Lake Shore Bancorp, Inc.
Form 10-Q
August 14, 2012

**UNITED STATES**

**SECURITIES AND EXCHANGE COMMISSION**

**Washington, D.C. 20549**

**FORM 10-Q**

(Mark One)

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

For the quarterly period ended June 30, 2012

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

Commission file number: 000-51821

**LAKE SHORE BANCORP, INC.**

(Exact name of registrant as specified in its charter)

| | |
|---|---|
| United States<br>(State or other jurisdiction of incorporation or organization) | 20-4729288<br>(I.R.S. Employer Identification Number) |
| 31 East Fourth Street, Dunkirk, New York<br>(Address of principal executive offices) | 14048<br>(Zip code) |

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

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

Yes x No o

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

Yes x No o

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

| | | | |
|---|---|---|---|
| Large accelerated filer | o | Accelerated filer | ¨ |
| Non-accelerated file | o (Do not check if a smaller reporting company) | Smaller reporting company | x |

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

Yes o No x

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

Common stock ($0.01 par value) 5,939,132 shares outstanding as of August 1, 2012.

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**PART I**

**Item 1. Financial Statements**

**LAKE SHORE BANCORP, INC. and SUBSIDIARY**

Consolidated Statements of Financial Condition

| | June 30, 2012 | December 31, 2011 |
|---|---|---|
| | **(Unaudited)** | |
| | **(Dollars in thousands, except per share data)** | |
| Assets | | |
| Cash and due from banks | $7,714 | $7,031 |
| Interest earning deposits | 12,670 | 5,402 |
| Federal funds sold | 9,016 | 11,271 |
| Cash and Cash Equivalents | 29,400 | 23,704 |
| Securities available for sale | 170,679 | 164,165 |
| Federal Home Loan Bank stock, at cost | 2,116 | 2,219 |
| Loans receivable, net of allowance for loan losses 2012 $1,324; 2011 $1,366 | 266,190 | 275,068 |
| Premises and equipment, net | 8,498 | 8,530 |
| Accrued interest receivable | 1,801 | 1,919 |
| Bank owned life insurance | 11,496 | 11,376 |
| Other assets | 1,939 | 1,616 |
| Total Assets | $492,119 | $488,597 |
| Liabilities and Stockholders' Equity | | |
| Liabilities | | |
| Deposits: | | |
| Interest bearing | $353,949 | $352,369 |
| Non-interest bearing | 30,830 | 27,429 |

| | | |
|---|---|---|
| Total Deposits | 384,779 | 379,798 |
| Short-term borrowings | 14,320 | 6,910 |
| Long-term debt | 17,150 | 27,230 |
| Advances from borrowers for taxes and insurance | 2,967 | 3,148 |
| Other liabilities | 7,192 | 7,564 |
| Total Liabilities | 426,408 | 424,650 |
| Commitments and Contingencies | — | — |
| Stockholders' Equity | | |
| Common stock, $0.01 par value per share, 25,000,000 shares authorized; 6,612,500 shares issued and 5,939,132 shares outstanding at June 30, 2012 and December 31, 2011 | 66 | 66 |
| Additional paid-in capital | 27,978 | 27,987 |
| Treasury stock, at cost (673,368 shares at June 30, 2012 and December 31, 2011) | (6,260) | (6,260) |
| Unearned shares held by ESOP | (2,004) | (2,046) |
| Unearned shares held by RRP | (580) | (606) |
| Retained earnings | 41,376 | 39,770 |
| Accumulated other comprehensive income | 5,135 | 5,036 |
| Total Stockholders' Equity | 65,711 | 63,947 |
| Total Liabilities and Stockholders' Equity | $492,119 | $488,597 |

*See notes to consolidated financial statements.*

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**LAKE SHORE BANCORP, INC. and SUBSIDIARY**

CONSOLIDATED STATEMENTS OF INCOME

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|
| | 2012 | 2011 | 2012 | 2011 |
| | (Unaudited) | | | |
| | (Dollars in thousands except per share data) | | | |
| Interest Income | | | | |
| Loans, including fees | $3,553 | $3,580 | $7,150 | $7,085 |
| Investment securities, taxable | 972 | 1,137 | 1,982 | 2,281 |
| Investment securities, tax-exempt | 479 | 498 | 948 | 965 |
| Other | 9 | 6 | 13 | 20 |
| Total Interest Income | 5,013 | 5,221 | 10,093 | 10,351 |
| Interest Expense | | | | |
| Deposits | 1,036 | 1,147 | 2,117 | 2,359 |
| Short-term borrowings | 13 | 8 | 23 | 15 |
| Long-term debt | 117 | 230 | 264 | 486 |
| Other | 27 | 28 | 54 | 56 |
| Total Interest Expense | 1,193 | 1,413 | 2,458 | 2,916 |
| Net Interest Income | 3,820 | 3,808 | 7,635 | 7,435 |
| Provision for loan losses | 85 | 265 | 50 | 285 |
| Net Interest Income after Provision for Loan Losses | 3,735 | 3,543 | 7,585 | 7,150 |
| Non-interest income | | | | |
| Service charges and fees | 429 | 427 | 848 | 848 |
| Earnings on bank owned life insurance | 61 | 66 | 120 | 129 |
| Total other-than-temporary impairment (“OTTI”) losses | (566) | — | (566) | — |
| Portion of OTTI losses recognized in comprehensive income (before taxes) | 509 | — | 509 | — |
| Net OTTI losses recognized in earnings | (57) | — | (57) | — |
| Gain on sale of securities available for sale | — | 31 | — | 31 |
| Recovery on previously impaired investment securities | — | — | — | 57 |

| | | | | |
|---|---|---|---|---|
| Other | 24 | 21 | 67 | 60 |
| Total Non-Interest Income | 457 | 545 | 978 | 1,125 |
| | | | | |
| Non-interest Expenses | | | | |
| Salaries and employee benefits | 1,539 | 1,391 | 3,076 | 2,938 |
| Occupancy and equipment | 448 | 434 | 890 | 895 |
| Professional services | 352 | 304 | 668 | 577 |
| Data processing | 153 | 143 | 305 | 282 |
| Advertising | 81 | 130 | 253 | 253 |
| FDIC Insurance | 56 | 127 | 122 | 249 |
| Postage and Supplies | 56 | 58 | 117 | 133 |
| Other | 359 | 246 | 680 | 508 |
| Total Non-Interest Expenses | 3,044 | 2,833 | 6,111 | 5,835 |
| | | | | |
| Income before Income Taxes | 1,148 | 1,255 | 2,452 | 2,440 |
| | | | | |
| Income tax expense | 253 | 268 | 550 | 503 |
| | | | | |
| Net Income | $895 | $987 | $1,902 | $1,937 |
| Basic and diluted earnings per common share | $0.16 | $0.17 | $0.33 | $0.34 |
| Dividends declared per share | $0.07 | $0.07 | $0.14 | $0.14 |

*See notes to consolidated financial statements.*

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**Lake Shore Bancorp Inc. and Subsidiary**

**Consolidated Statements of Comprehensive Income**

| | Three Months Ended **June 30,** | | Six Months Ended **June 30,** | |
|---|---|---|---|---|
| | 2012 | 2011 | 2012 | 2011 |
| | | (Unaudited) (Dollars in thousands) | | |
| Net Income | $895 | $987 | $1,902 | $1,937 |
| Other Comprehensive Income, net of tax: | | | | |
| Unrealized holding gains on securities available for sale | 562 | 1,623 | 64 | 2,407 |
| Reclassification adjustments related to: | | | | |
| Recovery on previously impaired investment securities | — | — | — | (35) |
| Gains on sales of securities included in net income | — | (19) | — | (19) |
| Impairment charge for losses included in net income | 35 | — | 35 | — |
| Total Other Comprehensive Income | 597 | 1,604 | 99 | 2,353 |
| Total Comprehensive Income | $1,492 | $2,591 | $2,001 | $4,290 |

*See notes to consolidated financial statements.*

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**LAKE SHORE BANCORP, INC. and SUBSIDIARY**

**CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY**

**Six Months Ended June 30, 2012 and 2011 (unaudited)**

| | Common Stock | Additional Paid-in Capital | Treasury Stock | Unearned Shares Held by ESOP | Unearned Shares Held by RRP | Retained Earnings | Accumulated Other Comprehensive Income (Loss) | Total |
|---|---|---|---|---|---|---|---|---|
| | (Dollars in thousands, except share and per share data) | | | | | | | |
| Balance – January 1, 2011 | $66 | $27,920 | $(6,091) | $(2,132) | $(757) | $36,737 | $(533) | $55,210 |
| Net income | — | — | — | — | — | 1,937 | — | 1,937 |
| Other comprehensive income, net of tax | — | — | — | — | — | — | 2,353 | 2,353 |
| ESOP shares earned (3,968 shares) | — | (2) | — | 43 | — | — | — | 41 |
| Stock based compensation | — | 53 | — | — | — | — | — | 53 |
| RRP shares earned (5,599 shares) | — | (17) | — | — | 76 | — | — | 59 |
| Purchase of treasury stock, at cost (17,950 shares) | — | — | (169) | — | — | — | — | (169) |
| Cash dividends declared ($0.14 per share) | — | — | — | — | — | (367) | — | (367) |
| Balance – June 30, 2011 | $66 | $27,954 | $(6,260) | $(2,089) | $(681) | $38,307 | $1,820 | $59,117 |
| Balance – January 1, 2012 | $66 | $27,987 | $(6,260) | $(2,046) | $(606) | $39,770 | $5,036 | $63,947 |
| Net income | — | — | — | — | — | 1,902 | — | 1,902 |
| Other comprehensive income, net of tax | — | — | — | — | — | — | 99 | 99 |
| ESOP shares earned (3,968 shares) | — | (3) | — | 42 | — | — | — | 39 |
| Stock based compensation | — | 5 | — | — | — | — | — | 5 |
| RRP shares earned (1,966 shares) | — | (11) | — | — | 26 | — | — | 15 |
| Cash dividends declared ($0.14 per share) | — | — | — | — | — | (296) | — | (296) |
| Balance – June 30, 2012 | $66 | $27,978 | $(6,260) | $(2,004) | $(580) | $41,376 | $5,135 | $65,711 |

*See notes to consolidated financial statements.*

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**LAKE SHORE BANCORP, INC. and SUBSIDIARY**

CONSOLIDATED STATEMENTS of CASH FLOWS

| | Six Months Ended June 30, 2012 (Unaudited) (Dollars in thousands) | | **2011** | |
|---|---|---|---|---|
| Cash Flows from Operating Activities | | | | |
| Net Income | $ | 1,902 | $ | 1,937 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | | | |
| Net amortization of investment securities | | 160 | | 41 |
| Amortization of deferred loan costs | | 276 | | 249 |
| Provision for loan losses | | 50 | | 285 |
| Impairment of investment securities | | 57 | | — |
| Recovery on previously impaired investment securities | | — | | (57) |
| Gain on sale of investment securities | | — | | (31) |
| Originations of loans held for sale | | (156) | | (253) |
| Proceeds from sales of loans held for sale | | 156 | | 253 |
| Depreciation and amortization | | 326 | | 332 |
| Increase in bank owned life insurance, net | | (120) | | (129) |
| | | 39 | | 41 |

| | | |
|---|---|---|
| ESOP shares committed to be released | | |
| Stock based compensation expense | 20 | 112 |
| Decrease (increase) in accrued interest receivable | 118 | (120) |
| Decrease in other assets | 448 | 903 |
| Decrease in other liabilities | (434) | (84) |
| Net Cash Provided by Operating Activities | 2,842 | 3,479 |
| Cash Flows from Investing Activities | | |
| Activity in available for sale securities: | | |
| Sales | — | 4,673 |
| Maturities, prepayments and calls | 15,884 | 11,588 |
| Purchases | (22,454) | (16,599) |
| Purchases of Federal Home Loan Bank Stock | (17) | (44) |
| Redemptions of Federal Home Loan Bank Stock | 120 | 118 |
| Loan origination and principal collections, net | 7,784 | (9,273) |
| Additions to premises and equipment | (297) | (121) |
| Net Cash Provided by (Used in) Investing Activities | 1,020 | (9,658) |
| Cash Flows from Financing Activities | | |
| Net increase in deposits | 4,981 | 3,105 |
| Net decrease in advances from borrowers for taxes and insurance | (181) | (134) |
| Net increase in short-term borrowings | 7,410 | 950 |
| | — | 3,000 |

| | | | | |
|---|---|---|---|---|
| Proceeds from issuance of long-term debt | | | | |
| Repayment of long-term debt | | (10,080) | | (6,580) |
| Purchase of Treasury Stock | | — | | (169) |
| Cash dividends paid | | (296) | | (367) |
| Net Cash Provided by (Used In) Financing Activities | | 1,834 | | (195) |
| Net Increase (Decrease) in Cash and Cash Equivalents | | 5,696 | | (6,374) |
| Cash and Cash Equivalents – Beginning | | 23,704 | | 33,514 |
| Cash and Cash Equivalents – Ending | $ | 29,400 | $ | 27,140 |
| Supplementary Cash Flows Information | | | | |
| Interest paid | $ | 2,498 | $ | 2,954 |
| Income taxes paid | $ | 706 | $ | 365 |
| Supplementary Schedule of Noncash Investing and Financing Activities | | | | |
| Foreclosed real estate acquired in settlement of loans | $ | 887 | $ | 71 |

*See notes to consolidated financial statements*

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LAKE SHORE BANCORP, INC. and Subsidiary

Notes to Consolidated Financial Statements (unaudited)

**NOTE 1 – NATURE OF OPERATIONS AND BASIS OF PRESENTATION**

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

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

The interim financial statements included herein as of June 30, 2012 and for the three and six months ended June 30, 2012 and 2011 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, 2011 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 Form 10-K for the year ended December 31, 2011. The consolidated results of operations for the three and six months ended June 30, 2012 are not necessarily indicative of the results for any subsequent period or the entire year ending December 31, 2012.

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 June 30, 2012 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**

There were no new accounting standards affecting the Company during the period that were not previously disclosed.

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**NOTE 3 – INVESTMENT SECURITIES**

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

| | June 30, 2012 | | | |
|---|---|---|---|---|
| | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value |
| | (Dollars in Thousands) | | | |
| Securities Available for Sale: | | | | |
| U.S. Treasury bonds | $12,915 | $ 2,421 | $ — | $15,336 |
| Municipal bonds | 51,688 | 3,800 | (27) | 55,461 |
| Mortgage-backed securities: | | | | |
| Collateralized mortgage obligations -private label | 108 | 2 | — | 110 |
| Collateralized mortgage obligations -government sponsored entities | 61,186 | 795 | (50) | 61,931 |
| Government National Mortgage Association | 2,934 | 275 | — | 3,209 |
| Federal National Mortgage Association | 21,593 | 1,127 | — | 22,720 |
| Federal Home Loan Mortgage Corporation | 6,679 | 527 | — | 7,206 |
| Asset-backed securities -private label | 5,020 | 491 | (985) | 4,526 |
| Asset-backed securities -government sponsored entities | 159 | 15 | — | 174 |
| Equity securities | 22 | — | (16) | 6 |
| | $162,304 | $ 9,453 | $ (1,078) | $170,679 |

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**NOTE 3 – INVESTMENT SECURITIES (continued)**

| | December 31, 2011 | | | |
|---|---|---|---|---|
| | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value |
| | (Dollars in Thousands) | | | |
| SECURITIES AVAILABLE FOR SALE: | | | | |
| U.S. Treasury bonds | $12,935 | $2,143 | $ — | $15,078 |
| Municipal bonds | 49,561 | 4,115 | — | 53,676 |
| Mortgage-backed securities: | | | | |
| Collateralized mortgage obligations -private label | 133 | — | (4) | 129 |
| Collateralized mortgage obligations -government sponsored entities | 59,669 | 1,127 | (25) | 60,771 |
| Government National Mortgage Association | 3,141 | 208 | — | 3,349 |
| Federal National Mortgage Association | 19,612 | 958 | — | 20,570 |
| Federal Home Loan Mortgage Corporation | 5,246 | 520 | — | 5,766 |
| Asset-backed securities -private label | 5,459 | 378 | (1,205) | 4,632 |
| Asset-backed securities -government sponsored entities | 173 | 16 | — | 189 |
| Equity securities | 22 | — | (17) | 5 |
| | $155,951 | $9,465 | $ (1,251) | $164,165 |

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

At June 30, 2012 and December 31, 2011, equity securities consisted of 22,368 shares of Federal Home Loan Mortgage Corporation ("FHLMC") common stock.

At June 30, 2012, thirty-two municipal bonds with a cost of $10.0 million and fair value of $11.0 million were pledged under a collateral agreement with the Federal Reserve Bank of New York for liquidity borrowing. In addition, at June 30, 2012, eleven municipal bonds with a cost of $4.1 million and a fair value of $4.5 million were pledged as collateral for customer deposits in excess of the Federal Deposit Insurance Corporation ("FDIC") insurance limits. At December 31, 2011, thirty-two municipal bonds with a cost of $10.0 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, 2011, eleven municipal bonds with a cost of $4.1 million and a fair value of $4.6 million were pledged as collateral for customer deposits in excess of the FDIC insurance limits.

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**NOTE 3 – INVESTMENT SECURITIES (continued)**

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

| | Less than 12 Months | | 12 Months or More | | Total | |
|---|---|---|---|---|---|---|
| | Fair Value | Gross Unrealized Losses | Fair Value | Gross Unrealized Losses | Fair Value | Gross Unrealized Losses |
| | | | (Dollars in thousands) | | | |
| June 30, 2012 | | | | | | |
| Municipal bonds | $1,529 | $ (27 ) | $— | $ — | $1,529 | $ (27 ) |
| Mortgage-backed securities | 12,188 | (50 ) | — | — | 12,188 | (50 ) |
| Asset-backed securities – private label | — | — | 3,724 | (985 ) | 3,724 | (985 ) |
| Equity securities | — | — | 6 | (16 ) | 6 | (16 ) |
| | $13,717 | $ (77 ) | $3,730 | $ (1,001 ) | $17,447 | $ (1,078 ) |
| December 31, 2011 | | | | | | |
| Mortgage-backed securities | $6,982 | $ (29 ) | $— | $ — | $6,982 | $ (29 ) |
| Asset-backed securities – private label | — | — | 3,846 | (1,205 ) | 3,846 | (1,205 ) |
| Equity securities | — | — | 5 | (17 ) | 5 | (17 ) |
| | $6,982 | $ (29 ) | $3,851 | $ (1,222 ) | $10,833 | $ (1,251 ) |

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 in accordance with FASB ASC Topic 320 "*Investments - Debt and Equity Securities*" are other-than-temporary, 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 June 30, 2012 the Company's investment portfolio included twelve mortgage-backed securities and seven municipal bonds in the unrealized losses less than twelve months category. The mortgage-backed securities and municipal bonds were not evaluated further for OTTI as the unrealized losses on the individual securities were less than 20% of book value, which management deemed to be immaterial, 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.

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**NOTE 3 – INVESTMENT SECURITIES (continued)**

At June 30, 2012, the Company had one equity security, and four private label asset-backed securities in the unrealized loss of twelve months or more category. The Company’s investment in equity securities is a requirement of its membership with the FHLMC. The equity security was not evaluated further for OTTI, despite the percentage of unrealized losses, due to immateriality.

One of the four private label asset-backed securities in this category was not evaluated further for OTTI, as the unrealized loss was less than 20% of book value. The temporary impairment was due to declines in fair value resulting from changes in interest rates and/or increased credit liquidity spreads since the security was purchased. The Company expects this security to be repaid in full, with no losses realized. Management does not intend to sell this security and it is more likely than not that it will not be required to sell this security.

Three of the four private label securities in this category were evaluated further for OTTI, as the unrealized loss was 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 following table provides additional information relating to these private label asset-backed securities as of June 30, 2012 (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 | $1,943 | $1,434 | $(509) | C | 40.70% | 39.80% | 18.90% | 2.00% |
| 2 | 1,217 | 906 | (311) | CCC | 34.80% | 32.90% | 14.90% | 1.50% |
| 3 | 1,000 | 843 | (157) | CCC | 21.30% | 20.00% | 12.90% | 0.60% |
| Total | $ 4,160 | $3,183 | $(977) | | | | | |

The three private label asset-backed securities listed above were evaluated for OTTI under the guidance of FASB ASC Topic 320. The Company believes the unrealized losses on these three private label asset-backed securities occurred due to the current challenging economic environment, high unemployment rates, a continued decline in housing values in many areas of the country, and increased delinquency trends. It is possible that principal losses may be incurred on the tranches we hold in these specific securities. Management’s evaluation of the estimated discounted cash flows in comparison to the amortized book value reflected the need to record an initial OTTI charge against earnings of $57,000 for one of the securities noted above, as of June 30, 2012, as the calculation of the estimated discounted cash flows showed an additional principal loss. Management’s evaluation of the estimated discounted cash flows in comparison to the amortized book value for the remaining securities listed above did not reflect the need to record OTTI charges against earnings as of June 30, 2012. The estimated discounted cash flows for these remaining 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 more likely than not it will not be required to sell these securities.

Management also completed an OTTI analysis for two private label asset-backed securities, which did not have unrealized losses as of June 30, 2012. However, an impairment charge had been taken on these securities during 2008. Management reviewed key credit metrics for these securities, including delinquency rates, cumulative default rates, prepayment speeds, foreclosure rates, loan-to-values and credit support levels. Management's calculation of the estimated discounted cash flows did not show additional principal losses for these securities under various prepayment and default rate scenarios. As a result of the stress tests that were performed, management concluded that additional OTTI charges were not required as of June 30, 2012 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.

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**NOTE 3 – INVESTMENT SECURITIES (continued)**

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:

| | For the Six Months Ended June 30, 2012 | For the Year Ended December 31, 2011 |
|---|---|---|
| | (Dollars in thousands) | |
| Beginning balance | $1,084 | $ 1,176 |
| Addition: | | |
| Credit loss not previously recognized | 57 | — |
| Reductions: | | |
| Losses realized during the period on OTTI previously recognized | (20 ) | (35 ) |
| Receipt of cash flows on previously recorded OTTI | — | (57 ) |
| Ending balance | $1,121 | $ 1,084 |

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

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

| | Amortized Cost | Fair Value |
|---|---|---|

| | (Dollars in Thousands) | |
|---|---|---|
| June 30, 2012: | | |
| After five years through ten years | $19,426 | $21,916 |
| After ten years | 45,177 | 48,881 |
| Mortgage-backed securities | 92,500 | 95,176 |
| Asset-backed securities | 5,179 | 4,700 |
| Equity securities | 22 | 6 |
| | $162,304 | $170,679 |

During the six months ended June 30, 2012, the Company did not sell any available for sale securities. The Company sold available for sale securities during the six months ended June 30, 2011, for total proceeds of $4.7 million, resulting in gross realized gains of $115,000 and gross realized losses of $84,000.

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

Other Loans:

- Commercial – includes business installment loans, lines of credit, and other commercial loans. Most of our commercial loans have variable interest rates tied to the prime rate, and are for terms generally not in excess of 10 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 businesses and the income stream of the borrower. Such risks can be significantly affected by economic conditions.

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

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

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**NOTE 4 - ALLOWANCE FOR LOAN LOSSES (continued)**

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

The following table summarizes the activity in the allowance for loan losses for the three and six months ended June 30, 2011 and 2012 and the distribution of the allowance for loan losses and loans receivable by loan portfolio class and impairment method as of June 30, 2012:

| | **Real Estate Loans** | | | | Other Loans | | | |
|---|---|---|---|---|---|---|---|---|
| | One-to Four-Family | Home Equity | Commercial | Construction | Commercial | Consumer | Unallocated | Total |
| | | | | (Dollars in thousands) | | | | |
| June 30, 2011 | | | | | | | | |
| Allowance for Loan Losses: | | | | | | | | |
| Balance – April 1, 2011 | $306 | $90 | $350 | $— | $177 | $21 | $— | $944 |
| Charge-offs | — | — | — | — | — | (5) | — | (5) |
| Recoveries | — | — | — | — | — | 2 | — | 2 |
| Provision | 67 | — | 148 | — | 51 | (1) | — | 265 |
| Balance – June 30, 2011 | $373 | $90 | $498 | $— | $228 | $17 | $— | $1,206 |
| Balance – January 1, 2011 | $407 | $141 | $278 | $1 | $104 | $21 | $1 | $953 |
| Charge-offs | — | (29) | — | — | — | (10) | — | (39) |
| Recoveries | 4 | — | — | — | — | 3 | — | 7 |
| Provision | (38) | (22) | 220 | (1) | 124 | 3 | (1) | 285 |
| | $373 | $90 | $498 | $— | $228 | $17 | $— | $1,206 |

Balance –
June 30,
2011

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**NOTE 4 - ALLOWANCE FOR LOAN LOSSES (continued)**

| | **Real Estate Loans** | | | | Other Loans | | | |
|---|---|---|---|---|---|---|---|---|
| | One- to Four-Family | Home Equity | Commercial | Construction | Commercial | Consumer | Unallocated | Total |
| | (Dollars in thousands) | | | | | | | |
| June 30, 2012 | | | | | | | | |
| Allowance for Loan Losses: | | | | | | | | |
| Balance – April 1, 2012 | $381 | $66 | $ 719 | $ — | $146 | $ 10 | $ 3 | $1,325 |
| Charge-offs | (94) | — | — | — | — | (1) | — | (95) |
| Recoveries | — | — | 8 | — | — | 1 | — | 9 |
| Provision | 69 | 22 | (40) | 2 | 35 | (2) | (1) | 85 |
| Balance – June 30, 2012 | $356 | $88 | $ 687 | $ 2 | $181 | $ 8 | $ 2 | $1,324 |
| Balance – January 1, 2012 | $441 | $125 | $ 522 | $ — | $265 | $ 13 | $ — | $1,366 |
| Charge-offs | (100) | — | — | — | (1) | (1) | — | (102) |
| Recoveries | 1 | — | 8 | — | — | 1 | — | 10 |
| Provision | 14 | (37) | 157 | 2 | (83) | (5) | 2 | 50 |
| Balance – June 30, 2012 | $356 | $88 | $ 687 | $ 2 | $181 | $ 8 | $ 2 | $1,324 |
| Ending balance: individually evaluated for impairment | $— | $— | $ 8 | $ — | $— | $ — | $ — | $8 |
| Ending balance: collectively evaluated for impairment | $356 | $88 | $ 679 | $ 2 | $181 | $ 8 | $ 2 | $1,316 |
| **Gross Loans Receivable (1):** | | | | | | | | |
| Ending balance | $172,116 | $30,439 | $ 47,939 | $ 682 | $11,912 | $ 1,743 | $ — | $264,831 |
| Ending balance: individually evaluated for impairment | $— | $— | $ 130 | $ — | $13 | $ — | $ — | $143 |
| Ending balance: collectively evaluated for impairment | $172,116 | $30,439 | $ 47,809 | $ 682 | $11,899 | $ 1,743 | $ — | $264,688 |

(1) Gross Loans Receivable does not include

allowance
for loan
losses of
$(1,324) or
deferred loan
costs of
$2,683

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**NOTE 4 - ALLOWANCE FOR LOAN LOSSES (continued)**

The following table summarizes the distribution of the allowance for loan losses and loans receivable by loan portfolio class and impairment method as of December 31, 2011:

| | **Real Estate Loans** | | | | Other Loans | | | |
|---|---|---|---|---|---|---|---|---|
| | One- to Four-Family | Home Equity | Commercial | Construction | Commercial | Consumer | Unallocated | Total |
| | | | | (Dollars in thousands) | | | | |
| December 31, 2011 | | | | | | | | |
| Allowance for Loan Losses: | | | | | | | | |
| Balance – December 31, 2011 | $441 | $125 | $ 522 | $— | $265 | $ 13 | $ — | $1,366 |
| Ending balance: individually evaluated for impairment | $— | $— | $ 8 | $— | $— | $ — | $ — | $8 |
| Ending balance: collectively evaluated for impairment | $441 | $125 | $ 514 | $— | $265 | $ 13 | $ — | $1,358 |
| Gross Loans Receivable (1): | | | | | | | | |
| Ending Balance | $182,922 | $30,671 | $ 44,776 | $519 | $12,911 | $ 1,948 | $ — | $273,747 |
| Ending balance: individually evaluated for impairment | $— | $— | $ 133 | $— | $— | $ — | $ — | $133 |
| Ending balance: collectively evaluated for impairment | $182,922 | $30,671 | $ 44,643 | $519 | $12,911 | $ 1,948 | $ — | $273,614 |

(1) Gross Loans Receivable does not include allowance for loan losses of $(1,366) or deferred loan costs of $2,687.

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**NOTE 4 - ALLOWANCE FOR LOAN LOSSES (continued)**

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

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

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

| | Recorded Investment | Unpaid Principal Balance | Related Allowance | Average Recorded Investment | Interest Income Recognized |
|---|---|---|---|---|---|
| | (Dollars in thousands) | | | | |
| | At June 30, 2012 | | | For the six months ended June 30, 2012 | |
| With no related allowance recorded: | | | | | |
| Commercial real estate | $— | $ — | $ — | $ 59 | $ — |
| Commercial loans | 13 | 13 | — | 13 | — |
| With an allowance recorded: | | | | | |
| Commercial real estate | 130 | 130 | 8 | 133 | 7 |
| Total | $ 143 | $ 143 | $ 8 | $ 205 | $ 7 |

| | At December 31, 2011 | | | For the year ended December 31, 2011 | |
|---|---|---|---|---|---|
| With no related allowance recorded: | | | | | |

| | | | | | |
|---|---|---|---|---|---|
| Commercial real estate | $— | $ — | $ — | $131 | $ 14 |
| With an allowance recorded: | | | | | |
| Commercial real estate | 133 | 133 | 8 | 245 | 16 |
| Total | $133 | $ 133 | $ 8 | $376 | $ 30 |

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**NOTE 4 - ALLOWANCE FOR LOAN LOSSES (continued)**

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

| | 30-59 Days Past Due | 60-89 Days Past Due | 90 Days or More Past Due | Total Past Due | Current Due | **Total Loans Receivable** |
|---|---|---|---|---|---|---|
| | (Dollars in thousands) | | | | | |
| **June 30, 2012**: | | | | | | |
| Real Estate Loans: | | | | | | |
| Residential, one- to four-family | $745 | $412 | $995 | $2,152 | $169,964 | $ 172,116 |
| Home equity | 94 | 26 | 228 | 348 | 30,091 | 30,439 |
| Commercial | — | 255 | — | 255 | 47,684 | 47,939 |
| Construction | — | — | — | — | 682 | 682 |
| Other Loans: | | | | | | |
| Commercial | 83 | 21 | 93 | 197 | 11,715 | 11,912 |
| Consumer | 10 | — | 28 | 38 | 1,705 | 1,743 |
| Total | $932 | $714 | $1,344 | $2,990 | $261,841 | $ 264,831 |
| **December 31, 2011**: | | | | | | |
| Real Estate Loans: | | | | | | |
| Residential, one- to four-family | $949 | $608 | $1,989 | $3,546 | $179,376 | $ 182,922 |
| Home equity | 403 | 51 | 157 | 611 | 30,060 | 30,671 |
| Commercial | 890 | 39 | 228 | 1,157 | 43,619 | 44,776 |
| Construction | — | — | — | — | 519 | 519 |
| Other Loans: | | | | | | |
| Commercial | 41 | 3 | 159 | 203 | 12,708 | 12,911 |
| Consumer | 58 | 4 | 28 | 90 | 1,858 | 1,948 |
| Total | $2,341 | $705 | $2,561 | $5,607 | $268,140 | $ 273,747 |

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**NOTE 4 - ALLOWANCE FOR LOAN LOSSES (continued)**

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

| | At June 30, 2012 | At December 31, 2011 |
|---|---|---|
| | (Dollars in thousands) | |
| Loans past due 90 days or more but still accruing: | | |
| Real Estate Loans: | | |
| Residential, one- to four-family | $13 | $328 |
| Home equity | 54 | 21 |
| Commercial | — | — |
| Construction | — | — |
| Other loans: | | |
| Commercial | — | 87 |
| Consumer | 24 | 23 |
| Total | $91 | $459 |
| Loans accounted for on a non-accrual basis: | | |
| Real Estate Loans: | | |
| Residential, one- to four-family | $1,461 | $1,821 |
| Home equity | 213 | 209 |
| Commercial | 130 | 228 |
| Construction | — | — |
| Other loans: | | |
| Commercial | 160 | 76 |
| Consumer | 4 | 5 |
| Total | $1,968 | $2,339 |

The accrual of interest on loans is discontinued when, in management's opinion, the borrower may be unable to meet payments as they become due. When interest accrual is discontinued, all unpaid accrued interest is reversed. Interest income is subsequently recognized only to the extent cash payments are received. If ultimate collection of principal is in doubt, all cash receipts on impaired loans are applied to reduce the principal balance. Interest income not recognized on non-accrual loans during the six month period ended June 30, 2012 and June 30, 2011 was $69,000 and $56,000 respectively.

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

- Pass/Performing
- Watch/Special Mention – does not currently expose the Company to a sufficient degree of risk but does possess credit deficiencies or potential weaknesses deserving the Company’s close attention;

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**NOTE 4 - ALLOWANCE FOR LOAN LOSSES (continued)**

- Substandard – has one or more defined weaknesses and are characterized by the distinct possibility that the Company will sustain some loss if the deficiencies are not corrected;
- Doubtful – has all the weaknesses inherent in substandard loans with the additional characteristic that the weaknesses present make collection or liquidation in full on the basis of currently existing facts, conditions and values questionable, and there is a high possibility of loss; and
- Loss – loan is considered uncollectible and continuance as a loan of the Company is not warranted.

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 individually classified. Instead the Company uses the delinquency status as the credit quality indicator for consumer loans. Unless the loan is well secured and in the process of collection, all consumer loans that are more than 90 days past due are classified.

The following table summarizes the internal loan grades applied to the Company's loan portfolio as of June 30, 2012 and December 31, 2011:

| | **Pass/ Performing** | **Special Mention** | Substandard | Doubtful | Loss | Total |
|---|---|---|---|---|---|---|
| | (Dollars in thousands) | | | | | |
| June 30, 2012 | | | | | | |
| Real Estate Loans: | | | | | | |
| Residential, one- to four-family | $170,398 | $— | $ 1,718 | $ — | $— | $172,116 |
| Home Equity | 30,163 | — | 181 | 95 | — | 30,439 |
| Commercial | 43,756 | 3,977 | 76 | 130 | — | 47,939 |
| Construction | 682 | — | — | — | — | 682 |
| Other Loans: | | | | | | |
| Commercial | 10,889 | 716 | 199 | 108 | — | 11,912 |
| Consumer | 1,736 | — | 7 | — | — | 1,743 |
| Total | $257,624 | $4,693 | $ 2,181 | $ 333 | $— | $264,831 |
| December 31, 2011 | | | | | | |
| Real Estate Loans: | | | | | | |
| Residential, one- to four-family | $180,606 | $— | $ 1,991 | $ 265 | $60 | $182,922 |

| | | | | | | |
|---|---|---|---|---|---|---|
| Home Equity | 30,270 | — | 401 | — | — | 30,671 |
| Commercial | 41,234 | 3,233 | 81 | 228 | — | |