Lake Shore Bancorp, Inc.
Form 10-Q
August 14, 2009

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
FORM 10-Q

(Mark One)

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

For the quarterly period ended June 30, 2009

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

Commission file number: 000-51821

LAKE SHORE BANCORP, INC.

(Exact name of registrant as specified in its character)

United States	20-4729288
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification Number)
125 East Fourth Street, Dunkirk, New York	14048
(Address of principal executive offices)	(Zip code)

(716) 366-4070

(Registrant s telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months, and (2) has been subject to such filing requirements for the past 90 days.

Yes x No o

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 o No o

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 o Accelerated filer o

Non-accelerated file o (Do not check if a smaller reporting company) Smaller reporting company x

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

Yes o No x

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

Common stock ($0.01 par value) 6,189,814 shares outstanding as of July 31, 2009.

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PART I

Item 1. Financial Statements
LAKE SHORE BANCORP, INC. and SUBSIDIARY
CONSOLIDATED STATEMENTS OF FINANCIAL CONDITION

	June 30, 2009	December 31, 2008
	(Unaudited) (Dollars in thousands)	
ASSETS		
Cash and due from banks	**$ 7,185**	$ 6,784
Interest bearing deposits	**6,768**	4,671
Federal funds sold	**9,119**	17,583
Cash and Cash Equivalents	**23,072**	29,038
Securities available for sale	**118,583**	112,863
Federal Home Loan Bank stock, at cost	**2,737**	2,890
Loans receivable, net of allowance for loan losses 2009 $1,556; 2008 $1,476	**251,970**	240,463
Premises and equipment, net	**8,012**	8,195
Accrued interest receivable	**1,631**	1,730
Bank owned life insurance	**10,700**	10,566
Other assets	**1,736**	2,088
Total Assets	**$ 418,441**	$ 407,833
LIABILITIES AND STOCKHOLDERS EQUITY		
LIABILITIES		
Deposits:		
Interest bearing	**$ 288,443**	$ 267,437
Non-interest bearing	**19,834**	25,811
Total Deposits	**308,277**	293,248
Short-term borrowings	**3,450**	5,500
Long-term debt	**44,020**	46,460
Advances from borrowers for taxes and insurance	**2,856**	2,968
Other liabilities	**5,788**	5,429
Total Liabilities	**364,391**	353,605
COMMITMENTS AND CONTINGENCIES		
STOCKHOLDERS EQUITY		
Common stock, $0.01 par value per share, 25,000,000 shares authorized; 6,612,500 shares issued and 6,194,814 outstanding at June 30, 2009 and 6,612,500 shares issued and 6,257,798 outstanding at December 31, 2008	**66**	66
Additional paid-in capital	**27,794**	27,754
Treasury stock, at cost (417,686 shares at June 30, 2009 and 354,702 at December 31, 2008)	**(4,186)**	(3,748)
Unearned shares held by ESOP	**(2,259)**	(2,302)

Unearned shares held by RRP	**(1,090)**	(1,190)
Retained earnings	**33,064**	32,520
Accumulated other comprehensive income	**661**	1,128
Total Stockholders Equity	**54,050**	54,228
Total Liabilities and Stockholders Equity	**$ 418,441**	$ 407,833

See notes to consolidated financial statements.

LAKE SHORE BANCORP, INC. and SUBSIDIARY
CONSOLIDATED STATEMENTS OF INCOME

	Three Months Ended June 30, 2009	Three Months Ended June 30, 2008	Six Months Ended June 30, 2009	Six Months Ended June 30, 2008
	(Unaudited) (Dollars in Thousands, except per share data)			
INTEREST INCOME				
Loans, including fees	**$ 3,499**	$ 3,214	**$ 6,965**	$ 6,962
Investment securities, taxable	**1,198**	1,185	**2,399**	2,321
Investment securities, tax-exempt	**185**	122	**356**	235
Other	**26**	85	**56**	129
Total Interest Income	**4,908**	4,606	**9,776**	9,647
INTEREST EXPENSE				
Deposits	**1,586**	1,632	**3,165**	3,277
Short-term borrowings	**11**	48	**35**	182
Long-term debt	**446**	491	**895**	961
Other	**28**	30	**57**	60
Total Interest Expense	**2,071**	2,201	**4,152**	4,480
Net Interest Income	**2,837**	2,405	**5,624**	5,167
PROVISION FOR LOAN LOSSES	**40**	150	**160**	150
Net Interest Income after Provision for Loan Losses	**2,797**	2,255	**5,464**	5,017
NON-INTEREST INCOME				
Impairment charge on investment securities		(1,732)		(1,732)
Service charges and fees	**483**	519	**935**	967
Earnings on bank owned life insurance	**67**	101	**134**	204
Gain on sale of loans	**27**		**27**	
Other	**23**	27	**49**	66
Total Non-Interest Income (Loss)	**600**	(1,085)	**1,145**	(495)
NON-INTEREST EXPENSES				
Salaries and employee benefits	**1,342**	1,192	**2,727**	2,540
Occupancy and equipment	**342**	354	**715**	695
Professional services	**307**	309	**588**	596
FDIC insurance	**440**	7	**488**	14
Data processing	**120**	141	**253**	277
Advertising	**124**	84	**178**	186
Postage and supplies	**67**	61	**141**	128
Other	**224**	184	**553**	384
Total Non-Interest Expenses	**2,966**	2,332	**5,643**	4,820
Income (Loss) before Income Taxes	**431**	(1,162)	**966**	(298)

Income Taxes		**77**		(236)		**207**		(30)
Net Income (Loss)	**$**	**354**	$	(926)	**$**	**759**	$	(268)
Basic earnings (loss) per common share	**$**	**0.06**	$	(0.15)	**$**	**0.13**	$	(0.04)
Diluted earnings (loss) per common share	**$**	**0.06**	$	(0.15)	**$**	**0.13**	$	(0.04)
Dividends declared per share	**$**	**0.05**	$	0.05	**$**	**0.10**	$	0.09

See notes to consolidated financial statements.

LAKE SHORE BANCORP, INC. and SUBSIDIARY
CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS EQUITY
Six Months Ended June 30, 2009 and 2008 (Unaudited)

	Common Stock	Additional Paid-in Capital	Treasury Stock	Unearned Shares held by ESOP	Unearned Shares held by RRP	Retained Earnings	Accumulated Other Comprehensive Income	Total
	(Dollars in thousands, except per share data)							
BALANCE JANUARY 1, 2008	$ 66	$ 27,653	$ (2,215)	$ (2,388)	$ (1,367)	$ 31,534	$ 182	$ 53,465
Comprehensive loss:								
Net loss						(268)		(268)
Other comprehensive loss							(24)	(24)
TOTAL COMPREHENSIVE LOSS								(292)
ESOP shares earned (3,968 shares)		(5)		43				38
Stock based compensation		69						69
RRP shares earned (6,599 shares)		(12)			88			76
Purchase of treasury stock, at cost (55,973 shares)			(559)					(559)
Cash dividends declared ($0.09 per share)						(240)		(240)
BALANCE JUNE 30, 2008	$ 66	$ 27,705	$ (2,774)	$ (2,345)	$ (1,279)	$ 31,026	$ 158	$ 52,557
BALANCE JANUARY 1, 2009	$ 66	$ 27,754	$ (3,748)	$ (2,302)	$ (1,190)	$ 32,520	$ 1,128	$ 54,228
Cumulative effect of FSP FAS 115-2 and FAS 124-2 adoption (net of $4,000 tax effect)						8	(8)	
Comprehensive income:								
Net income						759		759
Other comprehensive loss							(459)	(459)
TOTAL COMPREHENSIVE INCOME								300
ESOP shares earned (3,968 shares)		(17)		43				26
Stock based compensation		74						74
RRP shares earned (7,504 shares)		(17)			100			83
Purchase of treasury stock, at cost (62,984 shares)			(438)					(438)
Cash dividends declared ($0.10 per share)						(223)		(223)
BALANCE JUNE 30, 2009	**$ 66**	**$ 27,794**	**$ (4,186)**	**$ (2,259)**	**$ (1,090)**	**$ 33,064**	**$ 661**	**$ 54,050**

See notes to consolidated financial statements.

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

	Six Months Ended June 30, 2009	Six Months Ended June 30, 2008
	(Unaudited) (Dollars in thousands)	
Cash Flows from Operating Activities		
Net income (loss)	**$ 759**	$ (268)
Adjustments to reconcile net income (loss) to net cash provided by operating activities:		
Net accretion of investment securities	**(139)**	(58)
Amortization of deferred loan costs	**223**	223
Provision for loan losses	**160**	150
Impairment of investment securities		1,732
Increase in fair value of interest rate floor derivative product		(64)
Loss on sale of interest rate floor derivative product	**135**	
Originations of loans held for sale	**(6,201)**	(405)
Proceeds from sales of loans	**6,228**	407
Gain on sale of loans	**(27)**	
Depreciation and amortization	**271**	266
Earnings on bank owned life insurance	**(134)**	(204)
ESOP shares committed to be released	**26**	38
Stock based compensation expense	**157**	145
Decrease (increase) in accrued interest receivable	**99**	(53)
Increase in other assets	**(158)**	(803)
Increase in other liabilities	**546**	1,002
Net Cash Provided by Operating Activities	**1,945**	2,108
Cash Flows from Investing Activities		
Activity in available for sale securities:		
Maturities, prepayments and calls	**18,162**	9,837
Purchases	**(24,672)**	(13,298)
Purchases of Federal Home Loan Bank Stock	**(49)**	(749)
Redemptions of Federal Home Loan Bank Stock	**202**	796
Proceeds from sale of interest rate floor derivative product	**890**	
Loan origination and principal collections, net	**(12,122)**	(9,897)
Additions to premises and equipment	**(88)**	(258)
Investment in unconsolidated entity		(150)
Net Cash Used In Investing Activities	**(17,677)**	(13,719)
Cash Flows from Financing Activities		
Net increase in deposits	**15,029**	29,904
Net increase (decrease) in advances from borrowers for taxes and insurance	**(112)**	44
Net decrease in short-term borrowings	**(2,050)**	(14,450)
Proceeds from issuance of long-term debt	**1,000**	18,900
Repayment of long-term debt	**(3,440)**	(5,740)
Purchase of Treasury Stock	**(438)**	(559)
Cash dividends paid	**(223)**	(240)
Net Cash Provided by Financing Activities	**9,766**	27,859

Net Increase (Decrease) in Cash and Cash Equivalents	**(5,966)**	16,248
CASH AND CASH EQUIVALENTS BEGINNING	**29,038**	10,091
CASH AND CASH EQUIVALENTS ENDING	**$ 23,072**	$ 26,339
SUPPLEMENTARY CASH FLOWS INFORMATION		
Interest paid	**$ 4,178**	$ 4,496
Income taxes paid	**$ 431**	$ 143
SUPPLEMENTARY SCHEDULE OF NONCASH INVESTING AND FINANCING ACTIVITIES		
Foreclosed real estate acquired in settlement of loans	**$ 305**	$ 422

See notes to consolidated financial statements.

LAKE SHORE BANCORP, INC. AND SUBSIDIARY
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

NOTE 1 NATURE OF OPERATIONS AND BASIS OF PRESENTATION

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

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

The interim financial statements included herein as of June 30, 2009 and for the three and six months ended June 30, 2009 and 2008 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 financial condition, results of operations and cash flows in conformity with accounting principles generally accepted in the United States of America (GAAP). The balance sheet at December 31, 2008 has been derived from the audited financial statements at that date, but does not include all of the information and footnotes required by GAAP for complete financial statements. The consolidated financial statements reflect all adjustments that are, in the opinion of management, necessary for a fair statement of such information. These interim consolidated financial statements should be read in conjunction with the consolidated financial statements and notes thereto included in the audited consolidated financial statements included in the Company s Form 10-K for the year ended December 31, 2008. The results of operations for the three and six months ended June 30, 2009 are not necessarily indicative of the results for any subsequent period or the entire year ending December 31, 2009.

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, and income taxes.

In May 2009, the FASB issued FASB Statement No. 165, *Subsequent Events* (SFAS No. 165). SFAS No. 165 establishes general standards of accounting for and disclosure of events that occur after the balance sheet date but before financial statements are issued. The Company adopted this statement for the quarter ending June 30, 2009. The Company evaluated events occurring subsequent to June 30, 2009 through August 14, 2009, the date the financial statements are being issued, and other than as set forth in Note 12, did not identify any subsequent events requiring disclosure pursuant to the provisions of SFAS No. 165.

NOTE 2 DERIVATIVE INSTRUMENTS

In August 2006, the Company entered into a derivative contract as part of its risk management strategy to protect against market fluctuations in interest rates. An interest rate floor was purchased for $221,000 to protect against a decline in the prime rate earned on a $10 million notional amount of home equity adjustable rate loans within our loan portfolio. The term of the interest rate floor product was 60 months. The Company followed Statement of Financial Accounting Standards (SFAS) No. 133, *Accounting for Derivative Instruments and Hedging Activities*, as amended, to account for this transaction. SFAS No. 133 requires an entity to recognize all derivatives as either assets or liabilities on the balance sheet and measure those instruments at fair value. Changes in the fair value of derivatives must be recognized in

NOTE 2 DERIVATIVE INSTRUMENTS (continued)

earnings when they occur, unless the derivatives qualify as a hedge. If a derivative qualifies as a hedge, a company can elect to use hedge accounting to eliminate or reduce income statement volatility that would arise from reporting changes in a derivative s fair value in income. The Company did not elect to use hedge accounting for this transaction. The interest rate floor was recorded in Other Assets on the Consolidated Statements of Condition and the change in fair value was recorded in Loan Interest Income on the Consolidated Statements of Income. On January 30, 2009, the Company sold the interest rate floor. From August 2006 through January 2009, the Company had recorded cumulative earnings of $346,000 in interest income and a cumulative increase in fair market value of $669,000, resulting in additional cash flow for the Company of $1.0 million. When the product was sold on January 30, 2009 for $890,000, a pretax loss on the sale was recorded, as the fair market value of the product which was recorded in Other Assets on December 31, 2008 had declined by $135,000. The loss on sale was recorded in the Other Non-Interest Expense section on the Consolidated Statements of Income. The decision to sell the interest rate floor product was made due to management s determination that the value of the product had reached its peak based on an evaluation of estimated prime rate changes in the future. During the three month period ended June 30, 2008, interest income received on the interest rate floor was $110,000. The decline in the fair market value of the interest rate floor was $262,000 during the same period, which was recorded as interest expense. During the six month period ended June 30, 2009 and 2008, the Company received $43,000 and $129,000, respectively, of interest income on the interest rate floor. The Company recorded an increase of $64,000 in fair market value in interest income during the six months ended June 30, 2008.

NOTE 3 ADOPTION OF NEW ACCOUNTING STANDARDS

The Company adopted Financial Accounting Standards Board Staff Position (FSP) Financial Accounting Standard (FAS) 157-4, *Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly* (FSP FAS 157-4) effective June 30, 2009. Financial Accounting Standards Board (FASB) Statement 157, *Fair Value Measurements,* defines fair value as the price that would be received to sell the asset or transfer the liability in an orderly transaction (that is, not a forced liquidation or distressed sale) between market participants at the measurement date under current market conditions. FSP FAS 157-4 provides additional guidance on determining when the volume and level of activity for the asset or liability has significantly decreased. FSP FAS 157-4 also includes guidance on identifying circumstances when a transaction may not be considered orderly. FSP FAS 157-4 provides a list of factors that a reporting entity should evaluate to determine whether there has been a significant decrease in the volume and level of activity for the asset or liability in relation to normal market activity for the asset or liability. When the reporting entity concludes there has been a significant decrease in the volume and level of activity for the asset or liability, further analysis of the information from that market is needed and significant adjustments to the related prices may be necessary to estimate fair value in accordance with SFAS 157. This FSP clarifies that when there has been a significant decrease in the volume and level of activity for the asset or liability, some transactions may not be orderly. In those situations, the entity must evaluate the weight of the evidence to determine whether the transaction is orderly. FSP FAS 157-4 provides a list of circumstances that may indicate that a transaction is not orderly. A transaction price that is not associated with an orderly transaction is given little, if any, weight when estimating fair value. The primary impact of FSP FAS 157-4 on the Company was to expand required disclosures pertaining to the methods used to determine fair values. See Note 10 for further details.

The Company adopted FSP FAS 115-2 and FAS 124-2, *Recognition and Presentation of Other-Than-Temporary Impairments* (FSP FAS 115-2 and FAS 124-2) effective June 30, 2009. FSP FAS 115-2 and FAS 124-2 clarifies the interaction of the factors that should be considered when determining whether a debt security is other-than-temporarily impaired. For debt securities, management must assess whether (a) it has the intent to sell the security and (b) it is more likely than not that it will be required to sell the security prior to its anticipated recovery. These steps are done before assessing whether the entity

NOTE 3 ADOPTION OF NEW ACCOUNTING STANDARDS (continued)

will recover the cost basis of the investment. Previously, this assessment required management to assert it has both the intent and the ability to hold a security for a period of time sufficient to allow for an anticipated recovery in fair value to avoid recognizing an other-than-temporary impairment (OTTI). This change does not affect the need to forecast recovery of the value of the security through either cash flows or market price. In instances when a determination is made that an other-than-temporary impairment exists but the investor does not intend to sell the debt security and it is not more likely than not that it will be required to sell the debt security prior to its anticipated recovery, FSP FAS 115-2 and FAS 124-2 changes the presentation and amount of the other-than-temporary impairment recognized in the income statement. The other-than-temporary impairment is separated into (a) the amount of the total other-than-temporary impairment related to a decrease in cash flows expected to be collected from the debt security (the credit loss) and (b) the amount of the total other-than-temporary impairment related to all other factors. The amount of the total other-than-temporary impairment related to the credit loss is recognized in earnings. The amount of the total other-than-temporary impairment related to all other factors is recognized in other comprehensive income. The adoption of FSP FAS 115-2 and FAS 124-2 did not have a material impact on the financial condition of the Company. See the Consolidated Statements of Changes in Stockholders Equity and Notes 6 and 10 for further details.

The Company adopted FSP No. FAS 107-1 and APB 28-1, *Interim Disclosures about Fair Value of Financial Instruments* (FSP FAS 107-1 and APB 28-1) effective June 30, 2009. FSP FAS 107-1 and APB 28-1 amends FASB Statement No. 107, *Disclosures about Fair Value of Financial Instruments,* to require disclosures about fair value of financial instruments for interim reporting periods of publicly traded companies as well as in annual financial statements. FSP FAS 107-1 and APB 28-1 also amends APB Opinion No. 28, *Interim Financial Reporting,* to require those disclosures in summarized financial information at interim reporting periods. The primary impact of FSP FAS 107-1 and APB 28-1 on the Company was to expand required disclosures pertaining to the fair values of financial instruments. See Note 10 for further details.

NOTE 4 RECENT ACCOUNTING PRONOUNCEMENTS

In June 2009, the FASB issued SFAS No. 166, *Accounting for Transfers of Financial Assets, an amendment of FASB Statement No. 140* (SFAS 166). This statement prescribes the information that a reporting entity must provide in its financial reports about a transfer of financial assets; the effects of a transfer on its financial position, financial performance and cash flows; and a transferor s continuing involvement in transferred financial assets. Specifically, among other aspects, SFAS 166 amends Statement of Financial Standard No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities* , (SFAS 140), by removing the concept of a qualifying special-purpose entity from SFAS 140 and removes the exception from applying FIN 46(R) to variable interest entities that are qualifying special-purpose entities. It also modifies the financial-components approach used in SFAS 140. SFAS 166 is effective for fiscal years beginning after November 15, 2009. The Company is in the process of determining the effect that the adoption of SFAS 166 will have on its financial position or results of operations.

In June 2009, the FASB released SFAS No. 167, *Amendments to FASB Interpretation No. 46(R)*, (SFAS 167). This statement addresses the effects on certain provisions of FASB Interpretation No. 46, Consolidation of Variable Interest Entities, as a result of the elimination of the qualifying special-purpose entity concept in SFAS 166. It addresses concerns about the application of certain key provisions of Interpretation 46(R), including those in which the accounting and disclosures under the Interpretation do not always provide timely and useful information about a company s involvement in a variable interest entity. This statement requires us to perform an analysis to determine whether any of our variable interests give us a controlling financial interest in a variable interest entity. In addition, this statement requires ongoing assessments of whether we are the primary beneficiary of a variable interest entity.

NOTE 4 RECENT ACCOUNTING PRONOUNCEMENTS (continued)

SFAS 167 is effective for fiscal years, and interim periods within those fiscal years, beginning after November 15, 2009. The Company is in the process of determining the effect that the adoption of SFAS 167 will have on its financial position or results of operations.

In June 2009, the FASB issued SFAS No. 168, *The FASB Accounting Standards Codification and the Hierarchy of Generally Accepted Accounting Principles, a replacement of FASB Statement No. 162* (SFAS 168). SFAS 168 replaces SFAS No. 162*, The Hierarchy of Generally Accepted Accounting Principles,* to establish the *FASB Accounting Standards Codification* as the source of authoritative accounting principles recognized by the FASB to be applied by nongovernmental entities in preparation of financial statements in conformity with generally accepted accounting principles in the United States. SFAS 168 is effective for interim and annual periods ending after September 15, 2009. The Company does not expect the adoption of this standard to have an impact on its financial position or results of operations.

NOTE 5 COMPREHENSIVE INCOME

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

The components of other comprehensive income and related tax effects for the three and six months ended June 30, 2009 and 2008 are as follows:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2009	**2008**	**2009**	**2008**
	(In Thousands)			
Changes in net unrealized holding gains on securities available for sale	$ (976)	$ (2,510)	$ (749)	$ (1,770)
Reclassification adjustment related to impairment charge for losses included in net loss		1,732		1,732
Net Unrealized Losses	(976)	(778)	(749)	(38)
Income tax benefit	378	288	290	14
Other Comprehensive Loss	$ (598)	$ (490)	$ (459)	$ (24)

NOTE 6 INVESTMENT SECURITIES

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

	June 30, 2009			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
	(In Thousands)			
SECURITIES AVAILABLE FOR SALE:				
U.S. Treasury bonds	$ 5,132	$ 506	$	$ 5,638
Municipal bonds	21,576	372	(185)	21,763
Mortgage-backed securities:				
Collateralized mortgage obligations	57,522	1,508	(215)	58,815
Government National Mortgage Association	8	1		9
Federal National Mortgage Association	10,957	441		11,398
Federal Home Loan Mortgage Corporation	11,805	475		12,280
Asset-backed securities	10,482	6	(1,822)	8,666
Equity securities	22		(8)	14
	$ 117,504	**$ 3,309**	**$ (2,230)**	**$ 118,583**

	December 31, 2008			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
	(In Thousands)			
SECURITIES AVAILABLE FOR SALE:				
U.S. Treasury bonds	$ 5,135	$ 1,386	$	$ 6,521
Municipal bonds	17,192	321	(191)	17,322
Mortgage-backed securities:				
Collateralized mortgage obligations	54,626	1,007	(330)	55,303
Government National Mortgage Association	23	2		25
Federal National Mortgage Association	8,250	411	(4)	8,657
Federal Home Loan Mortgage Corporation	14,385	463	(41)	14,807
Asset-backed securities	11,391	154	(1,333)	10,212
Equity securities	22		(6)	16
	$ 111,024	**$ 3,744**	**$ (1,905)**	**$ 112,863**

NOTE 6 INVESTMENT SECURITIES (continued)

Approximately 96% and 95% of the collateralized mortgage obligations were backed by federal agencies Freddie Mac, Fannie Mae, and Ginnie Mae at June 30, 2009 and December 31, 2008, respectively.

At June 30, 2009 and December 31, 2008, equity securities consisted of 22,368 shares of Federal Home Loan Mortgage Corporation common stock.

At June 30, 2009, thirty municipal bonds and one U.S. Treasury bond with a cost of $10,575,000 and fair value of $10,992,000 were pledged under a collateral agreement with the Federal Reserve for liquidity borrowing. At December 31, 2008, four municipal bonds and one U.S. Treasury bond with a cost of $2,515,000 and fair value of $2,950,000 were pledged under a collateral agreement with the Federal Reserve for liquidity borrowing.

The following tables 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
			(In Thousands)			
June 30, 2009:						
Municipal bonds	**$ 6,042**	**$ (113)**	**$ 1,016**	**$ (72)**	**$ 7,058**	**$ (185)**
Mortgage-backed securities	**8,910**	**(68)**	**2,623**	**(147)**	**11,533**	**(215)**
Asset-backed securities			**8,312**	**(1,822)**	**8,312**	**(1,822)**
Equity securities	**14**	**(8)**			**14**	**(8)**
	$ 14,966	**$ (189)**	**$ 11,951**	**$ (2,041)**	**$ 26,917**	**$ (2,230)**
December 31, 2008:						
Municipal bonds	$ 4,865	$ (84)	$ 1,314	$ (107)	$ 6,179	$ (191)
Mortgage-backed securities	12,016	(256)	7,809	(119)	19,825	(375)
Asset-backed securities	1,859	(254)	6,279	(1,079)	8,138	(1,333)
Equity securities	16	(6)			16	(6)
	$ 18,756	**$ (600)**	**$ 15,402**	**$ (1,305)**	**$ 34,158**	**$ (1,905)**

The Company reviews investment securities on an ongoing basis for the presence of OTTI with formal reviews performed quarterly. On June 30, 2009, the Company adopted FSP FAS 115-2 and FAS 124-2. FSP FAS 115-2 and FAS 124-2 requires companies to record all previously recorded non-credit related other-than-temporary impairment charges for debt securities as cumulative effect adjustments to retained earnings as of the beginning of the period of adoption.

At June 30, 2009 the Company s investment portfolio included 25 securities with gross unrealized losses in the less than twelve months category. These securities consisted primarily of municipal bonds and agency mortgage backed securities. The securities were not evaluated further for OTTI as the unrealized losses on the individual securities were less than 20% of their book value, which management deemed to be immaterial, and the credit ratings remained strong. The Company expects these securities to be repaid in full, with no losses realized. Management does not intend to sell these securities and it is not likely that it will be required to sell these securities.

NOTE 6 INVESTMENT SECURITIES (continued)

The Company has 22 securities in the twelve months or more category, as of June 30, 2009, which primarily consisted of non-agency asset-backed securities. Seven of twelve non-agency asset-backed securities in this category were subject to a formal OTTI review as the unrealized losses were greater than 20% of book value for the individual security, the related credit ratings were below investment grade, and the Company s analysis indicated a possible loss of principal. The OTTI analysis for these securities is discussed further below. The remaining 15 securities in this category primarily consist of municipal securities and agency mortgage-backed securities, and were not evaluated further for OTTI as the unrealized loss was less than 20% of book value and the credit ratings remained high. The temporary impairments are due to declines in fair values resulting from changes in interest rates or increased credit/liquidity spreads since the time the securities were purchased. The Company expects these securities to be repaid in full, with no losses realized. Management does not intend to sell these securities and it is not likely that it will be required to sell these securities.

The Company determines whether the unrealized losses are other than temporary in accordance with Emerging Issues Task Force (EITF) No. 99-20 *Recognition of Interest Income and Impairment on Purchased and Retained Beneficial Interests in Securitized Financial Asset*, as amended by FSP EITF 99-20-1 (EITF 99-20-1), when applicable, FSP FAS 115-1 and FAS 124-1 *The Meaning of Other Than Temporary Impairment and Its Application to Certain Investments*, (FSP FAS 115-1 and FAS 124-1), and FSP FAS 115-2 and FAS 124-2. 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. The difference between the present value of the expected cash flows and the amortized book value is considered a credit loss. The market 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 market value and the credit loss is recognized in other comprehensive income.

Four non-agency asset backed securities, on which an impairment loss was recorded during 2008 as described below were reviewed as of June 30, 2009 under the guidance of EITF 99-20, as amended by EITF 99-20-1. The Company believes the unrealized losses are due to the current economic environment, rising unemployment rates, a continued decline in housing values in many areas of the country, and increased delinquency trends. It is expected that principal losses will be incurred on the tranches we hold in these specific securities. Management s evaluation of the estimated discounted cash flows in comparison to the amortized book value did not reflect the need to record additional impairment charges against earnings, as the amount of impairment charges already taken appear to be sufficient. Management also concluded that it does not intend to sell the securities, and that it is not likely it will be required to sell the securities.

Management reviewed three non-agency asset backed securities, on which an impairment charge has not been taken, under the guidance of FSP FAS 115-2 and FSP FAS 124-2. These securities have exhibited significant unrealized losses for a sustained period of time and are determined to be trading in an inactive market. Management reviewed key credit metrics for these securities, including delinquency rates, cumulative default rates, prepayment speeds, foreclosure rates, loan-to-values and credit support levels. Although delinquency trends have increased and prepayment speeds have slowed down, the cumulative default rates on these securities have remained low. Furthermore, management s calculation of the estimated discounted cash flows did not show principal losses, under various prepayment speeds and

NOTE 6 INVESTMENT SECURITIES (continued)

default rates, for the tranches represented by the security holdings for these securities. As a result of its assessment, management concluded that principal losses were not expected on these three securities. It further concluded that the unrealized losses reflected a lack of liquidity for these securities due to the inactive market. As a result of the stress tests that were performed, management concluded that an other-than-temporary impairment did not exist as of June 30, 2009. Management also concluded that it does not intend to sell the securities, and that it is not likely it will be required to sell the securities.

The difference between the amortized book value and the fair value represents unrealized losses of $679,000 ($1.1 million pre-tax), as calculated under the calculated income approach, were recorded as a component of other comprehensive income, net of tax on the Company s Consolidated Statements of Stockholders Equity.

During 2008, the Company recorded OTTI charges of $1.9 million ($1.7 million after taxes) related to certain debt securities in the available for sale portfolio. The decision to classify these securities as other than temporarily impaired was based on a specific analysis of the structure of each security and an evaluation of the underlying collateral, the creditworthiness, capital adequacy and near term prospects of issuers, the level of credit subordination, estimates of loss severity, prepayments and future delinquencies, using information and industry knowledge available to the Company. At June 30, 2009, the difference between the amortized book value and the fair value represents unrealized losses of $254,000 ($414,000 pre-tax) on these securities, as calculated under the calculated income approach, were recorded as a component of other comprehensive income, net of tax on the Company s Consolidated Statements of Stockholders Equity.

The 2008 OTTI charge of $1.9 million was taken on four asset-backed securities that were privately issued (i.e., issued by corporations versus government agencies). At the time of purchase, the securities were all rated AAA. Three of the securities were collateralized by second lien home equity loans to prime borrowers. Since, the collateral was on a second lien position these securities were wrapped by an insurance guarantee. However, the insurance company also guaranteed other investment securities, and due to its exposure to the sub-prime housing market and inability to raise capital, in 2008, the major rating agencies downgraded the credit rating of the insurance company. This, in turn, caused the rating agencies to downgrade some of these securities. The fourth security was backed by first-lien residential mortgages to sub-prime borrowers. In the current economic environment, the fair market value of these types of securities declined significantly. Furthermore, the delinquency, foreclosure and cumulative default rate trends had increased and the securities were trading in inactive markets. As a result of management s analysis, it was determined that these four asset-backed securities had incurred other than temporary impairment.

Upon adoption of FSP FAS 115-2 and FAS 124-2 on June 30, 2009, the Company determined that $12,000 of the other-than-temporary impairment charges recorded in 2008 was related to non-credit factors. As such, an $8,000 (net of $4,000 of taxes) increase to retained earnings and a corresponding decrease to accumulated other comprehensive income was recorded as the cumulative effect impact of adopting FSP FAS 115-2 and FAS 124-2.

NOTE 6 INVESTMENT SECURITIES (continued)

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

	For the Three and Six Months Ended June 30, 2009
Beginning balance, January 1, 2009 and April 1, 2009 (1)	$ 1,934,000
Adjustments: Cumulative effect of accounting change upon adoption of FSP FAS 115-2 and FAS 124-2	(12,000)
Additions: Credit related OTTI recorded in current period	
Ending Balance, June 30, 2009	$ 1,922,000

(1) Amount represents the other-than-temporary impairment charges recorded in earnings during the year ended December 31, 2008 on four non-agency asset-backed securities.

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 investment securities are as follows:

	Amortized Cost	Fair Value
	(In Thousands)	
June 30, 2009:		
Within one year	$	$
After one year through five years	**1,493**	**1,564**
After five years through ten years	**7,489**	**7,697**
After ten years	**17,726**	**18,140**
Mortgage-backed securities	**80,292**	**82,502**
Asset-backed securities	**10,482**	**8,666**
Equity securities	**22**	**14**
	$ 117,504	**$ 118,583**

During the six month period ended June 30, 2009 and the year ended December 31, 2008, the Company did not sell any securities available for sale.

NOTE 7 EARNINGS (LOSS) PER SHARE

Earnings (loss) per share is calculated for the three and six month periods ending June 30, 2009 and 2008, respectively. Basic earnings (loss) per share is based upon the weighted average number of common shares outstanding, exclusive of unearned shares held by the Employee Stock Ownership Plan of Lake Shore Bancorp, Inc. (the ESOP) and unvested shares of restricted stock. Diluted earnings per share is based upon the weighted average number of common shares outstanding and common share equivalents

NOTE 7 EARNINGS (LOSS) PER SHARE (continued)

that would arise from the exercise of dilutive securities. Stock options and unvested restricted stock are regarded as potential common stock and are considered in the diluted earnings per share calculations to the extent they would be dilutive and computed using the treasury stock method.

Basic and diluted earnings (loss) per share was calculated as follows:

	Three Months ending June 30, 2009	Three Months ending June 30, 2008
Numerator net income (loss)	$ 354,000	$ (926,000)
Denominators:		
Basic weighted average shares outstanding	5,904,188	6,070,730
Increase in weighted average shares outstanding due to: (1)		
Stock options		
Unvested restricted stock awards		
Diluted weighted average shares outstanding	5,904,188	6,070,730
Earnings (loss) per share:		
Basic	$ 0.06	$ (0.15)
Diluted	$ 0.06	$ (0.15)

	Six Months ending June 30, 2009	Six Months ending June 30, 2008
Numerator net income (loss)	$ 759,000	$ (268,000)
Denominators:		
Basic weighted average shares outstanding	5,914,850	6,080,724
Increase in weighted average shares outstanding due to: (1)		
Stock options		
Unvested restricted stock awards		
Diluted weighted average shares outstanding	5,914,850	6,080,724