

LAKE SHORE BANCORP, INC.  
Form 10-Q  
November 12, 2015

United States  
Securities and Exchange Commission  
Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended September 30, 2015

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

Commission File No.: 000-51821

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

United States  
(State or other jurisdiction of incorporation or organization)

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

31 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

Edgar Filing: LAKE SHORE BANCORP, INC. - Form 10-Q

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

Yes  No

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

Large accelerated filer

Accelerated filer

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

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

Yes  No

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

There were 5,978,754 shares of the registrant’s common stock, \$0.01 par value per share, outstanding at November 9, 2015.

TABLE OF  
CONTENTS

ITEM	<u>PART I</u>	PAGE
1	<u>FINANCIAL STATEMENTS</u>	
	- <u>Consolidated Statements of Financial Condition as of September 30, 2015 and December 31, 2014 (Unaudited)</u>	1
	- <u>Consolidated Statements of Income for the Three and Nine Months ended September 30, 2015 and 2014 (Unaudited)</u>	2
	- <u>Consolidated Statements of Comprehensive Income for the Three and Nine Months ended September 30, 2015 and 2014 (Unaudited)</u>	3
	- <u>Consolidated Statements of Stockholders' Equity for the Nine Months ended September 30, 2015 and 2014 (Unaudited)</u>	4
	- <u>Consolidated Statements of Cash Flows for the Nine Months ended September 30, 2015 and 2014 (Unaudited)</u>	5
	-	6

Notes to  
Unaudited  
Consolidated  
Financial  
Statements

<u>2</u>	<u>MANAGEMENT'S</u>	<u>33</u>
	<u>DISCUSSION AND</u>	
	<u>ANALYSIS OF</u>	
	<u>FINANCIAL</u>	
	<u>CONDITION AND</u>	
	<u>RESULTS OF</u>	
	<u>OPERATIONS</u>	
<u>3</u>	<u>QUANTITATIVE</u>	<u>52</u>
	<u>AND QUALITATIVE</u>	
	<u>DISCLOSURES</u>	
	<u>ABOUT MARKET</u>	
	<u>RISK</u>	
<u>4</u>	<u>CONTROLS AND</u>	<u>52</u>
	<u>PROCEDURES</u>	

PART II

<u>1A</u>	<u>RISK FACTORS</u>	<u>52</u>
<u>2</u>	<u>UNREGISTERED</u>	<u>53</u>
	<u>SALES OF EQUITY</u>	
	<u>SECURITIES AND</u>	
	<u>USE OF PROCEEDS</u>	
<u>6</u>	<u>EXHIBITS</u>	<u>53</u>
<u>SIGNATURES</u>		<u>54</u>

---

## PART I

## Item 1. Financial Statements

## Lake Shore Bancorp, Inc. and Subsidiary

## Consolidated Statements of Financial Condition

	September 30, 2015 (Unaudited)	December 31, 2014 (Unaudited)
	(Dollars in thousands, except share data)	
Assets		
Cash and due from banks	\$ 7,313	\$ 7,460
Interest earning deposits	18,565	19,575
Federal funds sold	6,710	8,776
Cash and Cash Equivalents	32,588	35,811
Securities available for sale	116,806	138,202
Federal Home Loan Bank stock, at cost	1,355	1,375
Loans receivable, net of allowance for loan losses 2015 \$2,097; 2014 \$1,921	294,615	284,853
Premises and equipment, net	9,156	9,519
Accrued interest receivable	1,802	1,716
Bank owned life insurance	14,870	14,666
Other assets	1,105	1,329
Total Assets	\$ 472,297	\$ 487,471
Liabilities and Stockholders' Equity		
Liabilities		
Deposits:		
Interest bearing	\$ 326,164	\$ 349,777
Non-interest bearing	45,706	37,162
Total Deposits	371,870	386,939
Long-term debt	18,950	18,950
Advances from borrowers for taxes and insurance	1,894	3,415
Other liabilities	6,238	6,537
Total Liabilities	\$ 398,952	\$ 415,841
Commitments and Contingencies	-	-
Stockholders' Equity		
Common stock, \$0.01 par value per share, 25,000,000 shares authorized; 6,685,715 shares issued and 5,977,372 shares outstanding at September 30, 2015 and 6,673,940 shares issued	\$ 67	\$ 67

and 5,990,042 shares outstanding at December 31, 2014

Additional paid-in capital	28,891	28,684
Treasury stock, at cost (708,343 shares at September 30, 2015 and 683,898 shares at December 31, 2014)	(6,816)	(6,420)
Unearned shares held by ESOP	(1,727)	(1,791)
Unearned shares held by compensation plans	(630)	(622)
Retained earnings	50,237	48,192
Accumulated other comprehensive income	3,323	3,520
Total Stockholders' Equity	73,345	71,630
Total Liabilities and Stockholders' Equity	\$ 472,297	\$ 487,471

See notes to consolidated financial statements.

## Lake Shore Bancorp, Inc. and Subsidiary

## Consolidated Statements of Income

	Three Months		Nine Months Ended	
	Ended September 30, 2015	2014	2015	2014
	(Unaudited)			
	(Dollars in thousands, except per share data)			
Interest Income				
Loans, including fees	\$ 3,474	\$ 3,307	\$ 10,268	\$ 9,977
Investment securities, taxable	435	552	1,377	1,884
Investment securities, tax-exempt	513	530	1,573	1,589
Other	5	6	16	10
Total Interest Income	4,427	4,395	13,234	13,460
Interest Expense				
Deposits	538	724	1,794	2,229
Short-term borrowings	-	-	-	20
Long-term debt	99	102	296	182
Other	25	25	74	76
Total Interest Expense	662	851	2,164	2,507
Net Interest Income	3,765	3,544	11,070	10,953
Provision for Loan Losses	30	70	240	70
Net Interest Income after Provision for Loan Losses	3,735	3,474	10,830	10,883
Non-Interest Income				
Service charges and fees	406	396	1,184	1,202
Earnings on bank owned life insurance	68	65	204	190
Recovery on previously impaired investment securities	48	35	123	136
Net gain on sale of securities available for sale	440	-	440	59
Net gain on sale of loans	28	5	73	5
Other	38	30	85	89
Total Non-Interest Income	1,028	531	2,109	1,681
Non-Interest Expenses				
Salaries and employee benefits	1,663	1,682	5,150	4,936
Occupancy and equipment	561	531	1,697	1,648
Data processing	264	202	766	579
Professional services	235	298	738	956
Advertising	92	85	301	353
FDIC Insurance	75	70	219	211
Postage and supplies	74	61	201	194
Other	300	279	761	838
Total Non-Interest Expenses	3,264	3,208	9,833	9,715
Income before Income Taxes	1,499	797	3,106	2,849
Income Tax Expense	263	109	602	487
Net Income	\$ 1,236	\$ 688	\$ 2,504	\$ 2,362
Basic and diluted earnings per common share	\$ 0.21	\$ 0.12	\$ 0.42	\$ 0.41
Dividends declared per share	\$ 0.07	\$ 0.07	\$ 0.21	\$ 0.21

See notes to consolidated financial statements.





## Lake Shore Bancorp, Inc. and Subsidiary

## Consolidated Statements of Comprehensive Income

	Three Months Ended September 30, 2015    2014 (Unaudited) (Dollars in thousands)	
Net Income	\$ 1,236	\$ 688
Other Comprehensive Income, net of tax expense		
Unrealized holding gains on securities available for sale, net of tax expense	626	62
Reclassification adjustments related to:		
Recovery on previously impaired investment securities included in net income, net of tax expense	(32)	(21)
Net gain on sale of securities included in net income, net of tax expense	(290)	-
Total Other Comprehensive Income	304	41
Total Comprehensive Income	\$ 1,540	\$ 729
	Nine Months Ended September 30, 2015    2014 (Unaudited) (Dollars in thousands)	
Net Income	\$ 2,504	\$ 2,362
Other Comprehensive Income, net of tax expense		
Unrealized holding gains on securities available for sale, net of tax expense	174	2,528
Reclassification adjustments related to:		
Recovery on previously impaired investment securities included in net income, net of tax expense	(81)	(83)
Net gain on sale of securities included in net income, net of tax expense	(290)	(36)
Total Other Comprehensive (Loss) Income	(197)	2,409

Total Comprehensive Income	\$ 2,307	\$ 4,771
----------------------------	----------	----------

See notes to consolidated financial statements.

3

---

## Lake Shore Bancorp, Inc. and Subsidiary

## Consolidated Statements of Stockholders' Equity

Nine months Ended September 30, 2015 and 2014 (Unaudited)

	Common Stock	Additional Paid-In Capital	Treasury Stock	Unearned Shares Held by ESOP	Unearned Shares Held by Compensation Plans	Retained Earnings	Accumulated Other Comprehensive Income	Total
(Dollars in thousands, except share and per share data)								
Balance - January 1, 2014	\$ 66	\$ 28,039	\$ (6,588)	\$ (1,876)	\$ (499)	\$ 45,624	\$ 505	\$ 65,271
Net income	-	-	-	-	-	2,362	-	2,362
Other comprehensive income, net of tax expense of \$1,521	-	-	-	-	-	-	2,409	2,409
Stock options exercised (3,646 shares)	-	54	-	-	-	-	-	54
ESOP shares earned (5,951 shares)	-	9	-	64	-	-	-	73
Stock based compensation	-	(3)	-	-	-	-	-	(3)
Compensation plan shares granted (24,570 shares)	-	-	230	-	(230)	-	-	-
Compensation plan shares earned (5,322 shares)	-	5	-	-	60	-	-	65
Purchase of treasury stock, at cost (5,100 shares)	-	-	(62)	-	-	-	-	(62)
Cash dividends declared (\$0.21 per share)	-	-	-	-	-	(442)	-	(442)
Balance - September 30, 2014	\$ 66	\$ 28,104	\$ (6,420)	\$ (1,812)	\$ (669)	\$ 47,544	\$ 2,914	\$ 69,727
Balance - January 1, 2015	\$ 67	\$ 28,684	\$ (6,420)	\$ (1,791)	\$ (622)	\$ 48,192	\$ 3,520	\$ 71,630
Net income	-	-	-	-	-	2,504	-	2,504
Other comprehensive loss, net of tax benefit of \$510	-	-	-	-	-	-	(197)	(197)
Stock options exercised (11,775 shares)	-	136	-	-	-	-	-	136

Edgar Filing: LAKE SHORE BANCORP, INC. - Form 10-Q

ESOP shares earned (5,951 shares)	-	17	-	64	-	-	-	81
Stock based compensation	-	1	-	-	-	-	-	1
Compensation plan shares granted (15,455 shares)	-	-	145	-	(145)	-	-	-
Compensation plan shares earned (12,909 shares)	-	53	-	-	137	-	-	190
Purchase of treasury stock, at cost (39,900 shares)	-	-	(541)	-	-	-	-	(541)
Cash dividends declared (\$0.21 per share)	-	-	-	-	-	(459)	-	(459)
Balance - September 30, 2015	\$ 67	\$ 28,891	\$ (6,816)	\$ (1,727)	\$ (630)	\$ 50,237	\$ 3,323	\$ 73,345

See notes to consolidated  
financial statements.

## Lake Shore Bancorp, Inc. and Subsidiary

## Consolidated Statements of Cash Flows

	Nine Months Ended September 30,	
	2015	2014
	(Unaudited)	
	(Dollars in thousands)	
<b>CASH FLOWS FROM OPERATING ACTIVITIES</b>		
Net income	\$ 2,504	\$ 2,362
Adjustments to reconcile net income to net cash provided by operating activities:		
Net amortization of investment securities	228	223
Net amortization of deferred loan costs	416	341
Provision for loan losses	240	70
Recovery on previously impaired investment securities	(123)	(136)
Net gain on sale of investment securities	(440)	(59)
Originations of loans held for sale	(6,811)	(386)
Proceeds from sales of loans held for sale	6,884	391
Net gain on sale of loans	(73)	(5)
Depreciation and amortization	625	559
Increase in bank owned life insurance, net	(204)	(190)
ESOP shares committed to be released	81	73
Stock based compensation expense	191	62
Increase in accrued interest receivable	(86)	(77)
Decrease in other assets	452	268
Increase in other liabilities	211	52
Net Cash Provided by Operating Activities	4,095	3,548
<b>CASH FLOWS FROM INVESTING ACTIVITIES</b>		
Activity in available for sale securities:		
Sales	9,846	10,337
Maturities, prepayments and calls	11,178	10,577
Purchases of Federal Home Loan Bank Stock	(254)	(351)
Redemptions of Federal Home Loan Bank Stock	274	536
Loan origination and principal collections, net	(10,646)	1,634
Additions to premises and equipment	(262)	(446)
Net Cash Provided by Investing Activities	10,136	22,287
<b>CASH FLOWS FROM FINANCING ACTIVITIES</b>		
Net (decrease) increase in deposits	(15,069)	1,270
Net decrease in advances from borrowers for taxes and insurance	(1,521)	(1,415)
Net decrease in short term borrowings	-	(11,650)
Proceeds from issuance of long-term debt	8,250	15,200
Repayment of long-term debt	(8,250)	(4,100)
Proceeds from stock options exercised	136	54
Purchase of treasury stock	(541)	(62)
Cash dividends paid	(459)	(442)
Net Cash Used in Financing Activities	(17,454)	(1,145)
Net (Decrease) Increase in Cash and Cash Equivalents	(3,223)	24,690
CASH AND CASH EQUIVALENTS - BEGINNING	35,811	17,202
CASH AND CASH EQUIVALENTS - ENDING	\$ 32,588	\$ 41,892

SUPPLEMENTARY CASH FLOWS INFORMATION

Interest paid	\$ 2,169	\$ 2,492
Income taxes paid	\$ 370	\$ 648

SUPPLEMENTARY SCHEDULE OF NONCASH INVESTING AND FINANCING ACTIVITIES

Foreclosed real estate acquired in settlement of loans	\$ 265	\$ 171
--	--------	--------

See notes to consolidated financial statements.

Lake Shore Bancorp, Inc. and Subsidiary

Notes to Consolidated Financial Statements (Unaudited)

Note 1 – Nature of Operations and Basis of Presentation

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

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

The interim financial statements included herein as of September 30, 2015 and for the three and nine months ended September 30, 2015 and 2014 have been prepared by the Company, without audit, pursuant to the rules and regulations of the Securities and Exchange Commission, and therefore, do not include all information or footnotes necessary for a complete presentation of the consolidated statements of financial condition, results of operations and cash flows in conformity with accounting principles generally accepted in the United States of America (“GAAP”). The consolidated statement of financial condition at December 31, 2014 has been derived from the audited consolidated financial statements at that date, but does not include all of the information and footnotes required by GAAP for complete consolidated financial statements. The consolidated financial statements reflect all adjustments that are, in the opinion of management, necessary for a fair statement of such information and to make the financial statements not misleading. These interim consolidated financial statements should be read in conjunction with the consolidated financial statements and notes thereto included in the audited consolidated financial statements included in the Company’s Annual Report on Form 10-K for the year ended December 31, 2014. The consolidated statements of income for the three and nine months ended September 30, 2015 are not necessarily indicative of the results for any subsequent period or the entire year ending December 31, 2015.

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

The Company has evaluated events and transactions occurring subsequent to the statement of financial condition as of September 30, 2015 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 May 2014, the Financial Accounting Standards Board (“FASB”) issued Accounting Standards Update (“ASU”) 2014-09, “Revenue from Contracts with Customers” (“ASU 2014-09”). ASU 2014-09 is intended to clarify and simplify revenue recognition principles, develop a common revenue standard across industries and accounting frameworks, and improve the usefulness and consistency of revenue reporting. In response to stakeholders’ requests to defer the effective date of the guidance in ASU 2014-09 and in consideration of feedback received through extensive outreach with preparers, practitioners, and users of financial statements, the FASB issued ASU 2015-14, “Revenue from Contracts with Customers: Deferral of the Effective Date” (“ASU 2015-14”) in August 2015. ASU 2015-14 defers the effective date of ASU 2014-09 for all entities by one year. ASU 2014-09 is now effective for annual reporting periods, including interim reporting periods within those periods, beginning after December 15, 2017 for all public business entities. Early application is permitted as of annual reporting periods after December 15, 2016. The Company has not yet determined the impact the adoption of ASU 2014-09 will have on its financial condition and results of operations.



In June 2014, the FASB issued ASU 2014-12, “Compensation – Stock Compensation (Topic 718): Accounting for Share-Based Payments When the Terms of an Award Provide That a Performance Target Could Be Achieved after the Requisite Service Period” (“ASU 2014-12”). ASU 2014-12 applies to all reporting entities that grant their employees share-based payments in which the terms of the award provide that a performance target that affects vesting could be achieved after the requisite service period. The update requires that a performance target be treated as a performance condition. Compensation cost should be recognized in the period in which it becomes probable that the performance target will be achieved and should represent the compensation cost attributable to the period(s) for which the requisite service has already been rendered. If the performance target becomes probable of being achieved before the end of the requisite service period, the remaining unrecognized compensation cost should be recognized prospectively over the remaining requisite service period. The total amount of compensation cost recognized during and after the requisite service period should reflect the number of awards that are expected to vest and should be adjusted to reflect those awards that ultimately vest. The requisite service period ends when the employee can cease rendering service and still be eligible to vest in the award if the performance target is achieved. ASU 2014-12 is effective for the reporting periods beginning after December 15, 2015. Management does not expect the adoption of this update to have a material impact on the Company’s consolidated financial statements or results of operations.

### Note 3 – Investment Securities

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

	September 30, 2015			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
	(Dollars in thousands)			
<b>SECURITIES AVAILABLE FOR SALE:</b>				
U.S. Treasury bonds	\$ 12,788	\$ 1,621	\$ -	\$ 14,409
Municipal bonds	49,074	2,630	(18)	51,686
Mortgage-backed securities:				
Collateralized mortgage obligations-private label	52	-	-	52
Collateralized mortgage obligations-government sponsored entities	41,198	228	(286)	41,140
Government National Mortgage Association	424	36	-	460
Federal National Mortgage Association	4,592	251	-	4,843
Federal Home Loan Mortgage Corporation	2,313	114	-	2,427
Asset-backed securities-private label	1,214	493	(72)	1,635
Asset-backed securities-government sponsored entities	95	10	-	105
Equity securities	22	27	-	49
	\$ 111,772	\$ 5,410	\$ (376)	\$ 116,806

	December 31, 2014			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
	(Dollars in thousands)			
<b>SECURITIES AVAILABLE FOR SALE:</b>				
U.S. Treasury bonds	\$ 12,817	\$ 1,544	\$ -	\$ 14,361
Municipal bonds	57,158	3,635	(7)	60,786
Mortgage-backed securities:				
Collateralized mortgage obligations-private label	61	-	-	61
Collateralized mortgage obligations-government sponsored entities	50,465	237	(710)	49,992
Government National Mortgage Association	524	47	-	571
Federal National Mortgage Association	7,107	366	-	7,473
Federal Home Loan Mortgage Corporation	2,650	117	-	2,767
Asset-backed securities-private label	1,546	584	(107)	2,023
Asset-backed securities-government sponsored entities	111	11	-	122
Equity securities	22	24	-	46
	\$ 132,461	\$ 6,565	\$ (824)	\$ 138,202

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

At September 30, 2015 and at December 31, 2014, equity securities consisted of 22,368 shares of Federal Home Loan Mortgage Corporation ("FHLMC") common stock.

At September 30, 2015, thirty-four municipal bonds with a cost of \$11.1 million and fair value of \$11.7 million were pledged under a collateral agreement with the Federal Reserve Bank ("FRB") of New York for liquidity borrowing. At December 31, 2014 thirty-one municipal bonds with a cost of \$10.7 million and fair value of \$11.4 million were pledged with the FRB of New York for liquidity borrowing. In addition, at September 30, 2015, seven municipal bonds with a cost of \$1.6 million and a fair value of \$1.7 million, were pledged as collateral for customer deposits in excess of the Federal Deposit Insurance Corporation ("FDIC") insurance limits. At December 31, 2014, six municipal bonds with a cost and fair value of \$1.5 million and \$1.6 million, respectively, 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:

	Less than 12 months		12 months or more		Total	
	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses
	(Dollars In thousands)					
September 30, 2015						
Municipal bonds	\$ 970	\$ (9)	\$ 561	\$ (9)	\$ 1,531	\$ (18)
Mortgage-backed securities	5,714	(27)	19,952	(259)	25,666	(286)
Asset-backed securities -private label	441	(15)	701	(57)	1,142	(72)

\$ 7,125 \$ (51) \$ 21,214 \$ (325) \$ 28,339 \$ (376)

	Less than 12 months		12 months or more		Total	Gross Unrealized Losses
	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Fair Value	
(Dollars In thousands)						
December 31, 2014						
Municipal bonds	\$ -	\$ -	\$ 814	\$ (7)	\$ 814	\$ (7)
Mortgage-backed securities	7,569	(53)	25,027	(657)	32,596	(710)
Asset-backed securities -private label	610	(28)	829	(79)	1,439	(107)
	\$ 8,179	\$ (81)	\$ 26,670	\$ (743)	\$ 34,849	\$ (824)

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

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

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

The fair value of the security is determined using the same expected cash flows; the discount rate is a rate the Company determines from open market and other sources as appropriate for the security. The difference between the fair value and the credit loss is recognized in other comprehensive income, net of taxes.

At September 30, 2015, the Company’s investment portfolio included three municipal bonds, seven mortgage-backed securities and one private-label asset-backed security in the “unrealized losses less than twelve months” category. The three municipal bonds and seven mortgage-backed securities were not evaluated further for OTTI as the unrealized losses on the individual securities were less than 20% of book value, which management deemed to be immaterial. In addition, the mortgage-backed securities were issued by government sponsored enterprises. 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.

At September 30, 2015, the Company had one municipal bond, eighteen mortgage-backed securities and one private label asset-backed security in the “unrealized losses twelve months or more” category. The one municipal bond and eighteen mortgage-backed securities were not evaluated further for OTTI, as the unrealized losses were less than 20% of book value. The temporary impairments were due to declines in fair value resulting from changes in interest rates and/or increased credit liquidity spreads since the securities were purchased. The Company expects these securities to be repaid in full, with no losses realized. Management does not intend to sell these securities and it is more likely than not that it will not be required to sell these securities.

Edgar Filing: LAKE SHORE BANCORP, INC. - Form 10-Q

The following table provides additional information relating to the private label asset-backed securities with gross unrealized losses as of September 30, 2015 (dollars in thousands):

Security	Book Value	Fair Value	Unrealized Loss	Lowest Rating	Delinquent %		Foreclosure%	OREO%
					Over 60 days	Over 90 days		
1	\$ 758	\$ 701	\$ (57)	CCC	18.40%	17.90%	8.20%	2.80%
2	456	441	(15)	CCC	16.50%	15.60%	7.20%	1.50%
Total	\$ 1,214	\$ 1,142	\$ (72)					

The two 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 private label asset-backed securities occurred due to challenges in the economic environment resulting from the recent financial crisis and increased levels of delinquency trends in the underlying loan pools. It is possible that principal losses may be incurred on the tranches we hold in these specific securities. Management's evaluation of the estimated discounted cash flows in comparison to the amortized book value for the securities listed above did not reflect the need to record an OTTI charge against earnings during the nine months ended September 30, 2015. The estimated discounted cash flows for these securities did not show an additional principal loss under various prepayment and default rate scenarios. Management concluded that it does not intend to sell these securities and that it is not likely it will be required to sell these securities.

Management also completed an OTTI analysis for two private label asset-backed securities, which did not have unrealized losses as of September 30, 2015. Management reviewed key credit metrics for these securities, including delinquency rates, cumulative default rates, prepayment speeds, foreclosure rates, loan-to-value ratios 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 not required as of September 30, 2015 on these securities. Management also concluded that it does not intend to sell the securities and that it is not likely it will be required to sell these securities.

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

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

	For The Nine Months Ended September 30, 2015	For The Nine Months Ended September 30, 2014
Beginning balance	\$ 858	\$ 1,318
Additions:		

(Dollars in thousands)

Credit loss not previously recognized	-	-
Reductions:		
Realized loss on sale of security on OTTI previously recognized	-	(282)
Losses realized during the period on OTTI previously recognized	(2)	(3)
Receipt of cash flows on previously recorded OTTI	(123)	(136)
Ending balance	\$ 733	\$ 897

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

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

	Amortized Cost	Fair Value
	(Dollars in thousands)	
September 30, 2015:		
After one year through five years	\$ 7,300	\$ 7,877
After five years through ten years	30,005	32,076
After ten years	24,557	26,142
Mortgage-backed securities	48,579	48,922
Asset-backed securities	1,309	1,740
Equity securities	22	49
	\$ 111,772	\$ 116,806

During the nine months ended September 30, 2015, the Company sold twenty-seven municipal bonds and two mortgage-backed securities for total proceeds of \$9.8 million, resulting in realized gains of \$440,000. The Company sold one private-label, asset-backed security and six mortgage-backed securities during the nine months ended September 30, 2014 for total proceeds of \$10.3 million, resulting in gross realized gains of \$274,000 and gross realized losses of \$215,000.

#### Note 4 - Allowance for Loan Losses

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

##### Real Estate Loans:

- One- to Four-Family – are loans secured by first lien collateral on residential real estate primarily held in the Western New York region. These loans can be affected by economic conditions and the value of underlying properties. Western New York’s housing market has consistently demonstrated stability in home prices despite economic conditions. Furthermore, the Company has conservative underwriting standards and its residential lending policies and procedures ensure that its one- to four-family residential mortgage loans generally conform to secondary market guidelines.
- Home Equity - are loans or lines of credit secured by second lien collateral on owner-occupied residential real estate primarily held in the Western New York region. These loans can also be affected by economic conditions and the values of underlying properties. Home equity loans may have increased risk of loss if the Company does not hold the first mortgage resulting in the Company being in a secondary position in the event of collateral liquidation. The Company does not originate interest only home equity loans.
- Commercial Real Estate – are loans used to finance the purchase of real property, which generally consists of developed real estate that is held as first lien collateral for the loan. These loans are secured by real estate properties that are primarily held in the Western New York region. Commercial real estate lending involves additional risks



compared with one- to four-family residential lending, because payments on loans secured by commercial real estate properties are often dependent on the successful operation or management of the properties, and/or the collateral value of the commercial real estate securing the loan, and repayment of such loans may be subject to adverse conditions in the real estate market or economic conditions to a greater extent than one- to four-family residential mortgage loans. Also, commercial real estate loans typically involve large loan balances to single borrowers or groups of related borrowers. Accordingly, the nature of these types of loans make them more difficult for the Company to monitor and evaluate.

- Construction – are loans to finance the construction of either one- to four-family owner occupied homes or commercial real estate. At the end of the construction period, the loan automatically converts to either a one- to four-family or commercial mortgage, as applicable. Risk of loss on a construction loan depends largely upon the accuracy of the initial estimate of the value of the property at completion compared to the actual cost of construction. The Company limits its risk during

construction as disbursements are not made until the required work for each advance has been completed and an updated lien search is performed. The completion of the construction progress is verified by inspections performed by an independent appraisal firm. Construction delays may further impair the borrower's ability to repay the loan.

Other Loans:

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

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

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

The following tables summarize the activity in the allowance for loan losses for the three and nine months ended September 30, 2015 and 2014 and the distribution of the allowance for loan losses and loan receivable by loan portfolio class and impairment method as of September 30, 2015 and December 31, 2014.



Edgar Filing: LAKE SHORE BANCORP, INC. - Form 10-Q

	Real Estate Loans			Other Loans				Total
	One- to Four-Family	Home Equity	Commercial	Construction	Commercial	Consumer	Unallocated	
(Dollars in thousands)								
September 30, 2015								
Allowance for Loan Losses:								
Balance – July 1, 2015	\$ 393	\$ 103	\$ 1,394	\$ -	\$ 187	\$ 27	\$ 21	\$ 2,125
Charge-offs	(40)	-	-	-	(5)	(15)	-	(60)
Recoveries	-	-	-	-	-	2	-	2
Provision (Credit)	17	(2)	(42)	-	43	7	7	30
Balance – September 30, 2015	\$ 370	\$ 101	\$ 1,352	\$ -	\$ 225	\$ 21	\$ 28	\$ 2,097
Balance – January 1, 2015								
Balance – January 1, 2015	\$ 446	\$ 106	\$ 1,163	\$ -	\$ 184	\$ 22	\$ -	\$ 1,921
Charge-offs	(58)	(17)	-	-	(9)	(34)	-	(118)
Recoveries	12	8	21	-	7	6	-	54
Provision (Credit)	(30)	4	168	-	43	27	28	240
Balance – September 30, 2015	\$ 370	\$ 101	\$ 1,352	\$ -	\$ 225	\$ 21	\$ 28	\$ 2,097
Ending balance:								
individually evaluated for impairment	\$ -	\$ -	\$ 200	\$ -	\$ -	\$ -	\$ -	\$ 200
Ending balance:								
collectively evaluated for impairment	\$ 370	\$ 101	\$ 1,152	\$ -	\$ 225	\$ 21	\$ 28	\$ 1,897
Gross Loans								
Receivable (1):								
Ending balance	\$ 159,186	\$ 32,688	\$ 85,159	\$ -	\$ 15,360	\$ 1,420	\$ -	\$ 293,813
Ending balance:								
individually evaluated for impairment	\$ 204	\$ 9	\$ 2,746	\$ -	\$ 86	\$ -	\$ -	\$ 3,045
Ending balance:								
collectively evaluated for impairment	\$ 158,982	\$ 32,679	\$ 82,413	\$ -	\$ 15,274	\$ 1,420	\$ -	\$ 290,768

(1) Gross Loans Receivable does not include allowance for loan losses of \$(2,097) or deferred loan costs of \$2,899.





Edgar Filing: LAKE SHORE BANCORP, INC. - Form 10-Q

	Real Estate Loans				Other Loans			Total
	One- to Four-Family	Home Equity	Commercial	Construction	Commercial	Consumer	Unallocated	
(Dollars in thousands)								
September 30, 2014								
Allowance for Loan Losses:								
Balance – July 1, 2014	\$ 345	\$ 97	\$ 1,049	\$ -	\$ 196	\$ 22	\$ 64	\$ 1,773
Charge-offs	-	(12)	-	-	(21)	(11)	-	(44)
Recoveries	1	1	-	-	-	2	-	4
Provision (Credit)	82	15	(5)	-	25	11	(58)	70
Balance – September 30, 2014	\$ 428	\$ 101	\$ 1,044	\$ -	\$ 200	\$ 24	\$ 6	\$ 1,803
Balance – January 1, 2014								
Balance – January 1, 2014	\$ 355	\$ 80	\$ 1,104	\$ -	\$ 218	\$ 9	\$ 47	\$ 1,813
Charge-offs	(17)	(25)	-	-	(25)	(29)	-	(96)
Recoveries	3	1	-	-	-	12	-	16
Provision (Credit)	87	45	(60)	-	7	32	(41)	70
Balance – September 30, 2014	\$ 428	\$ 101	\$ 1,044	\$ -	\$ 200	\$ 24	\$ 6	\$ 1,803

The following table summarizes the distribution of the allowance for loan losses and loans receivable by loan portfolio class as of December 31, 2014:

	Real Estate Loans				Other Loans			Total
	One- to Four-Family	Home Equity	Commercial	Construction	Commercial	Consumer	Unallocated	
(Dollars in thousands)								
December 31, 2014								
Allowance for Loan Losses:								
Balance – December 31, 2014	\$ 446	\$ 106	\$ 1,163	\$ -	\$ 184	\$ 22	\$ -	\$ 1,921
Ending balance: individually evaluated for impairment	\$ -	\$ -	\$ 178	\$ -	\$ -	\$ -	\$ -	\$ 178
Ending balance: collectively evaluated for impairment	\$ 446	\$ 106	\$ 985	\$ -	\$ 184	\$ 22	\$ -	\$ 1,743
Gross Loans Receivable (1):								
Ending Balance	\$ 167,840	\$ 32,337	\$ 68,238	\$ 449	\$ 13,467	\$ 1,495	\$ -	\$ 283,826
Ending balance: individually evaluated for impairment	\$ 211	\$ 10	\$ 2,312	\$ -	\$ 10	\$ -	\$ -	\$ 2,543
Ending balance: collectively evaluated	\$ 167,629	\$ 32,327	\$ 65,926	\$ 449	\$ 13,457	\$ 1,495	\$ -	\$ 281,283

for impairment

(1) Gross Loans Receivable does not include allowance for loan losses of \$(1,921) or deferred loan costs of \$2,948.

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. The unallocated component of the allowance for loan losses reflects the margin of imprecision inherent in the underlying assumptions used in the methodologies for existing specific and general losses in the portfolio.

14

---



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

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

	Unpaid Recorded Principal Investment Balance		Related Allowance	Average Interest Recorded Income Recognized For the Nine Months Ended September 30, 2015	
	At September 30, 2015 (Dollars in thousands)				
With no related allowance recorded:					
Residential, one- to four-family	\$ 204	\$ 204	\$ -	\$ 207	\$ 10
Home equity	9	9	-	9	-
Commercial real estate	2,059	2,059	-	2,076	2
Commercial loans	86	86	-	98	2
With an allowance recorded:					
Commercial real estate	687	687	200	652	-
Commercial loans	-	-	-	-	-
Total	\$ 3,045	\$ 3,045	\$ 200	\$ 3,042	\$ 14

	At December 31, 2014 (Dollars in thousands)			For the Year Ended December 31, 2014	
With no related allowance recorded:					
Residential, one- to four-family	\$ 211	\$ 211	\$ -	\$ 216	\$ 11
Home equity	10	10	-	10	1
Commercial real estate	1,711	1,711	-	2,334	19
Commercial loans	10	10	-	6	-
With an allowance recorded:					
Commercial real estate	601	601	178	592	5
Commercial loans	-	-	-	6	-
Total	\$ 2,543	\$ 2,543	\$ 178	\$ 3,164	\$ 36



Edgar Filing: LAKE SHORE BANCORP, INC. - Form 10-Q

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

	30-59 Days Past Due	60-89 Days Past Due	90 Days or More Past Due	Total Past Due	Current Due	Total Loans Receivable	Loans on Non-Accrual
September 30, 2015:							
Real Estate Loans:							
Residential, one- to four-family	\$ 1,312	\$ 701	\$ 960	\$ 2,973	\$ 156,213	\$ 159,186	\$ 2,296
Home equity	301	184	148	633	32,055	32,688	241
Commercial	-	-	2,443	2,443	82,716	85,159	2,746
Construction	-	-	-	-	-	-	-
Other Loans:							
Commercial	15	-	70	85	15,275	15,360	182
Consumer	8	1	11	20	1,400	1,420	6
Total	\$ 1,636	\$ 886	\$ 3,632	\$ 6,154	\$ 287,659	\$ 293,813	\$ 5,471
December 31, 2014:							
Real Estate Loans:							
Residential, one- to four-family	\$ 1,327	\$ 467	\$ 1,059	\$ 2,853	\$ 164,987	\$ 167,840	\$ 2,413
Home equity	197	136	206	539	31,798	32,337	335
Commercial	21	-	1,891	1,912	66,326	68,238	1,891
Construction	-	-	-	-	449	449	-
Other Loans:							
Commercial	42	9	37	88	13,379	13,467	76
Consumer	22	5	13	40	1,455	1,495	4
Total	\$ 1,609	\$ 617	\$ 3,206	\$ 5,432	\$ 278,394	\$ 283,826	\$ 4,719

The accrual of interest on loans is discontinued when, in management's opinion, the borrower may be unable to meet payments as they become due. A loan does not have to be 90 days delinquent in order to be classified as non-accrual. When interest accrual is discontinued, all unpaid accrued interest is reversed. Interest income is subsequently recognized only to the extent cash payments are received. If ultimate collection of principal is in doubt, all cash receipts on impaired loans are applied to reduce the principal balance. Interest income not recognized on non-accrual loans during the nine month period ended September 30, 2015 and 2014 was \$313,000 and \$278,000, respectively.

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

- Pass/Performing;
- Special Mention – does not currently expose the Company to a sufficient degree of risk but does possess credit deficiencies or potential weaknesses deserving the Company's close attention;
- Substandard – has one or more well-defined weaknesses and are characterized by the distinct possibility that the Company will sustain some loss if the deficiencies are not corrected. A substandard asset would be one inadequately protected by the current net worth and paying capacity of the obligor or pledged collateral, if applicable;

Doubtful – has all the weaknesses inherent in substandard loans with the additional characteristic that the weaknesses present make collection or liquidation in full on the basis of currently existing facts, conditions and values questionable, and there is a high possibility of loss; and

- Loss – loan is considered uncollectible and continuance without the establishment of a specific valuation reserve is not warranted.

The Company's Asset Classification Committee is responsible for monitoring risk ratings and making changes as deemed appropriate. Each commercial loan is individually assigned a loan classification. The Company's consumer loans, including residential one- to four-family loans and home equity loans, are not classified as described above. Instead, the Company uses the delinquency status as the basis for classifying these loans.

Edgar Filing: LAKE SHORE BANCORP, INC. - Form 10-Q

Unless the loan is well secured and in the process of collection, all consumer loans that are more than 90 days past due are classified.

The following table summarizes the internal loan grades applied to the Company's loan portfolio as of September 30, 2015 and December 31, 2014:

	Pass/Performance	Special Mention	Substandard	Doubtful	Loss	Total
(Dollars in thousands)						
September 30, 2015						
Real Estate Loans:						
Residential, one- to four-family	\$ 156,282	\$ -	\$ 2,904	\$ -	\$ -	\$ 159,186
Home equity	32,313	-	375	-	-	32,688
Commercial	76,869	5,249	2,269	772	-	85,159
Construction	-	-	-	-	-	-
Other Loans:						
Commercial	14,832	281	207	40	-	15,360
Consumer	1,417	-	1	-	2	1,420
Total	\$ 281,713	\$ 5,530	\$ 5,756	\$ 812	\$ 2	\$ 293,813

December 31, 2014

Real Estate Loans:						
Residential, one- to four-family	\$ 164,517	\$ -	\$ 3,323	\$ -	\$ -	\$ 167,840
Home equity	31,899	-	407	29	2	32,337
Commercial	62,323	3,235	1,996	684	-	68,238
Construction	449	-	-	-	-	449
Other Loans:						
Commercial	12,692	619	151	5	-	13,467
Consumer	1,489	-	5	-	1	1,495
Total	\$ 273,369	\$ 3,854	\$ 5,882	\$ 718	\$ 3	\$ 283,826

Troubled debt restructurings ("TDRs") occur when we grant borrowers concessions that we would not otherwise grant but for economic or legal reasons pertaining to the borrower's financial difficulties. A concession is made when the terms of the loan modification are more favorable than the terms the borrower would have received in the current market under similar financial difficulties. These concessions may include, but are not limited to, modifications of the terms of the debt, the transfer of assets or the issuance of an equity interest by the borrower to satisfy all or part of the debt, or the addition of borrower(s). The Company identifies loans for potential TDRs primarily through direct communication with the borrower and evaluation of the borrower's financial statements, revenue projections, tax returns, and credit reports. Even if the borrower is not presently in default, management will consider the likelihood

that cash flow shortages, adverse economic conditions, and negative trends may result in a payment default in the near future. Generally, we will not return a TDR to accrual status until the borrower has demonstrated the ability to make principal and interest payments under the restructured terms for at least six consecutive months. The Company's TDRs are impaired loans, which may result in specific allocations and subsequent charge-offs if appropriate.

Edgar Filing: LAKE SHORE BANCORP, INC. - Form 10-Q

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

	Non-Accruing		Accruing		TDRs That Have Defaulted on Modified Terms Year to Date	
	Number of Loans	Recorded Investment (Dollars in thousands)	Number of Loans	Recorded Investment (Dollars in thousands)	Number of Loans	Recorded Investment (Dollars in thousands)
At September 30, 2015						
Real Estate Loans:						
Residential, one- to four-family	5	\$ 218	-	\$ -	5	\$ 218
Home equity	2	9	-	-	2	9
Total	7	\$ 227	-	\$ -	7	\$ 227
At December 31, 2014						
Real Estate Loans:						
Residential, one- to four-family	5	\$ 224	-	\$ -	5	\$ 224
Home equity	2	10	-	-	2	10
Total	7	\$ 234	-	\$ -	7	\$ 234

No additional loan commitments were outstanding to these borrowers at September 30, 2015 and at December 31, 2014.

There were no loans restructured and classified as TDRs during the three and nine months ended September 30, 2015.

No loans were first deemed TDRs during the three months ended September 30, 2014.

The following table details the activity in loans which were first deemed to be TDRs during the nine months ended September 30, 2014:

For the Nine Months Ended September 30, 2014	
Pre-Modification	Post-Modification
Number of Loans	Number of Loans
Outstanding Recorded Investment	Outstanding Recorded Investment

Real Estate Loans:

Residential, one- to four-family	1	\$	46	\$	46
Home equity	1		6		6
Total	2	\$	52	\$	52

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

Foreclosed real estate consists of property acquired in settlement of loans which is carried at its fair value less estimated selling costs. Write-downs from cost to fair value less estimated selling costs are recorded at the date of acquisition or repossession and are charged to the allowance for loan losses. Foreclosed real estate was \$344,000 and \$401,000 at September 30, 2015 and December 31, 2014, respectively, and was included as a component of other assets on the consolidated statements of financial condition. The recorded investment of consumer mortgage loans secured by residential real estate properties, for which formal foreclosure proceeds are in process according to local requirements of the applicable jurisdiction, was \$799,000 and \$861,000 at September 30, 2015 and December 31, 2014, respectively.



## Note 5 – Earnings per Share

Earnings per share was calculated for the three and nine months ended September 30, 2015 and 2014, respectively. Basic earnings per share is based upon the weighted average number of common shares outstanding, exclusive of unearned shares held by the Employee Stock Ownership Plan of Lake Shore Bancorp, Inc. (the “ESOP”), unearned shares held by the Lake Shore Bancorp, Inc. 2006 Recognition and Retention Plan (“RRP”), and unearned shares held by the Lake Shore Bancorp, Inc. 2012 Equity Incentive Plan (“EIP”). Diluted earnings per share is based upon the weighted average number of common shares outstanding and common share equivalents that would arise from the exercise of dilutive securities. Stock options are regarded as potential common stock and are considered in the diluted earnings per share calculations to the extent they would be dilutive and computed using the treasury stock method.

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

	Three Months Ended September 30,	
	2015	2014
Numerator – net income	\$ 1,236,000	\$ 688,000
Denominator:		
Basic weighted average shares outstanding	5,884,246	5,763,417
Increase in weighted average shares outstanding due to:		
Stock options	32,462	28,428
Diluted weighted average shares outstanding	5,916,708	5,791,845
Earnings per share:		
Basic	\$ 0.21	\$ 0.12
Diluted	\$ 0.21	\$ 0.12
	Nine Months Ended September 30,	
	2015	2014
Numerator – net income	\$ 2,504,000	\$ 2,362,000
Denominator:		
Basic weighted average shares outstanding	5,892,148	5,723,148
Increase in weighted average shares outstanding due to:		
Stock options	32,853	28,269
Diluted weighted average shares outstanding	5,925,001	5,751,417
Earnings per share:		
Basic	\$ 0.42	\$ 0.41
Diluted	\$ 0.42	\$ 0.41

## Note 6 – Commitments to Extend Credit

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

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



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

	Contract Amount	
	September 30, 2015	December 31, 2014
	(Dollars in thousands)	
Commitments to grant loans	\$ 10,618	\$ 19,027
Unfunded commitments under lines of credit	\$ 30,830	\$ 29,590

Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Commitments generally have fixed expiration dates or other termination clauses. The commitments for lines of credit may expire without being drawn upon. Therefore, the total commitment amounts do not necessarily represent future cash requirements. The amount of collateral obtained, if it is deemed necessary by the Company, is based on management's credit evaluation of the customer. At September 30, 2015 and December 31, 2014, the Company's loan commitments with fixed rates for the next five years totaled \$10.1 million and \$17.0 million, respectively. The range of interest rates on these fixed rate commitments was 3.54% to 6.25% at September 30, 2015.

#### Note 7 – Stock-based Compensation

As of September 30, 2015, the Company had four stock-based compensation plans, which are described below. The compensation cost that has been recorded under salary and benefits expense in the non-interest expense section of the consolidated statements of income for these plans was \$84,000 and \$62,000 for the three months ended September 30, 2015 and 2014, respectively. The compensation cost that has been recorded for the nine months ended September 30, 2015 and 2014 was \$245,000 and \$131,000, respectively.

#### 2006 Stock Option Plan

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

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

A summary of the status of the Stock Option Plan as of September 30, 2015 and 2014 is presented below:

September 30, 2015			September 30, 2014		
Options	Exercise Price	Remaining Contractual Life	Options	Exercise Price	Remaining Contractual Life
175,369	\$ 10.92		230,106	\$ 11.05	

Outstanding at beginning of year						
Granted	-	-		-	-	
Exercised	(11,775)	11.50		(3,646)	11.50	
Forfeited	-	-		-	-	
Outstanding at end of period	163,594	\$ 10.87	1 year	226,460	\$ 11.04	2 years
Options exercisable at end of period	163,594	\$ 10.87	1 year	222,905	\$ 11.09	2 years
Fair value of options granted		-			-	
:						

At September 30, 2015, stock options outstanding had an intrinsic value of \$429,000 and 60,753 options remained available for grant under the Stock Option Plan. There was no compensation expense related to the stock option plan for the quarter ended September 30, 2015. Compensation expense amounted to \$1,000 for

the quarter ended September 30, 2014. Compensation expense amounted to \$1,000 and \$3,000 for the nine months ended September 30, 2015 and 2014, respectively.

### Recognition and Retention Plan

The Company's 2006 Recognition and Retention Plan ("RRP"), which was approved by the Company's stockholders, permits the grant of restricted stock awards ("Awards") to employees and non-employee directors for up to 119,025 shares of common stock. As of September 30, 2015, there were 8,088 remaining shares available to grant under the RRP.

The Board of Directors has granted restricted stock awards during 2015 as follows:

Grant Date	Number of Restricted Stock Awards	Vesting	Fair Value of Award on Grant Date	Awardees
July 28, 2015	100	20% per year with first vesting date on July 28, 2016	\$ 13.42	Employee

As of September 30, 2015, there were 88,128 shares vested or distributed to eligible participants under the RRP. Compensation expense related to the RRP amounted to \$16,000 for the quarter ended September 30, 2015 and \$14,000 for the quarter ended September 30, 2014. Compensation expense related to the RRP amounted to \$49,000 and \$24,000 for the nine months ended September 30, 2015 and 2014, respectively. At September 30, 2015, \$255,000 of unrecognized compensation cost related to the RRP is expected to be recognized over a period of 24 to 58 months.

A summary of the status of unvested shares under the RRP for the nine months ended September 30, 2015 and 2014 is as follows:

	2015	Weighted Average Grant Price	2014	Weighted Average Grant Price
Unvested shares outstanding at beginning of year	29,031	\$ 11.88	6,595	\$ 7.99
Granted	100	13.42	24,471	12.16
Vested	(7,334)	10.75	(4,035)	7.97
Forfeited	-	-	-	-
Unvested shares outstanding at end of period	21,797	\$ 12.27	27,031	\$ 11.77

### 2012 Equity Incentive Plan

The Company's 2012 Equity Incentive Plan (the "EIP"), which was approved by the Company's stockholders on May 23, 2012, permits the grant of restricted stock awards, incentive stock options or non-qualified stock options to employees and non-employee directors for up to 200,000 shares of common stock. As required by federal regulations, awards

were not permitted to be made under the EIP until Federal Reserve Board approval was obtained. On April 24, 2014, the Company received the approval of the Federal Reserve Bank of Philadelphia to begin making awards under the EIP.

Edgar Filing: LAKE SHORE BANCORP, INC. - Form 10-Q

The Board of Directors has granted restricted stock awards under the EIP during 2015 as follows:

Grant Date	Number of Restricted Stock Awards	Vesting	Fair Value of Award on Grant Date	Awardees
January 20, 2015	3,463	100% on December 18, 2015	\$ 13.35	Non-employee directors
January 20, 2015	10,657	100% on December 15, 2017, if three year performance metric is achieved	13.35	Employees
January 30, 2015	835	100% on December 15, 2017, if three year performance metric is achieved	13.95	Employees

A summary of the status of unvested restricted stock awards under the EIP for the nine months ended September 30, 2015 and 2014 is as follows:

	2015	Weighted Average Grant Price	2014	Weighted Average Grant Price
Unvested shares outstanding at beginning of year	21,552	\$ 12.19	-	\$ -
Granted	14,955	13.38	24,570	12.18
Vested	(4,206)	12.16	-	-
Forfeited	-	-	-	-
Unvested shares outstanding at end of period	32,301	\$ 12.74	24,570	\$ 12.18

As of September 30, 2015 there were 7,724 shares vested or distributed to eligible participants under the EIP.

Compensation expense related to the EIP amounted to \$41,000 for the quarter ended September 30, 2015 and \$25,000 for the quarter ended September 30, 2014. Compensation expense related to the EIP amounted to \$114,000 for the nine months ended September 30, 2015 and \$33,000 for the nine months ended September 30, 2014. At September 30, 2015, \$327,000 of unrecognized compensation cost related to unvested awards is expected to be recognized over a period of 3 to 47 months.

#### Employee Stock Ownership Plan ("ESOP")

The Company established the ESOP for the benefit of eligible employees of the Company and the Bank. All Company and Bank employees meeting certain age and service requirements are eligible to participate in the ESOP. Participants' benefits become fully vested after five years of service once the employee is eligible to participate

in the ESOP. The Company utilized \$2.6 million of the proceeds of its 2006 stock offering to extend a loan to the ESOP and the ESOP used such proceeds to purchase 238,050 shares on the open market at an average price of \$10.70 per share, plus commission expenses. As a result of the purchase of shares by the ESOP, total stockholders' equity of the Company was reduced by \$2.6 million. As of September 30, 2015, the balance of the loan to the ESOP was \$1.7 million and the fair value of unallocated shares was \$2.2 million. As of September 30, 2015, there were 58,263 allocated shares and 166,634 unallocated shares compared to 51,647 allocated shares and 174,569 unallocated shares at September 30, 2014. The ESOP compensation expense was \$27,000 for the quarter ended September 30, 2015 and \$22,000 for the quarter ended September 30, 2014, based on 1,984 shares earned in each of those quarters. The ESOP compensation expense was \$81,000 for the nine months ended September 30, 2015 and \$71,000 for the nine months ended September 30, 2014 based on 5,951 shares earned in each of those periods.

#### Note 8 - Fair Value of Financial Instruments

Management uses its best judgment in estimating the fair value of the Company's financial instruments; however, there are inherent weaknesses in any estimation technique. Therefore, for substantially all financial



instruments, the fair value estimates herein are not necessarily indicative of the amounts the Company could have realized in a sale transaction on the dates indicated. The estimated fair value amounts have been measured as of September 30, 2015 and December 31, 2014 and have not been re-evaluated or updated for purposes of these consolidated financial statements subsequent to those respective dates. The estimated fair values of these financial instruments subsequent to the respective reporting dates may be different than the amounts reported here.

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

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

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

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

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

Edgar Filing: LAKE SHORE BANCORP, INC. - Form 10-Q

For assets measured at fair value on a recurring and nonrecurring basis, the fair value measurements by level within the fair value hierarchy used at September 30, 2015 and December 31, 2014 were as follows:

	Fair Value Measurements at September 30, 2015			
	Quoted Prices in Active Markets for September 30, 2015	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	\$ 14,409	\$ 14,409	\$ -	\$ -
Municipal bonds	51,686	-	51,686	-
Mortgage-backed securities:				
Collateralized mortgage obligations-private label	52	-	52	-
Collateralized mortgage obligations-government sponsored entities	41,140	-	41,140	-
Government National Mortgage Association	460	-	460	-
Federal National Mortgage Association	4,843	-	4,843	-
Federal Home Loan Mortgage Corporation	2,427	-	2,427	-
Asset-backed securities:				
Private label	1,635	-	-	1,635
Government sponsored entities	105	-	105	-
Equity securities	49	-	49	-
Total	\$ 116,806	\$ 14,409	\$ 100,762	\$ 1,635
Measured at fair value on a non-recurring basis:				
Impaired loans	\$ 646	\$ -	\$ -	\$ 646
Foreclosed real estate	349	-	-	349

Any transfers between levels would be recognized as of the actual date of event or change in circumstances that caused the transfer. There were no reclassifications between the Level 1 and Level 2 categories for the nine months ended September 30, 2015.

## Fair Value Measurements at December 31, 2014

	Quoted Prices in Active Markets for December 31, 2014	Significant Other Observable Inputs (Level 2)	Significant Other Unobservable Inputs (Level 3)
	Identical Assets (Level 1)	(Level 2)	(Level 3)
	(Dollars in thousands)		

## Measured at fair value on a recurring basis:

## Securities available for sale:

U.S. Treasury bonds	\$ 14,361	\$ 14,361	\$ -	\$ -
Municipal bonds	60,786	-	60,786	-
Mortgage-backed securities:				
Collateralized mortgage obligations-private label	61	-	61	-
Collateralized mortgage obligations-government sponsored entities	49,992	-	49,992	-
Government National Mortgage Association	571	-	571	-
Federal National Mortgage Association	7,473	-	7,473	-
Federal Home Loan Mortgage Corporation	2,767	-	2,767	-
Asset-backed securities:				
Private label	2,023	-	-	2,023
Government sponsored entities	122	-	122	-
Equity securities	46	-	46	-
Total	\$ 138,202	\$ 14,361	\$ 121,818	\$ 2,023

## Measured at fair value on a non-recurring basis:

Impaired loans	\$ 673	\$ -	\$ -	\$ 673
Foreclosed real estate	487	-	-	487

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

Edgar Filing: LAKE SHORE BANCORP, INC. - Form 10-Q

The following table presents a reconciliation of the securities available for sale measured at fair value on a recurring basis using significant unobservable inputs (Level 3), specifically, asset-backed securities - private label, for the nine months ended September 30, 2015 and 2014:

	2015	2014
	(Dollars in thousands)	
Beginning Balance	\$ 2,023	\$ 3,498
Total gains - realized/unrealized:		
Included in earnings	-	-
Included in other comprehensive income/loss	34	723
Total losses - realized/unrealized:		
Included in earnings	-	(98)
Included in other comprehensive income/loss	(91)	(176)
Sales	-	(1,544)
Principal paydowns	(331)	(360)
Transfers to (out of) Level 3	-	-
Ending Balance	\$ 1,635	\$ 2,043

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

The following table presents additional quantitative information about the Level 3 inputs for the asset-backed securities - private label category. The fair values for this category were developed using the discounted cash flow technique with the following unobservable input ranges as of September 30, 2015 and December 31, 2014 (dollars in thousands):

Security Category	Fair Value	Loan Type/Collateral	Credit Ratings	Unobservable Inputs		
				Constant Prepayment Speed (CPR)	Probability of Default (Annual Default Rate)	Loss Severity
Asset-backed securities - private label	\$ 1,635	Sub-prime First and Prime Second Lien - Residential Real Estate	B- thru D	4 - 10	4.0% - 6.0%	70.0% - 100.0%

December 31,  
2014

Asset-backed securities - private label	\$ 2,023	Sub-prime First and Prime Second Lien - Residential Real Estate	B- thru D 4 - 10	4.0% - 6.0%	70.0% - 100.0%
---	----------	---	------------------	-------------	----------------

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

26

---

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

At September 30, 2015, impaired loans valued using Level 3 inputs had a carrying amount of \$726,000 and valuation allowances of \$200,000 reflecting fair values of \$646,000. By comparison, at December 31, 2014, impaired loans valued using Level 3 inputs had a carrying amount of \$642,000 and valuation allowances of \$178,000 reflecting fair values of \$673,000.

Once a loan is determined to be impaired, the fair value of the loan continues to be evaluated based upon the market value of the underlying collateral securing the loan. At September 30, 2015, impaired loans whose carrying amount was written down utilizing Level 3 inputs during the nine month period ended September 30, 2015 comprised of one loan with a fair value of \$593,000 and resulted in an additional provision for loan loss of \$22,000. At December 31, 2014, impaired loans whose carrying amount was written down utilizing Level 3 inputs during the year ended December 31, 2014 comprised of one loan with a fair value of \$620,000 and resulted in an additional provision for loan loss of \$53,000.

At September 30, 2015, foreclosed real estate valued using Level 3 inputs had a carrying amount of \$358,000 and valuation allowances of \$52,000 reflecting fair values of \$349,000. By comparison at December 31, 2014, foreclosed real estate valued using Level 3 inputs had a carrying amount of \$484,000 and valuation allowances of \$120,000 reflecting fair values of \$487,000.

Once a loan is foreclosed, the fair value of the real estate owned continues to be evaluated based upon the market value of the repossessed real estate originally securing the loan. At September 30, 2015, foreclosed real estate whose carrying value was written down utilizing Level 3 inputs during the nine months ended September 30, 2015 comprised of seven properties with a fair value of \$264,000 and resulted in an additional provision for loan loss of \$39,000. At December 31, 2014, foreclosed real estate whose carrying value was written down utilizing Level 3 inputs during the year ended December 31, 2014 comprised of four properties with a fair value of \$334,000 and resulted in an additional provision for loan losses of \$26,000 and subsequent write-downs recorded in non-interest expense of \$43,000.

Edgar Filing: LAKE SHORE BANCORP, INC. - Form 10-Q

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

Quantitative Information about Level 3 Fair Value Measurements				
Fair Value				
(Dollars in thousands)	Estimate	Valuation Technique	Unobservable Input	Range
At September 30, 2015				
Impaired loans	\$ 646	Market valuation of underlying collateral (1)	Appraisal Adjustments (2)	0.00-25.00%
			Direct Disposal Costs (3)	7.00-10.00%
At December 31, 2014				
Foreclosed real estate	349	Market valuation of property (1)	Direct Disposal Costs (3)	7.00-15.00%
Impaired loans	\$ 673	Market valuation of underlying collateral (1)	Appraisal Adjustments (2)	0.00-25.00%
			Direct Disposal Costs (3)	7.00-10.00%
Foreclosed real estate	487	Market valuation of property (1)	Direct Disposal Costs (3)	7.00-15.00%

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

(2) Appraisals may be adjusted downward by management for qualitative factors, such as economic conditions. Downward adjustments may be caused by negative changes to the collateral or conditions in the real estate market, known property damage, estimated changes in potential cash flow (i.e., rental income) generated by the property, lack of an interior inspection or age of the appraisal.

(3) The fair value basis of impaired loans and foreclosed real estate may be adjusted to reflect management estimates of disposal costs including, but not necessarily limited to, real estate brokerage commissions, legal fees, and delinquent property taxes, with such costs estimates generally ranging from 7 to 15% of collateral or property market value.

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

Fair Value Measurements at September 30, 2015				
Carrying	Estimated	Assets	Quoted	Significant
			Prices in	Other
			Active	Observable
			Markets	Unobservable
			for	Inputs
			Identical	Inputs
			Significant	Significant
			Other	Other

Edgar Filing: LAKE SHORE BANCORP, INC. - Form 10-Q

	Amount	Fair Value	(Level 1)	(Level 2)	(Level 3)
	(Dollars in thousands)				
Financial assets:					
Cash and cash equivalents	\$ 32,588	\$ 32,588	\$ 32,588	\$ -	\$ -
Securities available for sale	116,806	116,806	14,409	100,762	1,635
Federal Home Loan Bank stock	1,355	1,355	-	1,355	-
Loans receivable, net	294,615	289,035	-	-	289,035
Accrued interest receivable	1,802	1,802	-	1,802	-
Financial liabilities:					
Deposits	371,870	374,535	-	374,535	-
Long-term debt	18,950	18,835	-	18,835	-
Accrued interest payable	34	34	-	34	-
Off-balance-sheet financial instruments	-	-	-	-	-



## Fair Value Measurements at December 31, 2014

	Carrying Amount (Dollars in thousands)	Estimated Fair Value	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Other Unobservable Inputs (Level 3)
Financial assets:					
Cash and cash equivalents	\$ 35,811	\$ 35,811	\$ 35,811	\$ -	\$ -
Securities available for sale	138,202	138,202	14,361	121,818	2,023
Federal Home Loan Bank stock	1,375	1,375	-	1,375	-
Loans receivable, net	284,853	283,569	-	-	283,569
Accrued interest receivable	1,716	1,716	-	1,716	-
Financial liabilities:					
Deposits	386,939	389,141	-	389,141	-
Long-term debt	18,950	19,277	-	19,277	-
Accrued interest payable	39	39	-	39	-
Off-balance-sheet financial instruments	-	-	-	-	-

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

Cash and cash equivalents (carried at cost)

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

Securities available for sale (carried at fair value)

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

Federal Home Loan Bank stock (carried at cost)

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

Loans Receivable (carried at cost)

The fair value of fixed-rate and variable rate performing loans is estimated using a discounted cash flow method. The discount rates take into account interest rates currently being offered to customers for loans with similar terms and with estimated maturity and market factors including liquidity. The estimate of maturity is based on the Company's contractual cash flows adjusted for prepayment estimates based on current economic and lending conditions. Due to the significant judgment involved in evaluating credit quality, loans are classified within Level 3 of the fair value hierarchy.

29

---

Accrued Interest Receivable and Payable (carried at cost)

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

Deposits (carried at cost)

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

Borrowings (carried at cost)

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

Off-Balance Sheet Financial Instruments (disclosed at cost)

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

Note 9 – Treasury Stock

During the quarter ended September 30, 2015, the Company made no repurchases of shares of common stock. During the nine months ended September 30, 2015, the Company repurchased 39,900 shares of common stock at an average cost of \$13.56 per share. These shares were repurchased pursuant to the Company's publicly announced common stock repurchase programs. As of September 30, 2015, there were 16,510 shares remaining to be repurchased under the existing stock repurchase program. During the nine months ended September 30, 2015, the Company transferred 15,455 shares of common stock out of the treasury stock reserved for the 2012 Equity Incentive Plan, at an average cost of \$9.39 per share, to fund awards granted under the 2012 Equity Incentive Plan.

During the quarter and nine months ended September 30, 2014, the Company repurchased 100 and 5,100 shares of common stock at an average price of \$12.39 and \$12.30 per share, respectively. These shares were repurchased pursuant to the Company's publicly announced common stock repurchase programs. As of September 30, 2014 there were 56,410 shares remaining to be repurchased under the existing stock repurchase program. During the quarter and nine months ended September 30, 2014, the Company transferred 21,052 and 24,570 shares of common stock out of the treasury stock reserved for the 2012 Equity Incentive Plan, at an average cost of \$9.39 per share, to fund awards granted under the 2012 Equity Incentive Plan.



## Note 10 – Other Comprehensive Income

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

	For the Three Months Ended September 30, 2015			For the Three Months Ended September 30, 2014		
	Pre-Tax Amount	Tax (Expense) Benefit	Net of Tax Amount	Pre-Tax Amount	Tax (Expense) Benefit	Net of Tax Amount
	(Unaudited)					
	(Dollars in thousands)					
Net unrealized gains on securities available for sale:						
Net unrealized gains arising during the period	\$ 949	\$ (323)	\$ 626	\$ 102	\$ (40)	\$ 62
Less: reclassification adjustment related to:						
Recovery on previously impaired investment securities included in net income	(48)	16	(32)	(35)	14	(21)
Net gain on sale of securities included in net income	(440)	150	(290)	-	-	-
Total Other Comprehensive Income	\$ 461	\$ (157)	\$ 304	\$ 67	\$ (26)	\$ 41

	For the Nine Months Ended September 30, 2015			For the Nine Months Ended September 30, 2014		
	Pre-Tax Amount	Tax (Expense) Benefit	Net of Tax Amount	Pre-Tax Amount	Tax (Expense) Benefit	Net of Tax Amount
	(Unaudited)					
	(Dollars in thousands)					
Net unrealized (losses) gains on securities available for sale:						
Net unrealized (losses) gains arising during the period	\$ (144)	\$ 318	\$ 174	\$ 4,125	\$ (1,597)	\$ 2,528
Less: reclassification adjustment related to:						
Recovery on previously impaired investment securities included in net income	(123)	42	(81)	(136)	53	(83)
Net gain on sale of securities included in net income	(440)	150	(290)	(59)	23	(36)
Total Other Comprehensive (Loss) Income	\$ (707)	\$ 510	\$ (197)	\$ 3,930	\$ (1,521)	\$ 2,409



Edgar Filing: LAKE SHORE BANCORP, INC. - Form 10-Q

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

Details about Accumulated Other Comprehensive Income (Loss) Components	Accounts Reclassified from Accumulated Other Comprehensive Income (Loss) for the three months ended September 30, 2015    2014 (Dollars in thousands)		Affected Line Item on the Consolidated Statements of Income
Net unrealized gains and losses on securities available for sale			
Recovery on previously impaired investment securities	\$ (48)	\$ (35)	Recovery on previously impaired investment securities
Sale of securities	(440)	-	Net gain on sale of securities available for sale
	(488)	(35)	
Provision for income tax expense	166	14	Income Tax Expense
Total reclassification for the period	\$ (322)	\$ (21)	Net Income

Details about Accumulated Other Comprehensive Income (Loss)	Accounts Reclassified from Accumulated Other Comprehensive Income (Loss) for the nine months ended September 30,		Affected Line Item on the Consolidated

Edgar Filing: LAKE SHORE BANCORP, INC. - Form 10-Q

Components	2015	2014	Statements of Income
	(Dollars in thousands)		
Net unrealized gains and losses on securities available for sale			
Recovery on previously impaired investment securities	\$ (123)	\$ (136)	Recovery on previously impaired investment securities
Sale of securities	(440)	(59)	Net gain on sale of securities available for sale
	(563)	(195)	
Provision for income tax expense	192	76	Income Tax Expense
Total reclassification for the period	\$ (371)	\$ (119)	Net Income

Note 11 – Subsequent Events

On October 28, 2015, the Board of Directors declared a quarterly cash dividend of \$0.07 per share on the Company's common stock, payable on November 19, 2015 to stockholders of record as of November 9, 2015. Lake Shore, MHC, which holds 3,636,875 shares, or approximately 60.8% of the Company's total outstanding stock, elected to waive its right to receive this cash dividend of approximately \$255,000. On March 3, 2015, the MHC received the non-objection of the Federal Reserve Bank of Philadelphia to waive its right to receive dividends paid by the Company during the twelve months ending February 3, 2016, aggregating up to \$0.28 per share. The MHC waived \$255,000 of dividends during the three months ended September 30, 2015 and \$765,000 of dividends during the nine months ended September 30, 2015. Cumulatively, Lake Shore, MHC has waived approximately \$7.2 million of cash dividends as of September 30, 2015. The dividends waived by Lake Shore, MHC are considered a restriction on the retained earnings of the Company.



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

Forward-Looking Statements

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

The following factors, including the factors set forth in Part II, Item 1A of this and previous Quarterly Reports on Form 10-Q and in Part I, Item 1A of the Company's Annual Report on Form 10-K for the year ended December 31, 2014, among others, could cause actual results to differ materially from the anticipated results or other expectations expressed in our forward-looking statements:

general and local economic conditions;

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

the ability of our customers to make loan payments;

our ability to continue to control costs and expenses;

changes in accounting principles, policies or guidelines;

our success in managing the risks involved in our business;

inflation, and market and monetary fluctuations;

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

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

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

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

#### Overview

The following discussion and analysis is presented to assist in the understanding and evaluation of our consolidated financial condition and results of operations. It is intended to complement the unaudited consolidated financial statements and notes thereto appearing elsewhere in this Form 10-Q and should be read in conjunction therewith. The detailed discussion focuses on our consolidated financial condition as of September 30, 2015 compared to the consolidated financial condition as of December 31, 2014 and the consolidated results of operations for the three and nine months ended September 30, 2015 and 2014.

Our results of operations depend primarily on our net interest income, which is the difference between the interest income we earn on loans and investments and the interest expense we pay on deposits and other

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

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

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

While the recession is officially over and improvements have been noted in the housing market and unemployment rate, the Federal Reserve has continued to maintain the Fed Funds rate at 0.00%-0.25% for more than six years. At its September 2015 meeting, the Federal Reserve did not raise the Fed Funds rate and indicated that it plans to assess both realized and expected progress towards its dual mandates of maximum employment and 2% inflation prior to any rate increase in the medium term. It also indicated that even after employment and inflation are near the mandate-consistent levels, economic conditions may, for some time, warrant keeping the target federal funds rate below normal. As a result, the anticipation that the Federal Reserve will increase the Fed Funds rate in 2015 has diminished, creating uncertainty about the timing of a potential increase in short term rates.

The quantitative easing (“QE”) program implemented by the Federal Reserve during the financial crisis as a tool to lower long-term rates ended in October 2014. Since that time, the Federal Reserve has continued to reinvest cash flow received on its portfolio back into agency mortgage backed securities and treasury bonds. This action continues to exert downward pressure on long-term rates. Current interest rates on residential mortgage loans remain very low compared to historical yields. We will continue to closely monitor the impact of the national and regional economy on our net interest margin, results of operations and critical risk areas, including interest rate risk and credit risk.

As discussed in the Company’s Annual Report on Form 10-K Part I, Item 1 “Business – Supervision and Regulation” for the year ended December 31, 2014, since October 2008 numerous legislative actions, including the Dodd-Frank Act, have been taken in response to the financial crisis affecting the banking system and financial markets. While we do not know all the possible outcomes from these initiatives, we can anticipate that the Company will need to dedicate more resources to ensure compliance with the new legislation and regulations, which may impact profitability. There can be no assurance as to the actual impact any governmental program will have on the financial markets or our financial condition and results of operations. We remain active in monitoring these developments and supporting the interests of our shareholders.

## Management Strategy

**Our Reputation.** Our primary management strategy has been to retain our perceived image as one of the most respected and recognized community banks in Western New York with over 124 years of service to our community. Our management strives to accomplish this goal by continuing to emphasize our high quality customer service and financial strength.

Branching. Our offices are located in Dunkirk, Fredonia, Jamestown, Lakewood and Westfield in Chautauqua County, New York and in Depew, East Amherst, Hamburg, Kenmore, Orchard Park, and Snyder in Erie

34

---

County, New York. Saturation of the market in Chautauqua County led to our expansion plan in Erie County, which is a critical component of our future profitability and growth.

An important strategic objective is to continue to evaluate and enhance the technology supporting our customer service. We are committed to making investments in technology and we believe that it represents an efficient way to deploy a portion of our capital. To this end, the Company has developed a five year plan for the implementation of cost effective and efficient digital services to meet our customer's technology needs, to focus on attracting new customers, and to improve our operational efficiencies. Although we remain committed to expanding our retail branch footprint whenever it makes strategic sense, we will be concentrating our near term efforts on expanding our digital footprint.

**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 quality personnel is a high priority.

**Lending.** Historically, our lending portfolio has consisted predominantly of residential one- to four-family mortgage loans. At September 30, 2015 and December 31, 2014, we held \$159.2 million and \$167.8 million of residential one- to four-family mortgage loans, respectively, which constituted 54.2% and 59.1% of our total loan portfolio, at such respective dates. Due to the interest rate risk inherent in holding long-term, fixed rate one- to four-family real estate loans in our portfolio in a potential rising interest rate environment, we have been strategically focused on the origination of commercial real estate loans to finance the purchase of real property, which generally consists of developed real estate. We have also focused on small business commercial lending, including business installment loans, lines of credit and other commercial loans. These types of commercial loans are generally made at higher interest rates and for shorter terms than one- to four-family real estate loans, which lowers the Bank's interest rate risk. At September 30, 2015 and December 31, 2014, our commercial real estate loan portfolio consisted of loans totaling \$85.2 million and \$68.2 million, respectively, or 29.0% and 24.0%, respectively, of total loans. At September 30, 2015 and December 31, 2014, our commercial loan portfolio consisted of loans totaling \$15.4 million and \$13.5 million, respectively, or 5.2% and 4.7%, respectively, of total loans. Other loan products offered to our customers include home equity lines of credit, construction loans and consumer loans, including automobile loans, overdraft lines of credit and share loans. In the fourth quarter of 2014, we began to sell low-yield long-term (generally 30 years) fixed rate one- to four-family residential loans that we originate, as part of our interest rate risk strategy and asset/liability management, and plan to continue to do so in the future, as it is deemed appropriate. We typically retain servicing rights when we sell one- to four-family residential mortgage loans.

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

At September 30, 2015 and December 31, 2014, we had \$116.8 million and \$138.2 million, respectively, invested in securities available for sale, the majority of which are Treasury securities, agency collateralized mortgage obligation securities ("CMOs"), agency mortgage-backed securities and municipal securities. At September 30, 2015, we had a net unrealized gain in the investment portfolio of \$5.0 million.

Asset-Liability Strategy. Our business consists primarily of originating one- to four-family residential real estate loans and commercial real estate loans secured by property in our market area and investing in residential mortgage-backed securities, CMOs and municipal securities. One- to four-family residential real estate loans generally involve a lower degree of credit risk and carry a lower yield than commercial real estate and commercial business loans. The average maturity of residential real estate loans is longer than that for commercial loans. Our loans are primarily funded by time deposits, which typically mature within 2 years on average and core deposits (i.e. checking, savings and money market accounts). As a result, we are exposed to interest rate risk, as our interest-bearing liabilities will mature or re-price more quickly than our interest-earning assets in a rising rate environment. Although we plan to continue to originate one- to four-family

residential mortgage loans going forward, we have been and intend to continue to increase our focus on the origination of commercial real estate loans and commercial business loans, which generally have higher returns and shorter durations than one- to four-family residential real estate loans. As part of our asset liability strategy, we review the duration of assets on our balance sheet, and if necessary, we may sell loans or securities to help manage our interest rate risk. Our strategy also involves managing interest expense. Overtime, we have decreased the volume of higher-rate time deposits and have concentrated on building lower-cost core deposits, with a focus on building commercial relationships, in order to help reduce and control our cost of funds. As part of our strategy to expand our commercial loan portfolio, we expect to attract lower cost core deposits as part of these borrower relationships. We offer competitive rates on a variety of deposit products to meet the needs of our customers and we promote long term deposits, where necessary, to meet asset-liability goals. We also consider borrowed funds or derivatives as an opportunity to extend the duration of liabilities at attractive levels.

We are actively involved in managing our balance sheet through the direction of our Asset-Liability Committee and the assistance of a third party advisor. Recent economic conditions have underscored the importance of a strong balance sheet. We strive to achieve this through managing our interest rate risk and maintaining strong capital levels, putting aside adequate loan loss reserves and keeping liquid assets on hand. Diversifying our asset mix may improve the net interest margin and may also reduce the exposure of our net interest income and earnings to interest rate risk. We will continue to manage our interest rate risk by diversifying the type and maturity of assets in our loan and investment portfolios and monitoring the maturities in our deposit portfolio and borrowing facilities.

#### Critical Accounting Policies

Disclosure of the Company's significant accounting policies is included in the notes to the consolidated financial statements of the Company's Annual Report on Form 10-K for the year ended December 31, 2014. Some of these policies require significant judgment, estimates and assumptions to be made by management, most particularly in connection with determining the provision for loan losses and the appropriate level of the allowance for loan losses, as well as management's evaluation of securities valuation, impairment of securities and income taxes. There have been no changes in critical accounting policies since December 31, 2014.

#### Analysis of Net Interest Income

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

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

	For the Three Months Ended September 30, 2015			For the Three Months Ended September 30, 2014		
	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	\$ 19,640	\$ 5	0.10%	\$ 36,265	\$ 6	0.07%
Securities	127,357	948	2.98%	144,321	1,082	3.00%
Loans	296,707	3,474	4.68%	275,079	3,307	4.81%
Total interest-earning assets	443,704	4,427	3.99%	455,665	4,395	3.86%
Other assets	33,666			33,550		
Total assets	\$ 477,370			\$ 489,215		
Interest-bearing liabilities						
Demand & NOW accounts	\$ 43,846	\$ 8	0.07%	\$ 46,321	\$ 14	0.12%
Money market accounts	74,726	38	0.20%	78,717	61	0.31%
Savings accounts	45,232	7	0.06%	42,295	11	0.10%
Time deposits	167,395	485	1.16%	186,567	638	1.37%
Borrowed funds	19,657	99	2.01%	18,950	102	2.15%
Other interest-bearing liabilities	1,037	25	9.64%	1,102	25	9.07%
Total interest-bearing liabilities	351,893	662	0.75%	373,952	851	0.91%
Other non-interest bearing liabilities	52,723			45,688		
Stockholders' equity	72,754			69,575		
Total liabilities & stockholders' equity	\$ 477,370			\$ 489,215		
Net interest income		\$ 3,765			\$ 3,544	
Interest rate spread			3.24%			2.95%
Net interest margin			3.39%			3.11%



	For the Nine Months Ended September 30, 2015			For the Nine Months Ended September 30, 2014		
	Average Balance	Interest Income/ Expense	Yield/ Rate	Average Balance	Interest Income/ Expense	Yield/ Rate
(Dollars in thousands)						
<b>Interest-earning assets:</b>						
Interest-earning deposits & federal funds sold	\$ 23,254	\$ 16	0.09%	\$ 25,500	\$ 10	0.05%
Securities	133,243	2,950	2.95%	152,106	3,473	3.04%
Loans	291,143	10,268	4.70%	275,316	9,977	4.83%
Total interest-earning assets	447,640	13,234	3.94%	452,922	13,460	3.96%
Other assets	33,721			34,279		
Total assets	\$ 481,361			\$ 487,201		
<b>Interest-bearing liabilities</b>						
Demand & NOW accounts	\$ 45,248	\$ 32	0.09%	\$ 45,780	\$ 41	0.12%
Money market accounts	76,259	135	0.24%	78,779	198	0.34%
Savings accounts	44,393	24	0.07%	41,228	32	0.10%
Time deposits	173,651	1,603	1.23%	189,854	1,958	1.38%
Borrowed funds	19,176	296	2.06%	19,276	202	1.40%
Other interest-bearing liabilities	1,053	74	9.37%	1,118	76	9.06%
Total interest-bearing liabilities	359,780	2,164	0.80%	376,035	2,507	0.89%
Other non-interest bearing liabilities	48,891			42,837		
Stockholders' equity	72,690			68,329		
Total liabilities & stockholders' equity	\$ 481,361			\$ 487,201		
Net interest income		\$ 11,070			\$ 10,953	
Interest rate spread			3.14%			3.07%
Net interest margin			3.30%			3.22%

Rate Volume Analysis. The following tables analyze the dollar amount of changes in interest income and interest expense for major components of interest-earning assets and interest-bearing liabilities. The tables show the amount of the change in interest income or expense caused by either changes in outstanding balances (volume) or changes in interest rates. The effect of a change in volume is measured by applying the average rate during the first period to the volume change between the two periods. The effect of changes in rate is measured by applying the change in rate between the two periods to the average volume during the first period. Changes attributable to both rate and volume, which cannot be segregated, have been allocated proportionately to the absolute value of the change due to volume and the change due to rate.

	Three Months Ended September 30, 2015 Compared to Three Months Ended September 30, 2014		
	Rate	Volume	Net Change
	(Dollars in thousands)		
Interest-earning assets:			
Interest-earning deposits & federal funds sold	\$ 2	\$ (3)	\$ (1)
Securities	(8)	(126)	(134)
Loans, including fees	(88)	255	167
Total interest-earning assets	(94)	126	32
Interest-bearing liabilities:			
Demand & NOW accounts	(5)	(1)	(6)
Money market accounts	(20)	(3)	(23)
Savings accounts	(5)	1	(4)
Time deposits	(91)	(62)	(153)
Total deposits	(121)	(65)	(186)
Other interest-bearing liabilities:			
Borrowed funds & other	(5)	2	(3)
Total interest-bearing liabilities	(126)	(63)	(189)
Total change in net interest income	\$ 32	\$ 189	\$ 221

Nine Months Ended September 30,  
2015

Compared to  
 Nine Months Ended September 30,  
 2014

Rate      Volume      Net Change  
 (Dollars in thousands)

Interest-earning assets:			
Interest-earning deposits & federal funds sold	\$ 7	\$ (1)	\$ 6
Securities	(103)	(420)	(523)
Loans, including fees	(272)	563	291
Total interest-earning assets	(368)	142	(226)
Interest-bearing liabilities:			
Demand & NOW accounts	(9)	-	(9)
Money market accounts	(57)	(6)	(63)
Savings accounts	(10)	2	(8)
Time deposits	(196)	(159)	(355)
Total deposits	(272)	(163)	(435)
Other interest-bearing liabilities:			
Borrowed funds & other	98	(6)	92
Total interest-bearing liabilities	(174)	(169)	(343)
Total change in net interest income	\$ (194)	\$ 311	\$ 117

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 re-price as long-term interest rates increase. As rates rise, we expect loan applications to decrease, prepayment speeds to slow down and the interest rate on our loan portfolio to remain static. Conversely, a majority of our interest-bearing liabilities have much shorter contractual maturities and are expected to re-price, resulting in increased interest expense. A significant portion of our deposits have no contractual maturities and are likely to re-price 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 and securities portfolios. An increasing rate environment is expected to cause a decrease in our net interest rate spread and a decrease in our earnings. Changes in market interest rates could also reduce the value of our interest-earning assets including, but not limited to, our securities portfolio. In particular, the unrealized gains and losses on securities available for sale are reported, net of tax, in accumulated other comprehensive income which is a component of stockholders' equity. As such, declines in the fair value of such securities resulting from increases in market interest rates may adversely affect stockholders' equity.

In a decreasing interest rate environment, our earnings may increase or decrease. If long-term interest-earning assets do not re-price and interest rates on short-term deposits begin to decrease, earnings may rise. However, low interest rates on loan products may result in an increase in prepayments, as borrowers refinance their loans. If we cannot re-invest the funds received from prepayments at a comparable spread, net interest income could be reduced. Also, in a falling interest rate environment, certain categories of deposits may reach a point where market forces prevent further reduction in interest paid on those products. The net effect of these circumstances is reduced net interest income and possibly net interest rate spread.

In the current extended low interest-rate environment, cost of funds have declined significantly (partially due to a decrease in higher cost time deposits), while yields on interest earning assets have remained flat. The net interest margin for the nine months ended September 30, 2015 was 3.30% in comparison to a net interest margin of 3.22% for the nine months ended September 30, 2014. The Bank's Asset-Liability Committee continues to review its options to minimize the impact of an increasing rate environment on its operations. The Bank's options include shortening the term of interest earning assets, increasing short term investments in liquid assets to take advantage of potential rising interest rates, increasing core deposit growth, implementing new products, promoting adjustable rate commercial loan products and using derivative products.

For the three months ended September 30, 2015, the average yields on our loan and investment portfolios were 4.68% and 2.98%, respectively, in comparison to 4.81% and 3.00%, respectively, for the three months ended September 30, 2014. Overall, the average yield on our interest earning assets increased by 13 basis points to 3.99% for the three months ended September 30, 2015 in comparison to the three months ended September 30, 2014 primarily due to a \$21.6 million increase in the average loan balance for the three month period ended September 30, 2015. The increase was partially offset by lower interest income earned on our securities portfolio, resulting from a \$17.0 million decrease in the average balance of securities for the same period. For the three months ended September 30, 2015 and 2014, the average rate that we paid on interest-bearing liabilities was 0.75% and 0.91%, respectively. The 16 basis points decrease was primarily due to a \$19.2 million decrease in average time deposits as well as a 21 basis points decrease in the average interest rate paid on time deposits since September 30, 2014. Our interest rate spread for the three months ended September 30, 2015 was 3.24% which was a 29 basis points increase in comparison to the three months ended September 30, 2014. Our net interest margin was 3.39% and 3.11% for the three months ended

September 30, 2015 and 2014, respectively.

For the nine month period ended September 30, 2015, the average yields on our loan and investment portfolios were 4.70% and 2.95%, respectively, in comparison to 4.83% and 3.04%, respectively, for the nine month period ended September 30, 2014. Overall, the average yield on our interest earning assets decreased by two basis points to 3.94% for the nine month period ended September 30, 2015 in comparison to the same period in 2014 primarily due to lower interest income earned on our securities portfolio as a result of an \$18.9 million decrease in the average balance of securities. The decrease in average yield on our interest earning assets was partially offset by an increase of \$15.8 million in the average balance of loans during the nine months ended September 30, 2015 in comparison to the nine months ended September 30, 2014. The average yield was also impacted by the low interest rate environment. For the nine months ended September 30, 2015 and 2014, the

40

---

average rate that we paid on interest-bearing liabilities was 0.80% and 0.89%, respectively. The nine basis points decrease was primarily due to a \$16.2 million decrease in average time deposits and a 15 basis points decrease in the average interest rate paid on time deposits. Our interest rate spread for the nine months ended September 30, 2015 was 3.14% which was a seven basis points increase in comparison to the nine months ended September 30, 2014. Our net interest margin was 3.30% and 3.22% for the nine months ended September 30, 2015 and 2014, respectively.

#### Comparison of Financial Condition at September 30, 2015 and December 31, 2014

Total assets at September 30, 2015 were \$472.3 million, a decrease of \$15.2 million, or 3.1%, from \$487.5 million at December 31, 2014. The decrease in total assets was primarily due to a \$21.4 million decrease in securities available for sale and a \$3.2 million decrease in cash and cash equivalents partially offset by an increase in net loans receivable of \$9.8 million.

Cash and cash equivalents decreased by \$3.2 million, or 9.0%, from \$35.8 million at December 31, 2014 to \$32.6 million at September 30, 2015. The decrease was primarily attributed to \$51.0 million of cash outflow for loan originations and a \$15.1 million decrease in total deposits, partially offset by the receipt of \$53.5 million of principal paydowns and maturities on the investment and loan portfolios and proceeds from the sale of \$9.4 million in available for sale securities that were not subsequently re-invested into the investment portfolio during the nine months ending September 30, 2015.

Securities available for sale decreased by \$21.4 million, or 15.5%, to \$116.8 million at September 30, 2015 compared to \$138.2 million at December 31, 2014. The decrease was primarily due to the receipt of \$11.2 million in principal paydowns and maturities on the investment portfolio and proceeds from the \$9.4 million sale of available for sale securities that were not subsequently re-invested into the investment portfolio. The Company is currently maintaining higher levels of liquid assets to be in a better position to take advantage of shifts in market interest rates and to manage interest rate risk.

Net loans receivable increased during the nine month period ended September 30, 2015 as shown in the table below:

	At September 30, 2015	At December 31, 2014	Change \$	%	
(Dollars in thousands)					
Real Estate Loans:					
Residential, one- to four-family	\$ 159,186	\$ 167,840	\$ (8,654)	(5.2)	%
Home equity	32,688	32,337	351	1.1	%
Commercial	85,159	68,238	16,921	24.8	%
Construction	-	449	(449)	(100.0)	%
Total real estate loans	277,033	268,864	8,169	3.0	%

Other Loans:					
Commercial	15,360	13,467	1,893	14.1	%
Consumer	1,420	1,495	(75)	(5.0)	%
Total gross loans	293,813	283,826	9,987	3.5	%
Allowance for loan losses	(2,097)	(1,921)	(176)	9.2	%
Net deferred loan costs	2,899	2,948	(49)	(1.7)	%
Loans receivable, net	\$ 294,615	\$ 284,853	\$ 9,762	3.4	%

The increase in net loans receivable was primarily due to an increase in commercial real estate loans and commercial business loans, partially offset by a decrease in residential, one- to four-family real estate loans, and construction loans. As fixed rate one- to four-family residential real estate loans present additional interest rate risk to our loan portfolio as a result of the longer duration of these types of assets, we remain strategically focused in 2015 on originating shorter duration commercial real estate and commercial business loans to

diversify our asset mix, to reduce interest rate risk, to take advantage of the opportunities available to serve small businesses in our market area, and to maintain the net interest margin.

**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 and non-accruing troubled debt restructurings.

Non-performing assets, including non-performing loans and foreclosed real estate, totaled \$5.8 million, or 1.24% of total assets, at September 30, 2015 and \$5.1 million, or 1.05% of total assets, at December 31, 2014. The increase in non-performing assets at September 30, 2015 was primarily due to the addition of two non-performing commercial real estate loans with total outstanding balances of \$726,000.



Edgar Filing: LAKE SHORE BANCORP, INC. - Form 10-Q

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

	At September 30, 2015	At December 31, 2014		
	(Dollars in thousands)			
Loans past due 90 days or more but still accruing:				
Real estate loans:				
Residential, one- to four-family	\$ 1	\$ -		
Home equity	19	1		
Commercial	-	-		
Construction	-	-		
Other loans:				
Commercial	-	-		
Consumer	6	9		
Total	\$ 26	\$ 10		
Loans accounted for on a non-accrual basis:				
Real estate loans:				
Residential, one- to four-family	\$ 2,296	\$ 2,413		
Home equity	241	335		
Commercial	2,746	1,891		
Construction	-	-		
Other loans:				
Commercial	182	76		
Consumer	6	4		
Total non-accrual loans	5,471	4,719		
Total non-performing loans	5,497	4,729		
Foreclosed real estate	344	401		
Total non-performing assets	\$ 5,841	\$ 5,130		
Ratios:				
Non-performing loans as a percent of total loans:	1.87 %	1.66 %		

Edgar Filing: LAKE SHORE BANCORP, INC. - Form 10-Q

Non-performing assets as a percent of total assets:	1.24	%	1.05	%
Troubled debt restructuring:				
Loans accounted for on a non-accrual basis				
Residential, one- to four-family	\$ -		\$ -	
Home equity	-		-	
Performing loans				
Residential, one- to four-family	\$ 218		\$ 224	
Home equity	9		10	

43

---

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

	At or for the Nine Months Ended September 30, 2015      2014 (Dollars in thousands)	
Balance at beginning of year:	\$ 1,921	\$ 1,813
Provision for loan losses	240	70
Charge-offs:		
Real estate loans:		
Residential, one- to four-family	(58)	(17)
Home equity	(17)	(25)
Commercial	-	-
Construction	-	-
Other loans:		
Commercial	(9)	(25)
Consumer	(34)	(29)
Total charge-offs	(118)	(96)
Recoveries:		
Real estate loans:		
Residential, one- to four-family	12	3
Home equity	8	1
Commercial	21	-
Construction	-	-
Other loans:		
Commercial	7	-
Consumer	6	12
Total recoveries	54	16
Net charge-offs	(64)	(80)
Balance at end of period	\$ 2,097	\$ 1,803
Average loans outstanding	\$ 291,143	\$ 275,316
Allowance for loan losses as a percent of total net loans	0.71%	0.66%
Allowance for loan losses as a percent of non-performing loans	38.15%	33.31%
Ratio of net charge-offs to average loans outstanding (1)	0.03%	0.04%

(1) Annualized

Edgar Filing: LAKE SHORE BANCORP, INC. - Form 10-Q

The table below shows changes in deposit balances by type of deposit account between September 30, 2015 and December 31, 2014:

	At September 30, 2015	At December 31, 2014	Change	
			\$	%
(Dollars in thousands)				
Demand deposits and NOW accounts:				
Non-interest bearing	\$ 45,706	\$ 37,162	\$ 8,544	23.0 %
Interest bearing	42,753	46,685	(3,932)	(8.4) %
Money market	74,959	78,457	(3,498)	(4.5) %
Savings	44,481	42,507	1,974	4.6 %
Time deposits	163,971	182,128	(18,157)	(10.0)%
Total Deposits	\$ 371,870	\$ 386,939	\$ (15,069)	(3.9) %

The decrease in total deposits was primarily due to a decrease in time deposits, partially offset by net growth in core deposits during the nine months ended September 30, 2015. Time deposits have decreased as certificate of deposit customers have sought higher yields elsewhere. The growth in core deposits was the result of the Company's continued strategic focus on growing low-cost core deposits among its retail and commercial customers in an effort to manage interest expenses.

While long-term debt did not change during the nine months ended September 30, 2015, the Company did restructure long-term debt in 2015 to lock in a lower rate to manage interest rate risk.

Total stockholders' equity increased by \$1.7 million or 2.4%, from \$71.6 million at December 31, 2014 to \$73.3 million at September 30, 2015. The increase was primarily due to net income of \$2.5 million during the nine months ended September 30, 2015. The increase was partially offset by payments of \$541,000 to purchase treasury stock and by the payment of \$459,000 in cash dividends during the nine months ended September 30, 2015.

#### Comparison of Results of Operations for the Three Months Ended September 30, 2015 and 2014

**General.** Net income was \$1.2 million for the three months ended September 30, 2015, or \$0.21 per basic and diluted share, an increase of \$548,000, or 79.7%, compared to net income of \$688,000, or \$0.12 per basic and diluted share, for the three months ended September 30, 2014. The increase in net income was primarily due to a \$497,000 increase in non-interest income and a \$221,000 increase in net interest income, partially offset by a \$154,000 increase in income tax expense.

**Interest Income.** Interest income increased by \$32,000, or 0.7%, to \$4.4 million for the three months ended September 30, 2015 compared to the three months ended September 30, 2014. This increase was primarily due to an increase in interest income on our loan portfolio of \$167,000, or 5.1%. The average balance in our loan portfolio

increased \$21.6 million, or 7.9%, for the three months ended September 30, 2015 compared to the same three month period in 2014. The increase in the average balance of loans receivable was primarily due to an increase in the average balance of commercial real estate loans and commercial loans, partially offset by a decrease in the average balance of one- to four family real estate loans. The average yield on the loan portfolio decreased from 4.81% for the three months ended September 30, 2014 to 4.68% for the three months ended September 30, 2015. The average yield on the loan portfolio decreased as new loans were originated or existing loans were refinanced at lower yields than the rates earned on loans which had paid off or on loans remaining in the portfolio, as a result of the current low interest rate environment. Investment interest income decreased by \$134,000, or 12.4%, from \$1.1 million for the three months ended September 30, 2014 to \$948,000 for the three months ended September 30, 2015, due to a decrease in the average balance of the investment portfolio from \$144.3 million for the three months ended September 30, 2014 to \$127.4 million for the three months ended September 30, 2015. This decrease was partially due to the Company's strategy to reinvest paydowns received on securities into shorter term cash and cash equivalents to be in a better position

to take advantage of future shifts in market interest rates. The Company also sold \$9.4 million of securities during the three months ended September 30, 2015. The sale of securities allowed the Bank to improve its liquidity position and to shorten the duration of its assets in order to reduce interest rate risk. The average yield on the investment portfolio decreased 2 basis points from 3.00% for the three months ended September 30, 2014 to 2.98% for the three months ended September 30, 2015, as a result of the declining portfolio balance of higher yielding securities.

**Interest Expense.** Interest expense decreased \$189,000, or 22.2%, to \$662,000 for the three months ended September 30, 2015 compared to \$851,000 for the three months ended September 30, 2014. Interest expense on deposits decreased by \$186,000, or 25.7%, to \$538,000 for the three months ended September 30, 2015 when compared to the three months ended September 30, 2014 primarily due to a \$22.7 million decrease in average deposits when comparing the three months ended September 30, 2015 to the three months ended September 30, 2014. The average balance of deposits for the three months ended September 30, 2015 was \$331.2 million with an average rate of 0.65% compared to the average balance of deposits of \$353.9 million and an average rate of 0.82% for the three months ended September 30, 2014. The decrease in the average balance of deposits was primarily due to a decrease in time deposits as customers have sought higher yields elsewhere. The decrease in the average rate paid on deposits was due to the continued low interest rate environment during the third quarter of 2015 and due to a shift in the deposit mix to lower cost core deposits from time deposits. The interest expense related to advances from the FHLBNY decreased \$3,000, or 2.9%, to \$99,000 for the three months ended September 30, 2015 when compared to the three months ended September 30, 2014. The decrease in the average rate paid on FHLBNY advances from 2.15% during the three months ended September 30, 2014 to 2.01% during the three months ended September 30, 2015 was primarily due to the restructuring of long-term debt in 2015 to lock in a lower rate to manage interest rate risk. The average balance in advances from FHLBNY increased \$707,000 from \$19.0 million for the three months ended September 30, 2014 to \$19.7 million for the three months ended September 30, 2015. .

**Provision for Loan Losses.** A \$30,000 provision for loan losses was recorded during the three months ended September 30, 2015, which was a \$40,000 decrease in comparison to the provision for loan losses recorded during the prior year period. Net charge-offs for the three months ended September 30, 2015 were \$58,000 compared to net charge-offs of \$40,000 for the three months ended September 30, 2014. Our non-performing loans increased to \$5.5 million, or 1.87% of total loans, at September 30, 2015 as compared to \$5.4 million, or 1.97% of total loans, at September 30, 2014.

During the three months ended September 30, 2015, the Company recorded a \$43,000 provision for loan losses on commercial loans due to an increase in classified loans and net charge-offs of loans. The Company also recorded a provision of \$17,000 for one- to four-family mortgages primarily due to net-charge-offs. A \$7,000 provision for loan losses was recorded on consumer loans to account for losses on overdraft lines of credit during the three months ended September 30, 2015. The provision for loan losses was partially offset by a \$42,000 credit for commercial real estate due to a decrease in the reserve amount on one impaired commercial real estate loan due to the receipt of additional loan collateral. During the three months ended September 30, 2015, the Company recorded an unallocated provision for loan losses of \$7,000. The unallocated provision reflects the margin of imprecision inherent in the underlying assumptions used in the methodologies for estimating allocated and general losses in the portfolio.

During the three months ended September 30, 2014, the Company recorded a \$97,000 provision for loan losses on one- to four-family and home equity loans and a \$25,000 provision for loan losses on commercial loans due to changes in the related environmental factors used to qualitatively assess inherent losses in the loan portfolio and due to an increase in loan balances. During the three months ended September 30, 2014, the Company recorded an \$11,000 provision for loan losses on consumer loans as a result of net charge-offs. The provision for loan losses was partially offset by a \$58,000 unallocated credit for loan losses. This unallocated provision reflects the margin of imprecision inherent in the underlying assumptions used in the methodologies for estimating allocated and general losses in the portfolio.

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

46

---

**Non-interest Income.** Non-interest income increased \$497,000, or 93.6%, to \$1.0 million for the three months ended September 30, 2015 compared to the three months ended September 30, 2014. The increase was primarily due to a \$440,000 gain on the sale of available for sales securities during the three months ended September 30, 2015, while there were no securities sold during the same period in 2014. The increase was also due to a \$28,000 net gain on the sale of loans during the three months ended September 30, 2015 in comparison to a net \$5,000 gain during the prior year period.

**Non-interest Expenses.** Non-interest expenses increased \$56,000, or 1.7%, to \$3.3 million for the three months ended September 30, 2015 when compared with the three months ended September 30, 2014. This increase was primarily due to a \$62,000 increase in data processing expenses associated with the implementation of updated banking systems during 2015. Occupancy and equipment expenses increased \$30,000 for the three months ended September 30, 2015 due to increased depreciation expense related to the implementation of updated banking systems compared to the three months ended September 30, 2014. Other expenses increased \$21,000, or 7.5%, for the three months ended September 30, 2015 compared to the three months ended September 30, 2014, primarily due to higher expenses related to foreclosed properties and properties in the process of foreclosure. Professional services decreased \$63,000, or 21.1%, primarily due to lower consulting expenses for the three months ended September 30, 2015 compared to the three months ended September 30, 2014.

**Income Tax Expense.** Income tax expense increased by \$154,000, or 141.3%, from \$109,000 for the three months ended September 30, 2014 to \$263,000 for the three months ended September 30, 2015. The increase in income tax expense was primarily due to an increase in income during the three months ended September 30, 2015. The increase was partially offset by recent reforms in New York State corporate tax law which merged the bank and corporate franchise tax laws. Beginning in 2015, the most significant change in the tax laws for the Company was a deduction that allows it a subtraction for half of the net interest income received from qualifying loans. This change effectively eliminated the Company's New York State tax on income resulting in it being taxed on its apportioned capital. The effective tax rate was 17.5% for the three months ended September 30, 2015 compared to 13.7% for the three months ended September 30, 2014. The increase in the effective tax rate was primarily due to our projected mix of tax-exempt income derived from the Company's municipal bond portfolio and bank-owned life insurance related to our higher projection of pre-tax income for the current year.

#### Comparison of Results of Operations for the Nine Months Ended September 30, 2015 and 2014

**General.** Net income was \$2.5 million for the nine month period ended September 30, 2015, or \$0.42 per diluted share, an increase of \$142,000, or 6.0%, compared to net income of \$2.4 million, or \$0.41 per diluted share, for the nine month period ended September 30, 2014. The increase in net income was primarily due to a \$428,000 increase in non-interest income and a \$117,000 increase in net interest income, partially offset by a \$170,000 increase in the provision for loan losses, a \$118,000 increase in non-interest expenses and a \$115,000 increase in income tax expense.

**Interest Income.** Interest income decreased by \$226,000, or 1.7%, to \$13.2 million for the nine month period ended September 30, 2015 compared to the nine month period ended September 30, 2014 primarily due to a decrease in investment interest income. Investment interest income decreased by \$523,000, or 15.1%, from \$3.5 million for the nine month period ended September 30, 2014 compared to \$3.0 million for the nine month period ended September 30, 2015. The average balance in the investment portfolio decreased from \$152.1 million for the nine months ended



September 30, 2014 to \$133.2 million for the nine months ended September 30, 2015. The decrease in the average balance of the investment portfolio was partially due to the Company's strategy to reinvest paydowns received on the securities portfolio and proceeds from the \$9.4 million sale of securities during the first nine months of 2015 into loan originations and shorter term cash and cash equivalents in order to be in a better position to take advantage of future shifts in market interest rates. The sale of securities has allowed the Bank to shorten the duration of its assets and limit its interest rate risk. The average yield on the investment portfolio decreased by 9 basis points from 3.04% for the nine month period ended September 30, 2014 to 2.95% for the nine month period ended September 30, 2015, as a result of the declining portfolio balance of higher yielding securities. Loan interest income increased by \$291,000, or 2.9%, to \$10.3 million for the nine month period ended September 30, 2015 compared to the nine month period

ended September 30, 2014, primarily due to an increase in the average balance of the loan portfolio from \$275.3 million for the nine month period ended September 30, 2014 to \$291.1 million for the nine month period ended September 30, 2015. The increase in the average balance of the loan portfolio was primarily due to increases in the average balances of commercial real estate loans, commercial loans and home equity loans partially offset by a decrease in the average balance of residential mortgages. The average yield on the loan portfolio decreased 13 basis points from 4.83% for the nine months ended September 30, 2014 to 4.70% for the nine months ended September 30, 2015. The average yield on the loan portfolio decreased as new loans were originated or existing loans were refinanced at lower yields than the rates earned on loans which had paid off or on loans remaining in the portfolio, as a result of the current low interest rate environment.

**Interest Expense.** Interest expense decreased by \$343,000, or 13.7%, to \$2.2 million for the nine month period ended September 30, 2015 compared to \$2.5 million for the nine month period ended September 30, 2014. The interest paid on deposits decreased by \$435,000, or 19.5%, to \$1.8 million for the nine month period ended September 30, 2015 when compared to the nine month period ended September 30, 2014, primarily due to the decrease in the average rate paid on deposits and a shift in the deposit mix, resulting in a larger percentage of the deposit portfolio consisting of low cost core deposits. The average balance of deposits for the nine month period ended September 30, 2015 was \$339.6 million with an average rate of 0.70% compared to the average balance of deposits of \$355.6 million and an average rate of 0.84% for the nine month period ended September 30, 2014. The decrease in the average balance of deposits was primarily due to a decrease in time deposits as customers have sought higher yields elsewhere. The decrease in the average rate paid on deposits was due to the continued low interest rate environment during the first nine months of 2015 and due to the shift in the deposit mix. The interest expense related to advances from the FHLB NY increased \$94,000, or 46.5%, to \$296,000 for the nine month period ended September 30, 2015 when compared to the nine month period ended September 30, 2014. The increase in the average rate paid on FHLB NY advances from 1.40% for the nine month period ended September 30, 2014 to 2.06% for the nine month period ended September 30, 2015 was primarily due to the refinancing of short-term borrowings into long-term debt during 2014 to lock in low long-term fixed rates and manage interest rate risk. The average balance in advances from FHLB NY decreased \$100,000 from \$19.3 million for the nine month period ended September 30, 2014 to \$19.2 million for the nine month period ended September 30, 2015.

**Provision for Loan Losses.** A provision to the allowance for loan losses of \$240,000 was recorded during the nine month period ended September 30, 2015, which was a \$170,000 increase in comparison to the provision recorded during the nine month period ended September 30, 2014. Net charge-offs were \$64,000 for the nine months ended September 30, 2015 compared to net charge-offs of \$80,000 for the nine month period ended September 30, 2014. Our non-performing loans were \$5.5 million, or 1.87% of total loans, at September 30, 2015 as compared to \$5.4 million, or 1.97% of total loans, at September 30, 2014.

During the nine month period ended September 30, 2015, the Company recorded a \$168,000 provision for loan losses on commercial real estate loans and a \$43,000 provision for loan losses on commercial loans, primarily due to an increase in loan originations during the nine month period ended September 30, 2015. The Company recorded a \$27,000 provision for loan losses on consumer loans to reflect net charge-offs recorded during the nine month period ended September 30, 2015. The provision for loan losses was offset by a \$30,000 credit for loan losses on one- to four-family loans during the nine month period ended September 30, 2015, primarily due to a review of the historical losses relating to these types of loans. The Company determined an adjustment was necessary due to a decrease in the historical average net charge-off rate on residential mortgages for the last five years. This decrease was also partially due to a decrease in classified one- to four-family loans and unclassified loan balances during the nine month period ended September 30, 2015. During the nine month period ended September 30, 2015, the Company recorded an unallocated provision for loan losses of \$28,000. This unallocated provision reflects the margin of imprecision

inherent in the underlying assumptions used in the methodologies for estimating allocated and general losses in the portfolio.

During the nine months ended September 30, 2014, the Company recorded a \$132,000 provision for loan losses on one- to four-family and home equity loans primarily due to changes in the related environmental factors used to qualitatively assess inherent losses in the loan portfolio and an increase in classified loan balances. During the nine months ended September 30, 2014, the Company recorded a \$32,000 provision for loan losses on consumer loans related to net charge-offs. The provision for loan losses was partially offset by a

\$60,000 credit for loan losses on commercial real estate loans during the nine months ended September 30, 2014, primarily due to changes in the environmental factors used to qualitatively assess inherent losses. The environmental change was specifically related to a decrease in the historical average of net charge-offs on these types of loans. The decrease was also attributed to a decrease in the outstanding balance of commercial real estate loans during the nine month period ended September 30, 2014. During the nine month period ended September 30, 2014, the Company recorded an unallocated credit for loan losses of \$41,000. This unallocated credit reflects the margin of imprecision inherent in the underlying assumptions used in the methodologies for estimating allocated and general losses in the portfolio.

**Non-interest Income.** Non-interest income increased \$428,000, or 25.5%, from \$1.7 million for the nine months ended September 30, 2014 to \$2.1 million for the nine months ended September 30, 2015. The increase was primarily due to a \$381,000 increase in the net gain on sale of securities during the nine months ended September 30, 2015. The Company sold \$9.4 million of available for sale securities during the first nine months of 2015 in comparison to a \$4.3 million sale of securities in the same 2014 period. During the nine months ended September 30, 2015, the Company recorded a net gain on the sale of loans of \$73,000, while the net gain on the sale of loans was \$5,000 during the same nine months in 2014. Service fee income declined \$18,000 during the nine months ended September 30, 2015 when compared with the nine months ended September 30, 2014.

**Non-interest Expense.** Non-interest expense increased by \$118,000, or 1.2%, to \$9.8 million for the nine month period ended September 30, 2015 compared to the nine month period ended September 30, 2014. Salaries and employee benefits expense increased \$214,000, or 4.3%, for the nine month period ended September 30, 2015 compared to the nine month period ended September 30, 2014. This increase was primarily due to annual salary increases, the hiring of an executive vice president for commercial lending in August 2014 and additional expense for stock grants awarded during 2014 and the nine months ended September 30, 2015. Data processing expenses increased \$187,000, or 32.3%, to \$766,000 for the nine months ended September 30, 2015 compared to \$579,000 for the nine months ended September 30, 2014, primarily due to the costs associated with the implementation of new mobile banking, online banking and loan origination technology and related software. Professional services decreased \$218,000, or 22.8%, during the nine month period ended September 30, 2015 as compared with the same period in 2014 primarily due to lower consulting costs. Advertising expenses decreased \$52,000, or 14.7%, during the nine month period ended September 30, 2015 as compared with the same period in 2014 primarily due to higher costs in the 2014 period related to the development of a new marketing campaign. Other expenses decreased \$77,000, or 9.2%, for the nine month period ended September 30, 2015 compared to the nine month period ended September 30, 2014, primarily due to an increase in net gains on the sale of foreclosed properties in the first nine months of 2015.

**Income Tax Expense.** Income tax expense increased by \$115,000, or 23.6%, from \$487,000 for the nine month period ended September 30, 2014 to \$602,000 for the nine month period ended September 30, 2015. The increase in income tax expense was primarily due to an increase in income during the nine months ended September 30, 2015, partially offset by the change in New York State corporate tax law. The increase in income tax expense was also partially due to a one-time tax expense of \$79,000 to record a deferred tax valuation allowance during the nine month period ended September 30, 2015. The valuation allowance was based on management's belief that it is more likely than not that the Company will not realize its state deferred tax assets. Because of the change in New York State corporate tax law, the Company will not generate sufficient taxable income within New York State to realize its state deferred tax assets. As a result of the one-time tax expense, our effective tax rate increased to 19.4% for the nine month period ended September 30, 2015, compared to 17.1% for the nine month period ended September 30, 2014. Without the one-time tax effect for 2015, our effective tax rate would have decreased to 16.8% for the nine month period ended September

30, 2015, primarily resulting from the reform in New York State corporate tax law and our projected mix of tax-exempt income derived from our municipal bond portfolio and bank-owned life insurance related to our projection of pre-tax income for the year.

## 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 fund loan commitments, to pay the deposit withdrawal requirements of our customers as well as to fund current and planned expenditures. Our primary sources of funds consist of deposits, fed funds balances, scheduled amortization and prepayments of loans and securities, maturities and sales of investments and loans, interest earning deposits at other financial institutions and funds provided from operations. We have a written agreement with the Federal Home Loan Bank of New York, which allows us to borrow up to \$113.8 million as of September 30, 2015, and is collateralized by a pledge of certain fixed-rate residential, one- to four-family real estate loans. At September 30, 2015, we had outstanding advances under this agreement of \$19.0 million. We have a written agreement with the Federal Reserve Bank discount window for overnight borrowings which is collateralized by a pledge of our securities, and allows us to borrow up to the value of the securities pledged, which was equal to a book value of \$11.1 million and a fair value of \$11.7 million as of September 30, 2015. There were no balances outstanding with the Federal Reserve Bank at September 30, 2015. We have also established lines of credits with correspondent banks for \$22.0 million, of which \$20.0 million is unsecured and the remaining \$2.0 million will be secured by a pledge of our securities when a draw is made. There were no borrowings on these lines as of September 30, 2015.

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

Our primary investing activities include the origination of loans and the purchase of investment securities. For the nine months ended September 30, 2015, we originated loans of approximately \$51.0 million in comparison to approximately \$31.7 million of loans originated during the nine months ended September 30, 2014. We did not purchase any investment securities during the nine months ended September 30, 2015 or 2014.

At September 30, 2015, we had loan commitments to borrowers of approximately \$10.6 million and overdraft lines of protection and unused home equity lines of credit of approximately \$30.8 million. Total deposits were \$371.9 million at September 30, 2015, as compared to \$389.5 million at September 30, 2014. Time deposit accounts scheduled to mature within one year were \$87.8 million at September 30, 2015. 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.

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.

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

We do not anticipate any material capital expenditures during the remainder of 2015. We do not have any balloon or other payments due on any long-term obligations or any off-balance sheet items other than loan commitments as described in Note 6 in the Notes to our Consolidated Financial Statements and the borrowing agreements noted above.

## Capital

As of January 1, 2015, new regulations that substantially amended the capital regulations became applicable to us. These regulations implement the Basel III regulatory capital reforms and changes required by the Dodd-Frank Act, as discussed in the “Supervision and Regulation – Federal Banking Regulation – Capital Requirements” section included in our Annual Report on Form 10-K for the year ended December 31, 2014.

Effective January 1, 2015, the Bank became subject to new capital requirements adopted by the OCC. These new requirements created a new required ratio for common equity Tier 1 (“CET1”) capital, increased the Tier 1 capital ratio requirements, changed the risk weight of certain assets for purposes of the risk-based capital ratios, created an additional capital conservation buffer over the required capital ratios and changed what qualifies as capital for purposes of meeting these various capital requirements. Beginning in 2016, failure to maintain the required capital conservation buffer will limit the ability of the Bank to pay dividends, repurchase shares or pay discretionary bonuses. The Company is exempt from consolidated capital requirements as those requirements do not apply to certain small savings and loan companies or bank holding companies with assets under \$1 billion.

Under the new capital regulations, the minimum capital ratios are: (1) CET1 capital ratio of 4.5% of risk-weighted assets; (2) a Tier 1 capital ratio of 6.0% of risk-weighted assets; (3) a total capital ratio of 8% of risk-weighted assets; and (4) a leverage ratio of 4.0%. CET1 generally consists of common stock and retained earnings, subject to applicable regulatory adjustments and deductions.

There are a number of changes in what constitutes regulatory capital, some of which are subject to transition periods. These changes include the phasing-out of certain instruments as qualifying capital. The Bank does not use any of these instruments. Under the new requirements for total capital, Tier 2 capital is no longer limited to the amount of Tier 1 capital included in total capital. Mortgage servicing rights, certain deferred tax assets and investments in unconsolidated subsidiaries over designated percentages of CET1 will be deducted from capital. The Bank has elected to permanently opt-out of the inclusion of accumulated other comprehensive income in our capital calculations, as permitted by the regulations. This opt-out will reduce the impact of market volatility on our regulatory capital levels.

The new requirements also include changes in the risk-weights of assets to better reflect credit risk and other risk exposures. These include a 150% risk weight (increased from 100%) for certain high volatility commercial real estate acquisitions, development and construction loans and for non-residential mortgage loans that are 90 days past due or otherwise in non-accrual status; a 20% (increased from 0%) credit conversion factor for the unused portion of a commitment with an original maturity of one year or less that is not unconditionally cancellable; a 250% risk weight (increased from 100%) for mortgage servicing and deferred tax assets that are not deducted from capital; and increased risk weights (0% to 600%) for equity exposures.

In addition to the minimum CET1, Tier 1 and total capital ratios, the Bank will have to maintain a capital conservation buffer consisting of additional CET1 capital greater than 2.5% of risk-weighted assets above the required minimum levels in order to avoid limitations on paying dividends, engaging in share repurchases, and paying discretionary bonuses based on percentages of eligible retained income that could be utilized for such actions. This new capital conservation buffer requirement will be phased in beginning in January 2016 at 0.625% of risk-weighted assets and increasing each year until fully implemented in January 2019.

The OCC’s prompt corrective action standards changed effective January 1, 2015. Under the new standards, in order to be considered well-capitalized, the Bank must have a CET1 ratio of 6.5% (new), a Tier 1 ratio of 8.0% (increased from 6.0%), a total risk-based capital ratio of 10.0% (unchanged) and a leverage ratio of 5.0% (unchanged). The Bank meets all of the new requirements, including the full capital conservation buffer that will be required by January 2019.





Edgar Filing: LAKE SHORE BANCORP, INC. - Form 10-Q

The Bank's actual capital amounts and ratios and those required by the regulatory standards in effect as of the dates presented are as follows:

	Actual	Minimum For Capital Adequacy Purposes	To Be Well Capitalized Under Prompt Corrective Action Provisions
At September 30, 2015			
CETI capital (to risk-weighted assets)	24.34 %	>= 4.50 %	>= 6.50 %
Tier 1 capital (to risk-weighted assets)	24.34 %	>= 6.00 %	>= 8.00 %
Total capital (to risk-weighted assets)	25.12 %	>= 8.00 %	>= 10.00 %
Tier 1 Leverage (to adjusted total assets)	13.94 %	>= 4.00 %	>= 5.00 %
			To Be Well Capitalized Under Prompt Corrective Action Provisions
At December 31, 2014			
CETI capital (to risk-weighted assets)	n/a	>= n/a	>= n/a
Tier 1 capital (to risk-weighted assets)	24.95 %	>= 4.00 %	>= 6.00 %
Total capital (to risk-weighted assets)	25.71 %	>= 8.00 %	>= 10.00 %
Tier 1 Leverage (to adjusted total assets)	13.16 %	>= 4.00 %	>= 5.00 %

#### Off-Balance Sheet Arrangements

Other than loan commitments, we do not have any off-balance sheet arrangements that have or are reasonably likely to have a current or future effect on our financial condition, revenues or expenses, results of operations, liquidity, capital expenditures, or capital resources that is material to investors. Refer to Note 6 in the Notes to our Consolidated Financial Statements for a summary of commitments outstanding as of September 30, 2015.

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

Not applicable as the Company is a smaller reporting company.

#### Item 4. Controls and Procedures.

Disclosure Controls and Procedures

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

#### Changes in Internal Control over Financial Reporting

There have not been any changes in the Company's internal control over financial reporting (as such term is defined in Rules 13a-15(f) and 15d-15(f) under the Securities Exchange Act of 1934) during the quarter ended September 30, 2015 that have materially affected, or are reasonably likely to materially affect, internal control over financial reporting.

## PART II

### Item 1A. Risk Factors.

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

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

The following table reports information regarding repurchases by Lake Shore Bancorp of its common stock in each month of the quarter ended September 30, 2015:

## COMPANY PURCHASES OF EQUITY SECURITIES

Period	Total Number of Shares Purchased	Average Price Paid per Share	Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs	Maximum Number of Shares that May Yet be Purchased Under the Plans or Programs (1)
July 1 through July 31, 2015	-	\$ -	-	16,510
August 1 through August 31, 2015	-	-	-	16,510
September 1 through September 30, 2015	-	-	-	16,510
Total	-	\$ -	-	16,510

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

## Item 6. Exhibits

- 31.1 Certification by the Chief Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley

31.2 Act of 2002\*  
 Certification by  
 the Chief  
 Financial Officer  
 Pursuant to  
 Section 302 of  
 the Sarbanes-  
 Oxley Act of  
 2002\*

32.1 Certification by  
 the Chief  
 Executive  
 Officer Pursuant  
 to 18 U.S.C.  
 Section 1350, as  
 Adopted  
 Pursuant to  
 Section 906 of  
 the  
 Sarbanes-Oxley  
 Act of 2002\*

32.2 Certification by  
 the Chief  
 Financial Officer  
 Pursuant to 18  
 U.S.C. Section  
 1350, as  
 Adopted  
 Pursuant to  
 Section 906 of  
 the  
 Sarbanes-Oxley  
 Act of 2002\*

101.INS XBRL Instance  
 Document\*

101.SCH XBRL  
 Taxonomy  
 Extension  
 Schema  
 Document\*

101.CAL XBRL  
 Taxonomy  
 Calculation  
 Linkbase  
 Document\*

101.DEF XBRL  
 Taxonomy  
 Extension  
 Definition  
 Linkbase  
 Document\*

101.LAB XBRL  
Taxonomy Label  
Linkbase  
Document\*

101.PRE XBRL  
Taxonomy  
Presentation  
Linkbase  
Document\*

---

\*Filed herewith.

SIGNATURES

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

LAKE SHORE BANCORP, INC.  
(Registrant)

November 12, 2015 By: /s/ Daniel P. Reininga  
Daniel P. Reininga  
President and Chief Executive Officer  
(Principal Executive Officer)

November 12, 2015 By: /s/ Rachel A. Foley  
Rachel A. Foley  
Chief Financial Officer  
(Principal Financial and Accounting Officer)