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

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended Setpember 30, 2010

OR

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

Commission file number: 000-51821

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

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

(716) 366-4070
(Registrant's telephone number, including area code)

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

Yes x No ¨

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

Yes ¨ No ¨

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

Large accelerated filer	¨	Accelerated filer	¨
Non-accelerated filer	¨	Smaller reporting company	x
Do not check if smaller reporting company			

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).
Yes ¨ No x

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

Common stock ($0.01 par value) 5,996,782 shares outstanding as of November 1, 2010.

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PART I

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

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

Common stock, $0.01 par value per share, 25,000,000 shares authorized; 6,612,500 shares issued and 5,996,782 shares outstanding at September 30, 2010 and 6,612,500 shares issued and 6,157,162 shares outstanding at December 31, 2009		
Additional paid-in capital	27,899	27,838
Treasury stock, at cost (615,718 shares at September 30, 2010 and 455,338 shares at December 31, 2009)	(5,764)	(4,467)
Unearned shares held by ESOP	(2,153)	(2,217)
Unearned shares held by RRP	(815)	(987)
Retained earnings	35,920	34,224
Accumulated other comprehensive income	2,734	989
Total Stockholders' Equity	57,887	55,446
Total Liabilities and Stockholders' Equity	$476,120	$425,656

See notes to consolidated financial statements.

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

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

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

See notes to consolidated financial statements.

LAKE SHORE BANCORP, INC. and SUBSIDIARY
CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY
Nine Months Ended September 30, 2010 and 2009 (Unaudited)

	Common Stock	Additional Paid-in Capital	Treasury Stock	Unearned Shares held by ESOP	Unearned Shares held by RRP	Retained Earnings	Accumulated Other Comprehensive Income	Total
	(Dollars in thousands, except per share data)							
Balance – January 1, 2009	$66	$ 27,754	$(3,748)	$(2,302)	$(1,190)	$32,520	$ 1,128	$54,228
Cumulative effect of adoption of revised ASC Topic 320 (net of $4 tax effect)	-	-	-	-	-	8	(8)	-
Comprehensive income:								
Net income	-	-	-	-	-	1,361	-	1,361
Other comprehensive loss	-	-	-	-	-	-	994	994
Total Comprehensive Income								2,355
ESOP shares earned (5,951 shares)	-	(24)	-	64	-	-	-	40
Stock based compensation	-	111	-	-	-	-	-	111
RRP shares earned (11,350 shares)	-	(26)	-	-	152	-	-	126
Purchase of treasury stock, at cost (87,984 shares)	-	-	(620)	-	-	-	-	(620)
Cash dividends declared ($0.15 per share)	-	-	-	-	-	(339)	-	(339)
Balance – September 30, 2009	$66	$ 27,815	$(4,368)	$(2,238)	$(1,038)	$33,550	$ 2,114	$55,901
Balance – January 1, 2010	$66	$ 27,838	$(4,467)	$(2,217)	$(987)	$34,224	$ 989	$55,446
Comprehensive income:								
Net income	-	-	-	-	-	2,148	-	2,148
Other comprehensive income	-	-	-	-	-	-	1,745	1,745
Total Comprehensive Income								3,893

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

See notes to consolidated financial statements.

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

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

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

See notes to consolidated financial statements.

LAKE SHORE BANCORP, INC. and Subsidiary
Notes to Consolidated Financial Statements (unaudited)

NOTE 1 – NATURE OF OPERATIONS AND BASIS OF PRESENTATION

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

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

The interim financial statements included herein as of September 30, 2010 and for the three and nine months ended September 30, 2010 and 2009 have been prepared by the Company, without audit, pursuant to the rules and regulations of the Securities and Exchange Commission, and therefore, do not include all information or footnotes necessary for a complete presentation of the consolidated statements of financial condition, results of operations and cash flows in conformity with accounting principles generally accepted in the United States of America ("GAAP"). The consolidated balance sheet at December 31, 2009 has been derived from the audited financial statements at that date, but does not include all of the information and footnotes required by GAAP for complete financial statements. The consolidated financial statements reflect all adjustments that are, in the opinion of management, necessary for a fair statement of such information and to make the financial statements not misleading. These interim consolidated financial statements should be read in conjunction with the consolidated financial statements and notes thereto included in the audited consolidated financial statements included in the Company's Form 10-K for the year ended December 31, 2009. The consolidated results of operations for the three and nine months ended September 30, 2010 are not necessarily indicative of the results for any subsequent period or the entire year ending December 31, 2010.

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

The Company has evaluated events and transactions occurring subsequent to the balance sheet as of September 30, 2010 for items that should potentially be recognized or disclosed in these consolidated financial statements. The evaluation was conducted through the date these consolidated financial statements were issued.

NOTE 2 – NEW ACCOUNTING STANDARDS

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

NOTE 2 – NEW ACCOUNTING STANDARDS (continued)

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

NOTE 3 – OTHER COMPREHENSIVE INCOME

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

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

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

NOTE 4 – INVESTMENT SECURITIES

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

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

NOTE 4 – INVESTMENT SECURITIES (continued)

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

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

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

At September 30, 2010, twenty-nine municipal bonds with a cost of $9.6 million and fair value of $10.3 million were pledged under a collateral agreement with the Federal Reserve Bank of New York for liquidity borrowing. In addition, at September 30, 2010, eight municipal bonds with a cost of $3.3 million and fair value of $3.4 million were pledged as collateral for customer deposits in excess of the FDIC insurance limits. At December 31, 2009, thirty municipal bonds and one U.S. Treasury bond with a cost of $10.6 million and fair value of $11.2 million were pledged under a collateral agreement with the Federal Reserve Bank of New York for liquidity borrowing. In addition, at December 31, 2009 seven municipal bonds with a cost of $3.0 million and fair value of $3.1 million were pledged as collateral for customer deposits in excess of the FDIC insurance limits.

The following table sets forth the Company's investment in securities available for sale with gross unrealized losses of less than twelve months and gross unrealized losses of twelve months or more and associated fair values as of the dates indicated:

NOTE 4 – INVESTMENT SECURITIES (continued)

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

The Company reviews investment securities on an ongoing basis for the presence of OTTI with formal reviews performed quarterly.

The Company determines whether the unrealized losses are other-than-temporary in accordance with FASB Accounting Standards Codification ("ASC") Topic 320. The evaluation is based upon factors such as the creditworthiness of the issuers/guarantors, the underlying collateral and the continuing performance of the securities.

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

At September 30, 2010 the Company's investment portfolio included eighteen municipal bonds, seven mortgage-backed securities and one government sponsored entity asset-backed security with gross unrealized losses in the less than twelve months category. These securities were not evaluated further for OTTI as the unrealized losses on the individual securities were less than 20% of their book value, which management deemed to be immaterial, and the credit ratings remained strong. The Company expects these securities to be repaid in full, with no losses realized. Management does not intend to sell these securities and it is more likely than not that it will not be required to sell these securities. The Company's investment in equity securities is a requirement of the FHLMC. These securities were not evaluated further for OTTI, despite the percentage of unrealized losses due to immateriality.

NOTE 4 – INVESTMENT SECURITIES (continued)

As of September 30, 2010, the Company had two municipal bonds, two mortgage-backed securities and five private-label asset-backed securities in the unrealized loss of twelve months or more category. Three of the five private label asset backed securities in this category were subject to a formal OTTI review as the unrealized losses were greater than 20% of book value for the individual security, or the related credit ratings were below investment grade, or the Company's analysis indicated a possible loss of principal. The OTTI analysis for these securities is discussed below. The remaining securities in this category were not evaluated further for OTTI as the unrealized loss was less than 20% of book value and the credit ratings remained high. The temporary impairments in these remaining securities were due to declines in fair values resulting from changes in interest rates or increased credit/liquidity spreads since the time the securities were purchased. The Company expects these securities to be repaid in full, with no losses realized. Management does not intend to sell these securities and it is more likely than not that it will not be required to sell these securities.

The following table provides information relating to the three private- label asset-backed securities that were subject to a formal OTTI review as of September 30, 2010 (dollars in thousands):

					Delinquent %			
Security	Book Value	Fair Value	Unrealized Gain/(Loss)	Lowest Rating	Over 60 days	Over 90 days	Foreclosure/ OREO / Bankruptcy%	OREO%
1	$2,000	$1,363	$ (637)	CC	38.30%	35.20%	7.40%	1.20%
2	1,612	1,253	(359)	B	33.20%	29.80%	6.40%	0.80%
3	1,000	795	(205)	CCC	14.20%	13.20%	8.50%	0.50%
Total	4,612	3,411	(1,201)					

The three private-label asset-backed securities listed above (# 1 thru #3) were evaluated for OTTI under the guidance of FASB ASC Topic 320. The Company believes the unrealized losses on these three private-label asset-backed securities occurred due to the current challenging economic environment, rising unemployment rates, a continued decline in housing values in many areas of the country, and increased delinquency trends. It is possible that principal losses may be incurred on the tranches we hold in these specific securities. Management's evaluation of the estimated discounted cash flows in comparison to the amortized book value did not reflect the need to record initial or additional OTTI charges against earnings during the quarter ended September 30, 2010. In the case where an OTTI impairment charge was recorded in 2008, it was determined that the amount already taken was sufficient. For the remaining securities, management determined that an initial OTTI impairment charge was not required as of September 30, 2010, as the calculations of the estimated discounted cash flows did not show principal losses for these securities under various prepayment and default rate scenarios. Management also concluded that it does not intend to sell the securities and that it is not likely it will be required to sell the securities.

Management also completed an OTTI analysis for three non-agency asset backed securities, which did not have unrealized losses as of September 30, 2010. However, an impairment charge had been taken on these securities during 2008. Management reviewed key credit metrics for these securities, including delinquency rates, cumulative default rates, prepayment speeds, foreclosure rates, loan-to-values and credit support levels. Management's calculation of the estimated discounted cash flows did not show additional principal losses for these securities under various prepayment and default rate scenarios.

NOTE 4 – INVESTMENT SECURITIES (continued)

As a result of the stress tests that were performed, management concluded that additional OTTI charges were not required as of September 30, 2010 on these securities. Management also concluded that it does not intend to sell the securities and that it is not likely it will be required to sell these securities.

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

The following table presents a summary of the credit related OTTI charges recognized as components of earnings (dollars in thousands):

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

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

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

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

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

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

NOTE 5 – EARNINGS PER SHARE

Earnings per share was calculated for the three and nine months ended September 30, 2010 and 2009, respectively. Basic earnings per share is based upon the weighted average number of common shares outstanding, exclusive of unearned shares held by the Employee Stock Ownership Plan of Lake Shore Bancorp, Inc. (the “ESOP”) and unearned shares held by the Recognition and Retention Plan (“RRP”). Diluted earnings per share is based upon the weighted average number of common shares outstanding and common share equivalents that would arise from the exercise of dilutive securities. Stock options and unvested restricted stock are regarded as potential common stock and are considered in the diluted earnings per share calculations to the extent they would be dilutive and computed using the treasury stock method.

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

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

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

(1) Stock options to purchase 249,455 shares under the Company’s 2006 Stock Option Plan (the “Stock Option Plan”) at $11.07 per share and restricted unvested shares of 32,041 under the RRP were outstanding during the nine month period ended September 30, 2010 but were not included in the calculation of diluted earnings per share because to do so would have been anti-dilutive. Stock options to purchase 238,258 shares under the Stock Option Plan at $11.22 per share and restricted unvested shares of 38,450 under the RRP plan were outstanding during the nine month period ended September 30, 2009, but were not included in the calculation of diluted earnings per share because to do so would have been anti-dilutive.

NOTE 6 – COMMITMENTS TO EXTEND CREDIT

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

NOTE 6 – COMMITMENTS TO EXTEND CREDIT (continued)

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

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

	Contract Amount	
	September 30, 2010	December 31, 2009
	(Dollars in thousands)	
Commitments to grant loans	$6,710	$7,818
Unfunded commitments under lines of credit	$26,204	$24,288

Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Commitments generally have fixed expiration dates or other termination clauses. The commitments for lines of credit may expire without being drawn upon. Therefore, the total commitment amounts do not necessarily represent future cash requirements. The amount of collateral obtained, if it is deemed necessary by the Company, is based on management's credit evaluation of the customer. At September 30, 2010 and December 31, 2009, the Company's fixed rate loan commitments totaled $6.2 million and $7.4 million, respectively. The range of interest rates on these fixed rate commitments was 3.49% to 7.50% at September 30, 2010.

NOTE 7– STOCK-BASED COMPENSATION

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

Stock Option Plan

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

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

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

NOTE 7– STOCK-BASED COMPENSATION (continued)

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

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

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

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

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

Recognition and Retention Plan

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

NOTE 7– STOCK-BASED COMPENSATION (continued)

The Board of Directors has granted Awards as follows:

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

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

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

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

Employee Stock Ownership Plan

The Company established the ESOP for the benefit of eligible employees of the Company and Bank. All Company and Bank employees meeting certain age and service requirements are eligible to participate in the ESOP. Participants' benefits become fully vested after five years of service. The Company utilized $2.6 million of the proceeds of its 2006 stock offering to extend a loan to the ESOP and the ESOP used such proceeds to purchase 238,050 shares of stock on the open market at an average price of $10.70 per share, plus commission expenses. As a result of the purchase of shares by the ESOP, total stockholders' equity of the Company was reduced by $2.6 million. As of September 30, 2010, the balance of the loan to the ESOP was $2.2 million and the fair value of unallocated shares was $1.6 million. As of September 30, 2010, there were 37,692 allocated shares and 200,358 unallocated shares compared to 29,756 allocated shares and 208,294 unallocated shares at September 30, 2009. The ESOP compensation expense was $16,000 for the quarter ended September 30, 2010 and $14,000 for the quarter ended September 30, 2009 based on 1,984 shares earned in each of those quarters. The ESOP compensation expense was $48,000 for the nine month period ended September 30, 2010 and $40,000 for the nine month period ended September 30, 2009 based on 5,951 shares earned during each period.

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NOTE 8 – FAIR VALUE OF FINANCIAL INSTRUMENTS

Management uses its best judgment in estimating the fair value of the Company's financial instruments; however, there are inherent weaknesses in any estimation technique. Therefore, for substantially all financial instruments, the fair value estimates herein are not necessarily indicative of the amounts the Company could have realized in a sale transaction on the dates indicated. The estimated fair value amounts have been measured as of September 30, 2010 and December 31, 2009 and have not been re-evaluated or updated for purposes of these consolidated financial statements subsequent to those respective dates. As such, the estimated fair values of these financial instruments subsequent to the respective reporting dates may be different than the amounts reported here.

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

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

Level 2: Inputs other than quoted prices included in Level 1 that are observable for the asset or liability either directly or indirectly. These might include quoted prices for similar assets or liabilities in active markets, quoted prices for identical or similar assets or liabilities in markets that are not active, inputs other than quoted prices that are observable for the asset or liability (such as interest rates, volatilities, prepayment speeds, credit risks, etc.) or inputs that are derived principally from or corroborated by market data by correlation or other means.

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

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

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

NOTE 8 – FAIR VALUE OF FINANCIAL INSTRUMENTS (continued)

	September 30, 2010	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Other Unobservable Inputs (Level 3)
	(In thousands)			
Measured at fair value on a recurring basis:				
Securities available for sale:				
U.S. Treasury bonds	$2,820	$2,820	$-	$ -
Municipal bonds	40,846	-	40,846	-
Mortgage-backed securities:				