

Lake Shore Bancorp, Inc.
Form 10-Q
November 15, 2010

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, 2010

OR

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
(State or other jurisdiction of incorporation or
organization)

20-4729288
(I.R.S. Employer Identification Number)

125 East Fourth Street, Dunkirk, New York
(Address of principal executive offices)

14048
(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

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company” in Rule 12b-2 of the Exchange Act.

| | | | |
|---|--------------------------|---------------------------|-------------------------------------|
| Large accelerated filer | <input type="checkbox"/> | Accelerated filer | <input type="checkbox"/> |
| Non-accelerated filer | <input type="checkbox"/> | Smaller reporting company | <input checked="" type="checkbox"/> |
| Do not check if 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) 5,996,782 shares outstanding as of November 1, 2010.

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PART I

Item 1. Financial Statements

LAKE SHORE BANCORP, INC. and SUBSIDIARY
CONSOLIDATED STATEMENTS OF FINANCIAL CONDITION

| | September 30, 2010 | December 31, 2009 |
|---|--|-------------------------|
| | (Unaudited) | |
| | (Dollars in thousands, except per share information) | |
| Assets | | |
| Cash and due from banks | \$7,239 | \$7,057 |
| Interest earning deposits | 14,996 | 7,754 |
| Federal funds sold | 22,051 | 7,253 |
| Cash and Cash Equivalents | 44,286 | 22,064 |
| Securities available for sale | 147,311 | 118,381 |
| Federal Home Loan Bank stock, at cost | 2,628 | 2,535 |
| Loans receivable, net of allowance for loan losses 2010 \$824; 2009 \$1,564 | 256,837 | 259,174 |
| Premises and equipment, net | 8,811 | 7,950 |
| Accrued interest receivable | 1,821 | 1,721 |
| Bank owned life insurance | 11,046 | 10,842 |
| Other assets | 3,380 | 2,989 |
| Total Assets | \$476,120 | \$425,656 |
| Liabilities and Stockholders' Equity | | |
| Liabilities | | |
| Deposits: | | |
| Interest bearing | \$337,160 | \$297,242 |
| Non-interest bearing | 26,678 | 21,172 |
| Total Deposits | 363,838 | 318,414 |
| Short-term borrowings | 2,350 | 6,850 |
| Long-term debt | 41,850 | 36,150 |
| Advances from borrowers for taxes and insurance | 1,643 | 3,070 |
| Other liabilities | 8,552 | 5,726 |
| Total Liabilities | 418,233 | 370,210 |
| Commitments and Contingencies | - | - |
| Stockholders' Equity | | |
| | 66 | 66 |

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Common stock, \$0.01 par value per share, 25,000,000 shares authorized;
 6,612,500 shares issued and 5,996,782 shares outstanding at September 30, 2010 and
 6,612,500 shares issued and 6,157,162 shares outstanding at December 31, 2009

| | | |
|---|------------------|------------------|
| Additional paid-in capital | 27,899 | 27,838 |
| Treasury stock, at cost (615,718 shares at September 30, 2010 and 455,338 shares at December 31, 2009) | (5,764) | (4,467) |
| Unearned shares held by ESOP | (2,153) | (2,217) |
| Unearned shares held by RRP | (815) | (987) |
| Retained earnings | 35,920 | 34,224 |
| Accumulated other comprehensive income | 2,734 | 989 |
| Total Stockholders' Equity | 57,887 | 55,446 |
| Total Liabilities and Stockholders' Equity | \$476,120 | \$425,656 |

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, | |
|--|---|--------------|------------------------------------|---------------|
| | 2010 | 2009 | 2010 | 2009 |
| | (Unaudited) | | | |
| | (Dollars in Thousands, except per share data) | | | |
| Interest Income | | | | |
| Loans, including fees | \$3,415 | \$3,523 | \$10,470 | \$10,488 |
| Investment securities, taxable | 1,173 | 1,183 | 3,464 | 3,582 |
| Investment securities, tax-exempt | 340 | 216 | 918 | 572 |
| Other | 18 | 21 | 40 | 77 |
| Total Interest Income | 4,946 | 4,943 | 14,892 | 14,719 |
| Interest Expense | | | | |
| Deposits | 1,197 | 1,521 | 3,536 | 4,686 |
| Short-term borrowings | 3 | 6 | 14 | 41 |
| Long-term debt | 375 | 444 | 1,104 | 1,339 |
| Other | 29 | 30 | 86 | 87 |
| Total Interest Expense | 1,604 | 2,001 | 4,740 | 6,153 |
| Net Interest Income | 3,342 | 2,942 | 10,152 | 8,566 |
| Provision for Loan Losses | 1,725 | 95 | 1,975 | 255 |
| Net Interest Income after Provision for Loan Losses | 1,617 | 2,847 | 8,177 | 8,311 |
| Non-Interest Income | | | | |
| Gain on sale of securities available for sale | 1,057 | - | 1,057 | - |
| Service charges and fees | 466 | 521 | 1,412 | 1,456 |
| Earnings on bank owned life insurance | 75 | 71 | 204 | 205 |
| Gain on sale of loans | - | 5 | - | 32 |
| Other | 34 | 36 | 86 | 85 |
| Total Non-Interest Income | 1,632 | 633 | 2,759 | 1,778 |
| Non-Interest Expenses | | | | |
| Salaries and employee benefits | 1,505 | 1,409 | 4,595 | 4,136 |
| Occupancy and equipment | 418 | 339 | 1,228 | 1,054 |
| Professional services | 260 | 308 | 791 | 896 |
| Data processing | 147 | 127 | 422 | 380 |
| FDIC Insurance | 130 | 103 | 373 | 591 |
| Advertising | 82 | 108 | 349 | 286 |
| Postage and supplies | 62 | 55 | 210 | 196 |
| Other | 232 | 258 | 731 | 811 |
| Total Non-Interest Expenses | 2,836 | 2,707 | 8,699 | 8,350 |
| Income before Income Taxes | 413 | 773 | 2,237 | 1,739 |

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| | | | | | |
|---|--------|---|--------|---------|---------|
| Income Taxes Expense (Benefit) | (365 |) | 171 | 89 | 378 |
| Net Income | \$778 | | \$602 | \$2,148 | \$1,361 |
| Basic and diluted earnings per common share | \$0.13 | | \$0.10 | \$0.37 | \$0.23 |
| Dividends declared per share | \$0.06 | | \$0.05 | \$0.18 | \$0.15 |

See notes to consolidated financial statements.

3

LAKE SHORE BANCORP, INC. and SUBSIDIARY
CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY
Nine Months Ended September 30, 2010 and 2009 (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 | Total |
|---|-----------------|----------------------------------|-------------------|---------------------------------------|--------------------------------------|----------------------|---|----------|
| (Dollars in thousands, except per share data) | | | | | | | | |
| Balance – January 1, 2009 | \$66 | \$ 27,754 | \$(3,748) | \$(2,302) | \$(1,190) | \$32,520 | \$ 1,128 | \$54,228 |
| Cumulative effect of adoption of revised ASC Topic 320 (net of \$4 tax effect) | - | - | - | - | - | 8 | (8) | - |
| Comprehensive income: | | | | | | | | |
| Net income | - | - | - | - | - | 1,361 | - | 1,361 |
| Other comprehensive loss | - | - | - | - | - | - | 994 | 994 |
| Total Comprehensive Income | | | | | | | | 2,355 |
| ESOP shares earned (5,951 shares) | - | (24) | - | 64 | - | - | - | 40 |
| Stock based compensation | - | 111 | - | - | - | - | - | 111 |
| RRP shares earned (11,350 shares) | - | (26) | - | - | 152 | - | - | 126 |
| Purchase of treasury stock, at cost (87,984 shares) | - | - | (620) | - | - | - | - | (620) |
| Cash dividends declared (\$0.15 per share) | - | - | - | - | - | (339) | - | (339) |
| Balance – September 30, 2009 | \$66 | \$ 27,815 | \$(4,368) | \$(2,238) | \$(1,038) | \$33,550 | \$ 2,114 | \$55,901 |
| Balance – January 1, 2010 | \$66 | \$ 27,838 | \$(4,467) | \$(2,217) | \$(987) | \$34,224 | \$ 989 | \$55,446 |
| Comprehensive income: | | | | | | | | |
| Net income | - | - | - | - | - | 2,148 | - | 2,148 |
| Other comprehensive income | - | - | - | - | - | - | 1,745 | 1,745 |
| Total Comprehensive Income | | | | | | | | 3,893 |

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| | | | | | | | | |
|--|------|-----------|------------|------------|----------|----------|----------|----------|
| ESOP shares earned (5,951 shares) | - | (16) | - | 64 | - | - | - | 48 |
| Stock based compensation | - | 111 | - | - | - | - | - | 111 |
| RRP shares earned (12,842 shares) | - | (34) | - | - | 172 | - | - | 138 |
| Purchase of treasury stock, at cost (160,380 shares) | - | - | (1,297) | - | - | - | - | (1,297) |
| Cash dividends declared (\$0.18 per share) | - | - | - | - | - | (452) | - | (452) |
| Balance – September 30, 2010 | \$66 | \$ 27,899 | \$(5,764) | \$(2,153) | \$(815) | \$35,920 | \$ 2,734 | \$57,887 |

See notes to consolidated financial statements.

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

| | Nine Months Ended September 30, 2010 2009 (Unaudited) (Dollars in thousands) | |
|---|---|----------------------|
| Cash Flows from Operating Activities | | |
| Net income | \$2,148 | \$ 1,361 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Net accretion of investment securities | (25) | (184) |
| Amortization of deferred loan costs | 363 | 349 |
| Provision for loan losses | 1,975 | 255 |
| Loss on sale of interest rate floor derivative product | - | 135 |
| Originations of loans held for sale | (243) | (6,242) |
| Proceeds from sales of loans | 243 | 6,274 |
| Gain on sale of loans | - | (32) |
| Gain on sale of securities | (1,057) | - |
| Depreciation and amortization | 441 | 407 |
| Earnings on bank owned life insurance | (204) | (205) |
| ESOP shares committed to be released | 48 | 40 |
| Stock based compensation expense | 249 | 237 |
| Increase in accrued interest receivable | (100) | (18) |
| (Increase) decrease in other assets | (665) | 255 |
| Increase in other liabilities | 217 | 315 |
| Net Cash Provided by Operating Activities | 3,390 | 2,947 |
| Cash Flows from Investing Activities | | |
| Activity in available for sale securities: | | |
| Sales | 10,776 | - |
| Maturities, prepayments and calls | 22,203 | 25,777 |
| Purchases | (55,971) | (31,134) |
| Purchases of Federal Home Loan Bank Stock | (354) | (49) |
| Redemptions of Federal Home Loan Bank Stock | 261 | 275 |
| Proceeds from sale of interest rate floor derivative product | - | 890 |
| Loan origination and principal collections, net | (229) | (18,500) |
| Additions to premises and equipment | (1,302) | (157) |
| Net Cash Used in Investing Activities | (24,616) | (22,898) |
| Cash Flows from Financing Activities | | |
| Net increase in deposits | 45,424 | 18,696 |
| Net decrease in advances from borrowers for taxes and insurance | (1,427) | (1,263) |
| Net decrease in short-term borrowings | (4,500) | (1,540) |
| Proceeds from issuance of long-term debt | 9,300 | 2,000 |
| Repayment of long-term debt | (3,600) | (6,560) |
| Purchase of Treasury Stock | (1,297) | (620) |

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| | | |
|---|----------|----------|
| Cash dividends paid | (452) | (339) |
| Net Cash Provided by Financing Activities | 43,448 | 10,374 |
| Net Increase (Decrease) in Cash and Cash Equivalents | 22,222 | (9,577) |
| Cash and Cash Equivalents – Beginning | 22,064 | 29,038 |
| Cash and Cash Equivalents – Ending | \$44,286 | \$19,461 |
| Supplementary Cash Flows Information | | |
| Interest paid | \$4,730 | \$6,194 |
| Income taxes paid | \$1,189 | \$500 |
| Supplementary Schedule of Noncash Investing and Financing Activities | | |
| Foreclosed real estate acquired in settlement of loans | \$228 | \$463 |
| Securities purchased and not settled | \$2,010 | \$285 |

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, 2010 and for the three and nine months ended September 30, 2010 and 2009 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, 2009 has been derived from the audited financial statements at that date, but does not include all of the information and footnotes required by GAAP for complete 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, 2009. The consolidated results of operations for the three and nine months ended September 30, 2010 are not necessarily indicative of the results for any subsequent period or the entire year ending December 31, 2010.

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, 2010 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

In January 2010, the Financial Accounting Standards Board (“FASB”) issued Accounting Standards Update 2010-06 “Fair Value Measurements and Disclosures” (“ASU 2010-06”). ASU 2010-06 requires a greater level of disaggregated information and more robust disclosure about valuation techniques and inputs to fair value measurements. Expanded disclosures will be required for information about changes in the reporting entity’s Level 3 fair value measurements due to purchases, sales, issuance, and settlements. ASU 2010-06 will also require additional disclosure on significant transfers between the Level 1, Level 2 and Level 3 fair value measurements. This statement is effective for interim and annual periods beginning after December 15, 2009, except for the disclosures about purchases, sales, issuances, and settlements in the roll forward of activity in the Level 3 fair value measurements. Those disclosures are effective for fiscal years beginning after December 15, 2010, and for interim periods within those fiscal years. Portions of this update are already adopted. The adopted portions of this update did not have a material impact on the Company’s

consolidated financial condition or results of operations and management is evaluating the impact of the portions of the update that are not yet effective.

NOTE 2 – NEW ACCOUNTING STANDARDS (continued)

In July 2010, the FASB issued Accounting Standards Update 2010-20, “Receivables (“Subtopic 310”): Disclosures about the Credit Quality of Financing Receivables and the Allowance for Credit Losses” (“ASU 2010-20”). The main objective of ASU 2010-20 is to provide financial statement users greater transparency about an entity’s allowance for credit losses and the credit quality of its financing receivables. Existing disclosure guidance was amended to require an entity to provide a greater level of disaggregated information about the credit quality of its financing receivable and its allowance for credit losses. In addition, the amendments in ASU 2010-20 require an entity to disclose credit quality indicators, past due information, and modifications of its financing receivables. These improvements will help financial statement users assess an entity’s credit risk exposures and its allowance for credit losses. ASU 2010-20 is effective for interim or annual period ending on or after December 15, 2010. Since ASU 2010-20 only requires enhanced disclosures, management does not expect the adoption of this statement to have a material impact on the Company’s consolidated financial condition or results of operations.

NOTE 3 – OTHER COMPREHENSIVE INCOME

Accounting principles generally require that recognized revenue, expenses, gains, and losses be included in net income. Although certain changes in assets and liabilities, such as unrealized gains and losses on available for sale securities and other-than-temporary impairment (“OTTI”) related to non-credit factors, are reported as a separate component of the stockholders’ equity section of the consolidated statements of financial condition, such items, along with net income, are components of other comprehensive income.

The components of other comprehensive income and related tax effects for the three and nine months ended September 30, 2010 and 2009 are as follows:

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|-------------------------------------|---------|------------------------------------|---------|
| | 2010 | 2009 | 2010 | 2009 |
| | (In Thousands) | | | |
| Unrealized holding gains on securities available for sale | \$1,326 | \$2,370 | \$3,903 | \$1,621 |
| Reclassification adjustment for gains on sales of securities included in net income | (1,057) | - | (1,057) | - |
| Changes in Net Unrealized Gains | 269 | 2,370 | 2,846 | 1,621 |
| Income tax expense | (105) | (917) | (1,101) | (627) |
| Other Comprehensive Income | \$164 | \$1,453 | \$1,745 | \$994 |

NOTE 4 – INVESTMENT SECURITIES

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

| | Amortized Cost | September, 30, 2010 Gross Unrealized Gains (In Thousands) | Gross Unrealized Losses | Fair Value |
|--|-------------------|---|-------------------------------|---------------|
| Securities Available for Sale: | | | | |
| U.S. Treasury bonds | \$2,581 | \$239 | \$- | \$2,820 |
| Municipal bonds | 39,500 | 1,643 | (297) | 40,846 |
| Mortgage-backed securities: | | | | |
| Collateralized mortgage obligations | | | | |
| - private label | 450 | 5 | (4) | 451 |
| Collateralized mortgage obligations | | | | |
| - government sponsored entities | 76,627 | 2,642 | (33) | 79,236 |
| Government National Mortgage Association | 4 | 1 | - | 5 |
| Federal National Mortgage Association | 11,325 | 619 | (6) | 11,938 |
| Federal Home Loan Mortgage Corporation | 4,940 | 483 | (1) | 5,422 |
| Asset-backed securities | | | | |
| - private label | 7,141 | 424 | (1,239) | 6,326 |
| Asset-backed securities | | | | |
| - government sponsored entities | 261 | - | (1) | 260 |
| Equity securities | 22 | - | (15) | 7 |
| | \$142,851 | \$6,056 | \$(1,596) | \$147,311 |

NOTE 4 – INVESTMENT SECURITIES (continued)

| | Amortized Cost | December 31, 2010 | | Fair Value |
|---|-------------------|------------------------------|-------------------------------|---------------|
| | | Gross Unrealized Gains | Gross Unrealized Losses | |
| | | | | |
| | | | (In Thousands) | |
| Securities Available for Sale: | | | | |
| U.S. Treasury bonds | \$5,129 | \$340 | \$- | \$5,469 |
| Municipal bonds | 27,303 | 757 | (93) | 27,967 |
| Mortgage-backed securities: | | | | |
| Collateralized mortgage obligations - private label | 1,888 | 1 | (124) | 1,765 |
| Collateralized mortgage obligations - government sponsored entities | 53,661 | 1,570 | (74) | 55,157 |
| Government National Mortgage Association | 7 | - | - | 7 |
| Federal National Mortgage Association | 9,564 | 425 | - | 9,989 |
| Federal Home Loan Mortgage Corporation | 9,615 | 413 | - | 10,028 |
| Asset-backed securities -private label | 9,256 | - | (1,619) | 7,637 |
| Asset-backed securities - government sponsored entities | 322 | 7 | - | 329 |
| Equity securities | 22 | 11 | - | 33 |
| | \$ 116,767 | \$3,524 | \$(1,910) | \$ 118,381 |

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

At September 30, 2010 and December 31, 2009, equity securities consisted of 22,368 shares of Federal Home Loan Mortgage Corporation (“FHLMC”) common stock.

At September 30, 2010, twenty-nine municipal bonds with a cost of \$9.6 million and fair value of \$10.3 million were pledged under a collateral agreement with the Federal Reserve Bank of New York for liquidity borrowing. In addition, at September 30, 2010, eight municipal bonds with a cost of \$3.3 million and fair value of \$3.4 million were pledged as collateral for customer deposits in excess of the FDIC insurance limits. At December 31, 2009, thirty municipal bonds and one U.S. Treasury bond with a cost of \$10.6 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 December 31, 2009 seven municipal bonds with a cost of \$3.0 million and fair value of \$3.1 million were pledged as collateral for customer deposits in excess of the FDIC insurance limits.

The following table sets forth the Company’s investment in 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:

NOTE 4 – INVESTMENT SECURITIES (continued)

| | Less than 12 Months | | 12 Months or More | | Total | |
|---|---------------------|------------|-------------------|------------|----------|------------|
| | Fair | Gross | Fair | Gross | Fair | Gross |
| | Value | Unrealized | Value | Unrealized | Value | Unrealized |
| | | Losses | | Losses | | Losses |
| | (In Thousands) | | | | | |
| September 30, 2010: | | | | | | |
| Municipal bonds | \$6,281 | \$(283) | \$583 | \$(14) | \$6,864 | \$(297) |
| Mortgage-backed securities | 3,544 | (39) | 225 | (5) | 3,769 | (44) |
| Asset-backed securities - private label | - | - | 5,035 | (1,239) | 5,035 | (1,239) |
| Asset-backed securities - government sponsored entities | 260 | (1) | - | - | 260 | (1) |
| Equity securities | 7 | (15) | - | - | 7 | (15) |
| | \$10,092 | \$(338) | \$5,843 | \$(1,258) | \$15,935 | \$(1,596) |
| December 31, 2009: | | | | | | |
| Municipal bonds | \$5,303 | \$(93) | \$- | \$- | \$5,303 | \$(93) |
| Mortgage-backed securities | 6,940 | (74) | 1,724 | (124) | 8,664 | (198) |
| Asset-backed securities - private label | - | - | 7,637 | (1,619) | 7,637 | (1,619) |
| | \$12,243 | \$(167) | \$9,361 | \$(1,743) | \$21,604 | \$(1,910) |

The Company reviews investment securities on an ongoing basis for the presence of 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. 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, 2010 the Company’s investment portfolio included eighteen municipal bonds, seven mortgage-backed securities and one government sponsored entity asset-backed security with gross unrealized losses in the less than twelve months category. These securities were not evaluated further for OTTI as the unrealized losses on the individual securities were less than 20% of their book value, which management deemed to be immaterial, and the

credit ratings remained strong. 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. The Company's investment in equity securities is a requirement of the FHLMC. These securities were not evaluated further for OTTI, despite the percentage of unrealized losses due to immateriality.

NOTE 4 – INVESTMENT SECURITIES (continued)

As of September 30, 2010, the Company had two municipal bonds, two mortgage-backed securities and five private-label asset-backed securities in the unrealized loss of twelve months or more category. Three of the five private label asset backed securities in this category were subject to a formal OTTI review as the unrealized losses were greater than 20% of book value for the individual security, or the related credit ratings were below investment grade, or the Company's analysis indicated a possible loss of principal. The OTTI analysis for these securities is discussed below. The remaining securities in this category were not evaluated further for OTTI as the unrealized loss was less than 20% of book value and the credit ratings remained high. The temporary impairments in these remaining securities were due to declines in fair values resulting from changes in interest rates or increased credit/liquidity spreads since the time 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.

The following table provides information relating to the three private-label asset-backed securities that were subject to a formal OTTI review as of September 30, 2010 (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 | \$2,000 | \$1,363 | \$ (637) | CC | 38.30 % | 35.20 % | 7.40 % | 1.20 % | |
| 2 | 1,612 | 1,253 | (359) | B | 33.20 % | 29.80 % | 6.40 % | 0.80 % | |
| 3 | 1,000 | 795 | (205) | CCC | 14.20 % | 13.20 % | 8.50 % | 0.50 % | |
| Total | 4,612 | 3,411 | (1,201) | | | | | | |

The three private-label asset-backed securities listed above (# 1 thru #3) 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, rising 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 did not reflect the need to record initial or additional OTTI charges against earnings during the quarter ended September 30, 2010. In the case where an OTTI impairment charge was recorded in 2008, it was determined that the amount already taken was sufficient. For the remaining securities, management determined that an initial OTTI impairment charge was not required as of September 30, 2010, as the calculations of the estimated discounted cash flows did not show principal losses for these securities under various prepayment and default rate scenarios. Management also concluded that it does not intend to sell the securities and that it is not likely it will be required to sell the securities.

Management also completed an OTTI analysis for three non-agency asset backed securities, which did not have unrealized losses as of September 30, 2010. 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.

NOTE 4 – INVESTMENT SECURITIES (continued)

As a result of the stress tests that were performed, management concluded that additional OTTI charges were not required as of September 30, 2010 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 above 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 (dollars in thousands):

| | For the Nine Months Ended September 30, 2010 |
|--|--|
| Beginning balance, January 1, 2010 | \$1,922 |
| Addition: Credit related OTTI recorded in current period | - |
| Reductions: Realized loss on sale | (457) |
| Ending balance, September 30, 2010 | \$1,465 |

During the quarter ended September 30, 2010, management sold one private-label asset-backed security for a loss of \$108,000 on which an OTTI charge had been recorded during 2008.

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 | Fair Value |
|------------------------------------|-------------------|---------------|
| | (In Thousands) | |
| September 30, 2010 | | |
| After five years through ten years | \$6,482 | \$6,984 |
| After ten years | 35,599 | 36,682 |
| Mortgage-backed securities | 93,346 | 97,052 |
| Asset-backed securities | 7,402 | 6,586 |
| Equity securities | 22 | 7 |
| | \$142,851 | \$147,311 |

The Company sold available for sale securities during the nine months ended September 30, 2010, for total proceeds of \$10.8 million, resulting in gross realized gains of \$1.4 million and gross realized losses of \$324,000. During the year ended December 31, 2009, the Company did not sell any securities available for sale.

NOTE 5 – EARNINGS PER SHARE

Earnings per share was calculated for the three and nine months ended September 30, 2010 and 2009, 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.

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

| | Three Months Ended September 30, 2010 | Three Months Ended September 30, 2009 |
|--|--|--|
| Numerator – net income | \$ 778,000 | \$ 602,000 |
| Denominators: | | |
| Basic weighted average shares outstanding | 5,776,740 | 5,887,397 |
| Diluted weighted average shares outstanding(1) | 5,776,740 | 5,887,397 |
| Earnings per share: | | |
| Basic and Diluted: | \$ 0.13 | \$ 0.10 |

| | Nine Months Ended September 30, 2010 | Nine Months Ended September 30, 2009 |
|--|---|---|
| Numerator – net income | \$ 2,148,000 | \$ 1,361,000 |
| Denominators: | | |
| Basic weighted average shares outstanding | 5,805,608 | 5,905,598 |
| Diluted weighted average shares outstanding(1) | 5,805,608 | 5,905,598 |
| Earnings per share: | | |
| Basic and Diluted: | \$ 0.37 | \$ 0.23 |

(1) Stock options to purchase 249,455 shares under the Company’s 2006 Stock Option Plan (the “Stock Option Plan”) at \$11.07 per share and restricted unvested shares of 32,041 under the RRP were outstanding during the nine month period ended September 30, 2010 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 238,258 shares under the Stock Option Plan at \$11.22 per share and restricted unvested shares of 38,450 under the RRP plan were outstanding during the nine month period ended September 30, 2009, 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.

NOTE 6 – COMMITMENTS TO EXTEND CREDIT (continued)

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, 2010 | December 31, 2009 |
| | (Dollars in thousands) | |
| Commitments to grant loans | \$6,710 | \$7,818 |
| Unfunded commitments under lines of credit | \$26,204 | \$24,288 |

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, 2010 and December 31, 2009, the Company's fixed rate loan commitments totaled \$6.2 million and \$7.4 million, respectively. The range of interest rates on these fixed rate commitments was 3.49% to 7.50% at September 30, 2010.

NOTE 7– STOCK-BASED COMPENSATION

As of September 30, 2010, the Company had three stock-based compensation plans, which are described below. The compensation cost that has been recorded under salary and benefits expense in the non-interest expense section of the consolidated statements of income for these plans was \$102,000 and \$94,000 for the three months ended September 30, 2010 and 2009, respectively. The compensation cost that has been recorded for the nine months ended September 30, 2010 and 2009 was \$297,000 and \$277,000, respectively.

Stock Option Plan

The Company's 2006 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.

The Board of Directors has granted stock options exercisable into shares of common stock as follows:

| Grant Date | Number of Stock Options Granted | Awardees |
|-------------------|------------------------------------|--|
| November 15, 2006 | 241,546 | Management and non-employee directors |
| January 13, 2009 | 18,969 | Non-employee directors |
| January 27, 2010 | 17,773 | Management |

NOTE 7– STOCK-BASED COMPENSATION (continued)

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 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.

The fair value of the January 27, 2010 stock option grants was estimated on the date of the grant using the Black-Scholes option-pricing model with the following assumptions: dividend yield of 3.05%; expected volatility of 13.70%; risk-free interest rate of 3.65%; and expected life of 10 years.

A summary of the status of the Stock Option Plan as of September 30, 2010 and 2009 is presented below:

| | September 30, 2010 | | | September 30, 2009 | | |
|---------------------------------------|--------------------|----------------|----------------------------|--------------------|----------------|----------------------------|
| | Options | Exercise Price | Remaining Contractual Life | Options | Exercise Price | Remaining Contractual Life |
| Outstanding at beginning of year | 238,258 | \$ 11.22 | | 219,289 | \$ 11.50 | |
| Granted | 17,773 | 7.88 | | 18,969 | 8.01 | |
| Forfeited | (6,576) | 8.01 | | - | - | |
| Outstanding at end of quarter | 249,455 | \$ 11.07 | | 238,258 | \$ 11.22 | |
| Options exercisable at end of quarter | 137,600 | \$ 11.40 | 6 years | 91,065 | \$ 11.50 | 7 years |
| Fair value of options granted | \$ 1.15 | | | \$ 2.33 | | |

At September 30, 2010, stock options outstanding did not have an intrinsic value (as the stock price on that date was below the exercise price) and 48,107 options remained available for grant under the Stock Option Plan. Compensation expense amounted to \$38,000 for the quarter ended September 30, 2010 and \$37,000 for the quarter ended September 30, 2009. Compensation expense amounted to \$111,000 for the nine month period ended September 30, 2010 and 2009. At September 30, 2010, \$209,000 of unrecognized compensation cost related to stock options is expected to be recognized over a period of 14 to 51 months.

Recognition and Retention Plan

The Company’s 2006 Recognition and Retention Plan, 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.

NOTE 7– STOCK-BASED COMPENSATION (continued)

The Board of Directors has granted Awards as follows:

| Grant Date | Number of Restricted Stock Awards | First Vesting Period | Fair Value of award on Grant Date | Awardees |
|-------------------|-----------------------------------|----------------------|-----------------------------------|---------------------------------------|
| November 15, 2006 | 83,305 | December 31, 2007 | \$ 11.50 | Management and non-employee directors |
| January 13, 2009 | 9,996 | January 13, 2010 | \$ 8.01 | Management and non-employee directors |
| January 27, 2010 | 11,900 | January 4, 2011 | \$ 7.88 | Management |

Awards vest at a rate of 20% per year. As of September 30, 2010, there were 41,811 shares vested or distributed to eligible participants under the RRP. Compensation expense related to the RRP amounted to \$48,000 for the quarter ended September 30, 2010 and \$43,000 for the quarter ended September 30, 2009. Compensation expense amounted to \$138,000 for the nine month period ended September 30, 2010 and \$126,000 for the nine month period ended September 30, 2009. At September 30, 2010, \$313,000 of unrecognized compensation cost related to the RRP is expected to be recognized over a period of 14 to 51 months.

A summary of the status of unvested shares under the RRP for the nine months ended September 30, 2010 and 2009 is as follows:

| | September 30, 2010 | Weighted Average Grant Price | September 30, 2009 | Weighted Average Grant Price |
|--|--------------------|------------------------------|--------------------|------------------------------|
| Unvested shares outstanding at beginning of year | 36,530 | \$ 10.55 | 39,804 | \$ 11.50 |
| Granted | 11,900 | 7.88 | 9,996 | 8.01 |
| Vested | (1,998) | 8.01 | - | - |
| Forfeited | (1,619) | 8.01 | - | - |
| Unvested shares outstanding at end of quarter | 44,813 | \$ 10.04 | 49,800 | \$ 10.80 |

Employee Stock Ownership Plan

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. 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, 2010, the balance of the loan to the ESOP was \$2.2 million and the fair value of unallocated shares was \$1.6 million. As of September 30, 2010, there were 37,692 allocated shares and 200,358 unallocated shares compared to 29,756 allocated shares and 208,294 unallocated shares at September 30, 2009. The ESOP compensation expense was \$16,000 for the quarter ended September 30, 2010 and \$14,000 for the quarter ended September 30, 2009 based on 1,984 shares earned in each of those quarters. The ESOP compensation expense was \$48,000 for the nine month period ended September 30, 2010 and \$40,000 for the nine month period ended September 30, 2009 based on 5,951 shares earned during each 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, 2010 and December 31, 2009 and have not been re-evaluated or updated for purposes of these consolidated financial statements subsequent to those respective dates. As such, 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 has the ability to 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. These 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.

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

For assets measured at fair value on a recurring and nonrecurring basis, the fair value measurements by level within the fair value hierarchy used at September 30, 2010 and December 31, 2009 are as follows:

NOTE 8 – FAIR VALUE OF FINANCIAL INSTRUMENTS (continued)

| | September 30, 2010 | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Other Unobservable Inputs (Level 3) |
|---|-----------------------|--|---|---|
| (In thousands) | | | | |
| Measured at fair value on a recurring basis: | | | | |
| Securities available for sale: | | | | |
| U.S. Treasury bonds | \$2,820 | \$2,820 | \$- | \$ - |
| Municipal bonds | 40,846 | - | 40,846 | - |
| Mortgage-backed securities: | | | | |
| Collateralized mortgage obligations - private label | 451 | - | 451 | - |
| Collateralized mortgage obligations - government sponsored entities | 79,236 | - | 79,236 | - |
| Government National Mortgage Association | 5 | - | 5 | - |
| Federal National Mortgage Association | 11,938 | - | 11,938 | - |
| Federal Home Loan Mortgage Corporation | 5,422 | - | 5,422 | - |
| Asset-backed securities: | | | | |
| Private label | 6,326 | - | 1,624 | 4,702 |
| Government sponsored entities | 260 | - | 260 | - |
| Equity securities | 7 | - | 7 | - |
| | \$147,311 | \$2,820 | \$139,789 | \$ 4,702 |

NOTE 8 – FAIR VALUE OF FINANCIAL INSTRUMENTS (continued)

| | December 31, 2009 | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Other Unobservable Inputs (Level 3) |
|---|----------------------|--|---|---|
| | | (In thousands) | | |
| Measured at fair value on a recurring basis: | | | | |
| Securities available for sale: | | | | |
| U.S. Treasury bonds | \$5,469 | \$5,469 | \$- | \$ - |
| Municipal bonds | 27,967 | - | 27,967 | - |
| Mortgage-backed securities: | | | | |
| Collateralized mortgage obligations - private label | 1,765 | - | 1,765 | - |
| Collateralized mortgage obligations - government sponsored entities | 55,157 | - | 55,157 | - |
| Government National Mortgage Association | 7 | - | 7 | - |
| Federal National Mortgage Association | 9,989 | - | 9,989 | - |
| Federal Home Loan Mortgage Corporation | 10,028 | - | 10,028 | - |
| Asset-backed securities: | | | | |
| Private label | 7,637 | - | 2,321 | 5,316 |
| Government sponsored entities | 329 | - | 329 | - |
| Equity securities | 33 | - | 33 | - |
| | \$118,381 | \$5,469 | \$107,596 | \$ 5,316 |
| Measured at fair value on a non-recurring basis: | | | | |
| Impaired loans | \$1,967 | \$- | \$- | \$ 1,967 |
| Foreclosed real estate | 322 | - | - | 322 |

There were no reclassifications between the Level 1 and Level 2 categories for the nine months ended September 30, 2010.

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) for the nine months ended September 30, 2010 and 2009:

| | 2010 | 2009 |
|---|----------------|---------|
| | (in thousands) | |
| Beginning Balance at January 1st | \$5,316 | \$4,676 |
| Total gains (losses) – realized/unrealized: | | |
| Included in earnings | (108) | - |
| Included in other comprehensive income (loss) | 865 | (730) |
| Purchases, issuances and settlements | - | - |
| Sales | (543) | - |
| Principal Paydowns | (828) | (137) |
| Transfers to Level 3 | - | 1,531 |
| Ending Balance at September 30th | \$4,702 | \$5,340 |

NOTE 8 – FAIR VALUE OF FINANCIAL INSTRUMENTS (continued)

Both observable and unobservable inputs may be used to determine the fair value of positions 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. Three non-agency asset-backed securities were transferred to Level 3 during the year ended December 31, 2009 as a result of the continued deterioration in the market place since December 31, 2008 and the difficulty in obtaining current pricing for these securities as they were trading in an inactive market.

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, 2010, there were no impaired loans with a specific reserve against them. Impaired loans decreased during the nine month period ended September 30, 2010 due to the charge off of \$2.6 million in impaired loans. As of December 31, 2009, impaired loans had a gross carrying amount of \$2.7 million, with a valuation allowance of \$698,000, resulting in additional provision for loan losses of \$128,000 for the year ended December 31, 2009.

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

| | September 30, 2010 | | December 31, 2009 | |
|---|--------------------|----------------------|-------------------|----------------------|
| | Carrying Amount | Estimated Fair Value | Carrying Amount | Estimated Fair Value |
| | (In Thousands) | | | |
| Financial assets: | | | | |
| Cash and cash equivalents | \$44,286 | \$44,286 | \$22,064 | \$22,064 |
| Securities available for sale | 147,311 | 147,311 | 118,381 | 118,381 |
| Federal Home Loan Bank stock | 2,628 | 2,628 | 2,535 | 2,535 |
| Loans receivable | 256,837 | 258,057 | 259,174 | 253,946 |
| Accrued interest receivable | 1,821 | 1,821 | 1,721 | 1,721 |
| Financial liabilities: | | | | |
| Deposits | 363,838 | 369,445 | 318,414 | 320,220 |
| Short-term borrowings | 2,350 | 2,350 | 6,850 | 6,850 |
| Long-term debt | 41,850 | 43,501 | 36,150 | 37,388 |
| Accrued interest payable | 142 | 142 | 132 | 132 |
| Off-balance-sheet financial instruments | - | - | - | - |

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

Cash and cash equivalents (carried at cost)

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

NOTE 8 – FAIR VALUE OF FINANCIAL INSTRUMENTS (continued)

Securities available for sale (carried at fair value)

Fair value on available for sale securities is based upon a market approach. 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. Due to the severe disruption in the credit markets during 2008 through 2010, trading activity in privately issued asset-backed securities was very limited. The markets for such securities were generally characterized by a sharp reduction to total cessation of non-agency asset-backed securities issuances, a significant reduction in trading volumes and extremely wide bid-ask spreads, all driven by the lack of market participants. Although estimated prices were generally obtained for such securities, the Company was significantly restricted in the level of market observable assumptions used in the valuation of its privately issued asset-backed securities portfolio. Securities available for sale measured within the Level 3 category consist of asset-backed – private label securities. Three asset-backed – private label securities were transferred to Level 3 during the year ended December 31, 2009 as a result of the continued deterioration in the market place since December 31, 2008 and the difficulty in obtaining current pricing for these securities. In addition to obtaining estimated prices from independent parties, the Company also performed internal modeling to estimate the fair value of privately issued asset-backed securities transferred from Level 2 to Level 3 valuations during the year ended December 31, 2009 and the nine months ended September 30, 2010 using a methodology similar to that described in fair value measurement guidance under GAAP. The Company's internal modeling techniques included discounting estimated bond-specific cash flows using assumptions of loan level cash flows, including estimates about the timing and amount of credit losses and prepayments. The Company used an implied discount rate of 12%-15% to determine the Level 3 fair value. In valuing investment securities at December 31, 2009 and September 30, 2010, the Company considered the results of its modeling and the values provided by the independent parties, but relied predominantly on the latter.

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)

The fair value of fixed-rate and variable rate performing loans is calculated by discounting scheduled cash flows through the estimated maturity using the current market origination rates. 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.

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. The fair value of certificates of deposit 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.

NOTE 8 – FAIR VALUE OF FINANCIAL INSTRUMENTS (continued)

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. 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.

NOTE 9 – TREASURY STOCK

During the quarter and nine months ended September 30, 2010, the Company repurchased 77,940 and 160,380 shares of common stock at an average cost of \$8.19 and \$8.09 per share, respectively. Of these shares 157,940 were repurchased pursuant to the Company's publicly announced common stock repurchase programs. The remaining 2,440 shares were repurchased from the trustee of the Company's unvested RRP stock, when two awardees sold vested shares. As of September 30, 2010, there were 29,702 shares remaining to be repurchased under the existing stock repurchase program.

During the quarter and nine months ended September 30, 2009, the Company repurchased 25,000 and 87,984 shares of common stock at an average cost of \$7.30 and \$7.05 per share, respectively. 85,534 of these shares were repurchased pursuant to the Company's publicly announced common stock repurchase programs. The remaining 2,450 shares were repurchased from the trustee of the Company's unvested RRP stock, when two awardees sold vested shares.

NOTE 10 – SUBSEQUENT EVENTS

On October 27, 2010, the Board of Directors declared a quarterly dividend of \$0.06 per share on the Company's common stock, payable on November 22, 2010 to shareholders of record as of November 8, 2010. Lake Shore, MHC, which owns 60.6% of the Company's outstanding common stock elected to waive its right to receive cash dividends of approximately \$218,000 for the three month period ended September 30, 2010 and \$655,000 for the nine month period ended September 30, 2010. Cumulatively, Lake Shore, MHC has waived approximately \$2.7 million of cash dividends as of September 30, 2010. The dividends waived by Lake Shore, MHC are considered a restriction on the retained earnings of the Company.

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

Forward-Looking Statements

This Quarterly Report on Form 10-Q contains certain forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. Such statements may be identified by words such as "believe," "will," "expect," "project," "may," "could," "anticipate," "estimate," "intend," "plan," "targets" and similar expressions. These statements 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, 2009, 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;

• changes in legislation or regulation; 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, 2010 compared to the financial condition as of December 31, 2009 and the consolidated results of operations for the three and nine months ended September 30, 2010 and 2009.

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 costs, and other general and administrative expenses.

Financial institutions like us 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 119 years of service to our community, our primary management strategy has been to maintain our reputation 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. We are one of the largest lenders in market share of residential mortgages in Chautauqua County.

Branching. In April 2010, we opened our newest branch in Depew, New York. This is our fifth Erie County, New York branch and our tenth branch overall. This office generated deposits of \$20.1 million as of September 30, 2010. In December 2008, we opened an office in Kenmore, New York. This office had generated deposits of \$29.8 million as of September 30, 2010. Our offices are located in Dunkirk, Fredonia, West Ellicott, Jamestown, and Westfield in Chautauqua County, New York and in Depew, East Amherst, Hamburg, Orchard Park and Kenmore 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.

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 employees constitute one of our competitive strengths. Thus, the retention of such persons and our ability to continue to attract high quality personnel are high priorities.

Residential Mortgage and Other Lending. Historically, our lending portfolio has been composed predominantly of residential mortgage loans. At September 30, 2010 and December 31, 2009, we held \$182.6 million and \$185.8 million of residential mortgage loans, respectively, which constituted 71.5% and 71.9% 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, 2010 and December 31, 2009, our commercial real estate loan portfolio consisted of loans totaling \$28.9 million and \$28.3 million, respectively, or 11.3% and 11.0%, 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, 2010 and December 31, 2009, our commercial loan portfolio consisted of loans totaling \$9.8 million and \$11.4 million, respectively, or 3.8% and 4.4%, respectively, of total loans. Other loan products offered to our customers include home equity loans, construction loans and consumer loans, including automobile loans, overdraft lines of credit and share loans. We will sell loans when appropriate and will retain servicing rights to those loans. We will invest excess funds in permissible investments such as mortgage-backed securities and asset-backed securities, when such investment opportunities are prudent. 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. At September 30, 2010 and December 31, 2009, our investment securities totaled \$149.9 million and \$120.9 million, respectively.

Recently Enacted Financial Reform Legislation.

On July 21, 2010, the President signed the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act” or “Act”) into law. Among other things, the Act dramatically impacts the rules governing the provision of consumer financial products and services, and implementation of the Act will require new mandatory and discretionary rulemakings by numerous federal regulatory agencies over the next several years. The new law significantly affects the operations of federal savings associations and their holding companies as, among other things, the Act: (1) abolishes the Office of Thrift Supervision (“OTS”), effective 90 days after the transfer of the OTS’s supervisory and other functions to the Board of Governors of the Federal Reserve System (“Federal Reserve”), Federal Deposit Insurance Corporation (“FDIC”), and Office of the Comptroller of the Currency (“OCC”); (2) creates the Bureau of Consumer Financial Protection (“BCFP”), a new independent consumer watchdog agency housed within the Federal Reserve that will have primary rulemaking authority with respect to all federal consumer financial laws; (3) requires that formal capital requirements be imposed on savings and loan holding companies generally commencing July 2015; (4) codifies the “source of strength” doctrine for all depository institution holding companies; (5) grants to the U.S. Department of the Treasury, FDIC and the Federal Reserve broad new powers to seize, close and wind down “too big to fail” financial (including non-bank) institutions in an orderly fashion; (6) establishes a new Financial Stability Oversight Council that is charged with identifying and responding to emerging risks throughout the financial system, composed primarily of federal financial services regulators and chaired by the Secretary of the Treasury Department; (7) adopts new standards and rules for the mortgage industry; (8) adopts new bank, thrift and holding company regulation; (9) permanently increases the standard maximum deposit insurance amount to \$250,000 per depositor, per institution for each account ownership category; (10) temporarily provides for unlimited deposit insurance coverage for “noninterest-bearing transaction accounts;” (11) repeals the long-standing statutory prohibition on the payment of interest on demand deposits; (12) adopts new federal regulation of the derivatives market; (13) adopts the so-called Volcker Rule, substantially restricting proprietary trading by depository institutions and their holding companies; (14) imposes requirements for “funeral plans” by large, complex financial companies; (15) establishes new regulation of the asset securitization market through “skin in the game” and enhanced disclosure requirements; (16) establishes new regulation of interchange fees; (17) establishes new and enhanced compensation and corporate governance oversight for the financial services industry; (18) provides enhanced oversight of municipal securities; (19) provides a specific framework for payment, clearing and settlement regulation; (20) tasks the federal banking agencies with adopting new and enhanced capital standards for all depository institutions; (21) significantly narrows the scope of federal preemption for national banks and federal savings associations; (22) revises the affiliate transaction and insider lending rules; and (23) revises the requirements applicable to “qualified thrift lenders.”

We are currently evaluating the potential impact of the Act on our business, financial condition, results of operations and prospects. We expect that some provisions of the Act may have adverse effects on all financial institutions including the Bank and Company, such as the cost of complying with the numerous new regulations and reporting requirements mandated by the Act.

Management of Interest Rate Risk

Treasury Yield Curve. As with all community banks, we generate revenue on the difference between the interest earned on loans, which are generally for longer terms, and the interest paid on deposits, which are generally for shorter terms. This mismatch between shorter term deposits and longer term loans usually produces a positive contribution to earnings because the yield curve is normally positively sloped. During the past year, rates have continued to stay low as the Federal Reserve has worked to help move the economy out of the recession. The Federal Reserve has maintained the federal funds interest rate between 0.0% and 0.25%. As noted above, new and comprehensive financial reform legislation was recently enacted in the United States, primarily intended to address perceived weaknesses in the United States financial regulatory system and to prevent future financial and economic crises. While the ultimate impact of the new law is not yet known, it likely will add to regulatory compliance expenses. Between September 2009 and September 2010, yields in long-term Treasury maturities have shifted downward. For example, the yield on the 10 year Treasury note decreased from 3.31% as of September 30, 2009 to 2.53% as of September 30, 2010, a decrease of 78 basis points. Over that same one year time period the yield on a mortgage backed security decreased by 100 basis points. Given the changes to the treasury yield curve and spread relationship with mortgages, our net interest margin could decline if interest rates on loans remain low or decline. In addition, if our cost of funds do not move in the same manner or to the same degree as the interest rate on loans, our interest margin could decline.

Interest Rate Risk. Residential mortgage rates have decreased during the past year. As of September 30, 2010, the monthly average commitment rate on a 30 year fixed rate mortgage was 4.58%, a decrease of 53 basis points from an average commitment rate of 5.11% as of September 30, 2009. Interest rates on new loans are well below the average rate on our loan portfolio. The lower rates on residential mortgage products for new loans often causes higher rate loans in the portfolio to be prepaid (re-financed) bringing down the overall portfolio yield. Adjustable rate mortgages continue to have their interest rates adjust downward which reduces interest income.

As a result, if interest rates rise, our cost of funds may increase, as deposits generally have shorter maturities than the assets we hold. This may cause our net interest margin to decline, as rates on longer term assets will not re-price commensurately with rates on deposit products.

We employ a third party financial advisor to assist us in managing our investment portfolio and developing balance sheet strategies. At September 30, 2010 and December 31, 2009, we had \$147.3 million and \$118.4 million, respectively, invested in securities available for sale, the majority of which are agency mortgage-backed, agency collateralized mortgage obligations (“CMOs”) and municipal securities.

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.

In management's opinion, the accounting policy relating to 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 results of operations. Refer to Note 8 of the Notes to 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 results of operations. 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 4 of the Notes to 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 the consolidated financial statements of our audited consolidated financial statements included in our Form 10-K for the year ended December 31, 2009 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 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 table sets forth certain information relating to our average balance sheets and reflects the average yield on interest-earnings 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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| | At September 30, 2010 | | | For the Three Months ended September 30, 2010 | | | For the Three Months ended September 30, 2009 | | | |
|--|--------------------------|----------------|--|--|--------------------------------|----------------|--|--------------------|--------------------------------|----------------|
| | Actual Balance | Yield/ Rate | | 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 | \$37,047 | 0.14 % | | \$32,430 | \$18 | 0.22 % | | \$17,881 | \$21 | 0.47 % |
| Securities | 149,939 | 3.90 % | | 147,563 | 1,513 | 4.10 % | | 120,082 | 1,399 | 4.66 % |
| Loans | 256,837 | 5.43 % | | 256,853 | 3,415 | 5.32 % | | 254,518 | 3,523 | 5.54 % |
| Total interest-earning assets | 443,823 | 4.47 % | | 436,846 | 4,946 | 4.53 % | | 392,481 | 4,943 | 5.04 % |
| Other assets | 32,297 | | | 30,772 | | | | 28,109 | | |
| Total assets | \$476,120 | | | \$467,618 | | | | \$420,590 | | |
| Interest-bearing liabilities: | | | | | | | | | | |
| Demand and | | | | | | | | | | |
| NOW accounts | \$39,946 | 0.19 % | | \$39,848 | \$19 | 0.19 % | | \$37,887 | \$17 | 0.18 % |
| Money market accounts | 47,782 | 0.64 % | | 46,074 | 78 | 0.68 % | | 28,827 | 56 | 0.78 % |
| Savings accounts | 32,512 | 0.25 % | | 32,546 | 21 | 0.26 % | | 30,525 | 21 | 0.28 % |
| Time deposits | 216,920 | 1.96 % | | 211,931 | 1,079 | 2.04 % | | 192,202 | 1,427 | 2.97 % |
| Borrowed funds | 44,200 | 3.37 % | | 44,705 | 378 | 3.38 % | | 46,760 | 450 | 3.85 % |
| Other interest-bearing liabilities | 1,293 | 8.87 % | | 1,299 | 29 | 8.93 % | | 1,336 | 30 | 8.98 % |
| Total interest-bearing liabilities | 382,653 | 1.65 % | | 376,403 | 1,604 | 1.70 % | | 337,537 | 2,001 | 2.37 % |
| Other non-interest bearing liabilities | 35,580 | | | 32,780 | | | | 28,332 | | |
| Stockholders' equity | 57,887 | | | 58,435 | | | | 54,721 | | |
| Total liabilities and stockholders' equity | \$476,120 | | | \$467,618 | | | | \$420,590 | | |
| Net interest income | | | | | \$3,342 | | | | \$2,942 | |
| Interest rate spread | | | | | | 2.83 % | | | | 2.67 % |
| Net interest margin | | | | | | 3.06 % | | | | 3.00 % |

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| | At September 30, 2010 | | | For the Nine Months ended September 30, 2010 | | | For the Nine Months ended September 30, 2009 | | | |
|--|--------------------------|----------------|--|---|--------------------------------|----------------|---|--------------------------------|----------------|--|
| | Actual Balance | Yield/ Rate | | 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 | \$37,047 | 0.14 % | | \$23,964 | \$40 | 0.22 % | \$19,017 | \$77 | 0.54 % | |
| Securities | 149,939 | 3.90 % | | 135,814 | 4,382 | 4.30 % | 118,303 | 4,154 | 4.68 % | |
| Loans | 256,837 | 5.43 % | | 257,428 | 10,470 | 5.42 % | 248,173 | 10,488 | 5.63 % | |
| Total interest-earning assets | 443,823 | 4.47 % | | 417,206 | 14,892 | 4.76 % | 385,493 | 14,719 | 5.09 % | |
| Other assets | 32,297 | | | 30,283 | | | 28,117 | | | |
| Total assets | \$476,120 | | | \$447,489 | | | \$413,610 | | | |
| Interest-bearing liabilities: | | | | | | | | | | |
| Demand and | | | | | | | | | | |
| NOW accounts | \$39,946 | 0.19 % | | \$39,600 | \$56 | 0.19 % | \$36,955 | \$52 | 0.19 % | |
| Money market accounts | 47,782 | 0.64 % | | 42,972 | 231 | 0.72 % | 26,844 | 149 | 0.74 % | |
| Savings accounts | 32,512 | 0.25 % | | 31,170 | 62 | 0.27 % | 29,598 | 65 | 0.29 % | |
| Time deposits | 216,920 | 1.96 % | | 200,474 | 3,187 | 2.12 % | 188,200 | 4,420 | 3.13 % | |
| Borrowed funds | 44,200 | 3.37 % | | 45,429 | 1,118 | 3.28 % | 49,065 | 1,380 | 3.75 % | |
| Other interest-bearing liabilities | 1,293 | 8.87 % | | 1,309 | 86 | 8.76 % | 1,343 | 87 | 8.64 % | |
| Total interest-bearing liabilities | 382,653 | 1.65 % | | 360,954 | 4,740 | 1.75 % | 332,005 | 6,153 | 2.47 % | |
| Other non-interest bearing liabilities | 35,580 | | | 29,530 | | | 27,046 | | | |
| Stockholders' equity | 57,887 | | | 57,005 | | | 54,559 | | | |
| Total liabilities and stockholders' equity | \$476,120 | | | \$447,489 | | | \$413,610 | | | |
| Net interest income | | | | | \$10,152 | | | \$8,566 | | |
| Interest rate spread | | | | | | 3.01 % | | | 2.62 % | |
| Net interest margin | | | | | | 3.24 % | | | 2.96 % | |

Rate Volume Analysis. The following table analyzes the dollar amount of changes in interest income and interest expense for major components of interest-earning assets and interest-bearing liabilities. The table shows 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, 2010 Compared to Three Months Ended September 30, 2009 | | |
|--|---|--------------|---------------|
| | Rate | Volume | Net Change |
| | (Dollars in thousands) | | |
| Interest-earning assets: | | | |
| Interest-earning deposits and Federal funds sold | \$(15) | \$12 | \$(3) |
| Securities | (181) | 295 | 114 |
| Loans | (140) | 32 | (108) |
| Total interest-earning assets | (336) | 339 | 3 |
| Interest-bearing liabilities: | | | |
| Demand and NOW accounts | 1 | 1 | 2 |
| Money market accounts | (8) | 30 | 22 |
| Savings accounts | (1) | 1 | - |
| Time deposits | (483) | 135 | (348) |
| Total deposits | (491) | 167 | (324) |
| Other interest-bearing liabilities: | | | |
| Borrowed funds and other | (53) | (20) | (73) |
| Total interest-bearing liabilities | (544) | 147 | (397) |
| Net change in net interest income | \$208 | \$192 | \$400 |

| | Nine Months Ended September 30, 2010 Compared to Nine Months Ended September 30, 2009 | | |
|--|---|------------|-----------------|
| | Rate | Volume | Net Change |
| | (Dollars in thousands) | | |
| Interest-earning assets: | | | |
| Interest-earning deposits and Federal funds sold | \$(53) | \$16 | \$(37) |
| Securities | (355) | 583 | 228 |
| Loans | (402) | 384 | (18) |
| Total interest-earning assets | (810) | 983 | 173 |
| Interest-bearing liabilities: | | | |
| Demand and NOW accounts | - | 4 | 4 |
| Money market accounts | (5) | 87 | 82 |
| Savings accounts | (6) | 3 | (3) |
| Time deposits | (1,506) | 273 | (1,233) |
| Total deposits | (1,517) | 367 | (1,150) |
| Other interest-bearing liabilities: | | | |

| | | | |
|------------------------------------|----------|--------|----------|
| Borrowed funds and other | (163) | (100) | (263) |
| Total interest-bearing liabilities | (1,680) | 267 | (1,413) |
| Net change in net interest income | \$870 | \$716 | \$1,586 |

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 a decreasing interest rate environment, our earnings may increase if long-term interest-earning assets do not reprice and interest rates on short-term deposits begin to decrease. In the current rate environment, rates on new loans have declined significantly resulting in the repricing of some of these assets. Rates on deposit products have also dropped, more than the decline on loan product rates, which has resulted in a positive impact on our interest rate spread. However, if rates on deposit products stop falling and some assets continue to reprice at lower yields or deposit rates begin to increase and rates on loans remain static, our earnings may be negatively impacted.

For the three months ended September 30, 2010, the average yields on our loan portfolio and investment portfolios were 5.32% and 4.10%, respectively, in comparison to 5.54% and 4.66%, respectively, for the three months ended September 30, 2009. Overall, the average yield on our interest earning assets decreased by 51 basis points for the three months ended September 30, 2010 in comparison to the three months ended September 30, 2009. For the three months ended September 30, 2010, the average rate that we were paying on interest-bearing liabilities decreased by 67 basis points in comparison to the same period in the prior year. This included a decrease in the interest paid on our borrowings from 3.85% to 3.38% and a 93 basis point decrease in the rate paid on time deposits from 2.97% at September 30, 2009 to 2.04% at September 30, 2010. Our interest rate spread for the three months ended September 30, 2010 was 2.83%, which constituted a 16 basis point increase in comparison to the three months ended September 30, 2009. Our net interest margin was 3.06% and 3.00% for the three months ended September 30, 2010 and 2009, respectively.

For the nine months ended September 30, 2010, the average yields on our loan portfolio and investment portfolios were 5.42% and 4.30%, respectively, in comparison to 5.63% and 4.68%, respectively, for the nine months ended September 30, 2009. Overall, the average yield on our interest earning assets decreased by 33 basis points for the nine months ended September 30, 2010 in comparison to the nine months ended September 30, 2009. For the nine months ended September 30, 2010, the average rate that we were paying on interest-bearing liabilities decreased by 72 basis points in comparison to the same period in the prior year. This included a decrease in the interest paid on our borrowings from 3.75% to 3.28% and a 101 basis point decrease on the rate paid on time deposits from 3.13% at September 30, 2009 to 2.12% at September 30, 2010. Our interest rate spread for the nine months ended September 30, 2010 was 3.01%, which constituted a 39 basis points increase in comparison to the nine months ended September 30, 2009. Our net interest margin was 3.24% and 2.96% for the nine months ended September 30, 2010 and 2009, respectively.

Comparison of Financial Condition at September 30, 2010 and December 31, 2009

Total assets at September 30, 2010 were \$476.1 million, an increase of \$50.4 million from \$425.7 million at December 31, 2009. The increase in total assets was primarily due to a \$28.9 million increase in securities available for sale and a \$22.2 million increase in cash and cash equivalents, funded by a \$45.4 million increase in total deposits.

Cash and cash equivalents increased 100.7% from \$22.1 million as of December 31, 2009 to \$44.3 million as of September 30, 2010. The increase was primarily attributable to a \$14.8 million increase in federal funds sold and a \$7.2 million increase in interest earning deposits. The increase in federal funds sold and interest earning deposits was funded from deposit growth at our Erie County, New York branch offices. Our Depew branch in Erie County opened during April 2010, and has generated deposits of \$20.1 million as of September 30, 2010.

Securities available for sale increased 24.4% to \$147.3 million at September 30, 2010 from \$118.4 million at December 31, 2009. The increase in securities available for sale was primarily due to purchases of investment securities (predominately mortgage backed securities and municipal bonds) using funds provided by paydowns on our investment and loan portfolios, deposit growth and an increase in long term debt.

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Loans receivable, net decreased by \$2.3 million to \$256.8 million at September 30, 2010 from \$259.2 million at December 31, 2009. The table below shows the changes in loan balance by loan type between September 30, 2010 and December 31, 2009:

| | September 30, 2010 | December 31, 2009 | \$ | Change | % |
|--------------------------------|-----------------------|----------------------|--------------------|---------------|----------|
| (Dollars in thousands) | | | | | |
| Real Estate Loans: | | | | | |
| Residential, 1-4 Family | \$182,571 | \$185,753 | \$ (3,182) | (1.7) | % |
| Home Equity | 31,072 | 30,158 | 914 | 3.0 | % |
| Commercial | 28,851 | 28,328 | 523 | 1.8 | % |
| Construction | 588 | 365 | 223 | 61.1 | % |
| Total Real Estate Loans | 243,082 | 244,604 | (1,522) | (0.6) | % |
| Commercial Loans | 9,754 | 11,430 | (1,676) | (14.7) | % |
| Consumer Loans | 2,396 | 2,377 | 19 | 0.8 | % |
| Total Gross Loans | 255,232 | 258,411 | (3,179) | (1.2) | % |
| Allowance for Loan Losses | (824) | (1,564) | 740 | (47.3) | % |
| Net deferred loan costs | 2,429 | 2,327 | 102 | 4.4 | % |
| Loans receivable, net | \$256,837 | \$259,174 | \$ (2,337) | (0.9) | % |

The decrease in loans receivable, net was primarily due to the charge off of \$2.7 million in loans to one commercial customer during the third quarter of 2010. The decrease in Residential, 1-4 Family loans is not significant in the current economic environment in comparison to other parts of the country and reflects the stability of our market area for residential mortgage loan originations.

The table below shows changes in deposit balances by type of deposits between September 30, 2010 and December 31, 2009:

| | September 30, 2010 | December 31, 2009 | \$ | Change | % |
|-------------------------|-----------------------|----------------------|------------------|-------------|----------|
| (Dollars in thousands) | | | | | |
| Demand Deposits: | | | | | |
| Non-interest bearing | \$26,678 | \$21,172 | \$ 5,506 | 26.0 | % |
| Interest bearing | 39,946 | 41,857 | (1,911) | (4.6) | % |
| Money market | 47,782 | 37,336 | 10,446 | 28.0 | % |
| Savings | 32,512 | 29,027 | 3,485 | 12.0 | % |
| Time deposits | 216,920 | 189,022 | 27,898 | 14.8 | % |
| Total Deposits | \$363,838 | \$318,414 | \$ 45,424 | 14.3 | % |

The growth in deposits was primarily attributable to our ability to offer competitive rates in the Erie County branches market area. Our newest branch office in Depew, New York, which opened in April 2010, generated \$20.1 million in deposits as of September 30, 2010. The increase was also due to customers placing funds in short term core deposits, such as money market and savings accounts due to the current economic and low interest rate environment.

Our borrowings, consisting of advances from the Federal Home Loan Bank of New York, increased by \$1.2 million from \$43.0 million at December 31, 2009 to \$44.2 million at September 30, 2010. Short-term borrowings decreased \$4.5 million from \$6.9 million at December 31, 2009 to \$2.4 million at September 30, 2010, as excess fed funds and deposits were utilized to meet funding requirements. Long-term borrowings increased \$5.7 million from \$36.2 million at December 31, 2009 to \$41.9 million at September 30, 2010, as a result of the Company's decision to manage interest rate risk by extending funding maturity dates to match long-term loans.

Total stockholders' equity increased \$2.4 million from \$55.4 million at December 31, 2009 to \$57.9 million as of September 30, 2010. The increase in total stockholders' equity was primarily due to net income of \$2.1 million for the nine months ended September 30, 2010, and increases in accumulated other comprehensive income and stock related awards, partially offset by treasury stock purchases and dividend payments.

Comparison of Results of Operations for the Three Months Ended September 30, 2010 and 2009

General. Net income was \$778,000 for the three months ended September 30, 2010, or \$0.13 per diluted share, an increase of \$176,000, or 29.2%, compared to net income of \$602,000, or \$0.10 per diluted share, for the three months ended September 30, 2009. The increase in net income during the quarter ended September 30, 2010 compared to the quarter ended September 30, 2009 was primarily due to a \$1.1 million gain on the sale of investments, a one-time \$399,000 decrease in income tax expenses and a \$324,000 decrease in interest paid on deposits during the quarter. The increase in net income was partially offset by a \$1.6 million increase in the provision for loan losses and a \$96,000 increase in salaries and employee benefits during the quarter ended September 30, 2010 compared to the same period in 2009.

Interest Income. Interest income was \$4.9 million for the three months ended September 30, 2010 and 2009. Loan interest income decreased by \$108,000, or 3.1%, to \$3.4 million for the three months ended September 30, 2010 compared to the same period in 2009. The average yield on our loan portfolio was 5.32% for the three months ended September 30, 2010 compared to 5.54% for the three months ended September 30, 2009. The average balance of loans receivable, net increased from \$254.5 million in the third quarter of 2009 to \$256.9 million in the third quarter of 2010. Investment interest income increased \$114,000, or 8.1%, to \$1.5 million for the three month period ended September 30, 2010 compared to the three month period ended September 30, 2009. The investment portfolio had an average balance of \$147.6 million and an average yield of 4.10% for the three months ended September 30, 2010 compared to an average balance of \$120.1 million and an average yield of 4.66% for the three months ended September 30, 2009. Other interest income decreased \$3,000, or 14.3%, from \$21,000 for the three month period ended September 30, 2009 to \$18,000 for the three month period ended September 30, 2010. The average balance in other interest-earning deposits and federal funds sold increased \$14.5 million or 81.4%, for the three month period ended September 30, 2010 compared to the three month period ended September 30, 2009, and the average yield decreased from 0.47% for the quarter ended September 30, 2009 to 0.22% for the quarter ended September 30, 2010.

Interest Expense. Interest expense decreased by \$397,000, or 19.8%, from \$2.0 million for the three months ended September 30, 2009 to \$1.6 million for the three months ended September 30, 2010. The interest paid on deposits decreased by \$324,000 to \$1.2 million for the three months ended September 30, 2010 when compared to the same period in 2009. This was due to a decrease in the average rate paid on interest bearing deposits from 2.10% for the three months ended September 30, 2009 to 1.50% for the three months ended September 30, 2010. The interest expense related to time deposits decreased \$348,000 from \$1.4 million for the three months ended September 30, 2009 to \$1.1 million for the three months ended September 30, 2010. The average rate paid on these deposits decreased from 2.97% to 2.04% while the average balance of these deposits increased from \$192.2 million to \$211.9 million for the three month periods ended September 30, 2009 and 2010, respectively. The interest expense related to advances from the Federal Home Loan Bank of New York decreased \$72,000 from \$450,000 for the three months ended September 30, 2009 to \$378,000 for the three months ended September 30, 2010. The average rate paid on

these borrowings decreased from 3.85% to 3.38% while the average balance of these borrowings also decreased from \$46.8 million to \$44.7 million for the three month periods ended September 30, 2009 and 2010, respectively.

Provision for Loan Losses. Provision for loan losses during the quarter ended September 30, 2010 was \$1.7 million compared to \$95,000 for the quarter ended September 30, 2009. The increase in the provision for loan losses for the quarter ended September 30, 2010 was primarily due to the chargeoff of \$2.4 million in reserves for \$2.4 million of commercial loans to one borrower. Despite the increase to our provision, our credit quality remains strong. The ratio of nonperforming loans to total gross loans was 0.92% as of September 30, 2010. The majority of our loans are residential mortgage loans or commercial 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 for loan losses 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 reviews the allowance for loan losses on a quarterly basis and makes provisions for loan losses in order to maintain adequacy of the allowance.

Non-interest Income. For the three months ended September 30, 2010, non-interest income was \$1.6 million compared to \$633,000 for the three months ended September 30, 2009. The increase in non-interest income was primarily due to a \$1.1 million gain on sale of investments recorded during the third quarter of 2010. In the third quarter of 2010, we sold one treasury security to take advantage of current gains in market value. We also sold 15 municipal bond securities for a gain on securities that were set to mature between 2014 and 2016 and re-invested the proceeds in longer term municipal bond securities, to take advantage of the positively sloped yield curve and increase interest income. We sold two mortgage backed securities for a loss because they had experienced severe price declines and presented increased credit risk to our investment portfolio. Service charges and fees decreased \$55,000, or 10.6%, for the third quarter of 2010 to \$466,000 compared to the same period in 2009. New federal regulations require expanded disclosure of overdraft fees and allows customers to “opt out” of these type of fees. The “opt out” election began July 1, 2010 for new customers and August 15, 2010 for existing customers. The Company contacted its customers, particularly those that are frequent users of the overdraft program, to ensure they understand such services and to allow them the opportunity to continue such services. Many of our customers have positively reacted to our outreach program and have “opted in” to this service. However, at this time, the full impact of these regulations on our fee income is unknown. It is expected that some of our customers will “opt out” of this service which may decrease service fee income in future periods.

Non-interest Expense. Non-interest expense increased by \$129,000 to \$2.8 million for the quarter ended September 30, 2010 from \$2.7 million for the quarter ended September 30, 2009. The increase was largely due to an increase of \$96,000 in salaries and employee benefits. The increase in salaries and employee benefits was due to the 2010 hiring of an executive officer as well as staff for our newest branch office in Depew, NY, annual salary increases and annual increases in health insurance premiums. Occupancy and equipment expenses increased by \$79,000 due to the opening of our new branch office in April 2010. Professional services fee expense decreased by \$48,000 during the three months ended September 30, 2010 compared to the three months ended September 30, 2009. Professional services decreased primarily due to a decrease in auditing and consulting expenses during the three months ended September 30, 2010.

Income Tax Expense(Benefit). Income tax expense decreased by \$536,000, or 313.5%, from a tax expense of \$171,000 for the three months ended September 30, 2009 to a tax benefit of \$365,000 for the three months ended September 30, 2010. The decrease in tax expense was primarily the result of a recent change in New York State bank franchise tax law. The change conforms the bad debt deduction allowed under New York State bank franchise tax law to that allowed for Federal income tax purposes. In addition, the change no longer requires a thrift institution to recapture its New York tax bad debt reserves accumulated in prior years. Because of this change in tax law, the deferred tax liability previously recognized in prior years was reversed resulting in a one-time tax benefit of \$399,000. As a result of the one-time tax benefit, our effective tax rate decreased to a negative (88.4)% for the three months ended September 30, 2010 compared to 22.1% for the three months ended September 30, 2009. Without this one-time tax benefit, our effective tax rate would have been 8.1% for the three month period ended September 30, 2010. The decrease in income tax expense was also largely attributed to an increase in tax exempt income on our municipal bond portfolio. As a result, our projected mix of tax-exempt income derived from our municipal bond portfolio and bank-owned life insurance increased significantly as it related to our projection of pre-tax income for the year, causing our effective tax rate estimate to decrease to 21.5% for the nine months ended September 30, 2010. This decrease combined with the impact on our effective tax recognized for the quarters ended March 31, 2010 and June 30, 2010 caused our effective tax rate to be much lower than September 30, 2009.

Comparison of Results of Operations for the Nine Months Ended September 30, 2010 and 2009

General. Net income was \$2.1 million for the nine months ended September 30, 2010, or \$0.37 per diluted share, an increase of \$787,000, or 57.8%, compared to net income of \$1.4 million, or \$0.23 per diluted share, for the nine months ended September 30, 2009. The increase in net income was primarily due to a \$1.4 million decrease in interest expense paid on deposits and borrowings, a \$1.1 million increase in gain on the sale of investments and a \$289,000 decrease in income tax expenses, partially offset by a \$1.7 million increase in the provision for loan losses and a \$459,000 increase in salaries and other employee benefits expenses.

Interest Income. Interest income increased by \$173,000, or 1.2%, to \$14.9 million for the nine months ended September 30, 2010 compared to the nine months ended September 30, 2009. Investment security interest income increased by \$228,000, or 5.5%, to \$4.4 million for the nine months ended September 30, 2010. The average balance in investments increased by \$17.5 million, or 14.8%, to \$135.8 million for the nine month period ended September 30, 2010 compared to \$118.3 million for the nine month period ended September 30, 2009, while the average yield on our investment portfolio decreased from 4.68% for the nine months ended September 30, 2009 to 4.30% for the nine month period ended September 30, 2010. Loan interest income was \$10.5 million for the nine months ended September 30, 2010 and 2009. The average yield on our loan portfolio was 5.63% for the nine months ended September 30, 2009 and 5.42% for the nine months ended September 30, 2010. The average balance in our loan portfolio increased \$9.3 million, or 3.7%, from \$248.2 million for the nine months ended September 30, 2009 to \$257.4 million for the nine month period ended September 30, 2010. Other interest income decreased \$37,000, or 48.1%, from \$77,000 for the nine month period ended September 30, 2009 to \$40,000 for the nine month period ended September 30, 2010. The average balance in other interest-earning deposits and federal funds sold increased \$4.9 million, or 26.0%, to \$24.0 million for the nine month period ended September 30, 2010 compared to the nine month period ended September 30, 2009, and the average yield decreased from 0.54% for the nine months ended September 30, 2009 to 0.22% for the nine months ended September 30, 2010.

Interest Expense. Interest expense decreased by \$1.4 million, or 23.0%, from \$6.2 million for the nine months ended September 30, 2009 to \$4.7 million for the nine months ended September 30, 2010. The interest paid on deposits decreased by \$1.2 million, or 24.5%, to \$3.5 million for the nine months ended September 30, 2010 when compared to the same period in 2009. This was due to a decrease in the average rate paid on interest bearing deposits from 2.22% for the nine months ended September 30, 2009 to 1.50% for the nine months ended September 30, 2010. The interest expense related to time deposits decreased \$1.2 million from \$4.4 million for the nine months ended September 30,

2009 to \$3.2 million for the nine months ended September 30, 2010. The average rate paid on these deposits decreased from 3.13% to 2.12% while the average balance of these deposits increased from \$188.2 million to \$200.5 million for the nine month periods ended September 30, 2009 and 2010, respectively. The interest expense related to advances from the Federal Home Loan Bank of New York decreased \$262,000, or 19.0%, from \$1.4 million for the nine months ended September 30, 2009 to \$1.1 million for the nine months ended September 30, 2010. The average rate paid on these borrowings decreased from 3.75% to 3.28% while the average balance of these borrowings also decreased from \$49.1 million to \$45.4 million for the nine month periods ended September 30, 2009 and 2010, respectively.

Provision for Loan Losses. Provision for loan losses during the nine months ended September 30, 2010 was \$2.0 million compared to \$255,000 for the nine months ended September 30, 2009. The provision for loan losses for the nine months ended September 30, 2010 was primarily due to the chargeoff of \$2.7 million on three commercial loans to one borrower. Despite the increase to our provision, our credit quality remains strong. The ratio of nonperforming loans to total gross loans was 0.92% as of September 30, 2010. The majority of our loans are residential mortgage loans or commercial 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.

Non-interest Income. For the nine months ended September 30, 2010, non-interest income increased \$981,000, or 55.2%, to \$2.8 million from \$1.8 million for the nine months ended September 30, 2009. The increase in non-interest income was primarily due to a \$1.1 million gain on the sale of investments recorded during the third quarter of 2010. In the third quarter of 2010, we sold one treasury security to take advantage of current gains in market value. We also sold 15 municipal bond securities for a gain on securities that were set to mature between 2014 and 2016 and re-invested the proceeds in longer term municipal bond securities, to take advantage of the positively sloped yield curve and increase interest income. We sold two mortgage backed securities for a loss because they had experienced severe price declines and presented increased credit risk to our investment portfolio. Service charges and fees decreased \$44,000, or 3.0%, to \$1.4 million for the nine month period ended September 30, 2010 compared to the same period in 2009 due to the new federal regulations which allows customers to “opt out” of these type of fees. The “opt out” election began July 1, 2010 for new customers and August 15, 2010 for existing customers.

Non-interest Expense. Non-interest expense increased by \$349,000, or 4.2%, to \$8.7 million for the nine months ended September 30, 2010 from \$8.4 million for the nine months ended September 30, 2009. The increase was largely due to an increase in salaries and other employee benefits of \$459,000, or 11.0%, to \$4.6 million due to the 2010 hiring of an executive officer and staff for our Depew branch, annual salary increases and annual increases in health insurance premiums. Occupancy and equipment expenses increased \$174,000, or 16.5%, from \$1.1 million for the nine months ended September 30, 2009 to \$1.2 million for the nine months ended September 30, 2010. The 2010 increase in occupancy and equipment expenses was primarily due to the opening of the Depew branch in April 2010. Advertising expenses increased \$63,000, or 22.0%, from \$286,000 for the nine months ended September 30, 2009 to \$349,000 for the nine months ended September 30, 2010. In the first nine months in 2010, we had increased marketing costs associated with the opening of the Depew branch and for a new general advertising campaign. FDIC insurance premiums decreased by \$218,000, or 37.0%, to \$373,000 for the nine months ended September 30, 2010 compared to the nine months ended September 30, 2009. In the 2009 period, the FDIC imposed a special assessment of \$185,000 to replenish the deposit reserves and increased premiums. Professional expenses decreased by \$105,000, or 11.7%, to \$791,000 primarily due a decrease in auditing and consulting services in 2010. Other non-interest expenses decreased by \$80,000, or 9.9%, to \$731,000 primarily due to a loss recorded on the sale of the Company’s interest rate floor derivative product of \$135,000 during the first nine months of 2009, which was partially offset by an increase in losses on the sale of foreclosure properties in the 2010 period.

Income Tax Expense. Income tax expense decreased by \$289,000, or 76.5%, from \$378,000 for the nine months ended September 30, 2009 to \$89,000 for the nine months ended September 30, 2010. The decrease in tax expense was primarily the result of a recent change in New York State bank franchise tax law. The change conforms the bad debt deduction allowed under New York State bank franchise tax law to that allowed for Federal income tax purposes. In addition, the change no longer requires a thrift institution to recapture its New York tax bad debt reserves accumulated in prior years. Because of this change in tax law, the deferred tax liability previously recognized in prior years was reversed resulting in a one-time tax benefit of \$399,000. As a result of the one-time tax benefit our effective tax rate decreased to 4.0% for the nine months ended September 30, 2010 compared to 21.7% for the nine months ended September 30, 2009. Without this one-time tax benefit, our effective tax rate would have been comparable to the prior year at 21.8% for the nine month period ended September 30, 2010.

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 \$2.7 million at September 30, 2010 and \$2.0 million at December 31, 2009. We charged off \$2.4 million in commercial loans to one customer which had become non-accruing during the third quarter of 2010.

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, 2010 | At December 31, 2009 |
|--|--------------------------------|-------------------------------|
| | (Dollars in thousands) | |
| Loans past due 90 days or more but still accruing: | | |
| Mortgage loans on real estate: | | |
| One-to-four family | \$497 | \$456 |
| Construction | - | - |
| Commercial real estate | 43 | 65 |
| Home equity loans and lines of credit | 47 | 142 |
| Other loans: | | |
| Commercial loans | - | - |
| Consumer loans | 51 | 1 |
| Total | \$638 | \$664 |
| Loans accounted for on a nonaccrual basis: | | |
| Mortgage loans on real estate: | | |
| One-to-four family | \$1,201 | \$753 |
| Construction | - | - |
| Commercial real estate . | 370 | 192 |
| Home equity loans and lines of credit.... | 103 | 32 |
| Other loans: | | |
| Commercial loans | 17 | 19 |
| Consumer loans | 13 | 17 |
| Total non-accrual loans | 1,704 | 1,013 |
| Total nonperforming loans | 2,342 | 1,677 |
| Foreclosed real estate | 381 | 322 |
| Restructured loans | - | - |

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| | | | | |
|--|---------|---|---------|---|
| Total nonperforming assets | \$2,723 | | \$1,999 | |
| Ratios: | | | | |
| Nonperforming loans as a percent of gross loans: | 0.92 | % | 0.65 | % |
| Nonperforming assets as a percent of total assets: | 0.57 | % | 0.47 | % |

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

| | For the Nine Months Ended September 30, 2010 | For the Year Ended December 31, 2009 | | |
|--|---|---|-------|---|
| | (Dollars in thousands) | | | |
| Balance at beginning of period: | \$1,564 | \$1,476 | | |
| Provision for loan losses | 1,975 | 265 | | |
| Charge-offs: | | | | |
| Mortgage loans on real estate: | | | | |
| One-to-four family | 35 | 146 | | |
| Construction | - | - | | |
| Commercial real estate | 2,440 | 24 | | |
| Home equity loans and lines of credit | - | 54 | | |
| Other loans: | | | | |
| Commercial loans | 247 | 9 | | |
| Consumer loans | 16 | 33 | | |
| Total charge-offs | 2,738 | 266 | | |
| Recoveries: | | | | |
| Mortgage loans on real estate: | | | | |
| One-to-four family | 19 | 74 | | |
| Construction | - | - | | |
| Commercial real estate | - | - | | |
| Home equity loans and lines of credit | - | 7 | | |
| Other loans: | | | | |
| Commercial loans | - | - | | |
| Consumer loans | 4 | 8 | | |
| Total recoveries | 23 | 89 | | |
| Net charge-offs | 2,715 | 177 | | |
| Balance at end of period | \$824 | \$1,564 | | |
| Average loans outstanding | \$257,428 | \$250,846 | | |
| Ratio of net charge-offs to average loans outstanding (1) | 1.41 | % | 0.07 | % |
| Allowance for loan losses as a percent of total net loans | 0.32 | % | 0.60 | % |
| Allowance for loan losses as a percent of non-performing loans | 35.18 | % | 93.26 | % |

(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 written agreements with the Federal Home Loan Bank of New York, which allowed us to borrow up to \$127.4 million as of September 30, 2010 which was collateralized by a pledge of our mortgage loans. At September 30, 2010, we had outstanding advances under this agreement of \$44.2 million.

Historically, loan repayments and maturing investment securities are 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, to a lesser extent, the purchase of investment securities. For the nine months ended September 30, 2010, we originated loans of approximately \$34.6 million in comparison to approximately \$59.0 million of loans originated during the nine months ended September 30, 2009. Purchases of investment securities totaled \$58.3 million in the nine months ended September 30, 2010 and \$31.2 million in the nine months ended September 30, 2009.

At September 30, 2010, we had loan commitments to borrowers of approximately \$6.7 million and overdraft lines of protection and unused home equity lines of credit of approximately \$26.2 million.

Total deposits were \$363.8 million at September 30, 2010, as compared to \$318.4 million at December 31, 2009. Time deposit accounts scheduled to mature within one year were \$119.4 million at September 30, 2010. 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.

During 2009, 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 and liquidity position remain strong and in 2010, our liquidity and credit quality have improved.

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 2010. 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 and letters 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, 2010.

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, 2010 that have materially affected, or are reasonably likely to materially affect, internal control over financial reporting.

PART II

Item 1A. Risk Factors

In addition to the other information set forth in this report, you should carefully consider the factors discussed under “Part I—Item 1A—Risk Factors” in our Form 10-K for the year ended December 31, 2009, as supplemented and updated by our previously filed Form 10-Qs during the fiscal 2010 and the discussion below. These factors could materially adversely affect our business, financial condition, liquidity, results of operations and capital position, and could cause our actual results to differ materially from our historical results or the results contemplated by the forward-looking statements contained in this report.

The recently enacted financial reform legislation may have an adverse effect on our ability to pay dividends, which would adversely affect the value of our common stock.

The value of the Company’s common stock is significantly affected by our ability to pay dividends to our public shareholders. The Company’s ability to pay dividends to our shareholders is subject to the ability of the Bank to make capital distributions to the Company, and also to the availability of cash at the holding company level in the event earnings are not sufficient to pay dividends. Moreover, our ability to pay dividends and the amount of such dividends is affected by the ability of Lake Shore, MHC, our mutual holding company, to waive the receipt of dividends declared by the Company. Lake Shore, MHC currently waives its right to receive most of its dividends on its shares of the Company, which means that the Company has more cash resources to pay dividends to our public stockholders than if Lake Shore, MHC accepted such dividends. Lake Shore, MHC is required to obtain Office of Thrift Supervision approval before it may waive its receipt of dividends, and the current dividend waiver approval is effective through February 2011. It is expected that Lake Shore, MHC will continue to waive the receipt of future dividends except to the extent dividends are needed to fund its continuing operations.

Office of Thrift Supervision regulations allow federally chartered mutual holding companies to waive dividends without taking into account the amount of waived dividends in determining an appropriate exchange ratio in the event of a conversion of a mutual holding company to stock form. However, under the recently enacted Dodd-Frank Act, the powers and duties of the Office of Thrift Supervision relating to mutual holding companies will be transferred to the Federal Reserve Board within one year of the enactment of the legislation (subject to an extension of up to six months), and the Office of Thrift Supervision will be eliminated. Accordingly, the Federal Reserve Board will become the new regulator of the Company and Lake Shore, MHC. The Dodd-Frank Act also provides that a mutual holding company will be required to give the Federal Reserve Board notice before waiving the receipt of dividends, and sets forth the standards for granting a waiver, including a requirement that waived dividends be considered in determining an appropriate exchange ratio in the event of a conversion of the mutual holding company to stock form. The Dodd-Frank Act, however, further provides that the Federal Reserve Board may not consider waived dividends in determining an appropriate exchange ratio in a conversion to stock form by any federal mutual holding company, such as Lake Shore, MHC, that have waived dividends prior to December 1, 2009. The Federal Reserve Board historically has generally not allowed mutual holding companies to waive the receipt of dividends, and there can be no assurance as to the conditions, if any, the Federal Reserve Board will place on future dividend waiver requests by grandfathered mutual holding companies such as Lake Shore, MHC.

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, 2010:

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, 2010 through July 31, 2010 | 10,871 | \$8.27 | 10,871 | 96,771 |
| August 1, 2010 through August 31, 2010 | 25,197 | \$8.29 | 25,197 | 71,574 |
| September 1, 2010 through September 30, 2010 | 41,872 | \$8.11 | 41,872 | 29,702 |
| Total | 77,940 | \$8.19 | 77,940 | 29,702 |

- (1) On February 24, 2010, our Board of Directors approved a new stock repurchase plan pursuant to which we can repurchase up to 122,642 shares of our outstanding common stock. This amount represented 5% of our outstanding stock not owned by the MHC as of February 24, 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 Amended and Restated Employment Agreement by and between David C. Mancuso and Lake Shore Bancorp, Inc. 4
- 10.2 Amended and Restated Employment Agreement by and between David C. Mancuso and Lake Shore Savings Bank 4
- 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*

* 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 April 2, 2008.
- 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 March 26, 2010.

