323 shares outstanding at December 31, 2017	$ 68	$ 68

Additional paid-in capital	30,870	30,719
Treasury stock, at cost (780,922 shares at September 30, 2018 and 729,418 shares at December 31, 2017)	(8,137)	(7,309)
Unearned shares held by ESOP	(1,471)	(1,535)
Unearned shares held by compensation plans	(273)	(540)
Retained earnings	58,339	56,181
Accumulated other comprehensive (loss) income	(595)	791
Total Stockholders' Equity	78,801	78,375
Total Liabilities and Stockholders' Equity	$ 546,153	$ 518,977

See notes to consolidated financial statements.

Lake Shore Bancorp, Inc. and Subsidiary

Consolidated Statements of Income

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2018	2017	2018	2017
	(Unaudited) (Dollars in thousands, except per share data)			
Interest Income				
Loans, including fees	$ 4,663	$ 4,289	$ 13,480	$ 12,456
Investment securities, taxable	267	189	753	597
Investment securities, tax-exempt	403	388	1,193	1,259
Other	157	81	439	167
Total Interest Income	5,490	4,947	15,865	14,479
Interest Expense				
Deposits	783	523	2,101	1,499
Long-term debt	134	139	413	328
Other	38	20	77	62
Total Interest Expense	955	682	2,591	1,889
Net Interest Income	4,535	4,265	13,274	12,590
Provision for Loan Losses	125	75	315	450
Net Interest Income after Provision for Loan Losses	4,410	4,190	12,959	12,140
Non-Interest Income				
Service charges and fees	457	441	1,371	1,353
Earnings on bank owned life insurance	103	91	273	268
Unrealized (loss) gain on equity securities	(5)	-	9	-
Recovery on previously impaired investment securities	34	25	124	96
Gain on sale of securities available for sale	-	22	-	244
Net gain on sale of loans	4	1	10	10
Other	36	37	89	83
Total Non-Interest Income	629	617	1,876	2,054
Non-Interest Expenses				
Salaries and employee benefits	2,083	1,898	6,182	5,610
Occupancy and equipment	587	565	1,735	1,740
Data processing	337	320	1,000	937
Professional services	237	231	716	703
Advertising	151	127	473	439
Postage and supplies	71	53	189	197
FDIC Insurance	40	38	114	111
Other	331	381	968	955
Total Non-Interest Expenses	3,837	3,613	11,377	10,692
Income before Income Taxes	1,202	1,194	3,458	3,502
Income Tax Expense	144	254	458	704
Net Income	$ 1,058	$ 940	$ 3,000	$ 2,798
Basic and diluted earnings per common share	$ 0.17	$ 0.15	$ 0.49	$ 0.46
Dividends declared per share	$ 0.10	$ 0.08	$ 0.30	$ 0.24

See notes to consolidated financial statements.

Lake Shore Bancorp, Inc. and Subsidiary

Consolidated Statements of Comprehensive Income

	Three Months Ended September 30,	
	2018	2017
	(Unaudited) (Dollars in thousands)	
Net Income	$ 1,058	940
Other Comprehensive Loss, net of tax benefit:		
Unrealized holding losses on securities available for sale, net of tax benefit	(467)	(60)
Reclassification adjustments related to:		
Recovery on previously impaired investment securities included in net income, net of tax expense	(27)	(16)
Net gain on sale of securities included in net income, net of tax expense	-	(15)
Total Other Comprehensive Loss	(494)	(91)
Total Comprehensive Income	$ 564	$ 849

	Nine Months Ended September 30,	
	2018	2017
	(Unaudited) (Dollars in thousands)	
Net Income	$ 3,000	$ 2,798
Other Comprehensive Loss, net of tax benefit:		
Unrealized holding losses on securities available for sale, net of tax benefit	(1,444)	(34)
Reclassification adjustments related to:		
Recovery on previously impaired investment securities included in net income, net of tax expense	(98)	(63)
Net gain on sale of securities included in net income, net of tax expense	-	(161)
Total Other Comprehensive Loss	(1,542)	(258)
Total Comprehensive Income	$ 1,458	$ 2,540

See notes to consolidated financial statements.

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Lake Shore Bancorp, Inc. and Subsidiary

Consolidated Statements of Stockholders' Equity

Nine Months Ended September 30, 2018 and 2017 (Unaudited)

	Common Stock	Additional Paid-In Capital	Treasury Stock	Unearned Shares Held by ESOP	Unearned Shares Held by Compensation Plans	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Total
	(Dollars in thousands, except share and per share data)							
Balance - January 1, 2017	$ 68	$ 30,532	$ (7,300)	$ (1,620)	$ (578)	$ 53,546	$ 1,382	$ 76,030
Net income	-	-	-	-	-	2,798	-	2,798
Other comprehensive loss, net of tax benefit of $133	-	-	-	-	-	-	(258)	(258)
ESOP shares earned (5,951 shares)	-	30	-	64	-	-	-	94
Stock based compensation	-	33	-	-	-	-	-	33
Compensation plan shares granted (27,348 shares)	-	-	270	-	(270)	-	-	-
Compensation plan shares forfeited (1,104 shares)	-	-	(10)	-	10	-	-	-
Compensation plan shares earned (20,569 shares)	-	72	-	-	220	-	-	292
Purchase of treasury stock, at cost (17,100 shares)	-	-	(269)	-	-	-	-	(269)
Cash dividends declared ($0.24 per share)	-	-	-	-	-	(559)	-	(559)
Balance - September 30, 2017	$ 68	$ 30,667	$ (7,309)	$ (1,556)	$ (618)	$ 55,785	$ 1,124	$ 78,161
Balance - January 1, 2018	$ 68	$ 30,719	$ (7,309)	$ (1,535)	$ (540)	$ 56,181	$ 791	$ 78,375
Net income	-	-	-	-	-	3,000	-	3,000
Other comprehensive loss, net of tax benefit of $410	-	-	-	-	-	-	(1,542)	(1,542)

Reclassification of the Income Tax Effects of the Tax Cuts and Jobs Act from AOCI	-	-	-	-	-	(156)	156	-
ESOP shares earned (5,951 shares)	-	36	-	64	-	-	-	100
Stock based compensation	-	33	-	-	-	-	-	33
Compensation plan shares granted (5,329 shares)	-	-	51	-	(51)	-	-	-
Compensation plan shares forfeited (10,433 shares)	-	-	(99)	-	93	-	-	(6)
Compensation plan shares earned (21,366 shares)	-	82	-	-	225	-	-	307
Purchase of treasury stock, at cost (46,400 shares)	-	-	(780)	-	-	-	-	(780)
Cash dividends declared ($0.30 per share)	-	-	-	-	-	(686)	-	(686)
Balance - September 30, 2018	$ 68	$ 30,870	$ (8,137)	$ (1,471)	$ (273)	$ 58,339	$ (595)	$ 78,801

See notes to consolidated financial statements.

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Lake Shore Bancorp, Inc. and Subsidiary

Consolidated Statements of Cash Flows

	Nine Months Ended September 30,	
	2018	2017
	(Unaudited)	
	(Dollars in thousands)	
CASH FLOWS FROM OPERATING ACTIVITIES		
Net income	$ 3,000	$ 2,798
Adjustments to reconcile net income to net cash provided by operating activities:		
Net amortization of investment securities	66	88
Net amortization of deferred loan costs	423	425
Provision for loan losses	315	450
Recovery on previously impaired investment securities	(124)	(96)
Unrealized gain on equity securities	(9)	-
Gain on sale of investment securities	-	(244)
Originations of loans held for sale	(777)	(796)
Proceeds from sales of loans held for sale	787	806
Gain on sale of loans	(10)	(10)
Depreciation and amortization	579	648
Increase in bank owned life insurance, net	(273)	(268)
ESOP shares committed to be released	100	94
Stock based compensation expense	334	325
Increase in accrued interest receivable	(243)	(234)
(Increase) decrease in other assets	(6)	161
Decrease in other liabilities	(323)	(99)
Net Cash Provided by Operating Activities	3,839	4,048
CASH FLOWS FROM INVESTING ACTIVITIES		
Activity in available for sale securities:		
Sales	-	6,510
Maturities, prepayments and calls	6,215	8,980
Purchases	(10,826)	(2,402)
Purchases of Federal Home Loan Bank Stock	(20)	(375)
Redemptions of Federal Home Loan Bank Stock	106	84
Loan origination and principal collections, net	(25,426)	(37,384)
Additions to premises and equipment	(589)	(1,294)
Purchase of bank owned life insurance	(1,750)	-
Net Cash Used in Investing Activities	(32,290)	(25,881)
CASH FLOWS FROM FINANCING ACTIVITIES		
Net increase in deposits	30,748	15,030
Net decrease in advances from borrowers for taxes and insurance	(1,375)	(1,475)
Proceeds from issuance of long-term debt	1,500	9,700
Repayment of long-term debt	(3,800)	(1,700)
Purchase of treasury stock	(780)	(269)
Cash dividends paid	(686)	(559)
Net Cash Provided by Financing Activities	25,607	20,727
Net Decrease in Cash and Cash Equivalents	(2,844)	(1,106)
CASH AND CASH EQUIVALENTS - BEGINNING	40,913	45,479

CASH AND CASH EQUIVALENTS - ENDING	$ 38,069	$ 44,373
SUPPLEMENTARY CASH FLOWS INFORMATION		
Interest paid	$ 2,564	$ 1,869
Income taxes paid	$ 477	$ 750
SUPPLEMENTARY SCHEDULE OF NONCASH INVESTING ACTIVITIES		
Foreclosed real estate acquired in settlement of loans	$ 1,495	$ 554

See notes to consolidated financial statements.

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Lake Shore Bancorp, Inc. and Subsidiary

Notes to Consolidated Financial Statements (Unaudited)

Note 1 – Basis of Presentation

The interim consolidated financial statements include the accounts of Lake Shore Bancorp, Inc. (the "Company", "us", "our", or "we") and Lake Shore Savings Bank (the "Bank"), its wholly owned subsidiary. All intercompany accounts and transactions of the consolidated subsidiary have been eliminated in consolidation.

The interim consolidated financial statements included herein as of September 30, 2018 and for the three and nine months ended September 30, 2018 and 2017 have been prepared by the Company, without audit, pursuant to the rules and regulations of the Securities and Exchange Commission, and therefore, do not include all information or footnotes necessary for a complete presentation of the consolidated statements of financial condition, results of operations and cash flows in conformity with accounting principles generally accepted in the United States of America ("GAAP"). The consolidated statement of financial condition at December 31, 2017 has been derived from the audited consolidated financial statements at that date, but does not include all of the information and footnotes required by GAAP for complete consolidated financial statements. The consolidated financial statements reflect all adjustments that are, in the opinion of management, necessary for a fair statement of such information and to make the financial statements not misleading. These interim consolidated financial statements should be read in conjunction with the consolidated financial statements and notes thereto included in the audited consolidated financial statements included in the Company's Annual Report on Form 10-K for the year ended December 31, 2017. The consolidated statements of income for the three and nine months ended September 30, 2018 are not necessarily indicative of the results for any subsequent period or the entire year ending December 31, 2018.

To prepare these consolidated financial statements in conformity with GAAP, management of the Company made a number of estimates and assumptions relating to the reporting of assets and liabilities and the reporting of revenue and expenses. Actual results could differ from those estimates. Material estimates that are particularly susceptible to significant change in the near term relate to the determination of the allowance for loan losses, securities valuation estimates, evaluation of impairment of securities and income taxes.

The Company has evaluated events and transactions occurring subsequent to the statement of financial condition as of September 30, 2018 for items that should potentially be recognized or disclosed in these consolidated financial statements. The evaluation was conducted through the date these consolidated financial statements were issued.

Note 2 – New Accounting Standards

The Company adopted Financial Accounting Standards Board ("FASB") Accounting Standards Update ("ASU") 2018-02, "Income Statement – Reporting Comprehensive Income (Topic 220): Reclassification of Certain Tax Effects from Accumulated Other Comprehensive Income" (ASU 2018-02) on January 1, 2018. ASU 2018-02 was issued to address the income tax accounting treatment of the stranded tax effects within other comprehensive income. This issue came about from the enactment of the Tax Cuts and Jobs Act (the "Tax Act") on December 22, 2017 that changed the Company's tax rate from 34% to 21%. ASU 2018-02 allows an entity to elect a reclassification from accumulated other comprehensive income ("AOCI") to retained earnings for stranded tax effects resulting from the Tax Act. The amount of that reclassification should include the effect of tax rate changes on the deferred tax amount, any related valuation allowance and other income tax effects on the items in AOCI. Upon adoption of ASU 2018-02, the Company reclassified the income tax effect of the Tax Act from AOCI to retained earnings. The reclassification increased AOCI and decreased retained earnings by $156,000, with zero net effect on total shareholders' equity. The Company uses the individual security approach for all available for sale securities when releasing income tax effects remaining in AOCI.

In July 2018, the FASB issued ASU 2018-11 "Leases (Topic 842): Targeted Improvements" ("ASU 2018-11"). ASU 2018-11 makes targeted improvements in order to provide relief to an entity's costs to implement certain aspects of ASU 2016-02 "Leases" (Topic 842)" ("ASU 2016-02"). ASU 2018-11 allows lessors to combine lease and associated non-lease components by class of underlying asset in contracts that meet certain criteria. For a lessor to qualify for this practical expedient, the lease and related non-lease components must have the same timing and pattern of transfer, and the lease component, if accounted for on a stand-alone basis, would be classified as an operating lease. ASU 2018-11 also provides entities with an optional transition method that allows entities to recognize a cumulative-effect adjustment to the opening balance of retained earnings in the ASU 2016-02 adoption period. This method eliminates the requirement for entities to restate the comparative periods presented to comply with ASU 2016-02. For public companies, this update will be effective for interim and annual periods beginning after December 15, 2018, and is to be applied on a modified retrospective basis. The amount of assets and liabilities to be added to the balance sheet under ASU 2016-02 and ASU 2018-11 are not expected to have a material impact on the Company's consolidated financial statements per preliminary estimates.

In August 2018, the FASB issued ASU 2018-13 "Fair Value Measurement" (Topic 820): Disclosure Framework—Changes to the Disclosure Requirements for Fair Value Measurement" ("ASU 2018-13"). ASU 2018-13 clarifies the fair value measurement disclosure requirements of Accounting Standards Codification ("ASC") 820 by adding, eliminating and modifying certain disclosure requirements. The amendments in ASU 2018-13 are effective for all entities for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2019. This update is not expected to have a material effect on the Company's consolidated financial statements.

In June 2016, the FASB issued ASU 2016-13, "Financial Instruments – Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments" (ASU 2016-13). ASU 2016-13 requires credit losses on most financial assets measured at amortized cost and certain other instruments to be measured using an expected credit loss model (referred to as the current expected credit loss ("CECL") model). Under the CECL model entities will estimate credit losses over the entire contractual term of the instrument (considering estimated prepayments, but not expected extensions or modifications unless reasonable expectation of a troubled debt restructuring exists) from the date of initial recognition of that instrument. Further, ASU 2016-13 made certain targeted amendments to the existing impairment for available for sale ("AFS") debt securities. For an AFS debt security for which there is neither the intent nor a more-likely-than-not requirement to sell, an entity will record credit losses as an allowance rather than a write-down of the amortized cost basis. ASU 2016-13 is effective for public business entities that are U.S. Securities and Exchange Commission ("SEC") filers for fiscal periods beginning after December 15, 2019, including interim reporting periods within those periods. An entity will apply the amendments in ASU 2016-13 through a cumulative-effect adjustment to retained earnings as of the beginning of the first reporting period in which the guidance is effective. We are currently assessing the potential impact on our consolidated financial statements; however, due to the significant differences in the revised guidance from existing GAAP, the implementation of this guidance may result in material changes in our accounting for credit losses on financial instruments. We are also reviewing the impact of additional disclosures required under ASU 2016-13 on our ongoing financial reporting. Alternative methodologies are being considered, data requirements and integrity are being reviewed and enhancements to the current process are being considered. The Company is continuing to evaluate and implement this guidance.

Note 3 – Investment Securities

Debt Securities

The amortized cost and fair value of securities are as follows:

	September 30, 2018			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
	(Dollars in thousands)			
SECURITIES AVAILABLE FOR SALE:				
Debt Securities				
U.S. Government Agencies	$ 2,012	$ -	$ (123)	$ 1,889
Municipal bonds	46,174	522	(265)	46,431
Mortgage-backed securities:				
Collateralized mortgage obligations-private label	27	-	-	27
Collateralized mortgage obligations-government sponsored entities	31,626	4	(1,165)	30,465
Government National Mortgage Association	196	6	-	202
Federal National Mortgage Association	2,477	28	(37)	2,468
Federal Home Loan Mortgage Corporation	1,314	13	(29)	1,298
Asset-backed securities-private label	-	291	-	291
Asset-backed securities-government sponsored entities	44	1	-	45
Total Debt Securities	$ 83,870	$ 865	$ (1,619)	$ 83,116
Equity Securities	22	9	-	31
Total Securities Available for Sale	$ 83,892	$ 874	$ (1,619)	$ 83,147

	December 31, 2017			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
	(Dollars in thousands)			
SECURITIES AVAILABLE FOR SALE:				
Debt Securities				
U.S. Government Agencies	$ 2,013	$ -	$ (26)	$ 1,987
Municipal bonds	44,256	1,312	(6)	45,562
Mortgage-backed securities:				
Collateralized mortgage obligations-private label	30	-	-	30
Collateralized mortgage obligations-government sponsored entities	28,195	28	(569)	27,654
Government National Mortgage Association	229	16	-	245
Federal National Mortgage Association	2,834	95	-	2,929
Federal Home Loan Mortgage Corporation	1,518	35	-	1,553
Asset-backed securities-private label	69	276	(1)	344
Asset-backed securities-government sponsored entities	57	3	-	60
Total Debt Securities	$ 79,201	$ 1,765	$ (602)	$ 80,364
Equity Securities	22	35	-	57
Total Securities Available for Sale	$ 79,223	$ 1,800	$ (602)	$ 80,421

Debt Securities

All of our collateralized mortgage obligations are backed by one- to four-family residential mortgages.

At September 30, 2018, thirty-two municipal bonds with a cost of $11.0 million and fair value of $11.1 million were pledged under a collateral agreement with the Federal Reserve Bank (“FRB”) of New York for liquidity borrowing. At December 31, 2017, thirty-three municipal bonds with a cost of $11.3 million and fair value of $11.7 million were pledged with the FRB. In addition, at September 30, 2018, twenty-one municipal bonds with a cost and fair value of $5.6 million were pledged as collateral for customer deposits in excess of the Federal Deposit Insurance Corporation (“FDIC”) insurance limits. At December 31, 2017, twenty municipal bonds with a cost of $5.1 million and fair value of $5.3 million were pledged as collateral for customer deposits in excess of the FDIC insurance limits.

The following table sets forth the Company’s investment in debt securities available for sale with gross unrealized losses of less than twelve months and gross unrealized losses of twelve months or more and associated fair values as of the dates indicated:

	Less than 12 months		12 months or more		Total	
	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses
	(Dollars in thousands)					
September 30, 2018						
U.S. Government Agencies	$ 1,889	$ (123)	$ -	$ -	$ 1,889	$ (123)
Municipal bonds	8,057	(255)	554	(10)	8,611	(265)
Mortgage-backed securities	15,304	(326)	17,068	(905)	32,372	(1,231)
	$ 25,250	$ (704)	$ 17,622	$ (915)	$ 42,872	$ (1,619)

December 31, 2017						
U.S. Government Agencies	$ 1,987	$ (26)	$ -	$ -	$ 1,987	$ (26)
Municipal bonds	491	(6)	-	-	491	(6)
Mortgage-backed securities	7,547	(57)	17,602	(512)	25,149	(569)
Asset-backed securities -private label	68	(1)	-	-	68	(1)
	$ 10,093	$ (90)	$ 17,602	$ (512)	$ 27,695	$ (602)

The Company reviews all investment securities on an ongoing basis for the presence of other-than-temporary impairment (“OTTI”) with formal reviews performed quarterly.

At September 30, 2018, the Company’s investment portfolio included several debt securities in the “unrealized losses less than twelve months” category. The debt securities were not evaluated further for OTTI as the unrealized losses on the individual debt securities were less than 20% of book value, which management deemed to be immaterial, the securities were issued by government sponsored enterprises and management has the intent and ability to hold these securities.

At September 30, 2018, the Company had several debt securities in the “unrealized losses twelve months or more” category. These securities were not evaluated further for OTTI, as the unrealized losses were less than 20% of book value and management has the intent and ability to hold until maturity. Management believes the temporary impairments were due to declines in fair value resulting from changes in interest rates and/or increased credit liquidity spreads since the securities were purchased.

Management completed an OTTI analysis for two private label asset-backed securities, which did not have unrealized losses as of September 30, 2018. Management concluded that there was a limited risk of principal losses for these securities and that additional OTTI charges were not required as of September 30, 2018 on these securities.

The unrealized losses on debt securities shown in the previous tables were recorded as a component of other comprehensive loss, net of tax benefit on the Company’s Consolidated Statements of Stockholders’ Equity.

The following table presents a summary of the credit-related OTTI charges recognized as components of income:

	For The Nine Months Ended September 30,	
	2018	2017
	(Dollars in thousands)	
Beginning balance	$ 435	$ 554
Additions:		
Credit loss not previously recognized	-	-
Reductions:		
Losses realized during the period on OTTI previously recognized	-	-
Receipt of cash flows on previously recorded OTTI	(67)	(96)
Ending balance	$ 368	$ 458

A deterioration in credit quality and/or other factors that may limit the liquidity of a security in our portfolio might adversely affect the fair values of the Company's investment portfolio and may increase the potential that certain unrealized losses will be designated as "other-than-temporary" and that the Company may incur additional write-downs in future periods.

During the nine months ended September 30, 2018, the Company did not sell any available for sale debt securities. During the nine months ended September 30, 2017, the Company sold eighteen municipal bonds for total proceeds of $6.5 million resulting in realized gains of $244,000.

Equity Securities

At September 30, 2018 and December 31, 2017, available for sale equity securities consisted of 22,368 shares of Federal Home Loan Mortgage Corporation ("FHLMC") common stock. During the nine months ended September 30, 2018, the Company recognized an unrealized gain of $9,000 on the equity securities, which was recorded in noninterest income in the consolidated statements of income. There were no sales of equity securities during the nine months ended September 30, 2018.

Scheduled contractual maturities of available for sale securities are as follows:

	Amortized Cost	Fair Value

	(Dollars in thousands)	
September 30, 2018:		
After one year through five years	$ 5,472	$ 5,570
After five years through ten years	24,450	24,772
After ten years	18,264	17,978
Mortgage-backed securities	35,640	34,460
Asset-backed securities	44	336
Equity securities	22	31
	$ 83,892	$ 83,147

Note 4 - Allowance for Loan Losses

Management segregates the loan portfolio into loan types and analyzes the risk level for each loan type when determining its allowance for loan losses. The loan types are as follows:

Real Estate Loans:

- One- to Four-Family – are loans secured by first lien collateral on residential real estate primarily held in the Western New York region. These loans can be affected by economic conditions and the value of underlying properties. Western New York's housing market has consistently demonstrated stability in home prices despite economic conditions. Furthermore, the Company has conservative underwriting standards and its residential lending policies and procedures ensure that its one- to four-family residential mortgage loans generally conform to secondary market guidelines.
- Home Equity - are loans or lines of credit secured by first or second liens on owner-occupied residential real estate primarily held in the Western New York region. These loans can also be affected by economic conditions and the values of underlying properties. Home equity loans may have increased risk of loss if the Company does not hold the first mortgage resulting in the Company being in a secondary position in the event of collateral liquidation. The Company does not originate interest only home equity loans.
- Commercial Real Estate – are loans used to finance the purchase of real property, which generally consists of developed real estate that is held as first lien collateral for the loan. These loans are secured by real estate properties that are primarily held in the Western New York region. Commercial real estate lending involves additional risks compared with one- to four-family residential lending, because payments on loans secured by commercial real estate properties are often dependent on the successful operation or management of the properties, and/or the collateral value of the commercial real estate securing the loan, and repayment of such loans may be subject to adverse conditions in the real estate market or economic conditions to a greater extent than one- to four-family residential mortgage loans. Also, commercial real estate loans typically involve relatively large loan balances concentrated with single borrowers or groups of related borrowers.
- Construction – are loans to finance the construction of either one- to four-family owner occupied homes or commercial real estate. At the end of the construction period, the loan automatically converts to either a one- to four-family or commercial mortgage, as applicable. Risk of loss on a construction loan depends largely upon the accuracy of the initial estimate of the value of the property at completion compared to the actual cost of construction. The Company limits its risk during construction as disbursements are not made until the required work for each advance has been completed and an updated lien search is performed. The completion of the construction progress is verified by a Company loan officer or inspections performed by an independent appraisal firm. Construction loans also expose us to the risk of construction delays which may impair the borrower's ability to repay the loan.

Other Loans:

- Commercial – includes business installment loans, lines of credit, and other commercial loans. Most of our commercial loans have fixed interest rates, and are for terms generally not in excess of 5 years. Whenever possible, we collateralize these loans with a lien on business assets and equipment and require the personal guarantees from principals of the borrower. Commercial loans generally involve a higher degree of credit risk because the collateral underlying the loans may be in the form of intangible assets and/or inventory subject to market obsolescence. Commercial loans can also involve relatively large loan balances to a single borrower or groups of related borrowers, with the repayment of such loans typically dependent on the successful operation of the commercial business and the income stream of the borrower. Such risks can be significantly affected by economic conditions. Although commercial loans may be collateralized by equipment or other business assets, the liquidation of collateral in the event of a borrower default may be an insufficient source of repayment because the equipment or other business assets may be obsolete or of limited use, among other things. Accordingly, the repayment of a commercial loan depends primarily on the credit worthiness of the borrowers (and any guarantors), while liquidation of collateral is a secondary and often insufficient source of repayment.
- Consumer – consist of loans secured by collateral such as an automobile or a deposit account, unsecured loans and lines of credit. Consumer loans tend to have a higher credit risk due to the loans being either unsecured or secured by rapidly depreciable assets. Furthermore, consumer loan payments are dependent on the borrower's continuing financial stability, and therefore are more likely to be adversely affected by job loss, divorce, illness or personal

bankruptcy.

The allowance for loan losses is a valuation account that reflects the Company’s evaluation of the losses inherent in its loan portfolio. In order to determine the adequacy of the allowance for loan losses, the Company estimates losses by loan type using historical loss factors, as well as other environmental factors, such as trends in loan volume and loan type, loan concentrations, changes in the experience, ability and depth of the Company’s lending management, and national and local economic conditions. The Company's determination as to the classification of loans and the amount of loss allowances are subject to review by bank regulators, which can require the establishment of additional loss allowances.

The Company also reviews all loans on which the collectability of principal may not be reasonably assured, by reviewing payment status, financial conditions and estimated value of loan collateral. These loans are assigned an internal loan grade, and the Company assigns an amount of loss allowances to these classified loans based on loan grade.

Although the allocations noted below are by loan type, the allowance for loan losses is general in nature and is available to offset losses from any loan in the Company’s portfolio. The unallocated component of the allowance for loan losses reflects the margin of imprecision inherent in the underlying assumptions used in the methodologies for existing specific and general losses in the portfolio.

The following tables summarize the activity in the allowance for loan losses for the three and nine months ended September 30, 2018 and 2017 and the distribution of the allowance for loan losses and loans receivable by loan portfolio class and impairment method as of September 30, 2018 and December 31, 2017:

	Real Estate Loans				Other Loans			
	One- to Four-Family (2)	Home Equity	Commercial	Construction - Commercial	Commercial	Consumer	Unallocated	Total
	(Dollars in thousands)							
September 30, 2018								
Allowance for Loan Losses:								
Balance – July 1, 2018	$ 440	$ 86	$ 1,887	$ 329	$ 658	$ 30	$ 44	$ 3,474
Charge-offs	(23)	-	(181)	-	-	(9)	-	(213)
Recoveries	-	-	-	-	-	2	-	2
Provision (Credit)	18	2	249	(80)	(48)	2	(18)	125
Balance – September 30, 2018	$ 435	$ 88	$ 1,955	$ 249	$ 610	$ 25	$ 26	$ 3,388
Balance – January 1, 2018	$ 511	$ 122	$ 1,663	$ 347	$ 544	$ 35	$ 61	$ 3,283
Charge-offs	(23)	-	(181)	-	-	(32)	-	(236)
Recoveries	18	1	-	-	1	6	-	26
Provision (Credit)	(71)	(35)	473	(98)	65	16	(35)	315
Balance – September 30, 2018	$ 435	$ 88	$ 1,955	$ 249	$ 610	$ 25	$ 26	$ 3,388
Ending balance: individually evaluated for impairment	$ -	$ -	$ 30	$ -	$ -	$ -	$ -	$ 30
Ending balance: collectively evaluated for impairment	$ 435	$ 88	$ 1,925	$ 249	$ 610	$ 25	$ 26	$ 3,358
Gross Loans Receivable (1):								
Ending balance	$ 148,792	$ 41,132	$ 148,725	$ 22,150	$ 26,410	$ 1,332	$ -	$ 388,541
Ending balance: individually evaluated for impairment	$ 179	$ 19	$ 665	$ -	$ 61	$ -	$ -	$ 924
Ending balance: collectively evaluated for	$ 148,613	$ 41,113	$ 148,060	$ 22,150	$ 26,349	$ 1,332	$ -	$ 387,617

impairment

(1) Gross Loans Receivable does not include allowance for loan losses of $(3,388) or deferred loan costs of $3,284.
(2) Includes one- to four-family construction loans.

	Real Estate Loans				Other Loans			
	One- to Four-Family(1)	Home Equity	Commercial	Construction - Commercial	Commercial	Consumer	Unallocated	Total
	(Dollars in thousands)							
September 30, 2017								
Allowance for Loan Losses:								
Balance – July 1, 2017	$ 471	$ 124	$ 1,888	$ 302	$ 331	$ 32	$ 75	$ 3,223
Charge-offs	-	-	(75)	-	(2)	(8)	-	(85)
Recoveries	1	1	-	-	-	2	-	4
Provision (Credit)	54	10	(145)	15	167	5	(31)	75
Balance – September 30, 2017	$ 526	$ 135	$ 1,668	$ 317	$ 496	$ 31	$ 44	$ 3,217
Balance – January 1, 2017	$ 432	$ 114	$ 1,803	$ 149	$ 338	$ 28	$ 18	$ 2,882
Charge-offs	-	(3)	(75)	-	(20)	(36)	-	(134)
Recoveries	2	4	-	-	1	12	-	19
Provision (Credit)	92	20	(60)	168	177	27	26	450
Balance – September 30, 2017	$ 526	$ 135	$ 1,668	$ 317	$ 496	$ 31	$ 44	$ 3,217

(1) Includes one– to four-family construction loans.

	Real Estate Loans				Other Loans			
	One- to Four-Family(2)	Home Equity	Commercial	Construction - Commercial	Commercial	Consumer	Unallocated	Total
	(Dollars in thousands)							
December 31, 2017								
Allowance for Loan Losses:								
Balance – December 31, 2017	$ 511	$ 122	$ 1,663	$ 347	$ 544	$ 35	$ 61	$ 3,283
Ending balance: individually evaluated for impairment	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -
Ending balance: collectively evaluated for impairment	$ 511	$ 122	$ 1,663	$ 347	$ 544	$ 35	$ 61	$ 3,283

Gross Loans Receivable (1):								
Ending Balance	$ 144,614	$ 38,078	$ 122,747	$ 30,802	$ 27,612	$ 1,355	$ -	$ 365,208
Ending balance: individually evaluated for impairment	$ 184	$ 21	$ 1,498	$ -	$ 54	$ -	$ -	$ 1,757
Ending balance: collectively evaluated for impairment	$ 144,430	$ 38,057	$ 121,249	$ 30,802	$ 27,558	$ 1,355	$ -	$ 363,451

(1) Gross Loans Receivable does not include allowance for loan losses of $(3,283) or deferred loan costs of $3,138.
(2) Includes one– to four- family construction loans.

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A loan is considered impaired when, based on current information and events, it is probable that the Company will not be able to collect the scheduled payments of principal and interest when due according to the contractual terms of the loan agreement. Factors considered in determining impairment include payment status, collateral value and the probability of collecting scheduled payments when due. Impairment is measured on a loan-by-loan basis for commercial real estate loans and commercial loans. Larger groups of smaller balance homogeneous loans are collectively evaluated for impairment. Accordingly, the Company does not separately identify individual consumer, home equity, or one- to four-family loans for impairment disclosure, unless they are subject to a troubled debt restructuring.

The following is a summary of information pertaining to impaired loans at or for the periods indicated:

	Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Recorded Investment	Interest Income Recognized
	At September 30, 2018			For the Nine Months Ended September 30, 2018	
	(Dollars in thousands)				
With no related allowance recorded:					
Residential, one- to four-family	$ 179	$ 179	$ -	$ 181	$ 10
Home equity	19	19	-	19	-
Commercial real estate	409	409	-	413	-
Commercial loans	61	61	-	73	1
Total impaired loans with no related allowance	668	668	-	686	11
With an allowance recorded:					
Commercial real estate(1)	256	256	30	1,584	3
Total impaired loans with an allowance	256	256	30	1,584	3
Total of impaired loans:					
Residential, one- to four-family	179	179	-	181	10
Home equity	19	19	-	19	-
Commercial real estate	665	665	30	1,997	3
Commercial loans	61	61	-	73	1
Total impaired loans	$ 924	$ 924	$ 30	$ 2,270	$ 14

(1) Two commercial real estate loans with a combined recorded investment of $1.4 million and a related allowance of $60,000 were foreclosed upon during the nine months ended September 30, 2018 and included in Other Assets on the Consolidated Statement of Financial Condition at September 30, 2018.

	Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Recorded Investment	Interest Income Recognized
	At December 31, 2017			For the Year Ended December 31, 2017	
	(Dollars in thousands)				
With no related allowance recorded:					
Residential, one- to four-family	$ 184	$ 184	$ -	$ 197	$ 15
Home equity	21	21	-	21	-
Commercial real estate	1,498	1,498	-	1,674	222
Commercial loans	54	54	-	54	-
Total impaired loans with no related allowance	1,757	1,757	-	1,946	237
With an allowance recorded:					
Commercial real estate(1)	-	-	-	230	-
Commercial loans(2)	-	-	-	50	6
Total impaired loans with an allowance	-	-	-	280	6
Total of impaired loans:					
Residential, one- to four-family	184	184	-	197	15
Home equity	21	21	-	21	-
Commercial real estate	1,498	1,498	-	1,904	222
Commercial loans	54	54	-	104	6
Total impaired loans	$ 1,757	$ 1,757	$ -	$ 2,226	$ 243

(1)This loan was foreclosed upon during the year ended December 31, 2017 and was recorded in other assets at December 31, 2017.

(2)This loan was paid off during the year ended December 31, 2017.

The following tables provide an analysis of past due loans and non-accruing loans as of the dates indicated:

	30-59 Days Past Due	60-89 Days Past Due	90 Days or More Past Due	Total Past Due	Current Due	Total Loans Receivable	Loans on Non-Accrual
	(Dollars in thousands)						
September 30, 2018:							
Real Estate Loans:							
Residential, one- to four-family	$ 674	$ 407	$ 1,205	$ 2,286	$ 146,160	$ 148,446	$ 2,187
Home equity	153	52	341	546	40,586	41,132	336
Commercial	-	-	589	589	148,136	148,725	665
Construction - Commercial	-	-	-	-	22,150	22,150	-
Construction - Residential, one- to four-family	-	-	-	-	346	346	-
Other Loans:							
Commercial	-	52	76	128	26,282	26,410	76
Consumer	9	4	-	13	1,319	1,332	-
Total	$ 836	$ 515	$ 2,211	$ 3,562	$ 384,979	$ 388,541	$ 3,264

	30-59 Days Past Due	60-89 Days Past Due	90 Days or More Past Due	Total Past Due	Current Due	Total Loans Receivable	Loans on Non-Accrual
	(Dollars in thousands)						
December 31, 2017:							
Real Estate Loans:							
Residential, one- to four-family	$ 692	$ 942	$ 1,233	$ 2,867	$ 141,698	$ 144,565	$ 2,196
Home equity	27	59	212	298	37,780	38,078	235
Commercial	411	-	1,265	1,676	121,071	122,747	1,323
Construction - Commercial	-	-	-	-	30,802	30,802	-
Construction - Residential, one- to four-family	-	-	-	-	49	49	-
Other Loans:							
Commercial	61	8	54	123	27,489	27,612	54
Consumer	22	2	22	46	1,309	1,355	25
Total	$ 1,213	$ 1,011	$ 2,786	$ 5,010	$ 360,198	$ 365,208	$ 3,833

The accrual of interest on loans is discontinued when, in management’s opinion, the borrower may be unable to meet payments as they become due. A loan does not have to be 90 days delinquent in order to be classified as non-accrual. When interest accrual is discontinued, all unpaid accrued interest is reversed. If ultimate collection of principal is in doubt, all cash receipts on impaired loans are applied to reduce the principal balance. Interest income not recognized on non-accrual loans during the nine month periods ended September 30, 2018 and 2017 was $205,000 and $209,000, respectively.

The Company’s policies provide for the classification of loans as follows:

- Pass/Performing;
- Special Mention – does not currently expose the Company to a sufficient degree of risk but does possess credit deficiencies or potential weaknesses deserving the Company's close attention;
- Substandard – has one or more well-defined weaknesses and are characterized by the distinct possibility that the Company will sustain some loss if the deficiencies are not corrected. A substandard asset would be one inadequately protected by the current net worth and paying capacity of the obligor or pledged collateral, if applicable;
- Doubtful – has all the weaknesses inherent in substandard loans with the additional characteristic that the weaknesses present make collection or liquidation in full on the basis of currently existing facts, conditions and values questionable, and there is a high possibility of loss; and
- Loss – loan is considered uncollectible and continuance without the establishment of a specific valuation reserve is not warranted.

The Company's Asset Classification Committee is responsible for monitoring risk ratings and making changes as deemed appropriate. Each commercial loan is individually assigned a loan classification. The Company's consumer loans, including residential one- to four-family loans and home equity loans, are not classified as described above. Instead, the Company uses the delinquency status as the basis for classifying these loans. Generally, all consumer loans more than 90 days past due are classified and placed in non-accrual. Such loans that are well-secured and in the process of collection will remain in accrual status.

The following tables summarize the internal loan grades applied to the Company's loan portfolio as of September 30, 2018 and December 31, 2017:

	Pass/Performing	Special Mention	Substandard	Doubtful	Loss	Total
	(Dollars in thousands)					
September 30, 2018						
Real Estate Loans:						
Residential, one- to four-family	$ 145,747	$ -	$ 2,699	$ -	$ -	$ 148,446
Home equity	40,640	-	492	-	-	41,132
Commercial	146,011	728	1,986	-	-	148,725
Construction - Commercial	22,150	-	-	-	-	22,150
Construction - Residential, one- to four-family	346	-	-	-	-	346
Other Loans:						
Commercial	25,024	62	1,324	-	-	26,410
Consumer	1,328	-	4	-	-	1,332
Total	$ 381,246	$ 790	$ 6,505	$ -	$ -	$ 388,541

	Pass/Performing	Special Mention	Substandard	Doubtful	Loss	Total
	(Dollars in thousands)					
December 31, 2017						
Real Estate Loans:						
Residential, one- to four-family	$ 141,751	$ -	$ 2,814	$ -	$ -	$ 144,565
Home equity	37,611	-	467	-	-	38,078
Commercial	118,977	866	2,904	-	-	122,747
Construction - Commercial	30,802	-	-	-	-	30,802
Construction - Residential, one- to four-family	49	-	-	-	-	49
Other Loans:						
Commercial	26,165	1,093	354	-	-	27,612
Consumer	1,342	-	11	-	2	1,355
Total	$ 356,697	$ 1,959	$ 6,550	$ -	$ 2	$ 365,208

Troubled debt restructurings ("TDRs") occur when we grant borrowers concessions that we would not otherwise grant but for economic or legal reasons pertaining to the borrower's financial difficulties. A concession is made when the terms of the loan modification are more favorable than the terms the borrower would have received in the current market under similar financial difficulties. These concessions may include, but are not limited to, modifications of the terms of the debt, the transfer of assets or the issuance of an equity interest by the borrower to satisfy all or part of the debt, or the addition of borrower(s). The Company identifies loans for potential TDRs primarily through direct communication with the borrower and evaluation of the borrower's financial statements, revenue projections, tax returns, and credit reports. Even if the borrower is not presently in default, management will consider the likelihood that cash flow shortages, adverse economic conditions, and negative trends may result in a payment default in the near future. Generally, we will not return a TDR to accrual status until the borrower has demonstrated the ability to make principal and interest payments under the restructured terms for at least six consecutive months. The Company's TDRs are impaired loans, which may result in specific allocations and subsequent charge-offs if appropriate.

Some loan modifications classified as TDRs may not ultimately result in full collection of principal and interest, as modified, which may result in potential losses. These potential losses have been factored into our overall estimate of the allowance for loan losses.

The following table summarizes the loans that were classified as TDRs as of the dates indicated:

				Non-Accruing			Accruing			TDRs That Have Defaulted on Modified Terms Year to Date		
	Number of Loans	Recorded Investment		Number of Loans	Recorded Investment		Number of Loans	Recorded Investment		Number of Loans	Recorded Investment	
	(Dollars in thousands)											
At September 30, 2018												
Real Estate Loans:												
Residential, one- to four-family	5	$	179	-	$	-	5	$	179	-	$	-
Home equity	1		19	1		19	-		-	-		-
Total	6	$	198	1	$	19	5	$	179	-	$	-
At December 31, 2017												
Real Estate Loans:												
Residential, one- to four-family	5	$	184	-	$	-	5	$	184	-	$	-
Home equity	2		21	1		19	1		2	-		-
Total	7	$	205	1	$	19	6	$	186	-	$	-

No additional loan commitments were outstanding to these borrowers at September 30, 2018 and December 31, 2017.

There were no loans restructured and classified as TDRs during the three and nine month periods ended September 30, 2018 and September 30, 2017, respectively.

Foreclosed real estate consists of property acquired in settlement of loans which is carried at its fair value less estimated selling costs. Write-downs from cost to fair value less estimated selling costs are recorded at the date of acquisition or repossession and are charged to the allowance for loan losses. Foreclosed real estate was $1.7 million and $435,000 at September 30, 2018 and December 31, 2017, respectively, and was included as a component of other assets on the consolidated statements of financial condition. The recorded investment of consumer loans secured by residential real estate properties for which formal foreclosure proceedings are in process according to local requirements of the applicable jurisdiction was $1.4 million and $965,000 at September 30, 2018 and December 31, 2017, respectively.

Note 5 – Earnings per Share

Earnings per share was calculated for the three and nine months ended September 30, 2018 and 2017, respectively. Basic earnings per share is based upon the weighted average number of common shares outstanding, exclusive of unearned shares held by the Employee Stock Ownership Plan of Lake Shore Bancorp, Inc. (the “ESOP”), unearned shares held by the Lake Shore Bancorp, Inc. 2006 Recognition and Retention Plan (“RRP”), and unearned shares held by the Lake Shore Bancorp, Inc. 2012 Equity Incentive Plan (“EIP”). Diluted earnings per share is based upon the weighted average number of common shares outstanding and common share equivalents that would arise from the exercise of dilutive securities. Stock options are regarded as potential common stock and are considered in the diluted earnings per share calculations to the extent they would be dilutive and computed using the treasury stock method.

The calculated basic and diluted earnings per share are as follows:

	Three Months Ended September 30,	
	2018	2017
Numerator – net income	$ 1,058,000	$ 940,000
Denominator:		
Basic weighted average shares outstanding	6,074,753	6,115,140
Increase in weighted average shares outstanding due to:		
Stock options	14,276	9,113
Diluted weighted average shares outstanding (1)	6,089,029	6,124,253
Earnings per share:		
Basic	$ 0.17	$ 0.15
Diluted	$ 0.17	$ 0.15

	Nine Months Ended September 30,	
	2018	2017
Numerator – net income	$ 3,000,000	$ 2,798,000
Denominator:		
Basic weighted average shares outstanding	6,086,216	6,109,468
Increase in weighted average shares outstanding due to:		
Stock options	13,462	9,093
Diluted weighted average shares outstanding (1)	6,099,678	6,118,561
Earnings per share:		
Basic	$ 0.49	$ 0.46
Diluted	$ 0.49	$ 0.46

(1) Stock options to purchase 64,547 shares under the Company’s 2006 Stock Option Plan and 20,000 shares under the EIP at $14.38 for each plan were outstanding during the three and nine month periods ended September 30, 2017, but were not included in the calculation of diluted earnings per share because to do so would have been anti-dilutive. During the three and nine month periods ended September 30, 2018, there were no stock options excluded from the calculation of diluted earnings per share.

Note 6 – Commitments to Extend Credit

The Company has commitments to extend credit with off-balance sheet risk in the normal course of business to meet the financing needs of its customers. Such commitments involve, to varying degrees, elements of credit and interest rate risk in excess of the amount recognized in the consolidated statements of financial condition.

The Company's exposure to credit loss is represented by the contractual amount of these commitments. There were no loss reserves associated with these commitments at September 30, 2018 and December 31, 2017. The Company follows the same credit policies in making commitments as it does for on-balance sheet instruments.

The following commitments to extend credit were outstanding as of the dates specified:

	Contract Amount	
	September 30, 2018	December 31, 2017
	(Dollars in thousands)	
Commitments to grant loans	$ 41,273	$ 16,426
Unfunded commitments under lines of credit	$ 48,969	$ 41,395

Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Commitments generally have fixed expiration dates or other termination clauses. The commitments for lines of credit may expire without being drawn upon. Therefore, the total commitment amounts do not necessarily represent future cash requirements. The amount of collateral obtained, if it is deemed necessary by the Company, is based on management's credit evaluation of the customer. At September 30, 2018 and December 31, 2017, the Company's loan commitments with fixed interest rates for the next five years totaled $10.5 million and $7.9 million, respectively. The range of interest rates on these fixed rate commitments was 3.95% to 6.59% at September 30, 2018.

Note 7 – Stock-based Compensation

As of September 30, 2018, the Company had four stock-based compensation plans, which are described below. The compensation cost that has been recorded under salary and benefits expense in the non-interest expense section of the consolidated statements of income for these plans was $144,000 and $146,000 for the three months ended September 30, 2018 and 2017, respectively. The compensation cost that has been recorded for the nine months ended September 30, 2018 and 2017 was $434,000 and $418,000, respectively.

2006 Stock Option Plan

The Company's 2006 Stock Option Plan (the "Stock Option Plan"), which was approved by the Company's stockholders, permitted the grant of options to its employees and non-employee directors for up to 297,562 shares of common stock. The Stock Option Plan expired on October 24, 2016, and grants of options can no longer be awarded.

Both incentive stock options and non-qualified stock options have been granted under the Stock Option Plan. The exercise price of each stock option equals the market price of the Company's common stock on the date of grant and an option's maximum term is ten years. The stock options generally vest over a five year period.

A summary of the status of the Stock Option Plan during the nine months ended September 30, 2018 and 2017 is presented below:

:

	September 30, 2018			September 30, 2017		
	Options	Weighted Average Exercise Price	Remaining Contractual Life	Options	Weighted Average Exercise Price	Remaining Contractual Life
Outstanding at beginning of year	82,321	$ 12.98		82,826	$ 12.95	
Granted	-	-		-	-	
Exercised	-	-		-	-	
Forfeited	-	-		-	-	
Outstanding at end of period	82,321	$ 12.98	6.6 years	82,826	$ 12.95	7.6 years
Options exercisable at end of period	30,681	$ 10.61	6.6 years	18,279	$ 7.88	7.6 years
Fair value of options granted		$ -			$ -	

At September 30, 2018, stock options outstanding had an intrinsic value of $290,000 and there were no remaining options available for grant under the Stock Option Plan. There were no stock options exercised during the three and nine months ended September 30, 2018 and 2017. Compensation expense related to the Stock Option Plan for the three month period ended September 30, 2018 and 2017 was $8,000, respectively. Compensation expense related to the Stock Option Plan for the nine month period ended September 30, 2018 and 2017 was $25,000, respectively. At September 30, 2018, $104,000 of unrecognized compensation cost related to the Stock Option Plan is expected to be recognized over a period of 37 months.

2006 Recognition and Retention Plan

The Company's 2006 Recognition and Retention Plan ("RRP"), which was approved by the Company's stockholders, permitted the grant of restricted stock awards ("Awards") to employees and non-employee directors for up to 119,025 shares of common stock. The RRP expired on October 24, 2016, and as of October 24, 2016, all shares permitted under the plan have been granted.

As of September 30, 2018, there were 106,820 shares vested or distributed to eligible participants under the RRP. Compensation expense amounted to $23,000 for the three months ended September 30, 2018 and 2017, respectively. Compensation expense amounted to $67,000 and $66,000 for the nine months ended September 30, 2018 and 2017, respectively. At September 30, 2018, $130,000 of unrecognized compensation cost related to the RRP is expected to be recognized over a period of 37 months.

A summary of the status of unvested shares under the RRP for the nine months ended September 30, 2018 and 2017 is as follows:

	2018	Weighted Average Grant Price (per Share)	2017	Weighted Average Grant Price (per Share)
Unvested shares outstanding at beginning of year	17,119	$ 13.06	24,110	$ 12.96
Granted	-	-	-	-
Vested	(4,914)	12.17	(4,974)	12.14
Forfeited	-	-	-	-
Unvested shares outstanding at end of period	12,205	$ 13.42	19,136	$ 13.18

2012 Equity Incentive Plan

The Company's 2012 Equity Incentive Plan (the "EIP"), which was approved by the Company's stockholders on May 23, 2012, authorizes the issuance of up to 180,000 shares of common stock pursuant to grants of restricted stock awards and up to 20,000 shares of common stock pursuant to grants of incentive stock options and non-qualified stock options, subject to permitted adjustments for certain corporate transactions. Employees and directors of Lake Shore Bancorp or its subsidiaries are eligible to receive awards under the EIP, except that non-employees may not be granted incentive stock options.

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The Board of Directors granted restricted stock awards under the EIP during the nine months ended September 30, 2018 as follows:

Grant Date	Number of Restricted Stock Awards	Vesting	Fair Value per Share of Award on Grant Date	Awardees
February 7, 2018	5,285	100% on December 14, 2018	$ 17.00	Non-employee directors
April 24, 2018	44	100% on December 14, 2018	16.88	Non-employee director

A summary of the status of unvested restricted stock awards under the EIP for the nine months ended September 30, 2018 and 2017 is as follows:

	2018	Weighted Average Grant Price (per Share)	2017	Weighted Average Grant Price (per Share)
Unvested shares outstanding at beginning of year	42,915	$ 14.40	26,072	$ 12.77
Granted	5,329	17.00	27,348	15.90
Vested	(4,213)	12.16	(4,207)	12.16
Forfeited	(795)	14.85	(625)	13.76
Unvested shares outstanding at end of period	43,236	$ 14.93	48,588	$ 14.57

As of September 30, 2018, there were 36,010 shares vested or distributed to eligible participants under the EIP. Compensation expense related to restricted stock awards under the EIP amounted to $77,000 and $81,000 for the three months ended September 30, 2018 and 2017, respectively. Compensation expense related to EIP restricted stock awards during the nine months ended September 30, 2018 and 2017 was $234,000 and $224,000, respectively. At September 30, 2018, $220,000 of unrecognized compensation cost related to unvested restricted stock awards is expected to be recognized over a period of 15 months.

A summary of the status of stock options under the EIP for the nine months ended September 30, 2018 and 2017 is presented below:

	September 30, 2018			September 30, 2017		
	Options	Exercise Price	Remaining Contractual Life	Options	Exercise Price	Remaining Contractual Life
Outstanding at beginning of year	20,000	$ 14.38		20,000	$ 14.38	
Granted	-	-		-	-	
Exercised	-	-		-	-	

Forfeited	-	-		-	-	
Outstanding at end of period	20,000	$ 14.38	8.1 years	20,000	$ 14.38	9.1 years
Options exercisable at end of period	3,998	$ 14.38	8.1 years	-	$ -	
Fair value of options granted		-			-	

At September 30, 2018, stock options outstanding had an intrinsic value of $42,000 and there were no remaining options available for grant under the EIP. Compensation expense related to stock options outstanding under the EIP amounted to $3,000 for the three months ended September 30, 2018 and 2017, respectively, and amounted to $8,000 for the nine months ended September 30, 2018 and 2017, respectively. At September 30, 2018, $32,000 of unrecognized compensation cost related to unvested stock options is expected to be recognized over a period of 37 months.

Employee Stock Ownership Plan ("ESOP")

The Company established the ESOP for the benefit of eligible employees of the Company and Bank. All Company and Bank employees meeting certain age and service requirements are eligible to participate in the ESOP. Participants' benefits become fully vested after five years of service once the employee is eligible to participate in the ESOP. The Company utilized $2.6 million of the proceeds of its 2006 stock offering to extend a loan to the ESOP and the ESOP used such proceeds to purchase 238,050 shares of stock on the open market at an average price of $10.70 per share, plus commission expenses. As a result of the purchase of shares by the ESOP, total stockholders' equity of the Company was reduced by $2.6 million. As of September 30, 2018, the balance of the loan to the ESOP was $1.6 million and the fair value of unallocated shares was $2.4 million. As of September 30, 2018, there were 70,031 allocated shares and 142,830 unallocated shares compared to 62,956 allocated shares and 150,765 unallocated shares at September 30, 2017. The ESOP compensation expense was $33,000 for the three months ended September 30, 2018 and $31,000 for the three months ended September 30, 2017 based on 1,984 shares earned in each of those quarters. The ESOP compensation expense was $100,000 for the nine months ended September 30, 2018 and $94,000 for the nine months ended September 30, 2017 based on 5,951 shares earned in each of those periods.

Note 8 - Fair Value of Financial Instruments

Management uses its best judgment in estimating the fair value of the Company's financial instruments; however, there are inherent weaknesses in any estimation technique. Therefore, for substantially all financial instruments, the fair value estimates herein are not necessarily indicative of the amounts the Company could have realized in a sale transaction on the dates indicated. The estimated fair value amounts have been measured as of September 30, 2018 and December 31, 2017 and have not been re-evaluated or updated for purposes of these consolidated financial statements subsequent to those respective dates. The estimated fair values of these financial instruments subsequent to the respective reporting dates may be different than the amounts reported here.

The measurement of fair value under FASB ASC Topic 820, "Fair Value Measurements and Disclosures" ("ASC Topic 820") establishes a fair value hierarchy that prioritizes the inputs to valuation methods used to measure fair value. The hierarchy gives the highest priority to unadjusted quoted prices in active markets for identical assets or liabilities measurements (Level 1) and the lowest priority to unobservable input measurements (Level 3). The three levels of the fair value hierarchy under ASC Topic 820 are as follows:

Level 1: Unadjusted quoted prices in active markets for identical assets or liabilities that the reporting entity can access at the measurement date.

Level 2: Inputs other than quoted prices included in Level 1 that are observable for the asset or liability either directly or indirectly.

Level 3: Unobservable inputs for determining the fair values of assets or liabilities that reflect an entity’s own assumptions about the assumptions that market participants would use in pricing the assets or liabilities.

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

For assets measured at fair value on a recurring basis, the fair value measurements by level within the fair value hierarchy used at September 30, 2018 and December 31, 2017 were as follows:

	Fair Value Measurements at September 30, 2018			
	Fair Value	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Other Unobservable Inputs (Level 3)
	(Dollars in thousands)			
Measured at fair value on a recurring basis:				
Securities available for sale:				
Debt Securities				
U.S. Government Agencies	$ 1,889	$ 1,889	$ -	$ -
Municipal bonds	46,431	-	46,431	-
Mortgage-backed securities:				
Collateralized mortgage obligations-private label	27	-	27	-
Collateralized mortgage obligations-government sponsored entities	30,465	-	30,465	-
Government National Mortgage Association	202	-	202	-
Federal National Mortgage Association	2,468	-	2,468	-
Federal Home Loan Mortgage Corporation	1,298	-	1,298	-
Asset-backed securities:				
Private label	291	-	291	-
Government sponsored entities	45	-	45	-
Total Debt Securities	$ 83,116	$ 1,889	$ 81,227	$ -
Equity Securities	31	-	31	-
Total Securities Available for Sale	$ 83,147	$ 1,889	$ 81,258	$ -

	Fair Value Measurements at December 31, 2017			
	Fair Value	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Other Unobservable Inputs (Level 3)
	(Dollars in thousands)			
Measured at fair value on a recurring basis:				
Securities available for sale:				
Debt Securities				
U.S. Government Agencies	$ 1,987	$ 1,987	$ -	$ -
Municipal bonds	45,562	-	45,562	-
Mortgage-backed securities:				
Collateralized mortgage obligations-private label	30	-	30	-
Collateralized mortgage obligations-government sponsored entities	27,654	-	27,654	-
Government National Mortgage Association	245	-	245	-
Federal National Mortgage Association	2,929	-	2,929	-
Federal Home Loan Mortgage Corporation	1,553	-	1,553	-
Asset-backed securities:				
Private label	344	-	-	344
Government sponsored entities	60	-	60	-
Total Debt Securities	$ 80,364	$ 1,987	$ 78,033	$ 344
Equity Securities	57	-	57	-
Total Securities Available for Sale	$ 80,421	$ 1,987	$ 78,090	$ 344

Any transfers between levels would be recognized as of the actual date of event or change in circumstances that caused the transfer. There were no reclassifications between the Level 1 and Level 2 categories for the nine months ended September 30, 2018 and for the year ended December 31, 2017. During the nine months ended September 30, 2018, asset-backed securities – private label were transferred from the Level 3 category to the Level 2 category. These securities were transferred to Level 2 because the Company changed its method of valuing these securities and that method now uses Level 2 inputs. These securities are now valued using Level 2 inputs because the price volatility associated with these securities has been reduced and management considers the quoted market price for these securities to be reasonable.

Level 2 inputs for assets or liabilities measured at fair value on a recurring basis might include quoted prices for similar assets or liabilities in active markets, quoted prices for identical or similar assets or liabilities in markets that are not active, inputs other than quoted prices that are observable for the asset or liability (such as interest rates, volatilities, prepayment speeds, credit risks, etc.) or inputs that are derived principally from or corroborated by market data by correlation or other means.

The fair value of securities available for sale are determined by obtaining quoted market prices on nationally recognized securities exchanges (Level 1) or matrix pricing (Level 2), which is a mathematical technique used widely in the industry to value debt securities without relying exclusively on quoted market prices for the specific securities, but rather by relying on the securities' relationship to other benchmark quoted prices. The fair value measurements consider observable data that may include dealer quotes, market spreads, cash flows, the U.S. treasury yield curve, live trading levels, trade execution date, market consensus prepayment speeds, credit information and the security's terms and conditions, among other things. Level 2 securities which are fixed income instruments that are not quoted on an exchange, but are traded in active markets, are valued using prices obtained from our custodian, who use third party data service providers. Securities available for sale measured within the Level 3 category as of December 31, 2017 consisted of private label asset-backed securities.

The following table presents a reconciliation of the securities available for sale measured at fair value on a recurring basis using significant unobservable inputs (Level 3), specifically, asset-backed securities - private label, for the nine months ended September 30, 2018 and 2017:

	2018	2017
	(Dollars in thousands)	
Beginning Balance	$ 344	$ 832
Total gains - realized/unrealized:		
Included in earnings	-	-
Included in other comprehensive loss	-	11
Total losses - realized/unrealized:	-	
Included in earnings	-	-
Included in other comprehensive loss	-	(64)
Sales	-	-
Principal paydowns	-	(337)
Transfers to (out of) Level 3	(344)	-
Ending Balance	$ -	$ 442

Both observable and unobservable inputs may be used to determine the fair value of assets and liabilities measured on a recurring basis that the Company has classified within the Level 3 category. As a result, any unrealized gains and losses for assets within the Level 3 category may include changes in fair value attributable to both observable (e.g., changes in market interest rates) and unobservable (e.g., changes in unobservable long-dated volatilities) inputs.

The following table presents additional quantitative information about the Level 3 inputs for the asset-backed securities - private label category. The fair values for this category were developed using the discounted cash flow technique with the following unobservable input ranges as of December 31, 2017 (dollars in thousands):

				Unobservable Inputs		
Security Category	Fair Value	Loan Type/Collateral	Credit Ratings	Constant Prepayment Speed (CPR)	Probability of Default (Annual Default Rate)	Loss Severity

December 31, 2017						
Asset-backed securities - private label	$ 344	Sub-prime First and Prime Second Lien - Residential Real Estate	B- thru D	5-12	3.0-5.0%	75.0% - 100.0%

At December 31, 2017, Level 3 inputs were determined by the Company’s management using inputs from its third party financial advisor on a quarterly basis. The significant unobservable inputs used in the fair value measurement of the reporting entity’s asset-backed, private label securities are prepayment rates, probability of default and loss severity in the event of default. Significant increases or decreases in any of those inputs in isolation would result in a significantly lower or higher fair value measurement. Generally, a change in the assumption used for the probability of default is accompanied by a directionally similar change in the assumption used for the loss severity and a directionally opposite change in the assumption used for prepayment rates.

In addition to disclosure of the fair value of assets on a recurring basis, ASC Topic 820 requires disclosures for assets and liabilities measured at fair value on a non-recurring basis, such as impaired assets and foreclosed real estate. Loans are generally not recorded at fair value on a recurring basis. Periodically, the Company records non-recurring adjustments to the carrying value of loans based on fair value measurements for partial charge-offs of the uncollectible portions of these loans. Non-recurring adjustments also include certain impairment amounts for collateral-dependent loans calculated as required by ASC Topic 310, "Receivables – Loan Impairment," when establishing the allowance for loan losses. An impaired loan is carried at fair value based on either a recent appraisal less estimated selling costs of underlying collateral or discounted cash flows based on current market conditions.

For assets measured at fair value on a non-recurring basis, the fair value measurements by level within the fair value hierarchy used at September 30, 2018 and December 31, 2017 were as follows:

	Fair Value Measurements			
	Fair Value	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Other Unobservable Inputs (Level 3)
	(Dollars in thousands)			
Measured at fair value on a non-recurring basis:				
At September 30, 2018				
Impaired loans	$ 260	$ -	$ -	$ 260
Foreclosed real estate	1,650	-	-	1,650
At December 31, 2017				
Impaired loans	$ 35	$ -	$ -	$ 35
Foreclosed real estate	438	-	-	438

The following table presents additional quantitative information about assets measured at fair value on a non-recurring basis and for which the Company has utilized Level 3 inputs to determine fair value:

	Quantitative Information about Level 3 Fair Value Measurements			
(Dollars in thousands)	Fair Value Estimate	Valuation Technique	Unobservable Input	Range
At September 30, 2018				
Impaired loans	$ 260	Market valuation of underlying collateral (1)	Direct Disposal Costs (2)	7.00-13.70%
Foreclosed real estate	1,650	Market valuation of property (1)	Direct Disposal Costs (2)	3.90-10.00%
At December 31, 2017				
Impaired loans	$ 35	Market valuation of underlying collateral (1)	Direct Disposal Costs (2)	7.00%
Foreclosed real estate	438	Market valuation of property (1)	Direct Disposal Costs (2)	7.00-16.80%

(1) Fair value is generally determined through independent third-party appraisals of the underlying collateral, which generally includes various Level 3 inputs which are not observable.

(2) The fair value basis of impaired loans and foreclosed real estate may be adjusted to reflect management estimates of disposal costs including, but not necessarily limited to, real estate brokerage commissions, legal fees, and delinquent property taxes.

At September 30, 2018, impaired loans valued using Level 3 inputs had a carrying amount of $290,000 and valuation allowances of $30,000. By comparison at December 31, 2017, impaired loans valued using Level 3 inputs had a carrying amount of $35,000 and no valuation allowances.

Once a loan is determined to be impaired, the fair value of the loan continues to be evaluated based upon the market value of the underlying collateral securing the loan or by using a discounted future cash flow method if the loan is not collateral dependent. At September 30, 2018, impaired loans with a carrying amount that had been written down utilizing Level 3 inputs during the nine months ended September 30, 2018 comprised of one loan with a fair value of $226,000 and resulted in an additional provision for loan loss of $30,000.

At September 30, 2018, foreclosed real estate valued using Level 3 inputs had a carrying amount of $1.9 million and valuation allowances of $294,000. By comparison at December 31, 2017, foreclosed real estate valued using Level 3 inputs had a carrying amount of $557,000 and valuation allowances of $119,000.

Once a loan is foreclosed, the fair value of the real estate owned continues to be evaluated based upon the market value of the repossessed real estate originally securing the loan. At September 30, 2018, foreclosed real estate with a carrying value that had been written down utilizing Level 3 inputs during the nine months ended September 30, 2018 comprised of four properties with a fair value of $1.7 million and resulted in an additional provision for loan losses of $181,000 and subsequent write-downs recorded in non-interest expense of $22,000. At December 31, 2017, foreclosed real estate with a carrying value that had been written down utilizing Level 3 inputs during the year ended December 31, 2017 comprised of two properties with a fair value of $399,000 and resulted in an additional provision for loan losses of $75,000 and subsequent write-downs recorded in non-interest expense of $15,000.

The carrying amount and estimated fair value of the Company's financial instruments, whether carried at cost or fair value, are as follows:

	Fair Value Measurements at September 30, 2018				
	Carrying Amount	Estimated Fair Value	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Other Unobservable Inputs (Level 3)
	(Dollars in thousands)				
Financial assets:					
Cash and cash equivalents	$ 38,069	$ 38,069	$ 38,069	$ -	$ -
Securities available for sale	83,147	83,147	1,889	81,258	-
Federal Home Loan Bank stock	1,545	1,545	-	1,545	-
Loans receivable, net	388,437	371,524	-	-	371,524
Accrued interest receivable	2,044	2,044	-	2,044	-
Financial liabilities:					
Deposits	435,901	438,844	-	438,844	-
Long-term debt	24,650	23,972	-	23,972	-
Accrued interest payable	84	84	-	84	-
Off-balance-sheet financial instruments	-	-	-	-	-

	Fair Value Measurements at December 31, 2017				
	Carrying Amount	Estimated Fair Value	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Other Unobservable Inputs (Level 3)
	(Dollars in thousands)				
Financial assets:					
Cash and cash equivalents	$ 40,913	$ 40,913	$ 40,913	$ -	$ -
Securities available for sale	80,421	80,421	1,987	78,090	344
Federal Home Loan Bank stock	1,631	1,631	-	1,631	-
Loans receivable, net	365,063	356,275	-	-	356,275
Accrued interest receivable	1,801	1,801	-	1,801	-
Financial liabilities:					
Deposits	405,153	408,348	-	408,348	-
Long-term debt	26,950	26,634	-	26,634	-

Accrued interest payable	57	57	-	57	-
Off-balance-sheet financial instruments	-	-	-	-	-

Note 9 – Treasury Stock

During the three months ended September 30, 2018, the Company repurchased 12,100 shares of common stock at an average cost of $17.24 per share. During the nine months ended September 30, 2018, the Company repurchased 46,400 shares of common stock at an average cost of $16.81 per share. These shares were repurchased pursuant to the Company's publicly announced common stock repurchase program. As of September 30, 2018, there were 108,090 shares remaining to be repurchased under the existing stock repurchase program. During the nine months ended September 30, 2018, the Company transferred 5,329 shares of common stock out of treasury stock reserved for the 2012 Equity Incentive Plan, at an average cost of $9.39 per share to fund awards that had been granted under the plan. During the three and nine months ended September 30, 2018, there were 795 and 10,433 shares, respectively, transferred back into treasury stock reserved for the 2012 Equity Incentive Plan at an average cost of $9.81 and $9.42 per share, respectively, due to stock forfeitures.

During the three months ended September 30, 2017, the Company repurchased 3,600 shares of common stock at an average cost of $15.85 per share. During the nine months ended September 30, 2017, the Company repurchased 17,100 shares of common stock at an average cost of $15.75 per share. These shares were repurchased pursuant to the Company's publicly announced common stock repurchase program. As of September 30, 2017, there were 67,401 shares remaining to be repurchased under the existing stock repurchase program. During the nine months ended September 30, 2017, the Company transferred 27,348 shares of common stock out of the treasury stock reserved for the 2012 Equity Incentive Plan, at an average cost of $9.88 per share to fund awards that had been granted under the plan. During the three and nine months ended September 30, 2017, there were 904 and 1,104 shares, respectively, transferred back into treasury stock reserved for the 2012 Equity Incentive Plan at an average cost of $9.59 and $9.58 per share, respectively, due to stock forfeitures.

Note 10 – Other Comprehensive Loss

In addition to presenting the Consolidated Statements of Comprehensive Income herein, the following table shows the tax effects allocated to the Company's single component of other comprehensive loss for the periods presented:

	For the Three Months Ended September 30, 2018			For The Three Months Ended September 30, 2017		
	Pre-Tax Amount	Tax Benefit	Net of Tax Amount	Pre-Tax Amount	Tax Benefit	Net of Tax Amount
	(Unaudited) (Dollars in thousands)					
Net unrealized losses on securities available for sale:						
Net unrealized losses arising during the period	$ (591)	$ 124	$ (467)	$ (91)	$ 31	$ (60)
Less: reclassification adjustment related to:						
Recovery on previously impaired investment securities included in net income	(34)	7	(27)	(25)	9	(16)
Gain on sale of securities included in net income	-	-	-	(22)	7	(15)
Total Other Comprehensive Loss	$ (625)	$ 131	$ (494)	$ (138)	$ 47	$ (91)

For the Nine Months Ended September 30, 2018			For The Nine Months Ended September 30, 2017		
Pre-Tax Amount	Tax Benefit	Net of Tax Amount	Pre-Tax Amount	Tax Benefit	Net of Tax Amount
(Unaudited) (Dollars in thousands)					

Net unrealized losses on securities available for sale:						
Net unrealized losses arising during the period	$ (1,828)	$ 384	$ (1,444)	$ (51)	$ 17	$ (34)
Less: reclassification adjustment related to:						
Recovery on previously impaired investment securities included in net income	(124)	26	(98)	(96)	33	(63)
Gain on sale of securities included in net income	-	-	-	(244)	83	(161)
Total Other Comprehensive Loss	$ (1,952)	$ 410	$ (1,542)	$ (391)	$ 133	$ (258)

The following table presents the amounts reclassified out of the single component of the Company's accumulated other comprehensive loss for the indicated periods:

Details about Accumulated Other Comprehensive Loss Components	Amounts Reclassified from Accumulated Other Comprehensive Loss for the three months ended September 30, 2018	2017	Affected Line Item on the Consolidated Statements of Income
	(Dollars in thousands)		
Net unrealized gains and losses on securities available for sale:			
Recovery on previously impaired investment securities	$ (34)	$ (25)	Recovery on previously impaired investment securities
Sale of securities	-	(22)	Gain on sale of securities available for sale
	(34)	(47)	
Provision for income tax benefit	7	16	Income Tax Expense
Total reclassification for the period	$ (27)	$ (31)	Net Income

Details about Accumulated Other Comprehensive Loss Components	Amounts Reclassified from Accumulated Other Comprehensive Loss for the nine months ended September 30, 2018	2017	Affected Line Item on the Consolidated Statements of Income
	(Dollars in thousands)		
Net unrealized gains and losses on securities available for sale:			
Recovery on previously impaired investment securities	$ (124)	$ (96)	Recovery on previously impaired investment securities
Sale of securities	-	(244)	Gain on sale of securities available for sale
	(124)	(340)	

Provision for income tax benefit	26	116	Income Tax Expense
Total reclassification for the period	$ (98)	$ (224)	Net Income

Note 11 – Revenue Recognition

As of January 1, 2018, the Company adopted FASB ASU 2014-09 "Revenue from Contracts with Customers (Topic 606)" ("ASU 2014-09") for non-interest revenue streams. The Company has elected to apply ASU 2014-09 using the modified retrospective method. The implementation of the new standard did not have a material impact on the measurement or recognition of revenue; and as such, a cumulative effect adjustment to retained earnings was not deemed necessary under the modified retrospective implementation method. The adoption of ASU 2014-09 did, however, require additional disclosures.

The Company's non-interest revenue streams primarily result from services it provides to its deposit customers. When a customer makes a deposit, the Company records a liability under ASC 405 because the Company has an obligation to deliver cash to its customer on demand. A contract between the Company and a deposit account customer is typically documented in writing and is often terminable at will by the customer alone or by both the customer and the Company without penalty. The term of a deposit contract between a customer and the Company will likely be day-to-day or minute-to-minute, and the termination clause is likely similar to a renewal right where each day or minute represents the renewal of the contract. The Company generally fully satisfies its performance obligations on its contracts with customers as services are rendered and the transaction prices are typically fixed; charged either on a periodic basis or based on activity. Because performance obligations are satisfied as services are rendered and the transaction prices are fixed, there is little judgment involved in applying Topic 606 that significantly affects the determination of the amount and timing of revenue from contracts with customers. The Company's primary non-interest revenue streams within the scope of ASU 2014-

09 are described in further detail below. The Company has no material unsatisfied performance obligations as of September 30, 2018.

Service Charges on Deposit Accounts

Service charges and fees on deposit accounts consist of transaction-based fees, account maintenance fees, and overdraft service fees for various retail and business deposit customers.   Transaction-based fees, such as stop payment charges, are recognized at the time the Company fulfills the customer's request. Account maintenance fees, which relate primarily to monthly maintenance, are earned over the course of a month, representing the period over which the Company satisfies the performance obligation. Overdraft fees are recognized at the point in time that the overdraft occurs. Service charges on deposits are withdrawn directly from the customer's account balance.

Fees, Interchange Income, and Other Service Charges

Fees, interchange income, and other service charges are primarily comprised of debit card income, ATM fees, merchant services income and other service charges. Debit card income is primarily comprised of interchange fees earned whenever the Company's debit cards are used to purchase goods or services from a merchant via a card payment network, such as MasterCard. Interchange fees from cardholder transactions represent a percentage of the underlying transaction value. ATM fees are comprised of fees earned whenever a Company's ATM or debit card is used at a non-Company ATM or a non-Company cardholder uses a Company ATM. ATM fees represent a fixed fee for the convenience to cardholders for accessibility of funds. Merchant services income mainly represents fees charged to merchants serviced by a third party vendor under contract with the Company for debit or credit card processing, and represents a percentage of the underlying transaction value. Other service charges include revenue from services provided to our retail or business customers, which may include fees for wire transfer processing, bill pay services, cashier's checks and other services. The Company's performance obligation for fees, interchange income and other service charges are largely satisfied, and related revenue recognized, when the services are rendered or upon completion. Payment is typically immediately or in the following month.

Other

Other non-interest income consists of safe deposit rental fees. Safe deposit box rental fees are charged to the customer on an annual basis and recognized upon receipt of payment. The Company determined that since rentals and renewals occur fairly consistently over time, revenue is recognized on a basis consistent with the duration of the performance obligation.

Gain/Losses on Sale of OREO

The Company records a gain or loss from the sale of OREO when control of the property transfers to the buyer, which generally occurs at the time of an executed deed. When the Company finances the sale of OREO to the buyer, the Company assesses whether the buyer is committed to perform their obligations under the contract and whether collectability of the transaction price is probable. Once these criteria are met, the OREO asset is derecognized and the gain or loss on sale is recorded upon the transfer of control of the property to the buyer. In determining the gain or loss on the sale, the Company adjusts the transaction price and related gain (loss) on sale if a significant financing component is present. There were no sales of OREO in which the Company financed the sale during the three and nine months ended September 30, 2018.

Contract Balances

The Company's non-interest revenue streams are largely based on transactional activity. Consideration is often received immediately or shortly after the Company satisfies its performance obligation and revenue is recognized. The Company does not typically enter into long-term revenue contracts with customers, and therefore, does not experience significant contract balances. As of September 30, 2018 and December 31, 2017, the Company did not have any significant contract balances.

The following presents non-interest income, segregated by revenue streams in-scope and out-of-scope of Topic 606, for the three and nine months ended September 30, 2018 and 2017:

	For the Three Months Ended		For the Nine Months Ended	
	September 30, 2018	September 30, 2017	September 30, 2018	September 30, 2017
	(Dollars in thousands)			
Non-Interest Income				
In-Scope of Topic 606:				
Service charges on deposit accounts	$ 218	$ 221	$ 655	$ 690
Fees, interchange income and other service charges	203	190	595	554
Other	9	9	30	30
Non-interest Income (in-scope of Topic 606)	430	420	1,280	1,274
Non-interest Income (out of scope of Topic 606)	199	197	596	780
Total Non-Interest Income	$ 629	$ 617	$ 1,876	$ 2,054

Note 12 – Subsequent Events

On October 24, 2018, the Board of Directors declared a quarterly cash dividend of $0.10 per share on the Company's common stock, payable on November 19, 2018 to shareholders of record as of November 6, 2018. Lake Shore, MHC (the "MHC"), which holds 3,636,875 shares, or approximately 60.4% of the Company's total outstanding stock, elected to waive its right to receive this cash dividend of approximately $364,000. On March 9, 2018, the MHC received the non-objection of the Federal Reserve Bank of Philadelphia to waive its right to receive dividends paid by the Company during the twelve months ending February 7, 2019, aggregating up to $0.40 per share. The MHC waived $364,000 of dividends during the three months ended September 30, 2018 and $1.1 million during the nine months ended September 30, 2018. Cumulatively, Lake Shore, MHC has waived approximately $10.5 million of cash dividends as of September 30, 2018. The dividends waived by Lake Shore, MHC are considered a restriction on the retained earnings of the Company.

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

Forward-Looking Statements

This Quarterly Report on Form 10-Q contains certain forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. Such statements may be identified by words such as “believe,” “will,” “expect,” “project,” “may,” “could,” “anticipate,” “estimate,” “intend,” “plan,” “targets” and similar expressions. These statements are b upon our current beliefs and expectations and are subject to significant risks and uncertainties. Actual results may differ materially from those set forth in the forward-looking statements as a result of numerous factors.

The following factors, including the factors set forth in Part II, Item 1A of this Quarterly Report on Form 10-Q (if applicable) and in Part I, Item 1A of the Company’s Annual Report on Form 10-K for the year ended December 31, 2017, among others, could cause actual results to differ materially from the anticipated results or other expectations expressed in our forward-looking statements:

· general and local economic conditions;

· changes in interest rates, deposit flows, demand for mortgages and other loans, real estate values and competition;

· the ability of our customers to make loan payments;

· the effect of competition on rates of deposit and loan growth and net interest margin;

· our ability to continue to control costs and expenses;

· changes in accounting principles, policies or guidelines;

· our success in managing the risks involved in our business;

· inflation, and market and monetary fluctuations;

· the impact of more stringent capital requirements being imposed by banking regulators;

· changes in legislation or regulation, including the implementation of the Dodd-Frank Act; and

· other economic, competitive, governmental, regulatory and technological factors affecting our operations, pricing, products and services.

Any or all of our forward-looking statements in this Quarterly Report on Form 10-Q and in any other public statements we make may differ from actual outcomes. They can be affected by inaccurate assumptions we might make or known or unknown risks and uncertainties. Consequently, no forward-looking statements can be guaranteed. We undertake no obligation to publicly update any forward looking statement, whether as a result of new information, future events or otherwise. For a more complete discussion of certain risks, uncertainties and other factors affecting the Company, refer to the Company's Risk Factors, contained in Item 1A of the Company's Annual Report on Form 10-K for the year ended December 31, 2017.

Overview

The following discussion and analysis is presented to assist in the understanding and evaluation of our consolidated financial condition and results of operations. It is intended to complement the unaudited consolidated financial statements and notes thereto appearing elsewhere in this Form 10-Q and should be read in conjunction therewith. The detailed discussion focuses on our consolidated financial condition as of September 30, 2018 compared to the consolidated financial condition as of December 31, 2017 and the consolidated results of operations for the three and nine months ended September 30, 2018 and 2017.

Our results of operations depend primarily on our net interest income, which is the difference between the interest income we earn on loans and investments and the interest expense we pay on deposits, borrowings and other interest-bearing liabilities. Net interest income is affected by the relative amounts of interest-earning assets and interest-bearing liabilities and the interest rates we earn or pay on these balances.

Our operations are also affected by non-interest income, such as service charges and fees and gains and losses on the sales of securities and loans, our provision for loan losses and non-interest expenses which include salaries and employee benefits, occupancy and equipment costs, data processing, professional services, advertising and other general and administrative expenses.

Financial institutions like us, in general, are significantly affected by economic conditions, competition, and the monetary and fiscal policies of the federal government. Lending activities are influenced by the demand for and supply of housing and commercial real estate, competition among lenders, interest rate conditions, and funds availability. Our operations and lending are principally concentrated in the Western New York area, and our operations and earnings are influenced by local economic conditions. Deposit balances and cost of funds are influenced by prevailing market rates on competing investments, customer preferences, and levels of personal income and savings in our primary market area. Operations are also significantly impacted by government policies and actions of regulatory authorities. Future changes in applicable law, regulations or government policies may materially impact the Company.

To operate successfully, we must manage various types of risk, including but not limited to, interest rate risk, credit risk, liquidity risk, operational and information technology risks, strategic risk, reputation risk and compliance risk. A significant form of market risk for the Company is interest rate risk, as the Company's assets and liabilities are sensitive to changes in interest rates. Interest rate risk is the exposure of our net interest income to adverse movements in interest rates. Net interest income is our primary source of revenue and interest rate risk is a significant non-credit related risk to which our Company is exposed. Net interest income is affected by changes in interest rates as well as fluctuations in the level and duration of our assets and liabilities. In addition to directly impacting net interest income, changes in interest rates can also affect the amount of new loan originations, the ability of borrowers and debt issuers to repay loans and debt securities, the volume of loan repayments and refinancing, the flow and mix of deposits and the fair value of available for sale securities. In recent years, the Company has adjusted its strategies to manage interest rate risk by originating a greater volume of shorter-term, adjustable rate commercial real estate and commercial business loans and increasing its concentration of core deposits, which are less interest rate sensitive. In the third quarter of 2018 the Company entered into an interest rate swap arrangement with a notional amount of $3.0 million to convert a portion of its fixed rate residential, one- to four-family real estate loans into adjustable rate interest-earning assets, to better manage its exposure to movements in interest rates.

Credit risk is the risk to our earnings and stockholders' equity that results from customers, to whom loans have been made, and from issuers of debt securities in which the Company has invested, failing to repay their obligations. The magnitude of this risk depends on the capacity and willingness of borrowers and debt issuers to repay and the sufficiency of the value of collateral obtained to secure the loans made or investments purchased. This risk is managed by policies approved by the Company's Board of Directors, review of compliance with the policies and periodic reporting and evaluation of loans or securities that are non-performing or demonstrate other characteristics of potential loss.

Management Strategy

There have been no material changes in the Company's management strategy from what was disclosed in the Company's Annual Report on Form 10-K for the year ended December 31, 2017.

Critical Accounting Policies

Disclosure of the Company's significant accounting policies is included in the notes to the consolidated financial statements of the Company's Annual Report on Form 10-K for the year ended December 31, 2017. Some of these policies require significant judgment, estimates and assumptions to be made by management, most particularly in connection with determining the provision for loan losses and the appropriate level of the allowance for loan losses, as well as management's evaluation of securities valuation, impairment of securities and income taxes. There have been no material changes in critical accounting policies since December 31, 2017.

Analysis of Net Interest Income

Net interest income represents the difference between the interest we earn on our interest-earning assets, such as commercial loans, residential mortgage loans and investment securities, and the expense we pay on interest-bearing liabilities, such as deposits and borrowings. Net interest income depends on both the volume of our interest-earning assets and interest-bearing liabilities and the interest rates we earn or pay on them.

Average Balances, Interest and Average Yields. The following tables set forth certain information relating to our average balance sheet and reflect the average yield on interest-earning assets and average cost of interest-bearing liabilities, interest earned and interest paid for the periods indicated. Such yields and costs are derived by dividing interest income or expense by the average balance of interest-earning assets or interest-bearing liabilities, respectively, for the periods indicated. Average balances are derived from daily balances over the periods indicated. The average balances for loans are net of allowance for loan losses, but include non-accrual loans. Interest income on securities does not include a tax equivalent adjustment for bank qualified municipal bonds.

	For the Three Months Ended September 30, 2018			For the Three Months Ended September 30, 2017		
	Average Balance	Interest Income/ Expense	Yield/ Rate(2)	Average Balance	Interest Income/ Expense	Yield/ Rate(2)
	(Dollars in thousands)					
Interest-earning assets:						
Interest-earning deposits & federal funds sold	$ 32,972	$ 157	1.90%	$ 31,466	$ 81	1.03%
Securities(1)	85,797	670	3.12%	76,678	577	3.01%
Loans	383,810	4,663	4.86%	362,198	4,289	4.74%
Total interest-earning assets	502,579	5,490	4.37%	470,342	4,947	4.21%
Other assets	40,089			37,924		
Total assets	$ 542,668			$ 508,266		
Interest-bearing liabilities						
Demand & NOW accounts	$ 51,223	$ 15	0.12%	$ 49,850	$ 16	0.13%
Money market accounts	118,713	238	0.80%	87,099	72	0.33%
Savings accounts	52,825	8	0.06%	54,211	8	0.06%
Time deposits	150,178	522	1.39%			