

LAKE SHORE BANCORP, INC.  
Form 10-Q  
November 12, 2014

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

FORM 10-Q

(Mark One)

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

For the quarterly period ended September 30, 2014

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 5,938,951 shares of the registrant’s common stock, \$0.01 par value per share, outstanding at November 1, 2014.

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## PART I

## Item 1. Financial Statements

## Lake Shore Bancorp, Inc. and Subsidiary

## Consolidated Statements of Financial Condition

|   | September<br>30,<br>2014<br>(Unaudited)      | December<br>31,<br>2013<br>(Unaudited) |
|---|--|--|
|   | (Dollars in thousands,<br>except share data) |  |
| Assets  |  |  |
| Cash and due from banks   | \$ 8,162                                     | \$ 7,748                               |
| Interest earning deposits   | 27,381                                       | 2,321                                  |
| Federal funds sold  | 6,349  | 7,133                                  |
| Cash and Cash Equivalents   | 41,892                                       | 17,202                                 |
| Securities available for sale   | 140,951                                      | 157,964                                |
| Federal Home Loan Bank stock, at cost   | 1,375  | 1,560                                  |
| Loans receivable, net of allowance for loan losses 2014 \$1,803; 2013 \$1,813 | 275,156                                      | 277,345                                |
| Premises and equipment, net   | 9,529  | 9,642                                  |
| Accrued interest receivable   | 1,864  | 1,787                                  |
| Bank owned life insurance   | 14,597                                       | 14,407                                 |
| Other assets  | 1,223  | 2,260                                  |
| <b>Total Assets</b>   | <b>\$ 486,587</b>                            | <b>\$ 482,167</b>                      |
| Liabilities and Stockholders' Equity  |  |  |
| Liabilities   |  |  |
| Deposits:   |  |  |
| Interest bearing  | \$ 349,800                                   | \$ 353,915                             |
| Non-interest bearing  | 39,705                                       | 34,320                                 |
| <b>Total Deposits</b>   | <b>389,505</b>                               | <b>388,235</b>                         |
| Short-term borrowings   | -  | 11,650                                 |
| Long-term debt  | 18,950                                       | 7,850                                  |
| Advances from borrowers for taxes and insurance                               | 2,039  | 3,454                                  |
| Other liabilities   | 6,366  | 5,707                                  |
| <b>Total Liabilities</b>  | <b>\$ 416,860</b>                            | <b>\$ 416,896</b>                      |

|  |            |            |
|--|------------|------------|
| Commitments and Contingencies  | -          | -          |
| Stockholders' Equity   |            |            |
| Common stock, \$0.01 par value per share, 25,000,000 shares authorized; 6,622,849 shares issued and 5,938,951 shares outstanding at September 30, 2014 and 6,619,203 shares issued and 5,915,835 shares outstanding at December 31, 2013 | \$ 66      | \$ 66      |
| Additional paid-in capital   | 28,104     | 28,039     |
| Treasury stock, at cost (683,898 shares at September 30, 2014 and 703,368 shares at December 31, 2013)   | (6,420)    | (6,588)    |
| Unearned shares held by ESOP   | (1,812)    | (1,876)    |
| Unearned shares held by compensation plans   | (669)      | (499)      |
| Retained earnings  | 47,544     | 45,624     |
| Accumulated other comprehensive income   | 2,914      | 505        |
| Total Stockholders' Equity   | 69,727     | 65,271     |
| Total Liabilities and Stockholders' Equity   | \$ 486,587 | \$ 482,167 |

See notes to consolidated financial statements.

## Lake Shore Bancorp, Inc. and Subsidiary

## Consolidated Statements of Income

|   | Three Months                                  |              | Nine Months Ended |               |
|---|---|--------------|-------------------|---------------|
|   | Ended September                               | 2013         | September 30,     | 2013          |
|   | 30,   |              | September 30,     |               |
|   | 2014  | 2013         | 2014              | 2013          |
|   | (Unaudited)                                   |              |                   |               |
|   | (Dollars in thousands, except per share data) |              |                   |               |
| <b>Interest Income</b>  |   |              |                   |               |
| Loans, including fees   | \$ 3,307                                      | \$ 3,426     | \$ 9,977          | \$ 10,361     |
| Investment securities, taxable                                  | 552   | 696          | 1,884             | 2,071         |
| Investment securities, tax-exempt                               | 530   | 499          | 1,589             | 1,463         |
| Other   | 6   | 5            | 10                | 13            |
| <b>Total Interest Income</b>                                    | <b>4,395</b>                                  | <b>4,626</b> | <b>13,460</b>     | <b>13,908</b> |
| <b>Interest Expense</b>   |   |              |                   |               |
| Deposits  | 724   | 797          | 2,229             | 2,413         |
| Short-term borrowings   | -   | 12           | 20                | 38            |
| Long-term debt  | 102   | 50           | 182               | 165           |
| Other   | 25  | 27           | 76                | 79            |
| <b>Total Interest Expense</b>                                   | <b>851</b>                                    | <b>886</b>   | <b>2,507</b>      | <b>2,695</b>  |
| <b>Net Interest Income</b>                                      | <b>3,544</b>                                  | <b>3,740</b> | <b>10,953</b>     | <b>11,213</b> |
| Provision for Loan Losses                                       | 70  | 60           | 70                | 105           |
| <b>Net Interest Income after Provision for Loan Losses</b>      | <b>3,474</b>                                  | <b>3,680</b> | <b>10,883</b>     | <b>11,108</b> |
| <b>Non-Interest Income</b>                                      |   |              |                   |               |
| Service charges and fees  | 396   | 421          | 1,202             | 1,234         |
| Earnings on bank owned life insurance                           | 65  | 66           | 190               | 215           |
| Recovery on previously impaired investment securities           | 35  | -            | 136               | -             |
| Gain on sale of securities available for sale                   | -   | 206          | 59                | 206           |
| Gain on sale of loans   | 5   | -            | 5                 | -             |
| Total other-than-temporary impairment ("OTTI") losses           | -   | (613)        | -                 | (613)         |
| Portion of OTTI losses recognized in other comprehensive income | -   | 433          | -                 | 433           |
| (before taxes)  | -   | 433          | -                 | 433           |
| <b>Net OTTI losses recognized in earnings</b>                   | <b>-</b>                                      | <b>(180)</b> | <b>-</b>          | <b>(180)</b>  |
| Other   | 30  | 28           | 89                | 96            |
| <b>Total Non-Interest Income</b>                                | <b>531</b>                                    | <b>541</b>   | <b>1,681</b>      | <b>1,571</b>  |
| <b>Non-Interest Expenses</b>                                    |   |              |                   |               |
| Salaries and employee benefits                                  | 1,682   | 1,524        | 4,936             | 4,664         |
| Occupancy and equipment   | 531   | 520          | 1,648             | 1,509         |
| Professional services   | 298   | 333          | 956               | 1,079         |
| Data processing   | 202   | 163          | 579               | 480           |
| Advertising   | 85  | 93           | 353               | 357           |
| FDIC Insurance  | 70  | 64           | 211               | 194           |
| Postage and supplies  | 61  | 55           | 194               | 192           |
| Other   | 279   | 261          | 838               | 900           |
| <b>Total Non-Interest Expenses</b>                              | <b>3,208</b>                                  | <b>3,013</b> | <b>9,715</b>      | <b>9,375</b>  |

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|   |         |         |          |          |
|---|---------|---------|----------|----------|
| Income before Income Taxes                  | 797     | 1,208   | 2,849    | 3,304    |
| Income Tax Expense                          | 109     | 222     | 487      | 612      |
| Net Income                                  | \$ 688  | \$ 986  | \$ 2,362 | \$ 2,692 |
| Basic and Diluted earnings per common share | \$ 0.12 | \$ 0.17 | \$ 0.41  | \$ 0.47  |
| Dividends declared per share                | \$ 0.07 | \$ 0.07 | \$ 0.21  | \$ 0.21  |

See notes to consolidated financial statements.



## Lake Shore Bancorp, Inc. and Subsidiary

## Consolidated Statements of Comprehensive Income/(Loss)

|   | Three Months<br>Ended September<br>30,<br>2014      2013<br>(Unaudited)<br>(Dollars in<br>thousands) |        |
|---|--|--------|
| Net Income  | \$ 688   | \$ 986 |
| Other Comprehensive Income (Loss), net of tax (expense) benefit   |  |        |
| Unrealized holding gains (losses) on securities available for sale, net of tax (expense) benefit<br>2014 \$(40); 2013 \$141 | 62   | (223)  |
| Reclassification adjustments related to:  |  |        |
| Recovery on previously impaired investment securities, net of tax expense(1) 2014 \$14                                      | (21)   | -      |
| Net gain on sale of securities included in net income, net of tax expense(2) 2013 \$80                                      | -  | (126)  |
| Impairment charge for losses included in net income, net of tax benefit(3) 2013 \$70  | -  | 110    |
| Total Other Comprehensive Income (Loss)   | 41   | (239)  |
| Total Comprehensive Income  | \$ 729   | \$ 747 |

(1) Gross amount included in recovery on previously impaired investment securities on consolidated statements of income 2014 \$35

(2) Gross amount included in gain on sale of securities available for sale on consolidated statements of income 2013 \$206

(3) Included in net OTTI losses recognized in earnings on consolidated statements of income 2013 \$(180)

|   | Nine Months<br>Ended September<br>30,<br>2014      2013<br>(Unaudited)<br>(Dollars in<br>thousands) |          |
|---|---|----------|
| Net Income  | \$ 2,362  | \$ 2,692 |
| Other Comprehensive Income (Loss), net of tax (expense) benefit | 2,528   | (3,900)  |

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Unrealized holding gains (losses) on securities available for sale, net of tax (expense) benefit  
2014 \$(1,597); 2013 \$2,461

Reclassification adjustments related to:

|   |          |            |
|---|----------|------------|
| Recovery on previously impaired investment securities included in net income, net of tax expense(1) 2014 \$53 | (83)     | -          |
| Net gain on sale of securities included in net income, net of tax expense(2) 2014 \$23;<br>2013 \$80          | (36)     | (126)      |
| Impairment charge for losses included in net income, net of tax benefit(3) 2013 \$70                          | -        | 110        |
| Total Other Comprehensive Income (Loss)   | 2,409    | (3,916)    |
| Total Comprehensive Income (Loss)   | \$ 4,771 | \$ (1,224) |

(1) Gross amount included in recovery on previously impaired investment securities on consolidated statements of income 2014 \$136

(2) Gross amount included in gain on sale of securities available for sale on consolidated statements of income 2014 \$59; 2013 \$206

(3) Included in net OTTI losses recognized in earnings on consolidated statements of income 2013 \$(180)

See notes to consolidated financial statements.

## Lake Shore Bancorp, Inc. and Subsidiary

## Consolidated Statements of Changes in Stockholders' Equity

Nine Months Ended September 30, 2014 and 2013 (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     |
|---|-----------------|----------------------------------|-------------------|---------------------------------------|--|----------------------|---|-----------|
| (In thousands, except share and per share data)                 |                 |                                  |                   |                                       |  |                      |   |           |
| Balance - January 1,<br>2013                                    | \$ 66           | \$ 27,973                        | \$ (6,469)        | \$ (1,961)                            | \$ (553)   | \$ 42,468            | \$ 5,461  | \$ 66,985 |
| Net income  | -               | -                                | -                 | -                                     | -  | 2,692                | -   | 2,692     |
| Other comprehensive<br>loss, net of tax benefit of<br>\$2,471   | -               | -                                | -                 | -                                     | -  | -                    | (3,916)   | (3,916)   |
| Stock options exercised<br>(506 shares)                         | -               | 4                                | -                 | -                                     | -  | -                    | -   | 4         |
| ESOP shares earned<br>(5,951 shares)                            | -               | 3                                | -                 | 64                                    | -  | -                    | -   | 67        |
| Stock based<br>compensation                                     | -               | 7                                | -                 | -                                     | -  | -                    | -   | 7         |
| Compensation plan<br>shares earned (3,017<br>shares)            | -               | (11)                             | -                 | -                                     | 41   | -                    | -   | 30        |
| Purchase of treasury<br>stock, at cost (5,000<br>shares)        | -               | -                                | (58)              | -                                     | -  | -                    | -   | (58)      |
| Cash dividends declared<br>(\$0.21 per share)                   | -               | -                                | -                 | -                                     | -  | (441)                | -   | (441)     |
| Balance - September 30,<br>2013                                 | \$ 66           | \$ 27,976                        | \$ (6,527)        | \$ (1,897)                            | \$ (512)   | \$ 44,719            | \$ 1,545  | \$ 65,370 |
| Balance - January 1,<br>2014                                    | \$ 66           | \$ 28,039                        | \$ (6,588)        | \$ (1,876)                            | \$ (499)   | \$ 45,624            | \$ 505  | \$ 65,271 |
| Net income  | -               | -                                | -                 | -                                     | -  | 2,362                | -   | 2,362     |
| Other comprehensive<br>income, net of tax<br>expense of \$1,521 | -               | -                                | -                 | -                                     | -  | -                    | 2,409   | 2,409     |
| Stock options exercised<br>(3,646 shares)                       | -               | 54                               | -                 | -                                     | -  | -                    | -   | 54        |
| ESOP shares earned<br>(5,951 shares)                            | -               | 9                                | -                 | 64                                    | -  | -                    | -   | 73        |
|   | -               | (3)                              | -                 | -                                     | -  | -                    | -   | (3)       |

|  |       |           |            |            |          |           |          |           |
|--|-------|-----------|------------|------------|----------|-----------|----------|-----------|
| Stock based compensation                           |       |           |            |            |          |           |          |           |
| Compensation plan shares granted (24,570 shares)   | -     | -         | 230        | -          | (230)    | -         | -        | -         |
| Compensation plan shares earned (5,322 shares)     | -     | 5         | -          | -          | 60       | -         | -        | 65        |
| Purchase of treasury stock, at cost (5,100 shares) | -     | -         | (62)       | -          | -        | -         | -        | (62)      |
| Cash dividends declared (\$0.21 per share)         | -     | -         | -          | -          | -        | (442)     | -        | (442)     |
| Balance - September 30, 2014                       | \$ 66 | \$ 28,104 | \$ (6,420) | \$ (1,812) | \$ (669) | \$ 47,544 | \$ 2,914 | \$ 69,727 |

See notes to consolidated financial statements.

## Lake Shore Bancorp, Inc. and Subsidiary

## Consolidated Statements of Cash Flows

|   | Nine Months Ended September 30, |          |
|---|---------------------------------|----------|
|   | 2014                            | 2013     |
|   | (Unaudited)                     |          |
|   | (Dollars in thousands)          |          |
| <b>CASH FLOWS FROM OPERATING ACTIVITIES</b>                                       |                                 |          |
| Net income  | \$ 2,362                        | \$ 2,692 |
| Adjustments to reconcile net income to net cash provided by operating activities: |                                 |          |
| Net amortization of investment securities   | 223                             | 405      |
| Amortization of deferred loan costs   | 341                             | 386      |
| Provision for loan losses   | 70                              | 105      |
| Impairment of investment securities   | -                               | 180      |
| Recovery on previously impaired investment securities                             | (136)                           | -        |
| Net gain on sale of investment securities   | (59)                            | (206)    |
| Originations of loans held for sale   | (386)                           | (891)    |
| Proceeds from sales of loans held for sale  | 391                             | 891      |
| Gain on sale of loans   | (5)                             | -        |
| Depreciation and amortization   | 559                             | 516      |
| Increase in bank owned life insurance, net  | (190)                           | (215)    |
| ESOP shares committed to be released  | 73                              | 67       |
| Stock based compensation expense  | 62                              | 37       |
| Increase in accrued interest receivable   | (77)                            | (150)    |
| Decrease in other assets  | 268                             | 319      |
| Increase in other liabilities   | 52                              | 245      |
| Net Cash Provided by Operating Activities   | 3,548                           | 4,381    |
| <b>CASH FLOWS FROM INVESTING ACTIVITIES</b>                                       |                                 |          |
| Activity in available for sale securities:  |                                 |          |
| Sales   | 10,337                          | 3,863    |
| Maturities, prepayments and calls   | 10,577                          | 22,060   |
| Purchases   | -                               | (34,651) |
| Purchases of Federal Home Loan Bank Stock   | (351)                           | -        |
| Redemptions of Federal Home Loan Bank Stock                                       | 536                             | 231      |
| Loan origination and principal collections, net                                   | 1,634                           | (1,625)  |
| Additions to premises and equipment   | (446)                           | (636)    |
| Net Cash Provided by (Used in) Investing Activities                               | 22,287                          | (10,758) |
| <b>CASH FLOWS FROM FINANCING ACTIVITIES</b>                                       |                                 |          |
| Net increase in deposits  | 1,270                           | 12,609   |
| Net decrease in advances from borrowers for taxes and insurance                   | (1,415)                         | (1,281)  |
| Net (decrease) increase in short term borrowings                                  | (11,650)                        | 500      |
| Proceeds from issuance of long-term debt  | 15,200                          | 1,750    |
| Repayment of long-term debt   | (4,100)                         | (7,000)  |
| Proceeds from stock options exercised   | 54                              | 4        |
| Purchase of treasury stock  | (62)                            | (58)     |
| Cash dividends paid   | (442)                           | (441)    |
| Net Cash (Used in) Provided by Financing Activities                               | (1,145)                         | 6,083    |
| Net Increase (Decrease) in Cash and Cash Equivalents                              | 24,690                          | (294)    |
| CASH AND CASH EQUIVALENTS - BEGINNING   | 17,202                          | 19,765   |

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|  |           |           |
|--|-----------|-----------|
| CASH AND CASH EQUIVALENTS - ENDING                                   | \$ 41,892 | \$ 19,471 |
| SUPPLEMENTARY CASH FLOWS INFORMATION                                 |           |           |
| Interest paid  | \$ 2,492  | \$ 2,715  |
| Income taxes paid  | \$ 648    | \$ 868    |
| SUPPLEMENTARY SCHEDULE OF NONCASH INVESTING AND FINANCING ACTIVITIES |           |           |
| Foreclosed real estate acquired in settlement of loans               | \$ 171    | \$ 299    |
| Securities sold and not settled                                      | \$ -      | \$ 520    |

See notes to consolidated financial statements.

Lake Shore Bancorp, Inc. and Subsidiary

Notes to Consolidated Financial Statements (Unaudited)

Note 1 – Nature of Operations and Basis of Presentation

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

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

The interim financial statements included herein as of September 30, 2014 and for the three and nine months ended September 30, 2014 and 2013 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, 2013 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, 2013. The consolidated results of operations for the three and nine months ended September 30, 2014 are not necessarily indicative of the results for any subsequent period or the entire year ending December 31, 2014.

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

The Company has evaluated events and transactions occurring subsequent to the statement of financial condition as of September 30, 2014 for items that should potentially be recognized or disclosed in these consolidated financial statements. The evaluation was conducted through the date these consolidated financial statements were issued.

Note 2 – New Accounting Standards

In May 2014, the Financial Accounting Standards Board (“FASB”) issued Accounting Standards Update (“ASU”) 2014-09, “Revenue from Contracts with Customers” (“ASU 2014-09”) which outlines a single comprehensive model for entities to use in accounting for revenue arising from contracts with customers and supersedes most current revenue recognition guidance, including industry-specific guidance. The core principle of the revenue model is that an entity recognizes revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. In applying the revenue model to contracts within its scope, an entity will identify the contract(s) with a customer (step 1), identify the performance obligations in the contract (step 2), determine the transaction price (step 3), allocate the transaction price to the performance obligations in the contract (step 4), and recognize revenue when (or as) the entity satisfies a performance obligation (step 5). ASU 2014-09 applies to all contracts with customers except those that are within the scope of other topics in the FASB ASC. ASU 2014-09 requires entities to disclose both quantitative and qualitative information that enables users of financial statements to understand the nature, amount, timing, and uncertainty of revenue and



cash flows arising from contracts with customers. ASU 2014-09 is effective for annual reporting periods, including interim reporting periods within those periods, beginning after December 15, 2016. Early application is not permitted. The Company has not yet determined the impact the adoption of ASU 2014-09 will have on its financial condition and results of operations.

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

In August 2014, the FASB issued ASU 2014-14, “Receivables – Troubled Debt Restructurings by Creditors (Subtopic 310-40): Classification of Certain Government-Guaranteed Mortgage Loans Upon Foreclosure” (“ASU 2014-14”). ASU 2014-14 applies to all creditors that hold government-guaranteed mortgage loans. The update requires that a mortgage loan be derecognized and that a separate other receivable be recognized upon foreclosure if three conditions are met. The first condition would be that the loan has a government guarantee that is not separable from the loan before foreclosure. The second condition is that at the time of foreclosure, the creditor has the intent to convey the real estate property to the guarantor and make a claim on the guarantee, and the creditor has the ability to recover under that claim. The third and final condition is that at the time of foreclosure, any amount of the claim that is determined on the basis of the fair value of the real estate is fixed. Upon foreclosure, the separate other receivable should be measured based on the amount of the loan balance (principal and interest) expected to be recovered from the guarantor. ASU 2014-14 is effective for the reporting periods beginning after December 15, 2014. Management does not expect the adoption of this update to have a material impact on the Company’s consolidated financial statements or results of operations.

## Note 3 – Investment Securities

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

|   | September 30, 2014     |                              |                               |               |
|---|------------------------|------------------------------|-------------------------------|---------------|
|   | Amortized<br>Cost      | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses | Fair<br>Value |
|   | (Dollars in thousands) |                              |                               |               |
| <b>SECURITIES AVAILABLE FOR SALE:</b>                             |                        |                              |                               |               |
| U.S. Treasury bonds   | \$ 12,827              | \$ 1,301                     | \$ -                          | \$ 14,128     |
| Municipal bonds   | 57,168                 | 3,360                        | (54)                          | 60,474        |
| Mortgage-backed securities:                                       |                        |                              |                               |               |
| Collateralized mortgage obligations-private label                 | 65                     | -                            | -                             | 65            |
| Collateralized mortgage obligations-government sponsored entities | 53,593                 | 282                          | (1,049)                       | 52,826        |
| Government National Mortgage Association                          | 551                    | 40                           | -                             | 591           |
| Federal National Mortgage Association                             | 7,475                  | 328                          | (12)                          | 7,791         |
| Federal Home Loan Mortgage Corporation                            | 2,746                  | 101                          | -                             | 2,847         |
| Asset-backed securities-private label                             | 1,635                  | 530                          | (122)                         | 2,043         |
| Asset-backed securities-government sponsored entities             | 116                    | 11                           | -                             | 127           |
| Equity securities   | 22                     | 37                           | -                             | 59            |
|   | \$ 136,198             | \$ 5,990                     | \$ (1,237)                    | \$ 140,951    |

|   | December 31, 2013      |                              |                               |               |
|---|------------------------|------------------------------|-------------------------------|---------------|
|   | Amortized<br>Cost      | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses | Fair<br>Value |
|   | (Dollars in thousands) |                              |                               |               |
| <b>SECURITIES AVAILABLE FOR SALE:</b>                             |                        |                              |                               |               |
| U.S. Treasury bonds   | \$ 12,857              | \$ 991                       | \$ -                          | \$ 13,848     |
| Municipal bonds   | 57,199                 | 1,385                        | (540)                         | 58,044        |
| Mortgage-backed securities:                                       |                        |                              |                               |               |
| Collateralized mortgage obligations-private label                 | 77                     | 4                            | -                             | 81            |
| Collateralized mortgage obligations-government sponsored entities | 63,840                 | 362                          | (1,577)                       | 62,625        |
| Government National Mortgage Association                          | 2,153                  | 66                           | -                             | 2,219         |
| Federal National Mortgage Association                             | 11,452                 | 318                          | (136)                         | 11,634        |
| Federal Home Loan Mortgage Corporation                            | 5,774                  | 117                          | (75)                          | 5,816         |
| Asset-backed securities-private label                             | 3,637                  | 618                          | (757)                         | 3,498         |
| Asset-backed securities-government sponsored entities             | 130                    | 4                            | -                             | 134           |
| Equity securities   | 22                     | 43                           | -                             | 65            |
|   | \$ 157,141             | \$ 3,908                     | \$ (3,085)                    | \$ 157,964    |

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



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At September 30, 2014 and at December 31, 2013, equity securities consisted of 22,368 shares of Federal Home Loan Mortgage Corporation (“FHLMC”) common stock.

At September 30, 2014 and December 31, 2013, thirty-one municipal bonds with a cost of \$10.7 million and fair value of \$11.4 million and \$11.1 million, respectively, were pledged under a collateral agreement with the Federal Reserve Bank of New York for liquidity borrowing. In addition, at September 30, 2014, six municipal bonds with a cost and fair value of \$1.5 million and \$1.6 million, respectively, were pledged as collateral for customer deposits in excess of the Federal Deposit Insurance Corporation (“FDIC”) insurance limits. At December 31, 2013, five municipal bonds with a cost and fair value of \$1.1 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:

|  | Less than 12 months    |          | 12 months or more |            | Total            |            |
|--|------------------------|----------|-------------------|------------|------------------|------------|
|  | Gross Unrealized       |          | Gross Unrealized  |            | Gross Unrealized |            |
|  | Fair Value             | Losses   | Fair Value        | Losses     | Fair Value       | Losses     |
|  | (Dollars In thousands) |          |                   |            |                  |            |
| September 30, 2014                     |                        |          |                   |            |                  |            |
| Municipal bonds                        | \$ -                   | \$ -     | \$ 1,721          | \$ (54)    | \$ 1,721         | \$ (54)    |
| Mortgage-backed securities             | 10,598                 | (122)    | 25,732            | (939)      | 36,330           | (1,061)    |
| Asset-backed securities -private label | -                      | -        | 1,513             | (122)      | 1,513            | (122)      |
|  | \$ 10,598              | \$ (122) | \$ 28,966         | \$ (1,115) | \$ 39,564        | \$ (1,237) |

|  | Less than 12 months    |            | 12 months or more |            | Total            |            |
|--|------------------------|------------|-------------------|------------|------------------|------------|
|  | Gross Unrealized       |            | Gross Unrealized  |            | Gross Unrealized |            |
|  | Fair Value             | Losses     | Fair Value        | Losses     | Fair Value       | Losses     |
|  | (Dollars In thousands) |            |                   |            |                  |            |
| December 31, 2013                      |                        |            |                   |            |                  |            |
| Municipal bonds                        | \$ 14,052              | \$ (540)   | \$ -              | \$ -       | \$ 14,052        | \$ (540)   |
| Mortgage backed securities             | 41,094                 | (1,267)    | 12,768            | (521)      | 53,862           | (1,788)    |
| Asset-backed securities -private label | -                      | -          | 2,794             | (757)      | 2,794            | (757)      |
|  | \$ 55,146              | \$ (1,807) | \$ 15,562         | \$ (1,278) | \$ 70,708        | \$ (3,085) |

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

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

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

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

At September 30, 2014, the Company's investment portfolio included ten mortgage-backed securities in the "unrealized losses less than twelve months" category. The mortgage-backed securities were not evaluated further for OTTI as the unrealized losses on the individual securities were less than 20% of book value, which management deemed to be immaterial, and the mortgage-backed securities were issued by government sponsored enterprises. The Company expects these securities to be repaid in full, with no losses realized. Management does not intend to sell these securities and it is more likely than not that it will not be required to sell these securities.

At September 30, 2014, the Company had five municipal bonds, twenty one mortgage-backed securities and two private label asset-backed securities in the "unrealized losses twelve months or more" category.

The five municipal bonds and twenty one 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 two private label asset-backed securities in this category 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 table provides additional information relating to these private label asset-backed securities as of September 30, 2014 (dollars in thousands):

| Security | Book Value | Fair Value | Unrealized Loss | Lowest Rating | Delinquent % Over 60 days | Delinquent % Over 90 days | Foreclosure/OREO/ Bankruptcy % | OREO% |
|----------|------------|------------|-----------------|---------------|---------------------------|---------------------------|--------------------------------|-------|
| 1        | \$ 949     | \$ 859     | \$ (90)         | CCC           | 24.10%                    | 22.50%                    | 12.30%                         | 1.20% |
| 2        | 686        | 654        | (32)            | CCC           | 17.40%                    | 15.90%                    | 6.00%                          | 1.50% |
| Total    | \$ 1,635   | \$ 1,513   | \$ (122)        |               |                           |                           |                                |       |

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 two private label asset-backed securities occurred due to the ongoing challenges in the economic environment and increased levels of delinquency trends in the underlying loan pools. It is possible that principal losses may be incurred on the tranches we hold in these specific securities. Management's evaluation of the estimated discounted cash flows in comparison to the amortized book value for the securities listed above did not reflect the need to record an OTTI charge against earnings during the nine months ended September 30, 2014. The estimated discounted cash flows for these securities did not show an additional principal loss under various prepayment and default rate scenarios. Management concluded that it does not

intend to sell these securities and that it is not likely it will be required to sell these securities.

Management also completed an OTTI analysis for two private label asset-backed securities, which did not have unrealized losses as of September 30, 2014. Management reviewed key credit metrics for these securities, including delinquency rates, cumulative default rates, prepayment speeds, foreclosure rates, loan-to-value ratios and credit support levels. Management's calculation of the estimated discounted cash flows did not show additional principal losses for these securities under various prepayment and default rate scenarios. As a result of the stress tests that were performed, management concluded that additional OTTI charges were not required as of September 30, 2014 on these securities. Management also concluded that it does not intend to sell the securities and that it is not likely it will be required to sell these securities.

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

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

|   | For The<br>Nine<br>Months<br>Ended<br>September<br>30,<br>2014 | For The<br>Nine<br>Months<br>Ended<br>September<br>30,<br>2013 |
|---|--|--|
|   | (Dollars in thousands)   |  |
| Beginning balance   | \$ 1,318   | \$ 1,155   |
| Additions:  |  |  |
| Credit loss not previously recognized                           | -  | 180  |
| Reductions:   |  |  |
| Realized loss on sale of security on OTTI previously recognized | (282)  | -  |
| Losses realized during the period on OTTI previously recognized | (3)  | (13)   |
| Receipt of cash flows on previously recorded OTTI               | (136)  | -  |
| Ending balance  | \$ 897   | \$ 1,322   |

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<br>Cost      | Fair<br>Value |
|------------------------------------|------------------------|---------------|
|                                    | (Dollars in thousands) |               |
| September 30, 2014:                |                        |               |
| After one year through five years  | \$ 597                 | \$ 649        |
| After five years through ten years | 30,825                 | 33,119        |
| After ten years                    | 38,573                 | 40,834        |
| Mortgage-backed securities         | 64,430                 | 64,120        |
| Asset-backed securities            | 1,751                  | 2,170         |
| Equity securities                  | 22                     | 59            |
|                                    | \$ 136,198             | \$ 140,951    |

The Company sold one private-label asset-backed security and six mortgage-backed securities during the nine months ended September 30, 2014, for total proceeds of \$10.3 million, resulting in gross realized gains of \$274,000 and gross realized losses of \$215,000. During the nine months ended September 30, 2013, the Company sold available for sale securities for total proceeds of \$3.0 million, resulting in gross realized gains of \$206,000. During the nine months



ended September 30, 2013, the Company received a \$1.4 million settlement related to the sale of available for sale securities in the fourth quarter of 2012.

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. Home equity loans may have increased risk of loss if the Company does not hold the first mortgage resulting in the Company being in a secondary position in the event of collateral liquidation. The Company does not originate interest only home equity loans.
- Commercial Real Estate – are loans used to finance the purchase of real property, which generally consists of developed real estate that is held as first lien collateral for the loan. These loans are secured by real estate properties that are primarily held in the Western New York region. Commercial real estate lending involves additional risks compared with one- to four-family residential lending, because payments on loans secured by commercial real estate properties are often dependent on the successful operation or management of the properties, and/or the collateral value of the commercial real estate securing the loan, and repayment of such loans may be subject to adverse conditions in the real estate market or economic conditions to a greater extent than one- to four-family residential mortgage loans. Also, commercial real estate loans typically involve large loan balances to single borrowers or groups of related borrowers.
- 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 actual cost of construction.

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 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 business 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. The Company's determination as to the classification of loans and the amount of loss allowances are subject to review by regulatory agencies, which can require the establishment of additional loss allowances.

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

The following tables summarize the activity in the allowance for loan losses for the three and nine months ended September 30, 2014 and 2013 and the distribution of the allowance for loan losses and loan receivable by loan portfolio class and impairment method as of September 30, 2014.

|                              | Real Estate Loans |             |            |              | Other Loans |          |             | Total    |
|------------------------------|-------------------|-------------|------------|--------------|-------------|----------|-------------|----------|
|                              | One-Family        | Home Equity | Commercial | Construction | Commercial  | Consumer | Unallocated |          |
| (Dollars in thousands)       |                   |             |            |              |             |          |             |          |
| September 30, 2013           |                   |             |            |              |             |          |             |          |
| Allowance for Loan Losses:   |                   |             |            |              |             |          |             |          |
| Balance – July 1, 2013       | \$ 454            | \$ 41       | \$ 1,082   | \$ -         | \$ 226      | \$ 5     | \$ 15       | \$ 1,823 |
| Charge-offs                  | (52)              | -           | (21)       | -            | (17)        | (2)      | -           | (92)     |
| Recoveries                   | 27                | -           | -          | -            | 1           | -        | -           | 28       |
| Provision (Credit)           | (81)              | 38          | 119        | 2            | (12)        | 8        | (14)        | 60       |
| Balance – September 30, 2013 | \$ 348            | \$ 79       | \$ 1,180   | \$ 2         | \$ 198      | \$ 11    | \$ 1        | \$ 1,819 |
| September 30, 2013           |                   |             |            |              |             |          |             |          |
| Balance – January 1, 2013    | \$ 393            | \$ 79       | \$ 1,118   | \$ -         | \$ 202      | \$ 14    | \$ -        | \$ 1,806 |
| Charge-offs                  | (52)              | -           | (21)       | -            | (47)        | (19)     | -           | (139)    |
| Recoveries                   | 35                | 4           | 5          | -            | 3           | -        | -           | 47       |
| Provision (Credit)           | (28)              | (4)         | 78         | 2            | 40          | 16       | 1           | 105      |
| Balance – September 30, 2013 | \$ 348            | \$ 79       | \$ 1,180   | \$ 2         | \$ 198      | \$ 11    | \$ 1        | \$ 1,819 |

|   | Real Estate Loans   |             |            | Other Loans  |            |          |             | Total      |
|---|---------------------|-------------|------------|--------------|------------|----------|-------------|------------|
|   | One- to Four-Family | Home Equity | Commercial | Construction | Commercial | Consumer | Unallocated |            |
| (Dollars in thousands)                                |                     |             |            |              |            |          |             |            |
| September 30, 2014                                    |                     |             |            |              |            |          |             |            |
| Allowance for Loan Losses:                            |                     |             |            |              |            |          |             |            |
| Balance – July 1, 2014                                | \$ 345              | \$ 97       | \$ 1,049   | \$ -         | \$ 196     | \$ 22    | \$ 64       | \$ 1,773   |
| Charge-offs   | -                   | (12)        | -          | -            | (21)       | (11)     | -           | (44)       |
| Recoveries  | 1                   | 1           | -          | -            | -          | 2        | -           | 4          |
| Provision (Credit)                                    | 82                  | 15          | (5)        | -            | 25         | 11       | (58)        | 70         |
| Balance – September 30, 2014                          | \$ 428              | \$ 101      | \$ 1,044   | \$ -         | \$ 200     | \$ 24    | \$ 6        | \$ 1,803   |
| Balance – January 1, 2014                             | \$ 355              | \$ 80       | \$ 1,104   | \$ -         | \$ 218     | \$ 9     | \$ 47       | \$ 1,813   |
| Charge-offs   | (17)                | (25)        | -          | -            | (25)       | (29)     | -           | (96)       |
| Recoveries  | 3                   | 1           | -          | -            | -          | 12       | -           | 16         |
| Provision (Credit)                                    | 87                  | 45          | (60)       | -            | 7          | 32       | (41)        | 70         |
| Balance – September 30, 2014                          | \$ 428              | \$ 101      | \$ 1,044   | \$ -         | \$ 200     | \$ 24    | \$ 6        | \$ 1,803   |
| Ending balance: individually evaluated for impairment | \$ -                | -           | 125        | -            | 6          | -        | -           | \$ 131     |
| Ending balance: collectively evaluated for impairment | \$ 428              | \$ 101      | \$ 919     | \$ -         | \$ 194     | \$ 24    | \$ 6        | \$ 1,672   |
| Gross Loans Receivable (1):                           |                     |             |            |              |            |          |             |            |
| Ending balance  | \$ 167,301          | \$ 32,100   | \$ 58,585  | \$ 2,657     | \$ 11,809  | \$ 1,584 | \$ -        | \$ 274,036 |
| Ending balance: individually evaluated for impairment | \$ 213              | \$ 10       | \$ 3,023   | \$ -         | \$ 11      | \$ -     | \$ -        | \$ 3,257   |
| Ending balance: collectively evaluated for impairment | \$ 167,088          | \$ 32,090   | \$ 55,562  | \$ 2,657     | \$ 11,798  | \$ 1,584 | \$ -        | \$ 270,779 |

(1) Gross Loans Receivable does not include allowance for loan losses of \$(1,803) or deferred loan costs of \$2,923.



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The following table summarizes the distribution of the allowance for loan losses and loans receivable by loan portfolio class as of December 31, 2013:

|   | Real Estate Loans   |             |            | Other Loans  |            |          |             | Total      |
|---|---------------------|-------------|------------|--------------|------------|----------|-------------|------------|
|   | One- to Four-Family | Home Equity | Commercial | Construction | Commercial | Consumer | Unallocated |            |
| (Dollars in thousands)                                |                     |             |            |              |            |          |             |            |
| December 31, 2013                                     |                     |             |            |              |            |          |             |            |
| Allowance for Loan Losses:                            |                     |             |            |              |            |          |             |            |
| Balance – December 31, 2013                           | \$ 355              | \$ 80       | \$ 1,104   | \$ -         | \$ 218     | \$ 9     | \$ 47       | \$ 1,813   |
| Ending balance: individually evaluated for impairment | \$ -                | -           | 125        | -            | -          | -        | -           | \$ 125     |
| Ending balance: collectively evaluated for impairment | \$ 355              | \$ 80       | \$ 979     | \$ -         | \$ 218     | \$ 9     | \$ 47       | \$ 1,688   |
| Gross Loans Receivable (1):                           |                     |             |            |              |            |          |             |            |
| Ending Balance  | \$ 170,793          | \$ 31,675   | \$ 58,746  | \$ 936       | \$ 12,645  | \$ 1,517 | \$ -        | \$ 276,312 |
| Ending balance: individually evaluated for impairment | \$ 177              | \$ 4        | \$ 2,458   | \$ -         | \$ 9       | \$ -     | \$ -        | \$ 2,648   |
| Ending balance: collectively evaluated for impairment | \$ 170,616          | \$ 31,671   | \$ 56,288  | \$ 936       | \$ 12,636  | \$ 1,517 | \$ -        | \$ 273,664 |

(1) Gross Loans Receivable does not include allowance for loan losses of \$(1,813) or deferred loan costs of \$2,846.

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.



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

|                                     | Unpaid<br>Recorded Principal<br>Investment Balance<br>(Dollars in thousands) |                      |        | Average Interest<br>Recorded Income<br>Investment Recognized |       |
|-------------------------------------|--|----------------------|--------|--|-------|
|                                     | At September 30, 2014  | Related<br>Allowance |        | For the Nine Months<br>Ended<br>September 30, 2014           |       |
| With no related allowance recorded: |  |                      |        |  |       |
| Residential, one- to four-family    | \$ 213   | \$ 213               | \$ -   | \$ 217   | \$ 7  |
| Home equity                         | 10   | 10                   | -      | 11   | 1     |
| Commercial real estate              | 2,422  | 2,422                | -      | 2,423  | 16    |
| Commercial loans                    | 5  | 5                    | -      | 6  | -     |
| With an allowance recorded:         |  |                      |        |  |       |
| Commercial real estate              | 601  | 601                  | 125    | 589  | 5     |
| Commercial loans                    | 6  | 6                    | 6      | 7  | -     |
| Total                               | \$ 3,257   | \$ 3,257             | \$ 131 | \$ 3,253   | \$ 29 |

|                                  | At December 31, 2013                |          |        | For the Year<br>Ended<br>December 31,<br>2013 |        |
|----------------------------------|-------------------------------------|----------|--------|---|--------|
|                                  | With no related allowance recorded: |          |        |   |        |
| Residential, one- to four-family | \$ 177                              | \$ 177   | \$ -   | \$ 189  | \$ 11  |
| Home equity                      | 4                                   | 4        | -      | 5   | -      |
| Commercial real estate           | 1,911                               | 1,911    | -      | 1,969   | 80     |
| Commercial loans                 | 9                                   | 9        | -      | 69  | 4      |
| With an allowance recorded:      |                                     |          |        |   |        |
| Commercial real estate           | 547                                 | 547      | 125    | 656   | 55     |
| Commercial loans                 | -                                   | -        | -      | 44  | -      |
| Total                            | \$ 2,648                            | \$ 2,648 | \$ 125 | \$ 2,932                                      | \$ 150 |

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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 | 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 |
|----------------------------------|------------------------------|------------------------------|--------------------------------------|----------------------|----------------|---------------------------|-------------------------|
| September 30, 2014:              |                              |                              |                                      |                      |                |                           |                         |
| Real Estate Loans:               |                              |                              |                                      |                      |                |                           |                         |
| Residential, one- to four-family | \$ 740                       | \$ 1,081                     | \$ 1,155                             | \$ 2,976             | \$ 164,325     | \$ 167,301                | \$ 2,352                |
| Home equity                      | 241                          | 222                          | 156                                  | 619                  | 31,481         | 32,100                    | 300                     |
| Commercial                       | 623                          | -                            | 1,998                                | 2,621                | 55,964         | 58,585                    | 2,599                   |
| Construction                     | -                            | -                            | -                                    | -                    | 2,657          | 2,657                     | -                       |
| Other Loans:                     |                              |                              |                                      |                      |                |                           |                         |
| Commercial                       | 36                           | -                            | 37                                   | 73                   | 11,736         | 11,809                    | 77                      |
| Consumer                         | 2                            | -                            | 4                                    | 6                    | 1,578          | 1,584                     | 5                       |
| Total                            | \$ 1,642                     | \$ 1,303                     | \$ 3,350                             | \$ 6,295             | \$ 267,741     | \$ 274,036                | \$ 5,333                |
| December 31, 2013:               |                              |                              |                                      |                      |                |                           |                         |
| Real Estate Loans:               |                              |                              |                                      |                      |                |                           |                         |
| Residential, one- to four-family | \$ 1,629                     | \$ 825                       | \$ 880                               | \$ 3,334             | \$ 167,459     | \$ 170,793                | \$ 2,145                |
| Home equity                      | 326                          | 32                           | 156                                  | 514                  | 31,161         | 31,675                    | 325                     |
| Commercial                       | 43                           | -                            | 1,911                                | 1,954                | 56,792         | 58,746                    | 1,911                   |
| Construction                     | -                            | -                            | -                                    | -                    | 936            | 936                       | -                       |
| Other Loans:                     |                              |                              |                                      |                      |                |                           |                         |
| Commercial                       | 50                           | -                            | 41                                   | 91                   | 12,554         | 12,645                    | 137                     |
| Consumer                         | 18                           | 1                            | 4                                    | 23                   | 1,494          | 1,517                     | 7                       |
| Total                            | \$ 2,066                     | \$ 858                       | \$ 2,992                             | \$ 5,916             | \$ 270,396     | \$ 276,312                | \$ 4,525                |

The accrual of interest on loans is discontinued when, in management's opinion, the borrower may be unable to meet payments as they become due. A loan does not have to be 90 days delinquent in order to be classified as non-accrual. When interest accrual is discontinued, all unpaid accrued interest is reversed. Interest income is subsequently recognized only to the extent cash payments are received. If ultimate collection of principal is in doubt, all cash receipts on impaired loans are applied to reduce the principal balance. Interest income not recognized on non-accrual loans during the nine month periods ended September 30, 2014 and 2013 was \$278,000 and \$91,000, respectively.

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

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

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

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

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

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

The following table summarizes the internal loan grades applied to the Company's loan portfolio as of September 30, 2014 and December 31, 2013:

|                                  | Pass/Performance       | Special Mention | Substandard | Doubtful | Loss | Total      |
|----------------------------------|------------------------|-----------------|-------------|----------|------|------------|
|                                  | (Dollars in thousands) |                 |             |          |      |            |
| September 30, 2014               |                        |                 |             |          |      |            |
| Real Estate Loans:               |                        |                 |             |          |      |            |
| Residential, one- to four-family | \$ 164,201             | \$ -            | \$ 3,100    | \$ -     | \$ - | \$ 167,301 |
| Home equity                      | 31,667                 | -               | 433         | -        | -    | 32,100     |
| Commercial                       | 51,915                 | 3,269           | 2,714       | 687      | -    | 58,585     |
| Construction                     | 2,657                  | -               | -           | -        | -    | 2,657      |
| Other Loans:                     |                        |                 |             |          |      |            |
| Commercial                       | 11,123                 | 558             | 123         | 5        | -    | 11,809     |
| Consumer                         | 1,577                  | -               | 6           | -        | 1    | 1,584      |
| Total                            | \$ 263,140             | \$ 3,827        | \$ 6,376    | \$ 692   | \$ 1 | \$ 274,036 |

December 31, 2013

|                                  |            |          |          |        |      |            |
|----------------------------------|------------|----------|----------|--------|------|------------|
| Real Estate Loans:               |            |          |          |        |      |            |
| Residential, one- to four-family | \$ 168,018 | \$ -     | \$ 2,775 | \$ -   | \$ - | \$ 170,793 |
| Home equity                      | 31,253     | -        | 387      | 35     | -    | 31,675     |
| Commercial                       | 53,136     | 2,743    | 2,320    | 547    | -    | 58,746     |
| Construction                     | 936        | -        | -        | -      | -    | 936        |
| Other Loans:                     |            |          |          |        |      |            |
| Commercial                       | 12,080     | 347      | 218      | -      | -    | 12,645     |
| Consumer                         | 1,512      | -        | 1        | -      | 4    | 1,517      |
| Total                            | \$ 266,935 | \$ 3,090 | \$ 5,701 | \$ 582 | \$ 4 | \$ 276,312 |

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:

|                                  | Number<br>of Recorded<br>Loans | Investment<br>(Dollars in thousands) | Non-Accruing                   |                                      | Accruing                       |                                      | TDRs That<br>Have Defaulted<br>on Modified<br>Terms Year to<br>Date |                                      |
|----------------------------------|--------------------------------|--------------------------------------|--------------------------------|--------------------------------------|--------------------------------|--------------------------------------|---|--------------------------------------|
|                                  |                                |                                      | Number<br>of Recorded<br>Loans | Investment<br>(Dollars in thousands) | Number<br>of Recorded<br>Loans | Investment<br>(Dollars in thousands) | Number<br>of Recorded<br>Loans                                      | Investment<br>(Dollars in thousands) |
| At September 30, 2014            |                                |                                      |                                |                                      |                                |                                      |   |                                      |
| Real Estate Loans:               |                                |                                      |                                |                                      |                                |                                      |   |                                      |
| Residential, one- to four-family | 5                              | \$ 213                               | -                              | \$ -                                 | 5                              | \$ 213                               | -   | \$ -                                 |
| Home equity                      | 2                              | 10                                   | -                              | -                                    | 2                              | 10                                   | -   | -                                    |
| Total                            | 7                              | \$ 223                               | -                              | \$ -                                 | 7                              | \$ 223                               | -   | \$ -                                 |
| At December 31, 2013             |                                |                                      |                                |                                      |                                |                                      |   |                                      |
| Real Estate Loans:               |                                |                                      |                                |                                      |                                |                                      |   |                                      |
| Residential, one- to four-family | 4                              | \$ 192                               | 1                              | \$ 48                                | 3                              | \$ 144                               | 1   | \$ 48                                |
| Home equity                      | 1                              | 4                                    | -                              | -                                    | 1                              | 4                                    | -   | -                                    |
| Total                            | 5                              | \$ 196                               | 1                              | \$ 48                                | 4                              | \$ 148                               | 1   | \$ 48                                |

The following table details the activity in loans which were first deemed to be TDRs during the nine months ended September 30, 2014 and 2013. No loans were first deemed TDRs during the three months ended September 30, 2014 and 2013.

| For The Nine Months Ended September 30,<br>2014                |  | 2013   |  |
|--|--|--|--|
| Pre-Modification<br>Number Outstanding<br>of Recorded<br>Loans | Post-Modification<br>Outstanding<br>Recorded<br>Investment | Pre-Modification<br>Number Outstanding<br>of Recorded<br>Loans | Post-Modification<br>Outstanding<br>Recorded<br>Investment |

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(Dollars in thousands)

Real Estate Loans:

|                                  |   |    |    |    |    |   |    |     |    |     |
|----------------------------------|---|----|----|----|----|---|----|-----|----|-----|
| Residential, one- to four-family | 1 | \$ | 46 | \$ | 46 | 4 | \$ | 208 | \$ | 208 |
| Home equity                      | 1 |    | 6  |    | 6  | 1 |    | 5   |    | 5   |
| Total                            | 2 | \$ | 52 | \$ | 52 | 5 | \$ | 213 | \$ | 213 |

No additional loan commitments were outstanding to these borrowers at September 30, 2014 and at December 31, 2013.

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. The impact on the allowance was immaterial.

Note 5 – Earnings per Share

Earnings per share was calculated for the three and nine months ended September 30, 2014 and 2013, 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 2006 Recognition and Retention Plan (“RRP”), and the 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

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

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

|   | Three Months Ended |            |
|---|--------------------|------------|
|   | September 30,      |            |
|   | 2014               | 2013       |
| Numerator – net income                                  | \$ 688,000         | \$ 986,000 |
| Denominator:  |                    |            |
| Basic weighted average shares outstanding               | 5,763,417          | 5,703,020  |
| Increase in weighted average shares outstanding due to: |                    |            |
| Stock options   | 28,428             | 17,004     |
| Diluted weighted average shares outstanding             | 5,791,845          | 5,720,024  |
| Earnings per share:                                     |                    |            |
| Basic   | \$ 0.12            | \$ 0.17    |
| Diluted   | \$ 0.12            | \$ 0.17    |

|   | Nine Months Ended |              |
|---|-------------------|--------------|
|   | September 30,     |              |
|   | 2014              | 2013         |
| Numerator – net income                                  | \$ 2,362,000      | \$ 2,692,000 |
| Denominator:  |                   |              |
| Basic weighted average shares outstanding               | 5,723,148         | 5,701,450    |
| Increase in weighted average shares outstanding due to: |                   |              |
| Stock options   | 28,269            | 11,610       |
| Diluted weighted average shares outstanding             | 5,751,417         | 5,713,060    |
| Earnings per share:                                     |                   |              |
| Basic   | \$ 0.41           | \$ 0.47      |
| Diluted   | \$ 0.41           | \$ 0.47      |

Note 6 – Commitments to Extend Credit

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

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

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

| Contract Amount |          |
|-----------------|----------|
| September       | December |
| 30,             | 31,      |
| 2014            | 2013     |
|                 |          |



(Dollars in  
thousands)

|  |           |           |
|--|-----------|-----------|
| Commitments to grant loans                 | \$ 12,468 | \$ 8,420  |
| Unfunded commitments under lines of credit | \$ 28,118 | \$ 28,430 |

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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, 2014 and December 31, 2013, the Company's fixed rate loan commitments totaled \$8.0 million and \$6.2 million, respectively. The range of interest rates on the fixed rate commitments at September 30, 2014 was 3.75% to 6.25%.

#### Note 7 – Stock-based Compensation

As of September 30, 2014, 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 \$62,000 and \$33,000 for the three months ended September 30, 2014 and 2013, respectively. The compensation cost that has been recorded for the nine months ended September 30, 2014 and 2013, respectively was \$131,000 and \$98,000.

#### 2006 Stock Option Plan

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

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

A summary of the status of the Stock Option Plan as of September 30, 2014 and 2013 is presented below:

|                                      | September 30, 2014 |                |                            | September 30, 2013 |                |                            |
|--------------------------------------|--------------------|----------------|----------------------------|--------------------|----------------|----------------------------|
|                                      | Options            | Exercise Price | Remaining Contractual Life | Options            | Exercise Price | Remaining Contractual Life |
| Outstanding at beginning of year     | 230,106            | \$ 11.05       |                            | 236,809            | \$ 11.05       |                            |
| Granted                              | -                  | -              |                            | -                  | -              |                            |
| Exercised                            | (3,646)            | 11.50          |                            | (506)              | \$ 8.01        |                            |
| Forfeited                            | -                  | -              |                            | -                  | -              |                            |
| Outstanding at end of period         | 226,460            | \$ 11.04       | 2 years                    | 236,303            | \$ 11.05       | 3 years                    |
| Options exercisable at end of period | 222,905            | \$ 11.09       | 2 years                    | 227,043            | \$ 11.18       | 3 years                    |
| Fair value of options granted        |                    | -              |                            |                    | -              |                            |
| :                                    |                    |                |                            |                    |                |                            |

At September 30, 2014, stock options outstanding had an intrinsic value of \$8,000 and 60,753 options remained available for grant under the Stock Option Plan. Compensation expense amounted to \$1,000 for the quarter ended September 30, 2014 and \$3,000 for the quarter ended September 30, 2013. Compensation expense amounted to \$3,000 for the nine months ended September 30, 2014 and \$7,000 for the nine months ended September 30, 2013. At September 30, 2014, \$1,000 of unrecognized compensation cost related to stock options is expected to be recognized over a period of 3 months.

#### 2006 Recognition and Retention Plan

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

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On August 12, 2014, the Board of Directors granted 24,471 restricted stock awards under the RRP to non-employee directors and employees. The fair value of these awards on the grant date was \$12.16. Awards vest at a rate of 20% per year. As of September 30, 2014 there were 80,794 shares vested or distributed to eligible participants under the RRP. Compensation expense related to the RRP amounted to \$14,000 for the quarter ended September 30, 2014 and \$7,000 for the quarter ended September 30, 2013. Compensation expense related to the RRP amounted to \$24,000 for the nine months ended September 30, 2014 and 2013. At September 30, 2014, \$297,000 of unrecognized compensation cost related to the RRP is expected to be recognized over a period of 33 to 59 months.

A summary of the status of unvested shares under the RRP for the nine months ended September 30, 2014 and 2013 is as follows:

|  | 2014    | Weighted Average Grant Price | 2013    | Weighted Average Grant Price |
|--|---------|------------------------------|---------|------------------------------|
| Unvested shares outstanding at beginning of year | 6,595   | \$ 7.99                      | 10,630  | \$ 7.98                      |
| Granted  | 24,471  | 12.16                        | -       | -                            |
| Vested   | (4,035) | 7.97                         | (4,035) | 7.96                         |
| Forfeited  | -       | -                            | -       | -                            |
| Unvested shares outstanding at end of period     | 27,031  | \$ 11.77                     | 6,595   | \$ 7.99                      |

#### 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 as follows:

| Grant Date      | Number of Restricted Stock Awards | Vesting   | Fair Value of Award on Grant Date | Awardees               |
|-----------------|-----------------------------------|---|-----------------------------------|------------------------|
| May 21, 2014    | 3,518                             | 100% on December 9, 2014                                | \$ 12.28                          | Non-employee directors |
| August 12, 2014 | 21,052                            | 20% per year with first vesting date on August 12, 2015 | \$ 12.16                          | Non-employee directors |



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

|  | 2014   | Weighted Average Grant Price |
|--|--------|------------------------------|
| Unvested shares outstanding at beginning of year | -      | \$ -                         |
| Granted  | 24,570 | 12.18                        |
| Vested   | -      | -                            |
| Forfeited  | -      | -                            |
| Unvested shares outstanding at end of period     | 24,570 | \$ 12.18                     |

Compensation expense related to the EIP amounted to \$25,000 and \$33,000 for the three and nine months ended September 30, 2014. At September 30, 2014, \$265,000 of unrecognized compensation cost related to unvested awards is expected to be recognized over a period of 3 to 59 months.

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

The Company established the ESOP for the benefit of eligible employees of the Company and the Bank. All Company and Bank employees meeting certain age and service requirements are eligible to participate in the ESOP. Participants' benefits become fully vested after five years of service once the employee is eligible to participate in the ESOP. The Company utilized \$2.6 million of the proceeds of its 2006 stock offering to extend a loan to the ESOP and the ESOP used such proceeds to purchase 238,050 shares on the open market at an average price of \$10.70 per share, plus commission expenses. As a result of the purchase of shares by the ESOP, total stockholders' equity of the Company was reduced by \$2.6 million. As of September 30, 2014, the balance of the loan to the ESOP was \$1.9 million and the fair value of unallocated shares was \$2.2 million. As of September 30, 2014, there were 51,647 allocated shares and 174,569 unallocated shares compared to 46,731 allocated shares and 182,504 unallocated shares at September 30, 2013. The ESOP compensation expense was \$22,000 for the quarter ended September 30, 2014 and \$23,000 for the quarter ended September 30, 2013, based on 1,984 shares earned in each of those quarters. The ESOP compensation expense was \$71,000 for the nine months ended September 30, 2014, and \$67,000 for the nine months ended September 30, 2013 based on 5,951 shares earned in each of those quarters.

#### 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, 2014 and December 31, 2013 and have not been re-evaluated or updated for purposes of these consolidated financial statements subsequent to those respective dates. The estimated fair values of these financial instruments subsequent to the respective reporting dates may be different than the amounts reported here.

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

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

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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 and nonrecurring basis, the fair value measurements by level within the fair value hierarchy used at September 30, 2014 and December 31, 2013 were as follows:

|   | Fair Value Measurements at September 30, 2014   |                                  |   |   |
|---|---|----------------------------------|---|---|
|   | Quoted<br>Prices in<br>Active<br>Markets<br>for<br>September<br>30,<br>2014<br>(Dollars in thousands) | 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) |
| Measured at fair value on a recurring basis:                      |   |                                  |   |   |
| Securities available for sale:                                    |   |                                  |   |   |
| U.S. Treasury bonds   | \$ 14,128   | \$ 14,128                        | \$ -  | \$ -  |
| Municipal bonds   | 60,474  | -                                | 60,474  | -   |
| Mortgage-backed securities:                                       |   |                                  |   |   |
| Collateralized mortgage obligations-private label                 | 65  | -                                | 65  | -   |
| Collateralized mortgage obligations-government sponsored entities | 52,826  | -                                | 52,826  | -   |
| Government National Mortgage Association                          | 591   | -                                | 591   | -   |
| Federal National Mortgage Association                             | 7,791   | -                                | 7,791   | -   |
| Federal Home Loan Mortgage Corporation                            | 2,847   | -                                | 2,847   | -   |
| Asset-backed securities:  |   |                                  |   |   |
| Private label   | 2,043   | -                                | -   | 2,043   |
| Government sponsored entities                                     | 127   | -                                | 127   | -   |
| Equity securities   | 59  | -                                | 59  | -   |
| Total   | \$ 140,951  | \$ 14,128                        | \$ 124,780  | \$ 2,043  |

Measured at fair value on a non-recurring basis:



|                        |        |      |      |        |
|------------------------|--------|------|------|--------|
| Impaired loans         | \$ 699 | \$ - | \$ - | \$ 699 |
| Foreclosed real estate | 458    | -    | -    | 458    |

Any transfers between levels would be recognized as of the actual date of event or change in circumstances that caused the transfer. There were no reclassifications between the Level 1 and Level 2 categories for the nine months ended September 30, 2014.

## Fair Value Measurements at December 31, 2013

|                   | 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 31, 2013 |   |   |   |
|                   | (Dollars in thousands)  |   |   |

## Measured at fair value on a recurring basis:

## Securities available for sale:

|   |            |           |            |          |
|---|------------|-----------|------------|----------|
| U.S. Treasury bonds   | \$ 13,848  | \$ 13,848 | \$ -       | \$ -     |
| Municipal bonds   | 58,044     | -         | 58,044     | -        |
| Mortgage-backed securities:                                       |            |           |            |          |
| Collateralized mortgage obligations-private label                 | 81         | -         | 81         | -        |
| Collateralized mortgage obligations-government sponsored entities | 62,625     | -         | 62,625     | -        |
| Government National Mortgage Association                          | 2,219      | -         | 2,219      | -        |
| Federal National Mortgage Association                             | 11,634     | -         | 11,634     | -        |
| Federal Home Loan Mortgage Corporation                            | 5,816      | -         | 5,816      | -        |
| Asset-backed securities:  |            |           |            |          |
| Private label   | 3,498      | -         | -          | 3,498    |
| Government sponsored entities                                     | 134        | -         | 134        | -        |
| Equity securities   | 65         | -         | 65         | -        |
| Total   | \$ 157,964 | \$ 13,848 | \$ 140,618 | \$ 3,498 |

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

|                        |        |      |      |        |
|------------------------|--------|------|------|--------|
| Impaired loans         | \$ 699 | \$ - | \$ - | \$ 699 |
| Foreclosed real estate | 555    | -    | -    | 555    |

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 nine months ended September 30, 2014 and 2013:

|  | 2014                   | 2013     |
|--|------------------------|----------|
|  | (Dollars in thousands) |          |
| Beginning Balance                      | \$ 3,498               | \$ 3,873 |
| Total gains - realized/unrealized:     |                        |          |
| Included in earnings                   | -                      | -        |
| Included in other comprehensive income | 723                    | 240      |
| Total losses - realized/unrealized:    |                        |          |
| Included in earnings                   | (98)                   | (180)    |
| Included in other comprehensive income | (176)                  | -        |
| Sales                                  | (1,544)                | -        |
| Principal paydowns                     | (360)                  | (298)    |
| Transfers to (out of) Level 3          | -                      | -        |
| Ending Balance                         | \$ 2,043               | \$ 3,635 |

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

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

| Security Category                       | Fair Value Estimate | Loan Type/Collateral  | Credit Ratings | Unobservable Inputs             |  |                |
|---|---------------------|---|----------------|---------------------------------|--|----------------|
|   |                     |   |                | Constant Prepayment Speed (CPR) | Probability of Default (Annual Default Rate) | Loss Severity  |
| Asset-backed securities - private label | \$ 2,043            | Sub-prime First and Prime Second Lien - Residential Real Estate | B- thru D      | 4 - 10                          | 4.0% - 6.0%                                  | 70.0% - 100.0% |

Level 3 inputs are determined by internal management with inputs from its third party financial advisor on a quarterly basis. The significant unobservable inputs used in the fair value measurement of the reporting entity's asset-backed,

private label securities are prepayment rates, probability of default and loss severity in the event of default. Significant increases or decreases in any of those inputs in isolation would result in a significantly lower or higher fair value measurement. Generally, a change in the assumption used for the probability of default is accompanied by a directionally similar change in the assumption used for the loss severity and a directionally opposite change in the assumption used for prepayment rates.

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 related collateral or discounted cash flows based on current market conditions. As of September 30, 2014, two impaired loans with a specific allowance had a carrying amount of \$606,000 with a valuation allowance of \$131,000. The allocated allowance is based on a fair value measurement of underlying collateral of \$646,000 less estimated liquidation expenses equal to 10% of the collateral value, resulting in an additional \$6,000 provision for loan losses during the nine month period ended September 30, 2014. As of September 30, 2014, impaired loans with no specific allowance had a carrying amount of \$41,000 and a fair value of \$53,000. As of December 31, 2013, one impaired loan with a specific allowance had a carrying amount of \$547,000 with a valuation allowance of \$125,000. The allocated allowance is based on a fair value measurement of underlying collateral of \$646,000 less estimated liquidation expenses equal to 10% of the collateral value, past due and estimated delinquent real estate taxes, and an additional discount for dated financial information. As of December 31, 2013, one impaired loan with no specific allowance had a carrying amount of \$48,000 and a fair value of \$53,000. The use of independent appraisals, discounted cash flow models and management's best judgment are significant inputs in arriving at the fair value of the underlying collateral of impaired loans and are therefore classified within Level 3 of the fair value hierarchy.

Foreclosed real estate consists of property acquired in settlement of loans which is carried at its fair value based on recent appraisals less estimated selling costs. The fair value of foreclosed assets is reported on a non-recurring basis when the value of acquired property has been written down. Fair value is based upon independent market prices or appraised value of the property. These assets are included in Level 3 fair value based upon the lowest level of input that is significant to the fair value measurement. The use of independent appraisals and management's best judgment are significant inputs in arriving at the fair value of the underlying collateral on foreclosed real estate and is therefore classified within Level 3 of the fair value hierarchy. As of September 30, 2014, foreclosed real estate had a carrying amount of \$445,000 and was written down to \$365,000 based on a fair value of \$458,000 less estimated liquidation expenses of 7% to 15% of the collateral value, resulting in an additional write down of \$13,000 during the nine month period ended September 30, 2014. As of December 31, 2013 foreclosed real estate had a carrying amount of \$644,000 and was written down to \$486,000 based on a fair value of \$555,000 less estimated liquidation expenses of 7% to 15% of the collateral value resulting in \$158,000 in write-downs during the year ended December 31, 2013.

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

Fair Value Measurements at September 30, 2014

| Carrying<br>Amount | Estimated<br>Fair Value | 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) |
|--------------------|-------------------------|---|---|---|
|                    |                         |   |   |   |

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(Dollars in thousands)

Financial assets:

|                               |           |           |           |         |         |
|-------------------------------|-----------|-----------|-----------|---------|---------|
| Cash and cash equivalents     | \$ 41,892 | \$ 41,892 | \$ 41,892 | \$ -    | \$ -    |
| Securities available for sale | 140,951   | 140,951   | 14,128    | 124,780 | 2,043   |
| Federal Home Loan Bank stock  | 1,375     | 1,375     | -         | 1,375   | -       |
| Loans receivable, net         | 275,156   | 273,073   | -         | -       | 273,073 |
| Accrued interest receivable   | 1,864     | 1,864     | -         | 1,864   | -       |

Financial liabilities:

|                          |         |         |   |         |   |
|--------------------------|---------|---------|---|---------|---|
| Deposits                 | 389,505 | 392,269 | - | 392,269 | - |
| Long-term debt           | 18,950  | 19,052  | - | 19,052  | - |
| Accrued interest payable | 40      | 40      | - | 40      | - |

|   |   |   |   |   |   |
|---|---|---|---|---|---|
| Off-balance-sheet financial instruments | - | - | - | - | - |
|---|---|---|---|---|---|

## Fair Value Measurements at December 31, 2013

|   | Carrying<br>Amount<br>(Dollars in thousands) | Estimated<br>Fair Value | 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) |
|---|--|-------------------------|---|---|---|
| Financial assets:                       |  |                         |   |   |   |
| Cash and cash equivalents               | \$ 17,202                                    | \$ 17,202               | \$ 17,202   | \$ -  | \$ -  |
| Securities available for sale           | 157,964                                      | 157,964                 | 13,848  | 140,618   | 3,498   |
| Federal Home Loan Bank stock            | 1,560  | 1,560                   | -   | 1,560   | -   |
| Loans receivable, net                   | 277,345                                      | 266,449                 | -   | -   | 266,449   |
| Accrued interest receivable             | 1,787  | 1,787                   | -   | 1,787   | -   |
| Financial liabilities:                  |  |                         |   |   |   |
| Deposits                                | 388,235                                      | 392,801                 | -   | 392,801   | -   |
| Short-term borrowings                   | 11,650                                       | 11,650                  | -   | 11,650  | -   |
| Long-term debt                          | 7,850  | 7,971                   | -   | 7,971   | -   |
| Accrued interest payable                | 25   | 25                      | -   | 25  | -   |
| 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, the credit risk associated with the loan, 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. Fair value for significant nonperforming loans is based on carrying value which does not exceed recent external appraisals of any underlying collateral. Due to the significant judgment involved in evaluating credit quality, loans are classified within Level 3 of the fair value hierarchy.

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Accrued Interest Receivable and Payable (carried at cost)

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

Deposits (carried at cost)

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

Borrowings (carried at cost)

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

Off-Balance Sheet Financial Instruments (disclosed at cost)

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

Note 9 – Treasury Stock

During the quarter and nine months ended September 30, 2014, the Company repurchased 100 and 5,000 shares of common stock at an average price of \$12.39 and \$12.30 per share, respectively. These shares were repurchased pursuant to the Company's publicly announced common stock repurchase programs. As of September 30, 2014, there were 56,410 shares remaining to be repurchased under the existing stock repurchase program. During the quarter and nine months ended September 30, 2014, the Company transferred 21,052 and 24,570 shares of common stock out of the treasury stock reserved for the 2012 Equity Incentive Plan, respectively, at an average cost of \$9.39 per share to fund awards granted under the 2012 Equity Incentive Plan.

During the quarter and nine months ended September 30, 2013, the Company repurchased 5,000 shares of common stock at an average cost of \$11.55 per share. These shares were repurchased pursuant to the Company's publicly announced common stock repurchase programs. As of September 30, 2013, there were 66,510 shares remaining to be repurchased under the existing stock repurchase program.

Note 10 – Subsequent Events

On October 22, 2014, the Board of Directors declared a quarterly dividend of \$0.07 per share on the Company's common stock, payable on November 18, 2014 to stockholders of record as of November 4, 2014. Lake Shore, MHC, which holds 3,636,875 shares, or approximately 61.2% of the Company's total outstanding stock, elected to waive its right to receive this cash dividend of approximately \$255,000. On March 6, 2014, the MHC received the non-objection of the Federal Reserve Bank of Philadelphia to waive its right to receive dividends paid by the Company during the twelve months ending February 5, 2015, aggregating up to \$0.28 per share. The MHC waived \$255,000 of dividends during the three months ended September 30, 2014 and \$765,000 for the nine month period ended September 30, 2014. Cumulatively, Lake Shore, MHC has waived

approximately \$6.2 million of cash dividends as of September 30, 2014. The dividends waived by Lake Shore, MHC are considered a restriction on the retained earnings of the Company.

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

### Forward-Looking Statements

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

The following factors, including the factors set forth in Part II, Item 1A of this and previous Quarterly Reports on Form 10-Q and in Part I, Item 1A of the Company's Annual Report on Form 10-K for the year ended December 31, 2013, 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 effect of new capital standards to be imposed by banking regulators;

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

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

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

## Overview

The following discussion and analysis is presented to assist in the understanding and evaluation of our consolidated financial condition and results of operations. It is intended to complement the unaudited consolidated financial statements and notes thereto appearing elsewhere in this Form 10-Q and should be read in conjunction therewith. The detailed discussion focuses on our consolidated financial condition as of September 30, 2014 compared to the financial condition as of December 31, 2013 and the consolidated results of operations for the three and nine months ended September 30, 2014 and 2013.

Our results of operations depend primarily on our net interest income, which is the difference between the interest income we earn on loans and investments and the interest expense we pay on deposits and other interest-bearing liabilities such as borrowings. Net interest income is affected by the relative amounts of interest-earning assets and interest-bearing liabilities and the interest rates we earn or pay on these balances.

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

Financial institutions like us, in general, are significantly affected by economic conditions, competition, and the monetary and fiscal policies of the federal government. Lending activities are influenced by the demand for and supply of housing, competition among lenders, interest rate conditions, and funds availability. Our operations and lending are principally concentrated in the Western New York area, and our operations and earnings are influenced by local economic conditions. Deposit balances and cost of funds are influenced by prevailing market rates on competing investments, customer preferences, and levels of personal income and savings in our primary market area. Certain areas of the Western New York market area have recently experienced economic growth especially in Erie County, and the Company has more than doubled its asset size since December 31, 2000.

While the recession is officially over and improvements have been noted in the housing market and unemployment rate, the Federal Reserve has continued to maintain the Fed Funds rate at 0.00%-0.25% for more than five years. The Federal Reserve has indicated that the Fed Funds rate will remain low until its dual mandates of maximum employment and a 2% inflation rate are achieved on a consistent basis, and as such, this rate is not expected to increase until mid-2015 or beyond. At the December 2013 meeting of the Federal Open Market Committee ("FOMC"), the Federal Reserve began to taper its quantitative easing ("QE") program by reducing its purchases of mortgage-backed securities and treasury bonds by \$10 billion per month. This program was further reduced by the FOMC at each subsequent meeting until the end of the program in October 2014. The Fed continues to reinvest cash flow received on its portfolio back into agency mortgage backed securities and treasury bonds. This action will continue to exert downward pressure on long-term rates. Current interest rates on residential mortgage loans remain very low compared to historical yields, and the rates have declined since January 2014. Despite this recent decline in interest rates on residential mortgage loans, the current interest rates have increased by approximately 70 basis points in the past 18 months, which has resulted in decreased loan origination and refinance activity. We will continue to closely monitor the impact of the national and regional economy on our net interest margin, results of operations and critical risk areas, including interest rate risk and credit risk.

As discussed in the Company's Annual Report on Form 10-K Part I, Item 1 "Business – Supervision and Regulation" for the year ended December 31, 2013, since October 2008, numerous legislative actions, including the Dodd-Frank Act, have been taken in response to the financial crisis affecting the banking system and financial markets. While many of the regulations mandated by Dodd-Frank have been written, there are still a number that have not yet been finalized. While we do not know all the possible outcomes from these initiatives, we can anticipate that the Company will need to dedicate more resources to ensure compliance with the new legislation and regulations, which may impact profitability. There can be no assurance as to the actual impact any governmental program will have on the financial markets or our financial condition and results of operations. We remain active in monitoring these developments and supporting the interests of our shareholders.

## Management Strategy

**Our Reputation.** Our primary management strategy has been to retain our perceived image as one of the most respected and recognized community banks in Western New York with over 123 years of service to our community. Our management strives to accomplish this goal by continuing to emphasize our high quality customer service and financial strength.

**Branching.** We opened our sixth branch office in Erie County, New York during the second quarter of 2013. This branch is located in Snyder, New York and is our eleventh branch overall. Our offices are located in Dunkirk, Fredonia, Jamestown, Lakewood and Westfield in Chautauqua County, New York and in Depew, East Amherst, Hamburg, Kenmore, Orchard Park and Snyder in Erie County, New York. Saturation of the market in Chautauqua County led to our expansion plan in Erie County, which is a critical component of our future profitability and growth.

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

**Our People.** A large part of our success is related to customer service and customer satisfaction. Having employees who understand and value our clientele and their business is a key component to our success. We believe that our present staff is one of our competitive strengths, and thus the retention of such persons and our ability to continue to attract quality personnel is a high priority.

**Residential Mortgage and Other Lending.** Historically, our lending portfolio has consisted predominantly of residential one- to four-family mortgage loans. At September 30, 2014 and December 31, 2013, we held \$167.3 million and \$170.8 million of residential one- to four-family mortgage loans, respectively, which constituted 61.1% and 61.8% of our total loan portfolio, at such respective dates. We originate commercial real estate loans to finance the purchase of real property, which generally consists of developed real estate. At September 30, 2014 and December 31, 2013, our commercial real estate loan portfolio consisted of loans totaling \$58.6 million and \$58.7 million respectively, or 21.4% and 21.3%, respectively, of total loans. In addition to commercial real estate loans, we also engage in small business commercial lending, including business installment loans, lines of credit, and other commercial loans. At September 30, 2014 and December 31, 2013, our commercial business loan portfolio consisted of loans totaling \$11.8 million and \$12.6 million, respectively, or 4.3% and 4.6%, respectively, of total loans. Other loan products offered to our customers include home equity lines of credit, construction loans and consumer loans, including automobile loans, overdraft lines of credit and share loans. We may sell one- to four-family residential loans in the future as part of our interest rate risk strategy and asset/liability management, if it is deemed appropriate. We typically retain servicing rights when we sell one- to four-family residential mortgage loans. One- to four-family residential mortgage loans will continue to be the dominant type of loan in our lending portfolio.

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

At September 30, 2014 and December 31, 2013, we had \$141.0 million and \$158.0 million, respectively, invested in securities available for sale, the majority of which are Treasury securities, agency collateralized mortgage obligation securities (“CMOs”), agency mortgage-backed securities, and municipal securities.

Asset-Liability Strategy. As stated above, our business consists primarily of originating one- to four-family residential real estate loans and commercial real estate loans secured by property in our market area and



investing in residential mortgage-backed securities, CMOs and municipal securities. One- to four-family residential real estate loans generally involve a lower degree of credit risk and carry a lower yield than commercial real estate and commercial business loans. The average maturity of residential real estate loans is longer than that for commercial loans. Our loans are primarily funded by time deposits, which typically mature within 2 years on average and core deposits (i.e. checking, savings and money market accounts). As a result, we are exposed to interest rate risk, as our interest-bearing liabilities will mature or re-price more quickly than our interest-earning assets in a rising rate environment. Although we plan to continue to originate one- to four- family residential mortgage loans going forward, we have been and intend to continue to increase our focus on the origination of commercial real estate loans and commercial business loans, which generally have higher returns and shorter durations than one- to four- family residential real estate loans. As part of our asset liability strategy, we review the duration of assets on our balance sheet, and if necessary, we may sell loans or securities to help manage our interest rate risk. Our strategy also includes improving our funding mix by increasing core deposits in order to help reduce and control our cost of funds. We value core deposits because they represent longer-term customer relationships as well as lower cost of funds. As part of our strategy to expand our commercial loan portfolio, we expect to attract lower cost core deposits as part of these borrower relationships. We offer competitive rates on a variety of deposit products to meet the needs of our customers and we promote long term deposits, where possible, to meet asset-liability goals. We also consider borrowed funds or derivatives as an opportunity to extend the duration of liabilities at attractive levels.

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

#### Critical Accounting Policies

It is management's opinion that accounting estimates covering certain aspects of our business have more significance than others due to the relative importance of those areas to overall performance, or the level of subjectivity required in making such estimates. Management considers the accounting policy relating to the allowance for loan losses to be a critical accounting policy given the uncertainty in evaluating the level of the allowance for loan losses required for probable credit losses and the material effect that such judgments can have on the results of operations. Management's monthly evaluation of the adequacy of the allowance considers our historical loan loss experience, review of specific loans, current economic conditions, and such other factors considered appropriate to estimate loan losses. Management uses presently available information to estimate probable losses on loans; however, future additions to the allowance may be necessary based on changes in estimates, assumptions, or economic conditions. Significant factors that could give rise to changes in these estimates include, but are not limited to, changes in economic conditions in our local area, concentrations of risk and decline in local property values. The Company's determination as to the amount of its allowance for loan losses is subject to review by its regulatory agencies, which can require that we establish additional loss allowances. Refer to Note 4 of the Notes to Consolidated Financial Statements for more information on the allowance for loan losses.

In management's opinion, the accounting policy relating to the valuation of investments is a critical accounting policy. We use a third party vendor to provide independent pricing of the securities in our investment portfolio, with the exception of four securities which are not actively traded. The third party vendor utilizes public quotations, third party dealer quotes and pricing models. For the four securities that are not actively trading, the Company utilizes

discounted cash flow models to determine fair value pricing. Thus, the determination of fair value pricing on investments may require significant judgment or estimation, particularly when liquid markets do not exist for the item being valued. The use of different assumptions for these valuations could produce significantly different results which may have material positive or negative effects on the results of our operations. Refer to Note 8 of the Notes to Consolidated Financial Statements for more information on fair value.

Management also considers the accounting policy relating to the impairment of investments to be a critical accounting policy due to the subjectivity and judgment involved and the material effect an impairment loss could have on the consolidated results of income. The credit portion of a decline in the fair market value of investments below cost deemed to be OTTI may be charged to earnings resulting in the establishment of a new cost basis for an asset. Management continually reviews the current value of its investments for evidence of OTTI. Refer to Note 3 of the Notes to Consolidated Financial Statements for more information on OTTI.

These critical policies and their application are reviewed periodically by our Audit/Risk Committee and our Board of Directors. All accounting policies are important, and as such, we encourage the reader to review each of the policies included in the notes to our audited Consolidated Financial Statements included in our Annual Report on Form 10-K for the year ended December 31, 2013 to better understand how our financial performance is reported.

### Analysis of Net Interest Income

Net interest income represents the difference between the interest we earn on our interest-earning assets, such as 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 loans. Interest income on securities does not include a tax equivalent adjustment for bank qualified municipal bonds.

|  | For the Three Months Ended<br>September 30, 2014 |                                |                | For the Three Months Ended<br>September 30, 2013 |                                |                |
|--|--|--------------------------------|----------------|--|--------------------------------|----------------|
|  | 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)                         |  |                                |                |  |                                |                |
| <b>Interest-earning assets:</b>                |  |                                |                |  |                                |                |
| Interest-earning deposits & federal funds sold | \$ 36,265  | \$ 6                           | 0.07%          | \$ 24,609  | \$ 5                           | 0.08%          |
| Securities                                     | 144,321  | 1,082                          | 3.00%          | 157,728  | 1,195                          | 3.03%          |
| Loans  | 275,079  | 3,307                          | 4.81%          | 271,681  | 3,426                          | 5.04%          |
| Total interest-earning assets                  | 455,665  | 4,395                          | 3.86%          | 454,018  | 4,626                          | 4.08%          |
| Other assets                                   | 33,550   |                                |                | 34,165   |                                |                |
| Total assets                                   | \$ 489,215                                       |                                |                | \$ 488,183                                       |                                |                |
| <b>Interest-bearing liabilities</b>            |  |                                |                |  |                                |                |
| Demand & NOW accounts                          | \$ 46,321  | \$ 14                          | 0.12%          | \$ 42,481  | \$ 12                          | 0.11%          |
| Money market accounts                          | 78,717   | 61                             | 0.31%          | 75,327   | 67                             | 0.36%          |
| Savings accounts                               | 42,295   | 11                             | 0.10%          | 39,727   | 10                             | 0.10%          |
| Time deposits                                  | 186,567  | 638                            | 1.37%          | 200,221  | 708                            | 1.41%          |
| Borrowed funds                                 | 18,950   | 102                            | 2.15%          | 22,047   | 62                             | 1.12%          |
| Other interest-bearing liabilities             | 1,102  | 25                             | 9.07%          | 1,167  | 27                             | 9.25%          |
| Total interest-bearing liabilities             | 373,952  | 851                            | 0.91%          | 380,970  | 886                            | 0.93%          |
| Other non-interest bearing liabilities         | 45,688   |                                |                | 42,449   |                                |                |
| Stockholders' equity                           | 69,575   |                                |                | 64,764   |                                |                |
| Total liabilities & stockholders' equity       | \$ 489,215                                       |                                |                | \$ 488,183                                       |                                |                |
| Net interest income                            |  | \$ 3,544                       |                |  | \$ 3,740                       |                |
| Interest rate spread                           |  |                                | 2.95%          |  |                                | 3.15%          |
| Net interest margin                            |  |                                | 3.11%          |  |                                | 3.30%          |

|  | For the Nine Months Ended<br>September 30, 2014 |                                |                | For the Nine Months Ended<br>September 30, 2013 |                                |                |
|--|---|--------------------------------|----------------|---|--------------------------------|----------------|
|  | 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)                         |   |                                |                |   |                                |                |
| <b>Interest-earning assets:</b>                |   |                                |                |   |                                |                |
| Interest-earning deposits & federal funds sold | \$ 25,500                                       | \$ 10                          | 0.05%          | \$ 21,629                                       | \$ 13                          | 0.08%          |
| Securities                                     | 152,106   | 3,473                          | 3.04%          | 158,709   | 3,534                          | 2.97%          |
| Loans  | 275,316   | 9,977                          | 4.83%          | 271,271   | 10,361                         | 5.09%          |
| Total interest-earning assets                  | 452,922   | 13,460                         | 3.96%          | 451,609   | 13,908                         | 4.11%          |
| Other assets                                   | 34,279  |                                |                | 34,041  |                                |                |
| Total assets                                   | \$ 487,201                                      |                                |                | \$ 485,650                                      |                                |                |
| <b>Interest-bearing liabilities</b>            |   |                                |                |   |                                |                |
| Demand & NOW accounts                          | \$ 45,780                                       | \$ 41                          | 0.12%          | \$ 42,082                                       | \$ 36                          | 0.11%          |
| Money market accounts                          | 78,779  | 198                            | 0.34%          | 73,103  | 201                            | 0.37%          |
| Savings accounts                               | 41,228  | 32                             | 0.10%          | 38,754  | 30                             | 0.10%          |
| Time deposits                                  | 189,854   | 1,958                          | 1.38%          | 199,782   | 2,146                          | 1.43%          |
| Borrowed funds                                 | 19,276  | 202                            | 1.40%          | 23,454  | 203                            | 1.15%          |
| Other interest-bearing liabilities             | 1,118   | 76                             | 9.06%          | 1,181   | 79                             | 8.92%          |
| Total interest-bearing liabilities             | 376,035   | 2,507                          | 0.89%          | 378,356   | 2,695                          | 0.95%          |
| Other non-interest bearing liabilities         | 42,837  |                                |                | 40,805  |                                |                |
| Stockholders' equity                           | 68,329  |                                |                | 66,489  |                                |                |
| Total liabilities & stockholders' equity       | \$ 487,201                                      |                                |                | \$ 485,650                                      |                                |                |
| Net interest income                            |   | \$ 10,953                      |                |   | \$ 11,213                      |                |
| Interest rate spread                           |   |                                | 3.07%          |   |                                | 3.16%          |
| Net interest margin                            |   |                                | 3.22%          |   |                                | 3.31%          |

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



Three Months Ended  
September 30, 2014  
Compared to  
Three Months Ended  
September 30, 2013

Rate      Volume      Net  
Change  
(Dollars in thousands)

## Interest-earning assets:

|  |        |       |       |
|--|--------|-------|-------|
| Interest-earning deposits & federal funds sold | \$ (1) | \$ 2  | \$ 1  |
| Securities                                     | (12)   | (101) | (113) |
| Loans, including fees                          | (161)  | 42    | (119) |
| Total interest-earning assets                  | (174)  | (57)  | (231) |

## Interest-bearing liabilities:

|                                     |          |        |          |
|-------------------------------------|----------|--------|----------|
| Demand & NOW accounts               | 1        | 1      | 2        |
| Money market accounts               | (9)      | 3      | (6)      |
| Savings accounts                    | -        | 1      | 1        |
| Time deposits                       | (23)     | (47)   | (70)     |
| Total deposits                      | (31)     | (42)   | (73)     |
| Other interest-bearing liabilities: |          |        |          |
| Borrowed funds & other              | 49       | (11)   | 38       |
| Total interest-bearing liabilities  | 18       | (53)   | (35)     |
| Total change in net interest income | \$ (192) | \$ (4) | \$ (196) |

Nine Months Ended September 30,  
2014

Compared to  
Nine Months Ended September 30,  
2013

Rate      Volume      Net Change  
(Dollars in thousands)

## Interest-earning assets:

|  |        |       |        |
|--|--------|-------|--------|
| Interest-earning deposits & federal funds sold | \$ (5) | \$ 2  | \$ (3) |
| Securities                                     | 88     | (149) | (61)   |
| Loans, including fees                          | (537)  | 153   | (384)  |
| Total interest-earning assets                  | (454)  | 6     | (448)  |

## Interest-bearing liabilities:

|                       |      |       |       |
|-----------------------|------|-------|-------|
| Demand & NOW accounts | 2    | 3     | 5     |
| Money market accounts | (18) | 15    | (3)   |
| Savings accounts      | -    | 2     | 2     |
| Time deposits         | (84) | (104) | (188) |

|                                     |          |       |          |
|-------------------------------------|----------|-------|----------|
| Total deposits                      | (100)    | (84)  | (184)    |
| Other interest-bearing liabilities: |          |       |          |
| Borrowed funds & other              | (44)     | 40    | (4)      |
| Total interest-bearing liabilities  | (144)    | (44)  | (188)    |
| Total change in net interest income | \$ (310) | \$ 50 | \$ (260) |

Our earnings may be adversely impacted by an increase in interest rates because the majority of our interest-earning assets are long-term, fixed rate mortgage-related assets that will not re-price as long-term interest rates increase. As rates rise, we expect loan applications to decrease, prepayment speeds to slow down and the



interest rate on our loan portfolio to remain static. Conversely, a majority of our interest-bearing liabilities have much shorter contractual maturities and are expected to re-price, resulting in increased interest expense. A significant portion of our deposits have no contractual maturities and are likely to re-price quickly as short-term interest rates increase. Therefore, in an increasing rate environment, our cost of funds is expected to increase more rapidly than the yields earned on our loan and securities portfolios. An increasing rate environment is expected to cause a decrease in our net interest rate spread and a decrease in our earnings. In order to mitigate this effect, the Bank's Asset-Liability Committee is continuing to review its options in relation to core deposit growth, implementation of new products, promotion of adjustable rate commercial loan products and use of derivative products.

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, yields on the lending and investment portfolios have declined significantly, as have rates on deposit products and borrowed funds. Recently, the cost of funding has remained flat or increased slightly while asset yields have fallen, which has resulted in a decline of the net interest margin.

For the three months ended September 30, 2014, the average yields on our loan and investment portfolios were 4.81% and 3.00%, respectively, in comparison to 5.04% and 3.03%, respectively, for the three months ended September 30, 2013. Overall, the average yield on our interest earning assets decreased by 22 basis points to 3.86% for the three months ended September 30, 2014 in comparison to the three months ended September 30, 2013 primarily due to lower interest income earned on our loan portfolio as a result of the low interest rate environment and an increase in the average balance of cash and cash equivalents. For the three months ended September 30, 2014, the average rate that we were paying on interest-bearing liabilities decreased by two basis points to 0.91% in comparison with the same period in the prior year. This was primarily due to a decrease in the average interest rate paid on time deposits, offset by an increase in the rate paid on borrowed funds. The average balance of core deposits has increased by \$9.8 million since September 30, 2013 while there has been a decline of \$13.7 million in average time deposit balances. Our interest rate spread for the three months ended September 30, 2014 was 2.95% which was a 20 basis point decrease in comparison to the three months ended September 30, 2013. Our net interest margin was 3.11% and 3.30% for the three months ended September 30, 2014 and 2013, respectively.

For the nine month period ended September 30, 2014, the average yields on our loan portfolio and investment portfolio were 4.83% and 3.04%, respectively, in comparison to 5.09% and 2.97%, respectively for the nine month period ended September 30, 2013. Overall, the average yield on our interest earning assets decreased by 15 basis points to 3.96% for the nine months ended September 30, 2014 from 4.11% for the nine months ended September 30, 2013 primarily due to lower interest income earned on our loan portfolio as a result of the low interest rate environment and an increase in the average balance of cash and cash equivalents. For the nine months ended September 30, 2014, the average rate paid on interest-bearing liabilities decreased by six basis points to 0.89% in comparison to the same period in the prior year. This was primarily due to a decrease in the average interest rate paid

on time deposits from 1.43% for the nine month period ended September 30, 2013 to 1.38% for the nine month period ended September 30, 2014, along with a \$9.9 million decrease in the average balance of time deposits since September 30, 2013. The average balance of core deposits increased by \$11.8 million since September 30, 2013. The overall decrease in the average rate paid on interest-bearing liabilities was partially offset by a 25 basis point increase in the average interest rate paid on borrowed funds during the nine months ended September 30, 2014 in comparison to the same period in the prior year. Our interest rate spread for the nine months ended September 30, 2014 was 3.07%, which was a nine basis point decrease in comparison to the nine months ended September 30, 2013. Our net interest margin was 3.22% and 3.31% for the nine months ended September 30, 2014 and 2013, respectively.

## Comparison of Financial Condition at September 30, 2014 and December 31, 2013

Total assets at September 30, 2014 were \$486.6 million, an increase of \$4.4 million, or 0.9%, from \$482.2 million at December 31, 2013. The increase in total assets was primarily due to a \$24.7 million increase in cash and cash equivalents, partially offset by a \$17.0 million decrease in securities available for sale, a \$2.2 million decrease in loans receivable, net and a \$1.0 million decrease in other assets.

Cash and cash equivalents increased by \$24.7 million, or 143.5%, from \$17.2 million at December 31, 2013 to \$41.9 million at September 30, 2014. The increase was primarily attributed to the receipt of cash proceeds from the sale of \$10.3 million of available for sale securities and from \$13.1 million of net pay-downs on the investment and loan portfolios. The increase was also due to a \$1.3 million increase in total deposits which were partially offset by cash used to originate loans and pay-down borrowings.

Securities available for sale decreased by \$17.0 million, or 10.8%, to \$141.0 million at September 30, 2014 compared to \$158.0 million at December 31, 2013. The decrease was primarily due to the sale of six agency mortgage-backed securities totaling \$8.8 million and one asset-backed private label security which totaled \$1.5 million. The agency mortgage-backed securities were sold as part of the Bank's long-term strategy to position itself for a rising interest rate environment by shortening the duration of its assets. During the nine months ended September 30, 2014, \$10.6 million of paydowns were received on the investment portfolio and there were no new purchases of securities. A \$3.9 million increase in the market value (before taxes) of the securities available for sale portfolio was recorded between December 31, 2013 and September 30, 2014 due to a decrease in market interest rates.

Net loans receivable decreased during the nine month period ended September 30, 2014 as shown in the table below:

|                                  | At<br>September<br>30,<br>2014 | At<br>December<br>31,<br>2013 | Change     |         |
|----------------------------------|--------------------------------|-------------------------------|------------|---------|
|                                  |                                |                               | \$         | %       |
| (Dollars in thousands)           |                                |                               |            |         |
| Real Estate Loans:               |                                |                               |            |         |
| Residential, one- to four-family | \$ 167,301                     | \$ 170,793                    | \$ (3,492) | (2.0) % |
| Home equity                      | 32,100                         | 31,675                        | 425        | 1.3 %   |
| Commercial                       | 58,585                         | 58,746                        | (161)      | (0.3) % |
| Construction                     | 2,657                          | 936                           | 1,721      | 183.9 % |
| Total real estate loans          | 260,643                        | 262,150                       | (1,507)    | (0.6) % |
| Other Loans:                     |                                |                               |            |         |
| Commercial                       | 11,809                         | 12,645                        | (836)      | (6.6) % |
| Consumer                         | 1,584                          | 1,517                         | 67         | 4.4 %   |

|                           |            |            |            |       |   |
|---------------------------|------------|------------|------------|-------|---|
| Total gross loans         | 274,036    | 276,312    | (2,276)    | (0.8) | % |
| Allowance for loan losses | (1,803)    | (1,813)    | 10         | 0.6   | % |
| Net deferred loan costs   | 2,923      | 2,846      | 77         | 2.7   | % |
| Loans receivable, net     | \$ 275,156 | \$ 277,345 | \$ (2,189) | (0.8) | % |

The decrease in net loans receivable was primarily due to a decrease in residential, one- to four-family real estate loans and commercial business loans, partially offset by an increase in construction and home equity loans. As 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 remained strategically focused in 2014 on originating adjustable rate commercial real estate and commercial business loans to diversify our asset mix,

to take advantage of the opportunities available to serve small businesses in our market area, and to maintain the net interest margin.

Other assets decreased by \$1.0 million, or 45.9%, to \$1.2 million as of September 30, 2014 as compared to \$2.3 million at December 31, 2013. The decrease was attributable to a change in the volume of deferred tax assets resulting from increases in unrealized mark to market gains in our securities portfolio during the first nine months of 2014.

The table below shows changes in deposit balances by type of deposit account between September 30, 2014 and December 31, 2013:

|                                   | At<br>September<br>30,<br>2014 | At<br>December<br>31,<br>2013 | Change       |              |
|-----------------------------------|--------------------------------|-------------------------------|--------------|--------------|
|                                   |                                |                               | \$           | %            |
|                                   | (Dollars in thousands)         |                               |              |              |
| Demand deposits and NOW accounts: |                                |                               |              |              |
| Non-interest bearing              | \$ 39,705                      | \$ 34,320                     | \$ 5,385     | 15.7 %       |
| Interest bearing                  | 44,543                         | 44,517                        | 26           | 0.1 %        |
| Money market                      | 78,308                         | 77,990                        | 318          | 0.4 %        |
| Savings                           | 42,278                         | 38,833                        | 3,445        | 8.9 %        |
| Time deposits                     | 184,671                        | 192,575                       | (7,904)      | (4.1) %      |
| <b>Total Deposits</b>             | <b>\$ 389,505</b>              | <b>388,235</b>                | <b>1,270</b> | <b>0.3 %</b> |

The increase in total deposits was due to an increase in all deposit categories except for time deposits. The growth in checking, savings, and money market accounts was the result of the Company's continued strategic focus on growing low-cost core deposits among its retail and commercial customers.

Our borrowings, consisting of advances from the Federal Home Loan Bank of New York ("FHLB NY"), decreased by \$550,000, or 2.8%, from \$19.5 million at December 31, 2013 to \$19.0 million at September 30, 2014. Short-term borrowings decreased by \$11.7 million, or 100.0%, due to a refinancing of the borrowings into long-term debt to lock in fixed rates with lower interest rate risk. Long-term debt increased by \$11.1 million primarily due to the refinancing of short-term borrowings described previously. The refinancing of the short-term borrowings into long-term debt caused our weighted rate on borrowings to increase by 97 basis points to 2.12% at September 30, 2014 from 1.15% at December 31, 2013. During the nine months ended September 30, 2014, the Company paid off \$550,000 of long-term debt.

Total stockholders' equity increased by \$4.5 million, or 6.8%, from \$65.3 million at December 31, 2013 to \$69.7 million at September 30, 2014. The increase was primarily due to a \$2.4 million increase in unrealized mark to market

gains on available for sale securities (after taxes) and net income of \$2.4 million during the nine month period ended September 30, 2014, partially offset by \$442,000 in cash dividends paid during the nine month period ended September 30, 2014.

#### Comparison of Results of Operations for the Three Months Ended September 30, 2014 and 2013

General. Net income was \$688,000 for the three months ended September 30, 2014, or \$0.12 per diluted share, a decrease of \$298,000, or 30.2%, compared to net income of \$986,000, or \$0.17 per diluted share, for the three months ended September 30, 2013. The decrease in net income was due to a \$196,000 decrease in net interest income, a \$195,000 increase in non-interest expense, a \$10,000 increase in provision for loan losses and a \$10,000 decrease in non-interest income, partially offset by a \$113,000 decrease in income tax expense.

Interest Income. Interest income decreased by \$231,000, or 5.0%, to \$4.4 million for the three months ended September 30, 2014 compared to the three months ended September 30, 2013. This decrease was primarily a

result of reduced interest income on loans and investment securities resulting from the continued low interest rate environment. Loan interest income decreased by \$119,000, or 3.5%, to \$3.3 million for the three months ended September 30, 2014 compared to the three months ended September 30, 2013, primarily due to a decrease in the average yield of the loan portfolio from 5.04% for the three months ended September 30, 2013 to 4.81% for the three months ended September 30, 2014. The average yield on the loan portfolio decreased as new loans were originated or existing loans were refinanced at lower yields than the rates earned on loans which had paid off, as a result of the current low interest rate environment. The average balance of the loan portfolio increased \$3.4 million, or 1.3%, from \$271.7 million for the three months ended September 30, 2013 to \$275.1 million for the three months ended September 30, 2014. The increase in the average balance of loans receivable was primarily due to an increase in the average balance of one- to four-family real estate loans and home equity loans, partially offset by a decrease in the average balance of commercial real estate and commercial business loans. Investment interest income decreased \$113,000, or 9.5%, to \$1.1 million for the three months ended September 30, 2014 compared to the three months ended September 30, 2013, primarily due to a decrease in the average balance of the investment portfolio from \$157.7 million for the three months ended September 30, 2013 to \$144.3 million for the three months ended September 30, 2014. The average balance in the investment portfolio decreased primarily due to the sale of \$8.8 million in available for sale securities during the second quarter of 2014 and the receipt of \$10.6 million of pay-downs that have not been reinvested in the investment portfolio in order to reduce interest rate risk. The sale of securities and the increase in cash and cash equivalents on the Bank's balance sheet has allowed the Bank to position itself to take advantage of an anticipated rising interest rate environment by shortening the duration of assets, which reduces the risk of holding long term securities at low yields. The average yield on the investment portfolio decreased by three basis points from 3.03% for the three months ended September 30, 2013 to 3.00% for the three months ended September 30, 2014.

**Interest Expense.** Interest expense decreased \$35,000, or 4.0%, for the three months ended September 30, 2014 to \$851,000 compared to \$886,000 for the three months ended September 30, 2013. Interest expense on deposits decreased by \$73,000, or 9.2%, to \$724,000 for the three months ended September 30, 2014 when compared to the three months ended September 30, 2013 primarily due to the decrease in the average rate paid on deposits and a shift in the deposit mix, resulting in a larger percentage of the deposit portfolio consisting of low cost core deposits. The average balance of deposits for the three months ended September 30, 2014 was \$353.9 million with an average rate of 0.82% compared to the average balance of deposits of \$357.8 million and an average rate of 0.89% for the three months ended September 30, 2013. The decrease in the average balance of deposits was due to a decrease in average time deposits, partially offset by an increase in average core deposits. The shift in the deposit mix results in a larger percentage of the deposit portfolio consisting of low cost core deposits. The decrease in the average rate paid on deposits was due to the continued low interest rate environment during the third quarter of 2014. The interest expense related to advances from the FHLBNY increased \$40,000, or 64.5%, to \$102,000 for the three months ended September 30, 2014 when compared to the three months ended September 30, 2013. This increase was primarily due to a 103 basis point increase in the average rate paid on advances when comparing the three months ended September 30, 2014 with the three months ended September 30, 2013, due to the refinancing of short-term borrowings into long-term debt to lock in low long-term fixed rates and reduce interest rate risk. The average balance of advances from the FHLBNY for the three months ended September 30, 2014 was \$19.0 million with an average rate of 2.15% compared to the average balance of advances from the FHLBNY of \$22.0 million and an average rate of 1.12% for the three months ended September 30, 2013.

**Provision for Loan Losses.** A provision of \$70,000 was recorded to the allowance for loan losses during the three month period ended September 30, 2014, an increase of \$10,000, compared to a provision of \$60,000 during the three month period ended September 30, 2013. Non-performing loans increased to \$5.8 million, or 1.97% of total loans, at September 30, 2014 as compared to \$3.5 million, or 1.05% of total loans, at September 30, 2013. The increase in non-performing loans at September 30, 2014 was primarily due to the addition of two non-performing commercial real estate loans with a total outstanding balance of \$2.3 million. One of these non-performing commercial real estate loans had an outstanding balance of \$1.7 million and a provision for loan losses has not been recorded on this loan as

management believes that the value of the underlying collateral is sufficient to protect the Bank from loss. Net charge-offs were \$40,000 for the three month period ended September 30, 2014 compared to \$64,000 for the three month period ended September 30, 2013.



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

During the three month period ended September 30, 2013, the Company recorded a \$119,000 provision for loan losses in commercial real estate loans due to changes in the related environmental factors used to qualitatively assess inherent losses in the loan portfolio, including an increase in average commercial real estate loan balances. The Company recorded a \$38,000 provision for loan losses on home equity loans primarily due to an increase in classified loans. These provisions were offset by a \$93,000 credit for loan losses on one- to four-family loans and commercial loans during the three month period ended September 30, 2013, due to a decrease in classified loans in these loan categories.

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

**Non-interest Income.** Non-interest income decreased \$10,000, or 1.8%, to \$531,000 for the three months ended September 30, 2014 compared to the three months ended September 30, 2013. The decrease was due to a \$206,000 net gain recorded on the sale of available for sale securities during the prior year period, partially offset by a non-cash pre-tax impairment charge of \$180,000 for one asset-backed security recorded during the prior year period. During the three months ended September 30, 2014, a \$35,000 recovery was recorded on previously impaired investment securities, as well as a \$5,000 gain on the sale of loans. Service charges and fees decreased by \$25,000 in comparison to the three month period ended September 30, 2013.

**Non-interest Expenses.** Non-interest expenses increased \$195,000, or 6.5%, to \$3.2 million for the three months ended September 30, 2014. The increase was primarily due to increases in salaries and employee benefit expenses, occupancy and equipment expenses, data processing costs and other expense, partially offset by a decrease in professional fees in the third quarter of 2014. Salaries and employee benefit expenses increased \$158,000, or 10.4%, for the three months ended September 30, 2014 as compared to the prior year period. The increase was primarily due to the hiring of an executive vice president for commercial lending, annual salary increases and additional expense for stock grants awarded during the third quarter of 2014. Occupancy and equipment expense increased \$11,000, or 2.1% when compared to the same period in 2013 due to increases for software maintenance, utilities, property taxes and maintenance and repairs of buildings and equipment. Data processing expense increased by \$39,000, or 23.9%, for the three months ended September 30, 2014 compared to the same period in 2013 primarily due to the costs associated with the implementation of new mobile banking, online banking and loan origination technology and related software as well as consulting fees related to the negotiation of our core processing contract. Professional services expense decreased \$35,000, or 10.5%, for the three months ended September 30, 2014 compared to the same period in 2013 primarily due to a decrease in legal and consulting costs. Other expenses increased \$18,000, or 6.9%, for the three months ended September 30, 2014 when compared with the three months ended September 30, 2013 primarily due to a check fraud loss, collection expense and foreclosed property expenses.

Income Taxes Expense. Income tax expense decreased by \$113,000, or 50.9%, from \$222,000 for the three months ended September 30, 2013 to \$109,000 for the three months ended September 30, 2014. The decrease was primarily due to a decrease in income before income taxes during the three months ended September 30, 2014 as well as a decrease in the effective tax rate from 18.4% for the three month period ended September 30, 2013 to 13.7% for the three month period ended September 30, 2014. The decrease in the effective tax rate was primarily due to a decrease in income as well as a disproportionate increase in tax exempt income.

## Comparison of Results of Operations for the Nine Months Ended September 30, 2014 and 2013

General. Net income decreased by \$330,000, or 12.3%, to \$2.4 million for the nine month period ended September 30, 2014, or \$0.41 per diluted share, as compared to \$2.7 million, or \$0.47 per diluted share, for the nine month period ended September 30, 2013. The decrease in net income was primarily due to a \$340,000 increase in non-interest expenses and a \$260,000 decrease in net interest income, partially offset by a \$125,000 decrease in income tax expense, a \$110,000 increase in non-interest income and a \$35,000 decrease in the provision for loan losses.

Interest Income. Interest income decreased by \$448,000, or 3.2%, to \$13.5 million for the nine month period ended September 30, 2014 compared to the nine month period ended September 30, 2013. This decrease was primarily a result of reduced interest income on loans and investment securities due to the continued low interest rate environment. Loan interest income decreased by \$384,000, or 3.7%, to \$10.0 million for the nine month period ended September 30, 2014 compared to the nine month period ended September 30, 2013, primarily due to a decrease in the average yield of the loan portfolio from 5.09% for the nine month period ended September 30, 2013 to 4.83% for the nine month period ended September 30, 2014. The average yield on the loan portfolio decreased as new loans were originated or existing loans were refinanced at lower yields than the rates earned on loans which had paid off, as a result of the current low interest rate environment. The average balance of the loan portfolio increased \$4.0 million, or 1.5%, from \$271.3 million for the nine month period ended September 30, 2013 to \$275.3 million for the nine month period ended September 30, 2014. The increase in the average balance of loans receivable was primarily due to an increase in the average balance of one- to four- family real estate loans and home equity loans, partially offset by a decrease in the average balance of commercial real estate and commercial business loans. Investment interest income decreased by \$61,000, or 1.7%, to \$3.5 million for the nine month period ended September 30, 2014 when compared to the nine month period ended September 30, 2013, primarily due to a decrease in the average balance in the investment portfolio. The average balance in the investment portfolio decreased from \$158.7 million for the nine months ended September 30, 2013 to \$152.1 million for the nine months ended September 30, 2014. The average balance in the investment portfolio decreased primarily due to the sale of \$10.3 million in available for sale securities during the second quarter of 2014 in order to reduce interest rate risk. The sale of securities and the increase in cash and cash equivalents on the Bank's balance sheet has allowed the Bank to position itself to take advantage of an anticipated rising interest rate environment by shortening the duration of assets, which reduces the risk of holding long term securities at low yields. The average yield on the investment portfolio increased by seven basis points from 2.97% for the nine month period ended September 30, 2013 to 3.04% for the nine month period ended September 30, 2014. The average yield on the investment portfolio increased due to the purchase of higher yielding investments during the second half of 2013.

Interest Expense. Interest expense decreased by \$188,000, or 7.0%, to \$2.5 million for the nine month period ended September 30, 2014 compared to \$2.7 million for the nine month period ended September 30, 2013. The interest paid on deposits decreased by \$184,000, or 7.6%, to \$2.2 million for the nine month period ended September 30, 2014 when compared to the nine month period ended September 30, 2013, primarily due to the decrease in the average rate paid on deposits and a shift in the deposit mix, resulting in a larger percentage of the deposit portfolio consisting of low cost core deposits. The average balance of deposits for the nine month period ended September 30, 2014 was \$355.6 million with an average rate of 0.84% compared to the average balance of deposits of \$353.7 million and an average rate of 0.91% for the nine month period ended September 30, 2013. The increase in the average balance of deposits was due to an increase in average core deposits, partially offset by a decrease in average time deposits. The decrease in the average rate paid on deposits was due to the continued low interest rate environment during the first nine months of 2014 and due to the shift in the deposit mix, resulting in a larger percentage of the deposit portfolio

consisting of low cost core deposits. The interest expense related to advances from the FHLBNY was \$202,000 for the nine months ended September 30, 2014 compared to \$203,000 for the nine months ended September 30, 2013. The average balance of advances from the FHLBNY for the nine months ended September 30, 2014 was \$19.3 million with an average rate of 1.40% compared to the average balance of advances from the FHLBNY of \$23.5 million and an average rate of 1.15% for the nine months ended September 30, 2013. The increase in the average rate paid on advances from the FHLBNY was primarily due to the refinancing of short-term borrowings into long-term debt during the nine months ended September 30, 2014 to lock in low long-term fixed rates and lower interest rate risk.

Provision for Loan Losses. A provision of \$70,000 was recorded to the allowance for loan losses during the nine month period ended September 30, 2014, a decrease of \$35,000, as compared to a provision of \$105,000 during the nine month period ended September 30, 2013. Net charge-offs were \$80,000 for the nine month period ended September 30, 2014 compared to \$92,000 for the nine month period ended September 30, 2013. Non-performing loans increased to \$5.8 million, or 1.97% of total loans, at September 30, 2014 as compared to \$3.5 million, or 1.05% of total loans, at September 30, 2013. The increase in the non-performing loans at September 30, 2014 was primarily due to the addition of two non-performing commercial real estate loans with a total outstanding balance of \$2.3 million. One of these non-performing commercial real estate loans had an outstanding balance of \$1.7 million and a provision for loan losses has not been recorded on this loan as management believes that the value of the underlying collateral is sufficient to protect the Bank from loss.

During the nine months ended September 30, 2014, the Company recorded a \$132,000 provision for loan losses on one- to four-family and home equity loans primarily due to changes in the related environmental factors used to qualitatively assess inherent losses in the loan portfolio and an increase in classified loan balances. During the nine months ended September 30, 2014, the Company recorded a \$32,000 provision for loan losses on consumer loans related to net charge-offs. The provisions for loan losses were partially offset by a \$60,000 credit for loan losses on commercial real estate loans during the nine months ended September 30, 2014, primarily due to changes in the environmental factors used to qualitatively assess inherent losses. The environmental change was specifically related to a decrease in the historical average of net charge-offs on these types of loans. The decrease was also attributed to a decrease in the outstanding balance of commercial real estate loans during the nine month period ended September 30, 2014. The provisions for loan losses was also partially offset by a \$41,000 unallocated credit for loan losses. The unallocated credit reflects the margin of imprecision inherent in the underlying assumptions used in the methodologies to estimate an allowance for loan loss.

During the nine month period ended September 30, 2013, the Company recorded a \$78,000 provision for loan losses in commercial real estate loans due to changes in the related environmental factors, including an increase in average commercial real estate loan balances. The Company also recorded a \$40,000 provision for loan losses on commercial loans primarily due to changes in the environmental factors as a result of an increase in historical average net charge-offs, as well as increased loan charge-offs during the nine month period ended September 30, 2013. A \$16,000 provision for loan losses was recorded on consumer loans primarily due to increased loan charge-offs during the nine month period ended September 30, 2013. The provision for loan losses was reduced by a \$32,000 credit for loan losses on one- to four-family loans and home equity loans during the nine month period ended September 30, 2013, due to a decrease in classified loans.

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

Non-interest Income. Non-interest income increased \$110,000, or 7.0%, from \$1.6 million for the nine months ended September 30, 2013 to \$1.7 million for the nine months ended September 30, 2014. The increase was primarily due to a non-cash, pre-tax impairment charge of \$180,000 recorded on one asset-backed security during the prior year period. Non-interest income was also partially impacted by a \$136,000 recovery recorded during the nine month period ended September 30, 2014 of previously impaired investment securities as well as by a \$5,000 gain on the sale of loans.

These increases were partially offset by a \$147,000 decrease in the gain recorded on the sale of available for sale securities during the nine month period ended September 30, 2014 as compared to the prior year period. Furthermore, there was a \$32,000 decrease in service charges and fees during the nine month period ended September 30, 2014 as compared to the nine month period ended September 30, 2013. Earnings on bank owned life insurance income decreased \$25,000 for the nine months ended September 30, 2014 when compared to the nine months ended September 30, 2013, as a result of declining yields.

Non-interest Expense. Non-interest expense increased by \$340,000, or 3.6%, to \$9.7 million for the nine month period ended September 30, 2014 compared to the nine month period ended September 30, 2013. Salaries and employee benefits expense increased \$272,000, or 5.8%, for the nine month period ended

September 30, 2014 compared to the nine month period ended September 30, 2013. This was primarily due to annual salary increases, the hiring of an executive vice president for commercial lending, increased staffing expenses for our newest branch office in Snyder, NY which opened in April 2013, lower deferred salary expense due to decreased loan originations and additional expense for stock grants awarded during the nine month period ended September 30, 2014. Occupancy and equipment expense increased \$139,000, or 9.2%, for the nine month period ended September 30, 2014 compared to the nine month period ended September 30, 2013, primarily due to increases in software maintenance costs, utilities, property taxes, maintenance and repairs of buildings and equipment and the opening of the Snyder office in the second quarter of 2013. Data processing expense increased \$99,000, or 20.6%, during the nine month period ended September 30, 2014, primarily due to the costs associated with the implementation of new mobile banking, online banking and loan origination technology and related software as well as consulting fees related to the negotiation of our core processing contract. FDIC insurance expense increased \$17,000, or 8.8%, for the nine month period ended September 30, 2014 compared to the nine month period ended September 30, 2013, due to an increase in assessed fees. Professional services expense decreased \$123,000, or 11.4%, for the nine month period ended September 30, 2014 compared to the nine month period September 30, 2013, primarily due to lower legal, accounting and consulting expenses. Other expenses decreased \$62,000, or 6.9%, for the nine month period ended September 30, 2014 when compared with the nine month period ended September 30, 2013 primarily due to decreased expenses related to collections and foreclosed properties.

**Income Tax Expense.** Income tax expense decreased by \$125,000, or 20.4%, from \$612,000 for the nine months ended September 30, 2013 to \$487,000 for the nine months ended September 30, 2014. The decrease was primarily due to a decrease in income before income taxes during the nine months ended September 30, 2014, as well as a decrease in the effective tax rate from 18.5% for the nine month period ended September 30, 2013 to 17.1% for the nine month period ended September 30, 2014. The decrease in the effective tax rate was primarily due to a decrease in income as well as a disproportionate increase in tax exempt income.

**Loans Past Due and Non-performing Assets.** We define non-performing loans as loans that are either non-accruing or accruing whose payments are 90 days or more past due and non-accruing troubled debt restructurings.

Non-performing assets, including non-performing loans and foreclosed real estate, totaled \$5.8 million, or 1.19% of total assets, at September 30, 2014 and \$5.2 million, or 1.08% of total assets, at December 31, 2013. The increase in non-performing assets at September 30, 2014 was primarily due to the addition of a non-performing commercial real estate loan with a total outstanding balance of \$601,000.

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

|   | At<br>September<br>30,<br>2014 | At<br>December<br>31,<br>2013 |      |   |
|---|--------------------------------|-------------------------------|------|---|
| (Dollars in thousands)                              |                                |                               |      |   |
| Loans past due 90 days or more but still accruing:  |                                |                               |      |   |
| Real estate loans:                                  |                                |                               |      |   |
| Residential, one- to four-family                    | \$ 70                          | \$ 79                         |      |   |
| Home equity   | -                              | 2                             |      |   |
| Commercial  | -                              | -                             |      |   |
| Construction  | -                              | -                             |      |   |
| Other loans:  |                                |                               |      |   |
| Commercial  | -                              | -                             |      |   |
| Consumer  | 9                              | -                             |      |   |
| Total   | \$ 79                          | \$ 81                         |      |   |
| Loans accounted for on a non-accrual basis:         |                                |                               |      |   |
| Real estate loans:                                  |                                |                               |      |   |
| Residential, one- to four-family                    | \$ 2,352                       | \$ 2,145                      |      |   |
| Home equity   | 300                            | 325                           |      |   |
| Commercial  | 2,599                          | 1,911                         |      |   |
| Construction  | -                              | -                             |      |   |
| Other loans:  |                                |                               |      |   |
| Commercial  | 77                             | 137                           |      |   |
| Consumer  | 5                              | 7                             |      |   |
| Total non-accrual loans                             | 5,333                          | 4,525                         |      |   |
| Total non-performing loans                          | 5,412                          | 4,606                         |      |   |
| Foreclosed real estate                              | 394                            | 581                           |      |   |
| Total non-performing assets                         | \$ 5,806                       | \$ 5,187                      |      |   |
| Ratios:   |                                |                               |      |   |
| Non-performing loans as a percent of net loans:     | 1.97                           | %                             | 1.66 | % |
| Non-performing assets as a percent of total assets: | 1.19                           | %                             | 1.08 | % |
| Troubled debt restructuring:                        |                                |                               |      |   |
| Loans accounted for on a non-accrual basis          |                                |                               |      |   |
| Residential, one- to four-family                    | \$ 41                          | \$ 48                         |      |   |



|                                  |        |        |
|----------------------------------|--------|--------|
| Performing loans                 |        |        |
| Residential, one- to four-family | \$ 186 | \$ 144 |
| Home equity                      | 10     | 4      |

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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 Nine<br>Months Ended<br>September 30,<br>2014      2013<br>(Dollars in thousands) |            |
|--|---|------------|
| Balance at beginning of year:                                  | \$ 1,813  | \$ 1,806   |
| Provision for loan losses                                      | 70  | 105        |
| Charge-offs:   |   |            |
| Real estate loans:   |   |            |
| Residential, one- to four-family                               | (17)  | (52)       |
| Home equity  | (25)  | -          |
| Commercial   | -   | (21)       |
| Construction   | -   | -          |
| Other loans:   |   |            |
| Commercial   | (25)  | (47)       |
| Consumer   | (29)  | (19)       |
| Total charge-offs  | (96)  | (139)      |
| Recoveries:  |   |            |
| Real estate loans:   |   |            |
| Residential, one- to four-family                               | 3   | 35         |
| Home equity  | 1   | 4          |
| Commercial   | -   | 5          |
| Construction   | -   | -          |
| Other loans:   |   |            |
| Commercial   | -   | 3          |
| Consumer   | 12  | -          |
| Total recoveries   | 16  | 47         |
| Net charge-offs  | (80)  | (92)       |
| Balance at end of period                                       | \$ 1,803  | \$ 1,819   |
| Average loans outstanding                                      | \$ 275,316  | \$ 271,271 |
| Allowance for loan losses as a percent of total net loans      | 0.66%   | 0.66%      |
| Allowance for loan losses as a percent of non-performing loans | 33.31%  | 63.25%     |
| Ratio of net charge-offs to average loans outstanding(1)       | 0.04%   | 0.05%      |

(1) Annualized

## Liquidity and Capital Resources

Liquidity describes our ability to meet the financial obligations that arise during the ordinary course of business. Liquidity is primarily needed to fund loan commitments, to pay the deposit withdrawal requirements of our customers as well as to fund current and planned expenditures. Our primary sources of funds consist of deposits, fed funds balances, scheduled amortization and prepayments of loans and securities, maturities and sales of investments, interest earning deposits at other financial institutions and funds provided from operations. We have a written agreement with the Federal Home Loan Bank of New York, which allows us to borrow up to \$122.4 million as of September 30, 2014, and is collateralized by a pledge of certain fixed-rate residential, one- to four-family real estate loans. At September 30, 2014, 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 \$10.7 million and a fair value of \$11.4 million as of September 30, 2014. There were no balances outstanding with the Federal Reserve Bank at September 30, 2014. We have also established lines of credits with correspondent banks for \$22.0 million, of which \$20.0 million is unsecured and the remaining \$2.0 million will be secured by a pledge of our securities when a draw is made. There were no borrowings on these lines as of September 30, 2014.

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

Our primary investing activities include the origination of loans and the purchase of investment securities. For the nine months ended September 30, 2014, we originated loans of approximately \$31.7 million in comparison to approximately \$39.7 million of loans originated during the nine months ended September 30, 2013. We did not purchase any investment securities in the nine months ended September 30, 2014 as compared to \$34.7 million of purchases in the nine months ended September 30, 2013.

At September 30, 2014, we had loan commitments to borrowers of approximately \$12.5 million and overdraft lines of protection and unused home equity lines of credit of approximately \$28.1 million. Total deposits were \$389.5 million at September 30, 2014, as compared to \$391.2 million at September 30, 2013. Time deposit accounts scheduled to mature within one year were \$98.5 million at September 30, 2014. 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.

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

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 the remainder of 2014. 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.

### Off-Balance Sheet Arrangements

Other than loan commitments, we do not have any off-balance sheet arrangements that have or are reasonably likely to have a current or future effect on our financial condition, revenues or expenses, results of operations, liquidity, capital expenditures, or capital resources that is material to investors. Refer to Note 6 in the Notes to our Consolidated Financial Statements for a summary of commitments outstanding as of September 30, 2014.

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

Not applicable as the Company is a smaller reporting company.

### Item 4. Controls and Procedures.

#### Disclosure Controls and Procedures

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

#### Changes in Internal Control over Financial Reporting

There have not been any changes in the Company's internal control over financial reporting (as such term is defined in Rules 13a-15(f) and 15d-15(f) under the Securities Exchange Act of 1934) during the quarter ended September 30, 2014 that have materially affected, or are reasonably likely to materially affect, internal control over financial reporting.

## PART II

### Item 1A. Risk Factors.

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

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

The following table reports information regarding repurchases by Lake Shore Bancorp of its common stock in each month of the quarter ended September 30, 2014:

## COMPANY PURCHASES OF EQUITY SECURITIES

| Period                                 | Total Number of Shares Purchased | Average Price Paid per Share | Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs | Maximum Number of Shares that May Yet be Purchased Under the Plans or Programs (1) |
|--|----------------------------------|------------------------------|--|--|
| July 1 through July 31, 2014           | -                                | \$ -                         | -  | 56,510   |
| August 1 through August 31, 2014       | -                                | -                            | -  | 56,510   |
| September 1 through September 30, 2014 | 100                              | 12.39                        | 100  | 56,410   |
| Total                                  | 100                              | \$ 12.39                     | 100  | 56,410   |

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

Item 6. Exhibits

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

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

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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)

November 12, 2014 By: /s/ Daniel P. Reininga  
Daniel P. Reininga  
President and Chief Executive Officer  
(Principal Executive Officer)

November 12, 2014 By: /s/ Rachel A. Foley  
Rachel A. Foley  
Chief Financial Officer  
(Principal Financial and Accounting Officer)