CORTLAND BANCORP INC
Form 10-Q
May 10, 2018

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 March 31, 2018

or

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the transition from to

Commission file number: 0-13814

Cortland Bancorp

(Exact name of registrant as specified in its charter)

| | |
|---|---|
| Ohio<br>(State or other jurisdiction of<br><br>Incorporation or organization) | 34-1451118<br>(I.R.S. Employer<br><br>Identification No.) |
| 194 West Main Street, Cortland, Ohio<br>(Address of principal executive offices) | 44410<br>(Zip code) |

330- 637-8040

(Registrant’s telephone number, including area code)

N/A

(Former name, former address and former fiscal year, if changed since last report)

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 (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes No

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

| | | |
|---|---|---|
| Large accelerated filer | | Accelerated filer |
| Non-accelerated filer | (Do not check if a smaller reporting company) | Smaller reporting company |
| Emerging growth company | | |

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act.

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

APPLICABLE ONLY TO ISSUERS INVOLVED IN BANKRUPTCY PROCEEDINGS DURING THE PRECEDING FIVE YEARS:

Indicate by check mark whether the registrant has filed all documents and reports required to be filed by Section 12, 13 or 15(d) of the Securities Exchange Act of 1934 subsequent to the distribution of securities under a plan confirmed by a court. Yes No

APPLICABLE ONLY TO CORPORATE ISSUERS:

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

| TITLE OF CLASS | SHARES OUTSTANDING |
|---|---|
| Common Stock, No Par Value | 4,421,537 Shares May 3, 2018 |

CORTLAND BANCORP AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS (UNAUDITED)

(Amounts in thousands, except share data)

| | March 31, 2018 | | December 31, 2017 | |
|---|---|---|---|---|
| ASSETS | | | | |
| Cash and due from banks | $ | 6,356 | $ | 9,741 |
| Interest-earning deposits | | 21,182 | | 9,384 |
| Total cash and cash equivalents | | 27,538 | | 19,125 |
| Investment securities available-for-sale (Note 3) | | 141,717 | | 162,422 |
| Loans held for sale | | 1,216 | | 2,780 |
| Total loans (Note 4) | | 451,914 | | 487,490 |
| Less allowance for loan losses (Note 4) | | (3,884) | | (4,578) |
| Net loans | | 448,030 | | 482,912 |
| Premises and equipment | | 9,283 | | 9,038 |
| Bank-owned life insurance | | 17,727 | | 17,650 |
| Other assets | | 17,627 | | 17,174 |
| Total assets | $ | 663,138 | $ | 711,101 |
| | | | | |
| LIABILITIES | | | | |
| Noninterest-bearing deposits | $ | 123,523 | $ | 123,291 |
| Interest-bearing deposits | | 431,016 | | 462,560 |
| Total deposits | | 554,539 | | 585,851 |
| Short-term borrowings | | 2,062 | | 2,678 |
| Federal Home Loan Bank advances - short term | | 18,000 | | 32,000 |
| Federal Home Loan Bank advances - long term | | 14,000 | | 14,000 |
| Subordinated debt (Note 7) | | 5,155 | | 5,155 |
| Other liabilities | | 9,255 | | 9,787 |
| Total liabilities | | 603,011 | | 649,471 |
| | | | | |
| SHAREHOLDERS' EQUITY | | | | |
| Common stock - $5.00 stated value - authorized 20,000,000 shares; issued 4,728,267 shares in 2018 and 2017; outstanding shares, 4,409,648 in 2018 | | 23,641 | | 23,641 |

| | | | | | | |
|---|---|---|---|---|---|---|
| and 4,420,136 in 2017 | | | | | | |
| Additional paid-in capital | | 20,893 | | | 20,928 | |
| Retained earnings | | 25,454 | | | 24,403 | |
| Accumulated other comprehensive loss | | (4,190 | ) | | (1,825 | ) |
| Treasury stock, at cost, 318,619 shares in 2018 and 308,131 in 2017 | | (5,671 | ) | | (5,517 | ) |
| Total shareholders' equity | | 60,127 | | | 61,630 | |
| Total liabilities and shareholders' equity | $ | 663,138 | | $ | 711,101 | |

See accompanying notes to the unaudited consolidated financial statements of Cortland Bancorp and Subsidiaries

CORTLAND BANCORP AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF INCOME (UNAUDITED)

(Amounts in thousands, except per share data)

| | THREE MONTHS ENDED MARCH 31, | |
|---|---|---|
| | 2018 | 2017 |
| INTEREST AND DIVIDEND INCOME | | |
| Interest and fees on loans | $5,588 | $4,618 |
| Interest and dividends on investment securities: | | |
| Taxable interest | 492 | 566 |
| Nontaxable interest | 429 | 469 |
| Dividends | 34 | 27 |
| Other interest income | 28 | 16 |
| Total interest and dividend income | 6,571 | 5,696 |
| INTEREST EXPENSE | | |
| Deposits | 789 | 586 |
| Short-term borrowings | 1 | 1 |
| Federal Home Loan Bank advances - short term | 91 | 37 |
| Federal Home Loan Bank advances - long term | 58 | 104 |
| Subordinated debt | 40 | 31 |
| Total interest expense | 979 | 759 |
| Net interest income | 5,592 | 4,937 |
| PROVISION FOR LOAN LOSSES | 500 | — |
| NET INTEREST INCOME AFTER PROVISION FOR LOAN LOSSES | 5,092 | 4,937 |
| NON-INTEREST INCOME | | |
| Fees for customer services | 555 | 508 |
| Investment securities available-for-sale gains, net | 20 | 9 |
| Mortgage banking gains, net | 238 | 194 |
| Earnings on bank-owned life insurance | 77 | 75 |
| Wealth management | 9 | 7 |
| Other non-interest income | 113 | 107 |
| Total non-interest income | 1,012 | 900 |
| NON-INTEREST EXPENSES | | |
| Salaries and employee benefits | 2,450 | 2,742 |
| Occupancy and equipment | 597 | 615 |
| State and local taxes | 125 | 115 |
| FDIC insurance | 44 | 53 |
| Professional fees | 189 | 161 |
| Advertising and marketing | 74 | 102 |
| Data processing fees | 63 | 61 |
| Other operating expenses | 784 | 798 |
| Total non-interest expenses | 4,326 | 4,647 |
| INCOME BEFORE FEDERAL INCOME TAX EXPENSE | 1,778 | 1,190 |

| | | |
|---|---|---|
| Federal income tax expense | 241 | 190 |
| NET INCOME | $1,537 | $1,000 |
| EARNINGS PER SHARE BASIC AND DILUTED | $0.35 | $0.23 |
| CASH DIVIDENDS DECLARED PER SHARE | $0.11 | $0.15 |

See accompanying notes to the unaudited consolidated financial statements of Cortland Bancorp and Subsidiaries

CORTLAND BANCORP AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS) (UNAUDITED)

(Amounts in thousands)

| | THREE MONTHS ENDED MARCH 31, | |
|---|---|---|
| | 2018 | 2017 |
| Net income | $1,537 | $1,000 |
| Other comprehensive loss: | | |
| Securities available for sale: | | |
| Unrealized holding (losses) gains on available-for-sale securities | (2,964) | 15 |
| Tax effect | 623 | (5) |
| Reclassification adjustment for net (gains) losses realized in net income | (20) | (9) |
| Tax effect | 4 | 3 |
| Total securities available-for-sale | (2,357) | 4 |
| Change in post-retirement obligations | (8) | (5) |
| Total other comprehensive loss | (2,365) | (1) |
| Total comprehensive (loss) income | $(828) | $999 |

See accompanying notes to the unaudited consolidated financial statements of Cortland Bancorp and Subsidiaries

CORTLAND BANCORP AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY (UNAUDITED)

(Amounts in thousands, except per share data)

| | Common Stock | Additional Paid-in Capital | Retained Earnings | Accumulated Other Comprehensive Income (Loss) | Treasury Stock | Total Shareholders' Equity |
|---|---|---|---|---|---|---|
| THREE MONTHS ENDED March 31, 2017 | | | | | | |
| Balance at December 31, 2016 | $ 23,641 | $ 20,878 | $ 21,485 | $ (2,961) | $ (5,373) | $ 57,670 |
| Net income | — | — | 1,000 | — | — | 1,000 |
| Other comprehensive loss | — | — | — | (1) | — | (1) |
| Cash dividend declared ($0.15 per share) | — | — | (663) | — | — | (663) |
| Equity compensation | — | 21 | — | — | 27 | 48 |
| Balance at March 31, 2017 | $ 23,641 | $ 20,899 | $ 21,822 | $ (2,962) | $ (5,346) | $ 58,054 |
| THREE MONTHS ENDED March 31, 2018 | | | | | | |
| Balance at December 31, 2017 | $ 23,641 | $ 20,928 | $ 24,403 | $ (1,825) | $ (5,517) | $ 61,630 |
| Net income | — | — | 1,537 | — | — | 1,537 |
| Other comprehensive loss | — | — | — | (2,365) | — | (2,365) |
| Cash dividend declared ($0.11 per share) | — | — | (486) | — | — | (486) |
| Treasury shares purchased (10,488 shares) | — | — | — | — | (223) | (223) |
| Equity compensation | — | (35) | — | — | 69 | 34 |
| Balance at March 31, 2018 | $ 23,641 | $ 20,893 | $ 25,454 | $ (4,190) | $ (5,671) | $ 60,127 |

See accompanying notes to the unaudited consolidated financial statements of Cortland Bancorp and Subsidiaries

CORTLAND BANCORP AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS (UNAUDITED)

(Amounts in thousands)

| | FOR THE THREE MONTHS ENDED MARCH 31, | |
|---|---|---|
| | 2018 | 2017 |
| Net cash flow from operating activities | $4,100 | $3,456 |
| Cash flow from investing activities | | |
| Purchases of available-for-sale securities | (5,885) | (6,421) |
| Proceeds from sale of available-for-sale securities | 19,841 | 15,725 |
| Proceeds from call, maturity and principal payments on available-for-sale securities | 3,352 | 4,357 |
| Net decrease in loans made to customers | 34,382 | 22,188 |
| Contributions to partnership funds | (278) | (2,235) |
| Purchases of premises and equipment | (462) | (409) |
| Net cash flow from investing activities | 50,950 | 33,205 |
| Cash deficit from financing activities | | |
| Net decrease in deposit accounts | (31,312) | (22,498) |
| Net change in short term borrowings | (616) | (421) |
| Net change in Federal Home Loan Bank advances - short term | (14,000) | (12,000) |
| Repayments of Federal Home Loan Bank advances - long term | (4,000) | (4,500) |
| Proceeds from Federal Home Loan Bank advances - long term | 4,000 | 4,000 |
| Dividends paid | (486) | (663) |
| Treasury shares purchased | (223) | — |
| Net cash deficit from financing activities | (46,637) | (36,082) |
| Net change in cash and cash equivalents | 8,413 | 579 |
| Cash and cash equivalents | | |
| Beginning of period | 19,125 | 15,351 |
| End of period | $27,538 | $15,930 |
| Supplemental disclosures: | | |
| Cash paid during the period for: | | |
| | | |
| Interest | $978 | $752 |
| Transfer of loans to other real estate owned | $— | $480 |

See accompanying notes to the unaudited consolidated financial statements of Cortland Bancorp and Subsidiaries

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

1.) Basis of Presentation and Reclassifications:

The accompanying unaudited consolidated financial statements of Cortland Bancorp (the Company) and the Cortland Savings and Banking Company (the Bank) have been prepared in accordance with accounting principles generally accepted in the United States (U.S. GAAP) for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by U.S. GAAP for complete financial statements. In the opinion of management, all adjustments (consisting of normal recurring items) considered necessary for a fair presentation have been included. Operating results for the three months ended March 31, 2018 are not necessarily indicative of the results that may be expected for the year ending December 31, 2018. These interim unaudited consolidated financial statements should be read in conjunction with our annual audited financial statements as of December 31, 2017, included in our Form 10-K for the year ended December 31, 2017, filed with the United States Securities and Exchange Commission. The accompanying Consolidated Balance Sheets at December 31, 2017, have been derived from the audited Consolidated Balance Sheets but do not include all of the information and footnotes required by U.S. GAAP for complete financial statements.

Effective January 1, 2017, the Company adopted ASU 2014-09 Revenue from Contracts with Customers – Topic 606 and all subsequent ASUs that modified ASC 606. The Company has elected to apply the standard utilizing the modified retrospective approach with a cumulative effect of adoption for the impact from uncompleted contracts at the date of adoption. The implementation of the new standard had no material impact to the measurement or recognition of revenue of prior periods.

Management determined that the primary sources of revenue emanating from interest income on loans and investments along with noninterest revenue resulting from investment security gains, gains on the sale of loans, earnings on bank owned life insurance, wealth management and other non-interest income are not within the scope of ASC 606. As a result, no changes were made during the period related to these sources of revenue.

The main types of non-interest income within the scope of the standard are as follows:

Service charges on deposit accounts – The Company has contracts with its deposit customers where fees are charged if the account balance falls below predetermined levels defined as compensating balances. These agreements can be cancelled at any time by either the Company or the deposit customer. Revenue from these transactions is recognized on a monthly basis as the Company has

an unconditional right to the fee consideration. The Company also has transaction fees related to specific transactions or activities resulting from a customer request or activity that include non-sufficient fund fees, overdraft fees, continuous overdraft fees and other fees such as stop payment fees. All of these fees are attributable to specific performance obligations of the Company where the revenue is recognized at a defined point in time, namely at the completion of the requested service/transaction.

Fees, exchange, and other service charges- This is primarily comprised of debit card income, ATM fees, merchant services income, and other service charges. Debit card income is primarily comprised of interchange fees earned whenever the Company’s debit and credit cards are processed through card payment networks such as Visa. ATM fees are primarily generated when a Company cardholder uses a non-Company ATM or a non-Company cardholder uses a Company ATM. Merchant services income mainly represents fees charged to merchants to process their debit card transactions, in addition to account management fees. Other service charges include cashier’s checks, check charges and other services. The Company’s performance obligation for fees, exchange, and other service charges are largely satisfied, and related revenue recognized, when the services are rendered or upon completion. Payment is typically received immediately or in the following month.

Gains (losses) on sale of other real estate owned – Gains and losses are recognized at the completion of the property sale when the buyer obtains control of the real estate and all of the performance obligations of Company have been satisfied. Evidence of the buyer obtaining control of the asset include transfer of the property title, physical possession of the asset, and the buyer obtaining control of the risks and rewards related to the asset. In situations where the Company agrees to provide financing to facilitate the sale, additional analysis is performed to ensure that the contract for sale identifies the buyer and seller, the asset to be transferred, payment terms, and that the contract has a true commercial substance and that collection of amounts due from the buyer is reasonable. In situations where financing terms are not reflective of current market terms, the transaction price is discounted impacting the gain/loss and the carrying value of the asset.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

The following table depicts the disaggregation of revenue derived from contracts with customers to depict the nature, amount, timing, and uncertainty of revenue and cash flows.

| | March 31, 2018 |
|---|---|
| Revenue stream | |
| Service charges on deposit accounts: | |
| Overdraft fees | $256 |
| Service charges | 99 |
| Other fees | 3 |
| Fees, exchange, and other service charges | 197 |
| Non-interest income (in-scope of Topic 606) | 555 |
| Non-interest income (out-of-scope of Topic 606) | 457 |
| Total non-interest income | $1,012 |

Certain items contained in the 2017 financial statements have been reclassified to conform to the presentation for 2018. Such reclassifications had no effect on the net results of operations or shareholders' equity.

2.) Authoritative Accounting Guidance:

In May 2014, the FASB issued ASU (Accounting Standard Update) 2014-09, Revenue from Contracts with Customers (a new revenue recognition standard). The Update's core principle is that a company will recognize revenue to depict the transfer of goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. In addition, this Update specifies the accounting for certain costs to obtain or fulfill a contract with a customer and expands disclosure requirements for revenue recognition. This Update is effective for annual reporting periods beginning after December 15, 2016, including interim periods within that reporting period. Since the guidance scopes out revenue associated with financial instruments, including loan receivables and investment securities, we do not expect the adoption of the new standard, or any of the amendments, to result in a material change from our current accounting for revenue because the majority of the Company's revenue is not within the scope of Topic 606. Upon adoption on January 1, 2018, we have included the related new disclosure requirements in Note 1.

In January 2016, the FASB issued ASU 2016-01, Financial Instruments – Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities. This Update applies to all entities that hold financial assets or owe financial liabilities and is intended to provide more useful information on the recognition, measurement, presentation, and disclosure of financial instruments. Among other things, this Update (a) requires equity investments (except those accounted for under the equity method of accounting or those that result in consolidation of the investee) to be measured at fair value with changes in fair value recognized in net income; (b) simplifies the impairment assessment of equity investments without readily determinable fair values by requiring a qualitative assessment to identify impairment; (c) eliminates the requirement to disclose the fair value of financial instruments measured at amortized cost for entities that are not public business entities; (d) eliminates the requirement for public business entities to disclose the method(s) and significant assumptions used to estimate the fair value that is required to be disclosed for financial instruments measured at amortized cost on the balance sheet; (e) requires public business entities to use the exit price notion when measuring the fair value of financial instruments for disclosure purposes; (f) requires separate presentation of financial assets and financial liabilities by measurement category and form of financial asset (that is, securities or loans and receivables) on the balance sheet or the accompanying notes to the financial statements; and (g) clarifies that an entity should evaluate the need for a valuation allowance on a deferred tax asset related to available-for-sale securities in combination with the entity’s other deferred tax assets.

The Company’s adoption of this standard during the reporting period had no effect on the Consolidated Financial Statements. On a prospective basis, the Company implemented changes to the measurement of the fair value of financial instruments using an exit price notion for disclosure purposes included in Note 9 to the financial statements. The December 31, 2017, fair value of each class of financial instruments disclosure did not utilize the exit price notion when measuring fair value and, therefore, would not be comparable to the March 31, 2018 disclosure.

In February 2016, the FASB issued ASU 2016-02, Leases (Topic 842). The standard requires lessees to recognize the assets and liabilities that arise from leases on the balance sheet. A lessee should recognize in the statement of financial position a liability to make lease payments (the lease liability) and a right-of-use asset representing its right to use the underlying asset for the lease term. A short-term lease is defined as one in which (a) the lease term is 12 months or less and (b) there is not an option to purchase the underlying asset that the lessee is reasonably certain to exercise. For short-term leases, lessees may elect to recognize lease payments over the lease term on a straight-line basis. For public business entities, the amendments in this Update are effective for fiscal years beginning after December 15, 2018, and interim periods within those years. For all other entities, the amendments in this Update are effective for fiscal years beginning after December 15, 2019, and for interim periods within fiscal years beginning after December 15, 2020. The amendments should be applied at the beginning of the earliest period presented using a modified retrospective approach with earlier application permitted as of the beginning of an interim or annual reporting period. The Company is currently assessing the practical expedients it may elect at adoption, but does not anticipate the amendments will have a significant impact on the financial statements. Based on the Company's preliminary analysis of its current portfolio, the impact to the Company's balance sheet is estimated to result in less than a 1 percent increase in assets and liabilities. The Company also anticipates additional disclosures to be provided at adoption.

In June 2016, the FASB issued ASU 2016-13, Financial Instruments - Credit Losses: Measurement of Credit Losses on Financial Instruments ("ASU 2016-13"), which changes the impairment model for most financial assets. This Update is intended to improve financial reporting by requiring timelier recording of credit losses on loans and other financial instruments held by financial institutions and other organizations. The underlying premise of the Update is that financial assets measured at amortized cost should be presented at the net amount expected to be collected, through an allowance for credit losses that is deducted from the amortized cost basis. The allowance for credit losses should reflect management's current estimate of credit losses that are expected to occur over the remaining life of a financial asset. The income statement will be effected for the measurement of credit losses for newly recognized financial assets, as well as the expected increases or decreases of expected credit losses that have taken place during the period. ASU 2016-13 is effective for annual and interim periods beginning after December 15, 2019, and early adoption is permitted for annual and interim periods beginning after December 15, 2018. With certain exceptions, transition to the new requirements will be through a cumulative effect adjustment to opening retained earnings as of the beginning of the first reporting period in which the guidance is adopted. The Company is currently evaluating the impact the adoption of the standard will have on the Company's financial position or results of operations. We expect to recognize a one-time cumulative effect adjustment to the allowance for loan losses as of the beginning of the first reporting period in which the new standard is effective, but cannot yet determine the magnitude of any such one-time adjustment or the overall impact of the new guidance on the consolidated financial statements.

In August 2016, the FASB issued ASU 2016-15, Statement of Cash Flows (Topic 230): Classification of Certain Cash Receipts and Cash Payments ("ASU 2016-15"), which addresses eight specific cash flow issues with the objective of reducing diversity in practice. Among these include recognizing cash payments for debt prepayment or debt extinguishment as cash outflows for financing activities; cash proceeds received from the settlement of insurance claims should be classified on the basis of the related insurance coverage; and cash proceeds received from the settlement of bank-owned life insurance policies should be classified as cash inflows from investing activities while the cash payments for premiums on bank-owned policies may be classified as cash outflows for investing activities, operating activities, or a combination of investing and operating activities. The amendments in this Update are effective for public business entities for fiscal years beginning after December 15, 2017, and interim periods within those fiscal years. For all other entities, the amendments are effective for fiscal years beginning after December 15, 2018, and interim periods within fiscal years beginning after December 15, 2019. Early adoption is permitted, including adoption in an interim period. If an entity early adopts the amendments in an interim period, any adjustments should be reflected as of the beginning of the fiscal year that includes that interim period. An entity that elects early adoption must adopt all of the amendments in the same period. The amendments in this Update should be applied using a retrospective transition method to each period presented. If it is impracticable to apply the amendments retrospectively for some of the issues, the amendments for those issues would be applied prospectively as of the earliest date practicable. The Company has adopted the standard. See the Company's Consolidated Statements of Cash Flows.

In March 2017, the FASB issued ASU 2017-08, Receivables – Nonrefundable Fees and Other Costs (Subtopic 310-20). The amendments in this Update shorten the amortization period for certain callable debt securities held at a premium. Specifically, the amendments require the premium to be amortized to the earliest call date. The amendments do not require an accounting change for securities held at a discount; the discount continues to be amortized to maturity. For public business entities, the amendments in this Update are effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2018. For all other entities, the amendments are effective for fiscal years beginning after December 15, 2019, and interim periods within fiscal years beginning after December 15, 2020. Early adoption is permitted, including adoption in an interim period. If an entity early adopts the amendments in an interim period, any adjustments should be reflected as of the beginning of the fiscal year that includes that interim period. An entity should apply the amendments in this Update on a modified retrospective basis through a cumulative-effect adjustment directly to retained earnings as of the beginning of the period of adoption. Additionally, in the period of adoption, an entity should provide disclosures about a change in accounting principle. This Update is not expected to have a significant impact on the Company’s financial statements.

In May 2017, the FASB issued ASU 2017-09, Compensation – Stock Compensation (Topic 718), which affects any entity that changes the terms or conditions of a share-based payment award. This Update amends the definition of modification by qualifying that modification accounting does not apply to changes to outstanding share-based payment awards that do not affect the total fair value, vesting requirements, or equity/liability classification of the awards. The amendments in this Update are effective for all entities for annual periods, and interim periods within those annual periods, beginning after December 15, 2017. Early adoption is permitted,

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

including adoption in any interim period, for (1) public business entities for reporting periods for which financial statements have not yet been issued and (2) all other entities for reporting periods for which financial statements have not yet been made available for issuance. The amendments in this Update should be applied prospectively to an award modified on or after the adoption date. The Company has adopted this standard and has no significant impact on the Company’s financial statements.

In August 2017, the FASB issued ASU 2017-12, Derivatives and Hedging (Topic 850), the objective of which is to improve the financial reporting of hedging relationships to better portray the economic results of an entity’s risk management activities in its financial statements. In addition, the amendments in this Update make certain targeted improvements to simplify the application and disclosure of the hedge accounting guidance in current general accepted accounting principles. For public business entities, the amendments in this Update are effective for fiscal years beginning after December 15, 2018, and interim periods within those fiscal years. For all other entities, the amendments are effective for fiscal years beginning after December 15, 2019, and interim periods beginning after December 15, 2020. Early application is permitted in any period after issuance. For cash flow and net investment hedges existing at the date of adoption, an entity should apply a cumulative-effect adjustment related to eliminating the separate measurement of ineffectiveness to accumulated other comprehensive income with a corresponding adjustment to the opening balance of retained earnings as of the beginning of the fiscal year that an entity adopts the amendments in this Update. The amended presentation and disclosure guidance is required only prospectively. This Update is not expected to have a significant impact on the Company’s financial statements.

In January 2018, the FASB issued ASU 2018-01, Leases (Topic 842), which provides an optional transition practical expedient to not evaluate under Topic 842 existing or expired land easements that were not previously accounted for as leases under the current lease guidance in Topic 840. An entity that elects this practical expedient should evaluate new or modified land easements under Topic 842 beginning at the date the entity adopts Topic 842; otherwise, an entity should evaluate all existing or expired land easements in connection with the adoption of the new lease requirements in Topic 842 to assess whether they meet the definition of a lease. The effective date and transition requirements for the amendments are the same as the effective date and transition requirements in ASU 2016-02. This Update is not expected to have a significant impact on the Company’s financial statements.

In February 2018, the FASB issued ASU 2018-02, Income Statement – Reporting Comprehensive Income (Topic 220). On December 22, 2017, the U.S. federal government enacted a tax bill, H.R.1, An Act to Provide for Reconciliation Pursuant to Titles II and V of the Concurrent Resolution on the Budget for Fiscal Year 2018 (Tax Cuts and Jobs Act), which requires deferred tax liabilities and assets to be adjusted for the effect of a change in tax laws. The amendments in this Update allow a reclassification from accumulated other comprehensive income to retained earnings for stranded tax effects resulting from the Tax Cuts and Jobs Act. The amendments in this Update are effective for all entities for fiscal years beginning after December 15, 2018, and interim periods within those fiscal years. Early adoption of the amendments in this Update is permitted. The amendments in this Update should be applied either in the period of adoption or retrospectively to each period (or periods) in which the effect of the change in the U.S. federal corporate income tax rate in the Tax Cuts and Jobs Act is recognized. The Company has elected to early adopt this standard as of December 31, 2017, which resulted in a one-time cumulative effect adjustment of $294,000 between retained earnings and accumulated other comprehensive loss on the Consolidated Balance Sheets. The adjustment had no impact on net income or any prior periods presented.

3.) Investment Securities:

Investments in debt securities are classified as held-to-maturity, available-for-sale or trading. Securities classified as held-to-maturity are those that management has the positive intent and ability to hold to maturity. Securities classified as available-for-sale are those that could be sold for liquidity, investment management, or similar reasons, even though management has no present intentions to do so. Securities classified as trading are those that management has bought principally for the purpose of selling in the near term. The Company currently has no securities classified as held-to-maturity or trading.

Available-for-sale securities, other than regulatory stock, are carried at fair value with unrealized gains and losses recorded as a separate component of shareholders’ equity, net of tax. Realized gains or losses on dispositions are based on net proceeds and the adjusted carrying amount of securities sold, using the specific identification method. Interest income includes amortization of purchase premium or discount and is amortized on the level-yield method without anticipating payments, except for U.S. Government mortgage-backed and related securities where twelve months of historical prepayments are taken into consideration.

The regulatory stock is carried at cost (its redeemable value) and the Company is required to hold such investments as a condition of membership in order to transact business with the Federal Home Loan Bank (FHLB) of Cincinnati and the Federal Reserve Bank (FRB). The stock is bought from and sold to the correspondent institutions based upon its par value. The stock cannot be traded or sold in any market and as such is classified as restricted stock, carried at cost (its redeemable value) and evaluated by management. The stock’s value is determined by the ultimate recoverability of the par value rather than by recognizing temporary declines. The determination of whether the par value will ultimately be recovered is influenced by criteria such as the following: (a) the significance

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of the decline in net assets of the FHLB and FRB as compared to the capital stock amount and the length of time this situation has persisted, (b) commitments by the FHLB and FRB to make payments required by law or regulation and the level of such payments in relation to the operating performance, (c) the impact of legislative and regulatory changes on the customer base of the FHLB and FRB and (d) the liquidity position of the FHLB and FRB. The Company does not consider these investments to be other-than-temporarily impaired at March 31, 2018.

Securities are evaluated periodically to determine whether a decline in value is other-than-temporary. Management utilizes criteria such as the magnitude and duration of the decline, along with the reasons underlying the decline, to determine whether the loss in value is other-than-temporary. The term "other-than-temporary" is not intended to indicate that the decline in value is permanent but indicates that the prospect for a near-term recovery of value is not necessarily favorable and that there is a lack of evidence to support a realizable value equal to or greater than the carrying value of the investment. Unrealized losses on available-for-sale investments have not been recognized into income. However, once a decline in value is determined to be other-than-temporary, the credit related other-than-temporary impairment (OTTI) is recognized in earnings while the non-credit related OTTI on securities not expected to be sold is recognized in other comprehensive income (loss).

The following table is a summary of investment securities available-for-sale:

| | (Amounts in thousands) | | | |
|---|---|---|---|---|
| March 31, 2018 | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value |
| U.S. Government agencies and corporations | $9,231 | $ 36 | $ 227 | $9,040 |
| Obligations of states and political subdivisions | 53,552 | 23 | 1,592 | 51,983 |
| U.S. Government-sponsored mortgage-backed securities | 64,565 | — | 2,401 | 62,164 |
| U.S. Government-sponsored collateralized mortgage obligations | 6,206 | — | 211 | 5,995 |
| U.S. Government-guaranteed small business administration pools | 9,210 | — | 346 | 8,864 |
| Trust preferred securities | 1,618 | — | 528 | 1,090 |
| Total debt securities | 144,382 | 59 | 5,305 | 139,136 |
| Federal Home Loan Bank (FHLB) stock | 2,355 | — | — | 2,355 |
| Federal Reserve Bank (FRB) stock | 226 | — | — | 226 |
| Total regulatory stock | 2,581 | — | — | 2,581 |
| Total investment securities available-for-sale | $146,963 | $ 59 | $ 5,305 | $141,717 |

| | (Amounts in thousands) | | | |
|---|---|---|---|---|
| December 31, 2017 | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value |
| U.S. Government agencies and corporations | $3,344 | $ 1 | $ 140 | $3,205 |
| Obligations of states and political subdivisions | 71,700 | 740 | 324 | 72,116 |

| | | | | |
|---|---|---|---|---|
| U.S. Government-sponsored mortgage-backed securities | 69,066 | 6 | 1,404 | 67,668 |
| U.S. Government-sponsored collateralized mortgage obligations | 6,463 | — | 161 | 6,302 |
| U.S. Government-guaranteed small business administration pools | 9,911 | — | 256 | 9,655 |
| Trust preferred securities | 1,618 | — | 723 | 895 |
| Total debt securities | 162,102 | 747 | 3,008 | 159,841 |
| Federal Home Loan Bank (FHLB) stock | 2,355 | — | — | 2,355 |
| Federal Reserve Bank (FRB) stock | 226 | — | — | 226 |
| Total regulatory stock | 2,581 | — | — | 2,581 |
| Total investment securities available-for-sale | $164,683 | $ 747 | $ 3,008 | $162,422 |

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The amortized cost and fair value of debt securities at March 31, 2018, by contractual maturity, are shown below. Actual maturities will differ from contractual maturities because issuers may have the right to call or prepay obligations with or without call or prepayment penalties.

| | (Amounts in thousands) | |
|---|---|---|
| | Amortized Cost | Fair Value |
| Due in one year or less | $— | $— |
| Due after one year through five years | 542 | 554 |
| Due after five years through ten years | 12,292 | 11,958 |
| Due after ten years | 60,777 | 58,465 |
| Total | 73,611 | 70,977 |
| U.S. Government-sponsored mortgage-backed and related securities | 70,771 | 68,159 |
| Total debt securities | $144,382 | $139,136 |

The table below sets forth the proceeds and gains or losses realized on available for sale securities sold or called for the periods presented:

| | (Amounts in thousands) Three Months Ended March 31, | |
|---|---|---|
| | 2018 | 2017 |
| Proceeds on securities sold | $19,841 | $15,725 |
| Gross realized gains | 123 | 146 |
| Gross realized losses | 103 | 137 |

Investment securities with a carrying value of approximately $63.8 million at March 31, 2018 and $105.0 million at December 31, 2017 were pledged to secure deposits and for other purposes. The remaining securities provide an adequate level of liquidity.

The following is a summary of the fair value of available-for-sale securities with unrealized losses and an aging of those unrealized losses at March 31, 2018:

(Amounts in thousands)

| | Less than 12 Months | | 12 Months or More | | Total | |
|---|---|---|---|---|---|---|
| | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses |
| U.S. Government agencies and corporations | $342 | $ 3 | $2,776 | $ 224 | $3,118 | $ 227 |
| Obligations of states and political subdivisions | 30,767 | 786 | 17,805 | 806 | 48,572 | 1,592 |
| U.S. Government-sponsored mortgage-backed securities | 23,589 | 590 | 38,575 | 1,811 | 62,164 | 2,401 |
| U.S. Government-sponsored collateralized mortgage obligations | — | — | 5,995 | 211 | 5,995 | 211 |
| U.S. Government-guaranteed small business administration pools | — | — | 8,864 | 346 | 8,864 | 346 |
| Trust preferred securities | — | — | 1,090 | 528 | 1,090 | 528 |
| Total | $54,698 | $ 1,379 | $75,105 | $ 3,926 | $129,803 | $ 5,305 |

The above table comprises 122 investment securities where the fair value is less than the related amortized cost.

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The following is a summary of the fair value of available-for-sale securities with unrealized losses and an aging of those unrealized losses at December 31, 2017:

| | (Amounts in thousands) | | | | | |
|---|---|---|---|---|---|---|
| | Less than 12 Months | | 12 Months or More | | Total | |
| | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses |
| U.S. Government agencies and corporations | $— | $ — | $2,860 | $ 140 | $2,860 | $ 140 |
| Obligations of states and political subdivisions | 7,430 | 24 | 18,066 | 300 | 25,496 | 324 |
| U.S. Government-sponsored mortgage-backed securities | 24,888 | 241 | 40,968 | 1,163 | 65,856 | 1,404 |
| U.S. Government-sponsored collateralized mortgage obligations | — | — | 6,302 | 161 | 6,302 | 161 |
| U.S. Government-guaranteed small business administration pools | 2,532 | 38 | 7,123 | 218 | 9,655 | 256 |
| Trust preferred securities | — | — | 895 | 723 | 895 | 723 |
| Total | $34,850 | $ 303 | $76,214 | $ 2,705 | $111,064 | $ 3,008 |

The above table comprises 83 investment securities where the fair value is less than the related amortized cost.

The trust preferred securities with an unrealized loss represent pools of trust preferred debt issued primarily by bank holding companies. The unrealized losses on the Company’s investment in U.S. Government agencies and corporations, obligations of states and political subdivisions, U.S. Government-sponsored mortgage-backed securities, U.S. Government-sponsored collateralized mortgage obligations and U.S. Government-guaranteed small business administration pools were caused by changes in market rates and related spreads. The significant increase in unrealized losses beginning in 2018 is a direct result of the spike in interest rates immediately following the passage of the Tax Act. It is expected that the securities would not be settled at less than the amortized cost of the Company’s investment because the decline in fair value is attributable to changes in interest rates and relative spreads and not credit quality. Also, except for the securities described below, the Company does not intend to sell those investments and it is not more-likely-than-not that the Company will be required to sell the investments before recovery of its amortized cost basis less any current period credit loss. The Company does not consider these investments to be other-than-temporarily impaired at March 31, 2018.

Securities Deemed to be Other-Than-Temporarily Impaired

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

For debt securities in an unrealized loss position, management assesses whether (a) it has the intent to sell the debt security or (b) it is more-likely-than-not that it will be required to sell the debt security before its anticipated recovery. If either of these conditions is met, an OTTI on the security must be recognized.

In instances in which a determination is made that a credit loss (defined as the difference between the present value of the cash flows expected to be collected and the amortized cost basis) exists but the entity does not intend to sell the debt security and it is not more-likely-than-not that the entity will be required to sell the debt security before the anticipated recovery of its remaining amortized cost basis (i.e., the amortized cost basis less any current-period credit loss), the Company presents the amount of the OTTI recognized in the Consolidated Statements of Income.

In these instances, the impairment is separated into (a) the amount of the total impairment related to the credit loss, and (b) the amount of the total impairment related to all other factors. The amount of the total OTTI related to the credit loss is recognized in earnings. The amount of the total impairment related to all other factors is recognized in other comprehensive income. The total other-than-temporary impairment is presented in the Consolidated Statements of Income with an offset for the amount of the total other-than-temporary impairment that is recognized in other comprehensive income.

As more fully disclosed in Note 9, the Company assessed the impairment of trust preferred securities currently in an illiquid market. The Company records impairment credit losses in earnings (before tax) and non-credit impairment losses in other comprehensive income (loss) (before tax). Through the impairment assessment process, there was no OTTI loss recognized in the three months ended March 31, 2018 and 2017.

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The following provides a cumulative rollforward of credit losses recognized in earnings for trust preferred securities held.

| | (Amounts in thousands) Three Months Ended March 31, | |
|---|---|---|
| | 2018 | 2017 |
| Beginning balance | $140 | $140 |
| Reduction for debt securities for which other-than-temporary impairment has been previously recognized and there is no related other comprehensive income | — | — |
| Credit losses on debt securities for which other-than-temporary impairment has not been previously recognized | — | — |
| Additional credit losses on debt securities for which other-than-temporary impairment was previously recognized | — | — |
| Sale of debt securities | — | — |
| Ending balance | $140 | $140 |

At March 31, 2018 and December 31, 2017, there were $1.1 million and $895,000, respectively, of investment securities considered to be in non-accrual status. This balance is comprised of two trust preferred securities at March 31, 2018. As a result of the delay in the collection of interest payments, management placed these securities in non-accrual status. Current estimates indicate that the interest payment delays may exceed ten years.

4.) Loans and Allowance for Loan Losses:

The Company, through the Bank, grants residential, consumer and commercial loans to customers located primarily in Northeastern Ohio and Western Pennsylvania.

The following represents the composition of the loan portfolio for the period ending:

| (Amounts in thousands) | |
|---|---|
| March 31, 2018 | December 31, 2017 |

| | Balance | % | Balance | % |
|---|---|---|---|---|
| Commercial | $75,568 | 16.7 | $113,341 | 23.3 |
| Commercial real estate | 284,306 | 62.9 | 283,135 | 58.1 |
| Residential real estate | 63,148 | 14.0 | 62,071 | 12.7 |
| Consumer - home equity | 25,498 | 5.6 | 26,018 | 5.3 |
| Consumer - other | 3,394 | 0.8 | 2,925 | 0.6 |
| Total loans | $451,914 | | $487,490 | |

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Management has an established methodology to determine the adequacy of the allowance for loan losses that assesses the risks and losses inherent in the loan portfolio. For purposes of determining the allowance for loan losses, the Company has segmented loans in the portfolio by product type. Loans are segmented into the following pools: commercial loans, commercial real estate loans, residential real estate loans and consumer loans. The pools of commercial real estate loans and commercial loans are also broken down further by industry sectors when analyzing the related pools. Using the largest concentrations as the qualifier, these industry sectors include non-residential buildings; skilled nursing and nursing care; residential real estate lessors, agents and managers; hotel and motels, and trucking. The Company also sub-segments the consumer loan portfolio into the following two classes: home equity loans and other consumer loans. Historical loss percentages for each risk category are calculated and used as the basis for calculating allowance allocations. These historical loss percentages are calculated over multiple periods for all portfolio segments. Management evaluates these results and utilizes the most reflective period in the calculation. Certain qualitative factors are then added to the historical allocation percentage to get the adjusted factor.

These factors include, but are not limited to, the following:

| Factor Considered: | Risk Trend: |
|---|---|
| Levels of and trends in charge-offs, classifications and non-accruals | Stable |
| Trends in volume and terms | Decreasing |
| Changes in lending policies and procedures | Stable |
| Experience, depth and ability of management, including loan review function | Stable |
| Economic trends, including valuation of underlying collateral | Stable |
| Concentrations of credit | Decreasing |

The following factors are analyzed and applied to loans internally graded with higher credit risk in addition to the above factors for non-classified loans:

| Factor Considered: | Risk Trend: |
|---|---|
| Levels and trends in classification | Stable |
| Declining trends in financial performance | Stable |
| Structure and lack of performance measures | Stable |
| Migration between risk categories | Stable |

The provision charged to operations can be allocated to a loan classification either as a positive or negative value as a result of any material changes to: net charge-offs or recovery which influence the historical allocation percentage, qualitative risk factors or loan balances.

The following is an analysis of changes in the allowance for loan losses for the periods ended:

| Three Months Ended | (Amounts in thousands) | | | | | |
|---|---|---|---|---|---|---|
| March 31, 2018 | Commercial | Commercial real estate | Residential real estate | Consumer - home equity | Consumer - other | Total |

| | | | | | | |
|---|---|---|---|---|---|---|
| Balance at beginning of period | $1,591 | $ 2,702 | $ 117 | $ 70 | $ 98 | $4,578 |
| Loan charge-offs | (1,163) | — | — | — | (50) | (1,213) |
| Recoveries | — | — | — | 3 | 16 | 19 |
| Net loan recoveries (charge-offs) | (1,163) | — | — | 3 | (34) | (1,194) |
| Provision charged to operations | 906 | (412) | (24) | (6) | 36 | 500 |
| Balance at end of period | $1,334 | $ 2,290 | $ 93 | $ 67 | $ 100 | $3,884 |

| | (Amounts in thousands) | | | | | |
|---|---|---|---|---|---|---|
| March 31, 2017 | Commercial | Commercial real estate | Residential real estate | Consumer - home equity | Consumer - other | Total |
| Balance at beginning of period | $1,394 | $ 3,072 | $ 163 | $ 150 | $ 89 | $4,868 |
| Loan charge-offs | — | (93) | — | — | (44) | (137) |
| Recoveries | 108 | — | — | 2 | 14 | 124 |
| Net loan recoveries (charge-offs) | 108 | (93) | — | 2 | (30) | (13) |
| Provision charged to operations | (256) | 247 | (21) | (4) | 34 | — |
| Balance at end of period | $1,246 | $ 3,226 | $ 142 | $ 148 | $ 93 | $4,855 |

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The total allowance reflects management's estimate of loan losses inherent in the loan portfolio at the consolidated balance sheet date.

The following tables present a full breakdown by portfolio classification of the allowance for loan losses and the recorded investment in loans at March 31, 2018 and December 31, 2017:

(Amounts in thousands)

| March 31, 2018 | Commercial | Commercial real estate | Residential real estate | Consumer - home equity | Consumer - other | Total |
|---|---|---|---|---|---|---|
| Allowance for loan losses: | | | | | | |
| Ending allowance balance attributable to loans: | | | | | | |
| Individually evaluated for impairment | $— | $ — | $ — | $ — | $ — | $— |
| Collectively evaluated for impairment | 1,334 | 2,290 | 93 | 67 | 100 | 3,884 |
| Total ending allowance balance | $1,334 | $ 2,290 | $ 93 | $ 67 | $ 100 | $3,884 |
| Loan Portfolio: | | | | | | |
| Individually evaluated for impairment | $4,278 | $ 4,355 | $ — | $ — | $ — | $8,633 |
| Collectively evaluated for impairment | 71,290 | 279,951 | 63,148 | 25,498 | 3,394 | 443,281 |
| Total ending loans balance | $75,568 | $ 284,306 | $ 63,148 | $ 25,498 | $ 3,394 | $451,914 |

(Amounts in thousands)

| December 31, 2017 | Commercial | Commercial real estate | Residential real estate | Consumer - home equity | Consumer - other | Total |
|---|---|---|---|---|---|---|
| Allowance for loan losses: | | | | | | |
| Ending allowance balance attributable to loans: | | | | | | |
| Individually evaluated for impairment | $625 | $ — | $ — | $ — | $ — | $625 |
| Collectively evaluated for impairment | 966 | 2,702 | 117 | 70 | 98 | 3,953 |
| Total ending allowance balance | $1,591 | $ 2,702 | $ 117 | $ 70 | $ 98 | $4,578 |
| Loan Portfolio: | | | | | | |
| Individually evaluated for impairment | $5,581 | $ 4,664 | $ — | $ — | $ — | $10,245 |
| Collectively evaluated for impairment | 107,760 | 278,471 | 62,071 | 26,018 | 2,925 | 477,245 |

| | | | | | | |
|---|---|---|---|---|---|---|
| Total ending loans balance | $113,341 | $ 283,135 | $ 62,071 | $ 26,018 | $ 2,925 | $487,490 |

The decrease in commercial loan balances from year-end was due in part to 60-day or less term commercial loans for a total of $43.0 million that closed in December 2017 and were fully secured by segregated deposit accounts with the Bank. The loans matured in the first quarter of 2018. The commercial charge off related to loans that were restructured with no principal forgiveness, but with a substantial concession in interest rate. The below market rate triggered recognition of a charge-off equivalent to the difference in present value of loan payments discounted at the market rate of interest. The charged off amount of $1.2 million is recorded as a loan discount. As loan payments are made, interest will be recognized at the market rate versus the negotiated rate via the amortization of the discount over the various lives of the loans. There was $625,000 in specific reserve previously allocated to these loans at December 31, 2017.

The decrease in the provision for commercial real estate loans is due mainly to a decrease in the concentration of credit factor. The recent segmentation of the commercial real estate loan portfolio into its five largest concentrations has resulted in lower allocations to those segments. The residential real estate, consumer-home equity and other household provisions remained fairly constant. The amount of net charge-offs also impacts the provision charged to operations for any category of loans. Charge-offs affect the historical rate applied to each category, and the amount needed to replenish the amount charged-off, which impacted home equity and consumer loans as well as commercial real estate loans.

The following tables represent credit exposures by internally assigned grades for March 31, 2018 and December 31, 2017. The grading analysis estimates the capability of the borrower to repay the contractual obligations of the loan agreements as scheduled or at all. The Company's internal credit risk grading system is based on experiences with similarly graded loans.

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The Company's internally assigned grades are as follows:

Pass – loans which are protected by the current net worth and paying capacity of the obligor or by the value of the underlying collateral. Within this category, there are grades of exceptional, quality, acceptable and pass monitor.
Special Mention – loans where a potential weakness or risk exists, which could cause a more serious problem if not corrected.
Substandard – loans that have a well-defined weakness based on objective evidence and are characterized by the distinct possibility that the Bank will sustain some loss if the deficiencies are not corrected.
Doubtful – loans classified as doubtful have all the weaknesses inherent in a substandard asset but with the severity which makes collection in full highly questionable and improbable, based on existing circumstances.
Loss – loans classified as a loss are considered uncollectible, or of such value that continuance as an asset is not warranted. This rating does not mean that the assets have no recovery or salvage value but rather that the assets should be charged off now, even though partial or full recovery may be possible in the future.

The following table is a summary of credit quality indicators by internally assigned grades as of March 31, 2018 and December 31, 2017:

| | (Amounts in thousands) | |
|---|---|---|
| | Commercial | Commercial real estate |
| March 31, 2018 | | |
| Pass | $61,834 | $ 252,092 |
| Special Mention | 6,255 | 26,773 |
| Substandard | 7,479 | 5,441 |
| Doubtful | — | — |
| Ending Balance | $75,568 | $ 284,306 |

| | (Amounts in thousands) | |
|---|---|---|
| | Commercial | Commercial real estate |
| December 31, 2017 | | |
| Pass | $100,436 | $ 252,960 |
| Special Mention | 4,836 | 24,307 |
| Substandard | 8,069 | 5,868 |
| Doubtful | — | — |
| Ending Balance | $113,341 | $ 283,135 |

The Company evaluates the classification of consumer, home equity and residential loans primarily on a pooled basis. If the Company becomes aware that adverse or distressed conditions exist that may affect a particular loan, the loan is downgraded following the above definitions of special mention and substandard. Nonaccrual loans in these categories are evaluated for charge off or charge down, and the remaining balance has the same allowance factor as pooled loans.

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The following table is a summary of consumer credit exposure as of March 31, 2018 and December 31, 2017:

| | (Amounts in thousands) | | |
|---|---|---|---|
| | Residential real estate | Consumer - home equity | Consumer - other |
| March 31, 2018 | | | |
| Performing | $62,742 | $ 25,289 | $ 3,394 |
| Nonperforming | 406 | 209 | — |
| Total | $63,148 | $ 25,498 | $ 3,394 |

| | (Amounts in thousands) | | |
|---|---|---|---|
| | Residential real estate | Consumer - home equity | Consumer - other |
| December 31, 2017 | | | |
| Performing | $61,824 | $ 25,889 | $ 2,925 |
| Nonperforming | 247 | 129 | — |
| Total | $62,071 | $ 26,018 | $ 2,925 |

Loans are considered to be nonperforming when they become 90 days past due or on nonaccrual status, though the Company may be receiving partial payments of interest and partial repayments of principal on such loans. When a loan is placed in non-accrual status, previously accrued but unpaid interest is deducted from interest income. Loans in foreclosure are considered nonperforming.

The following table is a summary of classes of loans on non-accrual status as of March 31, 2018 and December 31, 2017:

| | (Amounts in thousands) | |
|---|---|---|
| | March 31, 2018 | December 31, 2017 |
| Commercial | $— | $ — |
| Commercial real estate | 343 | 506 |
| Residential real estate | 406 | 247 |

| | | |
|---|---|---|
| Consumer: | | |
| Consumer - home equity | 209 | 129 |
| Consumer - other | — | — |
| Total | $958 | $ 882 |

Troubled Debt Restructuring

Nonperforming loans also include certain loans that have been modified in troubled debt restructurings (TDRs) where economic concessions have been granted to borrowers who have experienced or are expected to experience financial difficulties. These concessions typically result from the Company's loss mitigation activities and could include reductions in the interest rate, payment extensions, forgiveness of principal, forbearance or other actions. Certain TDRs are classified as nonperforming at the time of restructure and may only be returned to performing status after considering the borrower's sustained repayment performance for a reasonable period, generally six months.

There were no loans modified as TDR's during the period ended March 31, 2017.

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The following presents, by class, information related to loans modified in a TDR during the period ending March 31, 2018.

| (Dollar amounts in thousands) Three Months Ended March 31, 2018 | Number of contracts | Pre-modification recorded investment | Post-modification recorded investment | Increase in the allowance |
|---|---|---|---|---|
| Commercial | 7 | $ 5,373 | $ 4,210 | $ — |
| Commercial real estate | — | — | — | — |
| Total restructured loans | 7 | $ 5,373 | $ 4,210 | $ — |
| Subsequently defaulted | — | — | | |

The seven commercial loans were all to one borrower. The loans were restructured with no principal forgiveness, but with a substantial concession in interest rate. The below market rate triggered recognition of a charge-off equivalent to the difference in present value of loan payments discounted at the market rate of interest. The charged off amount of $1.2 million is recorded as loan discount. As loan payments are made, interest will be recognized at the market rate versus the negotiated rate via the amortization of the discount over the various lives of the loans.

The following table is an aging analysis of the recorded investment of past due loans as of March 31, 2018 and December 31, 2017:

| (Amounts in thousands) | 30-59 Days Past Due | 60-89 Days Past Due | 90 Days Or Greater | Total Past Due | Current | Total Loans | Recorded Investment > 90 Days and Accruing |
|---|---|---|---|---|---|---|---|
| March 31, 2018 | | | | | | | |
| Commercial | $56 | $ — | $ — | $ 56 | $75,512 | $75,568 | $ — |
| Commercial real estate | 168 | — | 240 | 408 | 283,898 | 284,306 | — |
| Residential real estate | 175 | 5 | 284 | 464 | 62,684 | 63,148 | — |
| Consumer: | | | | | | | |
| Consumer - home equity | 102 | — | 28 | 130 | 25,368 | 25,498 | — |
| Consumer - other | 11 | — | — | 11 | 3,383 | 3,394 | — |
| Total | $512 | $ 5 | $ 552 | $ 1,069 | $450,845 | $451,914 | $ — |

| (Amounts in thousands) | 30-59 Days | 60-89 Days | 90 Days Or | Total Past Due | Current | Total Loans | Recorded Investment > |
|---|---|---|---|---|---|---|---|

| | Past Due | Past Due | Greater | | | | 90 Days and Accruing |
|---|---|---|---|---|---|---|---|
| December 31, 2017 | | | | | | | |
| Commercial | $— | $— | $ — | $ — | $113,341 | $113,341 | $ — |
| Commercial real estate | 173 | 12 | 390 | 575 | 282,560 | 283,135 | — |
| Residential real estate | 240 | 29 | 216 | 485 | 61,586 | 62,071 | — |
| Consumer: | | | | | | | |
| Consumer - home equity | — | 82 | 28 | 110 | 25,908 | 26,018 | — |
| Consumer - other | 15 | — | — | 15 | 2,910 | 2,925 | — |
| Total | $428 | $ 123 | $ 634 | $ 1,185 | $486,305 | $487,490 | $ — |

An impaired loan is a loan on which, based on current information and events, it is probable that a creditor will be unable to collect all amounts due (including both interest and principal) according to the contractual terms of the loan agreement. However, an insignificant delay or insignificant shortfall in amount of payments on a loan does not indicate that the loan is impaired.

When a loan is determined to be impaired, impairment should be measured based on the present value of expected future cash flows discounted at the loan’s effective interest rate. However, as a practical expedient, the Company will measure impairment based on a loan’s observable market price, or the fair value of the collateral if the loan is collateral dependent.

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The following are the criteria for selecting individual loans / relationships for impairment analysis. Non-homogenous loans which meet the criteria below are evaluated quarterly.

- All borrowers whose loans are classified doubtful by examiners and internal loan review
- All loans on non-accrual status
- Any loan in foreclosure
- Any loan with a specific allowance
- Any loan determined to be collateral dependent for repayment
- Loans classified as troubled debt restructuring

Commercial loans and commercial real estate loans evaluated for impairment are excluded from the general pool of loans in the ALLL calculation regardless if a specific reserve was determined. If management determines that the value of the impaired loan is less than the recorded investment in the loan (net of previous charge-offs, deferred loan fees or costs and unamortized premium or discount), impairment is recognized through an allowance estimate or a charge-off to the allowance.

The following table presents the recorded investment and unpaid principal balances for impaired loans, excluding homogenous loans for which impaired analyses are not necessarily performed, with the associated allowance amount, if applicable, at March 31, 2018 and December 31, 2017. Also presented are the average recorded investments in the impaired balances and interest income recognized after impairment for the three months ended March 31, 2018 and 2017.

| | (Amounts in thousands) | | |
|---|---|---|---|
| | Recorded Investment | Unpaid Principal Balance | Related Allowance |
| March 31, 2018 | | | |
| With no related allowance recorded: | | | |
| Commercial | $4,278 | $ 5,430 | $ — |
| Commercial real estate | 4,355 | 4,355 | — |
| With an allowance recorded: | | | |
| Commercial | — | — | — |
| Commercial real estate | — | — | — |
| Total: | | | |
| Commercial | $4,278 | $ 5,430 | $ — |
| Commercial real estate | $4,355 | $ 4,355 | $ — |

| | (Amounts in thousands) | | |
|---|---|---|---|
| | Recorded Investment | Unpaid Principal Balance | Related Allowance |
| December 31, 2017 | | | |
| With no related allowance recorded: | | | |
| Commercial | $65 | $ 65 | $ — |
| Commercial real estate | 4,664 | 4,742 | — |

| | | | |
|---|---|---|---|
| With an allowance recorded: | | | |
| Commercial | 5,516 | 5,516 | 625 |
| Commercial real estate | — | — | — |
| Total: | | | |
| Commercial | $5,581 | $ 5,581 | $ 625 |
| Commercial real estate | $4,664 | $ 4,742 | $ — |

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| | (Amounts in thousands) Three Months Ended | |
|---|---|---|
| | Average Recorded Investment | Interest Income Recognized |
| March 31, 2018 | | |
| With no related allowance recorded: | | |
| Commercial | $1,467 | $ 3 |
| Commercial real estate | 4,540 | 108 |
| With an allowance recorded: | | |
| Commercial | 3,643 | 46 |
| Commercial real estate | — | — |
| Total: | | |
| Commercial | $5,110 | $ 49 |
| Commercial real estate | $4,540 | $ 108 |

| | (Amounts in thousands) Three Months Ended | |
|---|---|---|
| | Average Recorded Investment | Interest Income Recognized |
| March 31, 2017 | | |
| With no related allowance recorded: | | |
| Commercial | $97 | $ 2 |
| Commercial real estate | 5,603 | 74 |
| With an allowance recorded: | | |
| Commercial | — | — |
| Commercial real estate | 941 | 6 |
| Total: | | |
| Commercial | $97 | $ 2 |
| Commercial real estate | $6,544 | $ 80 |

5.) Legal Proceedings:

The Company is involved in legal actions arising in the ordinary course of business. In the opinion of management, the outcomes from these matters, either individually or in the aggregate, are not expected to have any material effect on the Company.

6.) Earnings Per Share and Capital Transactions:

Earnings per share is computed by dividing net income available to common shareholders by the weighted average number of shares of common outstanding stock, net of any treasury shares, during the period. Diluted earnings per share is calculated by dividing net income available to common shareholders by the weighted average number of shares of common stock outstanding, net of any treasury shares, after consideration of the potential dilutive effect of common stock equivalents, based upon the treasury stock method using an average market price for the period. The common stock equivalents are comprised of the restricted share awards.

| | Three Months Ended March 31, | |
|---|---|---|
| | 2018 | 2017 |
| Net income (amounts in thousands) | $1,537 | $1,000 |
| | | |
| Weighted average common shares outstanding | 4,393,449 | 4,406,646 |
| Net effect of dilutive common share equivalents | 8,327 | 4,528 |
| Adjusted average shares outstanding-dilutive | 4,401,776 | 4,411,174 |
| | | |
| Basic earnings per share | $0.35 | $0.23 |
| Diluted earnings per share | $0.35 | $0.23 |

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7.) Subordinated Debt:

In July 2007, a trust formed by the Company issued $5.0 million of floating rate trust preferred securities as part of a pooled offering of such securities due December 2037. The Company owns all $155,000 of the common securities issued by the trust. The securities bear interest at the 3-month LIBOR rate plus 1.45%. The rates at March 31, 2018 and December 31, 2017 were 3.57% and 3.04%, respectively. The Company issued subordinated debentures to the trust in exchange for the proceeds of the trust preferred offering. The debentures represent the sole assets of this trust. The Company may redeem the subordinated debentures, in whole or in part, at par.

The trust is not consolidated with the Company's financial statements. Accordingly, the Company does not report the securities issued by the trust as liabilities, but instead reports as liabilities the subordinated debentures issued by the Company and held by the trust. The subordinated debentures qualify as Tier 1 capital for regulatory purposes in determining and evaluating the Company's capital adequacy.

8.) Commitments:

The Bank is a party to financial instruments with off-balance sheet risk in the normal course of business to meet the financing needs of its customers. These financial instruments include commitments to extend credit, standby letters of credit and financial guarantees. Such instruments involve, to varying degrees, elements of credit risk in excess of the amount recognized on the Consolidated Balance Sheets. The contract or notional amounts on those instruments reflect the extent of involvement the Company has in particular classes of financial instruments.

In the event of nonperformance by the other party, the Company's exposure to credit loss on these financial instruments is represented by the contract or notional amount of the instrument. The Company uses the same credit policies in making commitments and conditional obligations as it does for instruments recorded on the balance sheet. The amount and nature of collateral obtained, if any, is based on management's credit evaluation.

The following table is a summary of such contractual commitments:

| | (Amounts in thousands) | |
|---|---|---|
| | March 31, 2018 | December 31, 2017 |
| Commitments to extend credit: | | |
| Fixed rate | $40,391 | $ 32,749 |
| Variable rate | 58,337 | 60,508 |
| Standby letters of credit | 3,445 | 3,600 |

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. Generally, these financial arrangements have fixed expiration dates or other termination clauses and may require payment of a fee. Standby letters of credit are conditional commitments issued by the Company to guarantee the performance of a customer to a third party. Since many of the commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. The Company evaluates each customer’s creditworthiness on a case-by-case basis. The amount of collateral obtained, if deemed necessary by the Company upon extension of credit, is based on management’s credit evaluation of the counterparty. Collateral held varies but may include accounts receivable, inventory, property, plant and equipment and income-producing commercial properties. The increase in commitments is in line with the Company’s increased focus on commercial and industrial lending, and specifically lines of credit.

The Company also offers limited overdraft protection as a non-contractual courtesy which is available to businesses as well as individually/jointly owned accounts in good standing for personal or household use. The Company reserves the right to discontinue this service without prior notice.

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The following table is a summary of overdraft protection for the periods indicated:

| (Amounts in thousands) | March 31, 2018 | December 31, 2017 |
|---|---|---|
| Overdraft protection available on depositors' accounts | $8,961 | $ 9,637 |
| Balance of overdrafts included in loans | 63 | 103 |
| Average daily balance of overdrafts | 107 | 115 |
| Average daily balance of overdrafts as a percentage of available | 1.19 % | 1.19 % |

Customer Derivatives - Interest Rates Swaps/Floors – The Company enters into interest rate swaps that allow our commercial loan customers to effectively convert a variable-rate commercial loan agreement to a fixed-rate commercial loan agreement. Under these agreements, the Company enters into a variable-rate loan agreement with a customer in addition to an interest rate swap agreement, which serves to effectively swap the customer's variable-rate into a fixed-rate. The Company then enters into a corresponding swap agreement with a third party in order to economically hedge its exposure through the customer agreement. The interest rate swaps with both the customers and third party are not designated as hedges under FASB ASC 815 and are marked to market through earnings. As the interest rate swaps are structured to offset each other, changes to the underlying benchmark interest rates considered in the valuation of these instruments do not result in an impact to earnings; however, there may be fair value adjustments related to credit quality variations between counterparties, which may impact earnings as required by FASB ASC 820. There was no effect on earnings in any periods presented. At March 31, 2018, based on the contract values, it was not necessary for any collateral to be pledged on the interest rate swap, compared to December 31, 2017 where the Company had one U.S. Government-sponsored mortgage-backed security pledged for collateral on its interest rate swaps with the third party financial institution at a fair value of $1.4 million.

Summary information regarding these derivatives is presented below:

| (Amounts in thousands) | Notional Amount | | | | Fair Value | |
|---|---|---|---|---|---|---|
| | March 31, 2018 | December 31, 2017 | Interest Rate Paid | Interest Rate Received | March 31, 2018 | December 31, 2017 |
| Customer interest rate swap | | | | | | |
| Maturing in 2020 | $2,480 | $ 2,504 | 1 Mo. Libor + Margin | Fixed | $39 | $ (16 ) |
| Maturing in 2025 | 5,199 | 5,288 | 1 Mo. Libor + Margin | Fixed | 62 | 36 |

| | | | | | | |
|---|---|---|---|---|---|---|
| Maturing in 2026 | 2,035 | 2,064 | 1 Mo. Libor + Margin | Fixed | 84 | (44 ) |
| Maturing in 2027 | 14,095 | 14,197 | 1 Mo. Libor + Margin | Fixed | 164 | 209 |
| Total | $23,809 | $ 24,053 | | | $349 | $ 185 |
| | | | | | | |
| Third party interest rate swap | | | | | | |
| Maturing in 2020 | $2,480 | $ 2,504 | Fixed | 1 Mo. Libor + Margin | $(39 ) | $ 16 |
| Maturing in 2025 | 5,199 | 5,288 | Fixed | 1 Mo. Libor + Margin | (62 ) | (36 ) |
| Maturing in 2026 | 2,035 | 2,064 | Fixed | 1 Mo. Libor + Margin | (84 ) | 44 |
| Maturing in 2027 | 14,095 | 14,197 | Fixed | 1 Mo. Libor + Margin | (164) | (209 ) |
| Total | $23,809 | $ 24,053 | | | $(349) | $ (185 ) |

The following table presents the fair values of derivative instruments in the balance sheet:

| | (Amounts in thousands) | | | |
|---|---|---|---|---|
| | Assets | | Liabilities | |
| | Balance Sheet Location | Fair Value | Balance Sheet Location | Fair Value |
| March 31, 2018 | | | | |
| Interest rate derivatives | Other assets | $ 349 | Other liabilities | $ 349 |
| | | | | |
| December 31, 2017 | | | | |
| Interest rate derivatives | Other assets | $ 185 | Other liabilities | $ 185 |

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9.) Fair Value of Assets and Liabilities:

Measurements

The Company groups assets and liabilities recorded at fair value into three levels based on the markets in which the assets and liabilities are traded and the reliability of the assumptions used to determine fair value. A financial instrument's level within the fair value hierarchy is based on the lowest level of input that is significant to the fair value measurement (with level 1 considered highest and level 3 considered lowest). A brief description of each level follows:

Level 1: Quoted prices are available in active markets for identical assets or liabilities as of the reported date.

Level 2: Pricing inputs are other than quoted prices in active markets, which are either directly or indirectly observable as of the reported date. The nature of these assets and liabilities include items for which quoted prices are available but which trade less frequently, and items that are fair valued using other financial instruments, the parameters of which can be directly observed.

Level 3: Assets and liabilities that have little to no pricing observability as of the reported date. These items do not have two-way markets and are measured using management's best estimate of fair value, where inputs into the determination of fair value require significant management judgment or estimation.

The following table presents the assets reported on the consolidated balance sheets, on a recurring basis, at their fair value as of March 31, 2018 and December 31, 2017 by level within the fair value hierarchy. Financial assets and liabilities are classified in their entirety based on the lowest level of input that is significant to the fair value measurement.

| | (Amounts in thousands) | | | |
|---|---|---|---|---|
| | | Fair Value Measurements at March 31, 2018 Using | | |
| Description | March 31, 2018 | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
| ASSETS | | | | |
| U.S. Government agencies and corporations | $9,040 | $— | $ 9,040 | $ — |
| Obligations of states and political subdivisions | 51,983 | — | 51,983 | — |
| U.S. Government-sponsored mortgage-backed securities | 62,164 | — | 62,164 | — |

| | | | | |
|---|---|---|---|---|
| U.S. Government-sponsored collateralized mortgage obligations | 5,995 | — | 5,995 | — |
| U.S. Government-guaranteed small business administration | | | | |
| pools | 8,864 | — | 8,864 | — |
| Trust preferred securities | 1,090 | — | — | 1,090 |
| Regulatory stock | 2,581 | 2,581 | — | — |
| Loans held for sale | 1,216 | 1,216 | — | — |
| Interest rate derivatives | 349 | — | 349 | — |
| LIABILITIES | | | | |
| Interest rate derivatives | $349 | $— | $ 349 | $ — |

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| | (Amounts in thousands) | | | |
|---|---|---|---|---|
| | | Fair Value Measurements at December 31, 2017 Using | | |
| Description | December 31, 2017 | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
| ASSETS | | | | |
| U.S. Government agencies and corporations | $3,205 | $— | $ 3,205 | $ — |
| Obligations of states and political subdivisions | 72,116 | — | 72,116 | — |
| U.S. Government-sponsored mortgage-backed securities | 67,668 | — | 67,668 | — |
| U.S. Government-sponsored collateralized mortgage obligations | 6,302 | — | 6,302 | — |
| U.S. Government-guaranteed small business administration pools | 9,655 | — | 9,655 | — |
| Trust preferred securities | 895 | — | — | 895 |
| Regulatory stock | 2,581 | 2,581 | — | — |
| Loans held for sale | 2,780 | 2,780 | — | — |
| Interest rate derivatives | 185 | — | 185 | — |
| LIABILITIES | | | | |
| Interest rate derivatives | $185 | $— | $ 185 | $ — |

The following tables present the changes in the Level 3 fair value category for the three months ended March 31, 2018 and 2017. The Company classifies financial instruments in Level 3 of the fair-value hierarchy when there is reliance on at least one significant unobservable input to the valuation model. In addition to these unobservable inputs, the valuation models for Level 3 financial instruments typically also rely on a number of inputs that are readily observable either directly or indirectly.

| | (Amounts in thousands) Three Months Ended March 31, | |
|---|---|---|
| | 2018 | 2017 |
| | Trust preferred | Trust preferred |

| | securities | securities |
|---|---|---|
| Beginning balance | $895 | $ 825 |
| Net realized/unrealized losses included in: | | |
| Noninterest income | — | — |
| Other comprehensive income (loss) | 195 | 3 |
| Discount accretion (premium amortization) | — | — |
| Sales | — | — |
| Purchases, issuance, and settlements | — | (1 ) |
| Ending balance | $1,090 | $ 827 |
| Losses included in net income for the period relating to assets held at period end | $— | $ — |

The Company conducts OTTI analyses on a quarterly basis. The initial indication of other-than-temporary impairment for both debt and equity securities is a decline in the fair value below the amount recorded for an investment. A decline in value that is considered to be other-than-temporary is recorded as a loss within non-interest income in the consolidated statements of income. In determining whether an impairment is other than temporary, the Company considers a number of factors, including, but not limited to, the length of time and extent to which the market value has been less than cost, recent events specific to the issuer, including investment downgrades by rating agencies and economic conditions of its industry, and a determination that the Company does not intend to sell those investments and it is not more-likely-than-not that the Company will be required to sell the investments before recovery of its amortized cost basis less any current period credit loss. Among the factors that are considered in determining the Company's intent and ability is a review of its capital adequacy, interest rate risk position and liquidity.

The Company also considers the issuer's financial condition, capital strength and near-term prospects. In addition, for debt securities the Company considers the cause of the price decline (general level of interest rates and industry- and issuer-specific factors), current ability to make future payments in a timely manner and the issuer's ability to service debt, the assessment of a security's ability to

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recover any decline in market value, the ability of the issuer to meet contractual obligations and the Company's intent and ability to retain the security. All of the foregoing require considerable judgment.

Trust Preferred Securities

Trust preferred securities are accounted for under FASB ASC Topic 325 Investments Other. The Company evaluates current available information in estimating the future cash flows of securities and determines whether there have been favorable or adverse changes in estimated cash flows from the cash flows previously projected. The Company considers the structure and term of the pool and the financial condition of the underlying issuers. Specifically, the evaluation incorporates factors such as interest rates and appropriate risk premiums, the timing and amount of interest and principal payments and the allocation of payments to the various note classes. Current estimates of cash flows are based on the most recent trustee reports, announcements of deferrals or defaults, expected future default rates and other relevant market information.

The following table details the breakdown of trust preferred securities for the periods indicated:

| | (Dollar amounts in thousands) | |
|---|---|---|
| | March 31, 2018 | December 31, 2017 |
| Total number of trust preferred securities | 2 | 2 |
| Par value | $1,969 | $ 1,939 |
| | | |
| Number not considered OTTI | 1 | 1 |
| Par value | $933 | $ 903 |
| | | |
| Number considered OTTI | 1 | 1 |
| Par value | $1,036 | $ 1,036 |
| | | |
| Life-to-date impairment recognized in earnings | $140 | $ 140 |
| Life-to-date impairment recognized in other comprehensive income | 528 | 723 |
| Total life-to-date impairment | $668 | $ 863 |

The following table details the one debt security with other-than-temporary impairment, its credit rating at March 31, 2018 and the related losses recognized in earnings:

| | (Amounts in thousands) | | |
|---|---|---|---|
| Moody's/Fitch Rating | Amount of OTTI | Additions in QTD | Amount of OTTI |

| | | related to credit loss at January 1, 2018 | March 31, 2018 | related to credit loss at March 31, 2018 |
|---|---|---|---|---|
| Trapeza IX B-1 | Caa2/CC | $140 | $ — | $ 140 |
| Total | | $140 | $ — | $ 140 |

The following table details the one debt security with other-than-temporary impairment, its credit ratings at March 31, 2017 and the related losses recognized in earnings:

| | | (Amounts in thousands) | | |
|---|---|---|---|---|
| | Moody's/Fitch Rating | Amount of OTTI related to credit loss at January 1, 2017 | Additions in QTD March 31, 2017 | Amount of OTTI related to credit loss at March 31, 2017 |
| Trapeza IX B-1 | Caa2/CC | $140 | $ — | $ 140 |
| Total | | $140 | $ — | $ 140 |

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The following table provides additional information related to the Company's trust preferred securities as of March 31, 2018 used to evaluate other-than-temporary impairments:

(Amounts in thousands)

| Deal | Class | Amortized Cost | Fair Value | Unrealized Gain/(Loss) | Moody's/ Fitch Rating | Number of Issuers Currently Performing | Deferrals and Defaults as a % of Current Collateral | Excess Subordination as a % of Current Performing Collateral |
|---|---|---|---|---|---|---|---|---|
| PreTSL XXIII | C-2 | $ 758 | $ 448 | $ (310) | Ba1/CCC | 90 | 20.9 % | 7.12 % |
| Trapeza IX | B-1 | 860 | 642 | (218) | Caa2/CC | 30 | 14 | — |
| Total | | $ 1,618 | $ 1,090 | $ (528) | | | | |

The following table provides additional information related to the Company's trust preferred securities as of December 31, 2017 used to evaluate other-than-temporary impairments:

(Amounts in thousands)

| Deal | Class | Amortized Cost | Fair Value | Unrealized Gain/(Loss) | Moody's/ Fitch Rating | Number of Issuers Currently Performing | Deferrals and Defaults as a % of Current Collateral | Excess Subordination as a % of Current Performing Collateral |
|---|---|---|---|---|---|---|---|---|
| PreTSL XXIII | C-2 | $ 758 | $ 336 | $ (422) | Ba1/CCC | 90 | 20.9 % | 7.12 % |
| Trapeza IX | B-1 | 860 | 559 | (301) | Caa2/CC | 30 | 14 | — |
| Total | | $ 1,618 | $ 895 | $ (723) | | | | |

The market for these securities at March 31, 2018 and December 31, 2017 is not active and markets for similar securities are also not active. The inactivity was evidenced first by a significant widening of the bid-ask spread in the brokered markets in which trust preferred securities trade and then by a significant decrease in the volume of trades relative to historical levels. The new issue market is also inactive as new issuance is essentially nonexistent. There are currently very few market participants who are willing and/or able to transact for these securities. The pooled market value for these securities remains very depressed relative to historical levels. Although there has been marked improvement in the credit spread premium in the corporate bond space, no such improvement has been noted in the market for trust preferred securities.

Given conditions in the debt markets today and the absence of observable transactions in the secondary and the new issue markets, the Company determined the following:

- The few observable transactions and market quotations that are available are not reliable for purposes of determining fair value at March 31, 2018;
- An income valuation approach technique (present value technique) that maximizes the use of relevant observable inputs and minimizes the use of unobservable inputs will be equally or more representative of fair value than the market approach valuation technique used at measurement dates prior to 2008; and
- The trust preferred securities will be classified within Level 3 of the fair value hierarchy because the Company determined that significant judgments are required to determine fair value at the measurement date.

The Company enlisted the aid of an independent third party to perform the trust preferred security valuations. The approach to determining fair value involved the following process:

1. Estimate the credit quality of the collateral using average probability of default values for each issuer (adjusted for rating levels).
2. Consider the potential for correlation among issuers within the same industry for default probabilities (e.g. banks with other banks).
3. Forecast the cash flows for the underlying collateral and apply to each trust preferred security tranche to determine the resulting distribution among the securities, including prepayment and cures.
4. Discount the expected cash flows to calculate the present value of the security.

The PreTSL XXIII cash flows are discounted at 11.7% through its maturity date of December 2036 and would have to experience an additional $210 million of nonperforming collateral (of $860 million performing) in order to incur any impairment. The aggregate cash flows for the C-2 tranche are estimated to be $44.1 million on a current principal of $26.1 million. The Trapeza IX B-1 cash flows are discounted at 8.6% through its maturity of January 2038 and would experience additional impairment upon further occurrence of nonperforming collateral of $7.0 million (of $208 million performing). The aggregate cash flows for the B-1 tranche are estimated to be $42.6 million on a current principal of $23.8 million.

Financial Instruments

The Company discloses fair value information about financial instruments, whether or not recognized in the consolidated balance sheets, for which it is practicable to estimate the value. In cases where quoted market prices are not available, fair values are based on estimates using present value or other estimation techniques. Those techniques are significantly affected by the assumptions used, including the discount rate and estimates of future cash flows.

Such techniques and assumptions, as they apply to individual categories of the financial instruments, are as follows:

Cash and cash equivalents – The carrying amounts for cash and cash equivalents are a reasonable estimate of those assets' fair value.

Investment securities – Fair values of securities are based on quoted market prices, where available. If quoted market prices are not available, fair values are based on quoted market prices of comparable securities. Prices on trust preferred securities were calculated using a discounted cash-flow technique. Cash flows were estimated based on credit and prepayment assumptions. The present value of the projected cash flows was calculated using a discount rate equal to the current yield used to accrete the beneficial interest.

Loans held for sale – Loans held for sale consist of residential mortgage loans originated for sale. Loans held for sale are recorded at fair value based on what the secondary markets have offered on best efforts commitments.

Loans, net – Market quotations are generally not available for loan portfolios. In accordance with the prospective adoption of ASU No. 2016-01, the fair value of loans as of March 31, 2018 was measured using an exit price notion, which incorporates adjustments to the discount rate for alternate cost of funds, liquidity premiums and capital and serving charges. The fair value of loans as of December 31, 2017 was measured by discounting future cash flows using current market inputs at which loans with similar terms and qualities would be made to borrowers of similar credit quality.

Bank-owned life insurance – The fair value is based upon the cash surrender value of the underlying policies net of any split dollar obligation and matches the book value.

Accrued interest receivable – The carrying amount is a reasonable estimate of these assets' fair value.

Interest rate derivatives – The fair value is based on settlement values adjusted for credit risks associated with the counter parties and the Company and observable market interest rate curves.

Demand, savings and money market deposits – Demand, savings, and money market deposit accounts are valued at the amount payable on demand.

Time deposits – The fair value of certificates of deposit is based on the discounted value of contractual cash flows. The discount rates are estimated using market rates currently offered for similar instruments with similar remaining maturities.

Short term borrowings – Short term borrowings generally have an original term to maturity of one year or less. Consequently, their carrying value is a reasonable estimate of fair value.

FHLB advances - short term – Short term borrowings generally have an original term to maturity of one year or less. Advances of one month or less are considered to be at fair value. The fair value of notes with one to twelve month terms is based on the discounted value of contractual cash flows. The discount rates are estimated using market rates currently offered for similar instruments with similar remaining maturities.

FHLB advances - long term – The fair value for fixed rate advances is estimated by discounting the future cash flows using rates at which advances would be made to borrowers with similar credit ratings and for the same remaining maturities. The fair value for the fixed rate advances that are convertible to quarterly LIBOR floating rate advances on or after certain specified dates at the option of the FHLB and the FHLB fixed rate advances that are putable on or after certain specified dates at the option of the FHLB are priced using the FHLB of Cincinnati's model.

Subordinated debt – The floating issuances curves to maturity are averaged to obtain an index. The spread between BBB-rated bank debt and 25-year swap rates is determined to calculate the spread on outstanding trust preferred securities. The discount margin is then added to the index to arrive at a discount rate, which determines the present value of projected cash flows.

Accrued interest payable – The carrying amount is a reasonable estimate of these liabilities' fair value. The fair value of unrecorded commitments at March 31, 2018 and December 31, 2017 is not material.

In addition, other assets and liabilities of the Company that are not defined as financial instruments are not included in the disclosures, such as property and equipment. Also, non-financial instruments typically not recognized in financial statements nevertheless may have value but are not included in the above disclosures. These include, among other items, the estimated earning power of core deposit accounts, the trained work force, customer goodwill and similar items. Accordingly, the aggregate fair value amounts presented do not represent the underlying value of the Company.

The carrying amounts and fair values of the Company's financial instruments are as follows:

| | (Amounts in thousands) March 31, 2018 Carrying Amount | Level 1 | Level 2 | Level 3 | Fair Value |
|---|---|---|---|---|---|
| ASSETS: | | | | | |
| Cash and cash equivalents | $27,538 | $27,538 | $— | $— | $27,538 |
| Investment securities available-for-sale | 141,717 | 2,581 | 138,046 | 1,090 | 141,717 |
| Loans held for sale | 1,216 | 1,216 | — | — | 1,216 |
| Loans | 448,030 | — | — | 452,159 | 452,159 |
| Bank-owned life insurance | 17,727 | 17,727 | — | — | 17,727 |
| Accrued interest receivable | 2,090 | 2,090 | — | — | 2,090 |
| Interest rate derivatives | 349 | — | 349 | — | 349 |
| | | | | | |
| LIABILITIES: | | | | | |
| Demand, savings and money market deposits | $432,650 | $432,650 | $— | $— | $432,650 |
| Time deposits | 121,889 | — | — | 122,857 | 122,857 |
| Short term borrowings | 2,062 | 2,062 | — | — | 2,062 |
| Federal Home Loan Bank advances - short term | 18,000 | — | — | 17,973 | 17,973 |
| Federal Home Loan Bank advances - long term | 14,000 | — | — | 13,824 | 13,824 |
| Subordinated debt | 5,155 | — | — | 4,743 | 4,743 |
| Accrued interest payable | 326 | 326 | — | — | 326 |
| Interest rate derivatives | 349 | — | 349 | — | 349 |

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

| | (Amounts in thousands) December 31, 2017 Carrying Amount | Level 1 | Level 2 | Level 3 | Fair Value |
|---|---|---|---|---|---|
| ASSETS: | | | | | |
| Cash and cash equivalents | $19,125 | $19,125 | $— | $— | $19,125 |
| Investment securities available-for-sale | 162,422 | 2,581 | 158,946 | 895 | 162,422 |
| Loans held for sale | 2,780 | 2,780 | — | — | 2,780 |
| Loans | 482,912 | — | — | 486,230 | 486,230 |
| Bank-owned life insurance | 17,650 | 17,650 | — | — | 17,650 |
| Accrued interest receivable | 2,193 | 2,193 | — | — | 2,193 |
| Interest rate derivatives | 185 | — | 185 | — | 185 |
| LIABILITIES: | | | | | |
| Demand, savings and money market deposits | $458,562 | $458,562 | $— | $— | $458,562 |
| Time deposits | 127,289 | — | — | 128,624 | 128,624 |
| Short term borrowings | 2,678 | 2,678 | — | — | 2,678 |
| Federal Home Loan Bank advances - short term | 32,000 | — | — | 31,982 | 31,982 |
| Federal Home Loan Bank advances - long term | 14,000 | — | — | 13,880 | 13,880 |
| Subordinated debt | 5,155 | — | — | 4,785 | 4,785 |
| Accrued interest payable | 325 | 325 | — | — | 325 |
| Interest rate derivatives | 185 | — | 185 | — | 185 |

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

The following table presents quantitative information about the Level 3 significant unobservable inputs for assets and liabilities measured at fair value on a recurring and nonrecurring basis at March 31, 2018:

| | (Amounts in thousands) Fair value at March 31, 2018 | Valuation Technique | Significant Unobservable Input | Description of Inputs |
|---|---|---|---|---|
| Trust preferred securities | $ 1,090 | Discounted Cash Flow | Projected Prepayments | 1) Trust preferred securities issued by banks subject to Dodd-Frank's phase-out of trust preferred securities from Tier 1 Capital. All fixed rate within one year; variable rate at increasing intervals depending on spread.<br><br>2) Trust preferred securities issued by healthy, well capitalized banks that have fixed rate coupons greater than 8%.<br><br>3) 1% annually for all other fixed rate issues and all variable rate issues.<br><br>4) Zero for collateral issued by REITs and 2% for insurance companies. |
| | | | Projected Defaults | 1) All deferring issuers that do not meet the criteria for curing, as described below, are projected to default immediately.<br><br>2) Banks with high, near team default risk are identified using a CAMELS model, and projected to default immediately. Healthy banks are projected to default at a rate of 2% annually for 2 years, and 0.36% annually thereafter.<br><br>3) Insurance and REIT defaults are projected according to the historical default rates exhibited by companies with the same credit ratings. Historical default rates are doubled in each of the first two years of the projection to account for current economic conditions. Unrated issuers are assumed to have CCC- ratings. |
| | | | Projected Cures | 1) Deferring issuers that have definitive agreements to either be acquired or recapitalized. |
| | | | Projected | |

| | |
|---|---|
| Recoveries | 1) Zero for insurance companies, REITs and insolvent banks, and 10% for projected bank deferrals lagged 2 years. |
| Discount Rates | 1) Ranging from ~8.6% to ~11.7%, depending on each bond's seniority and remaining subordination after projected losses. |

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

The following table presents quantitative information about the Level 3 significant unobservable inputs for assets and liabilities measured at fair value on a recurring and nonrecurring basis at December 31, 2017:

| | (Amounts in thousands) Fair value at December 31, 2017 | Valuation Technique | Significant Unobservable Input | Description of Inputs |
|---|---|---|---|---|
| Trust preferred securities | $ 895 | Discounted Cash Flow | Projected Prepayments | 1) Trust preferred securities issued by banks subject to Dodd-Frank's phase-out of trust preferred securities from Tier 1 Capital. All fixed rate within one year; variable rate at increasing intervals depending on spread.<br><br>2) Trust preferred securities issued by healthy, well capitalized banks that have fixed rate coupons greater than 8%.<br><br>3) 1% annually for all other fixed rate issues and all variable rate issues.<br><br>4) Zero for collateral issued by REITs and 2% for insurance companies. |
| | | | Projected Defaults | 1) All deferring issuers that do not meet the criteria for curing, as described below, are projected to default immediately.<br><br>2) Banks with high, near team default risk are identified using a CAMELS model, and projected to default immediately. Healthy banks are projected to default at a rate of 2% annually for 2 years, and 0.36% annually thereafter.<br><br>3) Insurance and REIT defaults are projected according to the historical default rates exhibited by companies with the same credit ratings. Historical default rates are doubled in each of the first two years of the projection to account for current economic conditions. Unrated issuers are assumed to have CCC- ratings. |
| | | | Projected Cures | 1) Deferring issuers that have definitive agreements to either be acquired or recapitalized. |

| | | | | |
|---|---|---|---|---|
| | | | Projected Recoveries | 1) Zero for insurance companies, REITs and insolvent banks, and 10% for projected bank deferrals lagged 2 years. |
| | | | Discount Rates | 1) Ranging from ~9.10% to ~14.74%, depending on each bond's seniority and remaining subordination after projected losses. |
| Impaired loans | 4,891 | Cash Flow | Discount Rates | Range 4.50% to 5.38%<br>Weighted average 4.88% |

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

10.) Accumulated Other Comprehensive Income (Loss):

The following table presents the changes in accumulated other comprehensive income (loss) by component net of tax for the three months ended March 31, 2018 and 2017:

| (Amounts in thousands) Three Months Ended March 31, | 2018 | | 2017 | |
|---|---|---|---|---|
| | Unrealized losses on available-for-sale securities (a) | Change in pension and postretirement obligations (a) | Unrealized gains (losses) on available-for-sale securities (a) | Change in pension and postretirement obligations (a) |
| Beginning balance | $(1,787) | $ (38) | $ (2,909) | $ (52) |
| Other comprehensive income (loss) before reclassification | (2,341) | (8) | 10 | (5) |
| Amount reclassified from accumulated other comprehensive income (loss) | (16) | — | (6) | — |
| Total other comprehensive income (loss) | (2,357) | (8) | 4 | (5) |
| Ending balance | $(4,144) | $ (46) | $ (2,905) | $ (57) |

(a) All amounts are net of tax. Amounts in parentheses indicate debits.

The following table presents significant amounts reclassified out of each component of accumulated other comprehensive income (loss) for the three months ended March 31, 2018 and 2017:

| (Amounts in thousands) Three Months Ended March 31, | 2018 | 2017 | |
|---|---|---|---|
| | Amount reclassified | Amount reclassified | Affected line item in the statement where net income is presented |

| | from accumulated other comprehensive loss (a) | from accumulated other comprehensive income (a) | |
|---|---|---|---|
| Details about other comprehensive income or loss: | | | |
| Unrealized gains on available-for-sale securities | $ 20 | $ 9 | Investment securities available-for-sale gains , net |
| | (4 ) | (3 ) | Federal income tax expense |
| | $ 16 | $ 6 | Net of tax |

(a) Amounts in parentheses indicate debits to net income.

11.) Post-Retirement Obligations:

The Company accrues for the monthly benefit expense of post-retirement cost of insurance for split dollar life insurance coverage. The following table presents the changes in the accumulated liability:

| | (Amounts in thousands) Three Months Ended March 31, | |
|---|---|---|
| | 2018 | 2017 |
| Beginning balance | $876 | $840 |
| Expense recorded | 6 | 13 |
| Other comprehensive income (loss) recorded | 8 | 5 |
| Ending balance | $890 | $858 |

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

12.) Stock Repurchase Program:

On January 24, 2017, the Company's Board of Directors approved a program which allowed the Company to repurchase up to 100,000 shares, or approximately 2.3% of the 4,420,055 shares outstanding at January 24, 2017, of the Company's outstanding common stock. This program terminated on December 31, 2017. The Company purchased 12,863 shares under this program. On January 23, 2018, the Company's Board of Directors approved a new program which allowed the Company to repurchase up to 100,000 shares, or approximately 2.3% of the 4,420,136 shares outstanding at January 23, 2018, of the Company's outstanding common stock. This program will terminate on December 31, 2018 or upon purchase of 100,000 shares if earlier or at any time without prior notice. The Company purchased 10,488 shares under this program to date. Repurchased shares are designated as treasury shares, available for general corporate purposes, including possible use in connection with the Company's dividend reinvestment program, employee benefit plans, acquisitions or other distributions. Based on the value of the Company's stock on March 31, 2018, the remaining authorization to repurchase the stock for the program is approximately $2.1 million.

13.) Short-Term Borrowings:

The following table provides additional detail regarding short-term borrowings:

| | (Amounts in thousands) Repurchase Agreements (Sweep) Accounted for as Secured Borrowings | |
|---|---|---|
| | At March 31, 2018 | At December 31, 2017 |
| | Remaining Contractual Maturity of the Agreements | |
| | Overnight and Continuous | Overnight and Continuous |
| Repurchase agreements: | | |
| U.S. Government-sponsored mortgage-backed securities | $3,281 | $ 3,414 |
| Total collateral carrying value | $3,281 | $ 3,414 |
| Total short-term borrowings | $2,062 | $ 2,678 |

14.) Equity Compensation:

During 2015, the Company, created the 2015 Omnibus Equity Plan and The Director Equity Plan.

The Omnibus Equity Plan permits the award of up to 340,000 shares to the Company's employees to promote the long-term financial success of the Company, increasing shareholder value by providing employees the opportunity to acquire an ownership interest in the Company and enabling the Company and its related entities to attract and retain the services of those upon whom the successful conduct of business depends. In the first quarter of 2018 there were not any shares granted under the plan, however there were 12,976 restricted Board approved shares granted under the plan in March 2017. The Company is expensing the grant date fair value of all share-based compensation over the requisite vesting periods on a prorated straight-line basis. In the first three months of 2018 and 2017 compensation expense of $34,000 and $18,000, respectively, was recorded in the Consolidated Statements of Income. As of March 31, 2018, there was $218,000 of total unrecognized compensation expense related to the non-vested shares granted under the Plan. Shares awarded under this plan vest in equal thirds on the first three anniversaries of the award date if the employee remains employed with Cortland Bancorp. The remaining cost is expected to be recognized over a weighted average period of 18.9 months.

Granted shares are awarded upon meeting achievement of performance objectives derived from one or more of the performance criteria. The main metrics used for the periods presented were three-year earnings per share growth and three-year total shareholder return ranked versus a peer group.

The Director Equity Plan permits the award of up to 113,000 shares to nonemployee directors to promote the long-term financial success of the Company, increasing shareholder value by enabling the Company and its related entities to attract and retain the services of those directors upon whom the successful conduct of business depends. There were 1,656 Board approved shares granted under the plan in March 2017 with immediate vesting. In 2017, expense of $30,000 was recorded in the Consolidated Statements of Income, with none recorded as of March 31, 2018.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

The following is the activity under the two plans during the three months ended March 31, 2018:

| | Shares | Weighted Average Grant Date Fair Value |
|---|---|---|
| Nonvested at January 1, 2018 | 20,814 | $ 17.02 |
| Granted | — | — |
| Vested | (4,081 ) | 18.25 |
| Forfeited | — | — |
| Nonvested at March 31, 2018 | 16,733 | $ 16.72 |

15.) Subsequent Event:

The Company insures the lives of certain of its key officers and directors as a funding vehicle for deferred compensation programs. The value of the insurance contracts is recognized into income as cash value builds in the policies over time. Upon the death of an insured, the insurance proceeds may exceed the cash value recognized at the time of the occurrence. In this circumstance, the Company will recognize a gain for the difference.

In April 2018, the death of a former executive triggered the recognition of a gain of $1.5 million based upon the extent that the death proceeds exceeded the cash value of the policy recognized to date. The gain, representing $.34 per share, will be recorded in noninterest income in the second quarter 2018 income statement.

CONSOLIDATED AVERAGE BALANCE SHEETS, YIELDS AND RATES (UNAUDITED)

| | (Fully taxable equivalent basis in thousands of dollars) QUARTER-TO-DATE AS OF MARCH 31, 2018 | | | DECEMBER 31, 2017 | | | MARCH 31, 2017 | | |
|---|---|---|---|---|---|---|---|---|---|
| | Average Balance | Interest | Average Rate | Average Balance | Interest | Average Rate | Average Balance | Interest | Average Rate |
| ASSETS | | | | | | | | | |
| Interest earning deposits | $6,881 | $28 | 1.65 % | $7,188 | $22 | 1.19 % | $6,745 | $16 | 0.96 % |
| Investment securities available for sale (1) (2) (3) | 154,923 | 1,059 | 2.74 % | 166,121 | 1,266 | 3.03 % | 173,842 | 1,295 | 2.99 % |
| Loans (1) (2) (3) | 470,957 | 5,590 | 4.78 % | 430,283 | 5,084 | 4.71 % | 410,307 | 4,622 | 4.53 % |
| Total interest-earning assets | 632,761 | $6,677 | 4.25 % | 603,592 | $6,372 | 4.20 % | 590,894 | $5,933 | 4.04 % |
| Cash and due from banks | 7,080 | | | 7,604 | | | 7,461 | | |
| Bank premises and equipment | 9,056 | | | 9,051 | | | 9,245 | | |
| Other assets | 27,281 | | | 28,640 | | | 24,714 | | |
| Total non-interest-earning assets | 43,417 | | | 45,295 | | | 41,420 | | |
| Total assets | $676,178 | | | $648,887 | | | $632,314 | | |
| LIABILITIES AND SHAREHOLDERS' EQUITY | | | | | | | | | |
| Interest-bearing demand deposits | $202,950 | $286 | 0.57 % | $176,929 | $221 | 0.50 % | $162,117 | $147 | 0.37 % |
| Savings | 113,896 | 24 | 0.09 % | 113,184 | 24 | 0.08 % | 114,204 | 21 | 0.07 % |
| Time | 125,296 | 479 | 1.55 % | 123,137 | 455 | 1.47 % | 133,433 | 418 | 1.27 % |
| Total interest-bearing deposits | 442,142 | 789 | 0.72 % | 413,250 | 700 | 0.67 % | 409,754 | 586 | 0.58 % |
| Other borrowings | 38,957 | 150 | 1.56 % | 33,500 | 111 | 1.31 % | 39,458 | 142 | 1.47 % |
| Subordinated debt | 5,155 | 40 | 3.13 % | 5,155 | 37 | 2.82 % | 5,155 | 31 | 2.44 % |
| Total interest-bearing liabilities | 486,254 | $979 | 0.82 % | 451,905 | $848 | 0.75 % | 454,367 | $759 | 0.68 % |
| Demand deposits | 119,141 | | | 124,337 | | | 110,305 | | |
| Other liabilities | 10,118 | | | 10,302 | | | 9,968 | | |
| Shareholders' equity | 60,665 | | | 62,343 | | | 57,674 | | |
| Total liabilities and shareholders' equity | $676,178 | | | $648,887 | | | $632,314 | | |
| Net interest income | | $5,698 | | | $5,524 | | | $5,174 | |
| Net interest rate spread (4) | | | 3.43 % | | | 3.45 % | | | 3.36 % |
| Net interest margin (5) | | | 3.62 % | | | 3.65 % | | | 3.52 % |
| | | | 1.30 | | | 1.34 | | | 1.30 |

Ratio of interest-earning assets to

interest-bearing liabilities

(1) Includes both taxable and tax-exempt loans and investment securities available-for-sale.
(2) The amounts are presented on a fully taxable equivalent basis using the statutory rate of 21% in 2018 and 34% in 2017 and have been adjusted to reflect the effect of disallowed interest expenses related to carrying tax-exempt assets. The tax equivalent income adjustment for loans and investments available-for-sale was $2,000 and $104,000, respectively, for March 31, 2018; $3,000 and $240,000, respectively, for December 31, 2017; and $4,000 and $233,000, respectively, for March 31, 2017.
(3) Average balance outstanding includes the average amount outstanding of all non-accrual investment securities and loans. Investment securities consist of average total principal adjusted for amortization of premium and accretion of discount and includes both taxable and tax-exempt securities. Loans consist of average total loans, including loans held for sale, less average unearned income.
(4) Interest rate spread represents the difference between the yield on earning assets and the rate paid on interest-bearing liabilities.
(5) Net interest margin is calculated by dividing net interest income by total interest-earning assets.

SELECTED FINANCIAL DATA FOR THE QUARTER ENDED

(In thousands of dollars, except for ratios and per share amounts)

| Unaudited | March 31, 2018 | December 31, 2017 | September 30, 2017 | June 30, 2017 | March 31, 2017 |
|---|---|---|---|---|---|
| SUMMARY OF OPERATIONS | | | | | |
| Total interest income | $6,571 | $6,129 | $5,862 | $5,805 | $5,696 |
| Total interest expense | (979) | (848) | (800) | (783) | (759) |
| NET INTEREST INCOME (NII) | 5,592 | 5,281 | 5,062 | 5,022 | 4,937 |
| Provision for loan losses | (500) | — | (100) | — | — |
| NII after loss provision | 5,092 | 5,281 | 4,962 | 5,022 | 4,937 |
| Investment securities gains (losses) | 20 | (17) | (7) | 22 | 9 |
| Mortgage banking gains | 238 | 243 | 315 | 322 | 194 |
| Other income | 754 | 721 | 1,879 | 788 | 697 |
| Total non-interest expense | (4,326) | (4,603) | (4,665) | (4,686) | (4,647) |
| Income before tax expense | 1,778 | 1,625 | 2,484 | 1,468 | 1,190 |
| Federal income tax expense | 241 | 1,604 | 337 | 286 | 190 |
| Net income | $1,537 | $21 | $2,147 | $1,182 | $1,000 |
| | | | | | |
| PER COMMON SHARE DATA (1) | | | | | |
| Earnings per share, basic and diluted | $0.35 | $0.01 | $0.49 | $0.26 | $0.23 |
| Book value | 13.63 | 13.94 | 13.96 | 13.51 | 13.09 |
| Cash dividends declared per share | 0.11 | 0.08 | 0.08 | 0.08 | 0.15 |
| | | | | | |
| BALANCE SHEET DATA | | | | | |
| Assets | $663,138 | $711,101 | $631,984 | $634,736 | $619,893 |
| Investments | 141,717 | 162,422 | 165,049 | 162,677 | 165,099 |
| Loans | 451,914 | 487,490 | 411,417 | 409,766 | 397,087 |
| Allowance for loan losses | 3,884 | 4,578 | 4,777 | 4,830 | 4,855 |
| Deposits | 554,539 | 585,851 | 526,484 | 530,988 | 517,352 |
| Borrowings | 39,217 | 53,833 | 33,620 | 32,758 | 35,436 |
| Shareholders' equity | 60,127 | 61,630 | 61,734 | 59,910 | 58,054 |
| | | | | | |
| AVERAGE BALANCES | | | | | |
| Assets | $676,178 | $648,887 | $631,727 | $634,701 | $632,314 |
| Investments | 154,923 | 166,121 | 167,239 | 167,515 | 173,842 |
| Loans | 468,892 | 427,452 | 407,371 | 407,138 | 407,680 |
| Deposits | 561,283 | 537,587 | 525,279 | 527,510 | 520,059 |
| Borrowings | 44,112 | 38,655 | 34,817 | 37,755 | 44,613 |
| Shareholders' equity | 60,665 | 62,343 | 60,690 | 59,227 | 57,674 |
| | | | | | |
| ASSET QUALITY RATIOS | | | | | |
| Net recoveries (charge-offs) | $(1,194) | $(199) | $(153) | $(25) | $(13) |
| Net recoveries (charge-offs) as a percentage | (1.02)% | (0.19)% | (0.15)% | (0.02)% | (0.01)% |

| | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| of average total loans | | | | | | | | | | |
| Loans 30 days or more beyond their contractual | | | | | | | | | | |
| due date as a percent of total loans | 0.24 | % | 0.24 | % | 0.35 | % | 0.49 | % | 0.78 | % |
| Nonperforming loans | $9,258 | | $5,114 | | $5,328 | | $5,886 | | $7,421 | |
| Nonperforming securities | 1,090 | | 895 | | 837 | | 817 | | 827 | |
| Other real estate owned | — | | — | | — | | 480 | | 480 | |
| Total nonperforming assets | $10,348 | | $6,009 | | $6,165 | | $7,183 | | $8,728 | |
| Nonperforming assets as a percentage of: | | | | | | | | | | |
| Total assets | 1.56 | % | 0.85 | % | 0.98 | % | 1.13 | % | 1.41 | % |
| Equity plus allowance for loan losses | 16.17 | | 9.08 | | 9.27 | | 11.10 | | 13.87 | |
| Tier I capital | 14.93 | | 8.78 | | 9.00 | | 10.74 | | 13.22 | |
| | | | | | | | | | | |
| FINANCIAL RATIOS | | | | | | | | | | |
| Return on average equity | 10.13 | % | 0.13 | % | 14.15 | % | 7.98 | % | 6.94 | % |
| Return on average assets | 0.91 | | 0.01 | | 1.36 | | 0.74 | | 0.63 | |
| Efficiency ratio | 64.66 | | 71.13 | | 70.71 | | 73.70 | | 76.63 | |
| Effective tax rate | 13.55 | | 98.71 | | 13.57 | | 19.48 | | 15.97 | |
| Net interest margin | 3.62 | | 3.65 | | 3.61 | | 3.56 | | 3.52 | |

(1) Basic earnings per common share are based on weighted average shares outstanding. Diluted earnings per share is after consideration of common stock equivalent. Cash dividends per common share are based on actual dividends declared. Book value per common share is based on shares outstanding at each period end.

ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL

CONDITION AND RESULTS OF OPERATIONS

Financial Review

The following is management's discussion and analysis of the financial condition and results of operations of Cortland Bancorp (the Company). The discussion should be read in conjunction with the Consolidated Financial Statements and related notes and summary financial information included elsewhere in this quarterly report.

Note Regarding Forward-looking Statements

The Private Securities Litigation Reform Act of 1995 provides a "safe harbor" for forward-looking statements. In addition to historical information, certain information included in this discussion and other material filed or to be filed by the Company with the Securities and Exchange Commission (as well as information included in oral statements or other written statements made or to be made by the Company) may contain forward-looking statements that involve risks and uncertainties. The words "believes," "expects," "may," "will," "should," "projects," "contemplates," "anticipates," "f "intends," or similar terminology identify forward-looking statements. These statements reflect management's beliefs and assumptions, and are based on information currently available to management.

Economic circumstances, the Company's operations and actual results could differ significantly from those discussed in any forward-looking statements. Some of the factors that could cause or contribute to such differences are changes in the economy and interest rates either nationally or in the Company's market area, including the impact of the impairment of securities; political actions, including failure of the United States Congress to raise the federal debt ceiling or the imposition of changes in the federal budget; changes in customer preferences and consumer behavior; increased competitive pressures or changes in either the nature or composition of competitors; changes in the legal and regulatory environment; changes in factors influencing liquidity, such as expectations regarding the rate of inflation or deflation, currency exchange rates, and other factors influencing market volatility; changes in assumptions underlying the establishment of reserves for possible loan losses, reserves for repurchase of mortgage loans sold and other estimates; and risks associated with other global economic, political and financial factors.

While actual results may differ significantly from the results discussed in the forward-looking statements, the Company undertakes no obligation to update publicly any forward-looking statement for any reason, even if new information becomes available.

Analysis of Assets, Liabilities and Shareholders' Equity

Due to the seasonality of the loan and deposit balances in the year-end balance sheet, a comparison of March 31, 2017 is included in the analysis of assets and liabilities, in addition to the usual comparison to December 31, 2017. The following table contains the loan and deposit balances referenced in the discussions:

| | (Amounts in thousands) | | |
|---|---|---|---|
| | March 31, | December 31, | March 31, |

| | 2018 | 2017 | 2017 |
|---|---|---|---|
| Loans: | | | |
| Commercial | $75,568 | $113,341 | $64,555 |
| Commercial real estate | 284,306 | 283,135 | 245,875 |
| Residential real estate | 63,148 | 62,071 | 58,976 |
| Consumer - home equity | 25,498 | 26,018 | 24,573 |
| Consumer - other | 3,394 | 2,925 | 3,108 |
| Total loans | $451,914 | $487,490 | $397,087 |
| Total earning assets | $616,029 | $662,076 | $573,016 |
| Total assets | $663,138 | $711,101 | $619,893 |
| Deposits: | | | |
| Noninterest-bearing deposits | $123,523 | $123,291 | $111,952 |
| Interest-bearing demand deposits | 309,127 | 335,271 | 272,790 |
| Time deposits | 121,889 | 127,289 | 132,610 |
| Total deposits | $554,539 | $585,851 | $517,352 |
| Total interest bearing liabilities | $470,233 | $516,393 | $440,836 |

Earning assets are comprised of deposits at financial institutions, including the Federal Reserve Bank, investment securities and loans. Earning assets were $616.0 million at March 31, 2018, a decrease of 7.0% from the December 31, 2017 balance of $662.1 million. The decrease from December 31, 2017 was mainly due to a decrease in loans of $35.6 million, and a decrease of $20.7 million in investment securities offset by an increase in interest-earning deposits of $11.8 million.  Earning assets increased 7.5% from the March 31, 2017 balance of $573.0 million, which was due mainly to an increase in loans of $54.8 million and an increase in interest -earning deposits of $12.8 million offset by a decrease in investment securities $23.4 million. Total assets of $663.1 million at March 31, 2018 decreased by $48.0 million, or 6.7%, from the asset total of $711.1 million at December 31, 2017, and increased $43.2 million, or 7.0%, from the asset total of $619.9 million at March 31, 2017.

At March 31, 2018, the investment securities available-for-sale portfolio was $141.7 million compared to $162.4 million at December 31, 2017, a decrease of $20.7 million, or 12.8%. Investment securities available-for-sale represented 23.0% of earning assets at March 31, 2018, compared to 24.5% at December 31, 2017. As the Company manages its balance sheet for loan growth, asset mix, liquidity and current interest rates and interest rate forecasts, the investment portfolio is a primary source of liquidity and therefore reflects variation in balances accordingly. The investment securities available-for-sale portfolio represented 25.6% of each deposit dollar at March 31, 2018, down 2.2% from year-end levels.

The investment securities available-for-sale portfolio had net unrealized losses, net of tax, of $4.1 million and $1.8 million at March 31, 2018 and December 31, 2017, respectively. The increase in unrealized losses is reflective of the increase in interest rates during this first quarter of 2018 and its effect on securities valuation.

Loans held for sale decreased by $1.6 million to $1.2 million at March 31, 2018 from $2.8 million at December 31, 2017, reflecting the variation of the mortgage loan processing and origination activity during the winter season.

Total loans at March 31, 2018 were $451.9 million compared to $487.5 million at December 31, 2017, a 7.3% decrease, and $397.1 million at March 31, 2017, a 13.8% increase. Year-end loan balances included 60-day or less term commercial loans totaling $43.0 million that closed in December 2017 and were fully secured by segregated deposit accounts with the Bank, and matured in the first quarter of 2018. Excluding these seasonal loans at December 31, 2017, total loans actually increased $7.4 million, or 1.7% through March 31, 2018. The Company continues its objective of shifting its asset mix into in-market commercial loans with the intent of improving net interest margin. Total gross loans as a percentage of earning assets stood at 73.6% as of March 31, 2018, 74.1% as of December 31, 2017, and 69.7% as of March 31, 2017. The total loan-to-deposit ratio was 81.7% at March 31, 2018 and 83.7% at December 31, 2017 and 77.2% March 31, 2017.

The allowance for loan losses of $3.9 million, $4.6 million and $4.9 million, respectively, represented approximately 0.9% of outstanding loans at March 31, 2018 and at December 31, 2017 and 1.2% at March 31, 2017.

During the first three months, loan charge-offs were $1.2 million in 2018 compared to $137,000 for the same period in 2017, while the recovery of previously charged-off loans amounted to $19,000 in 2018 and $124,000 in 2017. The net charge-offs represent 102 basis points of average loans for 2018 and less than 10 basis points for 2017. Charge-offs of specific problem loans, as well as for smaller balance homogeneous loans, are recorded periodically during the year. The number of loan accounts and the amount of charge-offs associated with account balances vary from period to period as loans are deemed uncollectible by management. In the first three months of 2018 there was a commercial charge off related to loans to one customer that were restructured with no principal forgiveness, but with a substantial concession in interest rate. The below market rate triggered recognition of a charge-off equivalent to the difference in present value of loan payments discounted at the market rate of interest. The charged off amount of $1.2 million is recorded as loan discount. As loan payments are made, interest will be recognized at the market rate versus the negotiated rate via the amortization of the discount over the various lives of the loans. There was $625,000 in specific reserve previously allocated on these loans at December 31, 2017. Nonaccrual loans were $1.0 million at March 31, 2018, and at December 31, 2017, or 0.2% of total loans, and $3.1 million, or 0.8%, of total loans at March 31, 2017. The decrease in nonaccrual loans from the previous year was partially attributable to the payoff of one loan for over $1.0 million.

Bank-owned life insurance had a cash surrender value of $17.7 million at March 31, 2018 and at December 31, 2017. Comprising approximately 25% of capital, management does not intend to make any significant insurance purchases. Subsequent to March 31, 2018, the death of a former executive will trigger the collection of proceeds on policies contained herein, reducing recorded balance by approximately $2.3 million.

Other assets increased slightly to $17.6 million at March 31, 2018 from $17.2 million at December 31, 2017. At March 31, 2018, a $4.6 million investment in a partnership fund is included in other assets compared to $4.8 million at December 31, 2017, with an offsetting $2.6 million at March 31, 2018 and $2.9 million December 31, 2017 in other liabilities, which is the commitment to fund this affordable housing investment. Also included in other assets is a partnership investment of $5.5 million into a privately managed pooled fund of small business administration loans at March 31, 2018 and December 31, 2017.

Noninterest-bearing deposits measured $123.5 million at March 31, 2018 compared to $123.3 million at December 31, 2017 and $112.0 million at March 31, 2017. Interest-bearing deposits decreased $31.6 million to $431.0 million at March 31, 2018 from $462.6 million at December 31, 2017 and increased $25.6 million from $405.4 million at March 31, 2017. The decrease in interest-bearing deposits from year end is net of segregated money market deposit accounts with the Bank which fully collateralized $43.0 million in 60-day or less term commercial loans that closed in December 2017. The loans matured and the deposits withdrew in the first quarter of 2018. Absent the collateral deposits, interest-bearing deposits increased $11.5 million, or 2.7%, over the first three months of 2018.

Federal Home Loan Bank advances and short-term borrowings decreased to $34.1 million at March 31, 2018 from $48.7 million at December 31, 2017. Management continues to use short-term borrowings to bridge its current cash flow needs resulting in variations from period to period. Other liabilities measured $9.3 million at March 31, 2018 and $9.8 million at December 31, 2017. Included is the commitment to fund the affordable housing investment described above.

The Company’s total shareholders’ equity measured $60.1 million at March 31, 2018 and $61.6 million on December 31, 2017. Unrealized securities losses, which are recorded in shareholders’ equity net of tax, offset the growth in capital coming from earnings. The Company’s capital continues to meet the requirements for the Company to be deemed well-capitalized under all regulatory measures.

Cash dividends of $0.11 per share were paid to shareholders in the first quarter of 2018. Cash dividends of $0.15 per share were paid in the first three months of 2017, which included a one-time special dividend of $0.07 per share.

Capital Resources

The Company and the Bank are subject to regulatory capital requirements administered by federal banking agencies. Capital adequacy guidelines and prompt corrective action regulations involve quantitative measures of assets, liabilities, and certain off-balance-sheet items calculated under regulatory accounting practices. Capital amounts and classifications are also subject to qualitative judgments by regulators about components, risk weightings, and other factors, and the regulators can lower classifications in certain cases. Failure to meet various capital requirements can initiate regulatory action that could have a direct material effect on the financial statements.

The prompt corrective action regulations provide five categories, including well capitalized, adequately capitalized, undercapitalized, significantly undercapitalized, and critically undercapitalized, although these terms are not used to represent overall financial condition. If a bank is only adequately capitalized, regulatory approval is required to, among other things, accept, renew or roll-over brokered deposits. If a bank is undercapitalized, capital distributions and growth and expansion are limited, and plans for capital restoration are required.

The Board of Governors of the Federal Reserve Board and the FDIC approved the final rules implementing the Basel Committee on Banking Supervision's capital guidelines for U.S. banks (commonly known as Basel III). Under the final rules, which began for the Company and the Bank on January 1, 2015 and are subject to a phase-in period through January 1, 2019, minimum requirements will increase for both the quantity and quality of capital held by the Company and the Bank. The rules include a new common equity Tier 1 capital to risk-weighted assets ratio (CET1 ratio) of 4.5% and a capital conservation buffer of 2.5% of risk-weighted assets, which when fully phased-in, effectively results in a minimum CET1 ratio of 7.0%. Basel III raises the minimum ratio of Tier 1 capital to risk-weighted assets from 4.0% to 6.0% (which, with the capital conservation buffer, effectively results in a minimum Tier 1 capital ratio of 8.5% when fully phased-in), effectively results in a minimum total capital to risk-weighted assets ratio of 10.5% (with the capital conservation buffer fully phased-in), and requires a minimum leverage ratio of 4.0%. Basel III also makes changes to risk weights for certain assets and off-balance-sheet exposures. Management expects that the capital ratios for the Company and the Bank under Basel III will continue to exceed the well capitalized minimum capital requirements, as they currently exceed the fully phased in 2019 requirements.

At March 31, 2018 and December 31, 2017, actual capital levels and minimum required levels were:

| | (Dollars in thousands) | | | | | |
|---|---|---|---|---|---|---|
| March 31, 2018 | Actual Amount | Ratio | Minimum required for capital adequacy purposes Amount | Ratio | To be well-capitalized under prompt corrective action regulations Amount | Ratio |
| CET1 capital (to risk-weighted assets) | | | | | | |
| Company | $64,318 | 12.39% | $26,598 | 4.5 % | N/A | N/A |
| Bank | 60,844 | 11.80% | 26,424 | 4.5 % | $33,513 | 6.5 % |
| Tier 1 capital (to risk-weighted assets) | | | | | | |
| Company | 69,318 | 13.36% | 34,382 | 6.0 % | N/A | N/A |
| Bank | 60,844 | 11.80% | 34,158 | 6.0 % | 41,247 | 8.0 % |
| Total capital (to risk-weighted assets) | | | | | | |
| Company | 73,286 | 14.12% | 44,762 | 8.0 % | N/A | N/A |
| Bank | 70,812 | 13.73% | 44,469 | 8.0 % | 51,559 | 10.0 % |
| Tier 1 capital (to average assets) | | | | | | |
| Company | 69,318 | 10.20% | 27,175 | 4.0 % | N/A | N/A |
| Bank | 60,844 | 9.00 % | 27,033 | 4.0 % | 33,792 | 5.0 % |

| | (Dollars in thousands) | | | | | |
|---|---|---|---|---|---|---|
| December 31, 2017 | Actual Amount | Ratio | Minimum required for capital adequacy purposes Amount | Ratio | To be well-capitalized under prompt corrective action regulations Amount | Ratio |
| CET1 capital (to risk-weighted assets) | | | | | | |
| Company | $63,455 | 12.37% | $23,082 | 4.5 % | N/A | N/A |
| Bank | 59,853 | 11.75% | 22,931 | 4.5 % | $33,123 | 6.5 % |
| Tier 1 capital (to risk-weighted assets) | | | | | | |
| Company | 68,455 | 13.35% | 30,776 | 6.0 % | N/A | N/A |
| Bank | 59,853 | 11.75% | 30,575 | 6.0 % | 40,767 | 8.0 % |
| Total capital (to risk-weighted assets) | | | | | | |
| Company | 73,116 | 14.26% | 41,033 | 8.0 % | N/A | N/A |
| Bank | 70,514 | 13.84% | 40,767 | 8.0 % | 50,959 | 10.0 % |
| Tier 1 capital (to average assets) | | | | | | |
| Company | 68,455 | 10.77% | 25,416 | 4.0 % | N/A | N/A |
| Bank | 59,853 | 9.25 % | 25,879 | 4.0 % | 32,348 | 5.0 % |

The Company had $5.0 million of trust preferred securities at both March 31, 2018 and December 31, 2017 that qualified as Tier 1 capital. Refer to Note 7, “Subordinated Debt.”

The Bank was categorized as "well capitalized" at March 31, 2018 and December 31, 2017.

Certain Non-GAAP Measures

Certain financial information can be determined by methods other than Generally Accepted Accounting Principles (GAAP). Specifically, certain financial measures are based on core earnings rather than net income. Core earnings exclude income, expense, gains and losses that either are not reflective of ongoing operations or that are not expected to reoccur with any regularity or reoccur with a high degree of uncertainty and volatility. Such information may be useful to both investors and management and can aid them in understanding the Company’s current performance trends and financial condition. Core earnings are a supplemental tool for analysis and not a substitute for GAAP net income. Reconciliation from GAAP net income to the non-GAAP measure of core earnings can be referenced as part of management’s discussion and analysis of financial condition and results of operations.

There was no difference in core earnings and GAAP income or earnings per share for both the three months ended March 31, 2018 and March 31, 2017.

Analysis of Net Interest Income – Three months ended March 31, 2018 and 2017

| | (Amounts in thousands) Three months ended March 31, | |
|---|---|---|
| | 2018 | 2017 |
| Net interest income | $5,592 | $4,937 |
| Tax equivalent income adjustment for investment securities | 104 | 233 |
| Tax equivalent income adjustment for loans | 2 | 4 |
| Net interest income on a fully taxable equivalent basis | $5,698 | $5,174 |
| | | |
| Interest and dividends on investment securities | $955 | $1,062 |
| Tax equivalent income adjustment for investment securities | 104 | 233 |
| Investment securities income on a fully taxable equivalent basis | $1,059 | $1,295 |
| | | |
| Interest and fees on loans | $5,588 | $4,618 |
| Tax equivalent income adjustment for loans | 2 | 4 |
| Loan income on a fully taxable equivalent basis | $5,590 | $4,622 |

Net interest income, the principal source of the Company's earnings, is the amount by which interest and fees generated by interest-earning assets, primarily loans and investment securities, exceed the interest cost of deposits and borrowed funds. On a fully taxable equivalent basis, net interest income measured $5.7 million for March 31, 2018 and $5.2 million for March 31, 2017. The resulting net interest margin was 3.62% for March 31, 2018 and 3.52% for March 31, 2017.

The increase in interest income, on a fully taxable equivalent basis, of $744,000 is the product of a 7.1% year-over-year increase in average earning assets and a 21 basis point increase in yield. The increase in interest expense of $220,000 was a product of a 14 basis point increase in rates paid and a 7.0% increase in average interest-bearing liabilities. The net result was a 10.1% increase in net interest income on a fully taxable equivalent basis, and a 10 basis point increase in the Company's net interest margin on a growing asset base with a different mix.

On a fully taxable equivalent basis, income on investment securities available-for-sale decreased by $236,000, or 18.2%. The average invested balances in these securities decreased by $18.9 million, or 10.9%, from the levels of a year ago. The decrease in the average balance of investment securities was accompanied by a 25 basis point decrease in the tax equivalent yield of the portfolio. The Company will continue attempting to redeploy liquidity into loans which generate greater yields than securities, thus sacrificing securities balances when beneficial. The lower corporate tax rate effective in 2018 had a 25 basis point impact on the tax equivalent yield, otherwise security yields were comparable among the periods.

On a fully taxable equivalent basis, income on loans increased by $968,000, or 20.9%, for March 31, 2018 compared to the same period in 2017. A $60.7 million increase in the average balance of the loan portfolio, or 14.8%, was accompanied by a 25 basis point increase in the portfolio's tax equivalent yield. Despite the recent rise in short-term interest rates, strong competition for good credits continued to put pressure on offering rates. In addition, the amortization of the existing portfolio at higher rates decreases the effective yield. The commercial loan portfolio housed the majority of the increase in balances.

Other interest income increased by $12,000, or 75.0%, from the same period a year ago. The average balance of interest-earning deposits increased by $136,000, or 2.0%. The yield increased by 69 points from 2017 to 2018, reflecting the recent increases in the federal funds rate. Management intends to remain fully invested, minimizing on-balance sheet liquidity.

Average interest-bearing demand deposits and money market accounts increased by $40.8 million, or 25.2%, for the three months ended March 31, 2018 compared to the same period of 2017, while average savings balances decreased by $308,000, or 0.3%. Promotional rates offered on money market products, along with the continuing marketing of the Kasasa suite of products, drew in core deposits, thus producing the substantial increase in the demand balances. Total interest paid on interest-bearing demand deposits and money market accounts was $286,000, a $139,000 increase from last year. The yield increased 20 basis points from the three months ended March 31, 2017 to March 31, 2018. Total interest paid on savings accounts was $24,000, a $3,000 increase from last year. The average rate paid on savings accounts was 0.09% for the three months ended March 31, 2018 and 0.07% for the same period in 2017. The average balance of time deposit products decreased by $8.1 million, or 6.1%, as the average rate paid increased by 28 basis points, from 1.27% to 1.55%. Interest expense increased on time deposits by $61,000 from the prior year. The current low-rate environment offers little opportunity for time deposit customers, except for periodic special rates offered on a limited basis. Time deposits also include wholesale funds obtained at generally higher rates than in-market accounts.

Average borrowings and subordinated debt decreased by $501,000 while the average rate paid increased by 17 basis points. Cost of borrowings continues to rise in tandem with the Federal funds rate, thus offsetting any decline in borrowed balances. Management continues to utilize short-term borrowings to bridge liquidity gaps.

Impairment Analysis of Investment Securities

The Company owns two trust preferred securities totaling $2.0 million (original face) consisting of collateral issued by banks, thrifts, and insurance companies. The market for these securities at March 31, 2018 is not fully active and markets for similar securities are also not completely active. Given conditions in the debt markets today and the absence of observable transactions in the secondary and new issue markets, the Company determined the few observable transactions and market quotations that are available are not reliable for purposes of determining fair value at March 31, 2018. It was decided that an income valuation approach technique (present value technique) that maximizes the use of relevant observable inputs and minimizes the use of unobservable inputs continues to be more representative of fair value than the market approach valuation technique used at measurement dates prior to 2008.

The Company enlisted the aid of an independent third party to perform the trust preferred securities valuations. The approach to determining fair value involved the following process:

1. Estimate the credit quality of the collateral using average probability of default values for each issuer (adjusted for rating levels).
2. Consider the potential for correlation among issuers within the same industry for default probabilities (e.g. banks with other banks).
3. Forecast the cash flows for the underlying collateral and apply to each trust preferred security tranche to determine the resulting distribution among the securities.
4. Discount the expected cash flows to calculate the present value of the security.

The PreTSL XXIII cash flows are discounted at 11.7% through its maturity date of December 2036 and would have to experience an additional $210 million of nonperforming collateral (of $860 million performing) in order to incur any impairment. The aggregate cash flows for the C-2 tranche are estimated to be $44.1 million on a current principal of $26.1 million. The Trapeza IX B-1 cash flows are discounted at 8.6% through its maturity of January 2038 and would experience additional impairment upon further occurrence of nonperforming collateral of $7.0 million (of $208 million nonperforming). The aggregate cash flows for the B-1 tranche are estimated to be $42.6 million on a current principal of $23.8 million.

Based upon the results of the analysis, the Company currently believes that a weighted average price of approximately $0.51 per $1.00 of par value is representative of the fair value of the two trust preferred securities, with individual securities therein ranging from $0.44 to $056.

The Company considered all information available as of March 31, 2018 to estimate the impairment and resulting fair value of the trust preferred securities. These securities are supported by a number of banks and insurance companies located throughout the country. While the number of bank failures has declined since the historically high failure rates of 2009, 2010 and 2011, there is still the potential for troubled banks to fail. The Company did not recognize any credit related impairment in the first three months of 2018 or 2017. If the conditions of the underlying banks in the trust preferred securities worsen, there may be additional impairment to recognize in the remainder of 2018 or later.

Analysis of Provision for Loan Losses, Non-Interest Income, Non-Interest Expense and Federal Income Tax - Three Months Ended March 31, 2018 and 2017

During the first three months of both 2018 and 2017, the amount charged to operations as a provision for loan losses was adjusted to account for charge-offs against the allowance, as well as an increase in loan balances recorded in the portfolio, expected losses on specific problem loans and several qualitative factors, including factors specific to the local economy and to industries operating in the local market. The Company had allocated a portion of the allowance for a select few specific problem loans in 2017 and 2018, and has not experienced significant deterioration in any loan type, including the residential real estate portfolios or the commercial loan portfolio, and accordingly has not added any special provision for these loan types. Past due loans, potential problem loans, as well as loans on non-accrual have all steadily declined, helping to require a provision of only $500,000 in the first quarter of 2018 which is lower than the net charge-off of $1.2 million (of which previously had a specific reserve of $625,000) and required no provision in the first quarter of 2017. There was a favorable ruling in a bankruptcy court surrounding the eventual sale of a business to which the Company lent funds, resulting in a large recovery of amounts previously charged off in 2017. These recoveries displaced provisions throughout 2017. Provision expense levels are in recognition of loan growth and a changing composition of the loan portfolio as the Company manages its balance sheet with a commercially-oriented focus.

Total non-interest income increased by $112,000, or 12.4%, for March 31, 2018 compared to March 31, 2017.

Gains on securities called and net gains on the sale of available-for-sale investment securities increased by $11,000 in the first three months of 2018 from year ago levels, and remain revenue neutral.

For the quarter ended March 31, 2018, fees for customer service increased by $47,000, or 9.3% from the same period a year ago, driven by customer transactions on deposit accounts. Mortgage banking gains increased to $238,000 in 2018 from $194,000 in 2017, an increase of $44,000, reflective of a mortgage origination increase of $4.1 million. Wealth management income of $9,000 was recorded in 2018, compared to $7,000 in 2017, an increase of $2,000. After operating its own non-deposit investment service program, the Bank now has a Cortland Private Wealth Management program which partners with an external platform and advisory group to offer a full suite of program options, including private asset management, financial and estate planning, retirement plans, insurance and advisory services. Earnings on bank-owned life insurance increased by $2,000. In reference to the previously mentioned death of a former executive, the Company expects to realize a gain of $1.5 million for insurance proceeds in excess of the recorded cash value in the second quarter of 2018. Other sources of non-interest income increased by $6,000 from the same period a year ago. This latter income category is subject to fluctuation due to the non-recurring nature of some of the items.

Total non-interest expenses in the first three months were $4.3 million in 2018 compared to $4.6 million in 2017, a decrease of $321,000, or 6.9%. During the first three months of 2018, expenditures for salaries and employee benefits decreased by $292,000, or 10.6%, from the similar period a year ago. This is mainly a result of a workforce realignment and a branch consolidation in latter 2017. Full time equivalent employment averaged 160 during the first three months of 2018 and 163 during the first three months of 2017.

All other expense categories decreased by $29,000, or 1.5%, in the aggregate.

The effective tax rate for the first three months was 13.6% in 2018 and 16.0% in 2017, resulting in income tax expense of $241,000 in 2018 and $190,000 in 2017. The effective rate is affected by the current rate of profitability and tax-free components of the revenue stream. The lower rate in 2018 is primarily affected by the change in corporate tax rate from 34% to 21%.

The provision for income taxes differs from the amount of income tax determined applying the applicable U.S. statutory federal income tax rate (21% in 2018 and 34% in 2017) to pre-tax income as a result of the following differences:

| | (Amounts in thousands) March 31, | | | |
|---|---|---|---|---|
| | 2018 | | 2017 | |
| | Balance | % | Balance | % |
| Provision at statutory rate | $373 | 21.0 | $405 | 34.0 |
| Add (Deduct) tax effects of: | | | | |
| Earnings on bank-owned life insurance-net | (20) | (1.1) | (25) | (2.1) |
| Non-taxable interest income | (91) | (5.1) | (162) | (13.6) |
| Low income housing tax credits | (35) | (2.0) | (45) | (3.8) |
| Non-deductible expenses | 14 | 0.8 | 17 | 1.5 |
| Federal income tax expense | $241 | 13.6 | $190 | 16.0 |

Liquidity

The central role of the Company's liquidity management is to (1) ensure sufficient liquid funds to meet the normal transaction requirements of its customers, (2) take advantage of market opportunities requiring flexibility and speed, and (3) provide a cushion against unforeseen liquidity needs.

Liquidity risk arises from the possibility that the Company may not be able to satisfy current or future financial commitments or may become unduly reliant on alternative funding sources. The objective of liquidity management is to ensure the Company has the ability to fund balance sheet growth and meet deposit and debt obligations in a timely and cost-effective manner. Management monitors liquidity through a regular review of asset and liability maturities, funding sources, and loan and deposit forecasts. The Company maintains strategic and contingency liquidity plans to ensure sufficient available funding to satisfy requirements for balance sheet growth, proper management of capital markets funding sources and addressing unexpected liquidity requirements.

Principal sources of liquidity available to the Company include assets considered relatively liquid, such as interest-bearing deposits in other banks, federal funds sold and, cash and due from banks, as well as cash flows from maturities and repayments of loans, investment securities and mortgage-backed securities.

Principal repayments on mortgage-backed securities, collateralized mortgage obligations and small business administration pools, along with investment securities maturing or called amounted to $3.4 million in the first three months of 2018, which annualized represents 9.5% of the total combined portfolio, compared to $4.4 million, or 10.6%, of the portfolio a year ago. A large portion of the investment portfolio is allocated to amortizing debt in order to provide cash flows to supplement loan growth.

In order to address the concern of FDIC insurance of larger depositors, the Bank is a member of the Certificate of Deposit Account Registry Service (CDARS®) program and the Insured Cash Sweep (ICS) program. Through CDARS®, the Bank's customers can increase their FDIC insurance by up to $50 million through reciprocal certificate of deposit accounts and likewise through ICS, they can accomplish the same through money market savings accounts. This is accomplished by the Bank entering into reciprocal depository relationships with other member banks. The individual customer's large deposit is broken into amounts below $250,000 and placed with other banks that are members of the network. The reciprocal member bank issues certificates of deposit or money market savings accounts in amounts that ensure that the entire deposit is eligible for FDIC insurance. At March 31, 2018, the Bank had $17.8 million of deposits in the CDARS® program, of which $12.8 million was executed as one-way buy transactions and the Bank had $19.3 million of deposits in the ICS money market program, of which $6.0 million was executed as one-way buy transactions. Prospectively, for regulatory purposes, reciprocal CDARS® and ICS may no longer be considered a brokered deposit.

Along with its liquid assets, the Bank has other sources of liquidity available to it which help to ensure that adequate funds are available as needed. These other sources include, but are not limited to, the ability to obtain deposits through the adjustment of interest rates, the purchasing of federal funds, correspondent bank lines of credit and access to the Federal Reserve Discount Window. The Bank is also a member of the Federal Home Loan Bank of Cincinnati, which provides its largest source of liquidity. At March 31, 2018, the Bank had approximately $19.4 million available of collateral-based borrowing capacity at FHLB of Cincinnati, supplementing the $5.3 million of availability with the Federal Reserve Discount window. Additionally, the FHLB has committed a $31.6 million cash management line, of which nothing has been disbursed, subject to posting additional collateral. The Bank, by policy, has access to approximately 20% of total deposits in various forms of wholesale deposits that could be used as an additional source of liquidity. At March 31, 2018, there was $50.7 million in outstanding balances in wholesale deposits including internet-based deposits with access to an additional $59.8 million. The Company was also granted a total of $13.5 million in unsecured, discretionary Federal Funds lines of credit with correspondent banks with no funds drawn upon as of March 31, 2018. Unpledged securities of $74.3 million are also available for borrowing under repurchase agreements or as additional collateral for FHLB lines of credit or to sell to generate liquidity.

The Company has other more limited sources of liquidity. In addition to its existing liquid assets, it can raise funds in the securities market through debt or equity offerings or it can receive dividends from its bank subsidiary. Generally, the Bank may pay dividends without prior approval as long as the dividend is not more than the total of the current calendar year-to-date earnings plus any earnings from the previous two years not already paid out in dividends, as long as the Bank remains well-capitalized after the dividend payment. The amount available for dividends at March 31, 2018 is $7.8 million. Future dividend payments by the Bank to the Company are based upon future earnings. The Holding Company had cash of $50,000 at March 31, 2018 available to meet cash needs. It also held a $6.0 million note receivable, the cash flow from which approximates the debt service on the Junior Subordinated Debentures. Cash is generally used by the Holding Company to pay quarterly interest payments on the debentures, pay dividends to common shareholders, repurchase shares, and to fund operating expenses.

Cash and cash equivalents totaled $27.5 million at March 31, 2018 compared to $15.9 million at March 31, 2017 and $19.1 million at December 31, 2017, as the Company strives to be fully invested, minimizing on balance sheet liquidity.

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The following table details the cash flow from operating activities for the three months ended:

| | (Amounts in thousands) March 31, 2018 | 2017 |
|---|---|---|
| Net income | $1,537 | $1,000 |
| Adjustments to reconcile net income to net cash flow from operating activities: | | |
| Depreciation, amortization and accretion | 650 | 699 |
| Provision for loan losses | 500 | — |
| Investment securities available-for-sale gains, net | (20) | (9) |
| Originations of mortgage banking loans held for sale | (12,319) | (8,229) |
| Proceeds from the sale of mortgage banking loans | 14,121 | 10,541 |
| Mortgage banking gains, net | (238) | (194) |
| Earnings on bank-owned life insurance | (77) | (75) |
| Equity compensation | 34 | 48 |
| Changes in: | | |
| Deferred taxes | 130 | (99) |
| Other assets and liabilities | (218) | (226) |
| Net cash flow from operating activities | $4,100 | $3,456 |

Key variations stem from: 1) Substantial recoveries throughout 2017 displaced the need for a provision in 2017. The 2018 provision is reflective of the restructured loan previously referenced. 2). Mortgage loan originations and sales increased in 2018, producing higher gains. Refer to the Consolidated Statements of Cash Flows for a summary of the sources and uses of cash for 2018 and 2017.

Critical Accounting Policies and Estimates

The discussion and analysis of the Company’s financial condition and results of operation are based upon the Consolidated Financial Statements, which have been prepared in accordance with U.S. Generally Accepted Accounting Principles (GAAP). The preparation of these consolidated financial statements requires management to make estimates and judgments that affect the reported amounts of assets and liabilities, revenues and expenses, and related disclosures of contingent assets and liabilities at the date of the Company’s consolidated financial statements. Actual results may differ from these estimates under different assumptions or conditions.

Certain accounting policies involve significant judgments and assumptions by management which has a material impact on the carrying value of certain assets and liabilities; management considers such accounting policies to be critical accounting policies. The judgments and assumptions used by management are based on historical experience and other factors, which are believed to be reasonable under the circumstances.

Management believes the following are critical accounting policies that require the most significant judgments and estimates used in the preparation of the Company’s consolidated financial statements.

Accounting for the Allowance for Loan Losses

The determination of the allowance for loan losses and the resulting amount of the provision for loan losses charged to operations reflects management's current judgment about the credit quality of the loan portfolio and takes into consideration changes in lending policies and procedures, changes in economic and business conditions, changes in the nature and volume of the portfolio and, in the terms of loans, changes in the experience, ability and depth of lending management, changes in the volume and severity of past due, non-accrual and adversely classified or graded loans, changes in the quality of the loan review system, changes in the value of underlying collateral for collateral-dependent loans, the existence and effect of any concentrations of credit and the effect of competition, legal and regulatory requirements and other external factors. The nature of the process by which we determine the appropriate allowance for loan losses requires the exercise of considerable judgment. While management utilizes its best judgment and information available, the ultimate adequacy of the allowance is dependent upon a variety of factors beyond our control, including the performance of the loan portfolio, the economy, changes in interest rates and the view of the regulatory authorities toward loan classifications. The allowance is increased by the provision for loan losses and decreased by charge-offs when management believes the uncollectibility of a loan is confirmed. Subsequent recoveries, if any, are credited to the allowance. A weakening of the economy or other factors that adversely affect asset quality could result in an increase in the number of delinquencies, bankruptcies or defaults and a higher level of non-performing assets, net charge offs, and provision for loan losses in future periods.

The Company's allowance for loan losses methodology consists of three elements: specific valuation allowances based on probable losses on specific loans; valuation allowances based on historical loan loss experience for similar loans with similar characteristics and trends; and general valuation allowances based on general economic conditions and other qualitative risk factors both internal and external to the Company. These elements support the basis for determining allocations between the various loan categories and the overall adequacy of our allowance to provide for probable losses inherent in the loan portfolio.

With these methodologies, a general allowance is established for each loan type based on historical losses for each loan type in the portfolio. Additionally, management allocates a specific allowance for "Impaired Credits," which is based on current information and events; it is probable the Company will not collect all amounts due according to the original contractual terms of the loan agreement. The level of the general allowance is established to provide coverage for management's estimate of the credit risk in the loan portfolio by various loan segments not covered by the specific allowance. Additional information regarding allowance for credit losses can be found in the Notes to the Consolidated Financial Statements (Note 4) and elsewhere in this Management's Discussion and Analysis.

Investment Securities and Impairment

The classification and accounting for investment securities is discussed in detail in Note 3 of the Consolidated Financial Statements. Investment securities must be classified as held-to-maturity, available-for-sale, or trading. The appropriate classification is based partially on our ability to hold the securities to maturity and largely on management's intentions, if any, with respect to either holding or selling the securities. The classification of investment securities is significant since it directly impacts the accounting for unrealized gains and losses on securities. Unrealized gains and losses on trading securities, if any, flow directly through earnings during the periods in which they arise, whereas available-for-sale securities are recorded as a separate component of shareholders' equity (accumulated other comprehensive income or loss) and do not affect earnings until realized. The fair values of our investment securities are generally determined by reference to quoted market prices and reliable independent sources. At each reporting date, the Company assesses whether there is an "other-than-temporary" impairment to the Company's investment securities. Such impairment must be recognized in current earnings rather than in other comprehensive income (loss).

The Company reviews investment debt securities on an ongoing basis for the presence of other-than-temporary impairment (OTTI) with formal reviews performed quarterly. OTTI losses on individual investment securities are recognized in accordance with FASB ASC topic 320, Investments – Debt and Equity Securities. The purpose of this ASC is to provide greater clarity to investors about the credit and noncredit component of an OTTI event and to communicate more effectively when an OTTI event has occurred. This ASC amends the OTTI guidance in GAAP for debt securities, improves the presentation and disclosure of OTTI on investment securities and changes the calculation of the OTTI recognized in earnings in the financial statements. This ASC does not amend existing recognition and measurement guidance related to OTTI of equity securities.

For debt securities, ASC topic 320 requires an entity to assess whether it has the intent to sell the debt security or it is more-likely-than-not that it will be required to sell the debt security before its anticipated recovery. If either of these conditions is met, an OTTI on the security must be recognized.

In instances in which a determination is made that a credit loss (defined as the difference between the present value of the cash flows expected to be collected and the amortized cost basis) exists but the entity does not intend to sell the debt security and it is not more-likely-than-not that the entity will be required to sell the debt security before the anticipated recovery of its remaining amortized cost basis (i.e., the amortized cost basis less any current-period credit loss), ASC topic 320 changes the presentation and amount of the OTTI recognized in the income statement.

In these instances, the impairment is separated into the amount of the total impairment related to the credit loss and the amount of the total impairment related to all other factors. The amount of the total other-than-temporary impairment related to the credit loss is recognized in earnings. The amount of the total impairment related to all other factors is recognized in other comprehensive income (loss). The total OTTI is presented in the income statement with an offset for the amount of the total OTTI that is recognized in other comprehensive income (loss). In determining the amount of impairment related to credit loss, the Company uses a third party discounted cash flow model, several inputs for which require estimation and judgment. Among these inputs are projected deferral and default rates and estimated recovery rates. Realization of events different than that projected could result in a large variance in the values of the securities.

Income Taxes

The provision for income taxes is based on income reported for financial statement purposes and differs from the amount of taxes currently payable, since certain income and expense items are reported for financial statement purposes in different periods than those for tax reporting purposes. Accrued taxes represent the net estimated amount due or to be received from taxing authorities. In estimating accrued taxes, the Company assesses the relative merits and risks of the appropriate tax treatment of transactions taking into account statutory, judicial and regulatory guidance in the context of the Company’s tax position.

The Company accounts for income taxes using the asset and liability approach, the objective of which is to establish deferred tax assets and liabilities for the temporary differences between the financial reporting basis and tax basis of our assets and liabilities at enacted tax rates expected to be in effect when such amounts are realized or settled. The Company conducts periodic assessments of deferred tax assets, including net operating loss carryforwards, to determine if it is more-likely-than-not that they will be realized. In making these assessments, the Company considers taxable income in prior periods, projected future taxable income, potential tax planning strategies and projected future reversals of deferred tax items. These assessments involve a certain degree of subjectivity which may change significantly depending on the related circumstances.

Available Information

The Company files an annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K and amendments to those reports with the Securities and Exchange Commission (SEC) pursuant to Section 13(a) or 15(d) of the Exchange Act of 1934 Amended (the Exchange Act). The Company's website is www.cortlandbank.com. The Company makes available through its website, free of charge, the reports filed with the SEC, as soon as reasonably practicable after such material is electronically filed, or furnished to, the SEC. The SEC also maintains a website that contains reports, proxy and information statements, and other information regarding issuers that file electronically with the SEC at www.sec.gov. The public may read and copy any materials filed with the Commission at the SEC's Public Reference Room at 100 F Street, NE, Washington, DC 20549, on official business days during the hours of 10:00 am to 3:00 pm. The public may obtain information on the operation of the Public Reference Room by calling the Commission at 1-800-SEC-0330.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

There have been no material changes in the quantitative and qualitative information about market risk from the information provided in the Company's Form 10-K for the year ended December 31, 2017.

ITEM 4. CONTROLS AND PROCEDURES

Evaluation of Disclosure Controls and Procedures. With the supervision and participation by management, including the Company's principal executive officer and principal financial officer, the effectiveness of disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934 (the "Exchange Act")) has been evaluated as of the end of the period covered by this report. Based upon that evaluation, the Company's principal executive officer and principal financial officer have concluded that these controls and procedures were effective.

Changes in Internal Control Over Financial Reporting. Our Chief Executive Officer and Chief Financial Officer have concluded that there have been no significant changes during the period covered by this report in the Company's internal control over financial reporting (as defined in Rules 13a-13 and 15d-15 of the Exchange Act) that have materially affected, or are reasonably likely to materially affect, internal control over financial reporting.

## PART II—OTHER INFORMATION

### Item 1. Legal Proceedings

See Note (5) of the financial statements.

### Item 1A. Risk Factors

There have been no material changes in the risk factors disclosed by the Company in its Report on Form 10-K for the fiscal year ended December 31, 2017.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds—Not applicable

Company’s Common Stock. The following table shows information relating to the repurchase of shares of the Company’s common stock during the three months ended March 31, 2018:

| | Total Number of Shares Purchased | Average Price Paid Per Share | Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs | Maximum Number of Shares That May Yet Be Purchased Under the Plans or Programs* |
|---|---|---|---|---|
| January | — | $ — | — | 100,000 |
| February | 10,488 | 21.25 | 10,488 | 89,512 |
| March | — | — | — | — |
| Total | 10,488 | $ 21.25 | 10,488 | 89,512 |

*On January 23, 2018 the Company’s Board of Directors approved a Stock Repurchase Program. The program allows the Company to purchase up to 100,000 shares and expires at December 31, 2018. (See footnote 12)

Item 3. Defaults upon Senior Securities—Not applicable

Item 4. Mine Safety Disclosures—Not applicable

Item 5. Other Information—Not applicable

CORTLAND BANCORP AND SUBSIDIARIES

INDEX TO EXHIBITS

Item 6. Exhibits—The following exhibits are filed or incorporated by reference as part of this report:

| Exhibit No. | Exhibit Description | Incorporated by Reference Form** | Exhibit | Filing Date | Filed Herewith |
|---|---|---|---|---|---|
| 3.1 | Restated Amended Articles of Cortland Bancorp reflecting amendment dated June 25, 1999. Note: filed for purposes of SEC reporting compliance only. This restated document has not been filed with the State of Ohio. | 10-K(1) | 3.1 | 03/16/06 | |
| 3.2 | Code of Regulations, as amended. | 8-K | 3.2 | 05/30/17 | |
| 4.1 | The rights of holders of equity securities are defined in portions of the Articles of Incorporation as referenced in Exhibit 3.1 | 10-K(1) | 4.1 | 03/16/06 | |
| | and the Code of Regulations as referenced in Exhibit 3.2 | 8-K | 4.1 | 05/30/17 | |
| 4.2 | Agreement to furnish instruments and agreements defining rights of holders of long-term debt | | | | |
| *10.1 | Group Term Carve Out Plan dated February 23, 2001, by The Cortland Savings and Banking Company with each executive officer other than Rodger W. Platt and with selected other officers, as amended by the August 2002 letter amendment | 10-K(1) | 10.1 | 03/16/06 | |
| *10.1.1 | Amendment of Group Term Carve Out Plan, dated October 28, 2014 | 8-K | 10.1.1 | 11/03/14 | |
| 10.2 | [Reserved] | | | | |
| 10.3 | [Reserved] | | | | |
| *10.4 | Amended Director Retirement Agreement between Cortland Bancorp and David C. Cole, dated as of December 18, 2007 | 10-K | 10.4 | 03/17/08 | |
| 10.5 | [Reserved] | | | | |
| 10.6 | [Reserved] | | | | |
| *10.7 | Amended Director Retirement Agreement between Cortland Bancorp and James E. Hoffman III, dated as of December 18, 2007 | 10-K | 10.7 | 03/17/08 | |

| | | | | |
|---|---|---|---|---|
| *10.8 | Amended Director Retirement Agreement between Cortland Bancorp and Neil J. Kaback, dated as of December 18, 2007 | 10-K | 10.8 | 03/17/08 |
| 10.9 | [Reserved] | | | |
| *10.10 | Amended Director Retirement Agreement between Cortland Bancorp and Richard B. Thompson, dated as of December 18, 2007 | 10-K | 10.10 | 03/17/08 |
| *10.11 | Amended Director Retirement Agreement between Cortland Bancorp and Timothy K. Woofter, dated as of December 18, 2007 | 10-K | 10.11 | 03/17/08 |
| *10.12 | Form of Split Dollar Agreement entered into by Cortland Bancorp and each of Directors David C. Cole, James E. Hoffman III, and Timothy K. Woofter as of February 23, 2001, as of March 1, 2004, with Director Neil J. Kaback, and as of October 1, 2001, with Director Richard B. Thompson; | 10-K(1) | 10.12 | 03/16/06 |
| | as amended on December 26, 2006, for Directors Cole, Hoffman, Thompson, and Woofter; | 10-K | 10.12 | 03/15/07 |
| *10.13 | Director's Retirement Agreement between Cortland Bancorp and Director Joseph E. Koch, dated as of April 19, 2011 | 8-K | 10.13 | 04/22/11 |

| Exhibit No. | Exhibit Description | Incorporated by Reference Form** | Exhibit | Filing Date | Filed Herewith |
|---|---|---|---|---|---|
| *10.14 | Split Dollar Agreement and Endorsement between Cortland Bancorp and Director Joseph E. Koch, dated as of April 19, 2011 | 8-K | 10.14 | 04/22/11 | |
| *10.15 | Form of Indemnification Agreement entered into by Cortland Bancorp with each of its directors | 10-K(1) | 10.15 | 03/16/06 | |
| *10.16 | Endorsement Split Dollar Agreement between The Cortland Savings and Banking Company and David J. Lucido, dated as of March 27, 2012 | 10-K | 10.16 | 03/29/12 | |
| *10.17 | Seventh Amended Salary Continuation Agreement between The Cortland Savings and Banking Company and Timothy Carney, dated as of November 24, 2015 | 8-K | 10.17 | 12/01/15 | |
| *10.18 | Third Amended Salary Continuation Agreement between The Cortland Savings and Banking Company and Lawrence A. Fantauzzi, dated as of December 3, 2008 | 8-K | 10.18 | 12/12/08 | |
| *10.19 | Seventh Amended Salary Continuation Agreement between The Cortland Savings and Banking Company and James M. Gasior, dated as of November 24, 2015 | 8-K | 10.19 | 12/01/15 | |
| 10.20 | [Reserved] | | | | |
| 10.21 | [Reserved] | | | | |
| 10.22 | [Reserved] | | | | |
| *10.23 | Salary Continuation Agreement between The Cortland Savings and Banking Company and David J. Lucido, dated as of November 24, 2015 | 8-K | 10.23 | 12/01/15 | |
| *10.24 | Fourth Amended Split Dollar Agreement and Endorsement between The Cortland Savings and Banking Company and Timothy Carney, dated as of April 19, 2011 | 8-K | 10.24 | 04/22/11 | |
| *10.25 | Salary Continuation Agreement between The Cortland Savings and Banking Company and Stanley P. Feret, dated as of November 24, 2015 | 8-K | 10.25 | 12/01/15 | |
| *10.26 | Fourth Amended Split Dollar Agreement and Endorsement between The Cortland Savings and Banking Company and James M. Gasior, dated as of April 19, 2011 | 8-K | 10.26 | 04/22/11 | |
| 10.27 | [Reserved] | | | | |

| | | | | |
|---|---|---|---|---|
| 10.28 | [Reserved] | | | |
| 10.29 | [Reserved] | | | |
| *10.30 | Endorsement Split Dollar Agreement between The Cortland Savings and Banking Company and Stanley P. Feret, dated as of July 23, 2013 | 10-Q | 10.30 | 08/13/13 |
| *10.31.1 | Severance Agreement between Cortland Bancorp and Tim Carney, dated as of September 28, 2012, as amended November 24, 2015 | 10-K | 10.31.1 | 12/01/15 |
| *10.31.2 | Severance Agreement between Cortland Bancorp and James Gasior, dated as of September 28, 2012, as amended November 24, 2015 | 8-K | 10.31.2 | 12/01/15 |
| *10.31.3 | Severance Agreement between Cortland Bancorp and David J. Lucido, dated as of September 28, 2012, as amended November 24, 2015 | 8-K | 10.31.3 | 12/01/15 |

| Exhibit No. | Exhibit Description | Incorporated by Reference Form** | Exhibit | Filing Date | Filed Herewith |
|---|---|---|---|---|---|
| 10.32 | [Reserved] | | | | |
| 10.33 | [Reserved] | | | | |
| *10.34 | Severance Agreement between Cortland Bancorp and Stanley P. Feret, dated as of September 28, 2012, as amended November 24, 2015 | 8-K | 10.34 | 12/01/15 | |
| *10.35 | Annual Incentive Plan for Executive Officers | 8-K | 10.35 | 08/03/15 | |
| *10.36 | 2015 Omnibus Equity Plan | 10-Q | 10.36 | 08/11/15 | |
| 10.36.1 | Form of incentive stock option award under the 2015 Omnibus Equity Plan | 10-Q | 10.36.1 | 08/11/15 | |
| 10.36.2 | Form of nonqualified stock option award under the 2015 Omnibus Equity Plan | 10-Q | 10.36.2 | 08/11/15 | |
| 10.36.3 | Form of restricted stock award under the 2015 Omnibus Equity Plan | 10-Q | 10.36.3 | 08/11/15 | |
| *10.37 | 2015 Director Equity Plan | 10-Q | 10.37 | 08/11/15 | |
| 10.37.1 | Form of nonqualified stock option award under the 2015 Director Equity Plan | 10-Q | 10.37.1 | 08/11/15 | |
| 10.37.2 | Form of incentive stock option award under the 2015 Director Equity Plan | 10-Q | 10.37.2 | 08/11/15 | |
| 11 | Statement of re-computation of per share earnings | See Note 6 of Financial Statements | | | |
| 31.1 | Certification of the Chief Executive Officer under Rule 13a-14(a) | | | | |
| 31.2 | Certification of Chief Financial Officer under Rule 13a-14(a) | | | | |
| 32 | Section 1350 Certification of Chief Executive Officer and Chief Financial Officer required under section 906 of the Sarbanes-Oxley Act of 2002 | | | | |

| | |
|---|---|
| 101 | The following materials from Cortland Bancorp’s Quarterly Report on Form 10-Q for the quarter ended March 31, 2018, formatted in Extensible Business Reporting Language (XBRL): (a) Consolidated Balance Sheets; (b) Consolidated Statements of Income; (c) Consolidated Statements of Comprehensive Income; (d) Consolidated Statements of Changes in Shareholders’ Equity; (e) Consolidated Statements of Cash Flows; and (f) the Notes to Consolidated Financial Statements tagged as blocks of text and in detail (included with this filing) |

(1) Film number 06691632

* Management contract or compensatory plan or arrangement

** SEC File No. 000-13814

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CORTLAND BANCORP AND SUBSIDIARIES

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.

CORTLAND BANCORP

(Registrant)

| | |
|---|---|
| /s/ James M. Gasior<br>James M. Gasior<br><br>President and<br><br>Chief Executive Officer<br><br>(Principal Executive Officer) | Date: May 10, 2018 |
| /s/ David J. Lucido<br>David J. Lucido<br><br>Senior Vice President and<br><br>Chief Financial Officer<br><br>(Principal Financial and Accounting Officer) | Date: May 10, 2018 |