

Lake Shore Bancorp, Inc.  
Form 10-Q  
August 14, 2007  
Table of Contents

---

**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

---

**FORM 10-Q**

---

(Mark One)

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

For the quarterly period ended June 30, 2007

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

Commission file number: 000-51821

---

**LAKE SHORE BANCORP, INC.**

(Exact name of registrant as specified in its character)

---

United States  
(State or other jurisdiction of  
incorporation or organization)

20-4729288  
(I.R.S. Employer  
Identification Number)

125 East Fourth Street, Dunkirk, New York  
(Address of principal executive offices)

14048  
(Zip code)

(716) 366-4070

(Registrant's telephone number, including area code)

## Edgar Filing: Lake Shore Bancorp, Inc. - Form 10-Q

---

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in rule 12b-2 of the Exchange Act. (Check one):

Large Accelerated Filer  Accelerated Filer  Non-accelerated Filer

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:

Common stock (\$0.01 par value) 6,463,719 outstanding shares as of July 31, 2007.

---

**Table of Contents**

**TABLE OF CONTENTS**

	<b>PAGE</b>
<b><u>PART I</u></b>	
<b>ITEM</b>	
1	<b><u>FINANCIAL STATEMENTS</u></b>
	<u>- Consolidated Statements of Financial Condition as of June 30, 2007 and December 31, 2006</u> 2
	<u>- Consolidated Statements of Income for the Three and Six Months Ended June 30, 2007 and June 30, 2006</u> 3
	<u>- Consolidated Statements of Stockholders' Equity for the Six Months Ended June 30, 2007 and June 30, 2006</u> 4
	<u>- Consolidated Statements of Cash Flows for the Six Months ended June 30, 2007 and June 30, 2006</u> 5
	<u>- Notes to Consolidated Financial Statements</u> 6
2	<b><u>MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS</u></b> 13
3	<b><u>QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK</u></b> 30
4	<b><u>CONTROLS AND PROCEDURES</u></b> 31
4T	<b><u>CONTROLS AND PROCEDURES</u></b> 31
<b><u>PART II</u></b>	
1	<b><u>LEGAL PROCEEDINGS</u></b> 31
1A	<b><u>RISK FACTORS</u></b> 31
2	<b><u>UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS</u></b> 32
3	<b><u>DEFAULTS UPON SENIOR SECURITIES</u></b> 32
4	<b><u>SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS</u></b> 32
5	<b><u>OTHER INFORMATION</u></b> 33
6	<b><u>EXHIBITS</u></b> 33
	<b><u>SIGNATURES</u></b> 34

**Table of Contents****PART I****Item 1. Financial Statements  
LAKE SHORE BANCORP, INC. and SUBSIDIARY****CONSOLIDATED STATEMENTS OF FINANCIAL CONDITION**

	June 30, 2007 (Unaudited)	December 31, 2006
	(Dollars in thousands, except per share amounts)	
<b>ASSETS</b>		
Cash and due from banks	\$ 10,368	\$ 9,070
Interest bearing deposits	907	1,211
Federal funds sold	31	8,401
<b>Cash and Cash Equivalents</b>	<b>11,306</b>	18,682
Securities available for sale	106,612	108,016
Federal Home Loan Bank stock, at cost	2,463	2,481
Loans receivable, net of allowance for loan losses \$1,300 and \$1,257	209,032	205,677
Premises and equipment, net	7,171	7,234
Accrued interest receivable	1,436	1,404
Bank owned life insurance	9,954	9,749
Other assets	1,186	994
<b>Total Assets</b>	<b>349,160</b>	\$ 354,237
<b>LIABILITIES AND STOCKHOLDERS EQUITY</b>		
<b>LIABILITIES</b>		
Deposits:		
Interest bearing	\$ 230,081	\$ 232,179
Non-interest bearing	17,404	17,458
<b>Total Deposits</b>	<b>247,485</b>	249,637
Short-term borrowings	11,225	10,605
Long-term debt	31,490	32,750
Advances from borrowers for taxes and insurance	2,369	2,545
Other liabilities	4,559	4,953
<b>Total Liabilities</b>	<b>\$ 297,128</b>	\$ 300,490
<b>COMMITMENTS AND CONTINGENCIES</b>		
<b>STOCKHOLDERS EQUITY</b>		
Common stock, \$0.01 par value per share, 25,000,000 shares authorized; 6,612,500 shares issued and 6,463,719 outstanding	\$ 66	\$ 66
Additional paid-in capital	27,598	27,537

Edgar Filing: Lake Shore Bancorp, Inc. - Form 10-Q

Treasury stock, at cost (148,781 shares at June 30, 2007)	(1,852)	
Unearned shares held by ESOP	(2,430)	(2,473)
Unearned shares held by RRP	(1,467)	(1,565)
Retained earnings	30,499	30,063
Accumulated other comprehensive income (loss)	(382)	119
<b>Total Stockholders Equity</b>	<b>52,032</b>	<b>53,747</b>
<b>Total Liabilities and Stockholders Equity</b>	<b>\$ 349,160</b>	<b>\$ 354,237</b>

*See notes to consolidated financial statements.*

**Table of Contents****LAKE SHORE BANCORP, INC. and SUBSIDIARY****CONSOLIDATED STATEMENTS OF INCOME**

	<b>Three Months Ended</b>		<b>Six Months Ended</b>	
	<b>June 30,</b>		<b>June 30,</b>	
	<b>2007</b>	<b>2006</b>	<b>2007</b>	<b>2006</b>
	<b>(Unaudited)</b>			
	<b>(In Thousands, except per share amounts)</b>			
<b>INTEREST INCOME</b>				
Loans, including fees	<b>\$ 3,124</b>	\$ 3,117	\$ 6,326	\$ 6,213
Investment securities, taxable	<b>1,172</b>	1,072	2,323	2,113
Investment securities, tax-exempt	<b>89</b>	35	163	60
Other	<b>41</b>	285	111	392
<b>Total Interest Income</b>	<b>4,426</b>	4,509	8,923	8,778
<b>INTEREST EXPENSE</b>				
Deposits	<b>1,753</b>	1,394	3,476	2,733
Short-term borrowings	<b>145</b>	150	294	345
Long-term debt	<b>320</b>	373	639	720
Other	<b>30</b>	43	60	83
<b>Total Interest Expense</b>	<b>2,248</b>	1,960	4,469	3,881
<b>Net Interest Income</b>	<b>2,178</b>	2,549	4,454	4,897
<b>PROVISION FOR LOAN LOSSES</b>		11	45	11
<b>Net Interest Income after Provision for Loan Losses</b>	<b>2,178</b>	2,538	4,409	4,886
<b>NON-INTEREST INCOME</b>				
Service charges and fees	<b>360</b>	367	701	687
Earnings on bank owned life insurance	<b>103</b>	49	205	94
Other	<b>29</b>	22	55	50
<b>Total Non-Interest Income</b>	<b>492</b>	438	961	831
<b>NON-INTEREST EXPENSES</b>				
Salaries and employee benefits	<b>1,199</b>	1,128	2,503	2,371
Occupancy and equipment	<b>319</b>	349	668	723
Data processing	<b>126</b>	108	239	218
Advertising	<b>67</b>	70	108	138
Postage and supplies	<b>58</b>	55	126	143
Professional services	<b>346</b>	238	605	423
Other	<b>182</b>	215	388	421
<b>Total Non-Interest Expenses</b>	<b>2,297</b>	2,163	4,637	4,437
<b>Income before Income Taxes</b>	<b>373</b>	813	733	1,280
<b>INCOME TAXES</b>	<b>71</b>	267	133	417
<b>Net Income</b>	<b>\$ 302</b>	\$ 546	\$ 600	\$ 863

Edgar Filing: Lake Shore Bancorp, Inc. - Form 10-Q

<b>Basic earnings per common share</b>	<b>\$ 0.05</b>	\$ 0.09	\$ 0.10	\$ 0.09
<b>Diluted earnings per common share</b>	<b>\$ 0.05</b>	\$ 0.09	\$ 0.10	\$ 0.09
<b>Dividends declared per share</b>	<b>\$ 0.03</b>	\$	\$ 0.06	\$

*See notes to consolidated financial statements.*

**Table of Contents****LAKE SHORE BANCORP, INC. and SUBSIDIARY****CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY**

Six Months Ended June 30, 2007 and 2006 (Unaudited)

	Common Stock	Additional Paid-in Capital	Treasury Stock	Unearned Shares held by ESOP	Unearned Shares held by RRP (In Thousands)	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Total
<b>BALANCE DECEMBER 31, 2005</b>	\$	\$	\$	\$	\$	\$ 28,326	\$ (331)	\$ 27,995
Net income						863		863
Comprehensive income:								
Change in unrealized net gains on securities available for sale, net of tax and reclassification adjustment							(859)	(859)
<b>TOTAL COMPREHENSIVE INCOME</b>								4
Initial capitalization of MHC						(100)		(100)
Issuance of common stock, net of offering costs (6,612,500 shares)	66	27,621						27,687
Common shares acquired by ESOP (238,500 shares)				(2,558)				(2,558)
<b>BALANCE JUNE 30, 2006</b>	\$ 66	\$ 27,621	\$	\$ (2,558)	\$	\$ 29,089	\$ (1,190)	\$ 53,028
<b>BALANCE DECEMBER 31, 2006</b>	\$ 66	\$ 27,537	\$	\$ (2,473)	\$ (1,565)	\$ 30,063	\$ 119	\$ 53,747
Net income						600		600
Comprehensive income:								
Change in unrealized net gains on securities available for sale, net of tax and reclassification adjustment							(501)	(501)
<b>TOTAL COMPREHENSIVE INCOME</b>								99
ESOP shares earned (3,968 shares)		6		43				49
Stock based compensation		69						69
RRP shares earned ( 7,321 shares)		(14)			98			84
Purchase of treasury stock, at cost			(1,852)					(1,852)
Cash dividends declared (\$0.06 per share)						(164)		(164)
<b>BALANCE JUNE 30, 2007</b>	\$ 66	\$ 27,598	\$ (1,852)	\$ (2,430)	\$ (1,467)	\$ 30,499	\$ (382)	\$ 52,032

See notes to consolidated financial statements.



**Table of Contents****LAKE SHORE BANCORP, INC. and SUBSIDIARY****CONSOLIDATED STATEMENTS OF CASH FLOWS**

	<b>Six Months Ended June 30, 2007      2006 (Unaudited) (In Thousands)</b>	
<b>CASH FLOWS FROM OPERATING ACTIVITIES</b>		
Net income	\$ 600	\$ 863
Adjustments to reconcile net income to net cash provided by operating activities:		
Net gains on sales of loans		(1)
Net amortization of investment securities premium	2	6
Provision for loan losses	45	11
Depreciation and amortization	272	347
Earnings on bank owned life insurance	(205)	(94)
ESOP shares committed to be released	49	
Stock based compensation expense	153	
Increase in accrued interest receivable	(32)	(48)
Decrease in other assets	140	897
Increase (decrease) in other liabilities	(394)	1,001
<b>Net Cash Provided by Operating Activities</b>	<b>630</b>	<b>2,982</b>
<b>CASH FLOWS FROM INVESTING ACTIVITIES</b>		
Activity in available for sale securities:		
Maturities, prepayments and calls	8,531	9,944
Purchases	(7,923)	(17,076)
Activity in held to maturity securities:		
Maturities, prepayments and calls		45
Purchases of Federal Home Loan Bank Stock	(326)	(417)
Redemptions of Federal Home Loan Bank Stock	344	519
Proceeds from sales of loans	32	308
Loan origination and principal collections, net	(3,466)	568
Additions to premises and equipment	(214)	(182)
<b>Net Cash Used in Investing Activities</b>	<b>(3,022)</b>	<b>(6,291)</b>
<b>CASH FLOWS FROM FINANCING ACTIVITIES</b>		
Net decrease in deposits	(2,152)	(6,337)
Net decrease in advances from borrowers for taxes and insurance	(176)	(104)
Net increase (decrease) in short-term borrowings	620	(2,900)
Proceeds from issuance of long-term debt		3,500
Repayment of long-term debt	(1,260)	(2,960)
Proceeds from issuance of common stock, net of offering costs		27,687
Cash provided to ESOP for purchase of shares		(2,558)
Purchase of Treasury Stock	(1,852)	
Cash dividends paid	(164)	
Dividends to capitalize MHC		(100)
<b>Net Cash Provided by (Used in) Financing Activities</b>	<b>(4,984)</b>	<b>16,228</b>
<b>Net Increase (Decrease) in Cash and Cash Equivalents</b>	<b>(7,376)</b>	<b>12,919</b>

Edgar Filing: Lake Shore Bancorp, Inc. - Form 10-Q

CASH AND CASH EQUIVALENTS	BEGINNING	18,682	12,053
CASH AND CASH EQUIVALENTS	ENDING	\$ 11,306	\$ 24,972
<b>SUPPLEMENTARY CASH FLOWS INFORMATION</b>			
Interest paid		\$ 4,562	\$ 3,759
Income taxes paid		\$ 632	\$ 190
<b>SUPPLEMENTARY SCHEDULE OF NONCASH INVESTING AND FINANCING ACTIVITIES</b>			
Foreclosed real estate acquired in settlement of loans		\$ 34	\$ 167
<i>See notes to consolidated financial statements.</i>			

**Table of Contents**

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

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)**

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

Lake Shore Bancorp, Inc. (the Company) was formed on April 3, 2006 to serve as the stock holding company for Lake Shore Savings Bank (the Bank) as part of the Bank's conversion and reorganization from a New York-chartered mutual savings and loan association to the federal mutual holding company form of organization. For a further discussion of the Company's formation and operations, see the Company's registration statement on Form S-1, as amended, which was declared effective by the Securities and Exchange Commission on February 13, 2006 (File Number 333-129439).

The interim financial statements included herein as of June 30, 2007 and for the three and six months ended June 30, 2007 and 2006 have been prepared by the Company, without audit, pursuant to the rules and regulations of the Securities and Exchange Commission, and therefore, do not include all information or footnotes necessary for a complete presentation of financial condition, results of operations and cash flows in conformity with accounting principles generally accepted in the United States of America. The financial statements reflect all adjustments that are, in the opinion of management, necessary for a fair statement of such information. These interim financial statements should be read in conjunction with the financial statements and notes thereto included in the audited financial statements included in the Company's Form 10-K for the period ended December 31, 2006. The results of operations for the three and six months ended June 30, 2007 are not necessarily indicative of the results for any subsequent period or the entire year ending December 31, 2007.

To prepare these financial statements in conformity with generally accepted accounting principles, 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.

**NOTE 2 STOCK OFFERING**

The Company completed its initial public stock offering on April 3, 2006. Prior to that time, the Bank was a mutual savings and loan association. The Company sold 2,975,625 shares, or 45% of its outstanding common stock, to subscribers in the offering. Lake Shore, MHC, a federally-chartered mutual holding company holds 3,636,875 shares, or 56% of the Company's outstanding common stock.

Net proceeds from the stock offering amounted to approximately \$ 27.7 million. Expenses related to the offering were approximately \$2.1 million. One half of the proceeds were retained by the Company. The remaining proceeds were contributed to the Bank. The Company utilized \$2.6 million of the proceeds to extend a loan to an employee stock ownership plan (the ESOP). As of June 30, 2007, the ESOP had used \$2.6 million in loan proceeds to purchase 238,050 shares of stock on the open market at an average price of \$10.70 per share, plus commission expenses. As a result of the purchase of shares by the ESOP, total stockholders' equity of the Company was reduced by \$2.6 million.

---

**Table of Contents**

**NOTE 3 DERIVATIVE INSTRUMENTS**

In August 2006, the Company entered into a derivative contract as part of its risk management strategy to protect against market fluctuations in interest rates. An interest rate floor was purchased for \$221,000 to protect against a decline in the prime rate earned on a \$10 million notional amount of adjustable rate loans within our portfolio. The term of the interest rate floor product is 60 months. The Company follows Statement of Financial Accounting Standards ( SFAS ) No. 133, Accounting for Derivative Instruments and Hedging Activities, as amended, to account for this transaction. SFAS No. 133 requires an entity to recognize all derivatives as either assets or liabilities on the balance sheet and measure those instruments at fair value. Changes in the fair value of derivatives must be recognized in earnings when they occur, unless the derivative qualifies as a hedge. If a derivative qualifies as a hedge, a company can elect to use hedge accounting to eliminate or reduce income statement volatility that would arise from reporting changes in a derivative s fair value in income. The Company did not elect to use hedge accounting for this transaction. The interest rate floor is recorded in Other Assets on the Consolidated Statement of Financial Condition and the change in fair value is recorded in Loan Interest Income on the Consolidated Statement of Income. As of June 30, 2007 and December 31, 2006, respectively, the fair market value of the interest rate floor was \$119,000 and \$220,000, resulting in \$101,000 of interest expense for the six months ended June 30, 2007.

**NOTE 4 RECENT ACCOUNTING PRONOUNCEMENTS**

In July 2006, the FASB issued FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes an interpretation of FASB Statement No. 109 ( FIN 48 ), which clarifies the accounting for uncertainty in tax positions. This Interpretation requires that companies recognize in their financial statements the impact of a tax position, if that position is more likely than not of being sustained on audit, based on the technical merits of the position. The provisions of FIN 48 are effective for fiscal years beginning after December 15, 2006, with the cumulative effect of the change in accounting principle recorded as an adjustment to opening retained earnings. The Company adopted FIN 48 on January 1, 2007 and FIN 48 did not have a material impact on the Company s consolidated financial position and results of operations.

In May 2007, the FASB issued FASB Staff Position ( FSP ) FIN 48-1 Definition of Settlement in FASB Interpretation No. 48 (FSP FIN 48-1). FSP FIN 48-1 provides guidance on how to determine whether a tax position is effectively settled for the purpose of recognizing previously unrecognized tax benefits. FSP FIN 48-1 is effective retroactively to January 1, 2007. The implementation of this standard did not have a material impact on our consolidated financial position or results of operations.

In September 2006, the FASB issued SFAS No. 157, Fair Value Measurements (SFAS 157), which defines fair value, establishes a framework for measuring fair value under accounting principles generally accepted in the United States of America, and expands disclosures about fair value measurements. SFAS No. 157 applies to other accounting pronouncements that require or permit fair value measurements. The new guidance is effective for financial statements issued for fiscal years beginning after November 15, 2007, and for interim periods within those fiscal years. The Company is currently evaluating the potential impact, if any, of the adoption of SFAS No. 157 on its consolidated financial position, results of operations and cash flows.

In February 2007, the FASB issued SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities-including an amendment of FASB Statement No. 115. SFAS No. 159 permits entities to choose to measure many financial instruments and certain other items at fair value. Unrealized gains and losses on items for which the fair value option has been elected will be recognized in earnings at each subsequent reporting date. SFAS No. 159 is effective for the Company on January 1, 2008. The Company is evaluating the impact that the adoption of SFAS No. 159 will have on its consolidated financial statements.

**Table of Contents**

In March 2007, the FASB ratified EITF Issue No. 06-11, Accounting for Income Tax Benefits of Dividends on Share-Based Payment Awards. EITF 06-11 requires companies to recognize the income tax benefit realized from dividends or dividend equivalents that are charged to retained earnings and paid to employees for nonvested equity-classified employee share-based payment awards as an increase to additional paid-in capital. EITF 06-11 is effective for fiscal years beginning after September 15, 2007. The Company does not expect EITF 06-11 to have a material impact on its financial position, results of operations or cash flows.

In September 2006, the FASB's Emerging Issues Task Force (EITF) issued EITF Issue No. 06-4, Accounting for Deferred Compensation and Postretirement Benefit Aspects of Endorsement Split Dollar Life Insurance Arrangements (EITF 06-4). EITF 06-4 requires the recognition of a liability related to the postretirement benefits covered by an endorsement split-dollar life insurance arrangement. The consensus highlights that the employer (who is also the policyholder) has a liability for the benefit it is providing to its employee. As such, if the policyholder has agreed to maintain the insurance policy in force for the employee's benefit during his or her retirement, then the liability recognized during the employee's active service period should be based on the future cost of insurance to be incurred during the employee's retirement. Alternatively, if the policy holder has agreed to provide the employee with a death benefit, then the liability for the future death benefit should be recognized by following the guidance in SFAS No. 106 or Accounting Principals Board (APB) Opinion No. 12, as appropriate. For transition, an entity can choose to apply the guidance using either of the following approaches: (a) a change in accounting principle through retrospective application to all periods presented or (b) a change in accounting principle through a cumulative-effect adjustment to the balance in retained earnings at the beginning of the year of adoption. The disclosures are required in fiscal years beginning after December 15, 2007, with early adoption permitted. The Company does not believe that the implementation of this guidance will have a material impact on the Company's consolidated financial statements.

On September 7, 2006, the Task Force reached a conclusion on EITF Issue No. 06-5, Accounting for Purchases of Life Insurance - Determining the Amount That Could Be Realized in Accordance with FASB Technical Bulletin No. 85-4, Accounting for Purchases of Life Insurance (EITF 06-5). The scope of EITF 06-5 consists of six separate issues relating to accounting for life insurance policies purchased by entities protecting against the loss of key persons. The six issues are clarifications of previously issued guidance on FASB Technical Bulletin No. 85-4. EITF 06-5 is effective for fiscal years beginning after December 15, 2006. The Company has evaluated the potential impact on the Company's consolidated financial statements and determined that the impact is minimal.

**Note 5 COMPREHENSIVE INCOME (LOSS)**

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

The components of other comprehensive income (loss) and related tax effects for the three and six months ended June 30, 2007 and 2006 are as follows:

	Three Months Ended June 30, 2007		Six Months Ended June 30, 2007	
	2006	2007	2006	2006
	(Unaudited)			
	(In Thousands)			
Unrealized holding losses on securities available for sale	\$ (910)	\$ (560)	\$ (794)	\$ (1,364)
Reclassification adjustment for (gains) losses realized in income				
<b>Net Unrealized Losses</b>	(910)	(560)	(794)	(1,364)
Income tax effect	337	207	293	505
<b>Net of Tax Amount</b>	\$ (573)	\$ (353)	\$ (501)	\$ (859)

**Table of Contents****NOTE 6 EARNINGS PER SHARE**

Earnings per share is calculated for the three and six month period ending June 30, 2007. The earnings per share for the three months ended June 30, 2006 is calculated for the period after the offering was closed and stock issued on April 3, 2006. The Company had no dilutive securities as of June 30, 2006. Basic net income per share is based upon the weighted average number of common shares outstanding, while diluted net income per share is based upon the weighted average number of common shares outstanding and common share equivalents that would arise from the exercise of dilutive securities.

The difference between the common shares issued and the common shares outstanding, for the purposes of calculating basic earnings per share, is a result of the unallocated ESOP, restricted stock shares, and treasury stock.

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

	<b>Three Months ending June 30, 2007</b>	<b>Three Months ending June 30, 2006</b>
Numerator net income	\$ 302,000	\$ 546,000
Denominators:		
Basic weighted average shares outstanding	6,263,852	6,374,450
Increase in weighted average shares outstanding due to:		
Stock options		
Unvested restricted stock awards	2,488	
Diluted shares outstanding	6,266,339	6,374,450
Earnings per share:		
Basic	\$ 0.05	\$ 0.09
Diluted	\$ 0.05	\$ 0.09

**Table of Contents**

	Six Months ending June 30, 2007	Six Months ending June 30, 2006
Numerator net income	\$ 600,000	\$ 546,000
Denominators:		
Basic weighted average shares outstanding	6,270,889	6,374,450
Increase in weighted average shares outstanding due to:		
Stock options		
Unvested restricted stock awards	1,331	
<b>Diluted shares outstanding</b>	<b>6,272,220</b>	<b>6,374,450</b>
Earnings per share:		
Basic	\$ 0.10	\$ 0.09
Diluted	\$ 0.10	\$ 0.09

**NOTE 7 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:

	Contract Amount	
	June 30, 2007	December 31, 2006
	(In Thousands)	
Commitments to grant loans	\$ 6,283	\$ 5,671
Unfunded commitments under lines of credit	\$ 21,052	\$ 21,298

Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Commitments generally have fixed expiration dates or other termination clauses. The commitments for lines of credit may expire without being drawn upon. Therefore, the total commitment amounts do not necessarily represent future cash requirements. The amount of collateral obtained, if it is deemed necessary by the Company, is based on management's credit evaluation of the customer. At June 30, 2007 and December 31, 2006, the Company's fixed rate loan commitments totaled \$5.1 million and \$3.9 million, respectively. The range of interest rates on these fixed rate commitments was 5.45% to 10.50% at June 30, 2007.

**Table of Contents****NOTE 8 STOCK-BASED COMPENSATION**

As of June 30, 2007, the Company had three stock-based compensation plans, which are described below. The Company accounts for the fair value of its grants under those plans in accordance with SFAS 123R, Share Based Payment. The Company granted stock options for the first time in 2006. The compensation cost that has been charged against income for these plans was \$101,000 for the three months ending June 30, 2007 and \$202,000 for the six months ending June 30, 2007.

**Stock Option Plan**

The Company's 2006 Stock Option Plan (the Stock Option Plan), which is shareholder-approved, permits the grant of share 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 option equals the market price of the Company's stock on the date of grant and an option's maximum term is ten years. The options generally vest over a five year period.

The fair value of each option grant is estimated on the date of grant using the Black-Scholes option-pricing model with the following assumptions: dividend yield of 1.04%; expected volatility of 9.64%; risk-free interest rate of 4.617%; and expected life of 10 years.

A summary of the status of the Company's stock option plan as of June 30, 2007 is presented below:

	Options	2007 Exercise Price
Outstanding at beginning of year	241,546	\$ 11.50
Granted		
Outstanding as of June 30, 2007	241,546	\$ 11.50
Options exercisable as of June 30, 2007		
Fair value of options granted	\$ 3.27	

At June 30, 2007, stock options outstanding had an intrinsic value of \$121,000 and 56,016 options remain unawarded. At June 30, 2007, \$702,000 of unrecognized compensation cost related to stock options is expected to be recognized over a period of 54 months.

**Recognition and Retention Plan**

The Company's 2006 Recognition and Retention Plan (the RRP), which is shareholder-approved, permits the grant of restricted stock awards ( Awards ) to employees and non-employee directors for up to 119,025 shares of common stock. Shares vest at a rate of 20% per year with the first vesting period ending December 31, 2007. On November 15, 2006, the Board of Directors granted 83,305 shares under the RRP Plan to members of management and non-employee directors. The fair value of the common stock on the grant date was \$11.50. As of June 30, 2007, there were no shares vested or distributed to eligible participants. Compensation expense amounted to \$42,000 for the three months ended June 30, 2007 and \$84,000 for the six months ending June 30, 2007 based on 3,642 shares and 7,321 shares earned, respectively, through those dates. At June 30, 2007, \$852,000 of unrecognized compensation cost related to the RRP plan is expected to be recognized over a period of 54 months.

**Employee Stock Ownership Plan**

In connection with the stock offering, the Company established the Employee Stock Ownership Plan of Lake Shore Bancorp, Inc. ( ESOP ) for the benefit of eligible employees of the Company and the Bank.



**Table of Contents**

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. As of June 30, 2007, there were 230,115 unallocated shares, having an aggregate market value of \$2.4 million. The ESOP compensation expense was \$24,000 for the three months ending June 30, 2007 and \$49,000 for the six months ending June 30, 2007, based on 1,984 and 3,968 shares earned, respectively, for those periods.

**NOTE 9 TREASURY STOCK**

During the quarter ended June 30, 2007, the Company repurchased 148,781 shares of common stock at an average cost of \$12.45 per share, pursuant to the Company's publicly announced common stock repurchase program. As of June 30, 2007, all of the shares authorized by the plan had been repurchased.

**NOTE 10 SUBSEQUENT EVENTS**

On July 25, 2007, the Board of Directors declared a quarterly dividend of \$0.03 per share on the Company's common stock, payable on August 15, 2007 to shareholders of record as of August 3, 2007. Lake Shore, MHC, which owns 56% of the Company's outstanding common stock elected to waive its right to receive cash dividends of approximately \$109,000 for the three month period ending June 30, 2007 and \$218,000 for the six month period ending June 30, 2007. Lake Shore, MHC has waived approximately \$327,000 of cash dividends cumulatively as of June 30, 2007. The dividends waived by Lake Shore, MHC are considered a restriction on the retained earnings of the Company.

## **Table of Contents**

### **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, in 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, 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;

our ability to effectively deploy the capital raised in our April 2006 initial public offering;

changes in accounting principles, policies or guidelines;

our success in managing the risks involved in our business;

inflation, and market and monetary fluctuations;

changes in legislation or regulation; 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**

Lake Shore Savings and Loan Association completed its reorganization from a New York State-chartered mutual savings and loan association into the federal mutual holding company form of organization on April 3, 2006. In connection with the reorganization, Lake Shore Savings and Loan Association changed its name to Lake Shore Savings Bank. When used herein, the name Lake Shore Savings refers to either Lake Shore Savings and Loan Association or Lake Shore Savings Bank, as context requires.

Edgar Filing: Lake Shore Bancorp, Inc. - Form 10-Q

As part of the reorganization, Lake Shore Bancorp was organized as a federally-chartered corporation,

## **Table of Contents**

registered as a savings and loan holding company with the Office of Thrift Supervision. Lake Shore Savings became a wholly-owned subsidiary of Lake Shore Bancorp. In connection with the reorganization, Lake Shore Bancorp sold 2,975,625 shares of its common stock to the public, representing 45% of its outstanding shares, at a price of \$10.00 per share. The remaining 3,636,875 shares, or 55% of its outstanding shares, were issued to Lake Shore, MHC. Lake Shore, MHC, a federal mutual holding company registered as a savings and loan holding company with the Office of Thrift Supervision (OTS), was formed as part of the reorganization.

The following discussion and analysis is presented to assist in the understanding and evaluation of our consolidated financial condition and results of operations. It is intended to complement the unaudited consolidated financial statements and notes thereto appearing elsewhere in this Form 10-Q and should be read in conjunction therewith. The detailed discussion focuses on our consolidated financial condition as of June 30, 2007 compared to the financial condition as of December 31, 2006 and the consolidated results of operations for the three and six months ended June 30, 2007 and 2006.

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 we pay on deposits and other interest-bearing liabilities. Net interest income is affected by the relative amounts of interest-earning assets and interest-bearing liabilities and the interest rates we earn or pay on these balances.

Our operations are also affected by non-interest income, such as service 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 costs, and other general and administrative expenses.

Financial institutions like us 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.

## **Management Strategy**

***Our Reputation.*** With more than 115 years of service to our community, our primary management strategy has been to maintain our reputation as one of the most respected and recognized community banks in Western New York. We strive to accomplish this goal by continuing to emphasize our high quality customer service and financial strength. We are one of the largest lenders in market share of residential mortgages in Chautauqua County.

***Branching.*** In 2003, we opened new branch offices in Orchard Park and East Amherst, New York. These new offices have generated deposits of \$25.2 million and \$16.0 million as of June 30, 2007, respectively. We also opened a new branch office in Hamburg, New York in December 2005, which has generated deposits of \$11.0 million as of June 30, 2007. Our offices are located in Dunkirk, Fredonia, Jamestown, Lakewood and Westfield, in Chautauqua County, New York and in East Amherst, Hamburg and Orchard Park 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.

***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 employees constitute one of our competitive strengths. Thus, the retention of such persons and our ability to continue to attract high quality personnel are high priorities.

---

**Table of Contents**

**Residential Mortgage and Other Lending.** Historically, our lending portfolio has been composed predominantly of residential mortgage loans. At June 30, 2007 and December 31, 2006, we held \$150.7 million and \$149.4 million of residential mortgage loans, respectively, which constituted 72.2% and 72.7% of our total loan portfolio, at such respective dates. We also originate commercial real estate loans to finance the purchase of real property, which generally consists of developed real estate. At June 30, 2007 and December 31, 2006, our commercial real estate loan portfolio consisted of loans totaling \$17.6 million and \$17.2 million respectively, or 8.4% and 8.3%, 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 June 30, 2007 and December 31, 2006, our commercial loan portfolio consisted of loans totaling \$8.0 million and \$8.7 million, respectively, or 3.8% and 4.3%, respectively, of total loans. Other loan products offered to our customers include home equity loans, construction loans and consumer loans, including auto loans, overdraft lines of credit and share loans. We will sell loans when appropriate and will retain servicing rights to those loans. We will invest excess funds in permissible investments such as mortgage-backed securities and asset-backed securities, when such investment opportunities are prudent. 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. At June 30, 2007 and December 31, 2006, our investment securities totaled \$109.1 million and \$110.5 million, respectively.

**Inverted Yield Curve.** As with most banks, we face a challenge in monitoring our interest rate risk with an inverted yield curve. Banks generate revenue on the difference between the interest earned on loans, which are generally for longer terms, and the interest paid on deposits, which are generally for shorter terms. This mismatch between shorter term deposits and longer term loans usually produces a positive contribution to earnings because the yield curve is normally positively sloped. Since May 2004, the Federal Reserve has increased the short-term federal funds rate. During this time frame, short and intermediate term interest rates have risen, while some long term rates, most notably the yield on 30 year U.S. Treasury bonds, have declined. The yield curve is now inverted with short term interest rates higher than long term rates. In this environment, the margin between interest earning assets and interest bearing liabilities is shrinking, resulting in reduced net interest income. The rate earned on new investments and loans may not offset the cost of repricing deposits and borrowings. In addition, borrowers that have adjustable rate loans may opt to prepay their loans rather than pay more interest because loan rates have adjusted higher. Adjustable rate loans are generally tied to short term indexes that move in conjunction with the changes in interest rates orchestrated by the Federal Reserve. If we experience a high level of prepayments on adjustable rate loans, that could reduce interest income.

The inverted yield curve makes it difficult to execute an organic growth strategy to improve income. Most depositors prefer shorter term deposits. When banks have to pay higher rates to attract new deposits, the marginal cost may exceed the marginal revenue earned on new loans or investments, due in part because short term rates are higher than long term rates. Attracting short term deposits may also increase the repricing mismatch between assets and liabilities. Our strategy of maintaining and increasing our interest income in an inverted yield curve environment is to retain deposits at reasonable costs by providing excellent customer service, and by engaging a third party financial advisor to assist us in investing such deposits in attractive permissible investment securities. At June 30, 2007 and December 31, 2006, we had \$106.6 million and \$108.0 million, respectively, in investment in securities available for sale, the majority of which are mortgage-backed or asset backed securities. All of our mortgage-backed

## **Table of Contents**

and asset-backed securities are rated AAA or are guaranteed by an agency of the federal government. We do not own any collateralized debt obligations (CDOs). In August 2006, we entered into a derivative contract as part of our risk management strategy to protect against market fluctuation in interest rates. An interest rate floor was purchased for \$221,000 to protect against a decline in the prime rate earned on home equity adjustable loans within our loan portfolio. Refer to Note 3 of Notes to our Consolidated Financial Statements for more information.

### **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 quarterly 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 the local area, concentrations of risk and decline in local property values.

Our evaluation of risk in maintaining the allowance for loan losses includes the review of all loans on which the collectibility of principal may not be reasonably assured. We consider the following factors as part of this evaluation: historical loan loss experience, payment status, the estimated value of the underlying collateral, loans originated in areas outside of the historic market area for loan activity, trends in loan volume, and national and local economic conditions. There may be other factors that may warrant consideration in maintaining an allowance at a level sufficient to provide for probable loan losses. Although our management believes that it has established and maintained the allowance for loan losses to reflect losses inherent in our loan portfolio, based on its evaluation of the factors noted above, future additions may be necessary if economic and other conditions differ substantially from the current operating environment.

The allowance consists of allocated, general and unallocated components. The allocated component relates to loans that are classified as doubtful, substandard or special mention. For such loans that are also classified as impaired, an allowance is established when the discounted cash flows (or collateral value or observable market price) of the impaired loan is lower than the carrying value for that loan. The general component covers non-classified loans and is based on historical loss experience adjusted for qualitative factors. An unallocated component is maintained to cover uncertainties that could affect management's estimate of probable losses. The unallocated component of the allowance reflects the margin of imprecision inherent in the underlying assumptions used in the methodologies for estimating specific and general losses in the portfolio.

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 results of operations. A decline in the fair value of investments below cost deemed to be other than temporary is 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 other than temporary impairment.

These critical policies and their application are reviewed periodically by our Audit 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 the consolidated financial statements of our audited consolidated financial statements included in Form 10-K for the year ended December 31, 2006 to better understand how our financial performance is reported.

**Table of Contents**

**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 time deposits. 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.

**Table of Contents**

**Average Balances, Interest and Average Yields.** The following tables set forth certain information relating to our average balance sheets and reflects the average yields on interest-earnings 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 income or expense by the average balance of interest-earning assets or interest-bearing liabilities, respectively, for the periods presented. 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 municipals.

	At June 30, 2007		For the Three Months ended June 30, 2007			For the Three Months ended June 30, 2006		
	Actual Balance	Yield/ Rate	Average Balance	Interest Income/ Expense	Yield/ Rate	Average Balance	Interest Income/ Expense	Yield/ Rate
<b>Interest-earning assets:</b>								
Federal funds sold & other interest-bearing deposits	\$ 938	5.11%	\$ 4,697	\$ 41	3.49%	\$ 25,726	\$ 285	4.43%
Securities	109,075	4.56%	110,181	1,261	4.58%	102,798	1,107	4.31%
Loans	209,032	6.05%	206,846	3,124	6.04%	204,961	3,117	6.08%
Total interest-earning assets	319,045	5.59%	321,724	4,426	5.50%	333,485	4,509	5.41%
Other assets	30,115		25,654			24,027		
Total assets	\$ 349,160		\$ 347,378			\$ 357,512		
<b>Interest-bearing liabilities:</b>								
Demand and NOW accounts	\$ 39,108	0.63%	\$ 37,347	\$ 62	0.66%	\$ 37,197	\$ 47	0.51%
Money market accounts	25,156	1.34%	25,474	87	1.37%	25,789	62	0.96%
Savings accounts	27,413	0.48%	27,073	34	0.50%	21,595	35	0.65%
Time deposits	138,404	4.51%	140,340	1,570	4.47%	139,650	1,250	3.58%
Borrowed funds	42,715	4.37%	42,153	465	4.41%	50,352	523	4.15%
Advances from borrowers on taxes and insurance***						2,115	12	2.27%
Other interest-bearing liabilities	1,394	8.61%	1,396	30	8.60%	1,416	31	8.76%
Total interest bearing liabilities	274,190	3.26%	273,783	2,248	3.28%	278,114	1,960	2.82%
<b>Other non-interest bearing liabilities</b>								
Stockholders equity	22,938		20,239			37,280		
Total liabilities and stockholders equity	\$ 349,160		\$ 347,378			\$ 357,512		
Net interest income				\$ 2,178			\$ 2,549	
Interest rate spread					2.22%			2.59%
Net interest margin					2.71%			3.06%

\*\*\* Beginning in July 2006, we no longer paid interest on funds held in escrow accounts. In 2007, the balance of funds in escrow accounts is included in the other non-interest bearing liabilities section.



**Table of Contents**

	At June 30, 2007		For the Six Months ended June 30, 2007			For the Six Months ended June 30, 2006		
	Actual	Yield/	Average	Interest Income/	Yield/	Average	Interest Income/	Yield/
	Balance	Rate	Balance	Expense	Rate	Balance	Expense	Rate
(Dollars in thousands)								
<b>Interest-earning assets:</b>								
Federal funds sold & other interest-bearing deposits	\$ 938	5.11%	\$ 5,746	\$ 111	3.86%	\$ 18,495	\$ 392	4.24%
Securities	109,075	4.56%	110,104	2,486	4.52%	103,030	2,173	4.22%
Loans	209,032	6.05%	206,136	6,326	6.14%	205,215	6,213	6.06%
Total interest-earning assets	319,045	5.59%	321,986	8,923	5.54%	326,740	8,778	5.37%
Other assets	30,115		25,738			23,916		
Total assets	\$ 349,160		\$ 347,724			\$ 350,656		
<b>Interest-bearing liabilities:</b>								
Demand and NOW accounts	\$ 39,108	0.63%	\$ 37,058	\$ 123	0.66%	\$ 37,294	\$ 92	0.49%
Money market accounts	25,156	1.34%	25,191	168	1.33%	26,578	124	0.93%
Savings accounts	27,413	0.48%	26,607	66	0.50%	24,875	70	0.56%
Time deposits	138,404	4.51%	141,189	3,119	4.42%	140,755	2,447	3.48%
Borrowed funds	42,715	4.37%	42,517	933	4.39%	52,150	1,065	4.08%
Advances from borrowers on taxes and insurance***						1,863	22	2.36%
Other interest-bearing liabilities	1,394	8.61%	1,399	60	8.58%	1,418	61	8.60%
Total interest bearing liabilities	274,190	3.26%	273,961	4,469	3.26%	284,933	3,881	2.72%
Other non-interest bearing liabilities	22,938		19,792			29,780		
Stockholders' equity	52,032		53,971			35,943		
Total liabilities and stockholders' equity	\$ 349,160		\$ 347,724			\$ 350,656		
Net interest income				\$ 4,454			\$ 4,897	
Interest rate spread					2.28%			2.65%
Net interest margin					2.77%			3.00%

\*\*\* Beginning in July 2006, we no longer paid interest on funds held in escrow accounts. In 2007, the balance of funds in escrow accounts is included in the other non-interest bearing liabilities section.

**Table of Contents**

**Rate Volume Analysis.** The following tables analyzes the dollar amount of changes in interest income and interest expense for major components of interest-earning assets and interest-bearing liabilities. It shows 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.

	<b>Three Months Ended June 30, 2007 Compared to Three Months Ended June 30, 2006</b>		
	<b>Rate</b>	<b>Volume</b>	<b>Net Change</b>
	<b>(Dollars in thousands)</b>		
<b>Interest-earning assets:</b>			
Federal funds sold and other interest-bearing deposits	\$ (50)	\$ (194)	\$ (244)
Securities	72	82	154
Loans	(22)	29	7
<b>Total interest-earning assets</b>		<b>(83)</b>	<b>(83)</b>
<b>Interest-bearing liabilities:</b>			
Demand and NOW accounts	15		15
Money market accounts	26	(1)	25
Savings accounts	(9)	8	(1)
Time deposits	314	6	320
<b>Total deposits</b>	<b>346</b>	<b>13</b>	<b>359</b>
<b>Other interest-bearing liabilities:</b>			
Borrowed funds	31	(89)	(58)
Advances from borrowers on taxes and insurance and other interest-bearing liabilities	(13)		(13)
<b>Total interest-bearing liabilities</b>	<b>364</b>	<b>(76)</b>	<b>288</b>
<b>Net change in interest income</b>	<b>\$ (364)</b>	<b>\$ (7)</b>	<b>\$ (371)</b>

**Table of Contents**

	<b>Six Months Ended June 30, 2007 Compared to Six Months Ended June 30, 2006 (Dollars in thousands)</b>		
	<b>Rate</b>	<b>Volume</b>	<b>Net Change</b>
<b>Interest-earning assets:</b>			
Federal funds sold and other interest-bearing deposits	\$ (32)	\$ (249)	\$ (281)
Securities	159	154	313
Loans	85	28	113
<b>Total interest-earning assets</b>	<b>212</b>	<b>(67)</b>	<b>145</b>
<b>Interest-bearing liabilities:</b>			
Demand and NOW accounts	32	(1)	31
Money market accounts	51	(7)	44
Savings accounts	(9)	5	(4)
Time deposits	664	8	672
<b>Total deposits</b>	<b>738</b>	<b>5</b>	<b>743</b>
<b>Other interest-bearing liabilities:</b>			
Borrowed funds	75	(207)	(132)
Advances from borrowers on taxes and insurance and other interest-bearing liabilities	(23)		(23)
<b>Total interest-bearing liabilities</b>	<b>790</b>	<b>(202)</b>	<b>588</b>
<b>Net change in interest income</b>	<b>\$ (578)</b>	<b>\$ 135</b>	<b>\$ (443)</b>

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 reprice as long-term interest rates increase. Conversely, a majority of our interest-bearing liabilities have much shorter contractual maturities and are expected to reprice. A significant portion of our deposits have no contractual maturities and are likely to reprice 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 portfolio and securities portfolio. An increasing rate environment is expected to cause a further narrowing of our net interest rate spread and a decrease in our earnings. If the current interest rate environment continues, we expect that it will have a negative impact on our results of operations as our interest-bearing liabilities, both deposits and borrowed funds, generally price off short-term interest rates, while our interest-earning assets, both mortgage loans and securities, generally price off long-term interest rates.

For the three months ended June 30, 2007, the average yield/rate on our loan and investment portfolios were 6.04 % and 4.58%, respectively, in comparison to rates of 6.08% and 4.31%, respectively, for the three months ended June 30, 2006. The decrease in yield on our loan portfolio during the 3 months ended June 30, 2007 in comparison to the same period in the prior year is due to the \$110,000 loss incurred on our interest rate floor product during the quarter ended June 30, 2007. This loss is recorded as a deduction to loan interest income. Overall, the average yield/rate on our interest earning assets has increased by 0.09% for the three months ended June 30, 2007 in comparison to the three months ended June 30, 2006. For the three months ended June 30, 2007, the average yield/rate that we were paying on deposit products had increased by 1.30% in comparison to the same period in the prior year. Furthermore, the interest paid on our borrowings had increased from 4.15% to 4.41%. Our interest rate spread for the three months ended June 30, 2007 was 2.22%, which was a 0.37% decrease in comparison to the three months ended June 30, 2006. Our net interest margin was 2.71% and 3.06% as of June 30, 2007 and 2006, respectively.

For the six months ended June 30, 2007, the average yield/rate on our loan and investment portfolios were 6.14% and 4.52%, respectively, in comparison to rates of 6.06% and 4.22%, respectively, for the six months ended June 30, 2006. Overall, the average yield/rate on our interest earning assets has increased

**Table of Contents**

by 0.17% for the six months ended June 30, 2007 in comparison to the six months ended June 30, 2006. For the six months ended June 30, 2007, the average yield/rate that we were paying on deposit products had increased by 1.45% in comparison to the same period in the prior year. Furthermore, the interest paid on our borrowings had increased from 4.08% to 4.39%. Our interest rate spread for the six months ended June 30, 2007 was 2.28%, which was a 0.37% decrease in comparison to the six months ended June 30, 2006. Our net interest margin was 2.77% and 3.00% as of June 30, 2007 and 2006, respectively.

**Comparison of Financial Condition at June 30, 2007 and December 31, 2006**

Total assets at June 30, 2007 were \$349.2 million, a decrease of \$5.0 million from \$354.2 million at December 31, 2006. The decrease in total assets is primarily due to a \$7.4 million decrease in cash and cash equivalents and a \$1.4 million decrease in investment securities, partially offset by a \$3.4 million increase in loans receivable, net.

Cash and cash equivalents decreased by \$7.4 million from \$18.7 million as of December 31, 2006 to \$11.3 million as of June 30, 2007. The decrease is attributable to an \$8.4 million decrease in federal funds sold. Federal funds sold decreased due to cash being utilized to repurchase \$1.9 million of outstanding common stock under our stock repurchase plan during the second quarter. We also utilized cash to pay down \$1.3 million of our long term borrowings. When we originate loans, we typically utilize cash received from loan payments made by our customers to fund new loans. During the six month period ending June 30, 2007, we originated more loans than paydowns received, which required us to utilize approximately \$3.5 million of excess cash on hand for new loan originations. For the six months ended June 30, 2007, we had an overall net decrease in total deposits of \$2.2 million due to the competitive interest rate environment on deposit accounts in our market area. When these deposits were initially received, we used the funds to purchase investment securities. When the funds were withdrawn, we used excess cash to pay for the withdrawals, instead of selling the interest-earning investment securities.

Investment securities decreased by \$1.4 million to \$109.1 million at June 30, 2007 from \$110.5 million at December 31, 2006. The decrease is attributable to the receipt of paydowns from securities within our investment portfolio. We do not have any exposure to sub-prime loans in our investment portfolio. All of our mortgage-backed and asset-backed securities are rated AAA or are guaranteed by an agency of the federal government. We do not own any collateralized debt obligations (CDOs).

Loans receivable, net increased by \$3.3 million to \$209.0 million at June 30, 2007 from \$205.7 million at December 31, 2006. The table below shows the changes in loan volume by loan type between December 31, 2006 and June 30, 2007:

	June 30, 2007	December 31, 2006 (in thousands)	Change	
			\$	%
<b>Real Estate Loans:</b>				
Residential, 1-4 Family	\$ 150,732	\$ 149,408	\$ 1,324	0.9%
Home Equity	25,732	25,896	(164)	(0.6)%
Commercial	17,623	17,150	473	2.8%
Construction	4,121	1,570	2,551	162.5%
	198,208	194,024	4,184	2.2%
Commercial Loans	8,035	8,746	(711)	(8.1)%
Consumer Loans	2,485	2,689	(204)	(7.6)%
<b>Total Gross Loans</b>	<b>208,728</b>	<b>205,459</b>	<b>3,269</b>	<b>1.6%</b>
Allowance for loan losses	(1,300)	(1,257)	(43)	(3.4)%
Net deferred loan costs	1,604	1,475	129	8.7%
<b>Loans receivable, net</b>	<b>\$ 209,032</b>	<b>\$ 205,677</b>	<b>\$ 3,355</b>	<b>1.6%</b>

The increase in commercial real estate loans and construction loans is attributable to our efforts to



**Table of Contents**

increase originations in this area. Residential mortgage loans increased due to increased sales of new and existing homes during the six month period ending June 30, 2007. Mortgage loans and commercial real estate loans represented 72.2% and 8.4%, respectively, of the loan portfolio at June 30, 2007. We do not carry any sub-prime loans in our mortgage portfolio.

The table below shows changes in deposit volumes by type of deposit between December 31, 2006 and June 30, 2007:

	June 30, 2007	December 31, 2006 (in thousands)	Change \$	%
<b>Demand Deposits:</b>				
Non-interest bearing	\$ 17,404	\$ 17,458	\$ (54)	(0.3)%
Interest bearing	39,108	38,992	116	0.3%
Money market	25,156	24,551	605	2.5%
Savings	27,413	25,922	1,491	5.8%
Time deposits	138,404	142,714	(4,310)	(3.0)%
<b>Total Deposits</b>	<b>\$ 247,485</b>	<b>\$ 249,637</b>	<b>\$ (2,152)</b>	<b>(0.9)%</b>

The overall decrease in time deposits may be attributed to the competitive interest rates being offered by other banks, credit unions, mutual funds and financial service groups in our market area and our unwillingness to pay premium rates that will increase our interest expense beyond interest rates that we can obtain when we invest deposit funds in the marketplace.

Our borrowings, consisting of advances from the Federal Home Loan Bank of New York, decreased by \$640,000 from \$43.4 million at December 31, 2006, to \$42.7 million at June 30, 2007.

Total stockholders' equity decreased by \$1.7 million from \$53.7 million at December 31, 2006 to \$52.0 million at June 30, 2007. The decrease in total stockholders' equity was primarily due to the purchase of \$1.9 million in outstanding common stock under our stock repurchase plan during the second quarter. The decrease was offset by net income of \$600,000 for the six months ending June 30, 2007. The stockholders' equity was also affected by a decrease in the net of tax unrealized gain on securities available for sale of \$501,000. Dividends declared and paid in 2007 reduced stockholders' equity by \$164,000 and stock-based compensation expenses increased stockholders' equity by \$202,000.

**Comparison of Results of Operations for the Three Months Ended June 30, 2007 and 2006**

**General.** Net income was \$302,000 for the three months ended June 30, 2007 a decrease of \$244,000, or 44.7%, compared to net income of \$546,000 for the three months ended June 30, 2006. The decrease in net income is attributed to a decrease in net interest income of \$371,000 to \$2.2 million for the three months ended June 30, 2007 from \$2.5 million for the three months ended June 30, 2006. The decrease in net interest income is primarily due to an increase in deposit interest expense of \$359,000. Earnings per share decreased \$0.04 per share, or 44.4% from \$0.09 for the three months ended June 30, 2006 to \$0.05 per share for the three months ended June 30, 2007.

---

**Table of Contents**

**Interest Income.** Interest income decreased \$83,000 or 1.8%, from \$4.5 million for the three months ended June 30, 2006 to \$4.4 million for the three months ended June 30, 2007. A majority of this decrease is due to a \$244,000 decrease in other interest income, from \$285,000 as of June 30, 2006 to \$41,000 as of June 30, 2007. This occurred due to a decrease in the average balance of Fed Funds sold and other interest bearing deposits from \$25.8 million as of June 30, 2006 to \$4.7 million as of June 30, 2007. The proceeds from our stock offering on April 3, 2006 were initially invested in federal funds sold. Since that time, the proceeds have been moved to other investments, resulting in the significant decrease in the average federal funds sold balance. The average yield on federal funds sold and other interest bearing deposits was 3.49% for the three months ending June 30, 2007 compared to 4.43% for the three months ended June 30, 2006. This decrease was partially offset by a \$154,000 increase in interest on investment securities, the average balance of which increased by \$7.4 million over the three months ended June 30, 2007 compared to the three months ended June 30, 2006. The investment portfolio had an average yield of 4.58% for the three months ended June 30, 2007 compared to an average yield of 4.31% for the three months ended June 30, 2006. The average balance on our loan portfolio increased \$1.9 million from an average balance of \$204.9 million for the three months ended June 30, 2006 to an average balance of \$206.8 million for the three months ended June 30, 2007. The average yield on our loan portfolio decreased from 6.08% to 6.04% for the three months ended June 30, 2006 and 2007, respectively. Interest income on our loan portfolio was reduced by a \$110,000 loss on the fair value of our interest rate floor derivative product during the three months ended June 30, 2007.

**Interest Expense.** Interest expense increased by \$288,000 or 14.7%, from \$2.0 million for the three months ended June 30, 2006 to \$2.2 million for the three months ended June 30, 2007. The interest paid on deposits increased by \$359,000 from \$1.4 million for the three months ended June 30, 2006 to \$1.8 million for the three months ended June 30, 2007. This was due to an increase in the average yield paid on interest-bearing deposits from 2.49% for the three months ended June 30, 2006 to 3.04% for the three months ended June 30, 2007. The interest expense related to advances from the Federal Home Loan Bank of New York decreased by \$58,000 from \$523,000 for the three months ended June 30, 2006 to \$465,000 for the three months ended June 30, 2007. While the average yield on these borrowings increased from 4.15% for the three months ending June 30, 2006 to 4.41% for the three months ending June 30, 2007, the average balance decreased from \$50.4 million as of June 30, 2006 to \$42.2 million as of June 30, 2007.

**Provision for Loan Losses.** For the three months ended June 30, 2007 and 2006, a provision for loan losses of \$0 and \$11,000 was recorded, respectively. Additions to the provision for loan loss was not deemed necessary during the three months ending June 30, 2007 based on management's evaluation of various factors, including trends in loan volume, type and volume of loans, and collection efforts. Management will continue to evaluate its allowance for loan losses on a quarterly basis.

We establish provision for loan losses, which are charged to operations, in order to maintain the allowance for loan losses at a level management considers necessary to absorb probable incurred credit losses in the loan portfolio. The amount of allowance is based on estimates and the ultimate losses may vary from such estimates as more information becomes available or later events occur. Management assesses the allowance for loan losses on a quarterly basis and makes provisions for loan losses in order to maintain the adequacy of the allowance.

**Non-interest Income.** For the three months ended June 30, 2007, non-interest income, which is a total of service charges and fees, earnings on bank-owned life insurance, and other income totaled \$492,000, which was an increase of \$54,000 in comparison to the corresponding period in the prior year. \$54,000 of the increase is due to increased earnings on bank owned life insurance, resulting from our purchase of an additional \$3.8 million of bank owned life insurance in the fourth quarter of 2006 to fund supplemental employee retirement plans.

**Non-interest Expense.** Non-interest expense increased by \$134,000 or 6.2% from \$2.2 million for the

---

**Table of Contents**

three months ended June 30, 2006 to \$2.3 million for the three months ended June 30, 2007. Non-interest expense includes the expense of salaries and employee benefits, occupancy and equipment, data processing and other items not related to expenses on deposits or borrowings. Salaries and employee benefits increased by \$71,000, or 6.3%, due to \$101,000 in additional expenses for stock-based plans that were implemented after being approved by shareholders in October 2006, offset by a decrease in salary expense of \$30,000 due to staff reductions which occurred during the second quarter of 2006. Professional service fees increased by \$108,000, or 45.4%, due to increased expenses for legal and other services related to being a public company. In addition, \$30,000 was paid to an outside consultant during the three months ending June 30, 2007 for services relating to enhancement of fee income. As a result of these services, we project fee income to increase during the remainder of 2007. Occupancy and equipment expense decreased by \$30,000, or 8.6%, due to assets being fully depreciated during the three months ended June 30, 2007, whereas in the same period last year, these assets were still on the depreciation schedule.

**Income Tax Expense.** Income taxes decreased by \$196,000, or 73.4%, from \$267,000 for the three months ending June 30, 2006 to \$71,000 for the three months ending June 30, 2007. This was partially attributable to lower income before income taxes during the three month period ended June 30, 2007 as compared to the same period in the prior year. During the quarter ended June 30, 2007, our tax-exempt income on our municipal bond portfolio and bank-owned life insurance increased in total as well as percentage of pre-tax income in comparison to the quarter ended June 30, 2006. Our municipal bond portfolio has more than doubled since June 30, 2006 and income on bank-owned life insurance has increased due to an additional purchase during the fourth quarter of 2006. As a result, our effective tax rate was reduced from 32.8% for the three months ending June 30, 2006 to 19.0% for the three months ending June 30, 2007.

**Comparison of Results of Operations for the Six Months Ended June 30, 2007 and 2006**

**General.** Net income was \$600,000 for the six months ended June 30, 2007, a decrease of \$263,000, or 30.5%, compared to net income of \$863,000 for the six months ended June 30, 2006. The decrease in net income was primarily attributed to a \$443,000 decrease in net interest income from \$4.9 million for the six month period ended June 30, 2006 to \$4.5 million for the six months ended June 30, 2007. The decrease in net interest income is primarily attributable to an increase in deposit interest expense of \$743,000, partially offset by an increase in interest income on investment securities of \$313,000.

**Interest Income.** Interest income increased \$145,000 or 1.7%, from \$8.8 million for the six months ended June 30, 2006 to \$8.9 million for the six months ended June 30, 2007. A majority of this increase is due to a \$313,000 increase in interest on investment securities, the average balance of which increased by \$7.1 million over the six months ended June 30, 2007 compared to the six months ended June 30, 2006. The investment portfolio had an average yield of 4.52% for the six months ended June 30, 2007 compared to an average yield of 4.22% for the six months ended June 30, 2006. The average yield on the loan portfolio increased from 6.06% for the six months ending June 30, 2006 to 6.14% for the six months ended June 30, 2007 due to an increase in our loan volume and an increase in rates on loan products. Interest income on our loan portfolio was reduced by a \$101,000 loss on the fair value of our interest rate floor derivative product during the six months ended June 30, 2007. The increase in interest income on loans and investment securities was partially offset by a \$281,000 decrease in other interest income. This decrease was attributable to a decrease in the average balance of Fed Funds sold and other interest bearing deposits from \$18.5 million as of June 30, 2006 to \$5.7 million as of June 30, 2007. The average yield on Fed Funds sold and other interest bearing deposits was 4.24% for the six months ending June 30, 2007 compared to 3.86% for the six months ended June 30, 2006. The proceeds from our stock offering on April 3, 2006 were initially invested in federal funds sold. Since that time, the proceeds have been moved to other investments, resulting in the significant decrease in the average federal funds sold balance.



---

**Table of Contents**

**Interest Expense.** Interest expense increased by \$588,000 or 15.2%, from \$3.9 million for the six months ended June 30, 2006 to \$4.5 million for the six months ended June 30, 2007. The interest paid on deposits increased by \$743,000 from \$2.7 million for the six months ended June 30, 2006 to \$3.5 million for the six months ended June 30, 2007. This was due to an increase in the average yield paid on interest-bearing deposits from 2.38% for the six months ended June 30, 2006 to 3.02% for the six months ended June 30, 2007. The interest expense related to advances from the Federal Home Loan Bank of New York decreased by \$132,000 from \$1.1 million for the six months ended June 30, 2006 to \$933,000 for the six months ended June 30, 2007. While the average yield on these borrowings increased from 4.08% for the six months ending June 30, 2006 to 4.39% for the six months ending June 30, 2007, the average balance decreased from \$52.2 million as of June 30, 2006 to \$42.5 million as of June 30, 2007.

**Provision for Loan Losses.** For the six months ended June 30, 2007 and 2006, a provision for loan losses of \$45,000 and \$11,000 was recorded, respectively. The increase during the six months ended June 30, 2007 was deemed necessary based on management's evaluation of various factors, including trends in loan volume, type and volume of loans, and collection efforts. Management determined that an increase was necessary due to an increase in our commercial loan portfolio. Management will continue to evaluate its allowance for loan losses on a quarterly basis.

We establish provision for loan losses, which are charged to operations, in order to maintain the allowance for loan losses at a level management considers necessary to absorb probable incurred credit losses in the loan portfolio. The amount of allowance is based on estimates and the ultimate losses may vary from such estimates as more information becomes available or later events occur. Management assesses the allowance for loan losses on a quarterly basis and makes provisions for loan losses in order to maintain the adequacy of the allowance.

**Non-interest Income.** For the six months ended June 30, 2007, non-interest income, which is a total of service charges and fees, earnings on bank-owned life insurance, and other income totaled \$961,000, which was an increase of \$130,000 in comparison to the corresponding period in the prior year. \$111,000 of the increase is due to increased earnings on bank owned life insurance, resulting from our purchase of an additional \$3.8 million of bank owned life insurance in the fourth quarter of 2006 to fund supplemental employee retirement plans.

**Non-interest Expense.** Non-interest expense increased by \$200,000 or 4.5% from \$4.4 million for the six months ended June 30, 2006 to \$4.6 million for the six months ended June 30, 2007. Non-interest expense includes the expense of salaries and employee benefits, occupancy and equipment, data processing and other items not related to expenses on deposits or borrowings. Salaries and employee benefits increased by \$132,000, or 5.6%, due to annual raises, \$202,000 in additional expenses for stock-based incentive plans that were implemented after being approved by shareholders in October 2006, offset by a decrease in salary expense of \$62,000 due to staff reductions which occurred during the second quarter of 2006 and by a decrease in retirement benefit expense of \$28,000 due to implementation of safe harbor provisions in the fourth quarter of 2006. Professional service fees increased by \$182,000, or 43.0%, due to increased expenses for legal and other services related to being a public company. In addition, \$30,000 was paid to an outside consultant during the six months ending June 30, 2007 for services relating to enhancement of fee income. As a result of these services, we project fee income to increase during the remainder of 2007. Occupancy and equipment expenses decreased by \$55,000, or 7.6%, due to assets being fully depreciated during the three months ended June 30, 2007, whereas in the same period last year, these assets were still on the depreciation schedule.

**Income Tax Expense.** Income taxes decreased by \$284,000, or 68.1%, from \$417,000 for the six months ending June 30, 2006 to \$133,000 for the six months ending June 30, 2007. This was partially

## **Table of Contents**

attributable to lower income before income taxes during the six month period ended June 30, 2007 as compared to the same period in the prior year. During the six months ending June 30, 2007, our tax-exempt income on our municipal bond portfolio and bank-owned life insurance increased in total as well as percentage of pre-tax income in comparison to the same period in the prior year. Our municipal bond portfolio has more than doubled since June 30, 2006 and income on bank-owned life insurance has increased due to an additional purchase during the fourth quarter of 2006. As a result, our effective tax rate was reduced from 32.6% for the six months ending June 30, 2006 to 18.1% for the six months ending June 30, 2007.

### **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 meet the lending and deposit withdrawal requirements of our customers and to fund current and planned expenditures. Our primary sources of funds consist of deposits, scheduled amortization and prepayments of loans and mortgage-backed and asset-backed securities, maturities and sales of other investments, interest bearing deposits at other financial institutions and funds provided from operations. We have written agreements with the Federal Home Loan Bank of New York, which as of June 30, 2007, allowed us to borrow up to \$34.6 million on an overnight line of credit and \$34.6 million on a one-month overnight repricing line of credit. As of June 30, 2007 we had borrowed \$1.3 million on the overnight line of credit. We had no borrowings on the one-month overnight repricing line of credit. We also have a third agreement to obtain advances from the Federal Home Loan Bank collateralized by a pledge of our mortgage loans. At June 30, 2007, we had outstanding advances on this agreement totaling \$41.4 million.

Loan repayments and maturing investment securities are a relatively predictable source of funds. However, 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 reduce the predictability of the timing of these sources of funds.

Our primary investing activities include the origination of loans and, to a lesser extent, the purchase of investment securities. For the six months ended June 30, 2007 and 2006, we originated loans of approximately \$20.0 million and \$15.8 million, respectively. Purchases of investment securities totaled \$7.9 million in the six months ended June 30, 2007 and \$17.1 million in the six months ended June 30, 2006.

At June 30, 2007, we had loan commitments to borrowers of approximately \$6.3 million and overdraft lines of protection and unused home equity lines of credit of approximately \$21.1 million.

Total deposits were \$247.5 million at June 30, 2007, as compared to \$249.6 million at December 31, 2006. Time deposit accounts scheduled to mature within one year were \$123.6 million at June 30, 2007. The decrease in total deposits occurred when management decided not to match high interest rates being offered by competitors in our market area, as it would have had a negative effect on our net interest margin and earnings. Recently, competitor rates have moved in line with the rates we are offering. As a result, we do not anticipate additional losses in our deposit portfolio. We also anticipate that a significant portion of the time deposits that are scheduled to mature within one year will remain with us.

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.

**Table of Contents**

**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. Non-performing assets, including non-performing loans and foreclosed real estate, totaled \$1.3 million at June 30, 2007 and \$1.5 million at December 31, 2006.

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

	At June 30, 2007 (Unaudited)	At December 31, 2006
	(Dollars in thousands)	
<b>Loans past due 90 days or more but still accruing:</b>		
Mortgage loans on real estate:		
One-to-four family	\$ 188	\$ 503
Construction		
Commercial real estate	55	133
Home equity loans and lines of credit	10	83
Other loans:		
Commercial loans	59	
Consumer loans		
Total	\$ 312	\$ 719
<b>Loans accounted for on a nonaccrual basis:</b>		
Mortgage loans on real estate:		
One-to-four family	\$ 887	\$ 579
Construction		
Commercial real estate		
Home equity loans and lines of credit	40	4
Other loans:		
Commercial loans		
Consumer loans	12	7
Total non-accrual loans	939	590
Total nonperforming loans	1,251	1,309
Foreclosed real estate	34	183
Restructured loans		
Total nonperforming assets	\$ 1,285	\$ 1,492
<b>Ratios:</b>		
Nonperforming loans as a percent of gross loans:	0.60%	0.64%
Nonperforming assets as a percent of total assets:	0.37%	0.42%

**Table of Contents**

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

	At or For the Six Months Ended June 30, 2007 (Unaudited)	At or For the Year Ended December 31, 2006
	(Dollars in thousands)	
Balance at beginning of period:	\$ 1,257	\$ 1,240
Provision for loan losses	45	158
<b>Charge-offs:</b>		
Mortgage loans on real estate:		
One-to-four family		49
Construction loans		
Commercial real estate		
Home equity loans and lines of credit		
Other loans:		
Commercial loans		86
Consumer loans	5	35
Total charge-offs	5	170
<b>Recoveries:</b>		
Mortgage loans on real estate:		
One-to-four family		
Construction		
Commercial real estate		
Home equity loans and lines of credit		
Other loans:		
Commercial loans		28
Consumer loans	3	1
Total Recoveries	3	29
Net charge-offs	2	141
Balance at end of period	\$ 1,300	\$ 1,257
Average loans outstanding	206,136	205,419
Ratio of net charge-offs to average loans outstanding	0.00%	0.07%

## **Table of Contents**

### **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 7 of the Notes to Consolidated Financial Statements for a summary of loan commitments outstanding as of June 30, 2007.

### **Item 3. Quantitative and Qualitative Disclosures about Market Risk Management of Market Risk**

There have been no material changes in information regarding quantitative and qualitative disclosures about market risk at June 30, 2007 from the information presented in the Company's Form 10-K for the year ended December 31, 2006.

### **Regulatory Capital**

We are subject to various regulatory capital requirements administered by the federal banking agencies. The Bank is a federal stock savings bank regulated by the Office of Thrift Supervision. The Company is a federal stock holding company corporation and is regulated as a savings and loan holding company by the Office of Thrift Supervision.

The Company's ability to pay dividends is primarily dependent upon the ability of its subsidiary bank to pay dividends to the Company. The payment of dividends is subject to continued compliance with minimum regulatory capital requirements. In addition, regulatory approval is generally required prior to declaring dividends in an amount in excess of net income for that year plus net income retained in the preceding two years. During the six months ending June 30, 2007, Lake Shore, MHC which owns 55% of the Company's outstanding common stock elected to waive its right to receive cash dividends of approximately \$218,000. The total dividends waived by Lake Shore, MHC were \$327,000 cumulatively as of June 30, 2007. The dividends waived by Lake Shore, MHC are considered a restriction on the retained earnings of the Company.

Failure to meet minimum capital requirements can initiate certain mandatory and possible additional discretionary actions by regulators that, if undertaken, could have a direct material effect on the financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the Bank must meet specific capital guidelines that involve quantitative measures of its assets, liabilities, and certain off-balance-sheet items as calculated under regulatory accounting practices. The Bank's capital amounts and classifications are also subject to qualitative judgments by the regulators about components, risk-weightings and other factors.

Quantitative measures established by regulation to ensure capital adequacy require the Bank to maintain minimum amounts and ratios (set forth in the table below) of total and Tier 1 capital to risk weighted assets, tangible equity to tangible assets and Tier 1 capital to adjusted total assets. Management believes, as of June 30, 2007, that the Bank meets all capital adequacy requirements to which it is subject.

The Company, as a savings and loan holding company, is not subject to formula based capital requirements at the holding company level. However, the Company is required by Office of Thrift Supervision regulation to maintain adequate capital to support its business activities.

**Table of Contents**

The Bank's actual capital amounts and ratios are presented in the following table.

	Actual		For Capital Adequacy Purposes		To be Well Capitalized under Prompt Corrective Action Provisions	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
<b>As of June 30, 2007:</b>						
Total capital (to risk-weighted assets)	\$ 43,919	24.2%	\$ ≥14,508	≥ 8.0%	\$ ≥18,135	≥ 10.0%
Tier 1 capital (to adjusted total assets)	42,022	12.2%	≥13,803	≥ 4.0%	≥17,253	≥ 5.0%
Tangible equity (to tangible assets)	42,022	12.2%	≥ 5,176	≥ 1.5%		
Tier 1 capital (to risk-weighted assets)	42,022	23.2%			≥10,881	≥ 6.0%

**Item 4. Controls and Procedures.**

Our management, including our Chief Executive Officer and Chief Financial Officer, has evaluated the effectiveness of our disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) as of the end of the period covered by this report. Based upon that evaluation, the Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures are effective, as of June 30, 2007, to ensure that information relating to us, which is required to be disclosed in the reports we file with the Securities and Exchange Commission under the Exchange Act, is (i) recorded, processed, summarized and reported as and when required and (ii) accumulated and communicated to our management, including our principal executive officer and principal financial officer, as appropriate to allow timely decisions regarding required disclosures.

There has been no change in our internal control over financial reporting identified in connection with the evaluation that occurred during our last fiscal quarter that has materially affected, or that is reasonably likely to materially affect, our internal control over financial reporting.

**Item 4T. Controls and Procedures.**

Not applicable.

**PART II****Item 1. Legal Proceedings**

We are not involved in any pending legal proceedings other than routine legal proceedings occurring in the ordinary course of business. We believe that these routine legal proceedings, in the aggregate, are immaterial to our financial condition and results of operations.

**Item 1A. Risk Factors**

There have been no material changes to the risk factors that are included in our Annual Report on Form 10-K for the year ended December 31, 2006 that could affect our business, results of operations or financial condition.

**Table of Contents****Item 2. Unregistered Sales of Equity Securities and Use of Proceeds.**

The following table provides information on repurchases by the Company of its common stock in each month of the quarter ended June 30, 2007:

**COMPANY PURCHASES OF EQUITY SECURITIES**

<b>Period</b>	<b>Total Number of Shares Purchased</b>	<b>Average Price Paid per Share</b>	<b>Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs</b>	<b>Maximum Number of Shares that may yet be Purchased under the Plans or Programs (1)</b>
April 1, 2007 through April 30, 2007				148,781
May 1, 2007 through May 31, 2007	80,000	12.58	80,000	68,781
June 1, 2007 through June 30, 2007	68,781	12.30	68,781	
<b>Total</b>	<b>148,781</b>	<b>12.45</b>	<b>148,781</b>	

- (1) On April 26, 2007, the Company announced that the Board of Directors had approved a stock repurchase plan pursuant to which the Company could repurchase up to 148,781 shares of its outstanding common stock. This amount represented 5% of the Company's outstanding stock not owned by Lake Shore, MHC. The repurchase plan did not have an expiration date. As of June 30, 2007, all of the shares authorized by the plan had been repurchased, thereby ending the plan.

**Item 3. Defaults Upon Senior Securities**

None.

**Item 4. Submission of Matters to a Vote of Security Holders.**

An annual meeting of shareholders of Lake Shore Bancorp, Inc. was held on May 23, 2007. The proposals submitted to shareholders and the tabulation of votes for each proposal were as follows:

**Proposal #1 - Election of Directors:**

	<b>Number of Votes For</b>	<b>Number of Votes Withheld</b>
To serve one-year terms:		
James P. Foley, DDS	6,127,378	232,633
Thomas E. Reed	6,127,858	232,153
Daniel P. Reininga	6,128,658	231,353
To serve two-year terms:		
David C. Mancuso	6,128,833	231,178
Gary W. Winger	6,128,858	231,153
Nancy L. Yocum	6,128,808	231,203
To serve three-year terms:		

Edgar Filing: Lake Shore Bancorp, Inc. - Form 10-Q

Sharon E. Brautigam	6,127,285	232,726
Michael E. Brunez	6,128,108	231,903



**Table of Contents**

**Proposal #2\*- Amend Lake Shore Bancorp, Inc. 2006 Stock Option Plan**

		Number of Votes		
For	Against	Abstain	Broker Non-Vote	
1,034,200	943,033	41,753	704,150	

**Proposal #3 \*- Amend Lake Shore Bancorp, Inc. 2006 Recognition and Retention Plan**

		Number of Votes		
For	Against	Abstain	Broker Non-Vote	
1,060,484	916,299	42,203	704,150	

\* Proposals 2 and 3 required the affirmative vote of a majority of shares not owned by Lake Shore, MHC. Lake Shore, MHC was not entitled to vote. 2,975,625 shares were not owned by Lake Shore, MHC, which means the affirmative vote of 1,478,813 was necessary for Proposals 2 and 3 to be approved.

**Item 5. Other Information.**

None.

**Item 6. Exhibits**

31.1 Rule 13a-14(a)/15d-14(a) Certifications

31.2 Section 1350 Certifications

**Table of Contents**

***SIGNATURES***

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

LAKE SHORE BANCORP, INC.  
(Registrant)

August 14, 2007

/s/ David C. Mancuso  
By: David C. Mancuso  
President and Chief Executive Officer  
(Principal Executive Officer)

August 14, 2007

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