

Lake Shore Bancorp, Inc.
Form 10-Q
May 16, 2011

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 March 31, 2011

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) 5,939,132 shares outstanding as of May 2, 2011.

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PART I

Item 1. Financial Statements

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

| | March 31, 2011 (Unaudited) | December 31, 2010 (Unaudited) |
|---|--|--|
| | (Dollars in thousands, except per share information) | |
| Assets | | |
| Cash and due from banks | \$7,394 | \$6,457 |
| Interest earning deposits | 17,187 | 16,351 |
| Federal funds sold | 2,676 | 10,706 |
| Cash and Cash Equivalents | 27,257 | 33,514 |
| Securities available for sale | 163,027 | 153,924 |
| Federal Home Loan Bank stock, at cost | 2,397 | 2,401 |
| Loans receivable, net of allowance for loan losses 2011 \$944; 2010 \$953 | 266,183 | 263,031 |
| Premises and equipment, net | 8,888 | 8,966 |
| Accrued interest receivable | 2,115 | 1,801 |
| Bank owned life insurance | 11,182 | 11,119 |
| Other assets | 2,865 | 4,291 |
| Total Assets | \$483,914 | \$479,047 |
| Liabilities and Stockholders' Equity | | |
| Liabilities | | |
| Deposits: | | |
| Interest bearing | \$352,032 | \$352,799 |
| Non-interest bearing | 24,732 | 22,986 |
| Total Deposits | 376,764 | 375,785 |
| Short-term borrowings | 8,800 | 5,000 |
| Long-term debt | 30,270 | 34,160 |
| Advances from borrowers for taxes and insurance | 2,100 | 3,027 |
| Other liabilities | 9,285 | 5,865 |
| Total Liabilities | 427,219 | 423,837 |
| Commitments and Contingencies | - | - |

| Stockholders' Equity | | |
|--|------------------|------------------|
| Common stock, \$0.01 par value per share, 25,000,000 shares authorized; 6,612,500 shares issued and 5,939,132 shares outstanding at March 31, 2011 and 6,612,500 shares issued and 5,957,082 shares outstanding at December 31, 2010 | 66 | 66 |
| Additional paid-in capital | 27,944 | 27,920 |
| Treasury stock, at cost (673,368 shares at March 31, 2011 and 655,418 shares at December 31, 2010) | (6,260) | (6,091) |
| Unearned shares held by ESOP | (2,110) | (2,132) |
| Unearned shares held by RRP | (700) | (757) |
| Retained earnings | 37,539 | 36,737 |
| Accumulated other comprehensive income (loss) | 216 | (533) |
| Total Stockholders' Equity | 56,695 | 55,210 |
| Total Liabilities and Stockholders' Equity | \$483,914 | \$479,047 |

See notes to consolidated financial statements.

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CONSOLIDATED STATEMENTS OF INCOME

| | Three Months Ended March 31, | |
|---|--|----------|
| | 2011 | 2010 |
| | (Unaudited) | |
| | (Dollars in thousands, except per share data) | |
| Interest Income | | |
| Loans, including fees | \$ 3,505 | \$ 3,542 |
| Investment securities, taxable | 1,144 | 1,115 |
| Investment securities, tax-exempt | 467 | 276 |
| Other | 14 | 9 |
| Total Interest Income | 5,130 | 4,942 |
| Interest Expense | | |
| Deposits | 1,212 | 1,159 |
| Short-term borrowings | 7 | 7 |
| Long-term debt | 256 | 352 |
| Other | 28 | 29 |
| Total Interest Expense | 1,503 | 1,547 |
| Net Interest Income | 3,627 | 3,395 |
| Provision for Loan Losses | 20 | 50 |
| Net Interest Income after Provision for Loan Losses | 3,607 | 3,345 |
| Non-Interest Income | | |
| Service charges and fees | 421 | 454 |
| Earnings on bank owned life insurance | 63 | 61 |
| Recovery on previously impaired investment securities | 57 | - |
| Other | 39 | 31 |
| Total Non-Interest Income | 580 | 546 |
| Non-Interest Expenses | | |
| Salaries and employee benefits | 1,547 | 1,574 |
| Occupancy and equipment | 461 | 388 |
| Professional services | 273 | 251 |
| Data processing | 139 | 140 |
| Advertising | 123 | 155 |
| FDIC Insurance | 122 | 113 |
| Postage and supplies | 75 | 78 |
| Other | 262 | 222 |
| Total Non-Interest Expenses | 3,002 | 2,921 |
| Income before Income Taxes | 1,185 | 970 |
| Income Taxes Expense | 235 | 249 |
| Net Income | \$ 950 | \$ 721 |

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| | | |
|---|---------|---------|
| Basic and diluted earnings per common share | \$ 0.17 | \$ 0.12 |
| Dividends declared per share | \$ 0.07 | \$ 0.06 |

See notes to consolidated financial statements.

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LAKE SHORE BANCORP, INC. and SUBSIDIARY
CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY
Three Months Ended March 30, 2011 and 2010 (Unaudited)

| | Common Stock | Additional Paid-in Capital | Treasury Stock | Unearned Shares held by ESOP | Unearned Shares held by RRP | Retained Earnings | Accumulated Other Comprehensive Income (Loss) | Total |
|---|-----------------|----------------------------------|-------------------|---------------------------------------|--------------------------------------|----------------------|---|----------|
| (Dollars in thousands, except share and per share data) | | | | | | | | |
| Balance – January 1, 2010 | \$66 | \$ 27,838 | \$ (4,467) | \$ (2,217) | \$ (987) | \$ 34,224 | \$ 989 | \$55,446 |
| Comprehensive income: | | | | | | | | |
| Net income | - | - | - | - | - | 721 | - | 721 |
| Other comprehensive income | - | - | - | - | - | - | 111 | 111 |
| Total Comprehensive Income | | | | | | | | 832 |
| ESOP shares earned (1,984 shares) | | | | | | | | |
| | - | (5) | - | 21 | - | - | - | 16 |
| Stock based compensation | - | 37 | - | - | - | - | - | 37 |
| RRP shares earned (4,120 shares) | | | | | | | | |
| | - | (11) | - | - | 55 | - | - | 44 |
| Purchase of treasury stock, at cost (72,440 shares) | | | | | | | | |
| | - | - | (576) | - | - | - | - | (576) |
| Cash dividends declared (\$0.06 per share) | | | | | | | | |
| | - | - | - | - | - | (160) | - | (160) |
| Balance – March 31, 2010 | \$66 | \$ 27,859 | \$ (5,043) | \$ (2,196) | \$ (932) | \$ 34,785 | \$ 1,100 | \$55,639 |
| Balance – January 1, 2011 | | | | | | | | |
| | \$66 | \$ 27,920 | \$ (6,091) | \$ (2,132) | \$ (757) | \$ 36,737 | \$ (533) | \$55,210 |
| Comprehensive income: | | | | | | | | |
| Net income | - | - | - | - | - | 950 | - | 950 |
| Other comprehensive income | - | - | - | - | - | - | 749 | 749 |
| Total Comprehensive Income | | | | | | | | 1,699 |
| ESOP shares earned (1,984 shares) | | | | | | | | |
| | - | (1) | - | 22 | - | - | - | 21 |
| Stock based compensation | - | 36 | - | - | - | - | - | 36 |
| RRP shares earned (4,251 shares) | | | | | | | | |
| | - | (11) | - | - | 57 | - | - | 46 |
| Purchase of treasury stock, at cost (17,950 shares) | | | | | | | | |
| | - | - | (169) | - | - | - | - | (169) |
| Cash dividends declared (\$0.07 per share) | | | | | | | | |
| | - | - | - | - | - | (148) | - | (148) |
| Balance – MARCH 31, 2011 | \$66 | \$ 27,944 | \$ (6,260) | \$ (2,110) | \$ (700) | \$ 37,539 | \$ 216 | \$56,695 |

See notes to consolidated financial statements.

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CONSOLIDATED STATEMENTS OF CASH FLOWS

| | Three Months Ended March 31, | |
|---|---------------------------------|-----------------|
| | 2011 | 2010 |
| | (Unaudited) | |
| | (Dollars in thousands) | |
| Cash Flows from Operating Activities | | |
| Net income | \$950 | \$721 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Net amortization (accretion) of investment securities | 17 | (33) |
| Amortization of deferred loan costs | 126 | 103 |
| Provision for loan losses | 20 | 50 |
| Recovery on previously impaired investment securities | (57) | - |
| Depreciation and amortization | 166 | 140 |
| Increase in bank owned life insurance, net | (63) | (61) |
| ESOP shares committed to be released | 21 | 16 |
| Stock based compensation expense | 82 | 81 |
| (Increase) decrease in accrued interest receivable | (314) | 3 |
| Decrease (increase) in other assets | 954 | (295) |
| Decrease in other liabilities | (261) | (225) |
| Net Cash Provided by Operating Activities | 1,641 | 500 |
| Cash Flows from Investing Activities | | |
| Activity in available for sale securities: | | |
| Maturities, prepayments and calls | 6,329 | 6,438 |
| Purchases | (10,490) | (13,177) |
| Purchases of Federal Home Loan Bank Stock | - | (316) |
| Redemptions of Federal Home Loan Bank Stock | 4 | 122 |
| Loan origination and principal collections, net | (3,298) | 1,558 |
| Additions to premises and equipment | (88) | (146) |
| Net Cash Used in Investing Activities | (7,543) | (5,521) |
| Cash Flows from Financing Activities | | |
| Net increase in deposits | 979 | 2,190 |
| Net decrease in advances from borrowers for taxes and insurance | (927) | (866) |
| Net increase (decrease) in short-term borrowings | 3,800 | (2,100) |
| Proceeds from issuance of long-term debt | - | 8,500 |
| Repayment of long-term debt | (3,890) | (2,100) |
| Purchase of Treasury Stock | (169) | (576) |
| Cash dividends paid | (148) | (160) |
| Net Cash Provided by (Used In) Financing Activities | (355) | 4,888 |
| Net Decrease in Cash and Cash Equivalents | (6,257) | (133) |

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| | | |
|--|----------|----------|
| Cash and Cash Equivalents – Beginning | 33,514 | 22,064 |
| Cash and Cash Equivalents – Ending | \$27,257 | \$21,931 |
| Supplementary Cash Flows Information | | |
| Interest paid | \$1,535 | \$1,542 |
| Income taxes paid | \$- | \$375 |
| Supplementary Schedule of Noncash Investing and Financing Activities | | |
| Foreclosed real estate acquired in settlement of loans | \$- | \$32 |
| Securities purchased and not settled | \$3,681 | \$772 |

See notes to consolidated financial statements.

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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 March 31, 2011 and for the three months ended March 31, 2011 and 2010 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, 2010 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, 2010. The consolidated results of operations for the three months ended March 31, 2011 are not necessarily indicative of the results for any subsequent period or the entire year ending December 31, 2011.

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 March 31, 2011 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 2011, the FASB issued Accounting Standards Codification (“ASC”) 2011-01, “Receivables (“Subtopic 310”): “Deferral of the Effective Date of Disclosures about Troubled Debt Restructurings in Update No. 2010-20” (“ASU 2011-01”). ASU 2011-01 deferred the effective date of the disclosure requirements for public entities about troubled debt restructurings included in FASB ASU 2010-20, “Receivables (“Subtopic 310”): Disclosures about the Credit Quality of Financing Receivables and the Allowance for Credit Losses” (“ASU 2010-20”). The requirements related to troubled debt restructurings are effective for interim and annual periods ending after June 15, 2011. 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.

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NOTE 2 – NEW ACCOUNTING STANDARDS (continued)

In April 2011, the FASB issued ASU 2011-02, “Receivables (“Subtopic 310”): “A Creditor’s Determination of Whether a Restructuring is a Troubled Debt Restructuring” (“ASU 2011-02”). ASU 2011-02 provides additional guidance and clarification in determining whether a creditor has granted a concession and whether a debtor is experiencing financial difficulties for purposes of determining whether a restructuring constitutes a troubled debt restructuring. This update is effective for interim and annual periods ending after June 15, 2011. 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 months ended March 31, 2011 and 2010 are as follows:

| | Three Months Ended March 31, 2011 2010 (In Thousands) | |
|---|---|------------|
| Unrealized holding gains on securities available for sale | \$1,278 | \$181 |
| Reclassification adjustment related to: | | |
| Recovery on previously impaired investment securities | (57) | - |
| Changes in Net Unrealized Gains | 1,221 | 181 |
| Income tax expense | (472) | (70) |
| Other Comprehensive Income | \$749 | \$111 |

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NOTE 4 – INVESTMENT SECURITIES

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

| | Amortized Cost | March 31, 2011 | | Fair Value |
|---|-------------------|------------------------------|-------------------------------|---------------|
| | | Gross Unrealized Gains | Gross Unrealized Losses | |
| (Dollars in thousands) | | | | |
| Securities Available for Sale: | | | | |
| U.S. Treasury bonds | \$10,941 | \$170 | \$(117) | \$10,994 |
| Municipal bonds | 53,483 | 563 | (1,277) | 52,769 |
| Mortgage-backed securities: | | | | |
| Collateralized mortgage obligations - private label | 185 | - | (2) | 183 |
| Collateralized mortgage obligations - government sponsored entities | 67,022 | 1,567 | (143) | 68,446 |
| Government National Mortgage Association | 3,400 | 1 | (80) | 3,321 |
| Federal National Mortgage Association | 15,763 | 403 | (173) | 15,993 |
| Federal Home Loan Mortgage Corporation | 5,455 | 305 | - | 5,760 |
| Asset-backed securities - private label | 6,191 | 302 | (1,172) | 5,321 |
| Asset-backed securities - government sponsored entities | 213 | 18 | - | 231 |
| Equity securities | 22 | - | (13) | 9 |
| | \$162,675 | \$3,329 | \$(2,977) | \$163,027 |

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NOTE 4 – INVESTMENT SECURITIES (continued)

| | Amortized Cost | December 31, 2010 Gross Unrealized Gains Gross Unrealized Losses | | Fair Value |
|---|-------------------|--|------------|---------------|
| | | (Dollars in thousands) | | |
| Securities Available for Sale: | | | | |
| U.S. Treasury bonds | \$8,961 | \$170 | \$(27) | \$9,104 |
| Municipal bonds | 47,995 | 292 | (2,541) | 45,746 |
| Mortgage-backed securities: | | | | |
| Collateralized mortgage obligations - private label | 305 | 3 | (4) | 304 |
| Collateralized mortgage obligations - government sponsored entities | 71,864 | 1,726 | (194) | 73,396 |
| Government National Mortgage Association | 2,461 | 1 | (55) | 2,407 |
| Federal National Mortgage Association | 10,545 | 454 | (133) | 10,866 |
| Federal Home Loan Mortgage Corporation | 5,817 | 390 | - | 6,207 |
| Asset-backed securities - private label | 6,586 | 253 | (1,189) | 5,650 |
| Asset-backed securities - government sponsored entities | 237 | - | - | 237 |
| Equity securities | 22 | - | (15) | 7 |
| | | | | |
| | \$154,793 | \$3,289 | \$(4,158) | \$153,924 |

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

At March 31, 2011 and December 31, 2010, equity securities consisted of 22,368 shares of Federal Home Loan Mortgage Corporation (“FHLMC”) common stock.

At March 31, 2011, twenty-nine municipal bonds with a cost of \$9.6 million and fair value of \$9.9 million were pledged under a collateral agreement with the Federal Reserve Bank of New York for liquidity borrowing. In addition, at March 31, 2011, eleven municipal bonds with a cost and fair value of \$4.1 million were pledged as collateral for customer deposits in excess of the FDIC insurance limits. At December 31, 2010, twenty-nine municipal bonds with a cost and fair value of \$9.6 million and fair value of \$9.7 million were pledged under a collateral agreement with the Federal Reserve Bank of New York for liquidity borrowing. In addition, at December 31, 2010, nine municipal bonds with a cost and fair value of \$3.4 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:

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NOTE 4 – INVESTMENT SECURITIES (continued)

| | Less than 12 Months | | 12 Months or More | | Total | Gross |
|---|------------------------|------------|-------------------|------------|----------|------------|
| | Fair | Gross | Fair | Gross | Fair | Unrealized |
| | Value | Unrealized | Value | Unrealized | Value | Losses |
| | | Losses | | Losses | | Losses |
| | (Dollars in thousands) | | | | | |
| March 31, 2011: | | | | | | |
| U.S Treasury Bonds | \$4,054 | \$(117) | \$- | \$- | \$4,054 | \$(117) |
| Municipal bonds | 27,302 | (1,226) | 547 | (51) | 27,849 | (1,277) |
| Mortgage-backed securities | 14,532 | (396) | 174 | (2) | 14,706 | (398) |
| Asset-backed securities - private label | - | - | 4,435 | (1,172) | 4,435 | (1,172) |
| Equity securities | 9 | (13) | - | - | 9 | (13) |
| | \$45,897 | \$(1,752) | \$5,156 | \$(1,225) | \$51,053 | \$(2,977) |
| December 31, 2010: | | | | | | |
| U.S. Treasury bonds | \$2,049 | \$(27) | \$- | \$- | \$2,049 | \$(27) |
| Municipal bonds | 34,806 | (2,476) | 533 | (65) | 35,339 | (2,541) |
| Mortgage-backed securities | 14,922 | (382) | 183 | (4) | 15,105 | (386) |
| Asset-backed securities - private label | - | - | 4,757 | (1,189) | 4,757 | (1,189) |
| Equity securities | 7 | (15) | - | - | 7 | (15) |
| | \$51,784 | \$(2,900) | \$5,473 | \$(1,258) | \$57,257 | \$(4,158) |

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 ASC Topic 320 "Investments - Debt and Equity Securities". The evaluation is based upon factors such as the creditworthiness of the issuers/guarantors, the underlying collateral and the continuing performance of the securities.

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

At March 31, 2011 the Company's investment portfolio included two U.S. Treasury bonds, 79 municipal bonds, ten mortgage-backed securities and one equity security with gross unrealized losses in the less than twelve months category. The treasury bond, municipal bonds and mortgage-backed 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.

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NOTE 4 – INVESTMENT SECURITIES (continued)

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.

As of March 31, 2011, the Company had two municipal bonds, one mortgage-backed security and four private-label asset-backed securities in the unrealized loss of twelve months or more category. Three of the four 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 March 31, 2011 (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 | \$1,368 | \$ (632) | CC | 44.00% | 40.80% | 10.60 % | 0.90 % |
| 2 | 1,477 | 1,148 | (329) | B | 37.90% | 35.10% | 9.60 % | 0.60 % |
| 3 | 1,000 | 811 | (189) | CCC | 22.80% | 21.10% | 11.10 % | 0.50 % |
| Total | \$4,477 | \$3,327 | \$ (1,150) | | | | | |

The three private-label asset-backed securities listed above were evaluated for OTTI under the guidance of FASB ASC Topic 320. The Company believes the unrealized losses on these three private-label asset-backed securities occurred due to the current challenging economic environment, high unemployment rates, a continued decline in housing values in many areas of the country, and increased delinquency trends. It is possible that principal losses may be incurred on the tranches we hold in these specific securities. Management's evaluation of the estimated discounted cash flows in comparison to the amortized book value did not reflect the need to record initial OTTI charges against earnings as of March 31, 2011 as the calculations of the estimated discounted cash flows did not show additional 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 two private-label asset backed securities, which did not have unrealized losses as of March 31, 2011. However, an impairment charge had been taken on these securities during 2008. Management reviewed key credit metrics for these securities, including delinquency rates, cumulative default rates, prepayment speeds, foreclosure rates, loan-to-values and credit support levels. Management's calculation of the estimated discounted cash flows did not show additional principal losses for these securities under various prepayment and default rate scenarios. As a result of the stress tests that were performed, management concluded that additional OTTI charges were

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NOTE 4 – INVESTMENT SECURITIES (continued)

not required as of March 31, 2011 on these securities. Management also concluded that it does not intend to sell these securities and that it is not likely it will be required to sell these securities.

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 Three Months Ended March 31, 2011 | For the Year Ended December 31, 2010 |
|---|--|---|
| Beginning balance | \$1,176 | \$1,922 |
| Addition: Credit related OTTI recorded in current period | - | - |
| Reductions: Realized loss on sale of security | - | (457) |
| Losses realized during the period on OTTI previously recognized | (11) | (147) |
| Receipt of cash flows on previously recorded OTTI | (57) | (142) |
| Ending balance | \$1,108 | \$1,176 |

During the year ended December 31, 2010, management sold one private-label asset-backed security on which a credit related OTTI charge of \$457,000 had been previously recorded. At the time of sale, an additional realized loss of \$108,000 was recognized and recorded in the non-interest income section on the Consolidated Statements of Income.

Further deterioration in credit quality and/or a continuation of the current imbalances in liquidity that exist in the marketplace might adversely affect the fair values of the Company's investment portfolio and may increase the potential that certain unrealized losses will be designated as other than temporary and that the Company may incur additional write-downs in future periods.

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

| | Amortized Cost (Dollars in thousands) | Fair Value |
|------------------------------------|---|---------------|
| March 31, 2011 | | |
| After five years through ten years | \$13,933 | \$14,134 |
| After ten years | 50,491 | 49,629 |
| Mortgage-backed securities | 91,825 | 93,703 |
| Asset-backed securities | 6,404 | 5,552 |
| Equity securities | 22 | 9 |
| | \$162,675 | \$163,027 |

During the three months ended March 31, 2011 and 2010, the Company did not sell any securities available for sale.

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NOTE 5 - ALLOWANCE FOR LOAN LOSSES

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

Real Estate Loans:

- One-to Four-Family – are loans secured by first lien collateral on residential real estate primarily held in the Western New York region. These loans can be affected by economic conditions and the value of underlying properties. Western New York has not been impacted as severely as other parts of the country by fluctuating real estate prices. Furthermore, the Company has conservative underwriting standards and does not have any sub-prime loans in its loan portfolio.
- Home Equity – are loans or lines of credit secured by second lien collateral on owner-occupied residential real estate primarily held in the Western New York area. These loans can also be affected by economic conditions and the values of underlying properties.
- Commercial Real Estate – are loans used to finance the purchase of real property, which generally consists of developed real estate that is held as first lien collateral for the loan. These loans are secured by real estate properties that are primarily held in the Western New York region. Commercial real estate lending involves additional risks compared with one-to four-family residential lending, because payments on loans secured by commercial real estate properties are often dependent on the successful operation or management of the properties, and/or the collateral value of the commercial real estate securing the loan, and repayment of such loans may be subject to adverse conditions in the real estate market or economic conditions to a greater extent than one-to four-family residential mortgage loans. Also, commercial real estate loans typically involve large loan balances to single borrowers or groups of related borrowers.
- Construction – are loans to finance the construction of either one-to four-family owner occupied homes or commercial real estate. At the end of the construction period, the loan automatically converts to either a conventional or commercial mortgage, as applicable. Risk of loss on a construction loan depends largely upon the accuracy of the initial estimate of the value of the property at completion compared to the estimated cost of construction.

Other Loans:

- Commercial – includes business installment loans, lines of credit, and other commercial loans. Most of our commercial loans have variable interest rates tied to the prime rate, and are for terms generally not in excess of 15 years. Whenever possible, we collateralize these loans with a lien on business assets and equipment and require the personal guarantees from principals of the borrower. Commercial loans generally involve a higher degree of credit risk because the collateral underlying the loans may be in the form of intangible assets and/or inventory subject to market obsolescence. Commercial loans can also involve relatively large loan balances to a single borrower or groups of related borrowers, with the repayment of such loans typically dependent on the successful operation and income stream of the borrower. Such risks can be significantly affected by economic conditions.
- Consumer – consist of loans secured by collateral such as an automobile or a deposit account, unsecured loans and lines of credit. Consumer loans tend to have a higher credit risk due to the loans being either unsecured or secured by rapidly depreciable assets. Furthermore, consumer loan payments are dependent on the borrower's continuing financial stability, and therefore are more likely to be adversely affected by job loss, divorce, illness or personal bankruptcy.

The allowance for loan losses is a valuation account that reflects the Company's evaluation of the losses inherent in its loan portfolio. In order to determine the adequacy of the allowance for loan losses, the Company estimates losses by loan type using historical loss factors, as well as

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NOTE 5 - ALLOWANCE FOR LOAN LOSSES (continued)

other environmental factors, such as trends in loan volume and loan type, loan concentrations, changes in the experience, ability and depth of the lending management, and national and local economic conditions. The Company also reviews all loans on which the collectability of principal may not be reasonably assured, by reviewing payment status, financial conditions and estimated value of loan collateral. These loans are assigned an internal loan grade, and the Company assigns the amount of loss components to these classified loans based on loan grade.

The following table summarizes the activity in the allowance for loan losses for the three months ended March 31, 2011 and the distribution of the allowance for loan losses and loans receivable by loan portfolio class and impairment method as of March 31, 2011:

| | Real Estate Loans | | | | Other Loans | | | Total |
|--|------------------------|----------------|------------|--------------|-------------|----------|-------------|-----------|
| | One-to Four-Family | Home Equity | Commercial | Construction | Commercial | Consumer | Unallocated | |
| | (Dollars in thousands) | | | | | | | |
| Allowance for Loan Losses: | | | | | | | | |
| Beginning balance | \$407 | \$141 | \$ 278 | \$1 | \$ 104 | \$ 21 | \$ 1 | \$953 |
| Chargeoffs | - | (29) | - | - | - | (5) | - | (34) |
| Recoveries | 4 | - | - | - | - | 1 | - | 5 |
| Provision | (105) | (22) | 72 | (1) | 73 | 4 | (1) | 20 |
| Ending balance | \$306 | \$90 | \$ 350 | \$- | \$ 177 | \$ 21 | \$ - | \$944 |
| Ending balance:individually evaluated for impairment | \$- | \$- | \$ 7 | \$- | \$ - | \$ - | \$ - | \$7 |
| Ending balance:collectively evaluated for impairment | \$306 | \$90 | \$ 343 | \$- | \$ 177 | \$ 21 | \$ - | \$937 |
| Gross Loans Receivable (1): | | | | | | | | |
| Ending balance | \$185,097 | \$30,456 | \$ 35,266 | \$630 | \$ 10,951 | \$ 2,199 | | \$264,599 |
| Ending balance: individually evaluated for impairment | \$- | \$- | \$ 275 | \$- | \$ - | \$ - | | \$275 |
| Ending balance: collectively evaluated for impairment | \$185,097 | \$30,456 | \$ 34,991 | \$630 | \$ 10,951 | \$ 2,199 | | \$264,324 |

(1) Gross Loans Receivable does not include allowance for loan losses of \$(944) or deferred loan costs of \$2,528.

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NOTE 5 - ALLOWANCE FOR LOAN LOSSES (continued)

The following table summarizes the distribution of the allowance for loan losses and loans receivable by loan portfolio class as of December 31, 2010:

| | Real Estate Loans | | | | Other Loans | | | Total |
|--|------------------------|----------------|------------|--------------|-------------|----------|-------------|-----------|
| | One-to Four-Family | Home Equity | Commercial | Construction | Commercial | Consumer | Unallocated | |
| | (Dollars in thousands) | | | | | | | |
| Allowance for Loan Losses: | | | | | | | | |
| Ending balance | \$407 | \$141 | \$ 278 | \$1 | \$ 104 | \$ 21 | \$ 1 | \$953 |
| Ending balance: individually evaluated for impairment | \$- | \$- | \$ - | \$- | \$ - | \$ - | \$ - | \$- |
| Ending balance: collectively evaluated for impairment | \$407 | \$141 | \$ 278 | \$1 | \$ 104 | \$ 21 | \$ 1 | \$953 |
| Gross Loans Receivable (1): | | | | | | | | |
| Ending balance | \$183,929 | \$30,613 | \$ 33,782 | \$616 | \$ 10,360 | \$ 2,224 | | \$261,524 |
| Ending balance: individually evaluated for impairment | \$- | \$- | \$ 277 | \$- | \$ - | \$ - | | \$277 |
| Ending balance: collectively evaluated for impairment | \$183,929 | \$30,613 | \$ 33,505 | \$616 | \$ 10,360 | \$ 2,224 | | \$261,247 |

(1) Gross Loans Receivable does not include allowance for loan losses of \$(953) or deferred loan costs of \$2,460.

Although the allocations noted above are by loan type, the allowance for loan losses is general in nature and is available to offset losses from any loan in the Company's portfolio.

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

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NOTE 5 - ALLOWANCE FOR LOAN LOSSES (continued)

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

| | Recorded Investment | Unpaid Principal Balance | Related Allowance | Average Recorded Investment | Interest Income Recognized |
|---|------------------------|--------------------------------|----------------------|-----------------------------------|----------------------------------|
| | (Dollars in thousands) | | | | |
| For the three months ended March 31, 2011 | | | | | |
| With no related allowance recorded: | | | | | |
| Commercial real estate | \$ 132 | \$ 132 | \$- | \$ 133 | \$ 3 |
| With an allowance recorded: | | | | | |
| Commercial real estate | 136 | 143 | 7 | 141 | 5 |
| Total | \$268 | \$275 | \$7 | \$274 | \$8 |
| For the year ended December 31, 2010 | | | | | |
| With no related allowance recorded: | | | | | |
| Commercial real estate | \$277 | \$277 | \$- | \$211 | \$5 |
| With an allowance recorded: | | | | | |
| Commercial real estate | - | - | - | 1,566 | 56 |
| Commercial loans | - | - | - | 147 | 8 |
| Total | \$277 | \$277 | \$- | \$1,924 | \$69 |

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NOTE 5 - ALLOWANCE FOR LOAN LOSSES (continued)

The following table provides an analysis of past due loans as of dates indicated:

| | 30-59 Days Past Due | 60-89 Days Past Due | 90 Days or More Past Due | Total Past Due | Current | Total Loans Receivable |
|---------------------|------------------------|------------------------|--------------------------------|-------------------|-----------|---------------------------|
| | (Dollars in thousands) | | | | | |
| March 31, 2011: | | | | | | |
| Real Estate Loans: | | | | | | |
| Residential, One-to | | | | | | |
| Four-Family | \$1,220 | \$256 | \$1,394 | \$2,870 | \$182,227 | \$185,097 |
| Home equity | 129 | - | 117 | 246 | 30,210 | 30,456 |
| Commercial | 43 | - | 369 | 412 | 34,854 | 35,266 |
| Construction | - | - | - | - | 630 | 630 |
| Other Loans: | | | | | | |
| Commercial | 455 | - | 17 | 472 | 10,479 | 10,951 |
| Consumer | 34 | 2 | 44 | 80 | 2,119 | 2,199 |
| Total | \$1,881 | \$258 | \$1,941 | \$4,080 | \$260,519 | \$264,599 |
| December 31, 2010: | | | | | | |
| Real Estate Loans: | | | | | | |
| Residential, One-to | | | | | | |
| Four-Family | \$1,435 | \$713 | \$1,490 | \$3,638 | \$180,291 | \$183,929 |
| Home equity | 188 | 116 | 135 | 439 | 30,174 | 30,613 |
| Commercial | 45 | - | 413 | 458 | 33,324 | 33,782 |
| Construction | - | - | - | - | 616 | 616 |
| Other Loans: | | | | | | |
| Commercial | 300 | - | 27 | 327 | 10,033 | 10,360 |
| Consumer | 13 | 13 | 70 | 96 | 2,128 | 2,224 |
| Total | \$1,981 | \$842 | \$2,135 | \$4,958 | \$256,566 | \$261,524 |

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NOTE 5 - ALLOWANCE FOR LOAN LOSSES (continued)

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

| | At March 31, 2011 | At December 31, 2010 |
|--|-------------------------|----------------------------|
| | (Dollars in thousands) | |
| Loans past due 90 days or more but still accruing: | | |
| Real Estate Loans: | | |
| Residential, One-to Four-Family | \$285 | \$ 391 |
| Home equity | 87 | 39 |
| Commercial | - | 43 |
| Construction | - | - |
| Other loans: | | |
| Commercial | - | - |
| Consumer | 34 | 59 |
| Total | \$406 | \$ 532 |
| Loans accounted for on a non-accrual basis: | | |
| Real Estate Loans: | | |
| Residential, One-to Four-Family | \$1,364 | \$ 1,279 |
| Home Equity | 128 | 122 |
| Commercial | 369 | 370 |
| Construction | - | - |
| Other loans: | | |
| Commercial | 24 | 27 |
| Consumer | 10 | 11 |
| Total | \$1,895 | \$ 1,809 |

The accrual of interest on loans is discontinued when, in management's opinion, the borrower may be unable to meet payments as they become due. When interest accrual is discontinued, all unpaid accrued interest is reversed. Interest income is subsequently recognized only to the extent cash payments are received. If ultimate collection of principal is in doubt, all cash receipts on impaired loans are applied to reduce the principal balance. Interest income not recognized on non-accrual loans during the three month period ended March 31, 2011 and March 31, 2010 was \$104,000 and \$52,000 respectively.

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

- Pass/Performing
- Watch/Special Mention – does not currently expose the Company to a sufficient degree of risk but does possess credit deficiencies or potential weaknesses deserving the Company's close attention;
- Substandard - has one or more defined weaknesses and are characterized by the distinct possibility that the Company will sustain some loss if the deficiencies are not corrected;
- Doubtful - has all the weaknesses inherent in substandard loans with the additional characteristic that the weaknesses present make collection or liquidation in full on the basis of currently existing facts, conditions and values questionable, and there is a high possibility of loss; and
 - Loss - loan is considered uncollectible and continuance as a loan of the Company is not warranted.

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NOTE 5 - ALLOWANCE FOR LOAN LOSSES (continued)

The Company's Asset Classification Committee is responsible for monitoring risk ratings and making changes as deemed appropriate. Each commercial loan is individually assigned a loan classification. The Company's consumer loans, including residential mortgages and home equity loans, are not individually classified. Instead the Company uses the delinquency status as the credit quality indicator for consumer loans. Unless the loan is well secured and in the process of collection, all consumer loans that are more than 90 days past due are classified.

The following table summarizes the internal loan grades applied to the Company's loan portfolio as of March 31, 2011:

| | Pass/Performing | Special Mention | Substandard | Doubtful | Loss | Total |
|------------------------|-----------------|--------------------|-------------|----------|------|------------|
| (Dollars in thousands) | | | | | | |
| Real Estate Loans: | | | | | | |
| One-to Four-family | \$ 183,001 | \$- | \$ 2,041 | \$ 55 | \$- | \$ 185,097 |
| Home Equity | 30,099 | - | 357 | - | - | 30,456 |
| Commercial | 32,403 | 2,452 | 42 | 369 | - | 35,266 |
| Construction | 630 | - | - | - | - | 630 |
| Other Loans: | | | | | | |
| Commercial | 10,155 | 560 | 123 | 113 | - | 10,951 |
| Consumer | 2,179 | - | 19 | - | 1 | 2,199 |
| Total | \$ 258,467 | \$ 3,012 | \$ 2,582 | \$ 537 | \$ 1 | \$ 264,599 |

The following table summarizes the internal loan grades applied to the loan portfolio as of December 31, 2010:

| | Pass/Performing | Special Mention | Substandard | Doubtful | Loss | Total |
|------------------------|-----------------|--------------------|-------------|----------|-------|------------|
| (Dollars in thousands) | | | | | | |
| Real Estate Loans: | | | | | | |
| One-to Four-family | \$ 181,631 | \$- | \$ 2,243 | \$ 55 | \$- | \$ 183,929 |
| Home Equity | 30,336 | - | 248 | - | 29 | 30,613 |
| Commercial | 32,185 | 1,184 | 43 | 370 | - | 33,782 |
| Construction | 616 | - | - | - | - | 616 |
| Other Loans: | | | | | | |
| Commercial | 9,706 | 351 | 199 | 104 | - | 10,360 |
| Consumer | 2,203 | - | 15 | 6 | - | 2,224 |
| Total | \$ 256,677 | \$ 1,535 | \$ 2,748 | \$ 535 | \$ 29 | \$ 261,524 |

NOTE 6 – EARNINGS PER SHARE

Earnings per share was calculated for the three months ended March 31, 2011 and 2010, 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.

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NOTE 6 – EARNINGS PER SHARE (continued)

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

| | Three Months Ended March 31, 2011 | Three Months Ended March 31, 2010 |
|--|---|---|
| Numerator – net income | \$ 950,000 | \$ 721,000 |
| Denominators: | | |
| Basic weighted average shares outstanding | 5,690,307 | 5,837,357 |
| Diluted weighted average shares outstanding(1) | 5,690,307 | 5,837,357 |
| Earnings per share: | | |
| Basic and Diluted: | \$ 0.17 | \$ 0.12 |

(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 23,404 under the Recognition and Retention Plan (the RRP) were outstanding during the three month period ended March 31, 2011 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 249,455 shares under the Stock Option Plan at \$11.07 per share and restricted unvested shares of 40,763 under the RRP plan were outstanding during the three month period ended March 31, 2010, but were not included in the calculation of diluted earnings per share because to do so would have been anti-dilutive.

NOTE 7– COMMITMENTS TO EXTEND CREDIT

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

The Company's exposure to credit loss is represented by the contractual amount of these commitments. The Company follows the same credit policies in making commitments as it does for on-balance sheet instruments.

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

| | March 31, 2011 | Contract Amount December 31, 2010 |
|--|------------------------|--|
| | (Dollars in thousands) | |
| Commitments to grant loans | \$8,745 | \$7,866 |
| Unfunded commitments under lines of credit | \$27,610 | \$27,065 |

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 March 31, 2011 and December 31, 2010, the Company's fixed rate loan commitments totaled \$5.4 million and \$5.5 million, respectively. The range of interest rates on these fixed rate commitments was 4.38% to 7.25% at March 31, 2011.

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NOTE 8– STOCK-BASED COMPENSATION

As of March 31, 2011, 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 \$103,000 and \$97,000 for the three months ended March 31, 2011 and 2010, respectively.

Stock Option Plan

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

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 |

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.

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NOTE 8– STOCK-BASED COMPENSATION (continued)

A summary of the status of the Stock Option Plan for the three months ended March 31, 2011 and 2010 is presented below:

| | March 31, 2011 | | | March 31, 2010 | | |
|--------------------------------------|----------------|----------------|----------------------------|----------------|----------------|----------------------------|
| | Options | Exercise Price | Remaining Contractual Life | Options | Exercise Price | Remaining Contractual Life |
| Outstanding at beginning of period | 249,455 | \$ 11.07 | | 238,258 | \$ 11.22 | |
| Granted | - | | | 17,773 | 7.88 | |
| Forfeited | - | | | (6,576) | 8.01 | |
| Outstanding at end of period | 249,455 | \$ 11.07 | | 249,455 | \$ 11.07 | |
| Options exercisable at end of period | 186,046 | \$ 11.32 | 5 years | 137,600 | \$ 11.40 | 6 years |
| Fair value of options granted | | | | \$ 1.15 | | |

At March 31, 2011, 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 \$36,000 for the quarter ended March 31, 2011 and \$37,000 for the quarter ended March 31, 2010. At March 31, 2011, \$135,000 of unrecognized compensation cost related to stock options is expected to be recognized over a period of 8 to 45 months.

Recognition and Retention Plan

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

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 ¹ | \$ 7.88 | Management |

¹After January 4, 2011, awards will begin to vest on January 27, 2012 and each January 27th thereafter.

Awards vest at a rate of 20% per year. As of March 31, 2011, there were 59,053 shares vested or distributed to eligible participants under the RRP. Compensation expense amounted to \$46,000 for the quarter ended March 31, 2011 and \$44,000 for the quarter ended March 31, 2010. At March 31, 2011, \$221,000 of unrecognized compensation cost related to the RRP is expected to be recognized over a period of 8 to 45 months.

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NOTE 8– STOCK-BASED COMPENSATION (continued)

A summary of the status of unvested shares under the RRP for the three months ended March 31, 2011 and 2010 is as follows:

| | March 31, 2011 | Weighted Average Grant Price | March 31, 2010 | Weighted Average Grant Price |
|--|-------------------|------------------------------------|-------------------|------------------------------------|
| Unvested shares outstanding at beginning of period | 31,546 | \$9.43 | 36,530 | \$10.55 |
| Granted | - | - | 11,900 | 7.88 |
| Vested | (3,975) | 7.93 | (1,998) | 8.01 |
| Forfeited | - | - | (1,619) | 8.01 |
| Unvested shares outstanding at end of period | 27,571 | \$9.64 | 44,813 | \$10.04 |

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 March 31, 2011, the balance of the loan to the ESOP was \$2.1 million and the fair value of unallocated shares was \$2.0 million. As of March 31, 2011, there were 41,659 allocated shares and 196,391 unallocated shares compared to 33,724 allocated shares and 204,326 unallocated shares at March 31, 2010. The ESOP compensation expense was \$21,000 for the three months ended March 31, 2011 and \$16,000 for the three months ended March 31, 2010 based on 1,984 shares earned in each of those periods.

NOTE 9– 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 March 31, 2011 and December 31, 2010 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.

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NOTE 9– FAIR VALUE OF FINANCIAL INSTRUMENTS (continued)

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 March 31, 2011 and December 31, 2010 are as follows:

| | March 31, 2011 | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Other Unobservable Inputs (Level 3) |
|---|-------------------|--|---|---|
| (Dollars in thousands) | | | | |
| Measured at fair value on a recurring basis: | | | | |
| Securities available for sale: | | | | |
| U.S. Treasury bonds | \$10,994 | \$10,944 | \$- | \$ - |
| Municipal bonds | 52,769 | - | 52,769 | - |
| Mortgage-backed securities: | | | | |
| Collateralized mortgage obligations - private label | 183 | - | 183 | - |
| Collateralized mortgage obligations - government sponsored entities | 68,446 | - | 68,446 | - |
| Government National Mortgage Association | 3,321 | - | 3,321 | - |
| Federal National Mortgage Association | 15,993 | - | 15,993 | - |
| Federal Home Loan Mortgage Corporation | 5,760 | - | 5,760 | - |
| Asset-backed securities: | | | | |
| Private label | 5,321 | - | 1,109 | 4,212 |
| Government sponsored entities | 231 | - | 231 | - |
| Equity securities | 9 | - | 9 | - |
| | \$163,027 | \$10,994 | \$147,821 | \$ 4,212 |
| Measured at fair value on a non-recurring basis: | | | | |
| Impaired loans | \$136 | \$- | \$- | \$ 136 |

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NOTE 9 - FAIR VALUE OF FINANCIAL INSTRUMENTS (continued)

| | December 31, 2010 | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Other Unobservable Inputs (Level 3) |
|---|----------------------|--|---|---|
| (Dollars in thousands) | | | | |
| Measured at fair value on a recurring basis: | | | | |
| Securities available for sale: | | | | |
| U.S. Treasury bonds | \$9,104 | \$9,104 | \$- | \$ - |
| Municipal bonds | 45,746 | - | 45,746 | - |
| Mortgage-backed securities: | | | | |
| Collateralized mortgage obligations - private label | 304 | - | 304 | - |
| Collateralized mortgage obligations - government sponsored entities | 73,396 | - | 73,396 | - |
| Government National Mortgage Association | 2,407 | - | 2,407 | - |
| Federal National Mortgage Association | 10,866 | - | 10,866 | - |
| Federal Home Loan Mortgage Corporation | 6,207 | - | 6,207 | - |
| Asset-backed securities: | | | | |
| Private label | 5,650 | - | 1,372 | 4,278 |
| Government sponsored entities | 237 | - | 237 | - |
| Equity securities | 7 | - | 7 | - |
| | \$153,924 | \$9,104 | \$140,542 | \$ 4,278 |
| Measured at fair value on a non-recurring basis: | | | | |
| Foreclosed real estate | \$10 | \$- | \$- | \$ 10 |

There were no reclassifications between the Level 1 and Level 2 categories for the three months ended March 31, 2011.

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 three months ended March 31, 2011 and 2010:

| | 2011 | 2010 |
|---|------------------------|---------|
| | (Dollars in thousands) | |
| Beginning Balance | \$4,278 | \$5,316 |
| Total gains – realized/unrealized: | | |
| Included in earnings | - | - |
| Included in other comprehensive income (loss) | 70 | 203 |
| Total losses – realized/unrealized: | | |
| Included in earnings | - | - |
| Included in other comprehensive income (loss) | (13) | (163) |
| Purchases, issuances and settlements | - | - |
| Sales | - | - |
| Principal paydowns | (123) | (95) |
| Transfers to Level 3 | - | - |

| | | |
|----------------|---------|---------|
| Ending Balance | \$4,212 | \$5,261 |
|----------------|---------|---------|

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NOTE 9 - 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.

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 March 31, 2011, impaired loans with a specific allowance had a gross carrying amount of \$143,000 with a valuation allowance of \$7,000, resulting in \$7,000 additional provision for loan losses for the three months ended March 31, 2011. As of December 31, 2010, there were no impaired loans with a specific reserve against them.

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:

| | March 31, 2011 | | December 31, 2010 | |
|---|------------------------|-------------------------|--------------------|-------------------------|
| | Carrying Amount | Estimated Fair Value | Carrying Amount | Estimated Fair Value |
| | (Dollars in thousands) | | | |
| Financial assets: | | | | |
| Cash and cash equivalents | \$27,257 | \$27,257 | \$33,514 | \$33,514 |
| Securities available for sale | 163,027 | 163,027 | 153,924 | 153,924 |
| Federal Home Loan Bank stock | 2,397 | 2,397 | 2,401 | 2,401 |
| Loans receivable | 266,183 | 262,356 | 263,031 | 262,441 |
| Accrued interest receivable | 2,115 | 2,115 | 1,801 | 1,801 |
| Financial liabilities: | | | | |
| Deposits | 376,764 | 382,631 | 375,785 | 381,961 |
| Short-term borrowings | 8,800 | 8,800 | 5,000 | 5,000 |
| Long-term debt | 30,270 | 31,142 | 34,160 | 35,285 |
| Accrued interest payable | 94 | 94 | 126 | 126 |
| 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.

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 March 31, 2011, trading activity in privately issued asset-backed securities was very limited. The markets for such securities were

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NOTE 9 - FAIR VALUE OF FINANCIAL INSTRUMENTS (continued)

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 private-label asset-backed securities. In addition to obtaining estimated prices from independent parties, the Company also performed internal modeling to estimate the fair value of private-label asset-backed securities included in the Level 3 fair value hierarchy during the three months ended March 31, 2011 and the year ended December 31, 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 March 31, 2011 and December 31, 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.

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.

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NOTE 10 – TREASURY STOCK

During the quarter ended March 31, 2011, the Company repurchased 17,950 shares of common stock at an average cost of \$9.39 per share. Of these shares 15,000 were repurchased pursuant to the Company's publicly announced common stock repurchase programs. The remaining 2,950 shares were repurchased from the trustee of the Company's unvested RRP stock, when an awardee sold vested shares. As of March 31, 2011, there were 91,510 shares remaining to be repurchased under the Company's existing stock repurchase program.

During the quarter ended March 31, 2010, the Company repurchased 72,440 shares of common stock at an average cost of \$7.95 per share. Of these shares 70,000 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 March 31, 2010, there were 117,642 shares remaining to be purchased under the existing stock repurchase program.

NOTE 11 – SUBSEQUENT EVENTS

On April 27, 2011, the Board of Directors declared a quarterly dividend of \$0.07 per share on the Company's common stock, payable on May 24, 2011 to shareholders of record as of May 9, 2011. Lake Shore, MHC, which holds 3,636,875 shares, or approximately 61.2% of the Company's total outstanding stock, intends to waive receipt of the dividend on its shares (except for a one-time payment of \$57,576 to raise cash levels at the MHC level in accordance with a commitment to the Office of Thrift Supervision). Lake Shore, MHC elected to waive its right to receive cash dividends of approximately \$255,000 for the three month period ended March 31, 2011. Cumulatively, Lake Shore, MHC has waived approximately \$3.1 million of cash dividends as of March 31, 2011. The dividends waived by Lake Shore, MHC are considered a restriction on the retained earnings of the Company.

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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, 2010, 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, including the implementation of the Dodd-Frank Act; and

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

Any or all of our forward-looking statements in this Quarterly Report on Form 10-Q and in any other public statements we make may differ from actual outcomes. They can be affected by inaccurate assumptions we might make or known or unknown risks and uncertainties. Consequently, no forward-looking statements can be guaranteed. We undertake no obligation to publicly update any forward looking statement, whether as a result of new information, future events or otherwise.

Overview

The following discussion and analysis is presented to assist in the understanding and evaluation of our consolidated financial condition and results of operations. It is intended to complement the unaudited consolidated financial statements and notes thereto appearing elsewhere in this Form 10-Q and should be read in conjunction therewith. The detailed discussion focuses on our consolidated financial condition as of March 31, 2011 compared to the financial condition as of December 31, 2010 and the consolidated results of operations for the three months ended March 31, 2011 and 2010.

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-

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bearing liabilities. Net interest income is affected by the relative amounts of interest-earning assets and interest-bearing liabilities and the interest rates we earn or pay on these balances.

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

Financial institutions like us, in general, are significantly affected by economic conditions, competition and the monetary and fiscal policies of the federal government. Lending activities are influenced by the demand for and supply of housing, competition among lenders, interest rate conditions, and funds availability. Our operations and lending are principally concentrated in the Western New York area, and our operations and earnings are influenced by local economic conditions. Deposit balances and cost of funds are influenced by prevailing market rates on competing investments, customer preferences, and levels of personal income and savings in our primary market area.

Management Strategy

Our Reputation. With more than 120 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 branch in Erie County, New York, and our tenth overall. This office had generated deposits of \$22.9 million as of March 31, 2011. In December 2008, we opened an office in Kenmore, New York, that has generated deposits of \$30.4 million as of March 31, 2011. Our offices are located in Dunkirk, Fredonia, Jamestown, West Ellicott, and Westfield in Chautauqua County, New York and in Depew, East Amherst, Hamburg, Kenmore, and Orchard Park in Erie County, New York. Saturation of the market in Chautauqua County led to our expansion plan in Erie County, which is a critical component of our future profitability and growth.

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

Residential Mortgage and Other Lending. Historically, our lending portfolio has been comprised predominantly of residential mortgage loans. At March 31, 2011 and December 31, 2010, we held \$185.1 million and \$183.9 million of one-to four-family residential mortgage loans, respectively, which constituted 70.0% and 70.3% 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 March 31, 2011 and December 31, 2010, our commercial real estate loan portfolio consisted of loans totaling \$35.3 million and \$33.8 million, respectively, or 13.3% and 12.9%, 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 March 31, 2011 and December 31, 2010, our commercial loan portfolio consisted of loans totaling \$11.0 million and \$10.4 million, respectively, or 4.1% and 4.0%, respectively, of total loans. Other loan products offered to our customers include home equity loans and lines of credit, construction loans and consumer loans, including automobile loans, overdraft lines of credit and share loans. We may sell one-to four-family residential mortgage loans in the future as part of our interest rate risk strategy and asset/liability management, if it is deemed appropriate. We typically retain servicing rights when we sell

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one-to four-family residential loans. one-to four-family residential mortgage loans will continue to be the dominant type of loan in our lending portfolio.

Investment Strategy. Our investment policy is designed primarily to manage the interest rate sensitivity of our assets and liabilities, to generate a favorable return without incurring undue interest rate and credit risk, to complement our lending activities and to provide and maintain liquidity within established guidelines. At March 31, 2011 and December 31, 2010, our investment securities totaled \$165.4 million and \$156.3 million, respectively.

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%. Between March 2010 and March 2011, yields in long-term Treasury maturities have shifted downward. For example, the yield on the 10 year Treasury note decreased from 3.84% as of March 31, 2010 to 3.47% as of March 31, 2011, a decrease of 37 basis points. Over that same one year time period the yield on a mortgage backed security decreased by 22 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 does not move in the same manner or to the same degree as the interest rates on loans and securities, our net interest margin could decline.

Interest Rate Risk. Residential mortgage rates have continued to decline during the past year. As of March 31, 2011, the monthly average commitment rate on a 30 year fixed rate residential mortgage was 5.1275%, a decrease of 19.75 basis points from an average commitment rate of 5.325% as of March 31, 2010. Interest rates on new loans are still 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 March 31, 2011 and December 31, 2010, we had \$163.0 million and \$153.9 million, respectively, invested in securities available for sale, the majority of which are agency mortgage-backed, agency collateralized mortgage obligations (“CMOs”) and municipal securities.

Other than Temporary Impairment (“OTTI”)

During 2008, we wrote down four non-agency asset-backed securities in our investment portfolio which were affected by the unprecedented events in the credit markets and the large decline in the housing market. The write-down resulted in a pre-tax loss of \$1.9 million (\$1.2 million, net of tax), which was recorded in “Other Non-interest Income” in the consolidated statements of income. All four of the securities were rated “AAA” by the major rating agencies when purchased but were subsequently downgraded. At the time of the write down, the fair market values for all of these securities experienced significant declines. The price declines, accounting rules and associated SEC guidance contributed to management’s determination that the impairment on these securities was “other-than-temporary” during

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2008. During the first quarter of 2011, we continued to receive expected payments on the remaining securities. In January 2011, one security paid off. No additional impairments in these securities or impairments on other securities were taken during the three month period ended March 31, 2011 or the year ended December 31, 2010. Management monitors the securities portfolio for the possibility of additional OTTI on a quarterly basis. Refer to Note 4 of the Notes to Consolidated Financial Statements for more information on OTTI.

Critical Accounting Policies

It is management's opinion that accounting estimates covering certain aspects of our business have more significance than others due to the relative importance of those areas to overall performance, or the level of subjectivity required in making such estimates. Management considers the accounting policy relating to the allowance for loan losses to be a critical accounting policy given the uncertainty in evaluating the level of the allowance for loan losses required for probable credit losses and the material effect that such judgments can have on the results of operations. Management's quarterly evaluation of the adequacy of the allowance considers our historical loan loss experience, review of specific loans, current economic conditions, and such other factors considered appropriate to estimate loan losses. Management uses presently available information to estimate probable losses on loans; however, future additions to the allowance may be necessary based on changes in estimates, assumptions, or economic conditions. Significant factors that could give rise to changes in these estimates include, but are not limited to, changes in economic conditions in our local area, concentrations of risk and decline in local property values. Refer to Note 5 of the Notes to Consolidated Financial Statements for more information on the allowance for loan losses.

In management's opinion, the accounting policy relating to the valuation of investments is a critical accounting policy. The fair values of our investments are determined using public quotations, third party dealer quotes, pricing models, or discounted cash flows. Thus, the determination may require significant judgment or estimation, particularly when liquid markets do not exist for the item being valued. The use of different assumptions for these valuations could produce significantly different results which may have material positive or negative effects on the results of our operations. Refer to Note 9 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 consolidated results of income. The credit portion of a decline in the fair value of investments below cost deemed to be other-than-temporary may be charged to earnings resulting in the establishment of a new cost basis for an asset. Management continually reviews the current value of its investments for evidence of OTTI. Refer to Note 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, 2010 to better understand how our financial performance is reported.

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Analysis of Net Interest Income

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

Average Balances, Interest and Average Yields. The following 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.

| | For the Three Months ended March 31, 2011 | | | For the Three Months ended March 31, 2010 | | | | |
|---|--|--------------------------------|----------------|--|--------------------|--------------------------------|----------------|---|
| | 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 | \$24,571 | \$14 | 0.23 | % | \$16,130 | \$9 | 0.22 | % |
| Securities | 158,932 | 1,611 | 4.05 | % | 122,900 | 1,391 | 4.53 | % |
| Loans | 263,617 | 3,505 | 5.32 | % | 257,659 | 3,542 | 5.50 | % |
| Total interest-earning assets | 447,120 | 5,130 | 4.59 | % | 396,689 | 4,942 | 4.98 | % |
| Other assets | 32,477 | | | | 29,770 | | | |
| Total assets | \$479,597 | | | | \$426,459 | | | |
| Interest-bearing liabilities: | | | | | | | | |
| Demand and | | | | | | | | |
| NOW accounts | \$40,089 | \$17 | 0.17 | % | \$38,842 | \$18 | 0.19 | % |
| Money market accounts | 48,350 | 66 | 0.55 | % | 40,908 | 76 | 0.74 | % |
| Savings accounts | 32,746 | 17 | 0.21 | % | 29,671 | 19 | 0.26 | % |
| Time deposits | 230,545 | 1,112 | 1.93 | % | 187,550 | 1,046 | 2.23 | % |
| Borrowed funds | 39,109 | 263 | 2.69 | % | 45,091 | 359 | 3.18 | % |
| Other interest-bearing liabilities | 1,280 | 28 | 8.75 | % | 1,318 | 29 | 8.80 | % |
| Total interest-bearing liabilities | 392,119 | 1,503 | 1.53 | % | 343,380 | 1,547 | 1.80 | % |
| Other non-interest bearing | | | | | | | | |
| liabilities | 31,291 | | | | 27,005 | | | |
| Stockholders' equity | 56,187 | | | | 56,074 | | | |
| Total liabilities and stockholders' equity | \$479,597 | | | | \$426,459 | | | |
| Net interest income | | \$3,627 | | | | \$3,395 | | |
| Interest rate spread | | | 3.06 | % | | | 3.18 | % |
| Net interest margin | | | 3.24 | % | | | 3.42 | % |

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

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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.

| | Three Months Ended March 31, 2011 Compared to Three Months Ended March 31, 2010 | | |
|--|---|--------------|--------------|
| | Rate | Volume | Net Change |
| | (Dollars in thousands) | | |
| Interest-earning assets: | | | |
| Interest-earning deposits and Federal funds sold | \$- | \$5 | \$5 |
| Securities | (156) | 376 | 220 |
| Loansdeposits, including fees | (118) | 81 | (37) |
| Total interest-earning assets | (274) | 462 | 188 |
| Interest-bearing liabilities: | | | |
| Demand and NOW accounts | (2) | 1 | (1) |
| Money market accounts | (22) | 12 | (10) |
| Savings accounts | (4) | 2 | (2) |
| Time deposits | (153) | 219 | 66 |
| Total deposits | (181) | 234 | 53 |
| Other interest-bearing liabilities: | | | |
| Borrowed funds and other | (52) | (45) | (97) |
| Total interest-bearing liabilities | (233) | 189 | (44) |
| Total change in net interest income | \$(41) | \$273 | \$232 |

Our earnings may be adversely impacted by an increase in interest rates because the majority of our interest-earning assets are long-term, fixed rate mortgage-related assets that will not reprice as long-term interest rates increase. Conversely, a majority of our interest-bearing liabilities have much shorter contractual maturities and are expected to reprice. A significant portion of our deposits have no contractual maturities and are likely to reprice quickly as short-term interest rates increase. Therefore, in an increasing rate environment, our cost of funds is expected to increase more rapidly than the yields earned on our loan portfolio and securities portfolio. An increasing rate environment is expected to cause a decrease in our net interest rate spread and a decrease in our earnings. In order to mitigate this effect, the Bank's Asset-Liability Committee is continuing to review its options in relation to core deposit growth, implementation of new products and use of derivatives.

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 March 31, 2011, the average yields on our loan portfolio and investment portfolios were 5.32% and 4.05%, respectively, in comparison to 5.50% and 4.53%, respectively, for the

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three months ended March 31, 2010. Overall, the average yield on our interest earning assets decreased by 39 basis points for the three months ended March 31, 2011 in comparison to the three months ended March 31, 2010. For the three months ended March 31, 2011, the average rate that we were paying on interest-bearing liabilities decreased by 27 basis points in comparison to the same period in the prior year. This was partially due to a decrease in the interest paid on our borrowings from 3.18% to 2.69% between the three months ended March 31, 2011 and 2010 and a 30 basis point decrease in the rate paid on time deposits from 2.23% for the three months ended March 31, 2010 to 1.93% for the three months ended March 31, 2011. Our interest rate spread for the three months ended March 31, 2011 was 3.06%, which constituted a 12 basis point decrease in comparison to the three months ended March 31, 2010. Our net interest margin was 3.24% and 3.42% for the three months ended March 31, 2011 and 2010, respectively.

Comparison of Financial Condition at March 31, 2011 and December 31, 2010

Total assets at March 31, 2011 were \$483.9 million, an increase of \$4.9 million, or 1.0%, from \$479.0 million at December 31, 2010. The increase in total assets was primarily due to a \$9.1 million increase in securities available for sale and a \$3.2 million increase in loans receivable, net, partially offset by a \$6.3 million decrease in cash and cash equivalents and a \$1.4 million decrease in other assets.

Cash and cash equivalents decreased by \$6.3 million from \$33.5 million at December 31, 2010 to \$27.3 million at March 31, 2011. The decrease was primarily attributed to an \$8.0 million decrease in federal funds sold which were utilized to fund loan originations and the purchase of securities available for sale.

Securities available for sale increased by \$9.1 million to \$163.0 million at March 31, 2011 compared to \$153.9 million at December 31, 2010. During the three month period ended March 31, 2011, the Company purchased \$14.2 million of securities, including mortgage-backed securities, municipal bonds and U.S. Treasury bonds. During the same period, \$6.2 million in paydowns were received on the investment portfolio and unrealized gains earned before taxes totaled approximately \$1.2 million.

Loans receivable, net increased by \$3.2 million to \$266.2 million at March 31, 2011 from \$263.0 million at December 31, 2010. The table below shows the changes in loan volume by loan type between March 31, 2011 and December 31, 2010:

| | At March 31, 2011 | At December 31, 2010 | Change \$ | % | |
|---------------------------------|-------------------------|-------------------------------|--------------|------------|----------|
| | (Dollars in thousands) | | | | |
| Real Estate Loans: | | | | | |
| Residential, One-to Four-Family | \$ 185,097 | \$ 183,929 | \$ 1,168 | 0.6 | % |
| Home Equity | 30,456 | 30,613 | (157) | (0.5) |)% |
| Commercial | 35,266 | 33,782 | 1,484 | 4.4 | % |
| Construction | 630 | 616 | 14 | 2.3 | % |
| Total Real Estate Loans | 251,449 | 248,940 | 2,509 | 1.0 | % |
| Other Loans: | | | | | |
| Commercial | 10,951 | 10,360 | 591 | 5.7 | % |
| Consumer | 2,199 | 2,224 | (25) | (1.1) |)% |
| Total Gross Loans | 264,599 | 261,524 | 3,075 | 1.2 | % |
| Allowance for loan losses | (944) | (953) | 9 | (0.9) |)% |

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| | | | | | |
|-------------------------|-----------|-----------|---------|-----|---|
| Net deferred loan costs | 2,528 | 2,460 | 68 | 2.8 | % |
| Loans receivable, net | \$266,183 | \$263,031 | \$3,152 | 1.2 | % |

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The increase in loan receivable, net was primarily due to an increase in residential, one-to four-family residential mortgage loans, commercial real estate loans, and commercial loans as a result of our strategic plan and opportunities available in our market area.

Other assets decreased by \$1.4 million, or 33.2%, to \$2.9 million as of March 31, 2011 in comparison to December 31, 2010. The decrease was primarily due to the refund of \$600,000 in estimated federal income tax payments made during 2010. The tax refund was a result of tax payments being made prior to the chargeoff of \$2.6 million in impaired loans during the third quarter of 2010. The decrease was also due to a \$500,000 decrease in deferred tax assets as a result of an increase in unrealized mark to market gains on the available for sale securities portfolio.

The table below shows changes in deposit balances by type of deposit between March 31, 2011 and December 31, 2010:

| | At March 31, 2011 | At December 31, 2010 | \$ | Change % | |
|------------------------|-------------------------|-------------------------------|--------------|-------------|----------|
| (Dollars in thousands) | | | | | |
| Demand Deposits: | | | | | |
| Non-interest bearing | \$24,732 | \$22,986 | \$1,746 | 7.6 | % |
| Interest bearing | 40,391 | 41,971 | (1,580) | (3.8) |)% |
| Money market | 49,132 | 47,815 | 1,317 | 2.8 | % |
| Savings | 34,148 | 32,126 | 2,022 | 6.3 | % |
| Time deposits | 228,361 | 230,887 | (2,526) | (1.1) |)% |
| Total Deposits | \$376,764 | \$375,785 | \$979 | 0.3 | % |

The growth in non-interest bearing demand deposits, as well as money markets and savings accounts was a result of the Company's continued strategic focus on attracting commercial deposit relationships as well as growing core deposits among its retail customers.

Our borrowings, consisting of advances from the Federal Home Loan Bank of New York ("FHLBNY"), decreased by \$100,000 from \$39.2 million at December 31, 2010 to \$39.1 million at March 31, 2011. Short-term borrowings increased by \$3.8 million from \$5.0 million at December 31, 2010 to \$8.8 million at March 31, 2011. Long-term borrowing decreased \$3.9 million from \$34.2 million at December 31, 2010 to \$30.3 million at March 31, 2011. As long-term debt matured, the Company rolled the proceeds into short-term borrowings to take advantage of lower interest rates.

Other liabilities increased by \$3.4 million, or 58.3%, from December 31, 2010 to March 31, 2011 primarily due to \$3.7 million that the Company owed for purchases of available for sale securities, that had not yet settled as of March 31, 2011.

Total stockholders' equity increased \$1.5 million from \$55.2 million at December 31, 2010 to \$56.7 million at March 31, 2011. The increase in total stockholders' equity was primarily due to \$950,000 in net income during the quarter ended March 31, 2011 and a \$749,000 net increase in unrealized gains on the Company's available for sale securities portfolio, offset by \$169,000 of treasury stock repurchases and \$148,000 in dividends paid.

Comparison of Results of Operations for the Three Months Ended March 31, 2011 and 2010

General. Net income was \$950,000 for the three months ended March 31, 2011, or \$0.17 per diluted share, an increase of \$229,000, or 31.8%, compared to net income of \$721,000, or \$0.12 per diluted share, for the three months ended March 31, 2010. The increase in net income was primarily due to a \$232,000 increase in net interest income, a \$34,000 increase in non-interest income, a \$30,000 decrease in the

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provision for loan losses, and a decrease in income tax expense of \$14,000, offset by an \$81,000 increase in total non-interest expense for the three months ended March 31, 2011 in comparison to the prior year period.

Interest Income. Interest income increased by \$188,000, or 3.8% for the three months ended March 31, 2011 compared to the three months ended March 31, 2010. Loan interest income decreased by \$37,000, or 1.0%, for the three month period ended March 31, 2011 when compared to the three month period ended March 31, 2010. Loan interest income decreased due to the low interest rate environment which caused a decrease in the average yield on our loan portfolio from 5.50% for the three months ended March 31, 2010 to 5.32% for the current period, offset by an increase in our average balance of loans receivable, net which increased from \$257.7 million for the three months ended March 31, 2010 to \$263.6 million for the three months ended March 31, 2011. The average balance on loans increased due to increased commercial lending since March 31, 2010. Investment interest income increased by \$220,000, or 15.8%, for the three months ended March 31, 2011 compared to the three months ended March 31, 2010. The investment portfolio had an average balance of \$158.9 million and an average yield of 4.05% for the three months ended March 31, 2011 compared to an average balance of \$122.9 million and an average yield of 4.53% for the three months ended March 31, 2010. The increase in the average balance on the investment portfolio was due to the investment of excess cash acquired through an increase in average deposits as a result of growth in the Erie County branches, while the average yield on investments decreased due to the low interest rate environment. Other interest income increased \$5,000, or 55.6%, from \$9,000 for the quarter ended March 31, 2010 to \$14,000 for the quarter ended March 31, 2011. The average balance in other interest-earning deposits and federal funds sold increased \$8.4 million, or 52.3%, for the three month period ended March 31, 2011 when compared to the three month period ended March 31, 2010, while the average yield remained steady at 0.23% for the three month period ended March 31, 2011 and 0.22% for the three month period ended March 31, 2010.

Interest Expense. Interest expense decreased by \$44,000, or 2.8%, for the three month period ended March 31, 2011 when compared to the three month period ended March 31, 2010. The interest paid on deposits increased \$53,000 during the three month period ended March 31, 2011 compared to the same period in 2010. During the three month period ended March 31, 2011, the average balance of deposits was \$351.7 million with an average rate of 1.38% compared to the average balance of deposits of \$297.0 million and an average rate of 1.56% for the three month period ended March 31, 2010. The average balance of deposits increased primarily due to deposit growth in our Erie County branches, which included the opening of a new branch during April 2010. The interest expense related to advances from the FHLBNY decreased by \$96,000, or 27.3%, for the three month period ended March 31, 2011 compared to the three month period ended March 31, 2010. The decrease in interest expense on advances occurred due to a \$6 million decrease in average balances and a 49 basis point decline in average rate in comparison to the three month period ended March 31, 2010. The decrease in the average advance balance was a result of the Company's decision to utilize excess cash obtained via deposit growth in 2010 to paydown borrowings. The low interest rate environment caused the average rate paid on deposits and borrowings to decrease.

Provision for Loan Losses. Provision for loan losses during the three month period ended March 31, 2011 was \$20,000, a decrease of \$30,000, or 60%, in comparison to the three month period ended March 31, 2010. Nonperforming loans have remained steady at \$2.3 million for the three month period ended March 31, 2011 and 2010, despite a \$6.0 million increase in average loans outstanding since March 31, 2010. Net charge-offs have also remained low with an annualized ratio of net charge-offs to average loans receivable of 0.04% and 0.0% for the three months ended March 31, 2011 and 2010, respectively. Management's review of the quality of the current loan portfolio, the economic conditions in the Western New York area and the adequacy of the existing allowance for loan loss balances indicated that a higher provision was not necessary at this time for one-to four-family and home equity loans. A negative provision for loan losses of \$127,000 was recorded for one-to four-family and home equity loans for during the three month period ended March 31, 2011 due to a decrease in historical losses on these types

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of loans. A provision for loan losses of \$145,000 was recorded for commercial loans due to an increase in outstanding commercial mortgage and non-mortgage loans during the three month period ended March 31, 2011. Refer to Note 5 of the Notes to Consolidated Financial Statements (unaudited) for details on the provision for loan losses. 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 portfolios.

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

Non-interest Income. Non-interest income increased \$34,000, or 6.2% from \$546,000 for the three months ended March 31, 2010 to \$580,000 for the three months ended March 31, 2011. The increase in non-interest income was primarily due to a \$57,000 recovery on a previously impaired investment security during the three months ended March 31, 2011, partially offset by a \$33,000 decrease in service charges and fees for the three months ended March 31, 2011 compared with the same three months in 2010. The decrease in service charges and fees was related to recent federal regulations enacted during the third quarter of 2010, which require expanded disclosure of overdraft fees and allows customers to “opt out” of these types of fees.

Non-interest Expense. Non-interest expense increased by \$81,000, or 2.8%, from \$2.9 million at March 31, 2010 to \$3.0 million at March 31, 2011. The increase was largely due to an increase in occupancy and equipment expenses of \$73,000, or 18.8%. This increase was primarily due to the April 2010 opening of our newest branch in Depew, NY and an increase in expenses related to renovations at the Company’s administration buildings in 2010 and 2011. Other expenses increased \$40,000, or 18.0%, for the three month period ended March 31, 2011 compared to the three month period ended March 31, 2010 due to increased charitable donations and loan servicing costs. Professional services increased \$22,000, or 8.8%, due to increased fees for consulting services during the three month period ended March 31, 2011. Advertising expenses decreased by \$32,000 for the three month period ended March 31, 2011 compared to the three month period ended March 31, 2010. In 2010, there were increased advertising costs associated with the branch opening in Depew, NY, in April 2010. Salaries and employee benefits expenses decreased by \$27,000, or 1.7%, for the three month period ended March 31, 2011 compared to the three month period ended March 31, 2010. The decrease in salaries and employee benefits expenses during the three month period ended March 31, 2011, was primarily due to higher loan originations, as salary expenses related to loan originations are deferred and expensed over the life of the loan and a reduction in retirement plan expenses. The decrease was partially offset by increased salary expenses for annual raises and additional staffing at the newest branch location.

Income Tax Expense. Income tax expense decreased by \$14,000, or 5.6%, for the three month period ended March 31, 2011 compared to the three month period ended March 31, 2010. The decrease was primarily due to increased tax exempt income, which caused our effective tax rate to decrease to 19.8% for the three month period ended March 31, 2011, compared to 25.7% for the three month period ended March 31, 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 \$2.5 million at March 31, 2011 and \$2.6 million at December 31, 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. We did not have any non-performing troubled debt restructured loans as of the dates indicated.

| | At March 31, 2011 | At December 31, 2010 | | |
|--|-------------------------|-------------------------------|------|---|
| | (Dollars in thousands) | | | |
| Loans past due 90 days or more but still accruing: | | | | |
| Real estate loans: | | | | |
| One-to four-family | \$285 | \$391 | | |
| Construction | - | - | | |
| Commercial real estate | - | 43 | | |
| Home equity loans and lines of credit | 87 | 39 | | |
| Other loans: | | | | |
| Commercial loans | - | - | | |
| Consumer loans | 34 | 59 | | |
| Total | \$406 | \$532 | | |
| Loans accounted for on a nonaccrual basis: | | | | |
| Real estate loans: | | | | |
| One-to four-family | \$1,364 | \$1,279 | | |
| Construction | - | - | | |
| Commercial real estate . | 369 | 370 | | |
| Home equity loans and lines of credit.... | 128 | 122 | | |
| Other loans: | | | | |
| Commercial loans | 24 | 27 | | |
| Consumer loans | 10 | 11 | | |
| Total non-accrual loans | 1,895 | 1,809 | | |
| Total nonperforming loans | 2,301 | 2,341 | | |
| Foreclosed real estate | 205 | 304 | | |
| Restructured loans | - | - | | |
| Total nonperforming assets | \$2,506 | \$2,645 | | |
| Ratios: | | | | |
| Nonperforming loans as a percent of net loans: | 0.86 | % | 0.89 | % |
| Nonperforming assets as a percent of total assets: | 0.52 | % | 0.55 | % |

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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:

| | At or For the Three Months Ended March 31, 2011 | At or For the Three Months Ended March 31, 2010 | | |
|--|--|--|-------|---|
| | (Dollars in thousands) | | | |
| Balance at beginning of period: | \$953 | \$1,564 | | |
| Provision for loan losses | 20 | 50 | | |
| Charge-offs: | | | | |
| Real estate loans: | | | | |
| One-to four-family | - | - | | |
| Construction | - | - | | |
| Commercial real estate. | - | 13 | | |
| Home equity loans and lines of credit | 29 | - | | |
| Other loans: | | | | |
| Commercial loans | - | - | | |
| Consumer loans | 5 | 4 | | |
| Total charge-offs | 34 | 17 | | |
| Recoveries: | | | | |
| Real estate loans: | | | | |
| One-to four-family | 4 | 19 | | |
| Construction | - | - | | |
| Commercial real estate | - | - | | |
| Home equity loans and lines of credit | - | - | | |
| Other loans: | | | | |
| Commercial loans. | - | - | | |
| Consumer loans. | 1 | 1 | | |
| Total recoveries | 5 | 20 | | |
| Net charge-offs | 29 | (3) | | |
| Balance at end of period | \$944 | \$1,617 | | |
| Average loans outstanding | \$263,617 | \$257,659 | | |
| Ratio of net charge-offs to average loans outstanding (1) | 0.04 | % | 0.00 | % |
| Allowance for loan losses as a percent of total net loans | 0.35 | % | 0.63 | % |
| Allowance for loan losses as a percent of non-performing loans | 41.03 | % | 74.93 | % |

(1) Annualized

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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 \$128.6 million as of March 31, 2011 which was collateralized by a pledge of our mortgage loans. At March 31, 2011, we had outstanding advances under this agreement of \$39.1 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 the purchase of investment securities. For the three months ended March 31, 2011, we originated loans of approximately \$15.2 million in comparison to approximately \$8.5 million of loans originated during the three months ended March 31, 2010. Purchases of investment securities totaled \$14.2 million in the three months ended March 31, 2011 and \$13.9 million in the three months ended March 31, 2010.

At March 31, 2011, we had loan commitments to borrowers of approximately \$8.7 million and overdraft lines of protection and unused home equity lines of credit of approximately \$27.6 million.

Total deposits were \$376.8 million at March 31, 2011, as compared to \$375.8 million at December 31, 2010. Time deposit accounts scheduled to mature within one year were \$117.7 million at March 31, 2011. 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 2011, our liquidity and credit quality have improved. The ratio of non-performing loans as a percent of total net loans was 0.86%, a decline of 3 basis points since December 31, 2010, and remains below 1.0%.

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 2011. 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 7 in the Notes to our Consolidated Financial Statements and the commitments and unused lines and letters of credit noted above.

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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 7 of the Notes to Consolidated Financial Statements for a summary of loan commitments outstanding as of March 31, 2011.

Item 3. Quantitative and Qualitative Disclosures about Market Risk.

Management of 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 March 31, 2011 that have materially affected, or are reasonably likely to materially affect, internal control over financial reporting.

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PART II

Item 1A. Risk Factors

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

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

The following table reports information regarding repurchases by the Company of its common stock in each month of the quarter ended March 31, 2011:

COMPANY PURCHASES OF EQUITY SECURITIES

| Period | Total Number of Shares Purchased (1) | 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 (2) |
|--|--|------------------------------------|--|---|
| January 1, 2011 through January 31, 2011 | 10,000 | \$ 9.05 | 10,000 | 96,510 |
| February 1, 2011 through February 28, 2011 | - | - | - | 96,510 |
| March 1, 2011 through March 31, 2011 | 5,000 | \$ 10.15 | 5,000 | 91,510 |
| Total | 15,000 | \$ 9.42 | 15,000 | 91,510 |

(1) Amounts do not reflect re-purchases of 2,950 shares of common stock from the trustee of the Company's Recognition and Retention Plan on January 3, 2011.

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

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Item 6. Exhibits

- 3.1 Charter of Lake Shore Bancorp, Inc.1
- 3.2 Amended and Restated Bylaws of Lake Shore Bancorp, Inc.2
- 4.1 Form of Stock Certificate of Lake Shore Bancorp, Inc.3
- 10.1 Employment Agreement between Daniel P. Reininga and Lake Shore Bancorp, Inc.4
- 10.2 Employment Agreement between Daniel P. Reininga and Lake Shore Savings Bank.4
- 10.3 Amended and Restated Change of Control Agreement between Rachel A. Foley and Lake Shore Bancorp, Inc.5
- 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 February 3, 2011.

5 Incorporated herein by reference to Exhibits 10.3 to Form 8-K, filed with the Securities and Exchange Commission on February 3, 2011.

