

Lake Shore Bancorp, Inc.  
Form 10-Q  
November 14, 2012

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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, 2012

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

Commission file number: 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 (I.R.S. Employer Identification Number)  
organization)

31 East Fourth Street, Dunkirk, New York 14048  
(Address of principal executive offices) (Zip code)

(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  No

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

Yes  No

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

Large accelerated filer  Accelerated filer

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Non-accelerated filer  (Do not check if a smaller reporting company) Smaller reporting company

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

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

Common stock (\$0.01 par value) 5,939,132 shares outstanding as of November 1, 2012.

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## PART I

## Item 1. Financial Statements

LAKE SHORE BANCORP, INC. and SUBSIDIARY  
Consolidated Statements of Financial ConditionSeptember 30, 2012  
(Unaudited)

December 31, 2011

(Dollars in thousands, except per share data)

## Assets

Cash and due from banks	\$ 8,233	\$ 7,031
Interest earning deposits	16,436	5,402
Federal funds sold	14,337	11,271
<b>Cash and Cash Equivalents</b>	<b>39,006</b>	<b>23,704</b>
Securities available for sale	168,890	164,165
Federal Home Loan Bank stock, at cost	2,019	2,219
Loans receivable, net of allowance for loan losses 2012 \$1,499; 2011 \$1,366	265,056	275,068
Premises and equipment, net	8,433	8,530
Accrued interest receivable	2,012	1,919
Bank owned life insurance	11,558	11,376
Other assets	1,759	1,616
<b>Total Assets</b>	<b>\$ 498,733</b>	<b>\$ 488,597</b>
<b>Liabilities and Stockholders' Equity</b>		
<b>Liabilities</b>		
<b>Deposits:</b>		
Interest bearing	\$ 355,376	\$ 352,369
Non-interest bearing	37,250	27,429
<b>Total Deposits</b>	<b>392,626</b>	<b>379,798</b>
Short-term borrowings	14,150	6,910
Long-term debt	15,150	27,230
Advances from borrowers for taxes and insurance	1,752	3,148
Other liabilities	7,999	7,564
<b>Total Liabilities</b>	<b>431,677</b>	<b>424,650</b>
<b>Commitments and Contingencies</b>	<b>—</b>	<b>—</b>
<b>Stockholders' Equity</b>		
Common stock, \$0.01 par value per share, 25,000,000 shares authorized;	66	66

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6,612,500 shares issued and 5,939,132 shares outstanding  
at September 30, 2012 and December  
31, 2011

Additional paid-in capital	27,973		27,987
Treasury stock, at cost (673,368 shares at September 30, 2012 and December 31, 2011)	(6,260	)	(6,260
Unearned shares held by ESOP	(1,982	)	(2,046
Unearned shares held by RRP	(566	)	(606
Retained earnings	41,837		39,770
Accumulated other comprehensive income	5,988		5,036
<b>Total Stockholders' Equity</b>	<b>67,056</b>		<b>63,947</b>
<b>Total Liabilities and Stockholders' Equity</b>	<b>\$ 498,733</b>		<b>\$ 488,597</b>

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,	
	2012	2011	2012	2011
	(Unaudited)			
	(Dollars in thousands except per share data)			
<b>Interest Income</b>				
Loans, including fees	\$3,450	\$3,657	\$10,600	\$10,742
Investment securities, taxable	875	1,086	2,857	3,367
Investment securities, tax-exempt	480	460	1,428	1,425
Other	10	9	23	29
<b>Total Interest Income</b>	<b>4,815</b>	<b>5,212</b>	<b>14,908</b>	<b>15,563</b>
<b>Interest Expense</b>				
Deposits	995	1,124	3,112	3,483
Short-term borrowings	14	4	37	19
Long-term debt	107	229	371	715
Other	27	27	81	83
<b>Total Interest Expense</b>	<b>1,143</b>	<b>1,384</b>	<b>3,601</b>	<b>4,300</b>
<b>Net Interest Income</b>	<b>3,672</b>	<b>3,828</b>	<b>11,307</b>	<b>11,263</b>
<b>Provision for loan losses</b>	<b>220</b>	<b>10</b>	<b>270</b>	<b>295</b>
<b>Net Interest Income after Provision for Loan Losses</b>	<b>3,452</b>	<b>3,818</b>	<b>11,037</b>	<b>10,968</b>
<b>Non-interest income</b>				
Service charges and fees	414	433	1,262	1,281
Earnings on bank owned life insurance	62	65	182	194
Total other-than-temporary impairment ("OTTI") losses	—	—	(566)	—
Portion of OTTI losses recognized in comprehensive income (before taxes)	—	—	509	—
<b>Net OTTI losses recognized in earnings</b>	<b>—</b>	<b>—</b>	<b>(57)</b>	<b>—</b>
<b>Gain on sale of securities available for sale</b>	<b>—</b>	<b>—</b>	<b>—</b>	<b>31</b>
<b>Recovery on previously impaired investment securities</b>	<b>—</b>	<b>—</b>	<b>—</b>	<b>57</b>
<b>Other</b>	<b>30</b>	<b>30</b>	<b>97</b>	<b>90</b>
<b>Total Non-Interest Income</b>	<b>506</b>	<b>528</b>	<b>1,484</b>	<b>1,653</b>
<b>Non-interest Expenses</b>				
Salaries and employee benefits	1,524	1,444	4,600	4,382
Occupancy and equipment	437	449	1,327	1,344
Professional services	338	274	1,006	851

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Data processing	161	144	466	426
Advertising	82	129	335	382
FDIC Insurance	62	15	184	264
Postage and Supplies	57	54	174	187
Other	213	269	893	777
Total Non-Interest Expenses	2,874	2,778	8,985	8,613
Income before Income Taxes	1,084	1,568	3,536	4,008
Income tax expense	221	412	771	915
Net Income	\$863	\$1,156	\$2,765	\$3,093
Basic and diluted earnings per common share	\$0.15	\$0.20	\$0.48	\$0.54
Dividends declared per share	\$0.07	\$0.07	\$0.21	\$0.21

See notes to consolidated financial statements.

LAKE SHORE BANCORP INC. AND SUBSIDIARY  
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
			(Unaudited)	
	(Dollars in thousands)			
Net Income	\$863	\$1,156	\$2,765	\$3,093
Other Comprehensive Income, net of tax:				
Unrealized holding gains on securities available for sale	853	2,839	917	5,246
Reclassification adjustments related to:				
Recovery on previously impaired investment securities	—	—	—	(35 )
Gains on sales of securities included in net income	—	—	—	(19 )
Impairment charge for losses included in net income	—	—	35	—
Total Other Comprehensive Income	853	2,839	952	5,192
Total Comprehensive Income	\$1,716	\$3,995	\$3,717	\$8,285

See notes to consolidated financial statements.



LAKE SHORE BANCORP, INC. and SUBSIDIARY  
CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY  
Nine Months Ended September 30, 2012 and 2011 (unaudited)

	Common Stock	Additional Paid-in Capital	Treasury Stock	Unearned Shares Held by ESOP	Unearned Shares Held by RRP	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Total
(Dollars in thousands, except share and per share data)								
Balance – January 1, 2011	\$ 66	\$ 27,920	\$ (6,091)	\$ (2,132)	\$ (757 )	\$ 36,737	\$ (533 )	\$ 55,210
Net income	—	—	—	—	—	3,093	—	3,093
Other comprehensive income, net of tax	—	—	—	—	—	—	5,192	5,192
ESOP shares earned (5,952 shares)	—	(3 )	—	64	—	—	—	61
Stock based compensation	—	80	—	—	—	—	—	80
RRP shares earned (8,446 shares)	—	(26 )	—	—	113	—	—	87
Purchase of treasury stock, at cost (17,950 shares)	—	—	(169 )	—	—	—	—	(169 )
Cash dividends declared (\$0.21 per share)	—	—	—	—	—	(513 )	—	(513 )
Balance – September 30, 2011	\$ 66	\$ 27,971	\$ (6,260)	\$ (2,068)	\$ (644 )	\$ 39,317	\$ 4,659	\$ 63,041
Balance – January 1, 2012	\$ 66	\$ 27,987	\$ (6,260)	\$ (2,046)	\$ (606 )	\$ 39,770	\$ 5,036	\$ 63,947
Net income	—	—	—	—	—	2,765	—	2,765
Other comprehensive income, net of tax	—	—	—	—	—	—	952	952
ESOP shares earned (5,951 shares)	—	(4 )	—	64	—	—	—	60
Stock based compensation	—	6	—	—	—	—	—	6
RRP shares earned (2,978 shares)	—	(16 )	—	—	40	—	—	24
	—	—	—	—	—	(698 )	—	(698 )

Cash dividends  
declared (\$0.21 per  
share)

Balance –  
September 30,  
2012

\$ 66	\$ 27,973	\$ (6,260)	\$ (1,982)	\$ (566 )	\$ 41,837	\$ 5,988	\$ 67,056
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See notes to consolidated financial statements.

LAKE SHORE BANCORP, INC. and SUBSIDIARY  
CONSOLIDATED STATEMENTS of CASH FLOWS

	Nine Months Ended September 30, 2012          2011 (Unaudited) (Dollars in thousands)	
<b>Cash Flows from Operating Activities</b>		
Net Income	\$2,765	\$3,093
Adjustments to reconcile net income to net cash provided by operating activities:		
Net amortization of investment securities	298	74
Amortization of deferred loan costs	421	374
Provision for loan losses	270	295
Impairment of investment securities	57	—
Recovery on previously impaired investment securities	—	(57)
Gain on sale of investment securities	—	(31)
Originations of loans held for sale	(274)	(487)
Proceeds from sales of loans held for sale	274	487
Depreciation and amortization	495	495
Increase in bank owned life insurance, net	(182)	(194)
ESOP shares committed to be released	60	61
Stock based compensation expense	30	167
Increase in accrued interest receivable	(93)	(302)
Decrease in other assets	627	806
(Decrease) increase in other liabilities	(165)	181
<b>Net Cash Provided by Operating Activities</b>	<b>4,583</b>	<b>4,962</b>
<b>Cash Flows from Investing Activities</b>		
Activity in available for sale securities:		
Sales	—	4,673
Maturities, prepayments and calls	25,002	16,676
Purchases	(28,529)	(18,666)
Purchases of Federal Home Loan Bank Stock	(17)	(51)
Redemptions of Federal Home Loan Bank Stock	217	183
Loan origination and principal collections, net	8,553	(13,602)
Additions to premises and equipment	(401)	(171)
<b>Net Cash Provided by (Used in) Investing Activities</b>	<b>4,825</b>	<b>(10,958)</b>
<b>Cash Flows from Financing Activities</b>		
Net increase in deposits	12,828	7,998
Net decrease in advances from borrowers for taxes and insurance	(1,396)	(1,309)
Net increase (decrease) in short-term borrowings	7,240	(350)
Proceeds from issuance of long-term debt	—	4,100
Repayment of long-term debt	(12,080)	(7,670)
Purchase of Treasury Stock	—	(169)
Cash dividends paid	(698)	(513)

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Net Cash Provided by Financing Activities	5,894	2,087
Net Increase (Decrease) in Cash and Cash Equivalents	15,302	(3,909 )
Cash and Cash Equivalents – Beginning	23,704	33,514
Cash and Cash Equivalents – Ending	\$39,006	\$29,605
<b>Supplementary Cash Flows Information</b>		
Interest paid	\$3,640	\$4,338
Income taxes paid	\$891	\$876
<b>Supplementary Schedule of Noncash Investing and Financing Activities</b>		
Foreclosed real estate acquired in settlement of loans	\$887	\$145
Securities purchased and not settled	\$—	\$2,065

See notes to consolidated financial statements.

LAKE SHORE BANCORP, INC. and Subsidiary  
Notes to Consolidated Financial Statements (unaudited)

NOTE 1 – NATURE OF OPERATIONS AND BASIS OF PRESENTATION

Lake Shore Bancorp, Inc. (the “Company”) was formed on April 3, 2006 to serve as the stock holding company for Lake Shore Savings Bank (“the Bank”) as part of the Bank’s conversion and reorganization from a New York-chartered mutual savings and loan association to the federal mutual holding company form of organization.

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

The interim financial statements included herein as of September 30, 2012 and for the three and nine months ended September 30, 2012 and 2011 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 balance sheet at December 31, 2011 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 Form 10-K for the year ended December 31, 2011. The consolidated results of operations for the three and nine months ended September 30, 2012 are not necessarily indicative of the results for any subsequent period or the entire year ending December 31, 2012.

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 balance sheet as of September 30, 2012 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

There were no new accounting standards affecting the Company during the period that were not previously disclosed.

## NOTE 3 – INVESTMENT SECURITIES

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

	September 30, 2012			
	Amortized	Gross	Gross	Fair
	Cost	Unrealized	Unrealized	Value
	(Dollars in Thousands)			
<b>Securities Available for Sale:</b>				
U.S. Treasury bonds	\$12,905	\$2,435	\$ —	\$15,340
Municipal bonds	51,676	4,876	—	56,552
<b>Mortgage-backed securities:</b>				
Collateralized mortgage obligations				
-private label	102	2	—	104
Collateralized mortgage obligations				
-government sponsored entities	60,536	732	(104 )	61,164
Government National Mortgage				
Association	2,783	332	—	3,115
Federal National Mortgage				
Association	19,882	1,357	—	21,239
Federal Home Loan Mortgage				
Corporation	6,196	587	—	6,783
Asset-backed securities				
-private label	4,868	512	(961 )	4,419
Asset-backed securities				
-government sponsored entities	153	15	—	168
Equity securities	22	—	(16 )	6
	\$159,123	\$10,848	\$(1,081 )	\$168,890

## NOTE 3 – INVESTMENT SECURITIES (continued)

	December 31, 2011			Fair Value
	Amortized Cost (Dollars in Thousands)	Gross Unrealized Gains	Gross Unrealized Losses	
<b>Securities Available for Sale:</b>				
U.S. Treasury bonds	\$ 12,935	\$ 2,143	\$ —	\$ 15,078
Municipal bonds	49,561	4,115	—	53,676
<b>Mortgage-backed securities:</b>				
Collateralized mortgage obligations				
-private label	133	—	(4 )	129
Collateralized mortgage obligations				
-government sponsored entities	59,669	1,127	(25 )	60,771
Government National Mortgage Association	3,141	208	—	3,349
Federal National Mortgage Association	19,612	958	—	20,570
Federal Home Loan Mortgage Corporation	5,246	520	—	5,766
Asset-backed securities				
-private label	5,459	378	(1,205 )	4,632
Asset-backed securities				
-government sponsored entities	173	16	—	189
Equity securities	22	—	(17 )	5
	\$ 155,951	\$ 9,465	\$ (1,251 )	\$ 164,165

All of our mortgage-backed securities and collateralized mortgage obligations are backed by residential mortgages.

At September 30, 2012 and December 31, 2011, equity securities consisted of 22,368 shares of Federal Home Loan Mortgage Corporation (“FHLMC”) common stock.

At September 30, 2012 and December 31, 2011, thirty-two municipal bonds with a cost of \$10.0 million and fair value of \$11.2 million were pledged under a collateral agreement with the Federal Reserve Bank of New York for liquidity borrowing. In addition, at September 30, 2012, five municipal bonds with a cost of \$1.1 million and a fair value of \$1.2 million were pledged as collateral for customer deposits in excess of the Federal Deposit Insurance Corporation (“FDIC”) insurance limits. In addition, at December 31, 2011, eleven municipal bonds with a cost of \$4.1 million and a fair value of \$4.6 million were pledged as collateral for customer deposits in excess of the FDIC insurance limits.

## NOTE 3 – INVESTMENT SECURITIES (continued)

The following table sets forth the Company’s investment in 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, 2012						
Mortgage-backed securities	\$14,312	\$(88 )	\$1,030	\$(16 )	\$15,342	\$(104 )
Asset-backed securities – private label	—	—	3,645	(961 )	3,645	(961 )
Equity securities	—	—	6	(16 )	6	(16 )
	\$14,312	\$(88 )	\$4,681	\$(993 )	\$18,993	\$(1,081 )
December 31, 2011						
Mortgage-backed securities	\$6,982	\$(29 )	\$—	\$—	\$6,982	\$(29 )
Asset-backed securities – private label	—	—	3,846	(1,205 )	3,846	(1,205 )
Equity securities	—	—	5	(17 )	5	(17 )
	\$6,982	\$(29 )	\$3,851	\$(1,222 )	\$10,833	\$(1,251 )

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

The Company determines whether the unrealized losses are other-than-temporary in accordance with FASB Accounting Standards Codification (“ASC”) Topic 320 “Investments - Debt and Equity Securities.” The evaluation is based upon factors such as the creditworthiness of the issuers/guarantors, the underlying collateral and the continuing performance of the securities.

Management also evaluates other facts and circumstances that may be indicative of an OTTI condition. This includes, but is not limited to, an evaluation of the type of security, length of time and extent to which fair value has been less than cost, and near-term prospects of the issuer. The Company uses the cash flow expected to be realized from the security, which includes assumptions about interest rates, timing and severity of defaults, estimates of potential recoveries, the cash flow distribution from the provisions in the applicable bond indenture and other factors, then applies a discounting rate equal to the effective yield of the security. If the present value of the expected cash flows is less than the amortized book value it is considered a credit loss. The fair value of the security is determined using the same expected cash flows; the discount rate is a rate the Company determines from open market and other sources as appropriate for the security. The difference between the fair value and the credit loss is recognized in other comprehensive income, net of taxes.

At September 30, 2012, the Company’s investment portfolio included twelve mortgage-backed securities in the unrealized losses less than twelve months category. The mortgage-backed securities were not evaluated further for OTTI as the unrealized losses on the individual securities were less than 20% of book value, which management deemed to be immaterial, and the securities were backed by government sponsored entities. The Company expects these securities to be repaid in full, with no losses realized. Management does not intend to sell these securities and it



is more likely than not that it will not be required to sell these securities.

## NOTE 3 – INVESTMENT SECURITIES (continued)

At September 30, 2012, the Company had one equity security, three mortgage-backed securities and four private-label asset-backed securities in the unrealized losses twelve months or more category. The Company's investment in equity securities is a requirement of its membership with the FHLMC. The equity security was not evaluated further for OTTI, despite the percentage of unrealized losses, due to immateriality.

The three mortgage-backed securities and one of the four private label asset-backed securities in this category were not evaluated further for OTTI, as the unrealized losses were less than 20% of book value. 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. The Company expects these securities to be repaid in full, with no losses realized. Management does not intend to sell these securities and it is more likely than not that it will not be required to sell these securities.

Three of the four private label asset-backed securities in this category were evaluated further for OTTI, as the unrealized loss was greater than 20% of book value for the individual security, the related credit ratings were below investment grade, or the Company's analysis indicated a possible loss of principal. The following table provides additional information relating to these private label asset-backed securities as of September 30, 2012 (dollars in thousands):

Security	Book Value	Fair Value	Unrealized Gain/(Loss)	Lowest Rating	Delinquent %		Foreclosure/OREO / Bankruptcy OREO	
					Over 60 days	Over 90 days	%	%
1	\$ 1,943	\$ 1,442	\$ (501 )	C	40.10%	38.60%	19.90%	0.80 %
2	1,168	865	(303 )	CCC	34.10%	32.60%	14.70%	1.00 %
3	1,000	850	(150 )	CCC	20.70%	19.50%	13.00%	0.50 %
Total	\$ 4,111	\$ 3,157	\$ (954 )					

The three private label asset-backed securities listed above were evaluated for OTTI under the guidance of FASB ASC Topic 320. The Company believes the unrealized losses on these three private label asset-backed securities occurred due to the current challenging economic environment, high unemployment rates, a continued decline in housing values in many areas of the country, and increased delinquency trends. It is possible that principal losses may be incurred on the tranches we hold in these specific securities. Management's evaluation of the estimated discounted cash flows in comparison to the amortized book value for the securities listed above did not reflect the need to record OTTI charges against earnings as of September 30, 2012 as the calculations of the estimated discounted cash flows either did not show additional principal losses or the additional principal loss was considered immaterial for these securities under various prepayment and default rate scenarios. Management also concluded that it does not intend to sell these securities and that it is not likely it will be required to sell these securities.

Management also completed an OTTI analysis for two private label asset-backed securities, which did not have unrealized losses as of September 30, 2012. However, an impairment charge had been taken on these securities during 2008. Management reviewed key credit metrics for these securities, including delinquency rates, cumulative default rates, prepayment speeds, foreclosure rates, loan-to-values and credit support levels. Management's calculation of the estimated discounted cash flows did not show additional principal losses for these securities under various prepayment and default rate scenarios. As a result of the stress tests that were performed, management concluded that additional OTTI charges were



## NOTE 3 – INVESTMENT SECURITIES (continued)

not required as of September 30, 2012 on these securities. Management also concluded that it does not intend to sell the securities and that it is not likely it will be required to sell these securities.

The unrealized losses shown in the previous table, were recorded as a component of other comprehensive income, net of tax on the Company's Consolidated Statements of Changes in Stockholders' Equity.

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

	For the Nine Months Ended September 30, 2012	For the Year Ended December 31, 2011
(Dollars in thousands)		
Beginning balance	\$ 1,084	\$ 1,176
Additions:		
Credit loss not previously recognized	57	—
Reductions:		
Losses realized during the period on OTTI previously recognized	(26 )	(35 )
Receipt of cash flows on previously recorded OTTI	—	(57 )
Ending balance	\$ 1,115	\$ 1,084

Further deterioration in credit quality and/or a continuation of the current imbalances in liquidity that exist in the marketplace 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.

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

	Amortized Cost (Dollars in Thousands)	Fair Value
September 30, 2012:		
After five years through ten years	\$ 20,683	\$ 23,476
After ten years	43,898	48,416
Mortgage-backed securities	89,499	92,405
Asset-backed securities	5,021	4,587
Equity securities	22	6
	\$ 159,123	\$ 168,890

During the nine months ended September 30, 2012, the Company did not sell any available for sale securities. The Company sold available for sale securities during the nine months ended September 30, 2011, for total proceeds of \$4.7 million, resulting in gross realized gains of \$115,000 and gross realized losses of \$84,000.

#### 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 has not been impacted as severely as other parts of the country by fluctuating real estate prices. Furthermore, the Company has conservative underwriting standards and does not have any sub-prime loans in its loan portfolio.
- Home Equity - are loans or lines of credit secured by second lien collateral on owner-occupied residential real estate primarily held in the Western New York area. These loans can also be affected by economic conditions and the values of underlying properties.
- 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 large loan balances to 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 conventional 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 estimated cost of construction.

##### Other Loans:

- Commercial – includes business installment loans, lines of credit, and other commercial loans. Most of our commercial loans have variable interest rates tied to the prime rate, and are for terms generally not in excess of 10 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 businesses and the income stream of the borrower. Such risks can be significantly affected by economic conditions.
- 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.

## NOTE 4 - ALLOWANCE FOR LOAN LOSSES (continued)

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 the amount of loss components to these classified loans based on loan grade.

The following table summarizes the activity in the allowance for loan losses for the three and nine months ended September 30, 2011 and 2012 and the distribution of the allowance for loan losses and loans receivable by loan portfolio class and impairment method as of September 30, 2012:

	Real Estate Loans			Other Loans				Unallocated Total
	One- to Four- Family	Home Equity	Commercial Construction	Commercial	Consumer			
(Dollars in thousands)								
September 30, 2011								
Allowance for Loan Losses:								
Balance – July 1, 2011	\$373	\$90	\$ 498	\$ —	\$228	\$ 17	\$ —	\$1,206
Charge-offs	—	—	—	—	(1 )	(3 )	—	(4 )
Recoveries	—	—	—	—	—	—	—	—
Provision	30	(37 )	23	—	(11 )	5	—	10
Balance—September 30, 2011	\$403	\$53	\$ 521	\$ —	\$216	\$ 19	\$ —	\$1,212
Balance – January 1, 2011								
Balance – January 1, 2011	\$407	\$141	\$ 278	\$ 1	\$104	\$ 21	\$ 1	\$953
Charge-offs	—	(29 )	—	—	(1 )	(13 )	—	(43 )
Recoveries	4	—	—	—	—	3	—	7
Provision	(8 )	(59 )	243	(1 )	113	8	(1 )	295
Balance—September 30, 2011	\$403	\$53	\$ 521	\$ —	\$216	\$ 19	\$ —	\$1,212

## NOTE 4 - ALLOWANCE FOR LOAN LOSSES (continued)

	Real Estate Loans			Other Loans				Total
	One- to Four- Family	Home Equity	Commercial	Construction	Commercial	Consumer	Unallocated	
(Dollars in thousands)								
September 30, 2012								
Allowance for Loan Losses:								
Balance – July 1, 2012	\$ 356	\$ 88	\$ 687	\$ 2	\$ 181	\$ 8	\$ 2	\$ 1,324
Charge-offs	—	(12 )	—	—	(33 )	(5 )	—	(50 )
Recoveries	—	—	5	—	—	—	—	5
Provision	—	(11 )	200	(1 )	26	3	3	220
Balance – September 30, 2012	\$ 356	\$ 65	\$ 892	\$ 1	\$ 174	\$ 6	\$ 5	\$ 1,499
Balance – January 1, 2012	\$ 441	\$ 125	\$ 522	\$ —	\$ 265	\$ 13	\$ —	\$ 1,366
Charge-offs	(100 )	(12 )	—	—	(34 )	(6 )	—	(152 )
Recoveries	1	—	13	—	—	1	—	15
Provision	14	(48 )	357	1	(57 )	(2 )	5	270
Balance – September 30, 2012	\$ 356	\$ 65	\$ 892	\$ 1	\$ 174	\$ 6	\$ 5	\$ 1,499
Ending balance: individually evaluated for impairment	\$ —	\$ —	\$ 30	\$ —	\$ —	\$ —	\$ —	\$ 30
Ending balance: collectively evaluated for impairment	\$ 356	\$ 65	\$ 862	\$ 1	\$ 174	\$ 6	\$ 5	\$ 1,469
<b>G r o s s L o a n s</b>								
Receivable (1):								
Ending balance	\$ 169,300	\$ 30,232	\$ 48,228	\$ 510	\$ 13,789	\$ 1,783	\$ —	\$ 263,842
Ending balance: individually evaluated for impairment	\$ —	\$ —	\$ 130	\$ —	\$ 56	\$ —	\$ —	\$ 186
Ending balance: collectively evaluated for impairment	\$ 169,300	\$ 30,232	\$ 48,098	\$ 510	\$ 13,733	\$ 1,783	\$ —	\$ 263,656

(1) Gross Loans Receivable does not include allowance for loan losses of \$(1,499) or deferred loan costs of \$2,713.





## NOTE 4 - ALLOWANCE FOR LOAN LOSSES (continued)

The following table summarizes the distribution of the allowance for loan losses and loans receivable by loan portfolio class and impairment method as of December 31, 2011:

	Real Estate Loans			Other Loans				Total
	One- to Four- Family	Home Equity	Commercial	Construction	Commercial	Consumer	Unallocated	
(Dollars in thousands)								
December 31, 2011								
Allowance for Loan Losses:								
Balance – December 31, 2011	\$441	\$125	\$ 522	\$ —	\$265	\$ 13	\$—	\$1,366
Ending balance: individually evaluated for impairment	\$—	\$—	\$ 8	\$ —	\$—	\$—	\$—	\$8
Ending balance: collectively evaluated for impairment	\$441	\$125	\$ 514	\$ —	\$265	\$ 13	\$—	\$1,358
Gross Loans Receivable (1):								
Ending Balance	\$182,922	\$30,671	\$ 44,776	\$ 519	\$12,911	\$ 1,948	\$—	\$273,747
Ending balance: individually evaluated for impairment	\$—	\$—	\$ 133	\$ —	\$—	\$—	\$—	\$133
Ending balance: collectively evaluated for impairment	\$182,922	\$30,671	\$ 44,643	\$ 519	\$12,911	\$ 1,948	\$—	\$273,614

(1) Gross Loans Receivable does not include allowance for loan losses of \$(1,366) or deferred loan costs of \$2,687.

## NOTE 4 - ALLOWANCE FOR LOAN LOSSES (continued)

Although the allocations noted above 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.

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 for the periods indicated:

	Recorded Investment	Unpaid Principal Balance	Related Allowance (Dollars in thousands)	Average Recorded Investment	Interest Income Recognized
	At September 30, 2012			For the nine months ended September 30, 2012	
With no related allowance recorded:					
Commercial real estate	\$—	\$—	\$—	\$—	\$—
Commercial loans	56	56	—	67	4
With an allowance recorded:					
Commercial real estate	130	130	30	171	7
Total	\$186	\$186	\$30	\$238	\$11
	At December 31, 2011			For the year ended December 31, 2011	
With no related allowance recorded:					
Commercial real estate	\$—	\$—	\$—	\$131	\$14
With an allowance recorded:					
Commercial real estate	133	133	8	245	16
Total	\$133	\$133	\$8	\$376	\$30

## NOTE 4 - ALLOWANCE FOR LOAN LOSSES (continued)

The following table provides an analysis of past due 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
(Dollars in thousands)						
September 30, 2012:						
Real Estate Loans:						
Residential, one- to						
four-family	\$ 1,099	\$ 703	\$ 1,145	\$ 2,947	\$ 166,353	\$ 169,300
Home equity	99	31	189	319	29,913	30,232
Commercial	—	—	255	255	47,973	48,228
Construction	—	—	—	—	510	510
Other Loans:						
Commercial	105	57	89	251	13,538	13,789
Consumer	40	10	35	85	1,698	1,783
Total	\$ 1,343	\$ 801	\$ 1,713	\$ 3,857	\$ 259,985	\$ 263,842
December 31, 2011:						
Real Estate Loans:						
Residential, one- to						
four-family	\$ 949	\$ 608	\$ 1,989	\$ 3,546	\$ 179,376	\$ 182,922
Home equity	403	51	157	611	30,060	30,671
Commercial	890	39	228	1,157	43,619	44,776
Construction	—	—	—	—	519	519
Other Loans:						
Commercial	41	3	159	203	12,708	12,911
Consumer	58	4	28	90	1,858	1,948
Total	\$ 2,341	\$ 705	\$ 2,561	\$ 5,607	\$ 268,140	\$ 273,747

## NOTE 4 - ALLOWANCE FOR LOAN LOSSES (continued)

The following table is a summary of non-accrual loans and accruing loans delinquent 90 days or more by loan class for the dates indicated:

	At September 30, 2012	At December 31, 2011
	(Dollars in thousands)	
Loans past due 90 days or more but still accruing:		
Real Estate Loans:		
Residential, one- to four-family	\$ 95	\$ 328
Home equity	21	21
Commercial	—	—
Construction	—	—
Other loans:		
Commercial	—	87
Consumer	33	23
Total	\$ 149	\$ 459
Loans accounted for on a non-accrual basis:		
Real Estate Loans:		
Residential, one- to four-family	\$ 1,454	\$ 1,821
Home equity	233	209
Commercial	255	228
Construction	—	—
Other loans:		
Commercial	192	76
Consumer	3	5
Total	\$ 2,137	\$ 2,339

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. When interest accrual is discontinued, all unpaid accrued interest is reversed. Interest income is subsequently recognized only to the extent cash payments are received. 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 period ended September 30, 2012 and September 30, 2011 was \$104,000 and \$85,000 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;

## NOTE 4 - ALLOWANCE FOR LOAN LOSSES (continued)

- 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 individually classified. Instead, the Company uses the delinquency status as the credit quality indicator for consumer loans. Unless the loan is well secured and in the process of collection, all consumer loans that are more than 90 days past due are classified.

The following table summarizes the internal loan grades applied to the Company's loan portfolio as of September 30, 2012 and December 31, 2011:

	Pass/ Performing	Special Mention	Substandard	Doubtful	Loss	Total
	(Dollars in thousands)					
September 30, 2012						
Real Estate Loans:						
Residential, one- to four-family	\$ 167,541	\$—	\$ 1,759	\$—	\$—	\$ 169,300
Home equity	29,943	—	289	—	—	30,232
Commercial	44,387	1,216	2,495	130	—	48,228
Construction	510	—	—	—	—	510
Other Loans:						
Commercial	13,065	461	188	75	—	13,789
Consumer	1,778	—	4	1	—	1,783
Total	\$ 257,224	\$ 1,677	\$ 4,735	\$ 206	\$—	\$ 263,842
December 31, 2011						
Real Estate Loans:						
Residential, one- to four-family	\$ 180,606	\$—	\$ 1,991	\$ 265	\$ 60	\$ 182,922
Home equity	30,270	—	401	—	—	30,671
Commercial	41,234	3,233	81	228	—	44,776
Construction	519	—	—	—	—	519
Other Loans:						
Commercial	11,252	1,313	241	105	—	12,911
Consumer	1,940	—	8	—	—	1,948
Total	\$ 265,821	\$ 4,546	\$ 2,722	\$ 598	\$ 60	\$ 273,747

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



NOTE 4 - ALLOWANCE FOR LOAN LOSSES (continued)

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.

For the nine months ended September 30, 2012, 80 one- to four-family real estate loans with aggregate balances of \$8.5 million were modified and not classified as TDRs. These loans were modified for qualified customers, who received a lower interest rate, in order for the Company to maintain the lending relationship and remain competitive in the current low interest rate environment. As of September 30, 2012, the Company had one home equity loan for \$31,000 that was classified as a TDR. The TDR home equity loan was modified due to the borrower's financial difficulties, in which case past due post-petition payments and attorney fees were capitalized as part of the loan balance, increasing the balance to \$34,000 from \$31,000, and the loan term was extended by 8 years with no change in interest rate. This loan was classified as a substandard loan with no specific reserve established and was 330 days past due under the modified terms at September 30, 2012.

NOTE 5 – EARNINGS PER SHARE

Earnings per share was calculated for the three and nine months ended September 30, 2012 and 2011, 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") and unearned shares held by the Recognition and Retention Plan ("RRP"). 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 and unvested restricted stock 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.



## NOTE 5 – EARNINGS PER SHARE (continued)

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

	Three Months Ended September 30, 2012	Three Months Ended September 30, 2011
Numerator – net income	\$ 863,000	\$ 1,156,000
Denominators:		
Basic weighted average shares outstanding	5,707,375	5,692,710
Increase in weighted average shares outstanding due to (1):		
Stock options	5,193	4,145
Unvested restricted stock awards	746	1,141
Diluted weighted average shares outstanding	5,713,314	5,697,996
Earnings per share:		
Basic	\$ 0.15	\$ 0.20
Diluted	\$ 0.15	\$ 0.20

	Nine Months Ended September 30, 2012	Nine Months Ended September 30, 2011
Numerator – net income	\$ 2,765,000	\$ 3,093,000
Denominators:		
Basic weighted average shares outstanding	5,704,409	5,690,554
Increase in weighted average shares outstanding due to (1):		
Stock options	4,652	4,369
Unvested restricted stock awards	244	525
Diluted weighted average shares outstanding	5,709,305	5,695,448
Earnings per share:		
Basic	\$ 0.48	\$ 0.54
Diluted	\$ 0.48	\$ 0.54

- (1) Stock options to purchase 206,643 shares under the Company's 2006 Stock Option Plan (the "Stock Option Plan") at \$11.50 per share were outstanding during the nine month period ended September 30, 2012 but were not included in the calculation of diluted earnings per share because to do so would have been anti-dilutive. Stock options to purchase 219,289 shares under the Stock Option Plan at \$11.50 per share and restricted unvested shares of 1,845 under the RRP plan were outstanding during the nine month period ended September 30, 2011, but were not included in the calculation of diluted earnings per share because to do so would have been anti-dilutive.

## 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. 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, 2012	December 31, 2011
	(Dollars in thousands)	
Commitments to grant loans	\$ 12,632	\$ 3,984
Unfunded commitments under lines of credit	\$ 27,099	\$ 26,304

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, 2012 and December 31, 2011, the Company's fixed rate loan commitments totaled \$6.9 million and \$2.0 million, respectively. The range of interest rates on these fixed rate commitments was 2.96% to 7.25% at September 30, 2012.

## NOTE 7– STOCK-BASED COMPENSATION

As of September 30, 2012, the Company had three stock-based compensation plans currently allocated, 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 \$31,000 and \$75,000 for the three months ended September 30, 2012 and 2011, respectively. The compensation cost that has been recorded for the nine months ended September 30, 2012 and September 30, 2011 was \$90,000 and \$228,000, respectively.

## Stock Option Plan

The Company's 2006 Stock Option Plan (the "Stock Option Plan"), which was approved by the Company's shareholders, permits the grant of options to its employees and non-employee directors for up to 297,562 shares of common stock.

Both incentive stock options and non-qualified stock options may be 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.

## NOTE 7– STOCK-BASED COMPENSATION (continued)

A summary of the status of the Stock Option Plan as of September 30, 2012 and 2011 is presented below:

	September 30, 2012			September 30, 2011		
	Options	Exercise Price	Remaining Contractual Life	Options	Exercise Price	Remaining Contractual Life
Outstanding at beginning of year	236,809	\$ 11.05		249,455	\$ 11.07	
Granted	—	—		—		
Forfeited	—	—		(12,646 )	11.50	
Outstanding at end of period	236,809	\$ 11.05		236,809	\$ 11.05	
Options exercisable at end of period	221,845	\$ 11.26	4 years	186,046	\$ 11.32	5 years

At September 30, 2012, stock options outstanding had an intrinsic value of \$74,000 and 60,753 options remained available for grant under the Stock Option Plan. Compensation expense amounted to \$1,000 for the quarter ended September 30, 2012 and \$27,000 for the quarter ended September 30, 2011. Compensation expense amounted to \$6,000 for the nine months ended September 30, 2012 and \$80,000 for the nine months ended September 30, 2011. At September 30, 2012, \$16,000 of unrecognized compensation cost related to stock options is expected to be recognized over a period of 15 to 27 months.

## Recognition and Retention Plan

The Company's 2006 Recognition and Retention Plan ("RRP"), which was approved by the Company's shareholders, permits the grant of restricted stock awards ("Awards") to employees and non-employee directors for up to 119,025 shares of common stock.

Awards vest at a rate of 20% per year. On July 25, 2012 the Board of Directors granted Awards for an aggregate of 300 shares under the RRP to members of management, with the first vesting period ending July 25, 2013. As of September 30, 2012, there were 70,344 shares vested or distributed to eligible participants under the RRP. Compensation expense amounted to \$9,000 for the quarter ended September 30, 2012 and \$28,000 for the quarter ended September 30, 2011. Compensation expense amounted to \$24,000 for the nine months ended September 30, 2012 and \$87,000 for the nine months ended September 30, 2011. At September 30, 2012, \$63,000 of unrecognized compensation cost related to the RRP is expected to be recognized over a period of 15 to 57 months.

A summary of the status of unvested shares under the RRP for the nine months ended September 30, 2012 and 2011 is as follows:

	September 30, 2012	Weighted Average Grant Price	September 30, 2011	Weighted Average Grant Price
Unvested shares outstanding at beginning of year	14,304	\$7.92	31,546	\$9.43
Granted	300	10.17	—	—

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Vested	(3,974 )	7.93	(3,975 )	7.93
Forfeited	—	—	(5,950 )	11.50
Unvested shares outstanding at end of quarter	10,630	\$7.98	21,621	\$9.13

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NOTE 7– STOCK-BASED COMPENSATION (continued)

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, 2012, the balance of the loan to the ESOP was \$2.0 million and the fair value of unallocated shares was \$1.9 million. As of September 30, 2012, there were 53,562 allocated shares and 184,488 unallocated shares compared to 45,627 allocated shares and 192,423 unallocated shares at September 30, 2011. The ESOP compensation expense was \$21,000 for the quarter ended September 30, 2012 based on 1,983 shares earned during the quarter and \$20,000 for the quarter ended September 30, 2011 based on 1,984 shares earned during the quarter. The ESOP compensation expense was \$60,000 for the nine months ended September 30, 2012 based on 5,951 shares earned during the period and \$61,000 for the nine months ended September 30, 2011 based on 5,952 shares earned during the period.

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, 2012 and December 31, 2011 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” 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 FASB 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.



## NOTE 8– FAIR VALUE OF FINANCIAL INSTRUMENTS (continued)

For assets measured at fair value on a recurring and nonrecurring basis, the fair value measurements by level within the fair value hierarchy used at September 30, 2012 and December 31, 2011 were as follows:

## Fair Value Measurements at September 30, 2012

	September 30, 2012	Quoted Prices in Active Markets for Identical Assets (Level 1) (Dollars in thousands)	Significant Other Observable Inputs (Level 2)	Significant Other Unobservable Inputs (Level 3)
Measured at fair value on a recurring basis:				
Securities available for sale:				
U.S. Treasury bonds	\$ 15,340	\$ 15,340	\$ —	\$ —
Municipal bonds	56,552	—	56,552	—
Mortgage-backed securities:				
Collateralized mortgage obligations - private label	104	—	104	—
Collateralized mortgage obligations - government sponsored entities	61,164	—	61,164	—
Government National Mortgage Association	3,115	—	3,115	—
Federal National Mortgage Association	21,239	—	21,239	—
Federal Home Loan Mortgage Corporation	6,783	—	6,783	—
Asset-backed securities:				
Private label	4,419	—	488	3,931
Government sponsored entities	168	—	168	—
Equity securities	6	—	6	—
Total	\$ 168,890	\$ 15,340	\$ 149,619	\$ 3,931
Measured at fair value on a non-recurring basis:				
Impaired loans	\$ 100	\$ —	\$ —	\$ 100
Foreclosed real estate	522	—	—	522

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, 2012.





## NOTE 8— FAIR VALUE OF FINANCIAL INSTRUMENTS (continued)

	Fair Value Measurements at December 31, 2011			
	December 31, 2011 (Dollars in thousands)	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Other Unobservable Inputs (Level 3)
Measured at fair value on a recurring basis:				
Securities available for sale:				
U.S. Treasury bonds	\$ 15,078	\$ 15,078	\$ —	\$ —
Municipal bonds	53,676	—	53,676	—
Mortgage-backed securities:				
Collateralized mortgage obligations - private label	129	—	129	—
Collateralized mortgage obligations - government sponsored entities	60,771	—	60,771	—
Government National Mortgage Association	3,349	—	3,349	—
Federal National Mortgage Association	20,570	—	20,570	—
Federal Home Loan Mortgage Corporation	5,766	—	5,766	—
Asset-backed securities:				
Private label	4,632	—	696	3,936
Government sponsored entities	189	—	189	—
Equity securities	5	—	5	—
Total	\$ 164,165	\$ 15,078	\$ 145,151	\$ 3,936
Measured at fair value on a non-recurring basis:				
Impaired loans	\$ 125	\$ —	\$ —	\$ 125
Foreclosed real estate	315	—	—	315

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.

## NOTE 8– FAIR VALUE OF FINANCIAL INSTRUMENTS (continued)

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, 2012 and 2011:

	2012	2011
	(Dollars in thousands)	
Beginning Balance	\$3,936	\$4,278
Total gains – realized/unrealized:		
Included in earnings	—	—
Included in other comprehensive income	373	128
Total losses – realized/unrealized:		
Included in earnings	(57 )	—
Included in other comprehensive income	—	(93 )
Purchases, issuances and settlements	—	—
Sales	—	—
Principal paydowns	(321 )	(329 )
Transfers to (out of) Level 3	—	—
Ending Balance	\$3,931	\$3,984

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 September 30, 2012 (dollars in thousands):

Security Category	Fair Value Estimate	Loan Type/ Collateral	Credit Ratings	Constant Prepayment Speed (CPR)	Unobservable Inputs Probability of Default (Annual Default Rate)	Loss Severity
Asset-backed securities – private label	\$ 3,931	Prime First and Second Lien-Residential Real Estate	CCC thru D	1-7	5.0%-10.5%	70.0%-100.0%

Level 3 inputs are determined by internal management with 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

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## NOTE 8– FAIR VALUE OF FINANCIAL INSTRUMENTS (continued)

assumption used for the loss severity and a directionally opposite change in the assumption used for prepayment rates.

Fair value on impaired loans is based on either recent appraisals less estimated selling costs of related collateral or discounted cash flows based on current market conditions. As of September 30, 2012, impaired loans without a specific allowance had a gross carrying amount of \$56,000. Impaired loans with a specific allowance as of September 30, 2012 had a gross carrying amount of \$130,000 with a valuation allowance of \$30,000, resulting in a \$22,000 additional provision for loan losses for the nine months ended September 30, 2012. As of December 31, 2011 impaired loans with a specific allowance had a gross carrying amount of \$133,000 with a valuation allowance of \$8,000. The use of independent appraisals, discounted cash flow models and management's best judgment are significant inputs in arriving at the fair value of the underlying collateral and impaired loans are therefore classified within Level 3 of the fair value hierarchy.

Foreclosed real estate consists of property acquired in settlement of loans which is carried at its fair value based on recent appraisals less estimated selling costs and which has been subsequently written down during the period. Fair value is based upon independent market prices or appraised value of the property. These assets are included in Level 3 fair value based upon the lowest level of input that is significant to the fair value measurement. The use of independent appraisals and management's best judgment are significant inputs in arriving at the fair value of the underlying collateral and foreclosed real estate is therefore classified within Level 3 of the fair value hierarchy.

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, 2012

	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	\$39,006	\$39,006	\$39,006	\$—	\$ —
Securities available for sale	168,890	168,890	15,340	149,619	3,931
Federal Home Loan Bank stock	2,019	2,019	2,019	—	—
Loans receivable	265,056	267,571	—	—	267,571
Accrued interest receivable	2,012	2,012	2,012	—	—
Financial liabilities:					
Deposits	392,626	398,666	180,541	218,125	—
Short-term borrowings	14,150	14,150	14,150	—	—
Long-term debt	15,150	15,572	—	15,572	—
Accrued interest payable	41	41	41	—	—
Off-balance-sheet financial instruments	—	—	—	—	—



## NOTE 8– FAIR VALUE OF FINANCIAL INSTRUMENTS (continued)

	Fair Value Measurements at December 31, 2011	
	Carrying Amount	Estimated Fair Value
	(Dollars in thousands)	
Financial assets:		
Cash and cash equivalents	\$ 23,704	\$ 23,704
Securities available for sale	164,165	164,165
Federal Home Loan Bank stock	2,219	2,219
Loans receivable	275,068	278,647
Accrued interest receivable	1,919	1,919
Financial liabilities:		
Deposits	379,798	385,995
Short-term borrowings	6,910	6,910
Long-term debt	27,230	27,978
Accrued interest payable	80	80
Off-balance-sheet financial instruments	—	—

The following valuation techniques were used to measure the fair value of financial instruments in the above table:

Cash and cash equivalents (carried at cost)

The carrying amount of cash and cash equivalents approximates fair value.

Securities available for sale (carried at fair value)

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 consist of private label asset-backed securities. The fair value measurement for these Level 3 securities is explained more fully earlier in this footnote.

Federal Home Loan Bank stock (carried at cost)

The carrying amount of Federal Home Loan Bank stock approximates fair value.

Loans Receivable (carried at cost)



NOTE 8– FAIR VALUE OF FINANCIAL INSTRUMENTS (continued)

The fair value of fixed-rate and variable rate performing loans is estimated using a discounted cash flow method. The discount rates take into account interest rates currently being offered to customers for loans with similar terms, the credit risk associated with the loan, estimated maturity and market factors including liquidity. The estimate of maturity is based on the Company's contractual cash flows adjusted for prepayment estimates based on current economic and lending conditions. Fair value for significant nonperforming loans is based on carrying value which does not exceed recent external appraisals of any underlying collateral. Due to the significant judgment involved in evaluating credit quality, loans are classified within Level 3 of the fair value hierarchy.

Accrued Interest Receivable and Payable (carried at cost)

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

Deposits (carried at cost)

The fair value of deposits with no stated maturity, such as savings, money market and checking is the amount payable on demand at the reporting date and are classified within Level 1 of the fair value hierarchy. The fair value of time deposits is based on the discounted value of contractual cash flows at current rates of interest for similar deposits using market rates currently offered for deposits of similar remaining maturities. Due to the minimal amount of unobservable inputs involved in evaluating assumptions used for discounted cash flows of time deposits, these deposits are classified within Level 2 of the fair value hierarchy.

Borrowings (carried at cost)

The fair value of long-term debt was calculated by discounting scheduled cash flows at current market rates of interest for similar borrowings through maturity of each instrument. Due to the minimal amount of unobservable inputs involved in evaluating assumptions used for discounted cash flows of long-term debt, they are classified within Level 2 of the fair value hierarchy. The carrying amount of short term borrowings approximates fair value of such liability.

Off-Balance Sheet Financial Instruments (disclosed at cost)

Fair values of the Company's off-balance sheet financial instruments (lending commitments) are based on fees currently charged to enter into similar agreements, taking into account, the remaining terms of the agreements and the counterparties' credit standing. Other than loan commitments, the Company does not have any off-balance sheet arrangements that have or are reasonably likely to have a current or future effect on its financial condition.

NOTE 9 – TREASURY STOCK

During the quarter and nine months ended September 30, 2012, the Company made no repurchases of shares of common stock. As of September 30, 2012, there were 91,510 shares remaining to be repurchased under the existing stock repurchase program.

During the quarter ended September 30, 2011, the Company did not repurchase any common stock. During the nine months ended September 30, 2011, the Company repurchased 17,950 shares of common stock at an average cost of \$9.39 per share. Of these shares, 15,000 were repurchased pursuant to the Company's publicly announced common stock repurchase programs. The remaining 2,950 shares were repurchased from the trustee of the Company's unvested



RRP stock, when two awardees sold vested shares. As of September 30, 2011, there were 91,510 shares remaining to be repurchased under the existing stock repurchase program.

NOTE 10 – SUBSEQUENT EVENTS

On October 24, 2012, the Board of Directors declared a quarterly dividend of \$0.04 per share on the Company's common stock, payable on November 20, 2012 to shareholders of record as of November 6, 2012.

Lake Shore, MHC (the "MHC") which holds 3,636,875 shares, or 61.2% of the Company's total outstanding stock, will not waive receipt of the dividend payment as it has in past quarters because of the Federal Reserve Board's interim final regulation which requires the prior approval of a majority of the eligible votes of the MHC's members (depositors) for the MHC to waive the receipt of dividends. Due to the significant time that would be required to obtain the member vote required by the Federal Reserve Board's regulation, the Board of Directors of the MHC has determined not to pursue such a vote in connection with this dividend. Without the dividend waiver, the Company must pay a dividend at the same rate on the shares that are held by the MHC as it does for public shareholders. Because of the increased number of shares that must receive the dividend payout, the Company has approved payment of this quarterly dividend at the amount of \$0.04 per share.

The Company also indicated that its Board of Directors has authorized management to resume purchasing shares of common stock in the open market pursuant to its stock repurchase plan that was adopted and announced during November 2010. The timing of the stock repurchases will depend on certain factors, including but not limited to, market conditions and prices, the Company's liquidity requirements and alternative uses of capital.

## 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 based 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 and previous Quarterly Reports on Form 10-Q and in Part I, Item 1A of the Company's Annual Report on Form 10-K for the year ended December 31, 2011, 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;
- 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 transfer of supervisory and enforcement authority over savings banks to the Office of the Comptroller of the Currency and savings and loan holding companies to the Federal Reserve Board;
- 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.

### 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, 2012 compared to the financial condition as of December 31, 2011 and the consolidated results of operations for the three and nine months ended September 30, 2012 and 2011.

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 we pay on deposits 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 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, professional fees, 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, 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.

#### Management Strategy

**Our Reputation.** With more than 121 years of service to our community, our primary management strategy has been to maintain our perceived image as one of the most respected and recognized community banks in Western New York. We strive to accomplish this goal by continuing to emphasize our high quality customer service and financial strength.

**Branching.** In April 2010, we opened our newest branch in Depew, New York. This is our fifth branch in Erie County, New York, and our tenth overall. This office had generated deposits of \$26.7 million as of September 30, 2012. Our offices are located in Dunkirk, Fredonia, Jamestown, Lakewood, and Westfield in Chautauqua County, New York and in Depew, East Amherst, Hamburg, Kenmore, and Orchard Park in Erie County, New York. Saturation of the market in Chautauqua County led to our expansion plan in Erie County, which is a critical component of our future profitability and growth. An important strategic objective is to continue to evaluate the technology supporting our customer service. We are committed to making investments in technology, and we believe that it represents an efficient way to deploy a portion of our capital. To this end, the Company has developed a five year plan for the implementation of cost effective and efficient digital services to meet our customer's technology needs, to focus on attracting new customers, and to improve our operational efficiencies. Although we remain committed to expanding our retail branch footprint whenever it makes strategic sense, we will be concentrating our near term efforts on developing "clicks" instead of "bricks."

**Our People.** A large part of our success is related to customer service and customer satisfaction. Having employees who understand and value our clientele and their business is a key component to our success. We believe that our present staff is one of our competitive strengths, and thus the retention of such persons and our ability to continue to attract high quality personnel is a high priority.

**Residential Mortgage and Other Lending.** Historically, our lending portfolio has been composed predominantly of residential one- to four-family mortgage loans. At September 30, 2012 and December 31, 2011, we held \$169.3 million and \$182.9 million of residential one- to four-family mortgage loans, respectively, which constituted 64.2% and 66.8% of our total loan portfolio, at such respective dates. We originate commercial real estate loans to finance

the purchase of real property, which generally consists of developed real estate. At September 30, 2012 and December 31, 2011, our commercial real estate loan portfolio consisted of loans totaling \$48.2 million and \$44.8 million respectively, or 18.3% and 16.4%, respectively, of total loans. In addition to commercial real estate loans, we also engage in small business commercial lending, including business installment loans, lines of credit, and other commercial loans. At September 30, 2012 and December 31, 2011, our commercial loan

portfolio consisted of loans totaling \$13.8 million and \$12.9 million, respectively, or 5.2% and 4.7%, respectively, of total loans. Other loan products offered to our customers include home equity loans and lines of credit, construction loans and consumer loans, including automobile loans, overdraft lines of credit and share loans. We may sell one-to four-family residential loans in the future as part of our interest rate risk strategy and asset/liability management, if it is deemed appropriate. We typically retain servicing rights when we sell one-to four-family residential loans. One- to four-family residential mortgage loans will continue to be the dominant type of loan in our lending portfolio.

**Investment Strategy.** Our investment policy is designed primarily to manage the interest rate sensitivity of our assets and liabilities, to generate a favorable return without incurring undue interest rate and credit risk, to complement our lending activities and to provide and maintain liquidity within established guidelines. We employ a third party financial advisor to assist us in managing our investment portfolio and developing balance sheet strategies.

At September 30, 2012 and December 31, 2011, we had \$168.9 million and \$164.2 million, respectively, invested in securities available for sale, the majority of which are agency mortgage-backed, agency collateralized mortgage obligations (“CMOs”) and municipal securities.

**Asset-Liability Strategy.** As stated above, our business consists primarily of originating one- to four-family residential mortgage loans and commercial real estate loans secured by property in our market area and investing in residential mortgage-backed securities, CMOs and municipal securities. Typically, one- to four-family residential mortgage loans involve a lower degree of risk and carry a lower yield than commercial real estate and commercial business loans. Our loans are primarily funded by time deposits and core deposits (i.e. checking, savings and money market accounts). This has resulted in our being vulnerable to increases in interest rates, as our interest-bearing liabilities will mature or re-price more quickly than our interest-earning assets in a rising rate environment. Although we plan to continue to originate one- to four-family residential mortgage loans going forward, we have been and intend to continue to increase our focus on the origination of commercial real estate loans and commercial business loans, which generally provide higher returns and have shorter durations than one- to four-family residential mortgage loans. Furthermore, our interest rate risk strategy involves improving our funding mix by increasing our core deposits in order to help reduce and control our cost of funds. We value core deposits because they represent longer-term customer relationships as well as lower cost of funds. As part of our strategy to expand our commercial loan portfolio, we expect to attract lower cost core deposits as part of these borrower relationships. We offer competitive rates on a variety of deposit products to meet the needs of our customers and we promote long term deposits, where possible, to meet asset-liability goals.

We are actively involved in managing our balance sheet through the direction of our Asset-Liability Committee and the assistance of a third party advisor. Recent economic conditions have underscored the importance of a strong balance sheet. We strive to achieve this through managing our interest rate risk and maintaining strong capital levels, putting aside adequate loan loss reserves and keeping liquid assets on hand. Diversifying our asset mix not only improves net interest margin but also reduces the exposure of our net interest income and earnings to interest rate risk. We will continue to manage our interest rate risk by diversifying the type and maturity of our assets in our loan and investment portfolios and monitoring the maturities in our deposit portfolio and borrowing facilities.

## Critical Accounting Policies

It is management's opinion that accounting estimates covering certain aspects of our business have more significance than others due to the relative importance of those areas to overall performance, or the level of subjectivity required in making such estimates. Management considers the accounting policy relating to the allowance for loan losses to be a critical accounting policy given the uncertainty in evaluating the level of the allowance for loan losses required for probable credit losses and the material effect that such judgments can have on the results of operations. Management's quarterly evaluation of the adequacy of the allowance considers our historical loan loss experience, review of specific loans, current economic conditions, and such other factors considered appropriate to estimate loan losses. Management uses presently available information to estimate probable losses on loans; however, future additions to the allowance may be necessary based on changes in estimates, assumptions, or economic conditions. Significant factors that could give rise to changes in these estimates include, but are not limited to, changes in economic conditions in our local area, concentrations of risk and decline in local property values. Refer to Note 4 of the Notes to the Consolidated Financial Statements for more information on the allowance for loan losses.

In management's opinion, the accounting policy relating to the valuation of investments is a critical accounting policy. The fair values of our investments are determined using public quotations, third party dealer quotes, pricing models, or discounted cash flows. Thus, the determination may require significant judgment or estimation, particularly when liquid markets do not exist for the item being valued. The use of different assumptions for these valuations could produce significantly different results which may have material positive or negative effects on the results of our operations. Refer to Note 8 of the Notes to the Consolidated Financial Statements for more information on fair value.

Management also considers the accounting policy relating to the impairment of investments to be a critical accounting policy due to the subjectivity and judgment involved and the material effect an impairment loss could have on the consolidated results of income. The credit portion of a decline in the fair value of investments below cost deemed to be other-than-temporary may be charged to earnings resulting in the establishment of a new cost basis for an asset. Management continually reviews the current value of its investments for evidence of OTTI. Refer to Note 3 of the Notes to the Consolidated Financial Statements for more information on OTTI.

These critical policies and their application are reviewed periodically by our Audit Committee and our Board of Directors. All accounting policies are important, and as such, we encourage the reader to review each of the policies included in the notes to our audited consolidated financial statements included in our Form 10-K for the year ended December 31, 2011 to better understand how our financial performance is reported.

## Analysis of Net Interest Income

Net interest income represents the difference between the interest we earn on our interest-earning assets, such as mortgage loans and investment securities, and the expense we pay on interest-bearing liabilities, such as time 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 sheets and reflects 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 income or expense by the average balance of interest-earning assets or interest-bearing liabilities, respectively, for the periods presented. 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 municipals.





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	For the Three Months ended September 30, 2012			For the Three Months ended September 30, 2011		
	Average Balance	Interest Income/ Expense	Yield/Rate  (Dollars in thousands)	Average Balance	Interest Income/ Expense	Yield/ Rate
Interest-earning assets:						
Interest-earning deposits & federal funds sold	\$ 30,280	\$ 10	0.13 %	\$ 21,582	\$ 9	0.17 %
Securities	171,223	1,355	3.17 %	160,431	1,546	3.85 %
Loans	264,717	3,450	5.21 %	273,702	3,657	5.34 %
Total interest-earning assets	466,220	4,815	4.13 %	455,715	5,212	4.57 %
Other assets	30,479			30,224		
Total assets	\$ 496,699			\$ 485,939		
Interest-bearing liabilities:						
Demand and NOW accounts	\$ 40,930	\$ 12	0.12 %	\$ 40,086	\$ 17	0.17 %
Money market accounts	65,020	75	0.46 %	50,766	70	0.55 %
Savings accounts	36,782	10	0.11 %	35,248	20	0.23 %
Time deposits	212,760	898	1.69 %	223,427	1,017	1.82 %
Borrowed funds	30,664	121	1.58 %	35,874	233	2.60 %
Other interest-bearing liabilities	1,216	27	8.88 %	1,260	27	8.57 %
Total interest-bearing liabilities	387,372	1,143	1.18 %	386,661	1,384	1.43 %
Other non-interest bearing liabilities	42,489			38,226		
Stockholders' equity	66,838			61,052		
Total liabilities and stockholders' equity	\$ 496,699			\$ 485,939		
Net interest income		\$ 3,672			\$ 3,828	
Interest rate spread			2.95 %			3.14 %
Net interest margin			3.15 %			3.36 %



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	For the Nine Months ended September 30, 2012			For the Nine Months ended September 30, 2011		
	Average Balance	Interest Income/ Expense	Yield/Rate	Average Balance	Interest Income/ Expense	Yield/ Rate
	(Dollars in thousands)					
Interest-earning assets:						
Interest-earning deposits & federal funds sold						
	\$ 25,116	\$ 23	0.12 %	\$ 20,661	\$ 29	0.19 %
Securities	169,694	4,285	3.37 %	161,976	4,792	3.94 %
Loans	267,878	10,600	5.28 %	268,876	10,742	5.33 %
Total interest-earning assets	462,688	14,908	4.30 %	451,513	15,563	4.60 %
Other assets	30,455			31,139		
Total assets	\$ 493,143			\$ 482,652		
Interest-bearing liabilities:						
Demand and NOW accounts						
	\$ 41,014	\$ 38	0.12 %	\$ 40,222	\$ 52	0.17 %
Money market accounts						
	62,641	240	0.51 %	49,911	205	0.55 %
Savings accounts	35,522	37	0.14 %	34,121	55	0.21 %
Time deposits	215,247	2,797	1.73 %	226,225	3,171	1.87 %
Borrowed funds	31,986	408	1.70 %	37,631	734	2.60 %
Other interest-bearing liabilities	1,227	81	8.80 %	1,270	83	8.71 %
Total interest-bearing liabilities	387,637	3,601	1.24 %	389,380	4,300	1.47 %
Other non-interest bearing liabilities	39,682			34,664		
Stockholders' equity	65,824			58,608		
Total liabilities and stockholders' equity	\$ 493,143			\$ 482,652		
Net interest income		\$ 11,307			\$ 11,263	
Interest rate spread			3.06 %			3.13 %
Net interest margin			3.26 %			3.33 %

Rate Volume Analysis. The following tables analyze the dollar amount of changes in interest income and interest expense for major components of interest-earning assets and interest-bearing liabilities. The tables show the amount

of the change in interest income or expense caused by either changes in outstanding balances (volume) or changes in interest rates. The effect of a change in volume is measured by applying the average rate during the first period to the volume change between the two periods. The effect of changes in rate is measured by applying the change in rate between the two periods to the average volume during the first period. Changes attributable to both rate and volume, which cannot be segregated, have been allocated proportionately to the absolute value of the change due to volume and the change due to rate.

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	Three Months ended September 30, 2012 Compared to Three Months ended September 30, 2011		
	Rate	Volume	Net Change
	(Dollars in thousands)		
<b>Interest-earning assets:</b>			
Interest-earning deposits and federal funds sold	\$(2 )	\$3	\$1
Securities	(290 )	99	(191 )
Loans, including fees deposits, including fees	(89 )	(118 )	(207 )
<b>Total interest-earning assets</b>	<b>(381 )</b>	<b>(16 )</b>	<b>(397 )</b>
<b>Interest-bearing liabilities:</b>			
Demand and NOW accounts	(5 )	—	(5 )
Money market accounts	(13 )	18	5
Savings accounts	(11 )	1	(10 )
Time deposits	(72 )	(47 )	(119 )
<b>Total deposits</b>	<b>(101 )</b>	<b>(28 )</b>	<b>(129 )</b>
<b>Other interest-bearing liabilities:</b>			
Borrowed funds and other	(81 )	(31 )	(112 )
<b>Total interest-bearing liabilities</b>	<b>(182 )</b>	<b>(59 )</b>	<b>(241 )</b>
<b>Total change in net interest income</b>	<b>\$(199 )</b>	<b>\$43</b>	<b>\$(156 )</b>

	Nine Months ended September 30, 2012 Compared to Nine Months ended September 30, 2011		
	Rate	Volume	Net Change
	(Dollars in thousands)		
<b>Interest-earning assets:</b>			
Interest-earning deposits and federal funds sold	\$(11 )	\$5	\$(6 )
Securities	(727 )	220	(507 )
Loans, including fees deposits, including fees	(102 )	(40 )	(142 )
<b>Total interest earning assets</b>	<b>(840 )</b>	<b>185</b>	<b>(655 )</b>
<b>Interest-bearing liabilities:</b>			
Demand and NOW accounts	(15 )	1	(14 )
Money market accounts	(15 )	50	35
Savings accounts	(20 )	2	(18 )
Time deposits	(225 )	(149 )	(374 )
<b>Total deposits</b>	<b>(275 )</b>	<b>(96 )</b>	<b>(371 )</b>
<b>Other interest-bearing liabilities:</b>			
Borrowed funds and other	(226 )	(102 )	(328 )
<b>Total interest-bearing liabilities</b>	<b>(501 )</b>	<b>(198 )</b>	<b>(699 )</b>

Total change in net interest income	\$(339	)	\$383	\$44
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Our earnings may be adversely impacted by an increase in interest rates because the majority of our interest-earning assets are long-term, fixed rate mortgage-related assets that will not reprice as long-term interest rates increase. Conversely, a majority of our interest-bearing liabilities have much shorter contractual maturities and are expected to reprice. A significant portion of our deposits have no contractual maturities and are likely to reprice quickly as short-term interest rates increase. Therefore, in an increasing rate environment, our cost of funds is expected to increase more rapidly than the yields earned on our loan portfolio and securities portfolio. An increasing rate environment is expected to cause a decrease in our net interest rate spread and a decrease in our earnings. In order to mitigate this effect,

the Bank's Asset-Liability Committee is continuing to review its options in relation to core deposit growth, implementation of new products, promotion of adjustable rate commercial loan products and use of derivative products.

In a decreasing interest rate environment, our earnings may increase or decrease. If long-term interest-earning assets do not reprice and interest rates on short-term deposits begin to decrease, earnings may rise. In the current rate environment, rates on the lending and investment portfolios have declined significantly but rates on deposit products and borrowed funds have also dropped, which has assisted in maintaining our interest rate spread. In the current extended low rate environment, the cost of funding is beginning to fall more slowly than the decline in asset yields, resulting in a flat or decreasing net interest margin.

For the three months ended September 30, 2012, the average yields on our loan portfolio and investment portfolio were 5.21% and 3.17%, respectively, in comparison to 5.34% and 3.85%, respectively, for the three months ended September 30, 2011. Overall, the average yield on our interest earning assets decreased by 44 basis points to 4.13% for the three months ended September 30, 2012 in comparison to the three months ended September 30, 2011. For the three months ended September 30, 2012, the average rate that we were paying on interest-bearing liabilities decreased by 25 basis points to 1.18% in comparison to the same period in the prior year. This was partially due to a 102 basis point decrease in the average interest rate paid on our borrowings from 2.60% for the three months ended September 30, 2011 to 1.58% for the three month period ended September 30, 2012 and a 13 basis point decrease in the average rate paid on time deposits from 1.82% for the three month period ended September 30, 2011 to 1.69% for the three month period ended September 30, 2012. Our interest rate spread for the three months ended September 30, 2012 was 2.95%, which was a 19 basis point decrease in comparison to the three months ended September 30, 2011. Our net interest margin was 3.15% and 3.36% for the three months ended September 30, 2012 and 2011, respectively.

For the nine months ended September 30, 2012, the average yields on our loan portfolio and investment portfolio were 5.28% and 3.37%, respectively, in comparison to 5.33% and 3.94%, respectively, for the nine months ended September 30, 2011. Overall, the average yield on our interest earning assets decreased by 30 basis points to 4.30% for the nine months ended September 30, 2012 in comparison to the nine months ended September 30, 2011. For the nine months ended September 30, 2012, the average rate that we were paying on interest-bearing liabilities decreased by 23 basis points to 1.24% in comparison to the same period in the prior year. This was partially due to a 90 basis point decrease in the average interest rate paid on our borrowings from 2.60% for the nine months ended September 30, 2011 to 1.70% for the nine month period ended September 30, 2012 and a 14 basis point decrease in the average rate paid on time deposits from 1.87% for the nine month period ended September 30, 2011 to 1.73% for the nine month period ended September 30, 2012. Our interest rate spread for the nine months ended September 30, 2012 was 3.06%, which was a 7 basis point decrease in comparison to the nine months ended September 30, 2011. Our net interest margin was 3.26% and 3.33% for the nine months ended September 30, 2012 and 2011, respectively.

#### Comparison of Financial Condition at September 30, 2012 and December 31, 2011

Total assets at September 30, 2012 were \$498.7 million, an increase of \$10.1 million, or 2.1%, from \$488.6 million at December 31, 2011. The increase in total assets was primarily due to a \$15.3 million increase in cash and cash equivalents and a \$4.7 million increase in securities available for sale, partially offset by a \$10.0 million decrease in loans receivable, net.

Cash and cash equivalents increased by \$15.3 million, or 64.6%, from \$23.7 million at December 31, 2011 to \$39.0 million at September 30, 2012. The increase was primarily attributed to a \$12.8 million increase in total deposits since December 31, 2011, as well as the receipt of cash flow from prepayments





on the loan and investment portfolios, which have not yet been re-deployed to fund new loans or purchase investment securities.

Securities available for sale increased \$4.7 million, or 2.9%, to \$168.9 million at September 30, 2012 compared to \$164.2 million at December 31, 2011. During the nine month period ended September 30, 2012, the Company purchased \$28.5 million of available for sale securities, including collateralized mortgage obligations, mortgage-backed securities and municipal bonds. The purchases were funded by the receipt of \$25.0 million in paydowns on the investment portfolio, with the remainder being funded by deposit growth and paydowns received on the loan portfolio. The change in the mark to market value of the securities available for sale portfolio between December 31, 2011 and September 30, 2012 was a net gain of \$1.6 million.

Loans receivable, net decreased during the nine month period between September 30, 2012 and December 31, 2011 as shown in the table below:

	At September 30, 2012	At December 31, 2011 (Dollars in thousands)	Change \$	%
<b>Real Estate Loans:</b>				
Residential, one- to four-family	\$ 169,300	\$ 182,922	\$ (13,622 )	(7.4 )%
Home equity	30,232	30,671	(439 )	(1.4 )%
Commercial	48,228	44,776	3,452	7.7 %
Construction	510	519	(9 )	(1.7 )%
<b>Total Real Estate Loans</b>	<b>248,270</b>	<b>258,888</b>	<b>(10,618 )</b>	<b>(4.1 )%</b>
<b>Other Loans:</b>				
Commercial	13,789	12,911	878	6.8 %
Consumer	1,783	1,948	(165 )	(8.5 )%
<b>Total Gross Loans</b>	<b>263,842</b>	<b>273,747</b>	<b>(9,905 )</b>	<b>(3.6 )%</b>
Allowance for loan losses	(1,499 )	(1,366 )	133	9.7 %
Net deferred loan costs	2,713	2,687	26	1.0 %
<b>Loans receivable, net</b>	<b>\$ 265,056</b>	<b>\$ 275,068</b>	<b>\$ (10,012 )</b>	<b>(3.6 )%</b>

The decrease in loans receivable, net was primarily due to a decrease in residential one- to four-family real estate loans and home equity loans, partially offset by an increase in commercial real estate and commercial loans. During 2012, we remain strategically focused on increasing our commercial real estate and commercial loan portfolios to diversify our asset mix, to take advantage of the opportunities available to serve small businesses in our market area, and to maintain an effective net interest margin. The decrease in residential, one- to four-family real estate loans was primarily due to a strategic decision made by the Company not to match lower rates offered by our competitors in an effort to avoid increased interest rate risk. Management continues to look for high quality loans to add to its portfolio and will continue to emphasize loan originations to the extent that it is profitable and prudent.

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The table below shows changes in deposit volumes by type of deposit between September 30, 2012 and December 31, 2011:

	At September 30, 2012	At December 31, 2011	\$	Change %	
		(Dollars in thousands)			
<b>Demand Deposits:</b>					
Non-interest bearing	\$37,250	\$27,429	\$9,821	35.8	%
Interest bearing	41,441	40,649	792	1.9	%
Money market	64,853	58,157	6,696	11.5	%
Savings	36,997	33,676	3,321	9.9	%
Time deposits	212,085	219,887	(7,802)	(3.5)	)%
<b>Total Deposits</b>	<b>\$392,626</b>	<b>\$379,798</b>	<b>\$12,828</b>	<b>3.4</b>	<b>%</b>

The growth in demand deposits as well as the growth in money market and savings accounts, was the result of the Company's continued strategic focus on attracting commercial deposit relationships and growing core deposits among its retail customers. The decrease in time deposits was a result of the Company's decision to not match unreasonable interest rates being offered by competitors in our market area in an effort to maintain our net interest margin.

Our borrowings, consisting of advances from the Federal Home Loan Bank of New York ("FHLB NY"), decreased by \$4.8 million, or 14.2%, from \$34.1 million at December 31, 2011 to \$29.3 million at September 30, 2012. Long-term debt decreased \$12.1 million from \$27.2 million at December 31, 2011 to \$15.2 million at September 30, 2012. Short-term borrowings increased \$7.2 million from \$6.9 million at December 31, 2011 to \$14.2 million at September 30, 2012. As long-term debt matured, the Company paid off \$4.8 million of such debt in order to reduce interest expense, and the remaining proceeds were transferred into short-term borrowings to take advantage of lower interest rates.

Total stockholders' equity increased \$3.1 million, or 4.9%, from \$63.9 million at December 31, 2011 to \$67.1 million at September 30, 2012. The increase in total stockholders' equity was primarily due to \$2.8 million in net income and \$1.0 million of unrealized mark to market gains after taxes during the nine month period ended September 30, 2012, partially offset by \$698,000 in cash dividends paid.

#### Comparison of Results of Operations for the Three Months Ended September 30, 2012 and 2011

**General.** Net income was \$863,000 for the three month period ended September 30, 2012, or \$0.15 per diluted share, a decrease of \$293,000, or 25.3%, compared to net income of \$1.2 million, or \$0.20 per diluted share, for the three month period ended September 30, 2011. The decrease in net income during the three month period ended September 30, 2012 compared to the three month period ended September 30, 2011 was due to a \$397,000 decrease in interest income, a \$210,000 increase in provision for loan losses and a \$96,000 increase in non-interest expense partially offset by a \$241,000 decrease in interest expense and a \$191,000 decrease in income tax expenses.

**Interest Income.** Interest income decreased by \$397,000, or 7.6%, to \$4.8 million for the three month period ended September 30, 2012 compared to the three month period ended September 30, 2011. Loan interest income decreased by \$207,000, or 5.7%, for the three month period ended September 30, 2012 compared to the same period in 2011 due to a decrease in the average yield and average balance of the loan portfolio. The average yield on our loan portfolio

decreased from 5.34% for the three month period ended September 30, 2011 to 5.21% for the three month period ended September 30, 2012, partially due to loan paydowns and new loan originations being recorded at lower interest rates as a result of the current economic environment. The average balance of the loan portfolio decreased \$9.0 million, or 3.3%,

from \$273.7 million for the quarter ended September 30, 2011 to \$264.7 million for the quarter ended September 30, 2012. The decrease in the average balance of loans receivable was primarily due to a decrease in the average balance of one- to four-family real estate and home equity loans, partially offset by an increase in the average balance of commercial real estate and commercial loans. As previously indicated, the decrease in one- to four-family and home equity loans was due to a strategic decision by the Company to not match competitor rates in an effort to avoid increased interest rate risk. Investment interest income decreased \$191,000, or 12.4%, to \$1.4 million for the three month period ended September 30, 2012 compared to \$1.5 million for the same period in 2011 due to the decrease in the average yield on investment securities. The investment portfolio had an average balance of \$171.2 million and an average yield of 3.17% for the three month period ended September 30, 2012 compared to an average balance of \$160.4 million and an average yield of 3.85% for the three month period ended September 30, 2011. The average yield on the investment portfolio decreased as new securities were purchased at lower yields than the rates earned on securities which had paid off, as a result of the current low interest rate environment. The average balance of the investment portfolio increased due to the re-investment of paydowns received on the loan and investment portfolios, as well as funds obtained through deposit growth, into the purchase of new available for sale securities.

**Interest Expense.** Interest expense decreased by \$241,000, or 17.4%, from \$1.4 million for the three months ended September 30, 2011 to \$1.1 million for the three months ended September 30, 2012. The interest paid on deposits decreased by \$129,000 to \$1.0 million for the three month period ended September 30, 2012 when compared to the three month period ended September 30, 2011 due primarily to the decrease in the average rate paid on deposits. The average balance of deposits for the three month period ended September 30, 2012 was \$355.5 million with an average rate of 1.12% compared to the average balance of deposits of \$349.5 million and an average rate of 1.29% for the three month period ended September 30, 2011. The decrease in the average rate paid on deposits was due to the continued low interest rate environment in 2012. The increase in the average balance of deposits was primarily due to deposit growth in core deposit accounts partially offset by a decrease in the average balance of time deposits. The interest expense related to advances from the FHLBNY decreased \$112,000, or 48.1%, to \$121,000 for the three month period ended September 30, 2012 when compared to the three month period ended September 30, 2011. This decrease was due to a \$5.2 million decrease in average FHLBNY advance balances and a 102 basis point decline in the average rate paid on FHLBNY advances when comparing the three month period ended September 30, 2012 with the same three month period in 2011. The decrease in the average advance balances was a result of the Company's decision to utilize excess cash obtained through deposit growth and loan prepayments to pay down borrowings. The low interest rate environment caused the average rate paid on borrowings to decrease.

**Provision for Loan Losses.** Provision for loan losses during the three month period ended September 30, 2012 was \$220,000, an increase of \$210,000 in comparison to \$10,000 for the three month period ended September 30, 2011. Non-performing loans have remained steady at \$2.3 million and \$2.5 million at September 30, 2012 and 2011, respectively. Net charge-offs were \$45,000 for the three months ended September 30, 2012 compared to \$4,000 for the three months ended September 30, 2011.

During the three month period ended September 30, 2012, the Company recorded a \$200,000 provision for loan losses on commercial real estate loans due to a downgrade in loan classification for two loans, loan growth and changes in environmental factors used to qualitatively assess inherent losses in the loan portfolio. An additional \$26,000 reserve was set aside for the commercial loan portfolio due to loan growth and an increased risk of loss on one classified loan based on the Company's quantitative analysis. The provisions related to commercial loans were partially offset by a \$6,000 reduction in the allowance for loan losses for one- to four-family real estate loans and home equity loans, due to the adequacy of the reserves already set aside.

Refer to Note 4 of the Notes to the Consolidated Financial Statements (unaudited) for details on the provision for loan losses.

The majority of our loans are residential mortgage loans backed by first lien collateral on real estate held in the Western New York region. Western New York has not been impacted as severely as other parts of the country by fluctuating real estate market values. We do not hold any sub-prime loans in our loan portfolio.

We establish provisions for loan losses, which are charged to operations, in order to maintain the allowance at a level management considers necessary to absorb probable incurred credit losses in the loan portfolio. The amount of allowance is based on estimates and the ultimate losses may vary from such estimates as more information becomes available or later events occur. Management assesses the allowance for loan losses on a quarterly basis and makes provisions for loan losses in order to maintain the adequacy of the allowance.

**Non-interest Income.** Non-interest income decreased \$22,000, or 4.2%, from \$528,000 for the three months ended September 30, 2011 to \$506,000 for the three months ended September 30, 2012. The decrease was primarily attributed to a \$19,000 decrease in service charges and fees related to the 2010 implementation of federal regulations requiring all banks to expand disclosures which enable customers to “opt out” of overdraft fees.

**Non-interest Expense.** Non-interest expense increased by \$97,000, or 3.5%, to \$2.9 million for the quarter ended September 30, 2012 from \$2.8 million for the quarter ended September 30, 2011. The increase was largely due to an \$80,000, or 5.5%, increase in salaries and employee benefits expense primarily due to the addition of two new directors, annual salary increases and annual increases in health insurance premiums. The increase in salaries and employee benefits expense was also impacted by the decrease in deferred salary expense incurred to originate loans due to a decrease in loan originations during the three months ended September 30, 2012 when compared to the same period in 2011. The increase in salaries and employee benefits expense was partially offset by lower stock option expenses for awards that became fully vested at December 31, 2011. Professional services increased by \$64,000, or 23.4%, for the three month period ended September 30, 2012 when compared to the same period in 2011. The increase was primarily due to an increase in legal and consulting services in 2012. Data processing expenses increased \$17,000 for the three month period ended September 30, 2012 when compared to the same three month period in 2011 primarily due to costs associated with ATM processing, resulting from an increase in the number of checking accounts and debit cards issued. Other non-interest expenses decreased by \$55,000, or 20.5%, for the three month period ended September 30, 2012 compared to the three month period ended September 30, 2011, primarily due to a \$45,000 gain on the sale of foreclosed properties in the three months ended September 30, 2012 and a \$19,000 decrease in foreclosure expenses during that same time. Advertising expenses decreased by \$47,000, or 36.4%, for the three month period ended September 30, 2012 compared to the same period in 2011, primarily due to a change in production schedules for various advertising campaigns. Occupancy and equipment expenses decreased \$12,000 for the three month period ended September 30, 2012 when compared to the same three month period in 2011 due to decreases in building maintenance and repair expense.

**Income Tax Expense.** Income tax expense decreased by \$191,000, or 46.4%, from \$412,000 for the three month period ended September 30, 2011 to \$221,000 for the three month period ended September 30, 2012. The decrease was primarily due to a decrease in income before income taxes for the three month period ended September 30, 2012 and a decrease in the effective tax rate which was 20.4% for the three month period ended September 30, 2012 compared to 26.3% for the three month period ended September 30, 2011. The effective tax rate is lower due to lower income before taxes with a slight increase in tax exempt income.

## Comparison of Results of Operations for the Nine Months Ended September 30, 2012 and 2011

General. Net income was \$2.8 million for the nine month period ended September 30, 2012, or \$0.48 per diluted share, a decrease of \$328,000, or 10.6%, compared to net income of \$3.1 million, or \$0.54 per diluted share, for the nine month period ended September 30, 2011. The decrease in net income during the nine month period ended September 30, 2012 compared to the nine month period ended September 30, 2011 was primarily due to a \$655,000 decrease in interest income, a \$372,000 increase in non-interest expenses and a \$169,000 decrease in non-interest income partially offset by a \$699,000 decrease in interest expense, a \$25,000 decrease in provision for loan losses and an \$144,000 decrease in income tax expenses.

Interest Income. Interest income decreased by \$655,000, or 4.2%, to \$14.9 million for the nine month period ended September 30, 2012 compared to the nine month period ended September 30, 2011. The decrease in interest income was primarily due to a decrease in investment interest income and to a lesser extent a decrease in loan interest income. Investment interest income decreased by \$507,000, or 10.6%, to \$4.3 million for the nine month period ended September 30, 2012 compared to \$4.8 million for the same period in 2011 due to the decrease in the average yield on investment securities. The investment portfolio had an average balance of \$169.7 million and an average yield of 3.37% for the nine month period ended September 30, 2012 compared to an average balance of \$162.0 million and an average yield of 3.94% for the nine month period ended September 30, 2011. The average yield on the investment portfolio decreased due to the yields on purchases of new securities being lower than yields on securities which had paid off, as a result of the current low interest rate environment. The average balance of the investment portfolio increased primarily due to the re-investment of paydowns on the loan and investment portfolio, as well as funds obtained from deposit growth, into the purchase of new available for sale securities. Loan interest income decreased by \$142,000, or 1.3%, to \$10.6 million for the nine month period ended September 30, 2012 compared to the same period in 2011, partially due to a \$1.0 million decrease in the average balance of loans to \$267.9 million. The average yield on the loan portfolio was 5.28% for the nine month period ended September 30, 2012 and 5.33% for the nine month period ended September 30, 2011.

Interest Expense. Interest expense decreased by \$699,000, or 16.3%, from \$4.3 million for the nine month period ended September 30, 2011 to \$3.6 million for the nine month period ended September 30, 2012. The interest paid on deposits decreased by \$371,000 to \$3.1 million for the nine month period ended September 30, 2012 when compared to the same period in 2011 due primarily to the decrease in the average rate paid on deposits. The average balance of deposits for the nine month period ended September 30, 2012 was \$354.4 million with an average rate of 1.17% compared to the average balance of deposits of \$350.5 million and an average rate of 1.33% for the nine month period ended September 30, 2011. The decrease in the average rate paid on deposits was due to the continued low interest rate environment in 2012. The increase in the average balance of deposits was primarily due to deposit growth in our core deposit accounts partially offset by a decrease in the average balance of time deposits. The interest expense related to advances from the FHLB NY decreased \$326,000, or 44.4%, to \$408,000 for the nine month period ended September 30, 2012 when compared to the nine month period ended September 30, 2011. The decrease in interest expense on advances occurred due to a \$5.6 million decrease in average balances and a 90 basis point decline in the average rate paid on advances when comparing the nine month period ended September 30, 2012 with the same nine month period in 2011. The decrease in the average advance balances was a result of the Company's decision to utilize excess cash obtained through deposit growth and loan prepayments to pay down borrowings. The low interest rate environment caused the average rate paid on borrowings to decrease.

**Provision for Loan Losses.** A net provision of \$270,000 was recorded to the allowance for loan losses during the nine month period ended September 30, 2012 compared to a provision of \$295,000 during the nine month period ended September 30, 2011. Our credit quality remains strong, as non-performing loans have remained steady at \$2.3 million and \$2.5 million at September 30, 2012 and 2011, respectively. Net charge-offs in 2012 were \$137,000 for the nine months ended September 30, 2012 compared to \$36,000 for the nine months ended September 30, 2011.

During the nine month period ended September 30, 2012, the Company recorded a \$357,000 provision for loan losses on commercial real estate loans due to an increase in the loan balances and number of classified loans in this category. This provision was offset by a \$57,000 reduction in the provision for loan losses on commercial loans due to a reduction in the classified loan balances for this loan type. The provision for loan losses was further reduced by a net \$30,000 decrease on the residential real estate loans (including one- to four-family loans and home equity loans) and consumer loans due to declining loan balances in these categories.

Provision for loan losses during the nine month period ended September 30, 2011 was \$295,000. Upon review of the environmental factors relating to the commercial real estate loans and commercial loans during 2011, management determined that a \$199,000 provision for loan losses was necessary due to the increase in portfolio size and the standard risks presented by the nature of these types of loans. During the nine months ended September 30, 2011, management also recorded \$157,000 in provision for loan losses for specific commercial real estate or commercial loans that had become classified loans or had been downgraded due to certain factors, such as delinquency. The provisions related to commercial loans were partially offset by a \$61,000 reduction in the allowance for loan losses for one- to four-family real estate loans and home equity loans, due to the adequacy of the reserves already set aside.

Refer to Note 4 of the Notes to the Consolidated Financial Statements (unaudited) for details on the provision for loan losses.

**Non-interest Income.** Non-interest income decreased \$169,000, or 10.2%, from \$1.7 million for the nine month period ended September 30, 2011 to \$1.5 million for the nine month period ended September 30, 2012. The decrease was primarily due to a non-cash, pre-tax impairment charge of \$57,000 related to the Company's write-down of one asset-backed security during the second quarter of 2012. The Company recognized a \$31,000 gain on the sale of municipal bond securities and a \$57,000 recovery on previously impaired asset-backed securities during the nine months ended September 30, 2011. Service charges and fees decreased \$19,000, or 1.5%, for the nine months ended September 30, 2012 when compared to the nine months ended September 30, 2011. The decrease in service charges and fees was primarily related to the 2010 implementation of federal regulations requiring all banks to expand disclosures which enable customers to "opt out" of overdraft fees.

**Non-interest Expense.** Non-interest expense increased by \$372,000, or 4.3%, to \$9.0 million for the nine month period ended September 30, 2012 compared to the nine month period ended September 30, 2011. Salaries and employee benefits expense increased \$218,000, or 5.0%, for the nine month period ended September 30, 2012 compared to the nine month period ended September 30, 2011. The increase was primarily due to the addition of two new directors in 2012, salary increases, higher benefit expenses, and an unplanned accrual for a retirement benefit. The increase in salaries and employee benefits expense was also impacted by the decrease in deferred salary expense incurred to originate loans due to a decrease in loan originations during the nine months ended September 30, 2012 when compared to the same period in 2011. The increase in salaries and employee benefits expense was also partially offset by lower stock option expenses for awards that became fully vested at December 31, 2011. Professional services increased \$155,000, or 18.2%, for the nine month period ended September 30, 2012 compared to the same nine month period in 2011, primarily due to increased legal and consulting services. Other non-interest expenses increased by \$116,000, or 14.9%, for the nine month period ended September 30, 2012 compared to the same period in 2011, primarily due to a \$104,000 increase in foreclosure expenses





incurred during the first nine months of 2012 as compared to the prior year period. The increases were partially offset by an \$80,000 decrease in FDIC insurance premiums, or 30.3%, for the nine month period ended September 30, 2012 compared to the same period in 2011, due to the new insurance premium calculation methodology that the FDIC enacted in accordance with the Dodd-Frank Act, which became effective in 2011. Advertising expenses decreased by \$47,000, or 12.3%, for the nine month period ended September 30, 2012 compared to the same period in 2011, primarily due to a change in production schedules for various advertising campaigns.

**Income Tax Expense.** Income tax expense decreased by \$144,000, or 15.7%, from \$915,000 for the nine month period ended September 30, 2011 to \$771,000 for the nine month period ended September 30, 2012. The decrease was primarily due to a decrease in income before income taxes which lowered the effective tax rate of 22.8% for the nine months ended September 30, 2011 to 21.8% for the nine months ended September 30, 2012.

#### Loans Past Due and Non-performing Assets

We define non-performing loans as loans that are either non-accruing or accruing whose payments are 90 days or more past due. Non-performing assets, including non-performing loans and foreclosed real estate, totaled \$3.0 million at September 30, 2012 and \$3.1 million at December 31, 2011.

The following table presents information regarding our non-accrual loans, accruing loans delinquent 90 days or more, and foreclosed real estate as of the dates indicated.

	At September 30, 2012		At December 31, 2011	
	(Dollars in thousands)			
Loans past due 90 days or more but still accruing:				
Real estate loans:				
Residential, one- to four-family	\$	95	\$	328
Home equity		21		21
Commercial		—		—
Construction		—		—
Other loans:				
Commercial		—		87
Consumer		33		23
Total	\$	149	\$	459
Loans accounted for on a non-accrual basis:				
Real estate loans:				
Residential, one- to four-family	\$	1,454	\$	1,821
Home equity (1)		233		209
Commercial		255		228
Construction		—		—
Other loans:				
Commercial		192		76
Consumer		3		5
Total non-accrual loans		2,137		2,339
Total non-performing loans		2,286		2,798
Foreclosed real estate		747		315
Restructured loans		—		—
Total non-performing assets	\$	3,033	\$	3,113
Ratios:				
Non-performing loans as a percent of net loans:		0.86	%	1.02
Non-performing assets as a percent of total assets:		0.61	%	0.64

(1) As of September 30, 2012 and December 31, 2011, one home equity loan for \$31,000 was restructured and classified as a troubled debt restructuring, due to the borrower's financial difficulties. The loan was placed on non-accrual status and was classified as a substandard loan with no specific reserve established and was 330 days past due under the modified terms as of September 30, 2012.

The following table sets forth activity in our allowance for loan losses and other ratios at or for the dates indicated:

	At or for the Nine Months ended September 30, 2012		At or for the Nine Months ended September 30, 2011	
	(Dollars in thousands)			
Balance at beginning of period:	\$ 1,366		\$ 953	
Provision for loan losses	270		295	
Charge-offs:				
Real estate loans:				
Residential, one- to four-family	100		—	
Home equity	12		29	
Commercial	—		—	
Construction	—		—	
Other loans:				
Commercial	34		1	
Consumer	6		13	
Total charge-offs	152		43	
Recoveries:				
Real estate loans:				
Residential, one- to four-family	1		4	
Home equity	—		—	
Commercial	13		—	
Construction	—		—	
Other loans:				
Commercial.	—		—	
Consumer.	1		3	
Total recoveries	15		7	
Net charge-offs	137		36	
Balance at end of period	\$ 1,499		\$ 1,212	
Average loans outstanding	\$ 267,878		\$ 268,876	
Allowance for loan losses as a percent of total loans	0.57	%	0.44	%
Allowance for loan losses as a percent of non-performing loans	65.57	%	49.45	%
Ratio of net charge-offs to average loans outstanding (1)	0.07	%	0.02	%

(1) Annualized

## Liquidity and Capital Resources

Liquidity describes our ability to meet the financial obligations that arise during the ordinary course of business. Liquidity is primarily needed to meet the lending and deposit withdrawal requirements of our customers and to fund current and planned expenditures. Our primary sources of funds consist of deposits, scheduled amortization and prepayments of loans and mortgage-backed and asset-backed securities, maturities and sales of other investments, interest earning deposits at other financial institutions and funds provided from operations. We have a written agreement with the Federal Home Loan Bank of New York, which allows us to borrow up to \$122.9 million as of September 30, 2012, and is collateralized by a pledge of our mortgage loans. At September 30, 2012, we had outstanding advances under this agreement of \$29.3 million. We have a written agreement with the Federal Reserve Bank discount window for overnight borrowings which is collateralized by a pledge of our securities, and allows us to borrow up to the value of the securities pledged, which was \$10.0 million as of September 30, 2012. There were no balances outstanding with the Federal Reserve Bank at September 30, 2012. In 2011, we established a line of credit with M&T Bank for \$7.0 million, of which \$5.0 million is unsecured and the remaining \$2.0 million will be secured by a pledge of our securities when a draw is made. There were no borrowings on this line as of September 30, 2012.

Historically, loan repayments and maturing investment securities were a relatively predictable source of funds. However, in light of the current economic environment, there are now more risks related to loan repayments and the valuation and maturity of investment securities. In addition, deposit flows, calls of investment securities, and prepayments of loans and mortgage-backed securities are strongly influenced by interest rates, general and local economic conditions, and competition in the marketplace. These factors and the current economic environment reduce the predictability of the timing of these sources of funds.

Our primary investing activities include the origination of loans and the purchase of investment securities. For the nine months ended September 30, 2012, we originated loans of approximately \$33.5 million in comparison to approximately \$45.8 million of loans originated during the nine months ended September 30, 2011. Purchases of investment securities totaled \$28.5 million in the nine months ended September 30, 2012 and \$20.7 million in the nine months ended September 30, 2011.

At September 30, 2012, we had loan commitments to borrowers of approximately \$12.6 million and overdraft lines of protection and unused home equity lines of credit of approximately \$27.1 million.

Total deposits were \$392.6 million at September 30, 2012, as compared to \$379.8 million at December 31, 2011. Time deposit accounts scheduled to mature within one year were \$92.7 million at September 30, 2012. Based on our deposit retention experience, current pricing strategy, and competitive pricing policies, we anticipate that a significant portion of these time deposits will remain with us following their maturity.

In recent years, macro-economic conditions negatively impacted liquidity and credit quality across the financial markets as the U.S. economy experienced a recession. Although recent reports have indicated improvements in the macro-economic conditions, the recession has had far-reaching effects. However, our financial condition, credit quality and liquidity position remain strong.

We are committed to maintaining a strong liquidity position; therefore, we monitor our liquidity position on a daily basis. We anticipate that we will have sufficient funds to meet our current funding commitments. The marginal cost of new funding, however, whether from deposits or borrowings from the Federal Home Loan Bank, will be carefully considered as we monitor our liquidity needs. Therefore, in order to minimize our cost of funds, we may consider additional borrowings from the Federal Home Loan Bank in the future.



We do not anticipate any material capital expenditures during the remainder of 2012. We do not have any balloon or other payments due on any long-term obligations or any off-balance sheet items other than loan commitments as described in Note 6 in the Notes to our Consolidated Financial Statements and the commitments and unused lines of credit noted above.

#### Off-Balance Sheet Arrangements

Other than loan commitments, we do not have any off-balance sheet arrangements that have or are reasonably likely to have a current or future effect on our financial condition, revenues or expenses, results of operations, liquidity, capital expenditures, or capital resources that is material to investors. Refer to Note 6 of the Notes to Consolidated Financial Statements for a summary of loan commitments outstanding as of September 30, 2012.

#### Item 3. Quantitative and Qualitative Disclosures about Market Risk.

Not applicable as the Company is a smaller reporting company.

#### Item 4. Controls and Procedures.

##### Disclosure Controls and Procedures

The Company's management, with the participation of its Chief Executive Officer and Chief Financial Officer, evaluated the effectiveness of the Company's disclosure controls and procedures (as defined in Rules 13(a)-15(e) and 15d-15(e) under the Securities Exchange Act of 1934) as of the end of the period covered by this report. Based upon such evaluation, the Company's Chief Executive Officer and Chief Financial Officer have concluded that, as of the end of such period, the Company's disclosure controls and procedures were effective.

##### Changes in Internal Control over Financial Reporting

There have not been any changes in the Company's internal control over financial reporting (as such term is defined in Rules 13a-15(f) and 15d-15(f) under the Securities Exchange Act of 1934) during the quarter ended September 30, 2012 that have materially affected, or are reasonably likely to materially affect, internal control over financial reporting.

## PART II

## Item 1A. Risk Factors

There have been no material changes in the Company's risk factors from those disclosed in its annual report on Form 10-K.

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

The following table reports information regarding repurchases by the Company of its common stock in each month of the quarter ended September 30, 2012:

## COMPANY PURCHASES OF EQUITY SECURITIES

Period	Total Number of Shares Purchased	Average Price Paid per Share	Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs	Maximum Number of Shares that May Yet be Purchased Under the Plans or Programs (1)
July 1, 2012 through July 31, 2012	—	—	—	91,510
August 1, 2012 through August 31, 2012	—	—	—	91,510
September 1, 2012 through September 30, 2012	—	—	—	91,510
Total	—	—	—	91,510

(1) On November 17, 2010, our Board of Directors approved a new stock repurchase plan pursuant to which we can repurchase up to 116,510 shares of our outstanding common stock. This amount represented 5% of our outstanding stock not owned by the MHC as of November 23, 2010. The repurchase plan does not have an expiration date and superseded all of the prior stock repurchase programs.



Item 6. Exhibits

- 3.1 Charter of Lake Shore Bancorp, Inc.1
- 3.2 Amended and Restated Bylaws of Lake Shore Bancorp, Inc.2
- 4.1 Form of Stock Certificate of Lake Shore Bancorp, Inc.3
- 10.1 Employment Agreement between Daniel P. Reininga and Lake Shore Bancorp, Inc.4
- 10.2 Employment Agreement between Daniel P. Reininga and Lake Shore Savings Bank4
- 10.3 Amended and Restated Change of Control Agreement between Rachel A. Foley and Lake Shore Bancorp, Inc.5
- 10.4 2012 Lake Shore Savings Bank Supplemental Executive Retirement Plan6
- 31.1 Certification by the Chief Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002\*
- 31.2 Certification by the Chief Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002\*
- 32.1 Certification by the Chief Executive Officer Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002\*
- 32.2 Certification by the Chief Financial Officer Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002\*
- 101.INS XBRL Instance Document7
- 101.SCH XBRL Taxonomy Extension Schema Document7
- 101.CAL XBRL Taxonomy Calculation Linkbase Document7
- 101.DEF XBRL Taxonomy Extension Definition Linkbase Document7
- 101.LAB XBRL Taxonomy Label Linkbase Document7
- 101.PRE XBRL Taxonomy Presentation Linkbase Document7

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\* Filed herewith

- 1 Incorporated herein by reference to the Exhibits to the Registration Statement on Form S-1, filed with the Securities and Exchange Commission on November 4, 2005 (Registration No. 333-129439).
- 2 Incorporated herein by reference to Exhibit 3.2 to Form 8-K, filed with the Securities and Exchange Commission on December 23, 2011.
- 3 Incorporated herein by reference to the Exhibits to Amendment No. 2 to the Registration Statement on Form S-1/A, filed with the Securities and Exchange Commission on February 8, 2006 (Registration No. 333-129439).
- 4 Incorporated herein by reference to Exhibits 10.1 and 10.2 to Form 8-K, filed with the Securities and Exchange Commission on February 3, 2011.
- 5 Incorporated herein by reference to Exhibit 10.3 to Form 8-K, filed with the Securities and Exchange Commission on February 3, 2011.
- 6 Incorporated herein by reference to Exhibit 10.1 to Form 8-K, filed with the Securities and Exchange Commission on June 29, 2012.
- 7 As provided in Rule 406T of Regulation S-T, this information is furnished and not filed for purposes of Sections 11 and 12 of the Securities Act of 1933 and Section 18 of the Securities Exchange Act of 1934.

SIGNATURES

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

LAKE SHORE BANCORP, INC.  
(Registrant)

November 14, 2012

By: /s/ Daniel P. Reininga  
Daniel P. Reininga  
President and Chief Executive Officer  
(Principal Executive Officer)

November 14, 2012

By: /s/ Rachel A. Foley  
Rachel A. Foley  
Chief Financial Officer  
(Principal Financial and Accounting  
Officer)