

LAKE SHORE BANCORP, INC.

Form 10-Q

August 12, 2016

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 June 30, 2016

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 ☐

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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 6,070,421 shares of the registrant’s common stock, \$0.01 par value per share, outstanding at August 9, 2016.

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## PART I

## Item 1. Financial Statements

## Lake Shore Bancorp, Inc. and Subsidiary

## Consolidated Statements of Financial Condition

|                                                                                                                                                                                   | June 30,<br>2016<br>(Unaudited) | December<br>31,<br>2015<br>(Dollars in thousands,<br>except share data) |
|-----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|---------------------------------|-------------------------------------------------------------------------|
| Assets                                                                                                                                                                            |                                 |                                                                         |
| Cash and due from banks                                                                                                                                                           | \$ 8,663                        | \$ 7,296                                                                |
| Interest earning deposits                                                                                                                                                         | 18,090                          | 12,714                                                                  |
| Federal funds sold                                                                                                                                                                | 14,445                          | 14,217                                                                  |
| Cash and Cash Equivalents                                                                                                                                                         | 41,198                          | 34,227                                                                  |
| Securities available for sale                                                                                                                                                     | 95,021                          | 113,213                                                                 |
| Federal Home Loan Bank stock, at cost                                                                                                                                             | 1,340                           | 1,454                                                                   |
| Loans receivable, net of allowance for loan losses 2016 \$2,060; 2015 \$1,985                                                                                                     | 315,218                         | 297,101                                                                 |
| Premises and equipment, net                                                                                                                                                       | 8,865                           | 9,144                                                                   |
| Accrued interest receivable                                                                                                                                                       | 1,563                           | 1,648                                                                   |
| Bank owned life insurance                                                                                                                                                         | 15,075                          | 14,938                                                                  |
| Other assets                                                                                                                                                                      | 1,700                           | 1,660                                                                   |
| Total Assets                                                                                                                                                                      | \$ 479,980                      | \$ 473,385                                                              |
| Liabilities and Stockholders' Equity                                                                                                                                              |                                 |                                                                         |
| Liabilities                                                                                                                                                                       |                                 |                                                                         |
| Deposits:                                                                                                                                                                         |                                 |                                                                         |
| Interest bearing                                                                                                                                                                  | \$ 322,581                      | \$ 323,931                                                              |
| Non-interest bearing                                                                                                                                                              | 52,263                          | 45,224                                                                  |
| Total Deposits                                                                                                                                                                    | 374,844                         | 369,155                                                                 |
| Long-term debt                                                                                                                                                                    | 18,950                          | 21,150                                                                  |
| Advances from borrowers for taxes and insurance                                                                                                                                   | 3,162                           | 3,285                                                                   |
| Other liabilities                                                                                                                                                                 | 5,979                           | 5,919                                                                   |
| Total Liabilities                                                                                                                                                                 | \$ 402,935                      | \$ 399,509                                                              |
| Commitments and Contingencies                                                                                                                                                     | -                               | -                                                                       |
| Stockholders' Equity                                                                                                                                                              |                                 |                                                                         |
| Common stock, \$0.01 par value per share, 25,000,000 shares authorized; 6,794,079 shares issued and 6,070,421 shares outstanding at June 30, 2016 and 6,727,428 shares issued and | \$ 68                           | \$ 67                                                                   |

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|                                                                                                   |            |            |
|---------------------------------------------------------------------------------------------------|------------|------------|
| 6,003,416 shares outstanding at December 31, 2015                                                 |            |            |
| Additional paid-in capital                                                                        | 30,131     | 29,359     |
| Treasury stock, at cost (723,658 shares at June 30, 2016 and 724,012 shares at December 31, 2015) | (7,100)    | (7,026)    |
| Unearned shares held by ESOP                                                                      | (1,663)    | (1,706)    |
| Unearned shares held by compensation plans                                                        | (659)      | (580)      |
| Retained earnings                                                                                 | 53,224     | 50,919     |
| Accumulated other comprehensive income                                                            | 3,044      | 2,843      |
| Total Stockholders' Equity                                                                        | 77,045     | 73,876     |
| Total Liabilities and Stockholders' Equity                                                        | \$ 479,980 | \$ 473,385 |

See notes to consolidated financial statements.

## Lake Shore Bancorp, Inc. and Subsidiary

## Consolidated Statements of Income

|                                                       | Three Months<br>Ended June 30,                |          | Six Months Ended<br>June 30, |          |
|-------------------------------------------------------|-----------------------------------------------|----------|------------------------------|----------|
|                                                       | 2016                                          | 2015     | 2016                         | 2015     |
|                                                       | (Unaudited)                                   |          |                              |          |
|                                                       | (Dollars in thousands, except per share data) |          |                              |          |
| Interest Income                                       |                                               |          |                              |          |
| Loans, including fees                                 | \$ 3,602                                      | \$ 3,424 | \$ 7,116                     | \$ 6,794 |
| Investment securities, taxable                        | 259                                           | 449      | 642                          | 942      |
| Investment securities, tax-exempt                     | 451                                           | 530      | 902                          | 1,060    |
| Other                                                 | 35                                            | 5        | 51                           | 11       |
| Total Interest Income                                 | 4,347                                         | 4,408    | 8,711                        | 8,807    |
| Interest Expense                                      |                                               |          |                              |          |
| Deposits                                              | 456                                           | 593      | 924                          | 1,256    |
| Long-term debt                                        | 91                                            | 98       | 187                          | 197      |
| Other                                                 | 23                                            | 25       | 46                           | 49       |
| Total Interest Expense                                | 570                                           | 716      | 1,157                        | 1,502    |
| Net Interest Income                                   | 3,777                                         | 3,692    | 7,554                        | 7,305    |
| Provision for Loan Losses                             | 55                                            | 185      | 185                          | 210      |
| Net Interest Income after Provision for Loan Losses   | 3,722                                         | 3,507    | 7,369                        | 7,095    |
| Non-Interest Income                                   |                                               |          |                              |          |
| Service charges and fees                              | 431                                           | 399      | 865                          | 778      |
| Earnings on bank owned life insurance                 | 70                                            | 69       | 137                          | 136      |
| Recovery on previously impaired investment securities | 33                                            | 43       | 68                           | 75       |
| Gain on sale of securities available for sale         | -                                             | -        | 1,636                        | -        |
| Net gain on sale of loans                             | 46                                            | 21       | 61                           | 45       |
| Other                                                 | 23                                            | 15       | 46                           | 47       |
| Total Non-Interest Income                             | 603                                           | 547      | 2,813                        | 1,081    |
| Non-Interest Expenses                                 |                                               |          |                              |          |
| Salaries and employee benefits                        | 1,795                                         | 1,684    | 3,585                        | 3,487    |
| Occupancy and equipment                               | 577                                           | 565      | 1,158                        | 1,136    |
| Data processing                                       | 261                                           | 252      | 526                          | 502      |
| Professional services                                 | 257                                           | 258      | 527                          | 503      |
| Advertising                                           | 189                                           | 103      | 302                          | 209      |
| FDIC Insurance                                        | 59                                            | 73       | 124                          | 144      |
| Postage and supplies                                  | 56                                            | 68       | 110                          | 127      |
| Other                                                 | 297                                           | 259      | 561                          | 461      |
| Total Non-Interest Expenses                           | 3,491                                         | 3,262    | 6,893                        | 6,569    |
| Income before Income Taxes                            | 834                                           | 792      | 3,289                        | 1,607    |
| Income Tax Expense                                    | 170                                           | 93       | 671                          | 339      |
| Net Income                                            | \$ 664                                        | \$ 699   | \$ 2,618                     | \$ 1,268 |
| Basic earnings per common share                       | \$ 0.11                                       | \$ 0.12  | \$ 0.44                      | \$ 0.22  |
| Diluted earnings per common share                     | \$ 0.11                                       | \$ 0.12  | \$ 0.44                      | \$ 0.21  |
| Dividends declared per share                          | \$ 0.07                                       | \$ 0.07  | \$ 0.14                      | \$ 0.14  |

See notes to consolidated financial statements.





Lake Shore Bancorp, Inc. and Subsidiary

Consolidated Statements of Comprehensive Income/(Loss)

|                                                                                                  | Three Months Ended<br>June 30,<br>2016      2015<br>(Unaudited)<br>(Dollars in<br>thousands) |          |
|--------------------------------------------------------------------------------------------------|----------------------------------------------------------------------------------------------|----------|
| Net Income                                                                                       | \$ 664                                                                                       | \$ 699   |
| Other Comprehensive Income (Loss), net of tax (expense) benefit                                  |                                                                                              |          |
| Unrealized holding gains (losses) on securities available for sale, net of tax (expense) benefit | 351                                                                                          | (1,025)  |
| Reclassification adjustments related to:                                                         |                                                                                              |          |
| Recovery on previously impaired investment securities included in net income, net of tax expense | (22)                                                                                         | (29)     |
| Total Other Comprehensive Income (Loss)                                                          | 329                                                                                          | (1,054)  |
| Total Comprehensive Income (Loss)                                                                | \$ 993                                                                                       | \$ (355) |

|                                                                                                  | Six Months Ended<br>June 30,<br>2016      2015<br>(Unaudited)<br>(Dollars in<br>thousands) |          |
|--------------------------------------------------------------------------------------------------|--------------------------------------------------------------------------------------------|----------|
| Net Income                                                                                       | \$ 2,618                                                                                   | \$ 1,268 |
| Other Comprehensive Income (Loss), net of tax (expense) benefit:                                 |                                                                                            |          |
| Unrealized holding gains (losses) on securities available for sale, net of tax (expense) benefit | 1,326                                                                                      | (452)    |
| Reclassification adjustments related to:                                                         |                                                                                            |          |
| Recovery on previously impaired investment securities included in net income, net of tax expense | (45)                                                                                       | (50)     |
| Gains on sale of securities included in net income, net of tax expense                           | (1,080)                                                                                    | -        |
| Total Other Comprehensive Income (Loss)                                                          | 201                                                                                        | (502)    |
| Total Comprehensive Income                                                                       | \$ 2,819                                                                                   | \$ 766   |

See notes to consolidated financial statements.

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Lake Shore Bancorp, Inc. and Subsidiary

Consolidated Statements of Stockholders' Equity

Six Months Ended June 30, 2016 and 2015 (Unaudited)

|                                                               | Common<br>Stock | Additional<br>Paid-In<br>Capital | Treasury<br>Stock | Unearned<br>Shares<br>Held by<br>ESOP | Unearned<br>Shares<br>Held by<br>Compensation<br>Plans | Retained<br>Earnings | Accumulated<br>Other<br>Comprehensive<br>Income | Total     |
|---------------------------------------------------------------|-----------------|----------------------------------|-------------------|---------------------------------------|--------------------------------------------------------|----------------------|-------------------------------------------------|-----------|
| (Dollars in thousands, except share and per share data)       |                 |                                  |                   |                                       |                                                        |                      |                                                 |           |
| Balance - January 1,<br>2015                                  | \$ 67           | \$ 28,684                        | \$ (6,420)        | \$ (1,791)                            | \$ (622)                                               | \$ 48,192            | \$ 3,520                                        | \$ 71,630 |
| Net income                                                    | -               | -                                | -                 | -                                     | -                                                      | 1,268                | -                                               | 1,268     |
| Other comprehensive<br>loss, net of tax benefit of<br>\$666   | -               | -                                | -                 | -                                     | -                                                      | -                    | (502)                                           | (502)     |
| Stock options exercised<br>(11,775 shares)                    | -               | 136                              | -                 | -                                     | -                                                      | -                    | -                                               | 136       |
| ESOP shares earned<br>(3,968 shares)                          | -               | 11                               | -                 | 43                                    | -                                                      | -                    | -                                               | 54        |
| Stock based<br>compensation                                   | -               | 1                                | -                 | -                                     | -                                                      | -                    | -                                               | 1         |
| Compensation plan<br>shares granted (15,455<br>shares)        | -               | -                                | 145               | -                                     | (145)                                                  | -                    | -                                               | -         |
| Compensation plan<br>shares earned (8,443<br>shares)          | -               | 16                               | -                 | -                                     | 91                                                     | -                    | -                                               | 107       |
| Purchase of treasury<br>stock, at cost (39,900<br>shares)     | -               | -                                | (541)             | -                                     | -                                                      | -                    | -                                               | (541)     |
| Cash dividends declared<br>(\$0.14 per share)                 | -               | -                                | -                 | -                                     | -                                                      | (307)                | -                                               | (307)     |
| Balance - June 30, 2015                                       | \$ 67           | \$ 28,848                        | \$ (6,816)        | \$ (1,748)                            | \$ (676)                                               | \$ 49,153            | \$ 3,018                                        | \$ 71,846 |
| Balance - January 1,<br>2016                                  | \$ 67           | \$ 29,359                        | \$ (7,026)        | \$ (1,706)                            | \$ (580)                                               | \$ 50,919            | \$ 2,843                                        | \$ 73,876 |
| Net income                                                    | -               | -                                | -                 | -                                     | -                                                      | 2,618                | -                                               | 2,618     |
| Other comprehensive<br>income, net of tax<br>expense of \$104 | -               | -                                | -                 | -                                     | -                                                      | -                    | 201                                             | 201       |
| Stock options exercised<br>(66,651 shares)                    | 1               | 736                              | -                 | -                                     | -                                                      | -                    | -                                               | 737       |
|                                                               | -               | 10                               | -                 | 43                                    | -                                                      | -                    | -                                               | 53        |

|                                                           |       |           |            |            |          |           |          |           |
|-----------------------------------------------------------|-------|-----------|------------|------------|----------|-----------|----------|-----------|
| ESOP shares earned<br>(3,968 shares)                      |       |           |            |            |          |           |          |           |
| Compensation plan<br>shares granted (20,354<br>shares)    | -     | -         | 197        | -          | (197)    | -         | -        | -         |
| Compensation plan<br>shares earned (11,320<br>shares)     | -     | 26        | -          | -          | 118      | -         | -        | 144       |
| Purchase of treasury<br>stock, at cost (20,000<br>shares) | -     | -         | (271)      | -          | -        | -         | -        | (271)     |
| Cash dividends declared<br>(\$0.14 per share)             | -     | -         | -          | -          | -        | (313)     | -        | (313)     |
| Balance - June 30, 2016                                   | \$ 68 | \$ 30,131 | \$ (7,100) | \$ (1,663) | \$ (659) | \$ 53,224 | \$ 3,044 | \$ 77,045 |

See notes to consolidated  
financial statements.

## Lake Shore Bancorp, Inc. and Subsidiary

## Consolidated Statements of Cash Flows

|                                                                                   | Six Months Ended<br>June 30,<br>2016          2015<br>(Unaudited)<br>(Dollars in thousands) |                  |
|-----------------------------------------------------------------------------------|---------------------------------------------------------------------------------------------|------------------|
| <b>CASH FLOWS FROM OPERATING ACTIVITIES</b>                                       |                                                                                             |                  |
| Net income                                                                        | \$ 2,618                                                                                    | \$ 1,268         |
| Adjustments to reconcile net income to net cash provided by operating activities: |                                                                                             |                  |
| Net amortization of investment securities                                         | 94                                                                                          | 162              |
| Net amortization of deferred loan costs                                           | 259                                                                                         | 244              |
| Provision for loan losses                                                         | 185                                                                                         | 210              |
| Recovery on previously impaired investment securities                             | (68)                                                                                        | (75)             |
| Gain on sale of investment securities                                             | (1,636)                                                                                     | -                |
| Originations of loans held for sale                                               | (2,996)                                                                                     | (3,277)          |
| Proceeds from sales of loans held for sale                                        | 3,057                                                                                       | 3,322            |
| Gain on sale of loans                                                             | (61)                                                                                        | (45)             |
| Depreciation and amortization                                                     | 430                                                                                         | 415              |
| Increase in bank owned life insurance, net                                        | (137)                                                                                       | (136)            |
| ESOP shares committed to be released                                              | 53                                                                                          | 54               |
| Stock based compensation expense                                                  | 144                                                                                         | 108              |
| Decrease in accrued interest receivable                                           | 85                                                                                          | 15               |
| Decrease in other assets                                                          | 53                                                                                          | 473              |
| Decrease in other liabilities                                                     | (44)                                                                                        | (204)            |
| Net Cash Provided by Operating Activities                                         | 2,036                                                                                       | 2,534            |
| <b>CASH FLOWS FROM INVESTING ACTIVITIES</b>                                       |                                                                                             |                  |
| Activity in available for sale securities:                                        |                                                                                             |                  |
| Sales                                                                             | 14,406                                                                                      | -                |
| Maturities, prepayments and calls                                                 | 5,701                                                                                       | 7,753            |
| Purchases of Federal Home Loan Bank Stock                                         | (3)                                                                                         | (29)             |
| Redemptions of Federal Home Loan Bank Stock                                       | 117                                                                                         | 49               |
| Loan origination and principal collections, net                                   | (18,654)                                                                                    | (12,188)         |
| Additions to premises and equipment                                               | (151)                                                                                       | (147)            |
| Net Cash Provided by (Used in) Investing Activities                               | 1,416                                                                                       | (4,562)          |
| <b>CASH FLOWS FROM FINANCING ACTIVITIES</b>                                       |                                                                                             |                  |
| Net increase (decrease) in deposits                                               | 5,689                                                                                       | (5,094)          |
| Net decrease in advances from borrowers for taxes and insurance                   | (123)                                                                                       | (131)            |
| Proceeds from issuance of long-term debt                                          | -                                                                                           | 3,250            |
| Repayment of long-term debt                                                       | (2,200)                                                                                     | (3,250)          |
| Proceeds from stock options exercised                                             | 737                                                                                         | 136              |
| Purchase of treasury stock                                                        | (271)                                                                                       | (541)            |
| Cash dividends paid                                                               | (313)                                                                                       | (307)            |
| Net Cash Provided by (Used in) Financing Activities                               | 3,519                                                                                       | (5,937)          |
| Net Increase (Decrease) in Cash and Cash Equivalents                              | 6,971                                                                                       | (7,965)          |
| <b>CASH AND CASH EQUIVALENTS - BEGINNING</b>                                      | 34,227                                                                                      | 35,811           |
| <b>CASH AND CASH EQUIVALENTS - ENDING</b>                                         | <b>\$ 41,198</b>                                                                            | <b>\$ 27,846</b> |
| <b>SUPPLEMENTARY CASH FLOWS INFORMATION</b>                                       |                                                                                             |                  |

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|                   |          |          |
|-------------------|----------|----------|
| Interest paid     | \$ 1,164 | \$ 1,501 |
| Income taxes paid | \$ 580   | \$ 370   |

SUPPLEMENTARY SCHEDULE OF NONCASH INVESTING ACTIVITIES

|                                                        |       |       |
|--------------------------------------------------------|-------|-------|
| Foreclosed real estate acquired in settlement of loans | \$ 97 | \$ 45 |
|--------------------------------------------------------|-------|-------|

See notes to consolidated financial statements.

Lake Shore Bancorp, Inc. and Subsidiary

Notes to Consolidated Financial Statements (Unaudited)

Note 1 – Basis of Presentation

The interim consolidated financial statements include the accounts of Lake Shore Bancorp, Inc. (the “Company”, “us”, “our”, or “we”) and Lake Shore Savings Bank (the “Bank”), its wholly owned subsidiary. All intercompany accounts and transactions of the consolidated subsidiary have been eliminated in consolidation.

The interim consolidated financial statements included herein as of June 30, 2016 and for the three and six months ended June 30, 2016 and 2015 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, 2015 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, 2015. The consolidated statements of income for the three and six months ended June 30, 2016 are not necessarily indicative of the results for any subsequent period or the entire year ending December 31, 2016.

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 June 30, 2016 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 June 2016, the FASB issued ASU 2016-13, “Financial Instruments – Credit Losses (Topic 326)” (“ASU 2016-13”). ASU 2016-13 is intended to provide financial statement users with more decision-useful information about the expected credit losses on financial instruments and other commitments to extend credit held by a reporting entity at each reporting date. To achieve this objective, the amendments in this Update replace the incurred loss impairment methodology in current GAAP with a methodology that reflects expected credit losses and requires consideration of a broader range of reasonable and supportable information to inform credit loss estimates. ASU 2016-13 is effective for annual reporting periods, including interim reporting periods within those periods, beginning after December 15, 2019 for all public business entities that are U.S. Securities and Exchange Commission (“SEC”) filers. Early application is permitted as of the annual reporting periods beginning after December 15, 2018, including interim periods within those periods. Management is currently evaluating the impact the adoption of ASU 2016-13 will have on its consolidated financial statements and results of operations.



## Note 3 – Investment Securities

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

|                                                                   | June 30, 2016          |                        |                         |            |
|-------------------------------------------------------------------|------------------------|------------------------|-------------------------|------------|
|                                                                   | Amortized Cost         | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value |
|                                                                   | (Dollars in thousands) |                        |                         |            |
| SECURITIES AVAILABLE FOR SALE:                                    |                        |                        |                         |            |
| Municipal bonds                                                   | \$ 49,047              | \$ 3,537               | \$ -                    | \$ 52,584  |
| Mortgage-backed securities:                                       |                        |                        |                         |            |
| Collateralized mortgage obligations-private label                 | 46                     | -                      | -                       | 46         |
| Collateralized mortgage obligations-government sponsored entities | 34,137                 | 311                    | (52)                    | 34,396     |
| Government National Mortgage Association                          | 352                    | 35                     | -                       | 387        |
| Federal National Mortgage Association                             | 3,952                  | 244                    | -                       | 4,196      |
| Federal Home Loan Mortgage Corporation                            | 2,025                  | 110                    | -                       | 2,135      |
| Asset-backed securities-private label                             | 749                    | 426                    | (26)                    | 1,149      |
| Asset-backed securities-government sponsored entities             | 79                     | 8                      | -                       | 87         |
| Equity securities                                                 | 22                     | 19                     | -                       | 41         |
|                                                                   | \$ 90,409              | \$ 4,690               | \$ (78)                 | \$ 95,021  |

|                                                                   | December 31, 2015      |                        |                         |            |
|-------------------------------------------------------------------|------------------------|------------------------|-------------------------|------------|
|                                                                   | Amortized Cost         | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value |
|                                                                   | (Dollars in thousands) |                        |                         |            |
| SECURITIES AVAILABLE FOR SALE:                                    |                        |                        |                         |            |
| U.S. Treasury bonds                                               | \$ 12,778              | \$ 1,333               | \$ -                    | \$ 14,111  |
| Municipal bonds                                                   | 49,064                 | 2,746                  | (2)                     | 51,808     |
| Mortgage-backed securities:                                       |                        |                        |                         |            |
| Collateralized mortgage obligations-private label                 | 48                     | -                      | -                       | 48         |
| Collateralized mortgage obligations-government sponsored entities | 38,838                 | 124                    | (620)                   | 38,342     |
| Government National Mortgage Association                          | 396                    | 31                     | -                       | 427        |
| Federal National Mortgage Association                             | 4,355                  | 187                    | -                       | 4,542      |
| Federal Home Loan Mortgage Corporation                            | 2,217                  | 84                     | -                       | 2,301      |
| Asset-backed securities-private label                             | 1,099                  | 464                    | (62)                    | 1,501      |
| Asset-backed securities-government sponsored entities             | 89                     | 8                      | -                       | 97         |
| Equity securities                                                 | 22                     | 14                     | -                       | 36         |
|                                                                   | \$ 108,906             | \$ 4,991               | \$ (684)                | \$ 113,213 |

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



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At June 30, 2016 and at December 31, 2015, equity securities consisted of 22,368 shares of Federal Home Loan Mortgage Corporation (“FHLMC”) common stock.

At June 30, 2016 and December 31, 2015, thirty-four municipal bonds with a cost of \$11.1 million and fair value of \$11.9 million and \$11.7 million, respectively, were pledged under a collateral agreement with the Federal Reserve Bank (“FRB”) of New York for liquidity borrowing. In addition, at June 30, 2016, fourteen municipal bonds with a cost and fair value of \$3.6 million and \$3.9 million, respectively, were pledged as collateral for customer deposits in excess of the Federal Deposit Insurance Corporation (“FDIC”) insurance limits. At December 31, 2015, nine municipal bonds with a cost and fair value of \$2.0 million and \$2.1 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<br>months |        | 12 months or more   |         | Total         |                     |
|----------------------------------------|------------------------|--------|---------------------|---------|---------------|---------------------|
|                                        | Gross<br>Unrealized    |        | Gross<br>Unrealized |         |               | Gross<br>Unrealized |
|                                        | Fair<br>Value          | Losses | Fair<br>Value       | Losses  | Fair<br>Value | Losses              |
|                                        | (Dollars In thousands) |        |                     |         |               |                     |
| June 30, 2016                          |                        |        |                     |         |               |                     |
| Mortgage-backed securities             | \$ -                   | \$ -   | \$ 8,959            | \$ (52) | \$ 8,959      | \$ (52)             |
| Asset-backed securities -private label | 267                    | (5)    | 456                 | (21)    | 723           | (26)                |
|                                        | \$ 267                 | \$ (5) | \$ 9,415            | \$ (73) | \$ 9,682      | \$ (78)             |

|                                        |          |          |           |          |           |          |
|----------------------------------------|----------|----------|-----------|----------|-----------|----------|
| December 31, 2015                      |          |          |           |          |           |          |
| Municipal bonds                        | \$ -     | \$ -     | \$ 567    | \$ (2)   | \$ 567    | \$ (2)   |
| Mortgage-backed securities             | 8,627    | (103)    | 21,249    | (517)    | 29,876    | (620)    |
| Asset-backed securities -private label | 379      | (11)     | 658       | (51)     | 1,037     | (62)     |
|                                        | \$ 9,006 | \$ (114) | \$ 22,474 | \$ (570) | \$ 31,480 | \$ (684) |

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 discount 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 (loss), net of taxes.

At June 30, 2016, the Company's investment portfolio included one private label asset-backed security in the "unrealized losses less than twelve months" category.

At June 30, 2016, the Company had fourteen mortgage-backed securities and one private label asset-backed security in the “unrealized losses twelve months or more” category. The fourteen 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.

The private label asset-backed securities noted above were evaluated further for OTTI, as the probability of default is high and the Company’s analysis indicated a possible loss of principal. The following tables provide additional information relating to the private label asset-backed securities as of June 30, 2016 and December 31, 2015 (dollars in thousands):

#### At June 30, 2016

| Security | Book Value | Fair Value | Unrealized Loss | Lowest Rating | Delinquent % |              | Foreclosure% | OREO% |
|----------|------------|------------|-----------------|---------------|--------------|--------------|--------------|-------|
|          |            |            |                 |               | Over 60 days | Over 90 days |              |       |
| 1        | \$ 477     | \$ 456     | \$ (21)         | CCC           | 16.20%       | 15.50%       | 7.30%        | 2.00% |
| 2        | 272        | 267        | (5)             | CCC           | 14.20%       | 13.10%       | 4.90%        | 1.30% |
| Total    | \$ 749     | \$ 723     | \$ (26)         |               |              |              |              |       |

#### At December 31, 2015

| Security | Book Value | Fair Value | Unrealized Loss | Lowest Rating | Delinquent % |              | Foreclosure% | OREO% |
|----------|------------|------------|-----------------|---------------|--------------|--------------|--------------|-------|
|          |            |            |                 |               | Over 60 days | Over 90 days |              |       |
| 1        | \$ 709     | \$ 658     | \$ (51)         | CCC           | 18.20%       | 17.40%       | 7.50%        | 2.60% |
| 2        | 390        | 379        | (11)            | CCC           | 16.30%       | 15.10%       | 7.00%        | 1.50% |
| Total    | \$ 1,099   | \$ 1,037   | \$ (62)         |               |              |              |              |       |

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 as of June 30, 2016. 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 prior to their maturity.

Management also completed an OTTI analysis for two private label asset-backed securities, which did not have unrealized losses as of June 30, 2016. 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 June 30, 2016 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 prior to their maturity.

The unrealized losses shown in the previous table, were recorded as a component of other comprehensive income (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 Six<br>Months Ended<br>June 30,<br>2016 2015<br>(Dollars in<br>thousands) |        |
|-----------------------------------------------------------------|-----------------------------------------------------------------------------------|--------|
| Beginning balance                                               | \$ 696                                                                            | \$ 858 |
| Additions:                                                      |                                                                                   |        |
| Credit loss not previously recognized                           | -                                                                                 | -      |
| Reductions:                                                     |                                                                                   |        |
| Losses realized during the period on OTTI previously recognized | -                                                                                 | (2)    |
| Receipt of cash flows on previously recorded OTTI               | (68)                                                                              | (75)   |
| Ending balance                                                  | \$ 628                                                                            | \$ 781 |

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<br>(Dollars in<br>thousands) | Fair Value |
|------------------------------------|---------------------------------------------|------------|
| June 30, 2016:                     |                                             |            |
| After one year through five years  | \$ 2,450                                    | \$ 2,623   |
| After five years through ten years | 28,530                                      | 30,608     |
| After ten years                    | 18,067                                      | 19,353     |
| Mortgage-backed securities         | 40,512                                      | 41,160     |
| Asset-backed securities            | 828                                         | 1,236      |
| Equity securities                  | 22                                          | 41         |
|                                    | \$ 90,409                                   | \$ 95,021  |

During the six months ended June 30, 2016, the Company sold nine U.S. Treasury Bonds for total proceeds of \$14.4 million, resulting in realized gains of \$1.6 million. During the six months ended June 30, 2015, the Company did not sell any securities available for sale.

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 first or second liens 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 relatively 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 a Company loan officer or an independent appraisal firm. Construction delays may also 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 – consist of loans secured by collateral such as an automobile or a deposit account, unsecured loans and lines of credit. Consumer loans tend to have a higher credit risk due to the loans being either unsecured or secured by rapidly depreciable assets. Furthermore, consumer loan payments are dependent on the borrower's continuing financial stability, and therefore are more likely to be adversely affected by job loss, divorce, illness or personal bankruptcy.

The allowance for loan losses is a valuation account that reflects the Company's evaluation of the losses inherent in its loan portfolio. In order to determine the adequacy of the allowance for loan losses, the Company estimates losses by loan type using historical loss factors, as well as other environmental factors, such as trends in loan volume and loan type, loan concentrations, changes in the experience, ability and depth of the Company's lending management, and national and local economic conditions. 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

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an internal loan grade, and the Company assigns the amount of loss allowances to these classified loans based on loan grade.

The following tables summarize the activity in the allowance for loan losses for the three and six months ended June 30, 2016 and 2015 and the distribution of the allowance for loan losses and loan receivable by loan portfolio class and impairment method as of June 30, 2016 and December 31, 2015:

|                                                       | Real Estate Loans      |             |            | Other Loans  |            |          |             |            |
|-------------------------------------------------------|------------------------|-------------|------------|--------------|------------|----------|-------------|------------|
|                                                       | One- to Four-Family    | Home Equity | Commercial | Construction | Commercial | Consumer | Unallocated | Total      |
|                                                       | (Dollars in thousands) |             |            |              |            |          |             |            |
| June 30, 2016                                         |                        |             |            |              |            |          |             |            |
| Allowance for Loan Losses:                            |                        |             |            |              |            |          |             |            |
| Balance – April 1, 2016                               | \$ 457                 | \$ 131      | \$ 1,095   | \$ 97        | \$ 227     | \$ 29    | \$ 16       | \$ 2,052   |
| Charge-offs                                           | -                      | (15)        | (1)        | -            | (26)       | (21)     | -           | (63)       |
| Recoveries                                            | 9                      | 1           | -          | -            | 1          | 5        | -           | 16         |
| Provision (Credit)                                    | (42)                   | 12          | (30)       | 32           | 73         | 9        | 1           | 55         |
| Balance – June 30, 2016                               | \$ 424                 | \$ 129      | \$ 1,064   | \$ 129       | \$ 275     | \$ 22    | \$ 17       | \$ 2,060   |
| Balance – January 1, 2016                             | \$ 351                 | \$ 120      | \$ 1,204   | \$ 59        | \$ 197     | \$ 22    | \$ 32       | \$ 1,985   |
| Charge-offs                                           | (49)                   | (18)        | (1)        | -            | (30)       | (32)     | -           | (130)      |
| Recoveries                                            | 10                     | 1           | -          | -            | 1          | 8        | -           | 20         |
| Provision (Credit)                                    | 112                    | 26          | (139)      | 70           | 107        | 24       | (15)        | 185        |
| Balance – June 30, 2016                               | \$ 424                 | \$ 129      | \$ 1,064   | \$ 129       | \$ 275     | \$ 22    | \$ 17       | \$ 2,060   |
| Ending balance: individually evaluated for impairment | \$ -                   | \$ -        | \$ 5       | \$ -         | \$ 21      | \$ -     | \$ -        | \$ 26      |
| Ending balance: collectively evaluated for impairment | \$ 424                 | \$ 129      | \$ 1,059   | \$ 129       | \$ 254     | \$ 22    | \$ 17       | \$ 2,034   |
| Gross Loans Receivable (1):                           |                        |             |            |              |            |          |             |            |
| Ending balance                                        | \$ 153,808             | \$ 33,029   | \$ 92,155  | \$ 12,083    | \$ 21,900  | \$ 1,329 | \$ -        | \$ 314,304 |
| Ending balance: individually evaluated for            | \$ 242                 | \$ 4        | \$ 2,302   | \$ -         | \$ 207     | \$ -     | \$ -        | \$ 2,755   |

impairment  
Ending balance:  
collectively  
evaluated for  
impairment

|            |           |           |           |           |          |      |            |
|------------|-----------|-----------|-----------|-----------|----------|------|------------|
| \$ 153,566 | \$ 33,025 | \$ 89,853 | \$ 12,083 | \$ 21,693 | \$ 1,329 | \$ - | \$ 311,549 |
|------------|-----------|-----------|-----------|-----------|----------|------|------------|

(1) Gross Loans Receivable does not include allowance for loan losses of \$(2,060) or deferred loan costs of \$2,974.

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|                            | Real Estate Loans      |                |            |              | Other Loans |          |             |          |
|----------------------------|------------------------|----------------|------------|--------------|-------------|----------|-------------|----------|
|                            | One-<br>to Four-Family | Home<br>Equity | Commercial | Construction | Commercial  | Consumer | Unallocated | Total    |
|                            | (Dollars in thousands) |                |            |              |             |          |             |          |
| June 30, 2015              |                        |                |            |              |             |          |             |          |
| Allowance for Loan Losses: |                        |                |            |              |             |          |             |          |
| Balance – April 1, 2015    | \$ 425                 | \$ 106         | \$ 1,181   | \$ -         | \$ 192      | \$ 26    | \$ 10       | \$ 1,940 |
| Charge-offs                | (1)                    | (2)            | -          | -            | (4)         | (11)     | -           | (18)     |
| Recoveries                 | 3                      | 7              | -          | -            | 7           | 1        | -           | 18       |
| Provision (Credit)         | (34)                   | (8)            | 213        | -            | (8)         | 11       | 11          | 185      |
| Balance – June 30, 2015    | \$ 393                 | \$ 103         | \$ 1,394   | \$ -         | \$ 187      | \$ 27    | \$ 21       | \$ 2,125 |
|                            |                        |                |            |              |             |          |             |          |
| Balance – January 1, 2015  | \$ 446                 | \$ 106         | \$ 1,163   | \$ -         | \$ 184      | \$ 22    | \$ -        | \$ 1,921 |
| Charge-offs                | (18)                   | (17)           | -          | -            | (4)         | (19)     | -           | (58)     |
| Recoveries                 | 12                     | 8              | 21         | -            | 7           | 4        | -           | 52       |
| Provision (Credit)         | (47)                   | 6              | 210        | -            | -           | 20       | 21          | 210      |
| Balance – June 30, 2015    | \$ 393                 | \$ 103         | \$ 1,394   | \$ -         | \$ 187      | \$ 27    | \$ 21       | \$ 2,125 |

The following table summarizes the distribution of the allowance for loan losses and loans receivable by loan portfolio class as of December 31, 2015:

|                                                       | Real Estate Loans      |                |            | Other Loans  |            |          |             |          |
|-------------------------------------------------------|------------------------|----------------|------------|--------------|------------|----------|-------------|----------|
|                                                       | One- to<br>Four-Family | Home<br>Equity | Commercial | Construction | Commercial | Consumer | Unallocated | Total    |
|                                                       | (Dollars in thousands) |                |            |              |            |          |             |          |
| December 31, 2015                                     |                        |                |            |              |            |          |             |          |
| Allowance for Loan Losses:                            |                        |                |            |              |            |          |             |          |
| Balance – December 31, 2015                           | \$ 351                 | \$ 120         | \$ 1,204   | \$ 59        | \$ 197     | \$ 22    | \$ 32       | \$ 1,985 |
| Ending balance: individually evaluated for impairment | \$ -                   | \$ -           | \$ 20      | \$ -         | \$ -       | \$ -     | \$ -        | \$ 20    |
| Ending balance: collectively evaluated for impairment | \$ 351                 | \$ 120         | \$ 1,184   | \$ 59        | \$ 197     | \$ 22    | \$ 32       | \$ 1,965 |

|                                                       |            |           |           |          |           |          |      |            |
|-------------------------------------------------------|------------|-----------|-----------|----------|-----------|----------|------|------------|
| Gross Loans Receivable (1):                           |            |           |           |          |           |          |      |            |
| Ending Balance                                        | \$ 157,307 | \$ 32,770 | \$ 83,967 | \$ 4,849 | \$ 15,741 | \$ 1,507 | \$ - | \$ 296,141 |
| Ending balance: individually evaluated for impairment | \$ 202     | \$ 8      | \$ 1,545  | \$ -     | \$ 80     | \$ -     | \$ - | \$ 1,835   |
| Ending balance: collectively evaluated for impairment | \$ 157,105 | \$ 32,762 | \$ 82,422 | \$ 4,849 | \$ 15,661 | \$ 1,507 | \$ - | \$ 294,306 |

<sup>(1)</sup> Gross Loans Receivable does not include allowance for loan losses of \$(1,985) or deferred loan costs of \$2,945.

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.

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

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

|                                            | Unpaid<br>Recorded Principal<br>Investment Balance | Related<br>Allowance | Average Interest<br>Recorded Income<br>Investment Recognized<br>For the Six Months<br>Ended<br>June 30, 2016 |
|--------------------------------------------|----------------------------------------------------|----------------------|--------------------------------------------------------------------------------------------------------------|
| At June 30, 2016<br>(Dollars in thousands) |                                                    |                      |                                                                                                              |
| With no related allowance recorded:        |                                                    |                      |                                                                                                              |
| Residential, one- to four-family           | \$ 242                                             | \$ 242               | \$ -                                                                                                         |
| Home equity                                | 4                                                  | 4                    | -                                                                                                            |
| Commercial real estate                     | 2,109                                              | 2,109                | -                                                                                                            |
| Commercial loans                           | 64                                                 | 64                   | -                                                                                                            |
| With an allowance recorded:                |                                                    |                      |                                                                                                              |
| Commercial real estate                     | 193                                                | 193                  | 5                                                                                                            |
| Commercial loans                           | 143                                                | 143                  | 21                                                                                                           |
| Total                                      | \$ 2,755                                           | \$ 2,755             | \$ 26                                                                                                        |

|                                                | Unpaid<br>Recorded Principal<br>Investment Balance | Related<br>Allowance | Average Interest<br>Recorded Income<br>Investment Recognized<br>For the Year Ended<br>December 31, 2015 |
|------------------------------------------------|----------------------------------------------------|----------------------|---------------------------------------------------------------------------------------------------------|
| At December 31, 2015<br>(Dollars in thousands) |                                                    |                      |                                                                                                         |
| With no related allowance recorded:            |                                                    |                      |                                                                                                         |
| Residential, one- to four-family               | \$ 202                                             | \$ 202               | \$ -                                                                                                    |
| Home equity                                    | 8                                                  | 8                    | -                                                                                                       |
| Commercial real estate                         | 1,503                                              | 1,503                | -                                                                                                       |
| Commercial loans                               | 80                                                 | 80                   | -                                                                                                       |
| With an allowance recorded:                    |                                                    |                      |                                                                                                         |
| Commercial real estate                         | 42                                                 | 42                   | 20                                                                                                      |
| Total                                          | \$ 1,835                                           | \$ 1,835             | \$ 20                                                                                                   |





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

|                                  | 30-59<br>Days<br>Past<br>Due<br>(Dollars in thousands) | 60-89<br>Days<br>Past<br>Due | 90 Days<br>or<br>More<br>Past<br>Due | Total<br>Past<br>Due | Current<br>Due | Total Loans<br>Receivable | Loans on<br>Non-Accrual |
|----------------------------------|--------------------------------------------------------|------------------------------|--------------------------------------|----------------------|----------------|---------------------------|-------------------------|
| June 30, 2016:                   |                                                        |                              |                                      |                      |                |                           |                         |
| Real Estate Loans:               |                                                        |                              |                                      |                      |                |                           |                         |
| Residential, one- to four-family | \$ 1,929                                               | \$ 335                       | \$ 916                               | \$ 3,180             | \$ 150,628     | \$ 153,808                | \$ 2,137                |
| Home equity                      | 116                                                    | 110                          | 191                                  | 417                  | 32,612         | 33,029                    | 354                     |
| Commercial                       | 1,479                                                  | 482                          | 1,350                                | 3,311                | 88,844         | 92,155                    | 1,677                   |
| Construction                     | -                                                      | -                            | -                                    | -                    | 12,083         | 12,083                    | -                       |
| Other Loans:                     |                                                        |                              |                                      |                      |                |                           |                         |
| Commercial                       | 120                                                    | -                            | 23                                   | 143                  | 21,757         | 21,900                    | 157                     |
| Consumer                         | 18                                                     | 7                            | 40                                   | 65                   | 1,264          | 1,329                     | 23                      |
| Total                            | \$ 3,662                                               | \$ 934                       | \$ 2,520                             | \$ 7,116             | \$ 307,188     | \$ 314,304                | \$ 4,348                |

|                                  | 30-59<br>Days<br>Past<br>Due<br>(Dollars in thousands) | 60-89<br>Days<br>Past<br>Due | 90 Days<br>or<br>More<br>Past<br>Due | Total<br>Past<br>Due | Current<br>Due | Total Loans<br>Receivable | Loans on<br>Non-Accrual |
|----------------------------------|--------------------------------------------------------|------------------------------|--------------------------------------|----------------------|----------------|---------------------------|-------------------------|
| December 31, 2015:               |                                                        |                              |                                      |                      |                |                           |                         |
| Real Estate Loans:               |                                                        |                              |                                      |                      |                |                           |                         |
| Residential, one- to four-family | \$ 1,519                                               | \$ 789                       | \$ 1,291                             | \$ 3,599             | \$ 153,708     | \$ 157,307                | \$ 2,462                |
| Home equity                      | 188                                                    | 32                           | 354                                  | 574                  | 32,196         | 32,770                    | 361                     |
| Commercial                       | -                                                      | -                            | 1,248                                | 1,248                | 82,719         | 83,967                    | 1,545                   |
| Construction                     | -                                                      | -                            | -                                    | -                    | 4,849          | 4,849                     | -                       |
| Other Loans:                     |                                                        |                              |                                      |                      |                |                           |                         |
| Commercial                       | 38                                                     | -                            | 30                                   | 68                   | 15,673         | 15,741                    | 132                     |
| Consumer                         | 17                                                     | 5                            | 28                                   | 50                   | 1,457          | 1,507                     | 6                       |
| Total                            | \$ 1,762                                               | \$ 826                       | \$ 2,951                             | \$ 5,539             | \$ 290,602     | \$ 296,141                | \$ 4,506                |

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 six month periods ended June 30, 2016 and 2015 was \$147,000 and \$209,000, 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.

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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. 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 June 30, 2016 and December 31, 2015:

|                                  | Pass/Perform           | Special<br>Mention | Substandard | Doubtful | Loss | Total      |
|----------------------------------|------------------------|--------------------|-------------|----------|------|------------|
|                                  | (Dollars in thousands) |                    |             |          |      |            |
| June 30, 2016                    |                        |                    |             |          |      |            |
| Real Estate Loans:               |                        |                    |             |          |      |            |
| Residential, one- to four-family | \$ 150,939             | \$ -               | \$ 2,869    | \$ -     | \$ - | \$ 153,808 |
| Home equity                      | 32,453                 | -                  | 576         | -        | -    | 33,029     |
| Commercial                       | 87,878                 | 1,697              | 2,580       | -        | -    | 92,155     |
| Construction                     | 12,083                 | -                  | -           | -        | -    | 12,083     |
| Other Loans:                     |                        |                    |             |          |      |            |
| Commercial                       | 21,519                 | 26                 | 355         | -        | -    | 21,900     |
| Consumer                         | 1,327                  | -                  | 1           | -        | 1    | 1,329      |
| Total                            | \$ 306,199             | \$ 1,723           | \$ 6,381    | \$ -     | \$ 1 | \$ 314,304 |

|                                  | Pass/Performing        | Special<br>Mention | Substandard | Doubtful | Loss | Total      |
|----------------------------------|------------------------|--------------------|-------------|----------|------|------------|
|                                  | (Dollars in thousands) |                    |             |          |      |            |
| December 31, 2015                |                        |                    |             |          |      |            |
| Real Estate Loans:               |                        |                    |             |          |      |            |
| Residential, one- to four-family | \$ 154,473             | \$ -               | \$ 2,617    | \$ 217   | \$ - | \$ 157,307 |
| Home equity                      | 32,210                 | -                  | 560         | -        | -    | 32,770     |
| Commercial                       | 76,953                 | 4,741              | 2,273       | -        | -    | 83,967     |
| Construction                     | 4,849                  | -                  | -           | -        | -    | 4,849      |
| Other Loans:                     |                        |                    |             |          |      |            |
| Commercial                       | 15,237                 | 262                | 242         | -        | -    | 15,741     |
| Consumer                         | 1,504                  | -                  | 1           | -        | 2    | 1,507      |
| Total                            | \$ 285,226             | \$ 5,003           | \$ 5,693    | \$ 217   | \$ 2 | \$ 296,141 |

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.

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

|                                  |                                                          |        |                                                              |      |                                                          |        | TDRs That Have<br>Defaulted on<br>Modified Terms<br>Year to Date |      |  |
|----------------------------------|----------------------------------------------------------|--------|--------------------------------------------------------------|------|----------------------------------------------------------|--------|------------------------------------------------------------------|------|--|
|                                  | Number<br>of Recorded<br>Loans<br>(Dollars in thousands) |        | Non-Accruing<br>Number<br>of Recorded<br>Loans<br>Investment |      | Accruing<br>Number<br>of Recorded<br>Loans<br>Investment |        | Number<br>of Recorded<br>Loans<br>Investment                     |      |  |
|                                  |                                                          |        |                                                              |      |                                                          |        |                                                                  |      |  |
| At June 30, 2016                 |                                                          |        |                                                              |      |                                                          |        |                                                                  |      |  |
| Real Estate Loans:               |                                                          |        |                                                              |      |                                                          |        |                                                                  |      |  |
| Residential, one- to four-family | 6                                                        | \$ 242 | -                                                            | \$ - | 6                                                        | \$ 242 | -                                                                | \$ - |  |
| Home equity                      | 1                                                        | 4      | -                                                            | -    | 1                                                        | 4      | -                                                                | -    |  |
| Total                            | 7                                                        | \$ 246 | -                                                            | \$ - | 7                                                        | \$ 246 | -                                                                | \$ - |  |
|                                  |                                                          |        |                                                              |      |                                                          |        |                                                                  |      |  |
| At December 31, 2015             |                                                          |        |                                                              |      |                                                          |        |                                                                  |      |  |
| Real Estate Loans:               |                                                          |        |                                                              |      |                                                          |        |                                                                  |      |  |
| Residential, one- to four-family | 5                                                        | \$ 216 | -                                                            | \$ - | 5                                                        | \$ 216 | -                                                                | \$ - |  |
| Home equity                      | 2                                                        | 8      | -                                                            | -    | 2                                                        | 8      | -                                                                | -    |  |
| Total                            | 7                                                        | \$ 224 | -                                                            | \$ - | 7                                                        | \$ 224 | -                                                                | \$ - |  |

No additional loan commitments were outstanding to these borrowers at June 30, 2016 and at December 31, 2015.

The following table details the activity in loans which were first deemed to be TDRs during the six months ended June 30, 2016:

|                                  | For The Six Months Ended June 30,<br>2016 |                                                                         |          |                                                            |
|----------------------------------|-------------------------------------------|-------------------------------------------------------------------------|----------|------------------------------------------------------------|
|                                  | Number<br>of<br>Loans                     | Pre-Modification<br>Outstanding<br>Investment<br>(Dollars in thousands) | Recorded | Post-Modification<br>Outstanding<br>Recorded<br>Investment |
| Real Estate Loans:               |                                           |                                                                         |          |                                                            |
| Residential, one- to four-family | 1                                         | \$ 31                                                                   |          | \$ 31                                                      |
| Home equity                      | -                                         | -                                                                       |          | -                                                          |
| Total                            | 1                                         | \$ 31                                                                   |          | \$ 31                                                      |

There were no loans restructured and classified as TDRs during the three months ended June 30, 2016 or during the three and six months ended June 30, 2015.

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 \$766,000 and \$712,000 at June 30, 2016 and December 31, 2015, 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 \$820,000 and \$708,000 at June 30, 2016 and December 31, 2015, respectively.

## Note 5 – Earnings per Share

Earnings per share was calculated for the three and six months ended June 30, 2016 and 2015, 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 June 30, |              |
|---------------------------------------------------------|-----------------------------|--------------|
|                                                         | 2016                        | 2015         |
| Numerator – net income                                  | \$ 664,000                  | \$ 699,000   |
| Denominator:                                            |                             |              |
| Basic weighted average shares outstanding               | 6,002,253                   | 5,895,692    |
| Increase in weighted average shares outstanding due to: |                             |              |
| Stock options                                           | 12,669                      | 34,381       |
| Diluted weighted average shares outstanding             | 6,014,922                   | 5,930,073    |
| Earnings per share:                                     |                             |              |
| Basic                                                   | \$ 0.11                     | \$ 0.12      |
| Diluted                                                 | \$ 0.11                     | \$ 0.12      |
|                                                         | Six Months Ended June 30,   |              |
|                                                         | 2016                        | 2015         |
| Numerator – net income                                  | \$ 2,618,000                | \$ 1,268,000 |
| Denominator:                                            |                             |              |
| Basic weighted average shares outstanding               | 5,982,063                   | 5,896,165    |
| Increase in weighted average shares outstanding due to: |                             |              |
| Stock options                                           | 12,529                      | 32,944       |
| Diluted weighted average shares outstanding             | 5,994,592                   | 5,929,109    |
| Earnings per share:                                     |                             |              |
| Basic                                                   | \$ 0.44                     | \$ 0.22      |
| Diluted                                                 | \$ 0.44                     | \$ 0.21      |

## 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. There were no loss reserves associated with these commitments at June 30, 2016 and December 31, 2015. 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           |                         |
|--------------------------------------------|---------------------------|-------------------------|
|                                            | June 30,<br>2016          | December<br>31,<br>2015 |
|                                            | (Dollars in<br>thousands) |                         |
| Commitments to grant loans                 | \$ 17,589                 | \$ 12,224               |
| Unfunded commitments under lines of credit | \$ 34,392                 | \$ 34,847               |

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 June 30, 2016 and December 31, 2015, the Company's loan commitments with fixed rates for the next five years totaled \$9.4 million and \$6.3 million, respectively. The range of interest rates on these fixed rate commitments was 3.38% to 6.25% at June 30, 2016.

#### Note 7 – Stock-based Compensation

As of June 30, 2016, 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 \$107,000 and \$83,000 for the three months ended June 30, 2016 and 2015, respectively. The compensation cost that has been recorded for the six months ended June 30, 2016 and 2015 was \$199,000 and \$161,000, respectively.

#### 2006 Stock Option Plan

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

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

A summary of the status of the Stock Option Plan as of June 30, 2016 and 2015 is presented below:

|                                     | June 30, 2016 |                   |                               | June 30, 2015 |                   |                               |
|-------------------------------------|---------------|-------------------|-------------------------------|---------------|-------------------|-------------------------------|
|                                     | Options       | Exercise<br>Price | Remaining<br>Contractual Life | Options       | Exercise<br>Price | Remaining<br>Contractual Life |
| Outstanding at beginning<br>of year | 118,087       | \$ 10.68          |                               | 175,369       | \$ 10.92          |                               |

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|                                      |          |          |           |          |          |           |
|--------------------------------------|----------|----------|-----------|----------|----------|-----------|
| Granted                              | -        | -        |           | -        | -        |           |
| Exercised                            | (66,651) | 11.04    |           | (11,775) | 11.50    |           |
| Forfeited                            | -        | -        |           | -        | -        |           |
| Outstanding at end of period         | 51,436   | \$ 10.21 | 1.5 years | 163,594  | \$ 10.87 | 1.7 years |
| Options exercisable at end of period | 51,436   | \$ 10.21 | 1.5 years | 163,594  | \$ 10.87 | 1.7 years |
| Fair value of options granted        |          | -        |           |          | -        |           |
| :                                    |          |          |           |          |          |           |

At June 30, 2016, stock options outstanding had an intrinsic value of \$145,000 and 64,547 options remained available for grant under the Stock Option Plan. The intrinsic value of stock options exercised was \$158,000 and \$22,000 for the six months ended June 30, 2016 and 2015, respectively. There was no compensation

expense related to the Stock Option Plan for the three and six month periods ended June 30, 2016. There was no compensation expense related to the Stock Option Plan for the three month period ended June 30, 2015. Compensation expense for the Stock Option Plan amounted to \$1,000 for the six month period ended June 30, 2015.

## 2006 Recognition and Retention Plan

The Company's 2006 Recognition and Retention Plan ("RRP"), which was approved by the Company's shareholders, permits the grant of restricted stock awards ("Awards") to employees and non-employee directors for up to 119,025 shares of common stock. As of June 30, 2016, there were 8,088 shares available to grant under the RRP.

As of June 30, 2016, there were 88,528 shares vested or distributed to eligible participants under the RRP. Compensation expense amounted to \$16,000 for the three months ended June 30, 2016 and 2015 and \$33,000 for the six months ended June 30, 2016 and 2015. At June 30, 2016, \$206,000 of unrecognized compensation cost related to the RRP is expected to be recognized over a period of 12 to 49 months.

A summary of the status of unvested shares under the RRP for the six months ended June 30, 2016 and 2015 is as follows:

|                                                  | 2016   | Weighted Average Grant Price (per Share) | 2015    | Weighted Average Grant Price (per Share) |
|--------------------------------------------------|--------|------------------------------------------|---------|------------------------------------------|
| Unvested shares outstanding at beginning of year | 21,397 | \$ 12.25                                 | 29,031  | \$ 11.88                                 |
| Vested                                           | -      | -                                        | (2,380) | 7.88                                     |
| Forfeited                                        | -      | -                                        | -       | -                                        |
| Unvested shares outstanding at end of period     | 21,397 | \$ 12.25                                 | 26,651  | \$ 12.24                                 |

## 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.

The Board of Directors has granted restricted stock awards under the EIP during 2016 as follows:

|            |         |          |
|------------|---------|----------|
| Grant Date | Vesting | Awardees |
|------------|---------|----------|

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|                     | Number of<br>Restricted Stock<br>Awards |                                                                               | Fair Value per Share<br>of Award on Grant<br>Date |                           |
|---------------------|-----------------------------------------|-------------------------------------------------------------------------------|---------------------------------------------------|---------------------------|
| January 20,<br>2016 | 14,337                                  | 100% on December 15, 2018, if<br>three year performance metric is<br>achieved | \$ 13.35                                          | Employees                 |
| January 28,<br>2016 | 4,078                                   | 100% on December 16, 2016                                                     | 13.50                                             | Non-employee<br>directors |
| April 27,<br>2016   | 1,939                                   | 100% on December 16, 2016                                                     | 13.31                                             | Non-employee<br>directors |

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A summary of the status of unvested restricted stock awards under the EIP for the six months ended June 30, 2016 and 2015 is as follows:

|                                                  | 2016   | Weighted Average Grant<br>Price (per Share) | 2015   | Weighted Average Grant<br>Price (per Share) |
|--------------------------------------------------|--------|---------------------------------------------|--------|---------------------------------------------|
| Unvested shares outstanding at beginning of year | 27,769 | \$ 12.64                                    | 21,552 | \$ 12.19                                    |
| Granted                                          | 20,354 | 13.38                                       | 14,955 | 13.38                                       |
| Vested                                           | -      | -                                           | -      | -                                           |
| Forfeited                                        | -      | -                                           | -      | -                                           |
| Unvested shares outstanding at end of period     | 48,123 | \$ 12.95                                    | 36,507 | \$ 12.68                                    |

As of June 30, 2016, there were 11,687 shares vested or distributed to eligible participants under the EIP.

Compensation expense related to the EIP amounted to \$64,000 for the three months ended June 30, 2016 and \$40,000 for the three months ended June 30, 2015. Compensation expense related to the EIP amounted to \$113,000 for the six months ended June 30, 2016 and \$73,000 for the six months ended June 30, 2015. At June 30, 2016, \$442,000 of unrecognized compensation cost related to unvested awards is expected to be recognized over a period of 6 to 38 months.

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

The Company established the ESOP for the benefit of eligible employees of the Company and Bank. All Company and Bank employees meeting certain age and service requirements are eligible to participate in the ESOP. Participants' benefits become fully vested after five years of service once the employee is eligible to participate in the ESOP. The Company utilized \$2.6 million of the proceeds of its 2006 stock offering to extend a loan to the ESOP and the ESOP used such proceeds to purchase 238,050 shares of stock on the open market at an average price of \$10.70 per share, plus commission expenses. As a result of the purchase of shares by the ESOP, total stockholders' equity of the Company was reduced by \$2.6 million. As of June 30, 2016, the balance of the loan to the ESOP was \$1.7 million and the fair value of unallocated shares was \$2.0 million. As of June 30, 2016, there were 63,594 allocated shares and 158,699 unallocated shares compared to 58,276 allocated shares and 166,634 unallocated shares at June 30, 2015.

The ESOP compensation expense was \$27,000 for the three months ended June 30, 2016 and 2015 based on 1,984 shares earned in each of those quarters. The ESOP compensation expense was \$53,000 for the six months ended June 30, 2016 and \$54,000 for the six months ended June 30, 2015 based on 3,968 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 June 30, 2016 and December 31, 2015 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:

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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.

For assets measured at fair value on a recurring basis, the fair value measurements by level within the fair value hierarchy used at June 30, 2016 and December 31, 2015 were as follows:

| Fair Value Measurements at June 30, 2016                          |                                                                                     |                                                           |                                                             |                        |
|-------------------------------------------------------------------|-------------------------------------------------------------------------------------|-----------------------------------------------------------|-------------------------------------------------------------|------------------------|
|                                                                   | Quoted<br>Prices in<br>Active<br>Markets<br>for<br>Identical<br>Assets<br>(Level 1) | Significant<br>Other<br>Observable<br>Inputs<br>(Level 2) | Significant<br>Other<br>Unobservable<br>Inputs<br>(Level 3) |                        |
| June 30,<br>2016                                                  | (Level 1)                                                                           | (Level 2)                                                 | (Level 3)                                                   | (Dollars in thousands) |
| Measured at fair value on a recurring basis:                      |                                                                                     |                                                           |                                                             |                        |
| Securities available for sale:                                    |                                                                                     |                                                           |                                                             |                        |
| Municipal bonds                                                   | \$ 52,584                                                                           | \$ -                                                      | \$ 52,584                                                   | \$ -                   |
| Mortgage-backed securities:                                       |                                                                                     |                                                           |                                                             |                        |
| Collateralized mortgage obligations-private label                 | 46                                                                                  | -                                                         | 46                                                          | -                      |
| Collateralized mortgage obligations-government sponsored entities | 34,396                                                                              | -                                                         | 34,396                                                      | -                      |
| Government National Mortgage Association                          | 387                                                                                 | -                                                         | 387                                                         | -                      |
| Federal National Mortgage Association                             | 4,196                                                                               | -                                                         | 4,196                                                       | -                      |
| Federal Home Loan Mortgage Corporation                            | 2,135                                                                               | -                                                         | 2,135                                                       | -                      |
| Asset-backed securities:                                          |                                                                                     |                                                           |                                                             |                        |
| Private label                                                     | 1,149                                                                               | -                                                         | -                                                           | 1,149                  |
| Government sponsored entities                                     | 87                                                                                  | -                                                         | 87                                                          | -                      |
| Equity securities                                                 | 41                                                                                  | -                                                         | 41                                                          | -                      |
| Total                                                             | \$ 95,021                                                                           | \$ -                                                      | \$ 93,872                                                   | \$ 1,149               |





## Fair Value Measurements at December 31, 2015

|                         | Quoted<br>Prices in<br>Active<br>Markets<br>for<br>Identical<br>Assets<br>(Level 1) | Significant<br>Other<br>Observable<br>Inputs<br>(Level 2) | Significant<br>Other<br>Unobservable<br>Inputs<br>(Level 3) |
|-------------------------|-------------------------------------------------------------------------------------|-----------------------------------------------------------|-------------------------------------------------------------|
| December<br>31,<br>2015 |                                                                                     |                                                           |                                                             |
|                         | (Dollars in thousands)                                                              |                                                           |                                                             |

Measured at fair value on a recurring basis:

Securities available for sale:

|                                                                   |            |           |           |          |
|-------------------------------------------------------------------|------------|-----------|-----------|----------|
| U.S. Treasury bonds                                               | \$ 14,111  | \$ 14,111 | \$ -      | \$ -     |
| Municipal bonds                                                   | 51,808     | -         | 51,808    | -        |
| Mortgage-backed securities:                                       |            |           |           |          |
| Collateralized mortgage obligations-private label                 | 48         | -         | 48        | -        |
| Collateralized mortgage obligations-government sponsored entities | 38,342     | -         | 38,342    | -        |
| Government National Mortgage Association                          | 427        | -         | 427       | -        |
| Federal National Mortgage Association                             | 4,542      | -         | 4,542     | -        |
| Federal Home Loan Mortgage Corporation                            | 2,301      | -         | 2,301     | -        |
| Asset-backed securities:                                          |            |           |           |          |
| Private label                                                     | 1,501      | -         | -         | 1,501    |
| Government sponsored entities                                     | 97         | -         | 97        | -        |
| Equity securities                                                 | 36         | -         | 36        | -        |
| Total                                                             | \$ 113,213 | \$ 14,111 | \$ 97,601 | \$ 1,501 |

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 six months ended June 30, 2016 and for the year ended December 31, 2015.

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.

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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 six months ended June 30, 2016 and 2015:

|                                              | 2016                   | 2015     |
|----------------------------------------------|------------------------|----------|
|                                              | (Dollars in thousands) |          |
| Beginning Balance                            | \$ 1,501               | \$ 2,023 |
| Total gains - realized/unrealized:           |                        |          |
| Included in earnings                         | -                      | -        |
| Included in other comprehensive income(loss) | 36                     | 21       |
| Total losses - realized/unrealized:          |                        |          |
| Included in earnings                         | -                      | -        |
| Included in other comprehensive income(loss) | (39)                   | (55)     |
| Sales                                        | -                      | -        |
| Principal paydowns                           | (349)                  | (195)    |
| Transfers to (out of) Level 3                | -                      | -        |
| Ending Balance                               | \$ 1,149               | \$ 1,794 |

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 June 30, 2016 and December 31, 2015 (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  |
| June 30, 2016                           |            |                                                                 |                |                                 |                                              |                |
| Asset-backed securities - private label | \$ 1,149   | Sub-prime First and Prime Second Lien - Residential Real Estate | B- thru D      | 5 - 10                          | 5.00%                                        | 70.0% - 100.0% |
| December 31, 2015                       |            |                                                                 |                |                                 |                                              |                |
| Asset-backed securities - private label | \$ 1,501   | 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 Company's management using 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.

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 appraisal less estimated selling costs of underlying collateral or discounted cash flows based on current market conditions.

For assets measured at fair value on a non-recurring basis, the fair value measurements by level within the fair value hierarchy used at June 30, 2016 and December 31, 2015 were as follows:

|                                                  | Fair Value Measurements                                                |                                              |                                                |           |
|--------------------------------------------------|------------------------------------------------------------------------|----------------------------------------------|------------------------------------------------|-----------|
|                                                  | Quoted<br>Prices in<br>Active<br>Markets<br>for<br>Identical<br>Assets | Significant<br>Other<br>Observable<br>Inputs | Significant<br>Other<br>Unobservable<br>Inputs |           |
|                                                  | Fair<br>Value<br>(Dollars in thousands)                                | (Level 1)                                    | (Level 2)                                      | (Level 3) |
| Measured at fair value on a non-recurring basis: |                                                                        |                                              |                                                |           |
| At June 30, 2016                                 |                                                                        |                                              |                                                |           |
| Impaired loans                                   | \$ 405                                                                 | \$ -                                         | \$ -                                           | \$ 405    |
| Foreclosed real estate                           | 336                                                                    | -                                            | -                                              | 336       |
| At December 31, 2015                             |                                                                        |                                              |                                                |           |
| Impaired loans                                   | \$ 98                                                                  | \$ -                                         | \$ -                                           | \$ 98     |
| Foreclosed real estate                           | 292                                                                    | -                                            | -                                              | 292       |

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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 |                     |                                                                             |                                                        |                            |
|----------------------------------------------------------------|---------------------|-----------------------------------------------------------------------------|--------------------------------------------------------|----------------------------|
| (Dollars in thousands)                                         | Fair Value Estimate | Valuation Technique                                                         | Unobservable Input                                     | Range                      |
| At June 30, 2016                                               |                     |                                                                             |                                                        |                            |
| Impaired loans                                                 | \$ 405              | Market valuation of underlying collateral (1) and discounted cash flows (2) | Appraisal Adjustments (3)<br>Direct Disposal Costs (4) | 0.00-15.00%<br>7.00-15.00% |
| Foreclosed real estate                                         | 336                 | Market valuation of property (1)                                            | Direct Disposal Costs (4)                              | 7.00-10.00%                |
| At December 31, 2015                                           |                     |                                                                             |                                                        |                            |
| Impaired loans                                                 | \$ 98               | Market valuation of underlying collateral (1)                               | Appraisal Adjustments (3)<br>Direct Disposal Costs (4) | 0.00-15.00%<br>7.00-10.00% |
| Foreclosed real estate                                         | 292                 | Market valuation of property (1)                                            | Appraisal Adjustments (3)<br>Direct Disposal Costs (4) | 0.00-25.00%<br>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) Fair value is generally determined using a discounted future cash flow method for non-collateral dependent loans. This method takes into account interest rates currently being offered to customers for loans with similar terms and with estimated maturity. The estimate of maturity is based on the Company's contractual cash flows and may be adjusted for prepayment estimates based on current economic and lending conditions.

(3) 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.

(4) 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.

At June 30, 2016, impaired loans valued using Level 3 inputs had a carrying amount of \$373,000 and valuation allowances of \$26,000. By comparison, at December 31, 2015, impaired loans valued using Level 3 inputs had a carrying amount of \$80,000 and valuation allowances of \$20,000.

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 or by using a discounted future cash flow method if the loan is not collateral dependent. At June 30, 2016, impaired loans whose carrying amount was written down utilizing Level 3 inputs during the six month period ended June 30, 2016 comprised of three loans with a fair value of \$352,000 and resulted in an additional provision for loan loss of \$26,000. At December 31, 2015, impaired loans whose carrying amount was written down utilizing Level 3 inputs during the year ended December 31, 2015 comprised of one loan with a fair value of \$45,000 and resulted in an additional provision for loan loss of \$20,000.

At June 30, 2016, foreclosed real estate valued using Level 3 inputs had a carrying amount of \$377,000 and valuation allowances of \$85,000. By comparison at December 31, 2015, foreclosed real estate valued using Level 3 inputs had a carrying amount of \$347,000 and valuation allowances of \$84,000.

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 June 30, 2016, foreclosed real estate whose carrying value was written down utilizing Level 3 inputs during the six month period ended June

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30, 2016 comprised of four properties with a fair value of \$153,000 and resulted in an additional provision for loan losses of \$4,000 and subsequent write-downs recorded in non-interest expense of \$3,000. At December 31, 2015, foreclosed real estate whose carrying value was written down utilizing Level 3 inputs during the year ended December 31, 2015 comprised of seven properties with a fair value of \$294,000 and resulted in an additional provision for loan losses of \$72,000.

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 June 30, 2016

|                                         |                                              |                         | Quoted<br>Prices in<br>Active<br>Markets<br>for<br>Identical<br>Assets<br>(Level 1) | Significant<br>Other<br>Observable<br>Inputs<br>(Level 2) | Significant<br>Other<br>Unobservable<br>Inputs<br>(Level 3) |
|-----------------------------------------|----------------------------------------------|-------------------------|-------------------------------------------------------------------------------------|-----------------------------------------------------------|-------------------------------------------------------------|
|                                         | Carrying<br>Amount<br>(Dollars in thousands) | Estimated<br>Fair Value |                                                                                     |                                                           |                                                             |
| Financial assets:                       |                                              |                         |                                                                                     |                                                           |                                                             |
| Cash and cash equivalents               | \$ 41,198                                    | \$ 41,198               | \$ 41,198                                                                           | \$ -                                                      | \$ -                                                        |
| Securities available for sale           | 95,021                                       | 95,021                  | -                                                                                   | 93,872                                                    | 1,149                                                       |
| Federal Home Loan Bank stock            | 1,340                                        | 1,340                   | -                                                                                   | 1,340                                                     | -                                                           |
| Loans receivable, net                   | 315,218                                      | 313,166                 | -                                                                                   | -                                                         | 313,166                                                     |
| Accrued interest receivable             | 1,563                                        | 1,563                   | -                                                                                   | 1,563                                                     | -                                                           |
| Financial liabilities:                  |                                              |                         |                                                                                     |                                                           |                                                             |
| Deposits                                | 374,844                                      | 377,489                 | -                                                                                   | 377,489                                                   | -                                                           |
| Long-term debt                          | 18,950                                       | 19,448                  | -                                                                                   | 19,448                                                    | -                                                           |
| Accrued interest payable                | 30                                           | 30                      | -                                                                                   | 30                                                        | -                                                           |
| Off-balance-sheet financial instruments | -                                            | -                       | -                                                                                   | -                                                         | -                                                           |

Fair Value Measurements at December 31, 2015

|                   |                                              |                         | Quoted<br>Prices in<br>Active<br>Markets<br>for<br>Identical<br>Assets<br>(Level 1) | Significant<br>Other<br>Observable<br>Inputs<br>(Level 2) | Significant<br>Other<br>Unobservable<br>Inputs<br>(Level 3) |
|-------------------|----------------------------------------------|-------------------------|-------------------------------------------------------------------------------------|-----------------------------------------------------------|-------------------------------------------------------------|
|                   | Carrying<br>Amount<br>(Dollars in thousands) | Estimated<br>Fair Value |                                                                                     |                                                           |                                                             |
| Financial assets: |                                              |                         |                                                                                     |                                                           |                                                             |

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|                                         |           |           |           |         |         |
|-----------------------------------------|-----------|-----------|-----------|---------|---------|
| Cash and cash equivalents               | \$ 34,227 | \$ 34,227 | \$ 34,227 | \$ -    | \$ -    |
| Securities available for sale           | 113,213   | 113,213   | 14,111    | 97,601  | 1,501   |
| Federal Home Loan Bank stock            | 1,454     | 1,454     | -         | 1,454   | -       |
| Loans receivable, net                   | 297,101   | 291,203   | -         | -       | 291,203 |
| Accrued interest receivable             | 1,648     | 1,648     | -         | 1,648   | -       |
| Financial liabilities:                  |           |           |           |         |         |
| Deposits                                | 369,155   | 370,120   | -         | 370,120 | -       |
| Long-term debt                          | 21,150    | 21,183    | -         | 21,183  | -       |
| Accrued interest payable                | 37        | 37        | -         | 37      | -       |
| 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.

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.

Off-Balance Sheet Financial Instruments (disclosed at cost)

Fair values of the Company's off-balance sheet financial instruments (lending commitments) are based on interest rates and fees currently charged to enter into similar agreements, taking into account, the remaining terms of the commitments 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 June 30, 2016, the Company repurchased 10,000 shares of common stock at an average cost of \$13.55 per share. During the six months ended June 30, 2016, the Company repurchased 20,000 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 program. As of June 30, 2016, there were 97,701 shares remaining to be repurchased under the existing stock repurchase program. During the three and six months ended June 30, 2016, the Company transferred 1,939 and 20,354 shares of common stock, respectively, from the treasury stock reserved for the 2012 Equity Incentive Plan, at an average cost of \$9.70 per share to fund awards that were granted.

During the quarter ended June 30, 2015, the Company repurchased 20,000 shares of common stock at an average cost of \$13.57 per share. During the six months ended June 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 program. As of June 30, 2015 there were 16,510 shares remaining to be repurchased under the then existing stock repurchase program. During the six months ended June 30, 2015, the Company transferred 15,455 shares of common stock from the treasury stock reserved for the 2012 Equity Incentive Plan, at an average cost of \$9.39 per share to fund awards that were granted.

# Note 10 – Other Comprehensive Income (Loss)

In addition to presenting the Consolidated Statements of Other Comprehensive Income (Loss) 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<br>June 30, 2016 |          |         | For the Three Months Ended<br>June 30, 2015 |         |            |
|------------------------------------------------------------------------------|---------------------------------------------|----------|---------|---------------------------------------------|---------|------------|
|                                                                              | Tax                                         | Net of   |         | Tax                                         | Net of  |            |
|                                                                              | Pre-Tax (Expense)                           | Tax      | Pre-Tax | (Expense)                                   | Tax     |            |
|                                                                              | Amount                                      | Benefit  | Amount  | Amount                                      | Benefit | Amount     |
|                                                                              | (Unaudited)                                 |          |         |                                             |         |            |
|                                                                              | (Dollars in thousands)                      |          |         |                                             |         |            |
| Net unrealized gains (losses) on securities available for sale:              |                                             |          |         |                                             |         |            |
| Net unrealized gains (losses) arising during the period                      | \$ 531                                      | \$ (180) | \$ 351  | \$ (1,555)                                  | \$ 530  | \$ (1,025) |
| Less: reclassification adjustment related to:                                |                                             |          |         |                                             |         |            |
| Recovery on previously impaired investment securities included in net income | (33)                                        | 11       | (22)    | (43)                                        | 14      | (29)       |
| Total Other Comprehensive Income (Loss)                                      | \$ 498                                      | \$ (169) | \$ 329  | \$ (1,598)                                  | \$ 544  | \$ (1,054) |

|                                                                              | For the Six Months Ended<br>June 30, 2016 |                             |                         | For the Six Months Ended<br>June 30, 2015 |                             |                      |
|------------------------------------------------------------------------------|-------------------------------------------|-----------------------------|-------------------------|-------------------------------------------|-----------------------------|----------------------|
|                                                                              | Pre-Tax<br>Amount                         | Tax<br>(Expense)<br>Benefit | Net of<br>Tax<br>Amount | Pre-Tax<br>Amount                         | Tax<br>(Expense)<br>Benefit | Net of Tax<br>Amount |
| (Dollars in thousands)                                                       |                                           |                             |                         |                                           |                             |                      |
| Net unrealized gains (losses) on securities available for sale:              |                                           |                             |                         |                                           |                             |                      |
| Net unrealized gains (losses) arising during the period                      | \$ 2,009                                  | \$ (683)                    | \$ 1,326                | \$ (1,093)                                | \$ 641                      | \$ (452)             |
| Less: reclassification adjustment related to:                                |                                           |                             |                         |                                           |                             |                      |
| Recovery on previously impaired investment securities included in net income | (68)                                      | 23                          | (45)                    | (75)                                      | 25                          | (50)                 |
| Gain on sale of securities included in net income                            | (1,636)                                   | 556                         | (1,080)                 | -                                         | -                           | -                    |
| Total Other Comprehensive Income (Loss)                                      | \$ 305                                    | \$ (104)                    | \$ 201                  | \$ (1,168)                                | \$ 666                      | \$ (502)             |

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

| Details about Accumulated Other Comprehensive Income Components  | Accounts<br>Reclassified<br>from<br>Accumulated<br>Other<br>Comprehensive<br>Income (Loss)<br>for the three<br>months ended<br>June 30,<br>2016 | 2015    | Affected Line Item on the Consolidated<br>Statements of Income |
|------------------------------------------------------------------|-------------------------------------------------------------------------------------------------------------------------------------------------|---------|----------------------------------------------------------------|
|                                                                  | (Dollars in thousands)                                                                                                                          |         |                                                                |
| Net unrealized gains and losses on securities available for sale |                                                                                                                                                 |         |                                                                |
| Recovery on previously impaired investment securities            | \$ (33)                                                                                                                                         | \$ (43) | Recovery on previously impaired investment securities          |
|                                                                  | (33)                                                                                                                                            | (43)    |                                                                |
| Provision for income tax expense                                 | 11                                                                                                                                              | 14      | Income Tax Expense                                             |
| Total reclassification for the period                            | \$ (22)                                                                                                                                         | \$ (29) | Net Income                                                     |

| Details about Accumulated Other Comprehensive Income Components  | Accounts<br>Reclassified from<br>Accumulated<br>Other<br>Comprehensive<br>Income (Loss)<br>for the six<br>months ended<br>June 30,<br>2016 | 2015    | Affected Line Item on the Consolidated<br>Statements of Income |
|------------------------------------------------------------------|--------------------------------------------------------------------------------------------------------------------------------------------|---------|----------------------------------------------------------------|
|                                                                  | (Dollars in thousands)                                                                                                                     |         |                                                                |
| Net unrealized gains and losses on securities available for sale |                                                                                                                                            |         |                                                                |
| Recovery on previously impaired investment securities            | \$ (68)                                                                                                                                    | \$ (75) | Recovery on previously impaired investment securities          |
| Sale of securities                                               | (1,636)                                                                                                                                    | -       | Gain on sale of securities available for sale                  |
|                                                                  | (1,704)                                                                                                                                    | (75)    |                                                                |

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|                                       |            |         |                    |
|---------------------------------------|------------|---------|--------------------|
| Provision for income tax expense      | 579        | 25      | Income Tax Expense |
| Total reclassification for the period | \$ (1,125) | \$ (50) | Net Income         |

### Note 11 – Subsequent Events

On July 27, 2016, the Board of Directors declared a quarterly cash dividend of \$0.07 per share on the Company's common stock, payable on August 22, 2016 to shareholders of record as of August 11, 2016. On March 2, 2016, Lake Shore, MHC (the "MHC"), which holds 3,636,875 shares, or approximately 59.9% of the Company's total outstanding stock, 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 2, 2017, aggregating up to \$0.28 per share. This quarter, the MHC elected to receive this cash dividend of approximately \$255,000 to replenish cash at the top-tier holding company for operating expenses. The MHC waived \$255,000 of dividends during the three months ended June 30, 2016 and \$510,000 during the six months ended June 30, 2016. Cumulatively, Lake Shore, MHC has waived approximately \$8.0 million of cash dividends as of June 30, 2016. 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 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, 2015, 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 June 30, 2016 compared to the consolidated financial condition as of December 31, 2015 and the consolidated results of operations for the three and six months ended June 30, 2016 and 2015.

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, borrowings 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 charges and 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, data processing, professional services, advertising 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 laws, regulations or government policies may materially impact the Company.

To operate successfully, we must manage various types of risk, including but not limited to, interest rate risk, credit risk, liquidity risk, operational and information technology risks, strategic risk, reputation risk and compliance risk. While all of these risks are important, the risks of greatest significance to us are interest rate risk and credit risk.

Interest rate risk is the exposure of our net interest income to adverse movements in interest rates. Since net interest income (the difference between interest earned on loans and investments and interest paid on deposits and borrowings) is our primary source of revenue, interest rate risk is the most significant non-credit related risk to which our Company is exposed. Net interest income is affected by changes in interest rates as well as fluctuations in the level and duration of our assets and liabilities. In addition to directly impacting net interest income, changes in interest rates can also affect the amount of new loan originations, the ability of borrowers and debt issuers to repay loans and debt securities, the volume of loan repayments and refinancings, and the flow and mix of deposits.

Credit risk is the risk to our earnings and stockholders' equity that results from customers, to whom loans have been made and from issuers of debt securities in which the Company has invested, failing to repay their obligations. The magnitude of risk depends on the capacity and willingness of borrowers and debt issuers to repay and the sufficiency of the value of collateral obtained to secure the loans made or investments purchased.

### Management Strategy

There have been no material changes in the Company's management strategy from what was disclosed in the Company's Annual Report on Form 10-K for the year ended December 31, 2015.

### 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, 2015. 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, 2015.

### 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 reflects the average yield on interest-earning assets and average cost of interest-bearing liabilities, interest earned and interest paid for the periods indicated. Such yields and costs are derived by dividing 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

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loans. Interest income on securities does not include a tax equivalent adjustment for bank qualified municipal bonds.

|                                                | For the Three Months Ended<br>June 30, 2016 |                                |                | For the Three Months Ended<br>June 30, 2015 |                                |                |
|------------------------------------------------|---------------------------------------------|--------------------------------|----------------|---------------------------------------------|--------------------------------|----------------|
|                                                | Average<br>Balance                          | Interest<br>Income/<br>Expense | Yield/<br>Rate | Average<br>Balance                          | Interest<br>Income/<br>Expense | Yield/<br>Rate |
|                                                | (Dollars in thousands)                      |                                |                |                                             |                                |                |
| Interest-earning assets:                       |                                             |                                |                |                                             |                                |                |
| Interest-earning deposits & federal funds sold | \$ 38,306                                   | \$ 35                          | 0.37%          | \$ 22,895                                   | \$ 5                           | 0.09%          |
| Securities <sup>(1)</sup>                      | 97,623                                      | 710                            | 2.91%          | 133,915                                     | 979                            | 2.92%          |
| Loans                                          | 306,751                                     | 3,602                          | 4.70%          | 292,160                                     | 3,424                          | 4.69%          |
| Total interest-earning assets                  | 442,680                                     | 4,347                          | 3.93%          | 448,970                                     | 4,408                          | 3.93%          |
| Other assets                                   | 34,083                                      |                                |                | 33,691                                      |                                |                |
| Total assets                                   | \$ 476,763                                  |                                |                | \$ 482,661                                  |                                |                |
| Interest-bearing liabilities                   |                                             |                                |                |                                             |                                |                |
| Demand & NOW accounts                          | \$ 45,361                                   | \$ 9                           | 0.08%          | \$ 45,842                                   | \$ 10                          | 0.09%          |
| Money market accounts                          | 78,309                                      | 36                             | 0.18%          | 76,469                                      | 39                             | 0.20%          |
| Savings accounts                               | 48,346                                      | 7                              | 0.06%          | 45,168                                      | 6                              | 0.05%          |
| Time deposits                                  | 151,343                                     | 404                            | 1.07%          | 173,887                                     | 538                            | 1.24%          |
| Borrowed funds                                 | 18,951                                      | 91                             | 1.92%          | 18,950                                      | 98                             | 2.07%          |
| Other interest-bearing liabilities             | 972                                         | 23                             | 9.47%          | 1,053                                       | 25                             | 9.50%          |
| Total interest-bearing liabilities             | 343,282                                     | 570                            | 0.66%          | 361,369                                     | 716                            | 0.79%          |
| Other non-interest bearing liabilities         | 56,962                                      |                                |                | 48,530                                      |                                |                |
| Stockholders' equity                           | 76,519                                      |                                |                | 72,762                                      |                                |                |
| Total liabilities & stockholders' equity       | \$ 476,763                                  |                                |                | \$ 482,661                                  |                                |                |
| Net interest income                            |                                             | \$ 3,777                       |                |                                             | \$ 3,692                       |                |
| Interest rate spread                           |                                             |                                | 3.27%          |                                             |                                | 3.14%          |
| Net interest margin                            |                                             |                                | 3.41%          |                                             |                                | 3.29%          |

<sup>(1)</sup> The tax equivalent adjustment for bank qualified municipals results in rates of 3.86% and 3.74% for the three months ended June 30, 2016 and 2015, respectively.



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|                                                | For the Six Months Ended<br>June 30, 2016 |                                |                | For the Six Months Ended<br>June 30, 2015 |                                |                |
|------------------------------------------------|-------------------------------------------|--------------------------------|----------------|-------------------------------------------|--------------------------------|----------------|
|                                                | Average<br>Balance                        | Interest<br>Income/<br>Expense | Yield/<br>Rate | Average<br>Balance                        | Interest<br>Income/<br>Expense | Yield/<br>Rate |
|                                                | (Dollars in thousands)                    |                                |                |                                           |                                |                |
| Interest-earning assets:                       |                                           |                                |                |                                           |                                |                |
| Interest-earning deposits & federal funds sold | \$ 32,746                                 | \$ 51                          | 0.31%          | \$ 25,092                                 | \$ 11                          | 0.09%          |
| Securities(1)                                  | 104,787                                   | 1,544                          | 2.95%          | 136,234                                   | 2,002                          | 2.94%          |
| Loans                                          | 304,067                                   | 7,116                          | 4.68%          | 288,314                                   | 6,794                          | 4.71%          |
| Total interest-earning assets                  | 441,600                                   | 8,711                          | 3.95%          | 449,640                                   | 8,807                          | 3.92%          |
| Other assets                                   | 34,277                                    |                                |                | 33,750                                    |                                |                |
| Total assets                                   | \$ 475,877                                |                                |                | \$ 483,390                                |                                |                |
| Interest-bearing liabilities                   |                                           |                                |                |                                           |                                |                |
| Demand & NOW accounts                          | \$ 44,346                                 | \$ 17                          | 0.08%          | \$ 45,961                                 | \$ 24                          | 0.10%          |
| Money market accounts                          | 78,280                                    | 70                             | 0.18%          | 77,038                                    | 97                             | 0.25%          |
| Savings accounts                               | 46,917                                    | 13                             | 0.06%          | 43,967                                    | 17                             | 0.08%          |
| Time deposits                                  | 154,524                                   | 824                            | 1.07%          | 176,829                                   | 1,118                          | 1.26%          |
| Borrowed funds                                 | 19,591                                    | 187                            | 1.91%          | 18,932                                    | 197                            | 2.08%          |
| Other interest-bearing liabilities             | 981                                       | 46                             | 9.38%          | 1,062                                     | 49                             | 9.23%          |
| Total interest-bearing liabilities             | 344,639                                   | 1,157                          | 0.67%          | 363,789                                   | 1,502                          | 0.83%          |
| Other non-interest bearing liabilities         | 55,406                                    |                                |                | 46,944                                    |                                |                |
| Stockholders' equity                           | 75,832                                    |                                |                | 72,657                                    |                                |                |
| Total liabilities & stockholders' equity       | \$ 475,877                                |                                |                | \$ 483,390                                |                                |                |
| Net interest income                            |                                           | \$ 7,554                       |                |                                           | \$ 7,305                       |                |
| Interest rate spread                           |                                           |                                | 3.28%          |                                           |                                | 3.09%          |
| Net interest margin                            |                                           |                                | 3.42%          |                                           |                                | 3.25%          |

(1) The tax equivalent adjustment for bank qualified municipals results in rates of 3.83% and 3.74% for the six months ended June 30, 2016 and 2015, respectively.

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 June  
30, 2016  
Compared to  
Three Months Ended June  
30, 2015

|                                                | Rate                   | Volume  | Net<br>Change |
|------------------------------------------------|------------------------|---------|---------------|
|                                                | (Dollars in thousands) |         |               |
| Interest-earning assets:                       |                        |         |               |
| Interest-earning deposits & federal funds sold | \$ 25                  | \$ 5    | \$ 30         |
| Securities                                     | (5)                    | (264)   | (269)         |
| Loans, including fees                          | 7                      | 171     | 178           |
| Total interest-earning assets                  | 27                     | (88)    | (61)          |
| Interest-bearing liabilities:                  |                        |         |               |
| Demand & NOW accounts                          | (1)                    | -       | (1)           |
| Money market accounts                          | (4)                    | 1       | (3)           |
| Savings accounts                               | 1                      | -       | 1             |
| Time deposits                                  | (69)                   | (65)    | (134)         |
| Total deposits                                 | (73)                   | (64)    | (137)         |
| Other interest-bearing liabilities:            |                        |         |               |
| Borrowed funds & other                         | (7)                    | (2)     | (9)           |
| Total interest-bearing liabilities             | (80)                   | (66)    | (146)         |
| Total change in net interest income            | \$ 107                 | \$ (22) | \$ 85         |

Six Months Ended June 30, 2016  
Compared to  
Six Months Ended June 30, 2015  
Rate      Volume      Net Change  
(Dollars in thousands)

|                                                |       |       |       |
|------------------------------------------------|-------|-------|-------|
| Interest-earning assets:                       |       |       |       |
| Interest-earning deposits & federal funds sold | \$ 36 | \$ 4  | \$ 40 |
| Securities                                     | 5     | (463) | (458) |
| Loans, including fees                          | (47)  | 369   | 322   |
| Total interest-earning assets                  | (6)   | (90)  | (96)  |

|                                     |        |       |        |
|-------------------------------------|--------|-------|--------|
| Interest-bearing liabilities:       |        |       |        |
| Demand & NOW accounts               | (6)    | (1)   | (7)    |
| Money market accounts               | (29)   | 2     | (27)   |
| Savings accounts                    | (5)    | 1     | (4)    |
| Time deposits                       | (163)  | (131) | (294)  |
| Total deposits                      | (203)  | (129) | (332)  |
| Other interest-bearing liabilities: |        |       |        |
| Borrowed funds & other              | (16)   | 3     | (13)   |
| Total interest-bearing liabilities  | (219)  | (126) | (345)  |
| Total change in net interest income | \$ 213 | \$ 36 | \$ 249 |

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. The Bank is “liability sensitive”, which indicates that liabilities generally re-price faster than assets. 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, our cost of funds have declined significantly due to lower interest rates being paid on deposit products, along with a 13.0% decrease in the average balance of time deposits since June 30, 2015. The yields on interest-earning assets have remained relatively flat primarily due to the interest rates on new loan originations being lower than the yields earned on loans which had paid off or on legacy loans remaining in the portfolio, along with a 27.1% decrease in the average balance of the securities portfolio. Management has strategically been re-investing paydowns received on the securities portfolio in shorter-term investments at lower rates, as well as selling long-term securities, in order to manage its interest rate risk. The net interest margin for the three months ended June 30, 2016 was 3.41% in comparison to a net interest margin of 3.29% for the three months ended June 30, 2015. The increase in the net interest margin was primarily due to a 13 basis points decrease in the average rate that we paid on interest-bearing liabilities since June 30, 2015 resulting from a decrease in time deposit accounts and increased focus on core deposit growth. The Bank’s Asset-Liability Committee continues to evaluate the options available to minimize the potential impact of a rising rate environment on its operations, as well as to prepare for the impact of a continued, prolonged, low-interest rate environment. The Committee and Bank management have implemented strategies to shorten the term of interest-earning assets and increase investments in liquid assets to position the Bank to be able to take advantage of rising interest rates in the future. Furthermore, strategies to increase core deposits and the origination of adjustable-rate commercial loans are also in place to manage interest rate risk and the net interest margin. The potential use of derivative products as a tool to mitigate IRR is being evaluated as well.



For the three months ended June 30, 2016, the average yields on our loan and investment portfolios were 4.70% and 2.91%, respectively, in comparison to 4.69% and 2.92%, respectively, for the three months ended June 30, 2015. Overall, the average yield on our interest earning assets was 3.93% for the three months ended June 30, 2016 and 2015. The average balance of loans increased \$14.6 million for the quarter ended June 30, 2016 as compared to the prior year's June quarter, while the average balance of our securities portfolio decreased \$36.3 million as compared to the same time period in the prior year. For the three months ended June 30, 2016 and 2015, the average rate that we paid on interest-bearing liabilities was 0.66% and 0.79%, respectively. The 13 basis points decrease was primarily due to a 17 basis points decrease in the average interest rate paid on time deposits for the quarter ended June 30, 2016 as compared to the prior year's June quarter. The average balance of deposits decreased \$18.0 million for the quarter ended June 30, 2016 as compared to the prior year's June quarter primarily due to a decrease in time deposits. Our interest rate spread for the three months ended June 30, 2016 was 3.27% which was a 13 basis points increase in comparison to the

three months ended June 30, 2015. Our net interest margin was 3.41% and 3.29% for the three months ended June 30, 2016 and 2015, respectively.

For the six months ended June 30, 2016, the average yields on our loan and investment portfolios were 4.68% and 2.95%, respectively, in comparison to 4.71% and 2.94%, respectively, for the six months ended June 30, 2015. Overall, the average yield on our interest earning assets increased by 3 basis points to 3.95% for the six months ended June 30, 2016 in comparison to the six months ended June 30, 2015 primarily due to adding higher yielding assets. In addition the average balance of interest-earning assets increased \$15.8 million for the six month period ended June 30, 2016 as compared to the prior year's same six month period. The increase in the average yield on interest earning assets was partially impacted by lower interest income earned on our securities portfolio, resulting from a \$31.4 million decrease in the average balance of the securities portfolio for the six months ended June 30, 2016 as compared to the prior year's same six month period. For the six month period ended June 30, 2016 and 2015, the average rate that we paid on interest-bearing liabilities was 0.67% and 0.83%, respectively. The 16 basis points decrease was primarily due to a 19 basis points decrease in the average interest rate paid on time deposits for the six months ended June 30, 2016 as compared to the prior year's same six month period. The average balance of deposits decreased \$19.7 million for the six months ended June 30, 2016 as compared to the prior year's same six month period primarily due to a decrease in time deposits. Our interest rate spread for the six months ended June 30, 2016 was 3.28% which was a 19 basis points increase in comparison to the six months ended June 30, 2015. Our net interest margin was 3.42% and 3.25% for the six months ended June 30, 2016 and 2015, respectively.

#### Comparison of Financial Condition at June 30, 2016 and December 31, 2015

Total assets at June 30, 2016 were \$480.0 million, an increase of \$6.6 million, or 1.4%, from \$473.4 million at December 31, 2015. The increase in total assets was primarily due to an \$18.1 million increase in loans receivable and a \$7.0 million increase in cash and cash equivalents partially offset by an \$18.2 million decrease in securities available for sale.

Cash and cash equivalents increased by \$7.0 million, or 20.4%, from \$34.2 million at December 31, 2015 to \$41.2 million at June 30, 2016. The increase was primarily due to the receipt of \$14.4 million from the sale of available for sale securities, \$19.1 million from the receipt of principal paydowns and maturities on the investment and loan portfolios, and a \$5.7 million increase in deposits, partially offset by a \$32.0 million cash outflow for loan originations during the first six months of 2016.

Securities available for sale decreased by \$18.2 million, or 16.1%, to \$95.0 million at June 30, 2016 compared to \$113.2 million at December 31, 2015. The decrease was primarily due to the sale of \$14.4 million of treasury securities during the first quarter of 2016 and due to the receipt of \$5.7 million in principal paydowns on the investment portfolio. The sale of treasury securities provided the Company with additional cash proceeds for future loan originations. The Company intends to continue to convert the sale proceeds into commercial loans over the next 12 months, which should result in a positive contribution to the Company's net interest margin and interest rate position, as well as impact small business customers in our market area. The decrease was partially offset by a \$1.9 million increase in the market value (before taxes) of the securities available for sale portfolio during the six months

ended June 30, 2016.

Net loans receivable increased during the six months ended June 30, 2016 as shown in the table below:

|                                  | At June<br>30,<br>2016 | At<br>December<br>31,<br>2015 | Change<br>\$ | %      |   |
|----------------------------------|------------------------|-------------------------------|--------------|--------|---|
| (Dollars in thousands)           |                        |                               |              |        |   |
| Real Estate Loans:               |                        |                               |              |        |   |
| Residential, one- to four-family | \$ 153,808             | \$ 157,307                    | \$ (3,499)   | (2.2)  | % |
| Home equity                      | 33,029                 | 32,770                        | 259          | 0.8    | % |
| Commercial                       | 92,155                 | 83,967                        | 8,188        | 9.8    | % |
| Construction                     | 12,083                 | 4,849                         | 7,234        | 149.2  | % |
| Total real estate loans          | 291,075                | 278,893                       | 12,182       | 4.4    | % |
| Other Loans:                     |                        |                               |              |        |   |
| Commercial                       | 21,900                 | 15,741                        | 6,159        | 39.1   | % |
| Consumer                         | 1,329                  | 1,507                         | (178)        | (11.8) | % |
| Total gross loans                | 314,304                | 296,141                       | 18,163       | 6.1    | % |
| Allowance for loan losses        | (2,060)                | (1,985)                       | (75)         | (3.8)  | % |
| Net deferred loan costs          | 2,974                  | 2,945                         | 29           | 1.0    | % |
| Loans receivable, net            | \$ 315,218             | \$ 297,101                    | \$ 18,117    | 6.1    | % |

The increase in net loans receivable was primarily due to an increase in construction loans, commercial real estate loans and commercial business loans, partially offset by a decrease in residential, one- to four-family real estate 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 2016 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 increase our net interest margin. In the first six months of 2016, we sold \$3.0 million in low-yielding long-term (generally 30 years) conforming fixed rate one- to four-family residential loans that we originated into the secondary market, as part of our strategy to manage interest rate risk, and plan to continue to do so in the future, as it is deemed appropriate.

Loans Past Due and Non-performing Assets. 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 June<br>30,<br>2016 | At<br>December<br>31,<br>2015 |  |
|-----------------------------------------------------|------------------------|-------------------------------|--|
| (Dollars in thousands)                              |                        |                               |  |
| Loans past due 90 days or more but still accruing:  |                        |                               |  |
| Real estate loans:                                  |                        |                               |  |
| Residential, one- to four-family                    | \$ -                   | \$ 47                         |  |
| Home equity                                         | 12                     | 88                            |  |
| Commercial                                          | -                      | -                             |  |
| Construction                                        | -                      | -                             |  |
| Other loans:                                        |                        |                               |  |
| Commercial                                          | -                      | -                             |  |
| Consumer                                            | 21                     | 27                            |  |
| Total                                               | \$ 33                  | \$ 162                        |  |
| Loans accounted for on a non-accrual basis:         |                        |                               |  |
| Real estate loans:                                  |                        |                               |  |
| Residential, one- to four-family                    | \$ 2,137               | \$ 2,462                      |  |
| Home equity                                         | 354                    | 361                           |  |
| Commercial                                          | 1,677                  | 1,545                         |  |
| Construction                                        | -                      | -                             |  |
| Other loans:                                        |                        |                               |  |
| Commercial                                          | 157                    | 132                           |  |
| Consumer                                            | 23                     | 6                             |  |
| Total non-accrual loans                             | 4,348                  | 4,506                         |  |
| Total non-performing loans                          | 4,381                  | 4,668                         |  |
| Foreclosed real estate                              | 766                    | 712                           |  |
| Total non-performing assets                         | \$ 5,147               | \$ 5,380                      |  |
| Ratios:                                             |                        |                               |  |
| Non-performing loans as a percent of total loans:   | 1.39 %                 | 1.57 %                        |  |
| Non-performing assets as a percent of total assets: | 1.07 %                 | 1.14 %                        |  |
| 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 | \$ 242 | \$ 216 |
| Home equity                      | 4      | 8      |

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

|                                                                | At or for the Six<br>Months Ended June 30, |            |
|----------------------------------------------------------------|--------------------------------------------|------------|
|                                                                | 2016                                       | 2015       |
|                                                                | (Dollars in thousands)                     |            |
| Balance at beginning of year:                                  | \$ 1,985                                   | \$ 1,921   |
| Provision for loan losses                                      | 185                                        | 210        |
| Charge-offs:                                                   |                                            |            |
| Real estate loans:                                             |                                            |            |
| Residential, one- to four-family                               | (49)                                       | (18)       |
| Home equity                                                    | (18)                                       | (17)       |
| Commercial                                                     | (1)                                        | -          |
| Construction                                                   | -                                          | -          |
| Other loans:                                                   |                                            |            |
| Commercial                                                     | (30)                                       | (4)        |
| Consumer                                                       | (32)                                       | (19)       |
| Total charge-offs                                              | (130)                                      | (58)       |
| Recoveries:                                                    |                                            |            |
| Real estate loans:                                             |                                            |            |
| Residential, one- to four-family                               | 10                                         | 12         |
| Home equity                                                    | 1                                          | 8          |
| Commercial                                                     | -                                          | 21         |
| Construction                                                   | -                                          | -          |
| Other loans:                                                   |                                            |            |
| Commercial                                                     | 1                                          | 7          |
| Consumer                                                       | 8                                          | 4          |
| Total recoveries                                               | 20                                         | 52         |
| Net charge-offs                                                | (110)                                      | (6)        |
| Balance at end of period                                       | \$ 2,060                                   | \$ 2,125   |
| Average loans outstanding                                      | \$ 304,067                                 | \$ 288,314 |
| Allowance for loan losses as a percent of total net loans      | 0.65%                                      | 0.72%      |
| Allowance for loan losses as a percent of non-performing loans | 47.02%                                     | 36.51%     |
| Ratio of net charge-offs to average loans outstanding(1)       | 0.07%                                      | 0.00%      |

(1) Annualized

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The table below shows changes in deposit balances by type of deposit account between June 30, 2016 and December 31, 2015:

|                                   | At June<br>30,<br>2016<br>(Dollars in thousands) | At<br>December<br>31,<br>2015 | Change   |         |
|-----------------------------------|--------------------------------------------------|-------------------------------|----------|---------|
|                                   |                                                  |                               | \$       | %       |
| Demand deposits and NOW accounts: |                                                  |                               |          |         |
| Non-interest bearing              | \$ 52,263                                        | \$ 45,224                     | \$ 7,039 | 15.6 %  |
| Interest bearing                  | 46,985                                           | 44,512                        | 2,473    | 5.6 %   |
| Money market                      | 77,483                                           | 76,231                        | 1,252    | 1.6 %   |
| Savings                           | 48,635                                           | 44,613                        | 4,022    | 9.0 %   |
| Time deposits                     | 149,478                                          | 158,575                       | (9,097)  | (5.7) % |
| Total deposits                    | \$ 374,844                                       | \$ 369,155                    | \$ 5,689 | 1.5 %   |

The increase in total deposits was primarily due to net growth in core deposits, partially offset by a decrease in time deposits. 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. Time deposits have decreased as certificate of deposit customers have sought higher yields elsewhere.

Our borrowings, consisting of advances from the Federal Home Loan Bank of New York ("FHLBNY"), decreased by \$2.2 million, or 10.4%, to \$19.0 million at June 30, 2016 from \$21.2 million at December 31, 2015. The decrease was due to the use of excess liquidity to pay off long-term debt which matured during the first six months of 2016.

Total stockholders' equity increased by \$3.2 million, or 4.3%, from \$73.9 million at December 31, 2015 to \$77.0 million at June 30, 2016. The increase in stockholders' equity was primarily due to net income of \$2.6 million, a \$772,000 increase in additional paid in capital resulting from stock option exercises and other comprehensive income of \$201,000 during the six months ended June 30, 2016, partially offset by \$313,000 in cash dividends paid and \$271,000 of common stock purchases during the six months ended June 30, 2016.

### Comparison of Results of Operations for the Three Months Ended June 30, 2016 and 2015

**General.** Net income was \$664,000 for the three months ended June 30, 2016, or \$0.11 per diluted share, a decrease of \$35,000, or 5.0%, compared to net income of \$699,000, or \$0.12 per diluted share, for the three months ended June 30, 2015. The decrease in net income was due to a \$229,000 increase in non-interest expense and a \$77,000 increase in income tax expense partially offset by a \$130,000 decrease in the provision for loan losses, an \$85,000 increase in net interest income and a \$56,000 increase in non-interest income.

**Interest Income.** Interest income decreased by \$61,000, or 1.4%, to \$4.3 million for the three months ended June 30, 2016 compared to the three months ended June 30, 2015 primarily due to a decrease in investment interest income.



Investment income decreased by \$269,000, or 27.5%, from \$979,000 for the three months ended June 30, 2015 to \$710,000 for the three months ended June 30, 2016 due to a decrease in the average balance of the investment portfolio from \$133.9 million for the three months ended June 30, 2015 to \$97.6 million for the three months ended June 30, 2016. The decrease in the average balance of the investment portfolio was primarily due to the Company's strategy to reinvest paydowns received on the securities portfolio into loan originations and shorter term cash and cash equivalents in order to be in a better position to take advantage of future increases in market interest rates. The Company also sold \$14.4 million of treasury bonds during the first quarter of 2016 to fund future commercial loan growth. Management intends to use the sale proceeds to originate shorter duration, adjustable rate commercial loans with yields higher than the yields earned on the sold bonds. The average yield on the investment portfolio remained steady at 2.91% and 2.92% for the three months ended June 30, 2016 and 2015, respectively. Loan interest income increased by \$178,000, or 5.2%, for the three months ended June 30, 2016 compared to the three months ended June 30,

2015, primarily due to an increase in the average balance of the loan portfolio by \$14.6 million, or 5.0%, from \$292.2 million for the three months ended June 30, 2015 to \$306.8 million for the three months ended June 30, 2016. 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 remained steady at 4.70% and 4.69% for the three months ended June 30, 2016 and 2015, respectively.

**Interest Expense.** Interest expense decreased \$146,000, or 20.4%, for the three months ended June 30, 2016 to \$570,000 compared to \$716,000 for the three months ended June 30, 2015. Interest paid on deposits decreased by \$137,000, or 23.1%, to \$456,000 for the three months ended June 30, 2016 when compared to the three months ended June 30, 2015, primarily due to a 13 basis points decrease in the average rate paid on deposits and an \$18.0 million decrease in average deposits. The average balance of deposits for the three months ended June 30, 2016 was \$323.4 million with an average rate of 0.56% compared to the average balance of deposits of \$341.4 million and an average rate of 0.69% for the three months ended June 30, 2015. 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 second quarter of 2016 and due to the shift in the deposit mix towards low cost core deposits. The interest expense related to advances from the FHLBNY decreased \$7,000, or 7.1%, to \$91,000 for the three months ended June 30, 2016 when compared to the three months ended June 30, 2015. The average rate paid on FHLBNY advances was 1.92% and 2.07% for the three months ended June 30, 2016 and 2015, respectively. The average balance of advances from the FHLBNY for the three months ended June 30, 2016 and 2015 was \$19.0 million.

**Provision for Loan Losses.** A provision of \$55,000 to the allowance for loan losses was recorded during the three months ended June 30, 2016, which was a \$130,000 decrease in comparison to the provision recorded during the three months ended June 30, 2015. Non-performing loans decreased to \$4.4 million at June 30, 2016 from \$4.7 million at December 31, 2015, representing 1.39% and 1.57%, respectively, of total loans. Net charge-offs were \$47,000 for the three months ended June 30, 2016, while the Company did not record any net charge-offs during the three months ended June 30, 2015.

During the three months ended June 30, 2016, the Company recorded a \$105,000 provision for construction and commercial business loans primarily due to an increase in loan originations during the three months ended June 30, 2016, to reflect the inherent losses expected on these loan types during the three months ended June 30, 2016. The Company recorded a \$125,000 credit provision on commercial real estate loans primarily due to a decrease in classified loan balances, which was partially offset by a \$95,000 provision for loan losses to reflect inherent losses expected on commercial real estate loans originated during the three months ended June 30, 2016. The Company recorded a \$21,000 provision on home equity and consumer loans primarily due to an increase in net charge-offs during the three months ended June 30, 2016. The Company recorded a \$42,000 credit provision on one-to four-family loans primarily due to a decrease in classified loan balances. The Company recorded a \$1,000 unallocated provision to reflect 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 June 30, 2015, the Company recorded a \$213,000 provision for loan losses on commercial real estate loans. Approximately \$121,000 of this provision was due to an increase in commercial real estate loan originations and approximately \$92,000 of this provision was related to an increase in classified loans and an increase in reserves associated with an impaired commercial real estate loan based on the receipt of an updated appraisal on the underlying collateral during the three month period ended June 30, 2015. The Company recorded an \$11,000 provision for loan losses on consumer loans related to losses on overdraft loan accounts during the three months ended June 30, 2015. The provisions for loan losses were offset by a \$50,000 credit for loan losses on one- to four-family, home equity and commercial loans during the three months ended June 30, 2015, primarily due to a

decrease in classified loans and a net recovery received on these types of loans during the quarter. During the three months ended June 30, 2015, the Company recorded an unallocated provision for loan losses of \$11,000. 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.

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

**Non-interest Income.** Non-interest income increased \$56,000, or 10.2%, to \$603,000 for the three months ended June 30, 2016 compared to the three months ended June 30, 2015. The increase was primarily due to a \$32,000, or 8.0%, increase in service charges and fees and a \$25,000 increase on the net gain on sale of loans during the three months ended June 30, 2016 as compared to the three months ended June 30, 2015.

**Non-interest Expenses.** Non-interest expense increased by \$229,000, or 7.0%, from \$3.3 million for the three month period ended June 30, 2015 to \$3.5 million for the three month period ended June 30, 2016. Salaries and employee benefits increased by \$111,000, or 6.6%, primarily due to annual salary increases, the hiring of an additional officer, expenses for stock grants awarded during 2016 and expenses for amendments to the benefit amounts payable to certain employees and directors under the director and executive supplemental retirement benefit plans, partially offset by a higher volume of deferred salary expense related to loan originations and lower unemployment and health insurance costs. Advertising expense for the three month period ended June 30, 2016, increased by \$86,000, or 83.5%, from the same three month period in 2015 primarily due to the development of a new marketing campaign related to the Company's 125th anniversary celebration. Other expenses increased \$38,000, or 14.7%, for the three months ended June 30, 2016 compared to the three months ended June 30, 2015, primarily due to higher expenses related to foreclosed properties in the second quarter of 2016.

**Income Tax Expense.** Income tax expense increased by \$77,000, or 82.8%, from \$93,000 for the three months ended June 30, 2015 to \$170,000 for the three months ended June 30, 2016. The increase in income tax expense was primarily due to an increase in the effective tax rate and an increase in pre-tax income during the three months ended June 30, 2016. Our effective tax rate was 20.4% for the three months ended June 30, 2016 as compared to an effective tax rate of 11.7% for the three months ended June 30, 2015. The increase in the 2016 effective tax rate was primarily due to the 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 current year.

#### Comparison of Results of Operations for the Six Months Ended June 30, 2016 and 2015

**General.** Net income was \$2.6 million for the six months ended June 30, 2016, or \$0.44 per diluted share, an increase of \$1.4 million, or 106.5%, compared to net income of \$1.3 million, or \$0.21 per diluted share, for the six months ended June 30, 2015. The increase in net income was primarily due to a \$1.7 million increase in non-interest income and a \$249,000 increase in net interest income, partially offset by a \$332,000 increase in income tax expense and a \$324,000 increase in non-interest expenses. The \$1.7 million increase in non-interest income was primarily due to a \$1.6 million pre-tax gain on the sale of securities for the six months ended June 30, 2016.

**Interest Income.** Interest income decreased by \$96,000, or 1.1%, to \$8.7 million for the six months ended June 30, 2016 compared to the six months ended June 30, 2015 primarily due to a decrease in investment interest income. Investment income decreased by \$458,000, or 22.9%, from \$2.0 million for the six months ended June 30, 2015 to \$1.5 million for the six months ended June 30, 2016 due to a \$31.4 million decrease in the average balance of the investment portfolio from \$136.2 million for the six months ended June 30, 2015 to \$104.8 million for the six months ended June 30, 2016. The decrease in the average balance of the investment portfolio was primarily due to the Company's strategy to reinvest paydowns received on the securities portfolio into loan originations and shorter term cash and cash equivalents in order to be in a better position to take advantage of future increases in market interest rates. The Company also sold \$14.4 million of treasury bonds during the first quarter of 2016 to fund future commercial loan growth. Management intends to use the sale proceeds to originate shorter duration, adjustable rate

commercial loans with yields higher than the yields earned on the sold bonds. The average yield on the investment portfolio remained steady at 2.95% and 2.94% for the six months ended June 30, 2016 and 2015, respectively. Loan interest income increased by \$322,000, or 4.7%, for the six months ended June 30, 2016 compared to the six months ended June 30, 2015, primarily due to an increase in the average balance of the loan portfolio by \$15.8 million, or 5.5%, from \$288.3 million for the six months ended June 30, 2015 to \$304.1 million for the six months ended June 30, 2016. 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 remained relatively flat at 4.68% and 4.71% for the six months ended June 30, 2016 and 2015, respectively.

**Interest Expense.** Interest expense decreased \$345,000, or 23.0%, for the six months ended June 30, 2016 to \$1.2 million compared to \$1.5 million for the six months ended June 30, 2015. Interest paid on deposits decreased by \$332,000, or 26.4%, to \$924,000 for the six months ended June 30, 2016 when compared to the six months ended June 30, 2015, primarily due to a 16 basis points decrease in the average rate paid on deposits and a \$19.7 million decrease in average deposits. The average balance of deposits for the six months ended June 30, 2016 was \$324.1 million with an average rate of 0.57% compared to the average balance of deposits of \$343.8 million and an average rate of 0.73% for the six months ended June 30, 2015. 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 half of 2016 and due to the shift in the deposit mix towards low cost core deposits. The interest expense related to advances from the FHLBNY decreased \$10,000, or 5.1%, to \$187,000 for the six months ended June 30, 2016 when compared to the six months ended June 30, 2015. The average rate paid on FHLBNY advances was 1.91% for the six months ended June 30, 2016 compared to an average rate of 2.08% for the six months ended June 30, 2015. The average balance of advances from the FHLBNY for the six months ended June 30, 2016 was \$19.6 million compared to an average balance of \$18.9 million for the six months ended June 30, 2015.

**Provision for Loan Losses.** A provision of \$185,000 to the allowance for loan losses was recorded during the six months ended June 30, 2016, which was a \$25,000 decrease in comparison to the provision recorded during the six months ended June 30, 2015. Non-performing loans decreased to \$4.4 million at June 30, 2016 from \$4.7 million at December 31, 2015, representing 1.39% and 1.57%, respectively, of total loans. Net charge-offs were \$110,000 for the six months ended June 30, 2016, compared to net charge-offs of \$6,000 during the six months ended June 30, 2015.

During the six months ended June 30, 2016, the Company recorded a \$177,000 provision for construction and commercial business loans, primarily due to an increase in loan originations during the six months ended June 30, 2016, to reflect the inherent losses expected on these loan types and due to a \$32,000 increase in net charge-offs for these loan types during the six months ended June 30, 2016. The Company recorded a \$162,000 provision for one- to four-family, home equity and consumer loans due to a review of the historical losses relating to these types of loans. The Company set aside \$76,000 of provision to reflect an increase in historical average net charge-offs for these loan types over the last five years. A provision of \$86,000 was also set aside for these loan types due to changes in the related environmental factors used to qualitatively assess inherent losses in the loan portfolio, partially offset by a decrease in classified loans for these loan types during the six months ended June 30, 2016. The Company recorded a \$139,000 net credit provision on commercial real estate loans. Specifically, the Company recorded a \$305,000 credit provision to reflect a decrease in the historical average net charge-offs for these loan types over the last five years and due to a decrease in classified commercial real estate loans. The credit provision for commercial real estate loans was partially offset by a \$166,000 provision for loan losses to reflect inherent losses on commercial real estate loans originated during the six months ended June 30, 2016. The Company recorded an unallocated credit to the provision for loan losses of \$15,000, to reflect the margin of imprecision inherent in the underlying assumptions used in the methodologies for estimating allocated and general losses in the portfolio.

During the six month period ended June 30, 2015, the Company recorded a \$210,000 provision for loan losses on commercial real estate loans. Approximately \$122,000 of the \$210,000 provision was attributed to an increase in reserves associated with two impaired commercial real estate loans based on the receipt of updated appraisals on the underlying collateral during the six month period ended June 30, 2015. The remaining \$88,000 was recorded to reflect an increase in commercial real estate loan originations during the six month period ended June 30, 2015. The Company recorded a \$20,000 provision for loan losses on consumer loans related to net charge-offs during the six month period ended June 30, 2015. The provisions for loan losses were offset by a \$47,000 credit for loan losses on

one- to four-family loans during the six month period ended June 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 historical average net charge-offs over the last five years. The decrease was also partially due to a decrease in classified one- to four-family loans during the six month period ended June 30, 2015. During the six month period ended June 30, 2015, the Company recorded an unallocated provision for loan losses of \$21,000. 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.

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

**Non-Interest Income.** Non-interest income increased \$1.7 million, or 160.2%, to \$2.8 million for the six months ended June 30, 2016 compared to the six months ended June 30, 2015. The increase was primarily due to a pre-tax gain on the sale of securities of \$1.6 million for the six months ended June 30, 2016, while there were no securities sold during the same period in 2015. The Company sold treasury bonds with the intent to convert the sale proceeds into commercial loans which will enable the Company to assist small businesses and commercial customers in its local market areas, as well as to shorten the duration of its interest-earning assets, improve its interest rate risk position and stabilize its net interest margin. The increase was also due to an \$87,000 increase, or 11.2%, in service charges and fees during the six months ended June 30, 2016 when compared to the same six month period in 2015.

**Non-Interest Expenses.** Non-interest expense increased by \$324,000, or 4.9%, from \$6.6 million for the six months ended June 30, 2015 to \$6.9 million for the six months ended June 30, 2016. Salaries and employee benefits increased by \$98,000, or 2.8%, primarily due to annual salary increases, additional expenses for stock grants awarded during 2016 and for amendments to the benefit amounts payable to certain directors and employees under the supplemental benefit plans, partially offset by a higher volume of deferred salary related to loan originations and lower unemployment and health insurance costs. Advertising expense for the six months ended June 30, 2016, increased by \$93,000, or 44.5%, from the same six month period in 2015 primarily due to the development of a new marketing campaign related to the Company's 125th anniversary celebration. Other expenses increased \$100,000, or 21.7%, for the six months ended June 30, 2016 compared to the six months ended June 30, 2015, primarily due to the first six months of 2015 having higher net gains on the sale of foreclosed properties when compared to the first six months of 2016. Professional services increased by \$24,000, or 4.8% for the six months ended June 30, 2016 as compared to the same six months in 2015, primarily due to increased consulting costs during the first six months of 2016. Data processing costs increased \$24,000, or 4.8%, from the six months ended June 30, 2015 to the six months ended June 30, 2016, primarily due to costs related to system enhancements that have taken place in the last 12 months, as well as due to increased use of electronic banking services by customers. Occupancy and equipment costs increased \$22,000, or 1.9%, from the six months ended June 30, 2015 to the six months ended June 30, 2016, primarily due to increased software and computer equipment purchases. FDIC Insurance decreased by \$20,000, or 13.9%, and postage and supplies decreased by \$17,000, or 13.4% for the six months ended June 30, 2016 when compared to the six months ended June 30, 2015.

**Income Tax Expense.** Income tax expense increased by \$332,000, or 97.9%, from \$339,000 for the six months ended June 30, 2015 to \$671,000 for the six months ended June 30, 2016. The increase in income tax expense was primarily due to an increase in pre-tax income and an increase in the effective tax rate during the six months ended June 30, 2016. Income tax expense for the six months ended June 30, 2015 included \$128,000 for a deferred tax valuation allowance recorded because of changes in New York State tax laws. Without this one-time tax effect for 2015, our effective tax rate would have been 13.1% for the six months ended June 30, 2015 as compared to an effective rate of 20.4% for the six months ended June 30, 2016. The increase in the 2016 effective tax rate was primarily due to the 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 current 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

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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 written agreements with the FHLBNY, which allows us to borrow the maximum lending values designated by the type of collateral pledged. As of June 30, 2016, our maximum lending value was \$111.4 million and was collateralized by a pledge of certain fixed-rate residential, one- to four-family loans. At June 30, 2016, 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 \$11.9 million as of June 30, 2016. There were no balances outstanding with the Federal Reserve Bank at June 30, 2016. 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 June 30, 2016.

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 six months ended June 30, 2016, we originated loans of approximately \$46.3 million in comparison to approximately \$34.9 million of loans originated during the six months ended June 30, 2015. Loan originations exceeded principal repayments and other deductions in the first six months of 2016 by \$18.7 million. The loan originations were funded through principal payments received on loans and securities and cash reserves. We did not purchase any investment securities during the six months ended June 30, 2016 or 2015.

At June 30, 2016, we had loan commitments to borrowers of approximately \$17.6 million and overdraft lines of credit, unused home equity lines of credit and unused commercial lines of credit of approximately \$34.4 million. Total deposits were \$374.8 million at June 30, 2016, as compared to \$369.2 million at December 31, 2015. The increase in total deposits was primarily due to growth in core deposits, partially offset by a decrease in time deposits during the first six months of 2016. The Company's strategic focus is on growing low-cost core deposits among its retail and commercial customers in an effort to manage interest expenses. Time deposits have decreased as certificate of deposit customers have sought higher yields elsewhere. Time deposit accounts scheduled to mature within one year were \$71.3 million at June 30, 2016. 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.

We do not anticipate any material capital expenditures during 2016. 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-

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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, 2015.

As of June 30, 2016, as shown in the table below, the Bank’s Tier 1 and Risk-based capital levels exceeded levels necessary to be considered “Well Capitalized” under Prompt Corrective Action provisions, as determined by the Office of the Comptroller of the Currency (the “OCC”), our primary regulator:

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:

|                                            |                 | Minimum<br>For Capital<br>Adequacy<br>Purposes | To Be Well<br>Capitalized<br>Under<br>Prompt<br>Corrective<br>Action<br>Provisions |
|--------------------------------------------|-----------------|------------------------------------------------|------------------------------------------------------------------------------------|
| At June 30, 2016                           | Actual<br>Ratio |                                                |                                                                                    |
| CETI capital (to risk-weighted assets)     | 23.58 %         | >= 4.50 %                                      | >= 6.50 %                                                                          |
| Tier 1 capital (to risk-weighted assets)   | 23.58 %         | >= 6.00 %                                      | >= 8.00 %                                                                          |
| Total capital (to risk-weighted assets)    | 24.28 %         | >= 8.00 %                                      | >= 10.00 %                                                                         |
| Tier 1 Leverage (to adjusted total assets) | 14.64 %         | >= 4.00 %                                      | >= 5.00 %                                                                          |
|                                            |                 |                                                | To Be Well<br>Capitalized<br>Under<br>Prompt<br>Corrective<br>Action<br>Provisions |
|                                            | Actual<br>Ratio | Minimum<br>For Capital<br>Adequacy<br>Purposes |                                                                                    |
| At December 31, 2015                       |                 |                                                |                                                                                    |
| CETI capital (to risk-weighted assets)     | 24.21 %         | >= 4.50 %                                      | >= 6.50 %                                                                          |
| Tier 1 capital (to risk-weighted assets)   | 24.21 %         | >= 6.00 %                                      | >= 8.00 %                                                                          |
| Total capital (to risk-weighted assets)    | 24.93 %         | >= 8.00 %                                      | >= 10.00 %                                                                         |
| Tier 1 Leverage (to adjusted total assets) | 14.31 %         | >= 4.00 %                                      | >= 5.00 %                                                                          |

In order to avoid limitations on distributions, including dividend payments, and certain discretionary bonus payments to executive officers, an institution must hold a capital conservation buffer above its minimum risk-based capital requirements. As of June 30, 2016, the Bank's capital conservation buffer was 16.28% exceeding the minimum of 0.625% for 2016.

### 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 June 30, 2016.

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

June 30, 2016 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 June 30, 2016:

#### COMPANY PURCHASES OF EQUITY SECURITIES

| Period                               | Total Number of<br>Shares Purchased | Average Price<br>Paid per<br>Share | Total Number of Shares<br>Purchased as Part of Publicly<br>Announced Plans or Programs | Maximum Number of Shares<br>that May Yet be Purchased<br>Under the Plans or Programs<br>(1) |
|--------------------------------------|-------------------------------------|------------------------------------|----------------------------------------------------------------------------------------|---------------------------------------------------------------------------------------------|
| April 1<br>through April<br>30, 2016 | 5,000                               | \$ 13.55                           | 5,000                                                                                  | 102,701                                                                                     |
| May 1<br>through May<br>31, 2016     | 5,000                               | 13.55                              | 5,000                                                                                  | 97,701                                                                                      |
| June 1<br>through June<br>30, 2016   | -                                   | -                                  | -                                                                                      | 97,701                                                                                      |
| Total                                | 10,000                              | \$ 13.55                           | 10,000                                                                                 | 97,701                                                                                      |

(1) On December 11, 2015, our Board of Directors approved a new stock repurchase plan pursuant to which we can repurchase up to 117,701 shares of our outstanding common stock. This amount represents approximately 5% of our outstanding common stock not owned by the MHC as of December 11, 2015. 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  
Act of 2002\*

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

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

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

101.INS XBRL Instance  
Document\*

|         |                                                                      |
|---------|----------------------------------------------------------------------|
| 101.SCH | XBRL<br>Taxonomy<br>Extension<br>Schema<br>Document*                 |
| 101.CAL | XBRL<br>Taxonomy<br>Calculation<br>Linkbase<br>Document*             |
| 101.DEF | XBRL<br>Taxonomy<br>Extension<br>Definition<br>Linkbase<br>Document* |
| 101.LAB | XBRL<br>Taxonomy Label<br>Linkbase<br>Document*                      |
| 101.PRE | XBRL<br>Taxonomy<br>Presentation<br>Linkbase<br>Document*            |

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\*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)

August 12, 2016 By: /s/ Daniel P. Reininga  
Daniel P. Reininga  
President and Chief Executive Officer  
(Principal Executive Officer)

August 12, 2016 By: /s/ Rachel A. Foley  
Rachel A. Foley  
Chief Financial Officer  
(Principal Financial and Accounting Officer)