CORTLAND BANCORP INC
Form 10-Q
August 15, 2011

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**UNITED STATES**
**SECURITIES AND EXCHANGE COMMISSION**
**Washington, D. C. 20549**
**FORM 10-Q**

(Mark One)

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

**For the quarterly period ended: June 30, 2011**

**or**

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

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

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

| | | | |
|---|---|---|---|
| Large accelerated filer o | Accelerated filer o | Non-accelerated filer o (Do not check if a smaller reporting company) | Small reporting company þ |

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

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 | 4,525,537 Shares August 8, 2011 |

**CORTLAND BANCORP AND SUBSIDIARIES**
**CONSOLIDATED BALANCE SHEETS**
**(Amounts in thousands, except share data)**

| | (Unaudited) JUNE 30, 2011 | DECEMBER 31, 2010 |
|---|---|---|
| **ASSETS** | | |
| Cash and due from banks | **$ 7,796** | $ 6,894 |
| Interest-bearing deposits | **12,937** | 8,910 |
| Total cash and cash equivalents | **20,733** | 15,804 |
| Investment securities available for sale (Note 3) | **176,689** | 168,158 |
| Investment securities held-to-maturity (estimated fair value of $20,941 at December 31, 2010) (Note 3) | | 20,300 |
| Total loans (Note 4) | **258,904** | 265,441 |
| Less allowance for loan losses (Note 4) | **(2,853)** | (2,501) |
| Net loans | **256,051** | 262,940 |
| Premises and equipment | **6,575** | 6,720 |
| Bank-owned life insurance | **12,747** | 12,491 |
| Other assets | **11,828** | 13,860 |
| **Total assets** | **$ 484,623** | $ 500,273 |
| **LIABILITIES** | | |
| Noninterest-bearing deposits | **$ 64,137** | $ 61,362 |
| Interest-bearing deposits | **326,845** | 330,147 |
| Total deposits | **390,982** | 391,509 |
| Federal Home Loan Bank advances short term | **2,000** | 20,500 |
| Federal Home Loan Bank advances long term | **32,500** | 32,500 |
| Other short-term borrowings | **5,249** | 4,901 |
| Subordinated debt | **5,155** | 5,155 |
| Other liabilities | **4,022** | 3,856 |
| **Total liabilities** | **439,908** | 458,421 |
| **SHAREHOLDERS EQUITY** | | |
| Common stock $5.00 stated value authorized 20,000,000 shares; issued 4,728,267 in 2011 and 2010; outstanding shares 4,525,537 in 2011 and 4,525,541 in 2010 | **23,641** | 23,641 |
| Additional paid-in capital | **20,850** | 20,850 |
| Retained earnings | **5,603** | 3,413 |

| | | | | |
|---|---|---|---|---|
| Accumulated other comprehensive loss | | **(1,785)** | | (2,458) |
| Treasury stock at cost, 202,730 at June 30, 2011 and 202,726 December 31, 2010 | | **(3,594)** | | (3,594) |
| **Total shareholders equity** | | **44,715** | | 41,852 |
| **Total liabilities and shareholders equity** | **$** | **484,623** | $ | 500,273 |

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

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**CORTLAND BANCORP AND SUBSIDIARIES**
**CONSOLIDATED STATEMENTS OF INCOME (UNAUDITED)**
**(Amounts in thousands, except per share data)**

| | THREE MONTHS ENDED JUNE 30, | | SIX MONTHS ENDED JUNE 30, | |
|---|---|---|---|---|
| | **2011** | 2010 | **2011** | 2010 |
| **INTEREST INCOME** | | | | |
| Interest and fees on loans | **$ 3,849** | $ 3,724 | **$ 7,612** | $ 7,403 |
| Interest and dividends on investment securities: | | | | |
| Taxable interest | **1,079** | 1,473 | **2,192** | 2,959 |
| Nontaxable interest | **354** | 356 | **749** | 677 |
| Dividends | **38** | 46 | **70** | 86 |
| Other interest income | **18** | 20 | **35** | 43 |
| Total interest income | **5,338** | 5,619 | **10,658** | 11,168 |
| **INTEREST EXPENSE** | | | | |
| Deposits | **841** | 1,046 | **1,705** | 2,162 |
| Other short-term borrowings | **1** | 2 | **3** | 4 |
| Federal Home Loan Bank advances short term | **23** | 214 | **74** | 474 |
| Federal Home Loan Bank advances long term | **316** | 339 | **629** | 699 |
| Subordinated debt | **22** | 23 | **45** | 45 |
| Total interest expense | **1,203** | 1,624 | **2,456** | 3,384 |
| Net interest income | **4,135** | 3,995 | **8,202** | 7,784 |
| **PROVISION FOR LOAN LOSSES** | **374** | 120 | **548** | 295 |
| **NET INTEREST INCOME AFTER PROVISION FOR LOAN LOSSES** | **3,761** | 3,875 | **7,654** | 7,489 |
| **NON-INTEREST INCOME** | | | | |
| Fees for customer services | **549** | 572 | **1,062** | 1,117 |
| Investment securities gains net | **698** | 963 | **781** | 963 |
| Impairment losses on investment securities: | | | | |
| Total other-than -temporary impairment losses | | (409) | **(141)** | (647) |
| Portion of (gains) losses recognized in other comprehensive income (before tax) | | (204) | **(61)** | (510) |
| Net impairment losses recognized in earnings | | (613) | **(202)** | (1,157) |
| Gain on sale of loans net | **20** | 38 | **36** | 42 |
| Other real estate losses net | **(71)** | | **(99)** | (4) |
| Earnings on bank owned life insurance | **126** | 128 | **250** | 264 |
| Other non-interest income | **18** | 26 | **45** | 53 |

| | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| Total non-interest income | | **1,340** | | 1,114 | | **1,873** | | 1,278 |
| **NON -INTEREST EXPENSES** | | | | | | | | |
| Salaries and employee benefits | | **1,799** | | 1,658 | | **3,594** | | 2,919 |
| Net occupancy and equipment expense | | **424** | | 446 | | **879** | | 918 |
| State and local taxes | | **117** | | 107 | | **233** | | 215 |
| FDIC insurance expense | | **162** | | 214 | | **373** | | 439 |
| Professional Fees | | **218** | | 221 | | **362** | | 401 |
| Office supplies | | **74** | | 87 | | **160** | | 173 |
| Other operating expenses | | **527** | | 477 | | **1,075** | | 884 |
| Total non-interest expenses | | **3,321** | | 3,210 | | **6,676** | | 5,949 |
| **INCOME BEFORE FEDERAL INCOME TAXES** | | **1,780** | | 1,779 | | **2,851** | | 2,818 |
| Federal income tax expense | | **459** | | 455 | | **661** | | 600 |
| **NET INCOME** | **$** | **1,321** | $ | 1,324 | **$** | **2,190** | $ | 2,218 |
| **BASIC EARNINGS PER COMMON SHARE (NOTE 6)** | **$** | **0.29** | $ | 0.29 | **$** | **0.48** | $ | 0.49 |
| **DILUTED EARNINGS PER COMMON SHARE (NOTE 6)** | **$** | **0.29** | $ | 0.29 | **$** | **0.48** | $ | 0.49 |
| **CASH DIVIDENDS DECLARED PER SHARE** | **$** | | $ | | **$** | | $ | |

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

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**CORTLAND BANCORP AND SUBSIDIARIES**
**CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS EQUITY (UNAUDITED)**
**(Amounts in thousands)**

| | COMMON STOCK | ADDITIONAL PAID-IN CAPITAL | RETAINED EARNINGS | ACCUMULATED OTHER COMPREHENSIVE LOSS | TREASURY STOCK | TOTAL SHARE-HOLDERS EQUITY |
|---|---|---|---|---|---|---|
| SIX MONTHS ENDED JUNE 30, 2010 | | | | | | |
| BALANCE AT DECEMBER 31, 2009 | $ 23,641 | $ 20,850 | $ 142 | $ (4,131) | $ (3,594) | $ 36,908 |
| Comprehensive income: | | | | | | |
| Net income | | | 2,218 | | | 2,218 |
| Other comprehensive income, net of tax : | | | | | | |
| Unrealized gains on available-for-sale securities, net of reclassification adjustment, net of tax of $390 | | | | 757 | | 757 |
| Other comprehensive gain related to securities for which other-than-temporary impairment has been recognized in earnings, net of reclassification adjustment, net of tax of $174 | | | | 337 | | 337 |
| Total comprehensive income | | | | | | 3,312 |
| BALANCE AT JUNE 30, 2010 | $ 23,641 | $ 20,850 | $ 2,360 | $ (3,037) | $ (3,594) | $ 40,220 |
| **SIX MONTHS ENDED JUNE 30, 2011** | | | | | | |
| **BALANCE AT DECEMBER 31, 2010** | **$ 23,641** | **$ 20,850** | **$ 3,413** | **$ (2,458)** | **$ (3,594)** | **$ 41,852** |
| **Comprehensive income:** | | | | | | |
| Net income | | | **2,190** | | | **2,190** |
| Other comprehensive income, net of tax : | | | | | | |
| | | | | **633** | | **633** |

| | | | | | | |
|---|---|---|---|---|---|---|
| Unrealized gains on available-for-sale securities, net of reclassification adjustment, net of tax of $326 | | | | | | |
| Other comprehensive gain related to securities for which other-than-temporary impairment has been recognized in earnings, net of tax of $21 | | | | **40** | | **40** |
| Total comprehensive income | | | | | | **2,863** |
| **BALANCE AT JUNE 30, 2011** | **$ 23,641** | **$ 20,850** | **$ 5,603** | **$ (1,785)** | **$ (3,594)** | **$ 44,715** |

**COMPONENTS OF OTHER COMPREHENSIVE INCOME**

| | **THREE MONTHS ENDED JUNE 30,** | | **SIX MONTHS ENDED JUNE 30,** | |
|---|---|---|---|---|
| | **2011** | 2010 | **2011** | 2010 |
| Net unrealized holding gains on available-for-sale securities arising during the period, net of taxes of $543 and $498 for the six month period, respectively, and net of tax of $(14) and $203 for the three month period, respectively | **$ (28)** | $ 395 | **$ 1,055** | $ 966 |
| Reclassification adjustment for net gains realized in net income, net of taxes of $266 and $327 for the six month period , respectively, and net of taxes of $237 and $327 for the three month period, respectively | **(461)** | (636) | **(515)** | (636) |
| Reclassification adjustment for other-than-temporary impairment losses on debt securities, net of taxes of $69 and $393 for the six month period, respectively, and net of taxes of $0 and $208 for the three month period, respectively | | 405 | **133** | 764 |
| Net unrealized gains on available-for -sale securities, net of tax | **(489)** | 164 | **673** | 1,094 |
| Net income | **1,321** | 1,324 | **2,190** | 2,218 |
| Total comprehensive income | **$ 832** | $ 1,488 | **$ 2,863** | $ 3,312 |

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

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**CORTLAND BANCORP AND SUBSIDIARIES**
**CONSOLIDATED STATEMENTS OF CASH FLOWS (UNAUDITED)**
(Amounts in thousands)

| | FOR THE SIX MONTHS ENDED JUNE 30, **2011** | FOR THE SIX MONTHS ENDED JUNE 30, 2010 |
|---|---|---|
| NET CASH FLOWS FROM OPERATING ACTIVITIES | **$ 4,840** | $ 2,481 |
| **CASH FLOWS FROM INVESTING ACTIVITIES** | | |
| Purchases of available-for-sale securities | **(18,758)** | (46,505) |
| Proceeds from sales of securities | **12,508** | 15,153 |
| Proceeds from call, maturity and principal payments on securities | **18,801** | 25,812 |
| Net decrease in loans made to customers | **6,088** | 10,765 |
| Proceeds from disposition of other real estate | **267** | 14 |
| Purchases of premises and equipment | **(138)** | (56) |
| Proceeds from life insurance policies | | 1,138 |
| Net cash flows from investing activities | **18,768** | 6,321 |
| **CASH DEFICIT FROM FINANCING ACTIVITIES** | | |
| Net decrease in deposit accounts | **(527)** | (17,006) |
| Net change in Federal Home Loan Bank advances | **(18,500)** | (5,000) |
| Net increase in short term borrowings | **348** | 149 |
| Net cash deficit from financing activities | **(18,679)** | (21,857) |
| **NET CHANGE IN CASH AND CASH EQUIVALENTS** | **4,929** | (13,055) |
| **CASH AND CASH EQUIVALENTS** | | |
| Beginning of period | **15,804** | 44,823 |
| End of period | **$ 20,733** | $ 31,768 |
| **SUPPLEMENTAL DISCLOSURES** | | |
| Cash paid during the period for: | | |
| Interest | **$ 2,519** | $ 3,499 |
| Income taxes | **$ 670** | $ 675 |

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

CORTLAND BANCORP AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

(Dollars in thousands, except for per share amounts)

1.) Basis of Presentation:

The accompanying unaudited consolidated financial statements 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 and six months ended June 30, 2011 are not necessarily indicative of the results that may be expected for the year ending December 31, 2011. These interim unaudited consolidated financial statements should be read in conjunction with our annual audited financial statements as of December 31, 2010, included in our Form 10-K for the year ended December 31, 2010, filed with the United States Securities and Exchange Commission. The accompanying consolidated balance sheet at December 31, 2010, has been derived from the audited consolidated balance sheet but does not include all of the information and footnotes required by U.S. GAAP for complete financial statements.

2.) Reclassifications:

Certain items contained in the 2010 financial statements have been reclassified to conform to the presentation for 2011. Such reclassifications had no effect on the net results of operations.

3.) Investment Securities:

Investments in debt and equity 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. The Company currently has no securities classified as trading.

As of March 31, 2011, in order to maintain maximum flexibility in managing the investment portfolio and to improve liquidity options, management opted to reclassify all investments in the held-to-maturity classification into the available-for-sale portfolio. The reclassification resulted in the recording of an unrealized gain of $522, an increase of $344 net of tax to other comprehensive income. Prior to the reclassification, held-to-maturity securities were stated at cost, adjusted for amortization of premiums and accretion of discounts, with such amortization or accretion included in interest income. Available-for-sale securities are carried at fair value with unrealized gains and losses recorded as a separate component of shareholders equity, net of tax effects. 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 premiums. Discounts on securities are amortized on the level-yield method without anticipating payments, except for both U.S. Government and private-label mortgage-backed and related securities where prepayments are anticipated.

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 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 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 loss.

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CORTLAND BANCORP AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

(Dollars in thousands, except for per share amounts)

*The following is a summary of investment securities:*

| | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Estimated Fair Value |
|---|---|---|---|---|
| **June 30, 2011** | | | | |
| **Investment securities available-for-sale** | | | | |
| U.S. Treasury securities | **$ 121** | **$ 15** | **$** | **$ 136** |
| U.S. Government agencies and corporations | **27,734** | **495** | | **28,229** |
| Obligations of states and political subdivisions | **34,372** | **473** | **281** | **34,564** |
| U.S. Government-sponsored mortgage-backed and related securities | **94,866** | **3,104** | **49** | **97,921** |
| Private-label mortgage-backed and related securities | **717** | **5** | **241** | **481** |
| Trust preferred securities | **17,929** | **93** | **6,300** | **11,722** |
| Total debt securities | **175,739** | **4,185** | **6,871** | **173,053** |
| Regulatory stock | **3,049** | | | **3,049** |
| General Motors equity investments | **606** | | **19** | **587** |
| Total available-for-sale | **$ 179,394** | **$ 4,185** | **$ 6,890** | **$ 176,689** |
| **December 31, 2010** | | | | |
| **Investment securities available-for-sale** | | | | |
| U.S. Government agencies and corporations | $ 28,913 | $ 541 | $ | $ 29,454 |
| Obligations of states and political subdivisions | 27,332 | 42 | 1,485 | 25,889 |
| U.S. Government-sponsored mortgage-backed and related securities | 93,956 | 2,752 | 222 | 96,486 |
| Private-label mortgage-backed and related securities | 208 | 6 | | 214 |
| Trust preferred securities | 18,137 | 101 | 5,459 | 12,779 |
| Corporate securities | 287 | | | 287 |
| Total debt securities | 168,833 | 3,442 | 7,166 | 165,109 |
| Regulatory stock | 3,049 | | | 3,049 |
| Total available-for-sale | $ 171,882 | $ 3,442 | $ 7,166 | $ 168,158 |
| **Investment securities held-to-maturity** | | | | |
| U.S. Treasury securities | $ 124 | $ 15 | $ | $ 139 |
| U.S. Government agencies and corporations | 1,993 | 107 | | 2,100 |
| Obligations of states and political subdivisions | 12,607 | 385 | 10 | 12,982 |
| | 5,010 | 338 | 1 | 5,347 |

| | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| U.S. Government-sponsored mortgage-backed and related securities | | | | | | | | |
| Private-label mortgage-backed and related securities | | 566 | | | | 193 | | 373 |
| Total held-to-maturity | $ | 20,300 | $ | 845 | $ | 204 | $ | 20,941 |

At June 30, 2011 and December 31, 2010, regulatory stock consisted of $2,823 in Federal Home Loan Bank (FHLB) stock and $226 in Federal Reserve Bank (FED) stock. Each investment is carried at cost, and the Company is required to hold such investments as a condition of membership in order to transact business with the FHLB and the FED.

While the Federal Home Loan Banks have been negatively impacted by the current economic conditions, the Federal Home Loan Bank of Cincinnati has reported profits for 2010 and the first half of 2011, remains in compliance with regulatory capital and liquidity requirements, continues to pay dividends on stock and makes redemptions at par value. With consideration given to these factors, management concluded that the stock was not impaired at June 30, 2011 or December 31, 2010.

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CORTLAND BANCORP AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

(Dollars in thousands, except for per share amounts)

The amortized cost and fair value of debt securities at June 30, 2011, 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.

| | Amortized Cost | Estimated Fair Value |
|---|---|---|
| **June 30, 2011** | | |
| **Investment securities available-for-sale** | | |
| Due in one year or less | **$ 2,829** | **$ 2,877** |
| Due after one year through five years | **4,339** | **4,461** |
| Due after five years through ten years | **26,640** | **27,108** |
| Due after ten years | **46,348** | **40,205** |
| Total investment securities available-for-sale | **80,156** | **74,651** |
| U.S. Government-sponsored mortgage-backed and related securities | **94,866** | **97,921** |
| Private-label mortgage-backed and related securities | **717** | **481** |
| Total investment securities | **$ 175,739** | **$ 173,053** |

The table below sets forth the proceeds and gains or losses realized on securities sold or called for the period ended:

| | THREE MONTHS ENDED June 30, **2011** | THREE MONTHS ENDED June 30, 2010 | SIX MONTHS ENDED June 30, **2011** | SIX MONTHS ENDED June 30, 2010 |
|---|---|---|---|---|
| Proceeds on securities sold | **$ 9,281** | $ 15,153 | **$ 12,508** | $ 15,153 |
| Gross realized gains | **410** | 920 | **491** | 920 |
| Gross realized losses | **33** | | **33** | |
| Proceeds on securities called | **$ 650** | $ 2,146 | **$ 980** | $ 2,146 |
| Gross realized gains | **2** | 43 | **4** | 43 |
| Gross realized losses | | | | |
| Exchange on General Motors transaction | | | | |
| Gross realized gains | **$ 319** | $ | **$ 319** | $ |
| Gross realized losses | | | | |

Available-for-sale securities, carried at fair value, totaled $176,689 at June 30, 2011 and $168,158 at December 31, 2010. These securities represent 100.00% and 89.23% of all investment securities at June 30, 2011 and December 31, 2010, respectively. In management s opinion, these levels provide an adequate level of liquidity.

Investment securities with a carrying value of approximately $107,541 at June 30, 2011 and $108,473 at December 31, 2010 were pledged to secure deposits and for other purposes.

CORTLAND BANCORP AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

(Dollars in thousands, except for per share amounts)

The following is a summary of the fair value of securities with unrealized losses and an aging of those unrealized losses at June 30, 2011:

| | Less than 12 Months | | 12 Months or More | | Total | |
|---|---|---|---|---|---|---|
| | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses |
| **June 30, 2011** | | | | | | |
| U.S. Government-sponsored mortgage-backed and related securities | **$ 11,710** | **$ 49** | **$** | **$** | **$ 11,710** | **$ 49** |
| Private-label mortgage-backed and related securities | | | **304** | **241** | **304** | **241** |
| Obligations of states and political subdivisions | **12,948** | **271** | **1,312** | **10** | **14,260** | **281** |
| Trust preferred securities | | | **11,113** | **6,300** | **11,113** | **6,300** |
| General Motors equity investments | **587** | **19** | | | **587** | **19** |
| Total | **$ 25,245** | **$ 339** | **$ 12,729** | **$ 6,551** | **$ 37,974** | **$ 6,890** |

The above table comprises 57 investment securities where the fair value is less than the related amortized cost.

The following is a summary of the fair value of securities with unrealized losses and an aging of those unrealized losses at December 31, 2010:

| | Less than 12 Months | | 12 Months or More | | Total | |
|---|---|---|---|---|---|---|
| | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses |
| **December 31, 2010** | | | | | | |
| U.S. Government-sponsored mortgage-backed and related securities | $ 26,538 | $ 222 | $ 33 | $ 1 | $ 26,571 | $ 223 |
| Private-label mortgage-backed and related securities | | | 373 | 193 | 373 | 193 |
| Obligations of states and political subdivisions | 20,075 | 1,351 | 4,290 | 144 | 24,365 | 1,495 |
| Trust preferred securities | | | 11,997 | 5,459 | 11,997 | 5,459 |
| Total | $ 46,613 | $ 1,573 | $ 16,693 | $ 5,797 | $ 63,306 | $ 7,370 |

The above table comprises 89 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 primarily issued by bank holding companies and insurance companies. The unrealized loss on these securities at June 30, 2011 was $6,300 compared to a $5,459 loss at December 31, 2010.

The unrealized losses on the Company s investment in obligations of states and political subdivisions, U.S. Government-sponsored mortgage-backed and related securities and private-label mortgage-backed and related securities were caused by changes in market rates and related spreads and are reflective of current distressed conditions in the credit markets and the on-going reassessment of appropriate liquidity and risk premiums. It is expected that the securities would not be settled at a price less than the amortized cost of the Company s investment because the decline in market value is attributable to changes in interest rates and relative spreads and not credit quality. Also, 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 those investments to be other-than-temporarily impaired at June 30, 2011.

Among the Company s numerous mortgage-backed securities is one privately-issued variable rate collateralized mortgage obligation (CMO). The security was valued on June 30, 2011 at $0.56 on a dollar and is scheduled to reprice in February of 2012. The Company had the security tested by a third party for subprime mortgage containment and none was found. As government intervention takes hold and the market in general somewhat settles, the CMO market has begun a slow recovery. At March 31, 2009, this security priced at $0.39 on a dollar and at December 31, 2010 at $0.66 on a dollar. The sizable increase in the value since March 2009 provides evidence that the impairment is temporary. General market liquidity has been improving, even with the government phasing out of its many assistive programs. The security carries a credit rating of A indicating little probability of default. Also, as a variable rate security, interest resets have been bringing the rate down, thus reducing the value. As interest rates rise in the next rate cycle, and the rate resets higher, the price of the security should also recover relative to book value. The security s underlying delinquency rate is 6.52%. A current analysis of this security indicates at the current delinquency and default rates, no loss is projected on this security through its maturity. The Company does not intend to sell this security and it is not more-likely-than-not that the Company will be required to sell the debt security before its anticipated recovery. As a result of all the facts presented, the Company does not consider this investment to be other-than-temporarily impaired.

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During September 2008, the U.S. government placed mortgage finance companies Federal National Mortgage Association (FNMA) and Federal Home Loan Mortgage Corporation (FHLMC), under conservatorship, giving management control to their regulator, the Federal Housing Finance Agency (FHFA) and providing both companies with access to credit from the U.S. Treasury. Debt obligations now provide an explicit guarantee of the full faith and credit of the United States government to existing and future debt holders of Fannie Mae and Freddie Mac limited to the period under which they are under conservatorship. The Company s investment in FNMA and FHLMC is $4,561 and $2,066, respectively.

In response to the takeover, the Federal Deposit Insurance Corporation (FDIC) tentatively approved a rule, proposed by all four federal bank regulators, that eases capital requirements for federally insured depository institutions that hold FNMA and FHLMC corporate debt, subordinated debt, mortgage guarantees and derivatives.

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. OTTI losses on individual investment securities were recognized during the first quarter of 2011 and none in the second quarter of 2011 in accordance with FASB ASC topic 320, *Investments Debt and Equity Securities*.

For debt securities in an unrealized loss position, ASC topic 320 requires an entity to assess 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), ASC topic 320 defines the presentation and amount of the OTTI recognized in the income statement.

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 (loss). The total other-than-temporary impairment is presented in the income statement with an offset for the amount of the total other-than-temporary impairment that is recognized in other comprehensive income (loss).

The Company assessed the impairment of certain securities currently in an illiquid market. Through the impairment assessment process, the Company determined that the investments discussed in the following table were other-than-temporarily impaired at June 30, 2011 and 2010. The Company recorded impairment credit losses in earnings on available-for-sale securities of $0 and $613 for the quarters ended June 30, 2011 and 2010, respectively. The $0 and $(204) non-credit portion of impairment recognized during the quarters ended June 30, 2011 and 2010, respectively, was recorded in other comprehensive loss.

| | THREE MONTHS ENDED June 30, | | SIX MONTHS ENDED June 30, | |
|---|---|---|---|---|
| | **2011** | 2010 | **2011** | 2010 |
| Trust preferred securities | **$** | $ 613 | **$ 202** | $ 1,157 |
| Total | **$** | $ 613 | **$ 202** | $ 1,157 |

In April 2011, as approved by the U.S. Bankruptcy court, unsecured bondholders of General Motors Corporation ( GM ) received partial distributions in accordance with the Amended Joint Chapter 11 Plan (the Plan ). The Company owned $2,350 par value of unsecured bonds determined to be other than temporarily impaired in 2009 and written down to a value of $287. In accordance with the Plan, the Company received in exchange for the bonds 9,131 shares of GM common shares, 8,301 GM Class A Warrants exercisable at $10 per share, 8,301 GM Class B Warrants exercisable at $18.33 per share, and escrow stubs representing the

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remaining shares and warrants distributable upon final settlement of the bankruptcy trust. The market value of the equity securities, excluding the escrow stubs, at the time of the exchange was $606, generating a recognizable gain of $319 over the fully written down value. Because the Company generally does not hold corporate equity securities, an exit strategy will be developed pending the receipt of any remaining distributions from the bankruptcy trust. The market value of the equity securities at June 30, 2011 was $587 with no value allocated to the escrow stubs due to their uncertain resolve and illiquid status.

For the quarter ended June 30, 2011, the Company recognized no OTTI. For the quarter ended June 30, 2010, the Company recognized OTTI of $613 attributable to 8 trust preferred securities with a cost basis of $12,447. The impairment charges were recognized after determining the likely future cash flows of these securities had been adversely impacted.

At June 30, 2011, there was $3,179 of investment securities considered to be in non-accrual status. This balance is comprised of trust preferred securities. As of June 30, 2011, the quarterly interest payments for 20 of its 32 investments in trust preferred securities have been placed in payment in kind status, which results in a temporary delay in the payment of interest. 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. All other trust preferred securities remain in accrual status.

4.) Loans and Allowance for Loan Loss:

The Company, through its subsidiary bank, grants residential, consumer and commercial loans to customers located primarily in Northeast Ohio and Western Pennsylvania.

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

| | **June 30, 2011** | | December 31, 2010 | |
|---|---|---|---|---|
| | **Balance** | **%** | Balance | % |
| Commercial real estate | **$ 151,009** | **58.3** | $ 146,389 | 55.1 |
| Commercial | **34,708** | **13.4** | 42,349 | 16 |
| Residential real estate | **49,624** | **19.2** | 52,262 | 19.7 |
| Residential real estate held for sale | **89** | | 262 | 0.1 |
| Consumer | **6,431** | **2.5** | 7,216 | 2.7 |
| Home equity | **17,043** | **6.6** | 16,963 | 6.4 |
| Total loans | **$ 258,904** | | $ 265,441 | |

Residential real estate held for sale is carried, in the aggregate, at the lower of cost or estimated market value based on secondary market prices.

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 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.

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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 | Increasing |
| Changes in lending policies and procedures | Stable |
| Experience, depth and ability of management | Increasing |
| Economic trends | Increasing |
| Concentrations of credit | Increasing |

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

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

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

| | THREE MONTHS ENDED June 30, | | SIX MONTHS ENDED June 30, | |
|---|---|---|---|---|
| | **2011** | 2010 | **2011** | 2010 |
| Balance at beginning of period | **$ 2,641** | $ 2,447 | **$ 2,501** | $ 2,437 |
| Loan charge-offs | **(290)** | (134) | **(347)** | (329) |
| Recoveries | **128** | 81 | **151** | 111 |
| Net loan charge-offs | **(162)** | (53) | **(196)** | (218) |
| Provision charged to operations | **374** | 120 | **548** | 295 |
| Balance at end of year | **$ 2,853** | $ 2,514 | **$ 2,853** | $ 2,514 |

The total allowance of $2,853 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 segment, the changes in the allowance for loan losses and the recorded investment in loans for the periods ended June 30, 2011 and December 31, 2010.

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| | Commercial | Commercial Real Estate | Consumer | Residential | Total |
|---|---|---|---|---|---|
| **June 30, 2011** | | | | | |
| **Allowance for credit losses:** | | | | | |
| Beginning balance | **$ 249** | **$ 1,611** | **$ 223** | **$ 418** | **$ 2,501** |
| Charge-offs | | **(200)** | **(96)** | **(51)** | **(347)** |
| Recoveries | **1** | **112** | **33** | **5** | **151** |
| Provision and Reallocation | **268** | **216** | **47** | **17** | **548** |
| Ending Balance | **$ 518** | **$ 1,739** | **$ 207** | **$ 389** | **$ 2,853** |
| Individually evaluated for impairment | **$ 80** | **$ 23** | **$** | **$** | **$ 103** |
| Collectively evaluated for impairment | **438** | **1,716** | **207** | **389** | **2,750** |
| **Loan Portfolio:** | | | | | |
| Ending Balance | **$ 34,708** | **$ 151,009** | **$ 23,474** | **$ 49,713** | **$ 258,904** |
| Individually evaluated for impairment | **$ 80** | **$ 1,717** | **$** | **$** | **$ 1,797** |
| Collectively evaluated for impairment | **34,628** | **149,292** | **23,474** | **49,713** | **257,107** |

| | Commercial | Commercial Real Estate | Consumer | Residential | Total |
|---|---|---|---|---|---|
| **December 31, 2010** | | | | | |
| **Allowance for credit losses:** | | | | | |
| Beginning balance | $ 209 | $ 1,666 | $ 247 | $ 315 | $ 2,437 |
| Charge-offs | (1) | (204) | (182) | (229) | (616) |
| Recoveries | | 58 | 99 | 18 | 175 |
| Provision and Reallocation | 41 | 91 | 59 | 314 | 505 |
| Ending Balance | $ 249 | $ 1,611 | $ 223 | $ 418 | $ 2,501 |
| Individually evaluated for impairment | $ 103 | $ 94 | $ | $ | $ 197 |
| Collectively evaluated for impairment | 146 | 1,517 | 223 | 418 | 2,304 |
| **Loan Portfolio:** | | | | | |
| Ending Balance | $ 42,349 | $ 146,389 | $ 24,179 | $ 52,524 | $ 265,441 |
| Individually evaluated for impairment | $ 155 | $ 1,738 | $ | $ | $ 1,893 |
| Collectively evaluated for impairment | 42,194 | 144,651 | 24,179 | 52,524 | 263,548 |

The following tables represent credit exposures by internally assigned grades for June 30, 2011 and December 31, 2010. 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.

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 make 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.

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The following is a summary of credit quality indicators by internally assigned grade as of June 30, 2011 and December 31, 2010:

| | Commercial | Commercial Real Estate | Total |
|---|---|---|---|
| **June 30, 2011** | | | |
| Pass | **$ 32,552** | **$ 130,600** | **$ 163,152** |
| Special Mention | **1,179** | **13,350** | **14,529** |
| Substandard | **977** | **7,059** | **8,036** |
| Doubtful/Loss | | | |
| Ending Balance | **$ 34,708** | **$ 151,009** | **$ 185,717** |

| | Commercial | Commercial Real Estate | Total |
|---|---|---|---|
| **December 31, 2010** | | | |
| Pass | $ 41,159 | $ 125,904 | $ 167,063 |
| Special Mention | 873 | 12,257 | 13,130 |
| Substandard | 317 | 8,228 | 8,545 |
| Doubtful/Loss | | | |
| Ending Balance | $ 42,349 | $ 146,389 | $ 188,738 |

The Bank evaluates the classification of consumer, home equity and residential loans primarily on a pooled basis. If the Bank 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. If the above conditions exist, the loan is considered nonperforming. If not, the pooled loan is not graded.

Loans are considered to be nonperforming when they become 90 days past due, 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 that were previously 90 days past due and are now current are also considered nonperforming until they show a six month history of being current. Loans in foreclosure are considered nonperforming.

Nonperforming loans also include certain loans that have been modified in trouble 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 $1,247 in TDRs at June 30, 2011 and $1,334 at December 31, 2010. The total interest recognized on these loans was $18 and $90 at June 30, 2011 and December 31, 2010, respectively. Had the loans at June 30, 2011 not been restructured, interest would have increased pretax income by $4, or likewise $12 at December 31, 2010.

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The following is a summary of consumer credit exposure as of June 30, 2011 and December 31, 2010.

| | Consumer Home Equity | Other Consumer | Residential |
|---|---|---|---|
| **June 30, 2011** | | | |
| Performing | **$ 16,739** | **$ 5,351** | **$ 48,602** |
| Nonperforming | **304** | **1,080** | **1,111** |
| Total | **$ 17,043** | **$ 6,431** | **$ 49,713** |
| **December 31, 2010** | | | |
| Performing | $ 16,762 | $ 6,130 | $ 51,395 |
| Nonperforming | 201 | 1,086 | 1,129 |
| Total | $ 16,963 | $ 7,216 | $ 52,524 |

The following is an aging analysis of the recorded investment of past due loans as of June 30, 2011 and December 31, 2010.

| | 31-59 Days Past Due | 60-89 Days Past Due | 90 Days Or Greater | Total Past Due | Current | Total Loans | Recorded Investment > 90 Days and Accruing |
|---|---|---|---|---|---|---|---|
| **June 30, 2011** | | | | | | | |
| Commercial real estate | **$** | **$ 853** | **$ 353** | **$ 1,206** | **$ 149,803** | **$ 151,009** | **$** |
| Commercial | | | **80** | **80** | **34,628** | **34,708** | |
| Residential | **89** | **177** | **724** | **990** | **48,723** | **49,713** | |
| Consumer: | | | | | | | |
| Consumer home equity | **32** | | **51** | **83** | **16,960** | **17,043** | |
| Consumer other | **8** | | **1,034** | **1,042** | **5,389** | **6,431** | |
| Total | **$ 129** | **$ 1,030** | **$ 2,242** | **$ 3,401** | **$ 255,503** | **$ 258,904** | **$** |
| **December 31, 2010** | | | | | | | |
| Commercial real estate | $ 418 | $ 55 | $ 102 | $ 575 | $ 145,814 | $ 146,389 | $ |
| Commercial | | | 132 | 132 | 42,217 | 42,349 | |
| Residential | 41 | 282 | 902 | 1,225 | 51,299 | 52,524 | |

| | | | | | | | |
|---|---|---|---|---|---|---|---|
| Consumer: | | | | | | | |
| Consumer home equity | 169 | | 47 | 216 | 16,747 | 16,963 | |
| Consumer other | 69 | 4 | 1,047 | 1,120 | 6,096 | 7,216 | |
| Total | $ 697 | $ 341 | $ 2,230 | $ 3,268 | $ 262,173 | $ 265,441 | $ |

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 bank 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 reserve

Any loan determined to be collateral dependent for repayment

Loans classified as troubled debt restructuring

Any loan evaluated for impairment is 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 June 30, 2011 and December 31, 2010. Also presented are the average recorded investments in the impaired balances and interest income recognized after impairment.

| | Recorded Investment | Unpaid Principal Balance | Related Allowance | Average Recorded Investment | Interest Income Recognized |
|---|---|---|---|---|---|
| **June 30, 2011** | | | | | |
| With no related allowance recorded: | | | | | |
| Commercial real estate | **$ 550** | **$ 550** | **$** | **$ 843** | **$ 6** |
| Commercial | | | | | |
| With an allowance recorded: | | | | | |
| Commercial real estate | **$ 1,167** | **$ 1,167** | **$ 23** | **$ 1,233** | **$ 18** |
| Commercial | **80** | **80** | **80** | **94** | |
| | | | | | |
| Total: | | | | | |
| Commercial real estate | **$ 1,717** | **$ 1,717** | **$ 23** | **$ 2,076** | **$ 24** |
| Commercial | **80** | **80** | **80** | **94** | |
| | | | | | |
| **December 31, 2010** | | | | | |
| With no related allowance recorded: | | | | | |
| Commercial real estate | $ 501 | $ 501 | $ | $ 233 | $ 2 |
| Commercial | 45 | 45 | | 18 | |
| With an allowance recorded: | | | | | |
| Commercial real estate | $ 1,237 | $ 1,237 | $ 94 | $ 364 | $ 2 |
| Commercial | 110 | 110 | 103 | 128 | 3 |

| | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| Total: | | | | | | | | | | |
| Commercial real estate | $ | 1,738 | $ | 1,738 | $ | 94 | $ | 597 | $ | 4 |
| Commercial | | 155 | | 155 | | 103 | | 146 | | 3 |

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The following is a summary of classes of loans on non-accrual status as of June 30, 2011 and December 31, 2010:

| | June 30, 2011 | December 31, 2010 |
|---|---|---|
| Commercial real estate | **$ 549** | $ 307 |
| Commercial | **80** | 132 |
| Residential | **890** | 1,040 |
| Consumer | | |
| Consumer home equity | **51** | 47 |
| Consumer other | **1,067** | 1,085 |
| Total | **$ 2,637** | $ 2,611 |

As of June 30, 2011 and December 31, 2010, there were $6,418 and $6,845, respectively, in loans that were neither classified as non-accrual nor considered impaired, but which can be considered potential problem loans.

5.) Legal Proceedings:

The Bank 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:

The following table sets forth the computation of basic earnings per common share and diluted earnings per common share. Basic earnings per share is computed by dividing net income by the weighted average number of shares outstanding during the applicable period.

| | THREES MONTHS ENDED June 30, | | SIX MONTHS ENDED June 30, | |
|---|---|---|---|---|
| | **2011** | 2010 | **2011** | 2010 |
| Net income | **$ 1,321** | $ 1,324 | **$ 2,190** | $ 2,218 |
| Weighted average common shares outstanding | **4,525,540** | 4,525,546 | **4,525,541** | 4,525,548 |
| Basic earnings per share | **$ 0.29** | $ 0.29 | **$ 0.48** | $ 0.49 |
| Diluted earnings per share | **$ 0.29** | $ 0.29 | **$ 0.48** | $ 0.49 |

7.) Subordinated Debt:

In July 2007 a trust formed by the Company issued $5,000 of floating rate trust preferred securities as part of a pooled offering of such securities due December 2037. The Bancorp owns all $155 of the common securities issued by the trust. The securities bear interest at the 3-month LIBOR rate plus 1.45%. The rates at June 30, 2011 and December 31, 2010 were 1.70% and 1.75%, 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 a premium declining ratably to par in September 2012.

In accordance with FASB ASC, Topic 942, *Financial Services Depository and Lending* 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 Company currently does not enter into derivative financial instruments including futures, forwards, interest rate risk swaps, option contracts, or other financial instruments with similar characteristics. The Company also does not participate in any partnerships or other special purpose entities that might give rise to off-balance sheet liabilities.

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The Company, through its subsidiary 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 of 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 is a summary of such contractual commitments:

| | June 30, 2011 | December 31, 2010 |
|---|---|---|
| Commitments to extend credit: | | |
| Fixed rate | **$ 8,958** | $ 7,395 |
| Variable rate | **52,649** | 36,717 |
| Standby letters of credit | **196** | 444 |

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 Bank 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 Bank evaluates each customer s creditworthiness on a case-by-case basis. The amount of collateral obtained, if deemed necessary by the Bank 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 Company s subsidiary bank 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. The available amount of overdraft protection on depositors accounts at June 30, 2011 totaled $10,205 and $10,333 at December 31, 2010. The total average daily balance of overdrafts used at June 30, 2011 was $116 and $126 at December 31, 2010, or less than 2% of the total aggregate overdraft protection available to depositors. The balance at June 30, 2011 of all deposit overdrafts included in total loans was $133 and $147 at December 31, 2010.

CORTLAND BANCORP AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

(Dollars in thousands, except for per share amounts)

9.) Fair Value of Assets and Liabilities

Measurements:

Accounting guidance under ASC Topic 820, *Fair Value Measurements and Disclosures,* affirms that the objective of fair value when the market for an asset is not active is the price that would be received to sell the asset in an orderly transaction, and clarifies and includes additional factors for determining whether there has been a significant decrease in market activity for an asset when the market for that asset is not active. ASC Topic 820 requires an entity to base its conclusion about whether a transaction was not orderly on the weight of the evidence.

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.

CORTLAND BANCORP AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)
(Dollars in thousands, except for per share amounts)

The following table presents the assets reported on the consolidated balance sheets at their fair value as of June 30, 2011 and December 31, 2010 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.

| | | Fair Value Measurements at 6/30/11 Using | | |
|---|---|---|---|---|
| Description | June 30, 2011 | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
| U.S. Treasury securities | **$ 136** | **$** | **$ 136** | **$** |
| U.S. Government agencies and corporations | **28,229** | | **28,229** | |
| Obligations of states and political subdivisions | **34,564** | | **34,564** | |
| U.S. Government-sponsored mortgage-backed and related securities | **97,921** | | **97,921** | |
| Private-label mortgage-backed and related securities | **481** | | **481** | |
| Trust preferred securities | **11,722** | | | **11,722** |
| General Motors equity investments | **587** | **587** | | |
| Total | **$ 173,640** | **$ 587** | **$ 161,331** | **$ 11,722** |

| | | Fair Value Measurements at 12/31/10 Using | | |
|---|---|---|---|---|
| Description | December 31, 2010 | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
| U.S. Government agencies and corporations | $ 29,454 | $ | $ 29,454 | $ |
| Obligations of states and political subdivisions | 25,889 | | 25,889 | |
| U.S. Government-sponsored mortgage-backed and related securities | 96,486 | | 96,486 | |
| Private-label mortgage-backed and related securities | 214 | | 214 | |
| Trust preferred securities | 12,779 | | | 12,779 |
| Corporate securities | 287 | | 287 | |

| | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| Total | $ | 165,109 | $ | | $ | 152,330 | $ | 12,779 |

The following tables present the changes in the Level 3 fair value category for the six months ended June 30, 2011 (Table 1) and the three months ended June 30, 2011 (Table 2). 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.

Table 1

| | | Net realized/unrealized gains/(losses) included in | | | | | |
|---|---|---|---|---|---|---|---|
| Net Unrealized | January 1, 2011 | Noninterest income | Other comprehensive income | Transfers in and/or out of Level 3 | Purchases, issuances and settlements | June 30, 2011 | Losses included in net income for the period relating to assets held at June 30, 2011 |
| Trust preferred securities | $ 12,779 | $ (202) | $ (849) | $ | $ (6) | $ 11,722 | $ (202) |

Table 2

| | | Net realized/unrealized gains/(losses) included in | | | | | |
|---|---|---|---|---|---|---|---|
| Net Unrealized | April 1, 2011 | Noninterest income | Other comprehensive income | Transfers in and/or out of Level 3 | Purchases, issuances and settlements | June 30, 2011 | Losses included in net income for the period relating to assets held at June 30, 2011 |
| Trust preferred securities | $ 13,188 | $ | $ (1,460) | $ | $ (6) | $ 11,722 | $ |

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CORTLAND BANCORP AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

(Dollars in thousands, except for per share amounts)

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 market 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 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 Company owns 32 trust preferred securities totaling $34,920 (par value) that are backed by trust preferred securities issued by banks, thrifts, insurance companies and real estate investment trusts. These securities were all rated investment grade at inception. Beginning during the second half of 2008 and through 2011, factors outside the Company s control impacted the fair value of these securities and will likely continue to do so for the foreseeable future. These factors include, but are not limited to, the following: guidance on fair value accounting, issuer credit deterioration, issuer deferral and default rates, potential failure or government seizure of underlying financial institutions or insurance companies, ratings agency actions, or regulatory actions. As a result of changes in these and various other factors during 2009 and 2010, Moody s Investors Service, Fitch Ratings and Standards and Poor s downgraded multiple trust preferred securities, including securities held by the Company. All 32 of the trust preferred securities held by the Company are now considered to be below investment grade. The deteriorating economic, credit and financial conditions experienced in 2008 and through 2010 have resulted in illiquid and inactive financial markets and severely depressed prices for these securities. The Company analyzed the cash flow characteristics of these securities and determined that for 12 of these securities, it does not consider the investment in these assets to be other-than-temporarily impaired at June 30, 2011. The Company does not intend to sell the securities and it is more-likely-than-not that the Company will be required to sell the securities before recovery of its amortized cost basis. There was no adverse change in the cash flows. Although the Company does not consider the investment in these assets to be other-than-temporarily impaired at June 30, 2011, there is a risk that subsequent evaluations could result in recognition of OTTI charges in the future. Upon completion of the June 30, 2011 analysis, the model indicated OTTI on the remaining 20 securities, none of which experienced additional defaults or deferrals during the period. These 20 securities had life-to-date impairment losses of $19.1 million, of which $16.6 million was recorded as expense and $2.5 was recorded in other comprehensive loss. These 20 securities remained classified as available-for-sale at June 30, 2011, and together, the 32 securities subjected to FASB ASC Topic 320 accounted for the entire $6.2 of unrealized losses in the trust preferred securities category at June 30, 2011.

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CORTLAND BANCORP AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

(Dollars in thousands, except for per share amounts)

The following table details the 20 debt securities with other-than-temporary impairment, their credit ratings at June 30, 2011 and the related losses recognized in earnings:

| | Moody s/Fitch Rating | Amount of OTTI related to credit loss at January 1, 2011 | Additions in QTD March 31, 2011 | Additions in QTD June 30, 2011 | Amount of OTTI related to credit loss at June 30, 2011 |
|---|---|---|---|---|---|
| Alesco Preferred Funding VIII Class E Notes 1 | C/C | $ 1,500 | $ | $ | $ 1,500 |
| MM Community Funding II Class B | Ba1/CC | 11 | | | 11 |
| PreTSL I Mezzanine | Ca/C | 430 | | | 430 |
| PreTSL II Mezzanine | Ca/C | 1,274 | 141 | | 1,415 |
| PreTSL V Mezzanine | Ba3/D | 97 | | | 97 |
| PreTSL VIII B-3 | C/C | 1,635 | | | 1,635 |
| PreTSL IX Class B-2 | Ca/C | 274 | | | 274 |
| PreTSL XV Class B-2 | C/C | 267 | 10 | | 277 |
| PreTSL XV Class B-3 | C/C | 269 | 10 | | 279 |
| PreTSL XVI D | NR/C | 518 | | | 518 |
| PreTSL XVI D | NR/C | 991 | | | 991 |
| PreTSL XVII Class C | Ca/C | 978 | | | 978 |
| PreTSL XVII Class D | NR/C | 930 | | | 930 |
| PreTSL XVIII Class D | NR/C | 513 | | | 513 |
| PreTSL XXIII Class C-FP | C/C | 211 | | | 211 |
| PreTSL XXV Class D | NR/C | 1,001 | | | 1,001 |
| PreTSL XXVI Class D | NR/C | 465 | | | 465 |
| Trapeza CDO II Class C-1 | Ca/C | 598 | | | 598 |
| Tropic CDO V Class B-1L | C/C | 4,427 | 1 | | 4,428 |
| Trapeza IX B-1 | Ca/CC | 10 | 40 | | 50 |
| Total | | $ 16,399 | $ 202 | $ | $ 16,601 |

CORTLAND BANCORP AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

(Dollars in thousands, except for per share amounts)

The following table provides additional information related to the Company s trust preferred securities as of June 30, 2011 used to evaluate other-than-temporary impairments.

| Deal | Class | Book Value | 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 I | Mezzanine | $ 516 | $ 602 | $ 86 | Ca/C | 16 | 42.76% | % |
| PreTSL II | Mezzanine | 691 | 542 | (149) | Ca/C | 23 | 39.89 | |
| PreTSL IV | Mezzanine | 183 | 151 | (32) | Ca/CCC | 4 | 27.07 | 19.42 |
| PreTSL V | Mezzanine | 22 | 13 | (9) | Ba3/D | | 100.00 | |
| PreTSL VIII | B-3 | 365 | 152 | (213) | C/C | 22 | 44.82 | |
| PreTSL IX | B-2 | 719 | 341 | (378) | Ca/C | 33 | 31.02 | |
| PreTSL XV | B-2 | 223 | 78 | (145) | C/C | 51 | 35.38 | |
| PreTSL XV | B-3 | 224 | 78 | (146) | C/C | 51 | 35.38 | |
| PreTSL XVI | D | | | | NR/C | 33 | 48.16 | |
| PreTSL XVI | D | | | | NR/C | 33 | 48.16 | |
| PreTSL XVII | C | | 7 | 7 | Ca/C | 35 | 36.46 | |
| PreTSL XVII | D | | | | NR/C | 35 | 36.46 | |
| PreTSL XVIII | D | | | | NR/C | 52 | 26.46 | |
| PreTSL XXIII | C-2 | 1,011 | 169 | (842) | C/C | 90 | 28.65 | |
| PreTSL XXIII | C-FP | 1,547 | 650 | (897) | C/C | 90 | 28.65 | |
| PreTSL XXV | D | | | | NR/C | 47 | 36.65 | |
| PreTSL XXVI | D | | | | NR/C | 49 | 27.74 | |
| I-PreTSL I | B-1 | 985 | 751 | (234) | NR/CCC | 15 | 16.79 | 1.66 |
| I-PreTSL I | B-2 | 1,000 | 751 | (249) | NR/CCC | 15 | 16.79 | 1.66 |
| I-PreTSL I | B-3 | 1,000 | 751 | (249) | NR/CCC | 15 | 16.79 | 1.66 |
| I-PreTSL II | B-3 | 2,991 | 2,755 | (236) | NR/B | 27 | 4.88 | 11.36 |
| I-PreTSL III | B-2 | 1,000 | 723 | (277) | B2/CCC | 23 | 11.63 | 6.02 |
| I-PreTSL III | C | 1,000 | 505 | (495) | NR/CCC | 23 | 11.63 | |
| I-PreTSL IV | B-1 | 1,000 | 624 | (376) | Ba2/CCC | 27 | 12.20 | 4.16 |
| I-PreTSL IV | B-2 | 1,000 | 624 | (376) | Ba2/CCC | 27 | 12.20 | 4.16 |
| I-PreTSL IV | C | 500 | 200 | (300) | Caa1/CC | 27 | 12.20 | |
| Alesco VIII | E | | | | C/C | 54 | 22.42 | |
| MM Community Funding III | B | 424 | 381 | (43) | Ba1/CC | 6 | 32.17 | 1.39 |
| MM Community Funding II | B | 164 | 163 | (1) | Baa2/BB | 5 | 29.31 | 17.77 |
| Tropic V | B-1L | | | | C/C | 44 | 43.57 | |
| Trapeza II | C-1 | 414 | 346 | (68) | Ca/C | 23 | 37.04 | |

| | | | | | | | |
|---|---|---|---|---|---|---|---|
| Trapeza IX | B-1 | 950 | 365 | (585) | Ca/CC | 40 | 11.26 |
| Total | | $ 17,929 | $ 11,722 | $ (6,207) | | | |

The market for these securities at June 30, 2011 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 no new trust preferred securities have been issued since 2007. 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.

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(Dollars in thousands, except for per share amounts)

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 June 30, 2011;
- 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 effective discount rates on an overall basis generally range from 18.16% to 43.99% and are highly dependent upon the credit quality of the collateral, the relative position of the tranche in the capital structure of the trust preferred security and the prepayment assumptions.

The Company also monitored default and deferral activity since June 30, 2011 for valuation consideration. There were no material unexpected results to consider.

The following table presents the assets measured on a nonrecurring basis on the consolidated balance sheets at their fair value as of June 30, 2011 and December 31, 2010, by level within the fair value hierarchy. Impaired loans that are collateral dependent are written down to fair value through the establishment of specific reserves. Techniques used to value the collateral that secure the impaired loans include: quoted market prices for identical assets classified as Level 1 inputs; observable inputs, employed by certified appraisers, for similar assets classified as Level 2 inputs. In cases where valuation techniques include inputs that are unobservable and are based on estimates and assumptions developed by management based on the best information available under each circumstance, the asset valuation is classified as Level 3 inputs.

| | June 30, 2011 | | | |
|---|---|---|---|---|
| | Level 1 | Level 2 | Level 3 | Total |
| Assets Measured on a nonrecurring basis: | | | | |
| Impaired loans | **$** | **$** | **$ 1,694** | **$ 1,694** |
| Other real estate owned | | | **562** | **562** |

| | December 31, 2010 | | | |
|---|---|---|---|---|
| | Level 1 | Level 2 | Level 3 | Total |
| Assets Measured on a nonrecurring basis: | | | | |
| Impaired loans | $ | $ | $ 3,903 | $ 3,903 |
| Other real estate owned | | | 848 | 848 |

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CORTLAND BANCORP AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

(Dollars in thousands, except for per share amounts)

Impaired Loans: A loan is considered to be impaired when, based on current information and events, it is probable that the Company will be unable to collect all amounts due (both interest and principal) according to the contractual terms of the loan agreement. Impaired loans are measured, as a practical expedient, at the loan s observable market price or the fair market value of the collateral if the loan is collateral dependent. At June 30, 2011, the recorded investment in impaired loans was $1,797 with a related reserve of $103 resulting in a net balance of $1,694. At December 31, 2010, the recorded investment in impaired loans was $4,100 with a related reserve of $197 resulting in a net balance of $3,903.

Other Real Estate Owned (OREO): Real Estate acquired through foreclosure or deed-in-lieu of foreclosure is included in other assets. Such real estate is carried at fair value less estimated costs to sell. Any reduction from the carrying value of the related loan to fair value at the time of acquisition is accounted for as a loan loss. Any subsequent reduction in fair market value is reflected as a valuation allowance through a charge to income. Costs of significant property improvements are capitalized, whereas costs, relating to holding and maintaining the property, are charged to expense. At June 30, 2011, the recorded investment in OREO was $644 with a valuation allowance of $82 resulting in a net balance of $562. At December 31 2010, the recorded investment in OREO was $883 with a valuation allowance of $35 resulting in a net balance of $848.

Financial Instruments:

The FASB ASC Topic 825, *Financial Instruments*, requires disclosure of 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, net of allowance for loan loss Market quotations are generally not available for loan portfolios. The fair value is estimated 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. Loans held for sale are carried, in aggregate, at the lower of cost or fair value.

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

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.

FHLB advances 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.

Other short-term borrowings Other 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.

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CORTLAND BANCORP AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

(Dollars in thousands, except for per share amounts)

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 June 30, 2011 and December 31, 2010 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 estimated fair values of the Company s financial instruments are as follows:

| | **June 30, 2011** | | December 31, 2010 | |
|---|---|---|---|---|
| | **Carrying Amount** | **Estimated Fair Value** | Carrying Amount | Estimated Fair Value |
| ASSETS: | | | | |
| Cash and cash equivalents | **$ 20,733** | **$ 20,733** | $ 15,804 | $ 15,804 |
| Investment securities available-for-sale | **176,689** | **176,689** | 168,158 | 168,158 |
| Investment securities held-to-maturity | | | 20,300 | 20,941 |
| Loans, net of allowance for loan losses | **256,051** | **261,562** | 262,940 | 268,557 |
| Accrued interest receivable | **2,067** | **2,067** | 2,124 | 2,124 |
| LIABILITIES | | | | |
| Demand, savings and money market deposits | **$ 227,752** | **$ 227,752** | $ 234,876 | $ 234,876 |
| Time deposits | **163,230** | **166,709** | 156,633 | 160,750 |
| FHLB advances | **34,500** | **37,636** | 53,000 | 56,216 |
| Other short-term borrowings | **5,249** | **5,249** | 4,901 | 4,901 |
| Subordinated debt | **5,155** | **4,234** | 5,155 | 3,962 |
| Accrued interest payable | **472** | **472** | 535 | 535 |

10.) Memorandum of Understanding

On May 26, 2009, the Board of Directors of Cortland Bancorp and Cortland Banks adopted resolutions authorizing its President and Chief Executive Officer to enter into the Memorandum of Understanding (MOU) with the Federal Reserve. The MOU was executed June 1, 2009. The Division of Financial Institutions, State of Ohio, became a party to the MOU in December 2009, when the agreement was revised. The revised MOU was executed December 31, 2009. The MOU requires the Company and Cortland Banks to obtain the Federal Reserve s approval prior to: (i) incurring any debt; (ii) repurchasing any of its stock; or (iii) paying any dividends.

The MOU also required Cortland Banks, within specified timeframes, submission of the following plans to the Federal Reserve for its approval: (i) Cortland Banks  a plan to strengthen and improve management of the overall risk exposure of the investment portfolio; (ii) the Company and Cortland Banks  a plan to maintain an adequate capital position, (iii) the Company and Cortland Banks  a plan to strengthen board oversight of the management and operations of the Bank and (iv) Cortland Banks  a plan for 2010 to improve the Bank s earnings and overall condition. The provisions of the MOU shall remain effective and enforceable until stayed, modified, terminated or suspended by the Federal Reserve. The Company is substantially in compliance with the provisions of the MOU as of June 30, 2011.

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**CORTLAND BANCORP AND SUBSIDIARIES**
**CONSOLIDATED AVERAGE BALANCE SHEETS, YIELDS AND RATES (UNAUDITED)**
**(Fully taxable equivalent basis in thousands of dollars)**

| | YEAR TO DATE AS OF | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| | **JUNE 30, 2011** | | | DECEMBER 31, 2010 | | | JUNE 30, 2010 | | |
| | **Average Balance** | **Interest** | **Average Rate** | Average Balance | Interest | Average Rate | Average Balance | Interest | Average Rate |
| **ASSETS** | | | | | | | | | |
| Interest earning deposits and other assets | **$ 16,103** | **$ 35** | **0.43%** | $ 24,898 | $ 92 | 0.36% | $ 29,795 | $ 43 | 0.29% |
| Investment securities (1) (2) | **182,798** | **3,378** | **3.70%** | 191,546 | 7,807 | 4.07% | 185,314 | 4,043 | 4.36% |
| Loans (1) (2) (3) | **258,346** | **7,636** | **5.94%** | 237,624 | 14,765 | 6.21% | 240,039 | 7,436 | 6.22% |
| **Total interest-earning assets** | **457,247** | **$ 11,049** | **4.85%** | 454,068 | $ 22,664 | 4.99% | 455,148 | $ 11,522 | 5.08% |
| Cash and due from banks | **6,897** | | | 6,570 | | | 6,597 | | |
| Bank premises and equipment | **6,670** | | | 6,918 | | | 7,019 | | |
| Other assets | **20,817** | | | 19,032 | | | 19,569 | | |
| **Total non-interest-earning assets** | **34,384** | | | 32,520 | | | 33,185 | | |
| **Total assets** | **$ 491,631** | | | $ 486,588 | | | $ 488,333 | | |
| **LIABILITIES AND SHAREHOLDERS EQUITY** | | | | | | | | | |
| Interest-bearing demand deposits | **$ 72,750** | **$ 96** | **0.27%** | $ 69,295 | $ 256 | 0.37% | $ 69,786 | $ 137 | 0.40% |
| Savings | **92,388** | **79** | **0.17%** | 89,049 | 212 | 0.24% | 88,267 | 134 | 0.31% |
| Time | **160,761** | **1,530** | **1.92%** | 158,578 | 3,611 | 2.28% | 160,207 | 1,891 | 2.38% |
| **Total interest-bearing deposits** | **325,899** | **1,705** | **1.05%** | 316,922 | 4,079 | 1.29% | 318,260 | 2,162 | 1.37% |
| Other borrowings | **48,818** | **706** | **2.92%** | 58,317 | 2,195 | 3.76% | 61,061 | 1,177 | 3.89% |
| Subordinated debt | **5,155** | **45** | **1.78%** | 5,155 | 93 | 1.81% | 5,155 | 45 | 1.73% |
| **Total interest-bearing liabilities** | **379,872** | **$ 2,456** | **1.30%** | 380,394 | $ 6,367 | 1.68% | 384,476 | $ 3,384 | 1.77% |
| Demand deposits | **63,761** | | | 61,320 | | | 60,283 | | |
| Other liabilities | **4,099** | | | 5,394 | | | 4,694 | | |

| | | | |
|---|---|---|---|
| Shareholders equity | **43,899** | 39,480 | 38,880 |
| **Total liabilities and Shareholders equity** | **$ 491,631** | $ 486,588 | $ 488,333 |
| Net interest income | **$ 8,593** | $ 16,297 | $ 8,138 |
| Net interest rate spread (4) | **3.55%** | 3.31% | 3.31% |
| Net interest margin (5) | **3.76%** | 3.59% | 3.58% |
| Ratio of interest-earning assets to interest-bearing liabilities | **1.20** | 1.19 | 1.18 |

(1) Includes both taxable and tax exempt securities and loans.

(2) Tax exempt interest is shown on a tax equivalent basis for proper comparison using a statutory federal income tax rate of 34%. The tax equivalent income adjustment for loans and investments is $24 and $367 for June 30, 2011, $59 and $733 for December 31, 2010 and $33 and $321 for June 30, 2010.

(3) Includes applicable loan origination and commitment fees, net of deferred origination cost amortization.

(4) Interest rate spread represents the difference between the yield on earning assets and the rate paid on interest bearing liabilities.

(5) Interest margin is calculated by dividing net interest income by total interest-earning assets.

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

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**CORTLAND BANCORP AND SUBSIDIARIES**
**CONSOLIDATED AVERAGE BALANCE SHEETS, YIELDS AND RATES (UNAUDITED)**
**(Fully taxable equivalent basis in thousands of dollars)**

| | **QUARTER TO DATE AS OF** | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| | **June 30, 2011** | | | MARCH 31, 2011 | | | June 30, 2010 | | |
| | **Average Balance** | **Interest** | **Average Rate** | Average Balance | Interest | Average Rate | Average Balance | Interest | Average Rate |
| **ASSETS** | | | | | | | | | |
| Interest earning deposits and other assets | **$ 19,553** | **$ 18** | **0.39%** | $ 12,614 | $ 17 | 0.52% | $ 25,320 | $ 20 | 0.33% |
| Investment securities (1) (2) | **177,703** | **1,644** | **3.70%** | 187,949 | 1,734 | 3.70% | 190,654 | 2,044 | 4.28% |
| Loans (2) (3) | **259,415** | **3,860** | **5.96%** | 257,266 | 3,775 | 5.91% | 238,058 | 3,740 | 6.29% |
| **Total interest-earning assets** | **456,671** | **$ 5,522** | **4.84%** | 457,829 | $ 5,526 | 4.85% | 454,032 | $ 5,804 | 5.12% |
| Cash and due from banks | **7,143** | | | 6,649 | | | 6,647 | | |
| Bank premises and equipment | **6,638** | | | 6,704 | | | 6,961 | | |
| Other assets | **21,811** | | | 19,808 | | | 20,033 | | |
| **Total non-interest-earning assets** | **35,592** | | | 33,161 | | | 33,641 | | |
| **Total assets** | **$ 492,263** | | | $ 490,990 | | | $ 487,673 | | |
| **LIABILITIES AND SHAREHOLDERS EQUITY** | | | | | | | | | |
| Interest-bearing demand deposits | **$ 71,050** | **$ 47** | **0.27%** | $ 74,471 | $ 48 | 0.26% | $ 70,190 | $ 64 | 0.36% |
| Savings | **93,461** | **41** | **0.17%** | 91,303 | 39 | 0.17% | 88,992 | 60 | 0.27% |
| Time | **160,919** | **753** | **1.88%** | 160,600 | 777 | 1.96% | 158,691 | 922 | 2.33% |
| **Total interest-bearing deposits** | **325,430** | **841** | **1.04%** | 326,374 | 864 | 1.07% | 317,873 | 1,046 | 1.32% |
| Other borrowings | **46,322** | **340** | **2.95%** | 51,342 | 366 | 2.89% | 59,222 | 555 | 3.76% |
| Subordinated Debt | **5,155** | **22** | **1.77%** | 5,155 | 23 | 1.78% | 5,155 | 23 | 1.76% |
| **Total interest-bearing liabilities** | **376,907** | **$ 1,203** | **1.28%** | 382,871 | $ 1,253 | 1.33% | 382,250 | $ 1,624 | 1.70% |
| Demand deposits | **65,778** | | | 61,721 | | | 60,988 | | |
| Other liabilities | **4,518** | | | 3,675 | | | 4,466 | | |
| Shareholders equity | **45,060** | | | 42,723 | | | 39,969 | | |

| | | | |
|---|---|---|---|
| **Total liabilities and Shareholders equity** | **$ 492,263** | $ 490,990 | $ 487,673 |
| Net interest income | **$ 4,319** | $ 4,273 | $ 4,180 |
| Net interest rate spread (4) | **3.56%** | 3.52% | 3.42% |
| Net interest margin (5) | **3.78%** | 3.74% | 3.68% |
| Ratio of interest-earning assets to interest-bearing liabilities | **1.21** | 1.20 | 1.19 |

(1) Includes both taxable and tax exempt securities and loans.

(2) Tax exempt interest is shown on a tax equivalent basis for proper comparison using a statutory federal income tax rate of 34%. The tax equivalent income adjustment for loans and investments is $11 and $173 for June 30, 2011, $12 and $194 for March 31, 2011 and $16 and $169 for June 30, 2010.

(3) Includes applicable loan origination and commitment fees, net of deferred origination cost amortization.

(4) Interest rate spread represents the difference between the yield on earning assets and the rate paid on interest bearing liabilities.

(5) Interest margin is calculated by dividing the difference between total interest earned and total interest expensed by total interest-earning assets.

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

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**CORTLAND BANCORP AND SUBSIDIARIES**
**ITEM 2. MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**
**SELECTED FINANCIAL DATA FOR QUARTER ENDED**
(In thousands of dollars, except for ratios and per share amounts)

| **Unaudited** | **June 30, 2011** | March 31, 2011 | December 31, 2010 | September 30, 2010 | June 30, 2010 |
|---|---|---|---|---|---|
| **SUMMARY OF OPERATIONS** | | | | | |
| Total interest income | **$ 5,338** | $ 5,320 | $ 5,334 | $ 5,370 | $ 5,619 |
| Total interest expense | **(1,203)** | (1,253) | (1,416) | (1,567) | (1,624) |
| NET INTEREST INCOME (NII) | **4,135** | 4,067 | 3,918 | 3,803 | 3,995 |
| Provision for loan losses | **(374)** | (174) | (180) | (30) | (120) |
| NII after loss provision | **3,761** | 3,893 | 3,738 | 3,773 | 3,875 |
| Security gains ( losses) including impairment losses | **698** | (119) | (81) | (1,419) | 350 |
| Gain on sale of loans | **20** | 16 | 131 | 63 | 38 |
| Total other income (excluding security and loan gains) | **622** | 636 | 716 | 645 | 726 |
| Total other noninterest expense | **(3,321)** | (3,355) | (3,205) | (3,287) | (3,210) |
| Income (loss) before tax | **1,780** | 1,071 | 1,299 | (225) | 1,779 |
| Net income (loss) | **$ 1,321** | $ 869 | $ 1,036 | $ 17 | $ 1,324 |
| **PER COMMON SHARE DATA (1)** | | | | | |
| Net (loss) income, both basic and diluted | **$ 0.29** | $ 0.19 | $ 0.23 | $ | $ 0.29 |
| Book value | **9.88** | 9.62 | 9.25 | 8.99 | 8.89 |
| **BALANCE SHEET DATA** | | | | | |
| Assets | **$ 484,623** | $ 489,568 | $ 500,273 | $ 482,886 | $ 478,872 |
| Investments | **176,689** | 179,916 | 188,458 | 201,366 | 178,970 |
| Net loans | **256,051** | 255,090 | 262,940 | 230,811 | 234,697 |
| Deposits | **390,982** | 384,206 | 391,509 | 376,638 | 370,489 |
| Borrowings | **39,749** | 52,565 | 57,901 | 55,865 | 58,515 |
| Subordinated Debt | **5,155** | 5,155 | 5,155 | 5,155 | 5,155 |
| Shareholders equity | **44,715** | 43,882 | 41,852 | 40,706 | 40,220 |
| **AVERAGE BALANCES** | | | | | |
| Assets | **$ 492,263** | $ 490,990 | $ 482,896 | $ 486,962 | $ 487,673 |

| | | | | | |
|---|---|---|---|---|---|
| Investments | **177,703** | 187,949 | 200,372 | 194,983 | 190,654 |
| Net loans | **256,813** | 254,721 | 234,251 | 231,282 | 235,546 |
| Deposits | **391,208** | 388,095 | 381,971 | 373,920 | 378,861 |
| Borrowings | **46,322** | 51,342 | 52,424 | 58,813 | 59,222 |
| Subordinated Debt | **5,155** | 5,155 | 5,155 | 5,155 | 5,155 |
| Shareholders equity | **45,060** | 42,723 | 39,655 | 40,488 | 39,969 |
| | | | | | |
| **ASSET QUALITY RATIOS** | | | | | |
| Loans 30 days or more beyond their contractual due date as a percent of total loans | **1.39%** | 1.47% | 1.37% | 1.31% | 0.78% |
| | | | | | |
| Nonperforming loans | **$ 3,804** | $ 3,782 | $ 3,858 | $ 2,275 | $ 1,961 |
| Nonperforming securities | **3,179** | 3,861 | 3,767 | 2,079 | 2,354 |
| Other real estate owned | **562** | 560 | 848 | 976 | 760 |
| | | | | | |
| Total nonperforming assets | **$ 7,545** | $ 8,203 | $ 8,473 | $ 5,330 | $ 5,075 |
| | | | | | |
| Nonperforming assets as a percentage of: | | | | | |
| Total assets | **1.56%** | 1.68% | 1.69% | 1.10% | 1.06% |
| Equity plus allowance for loan losses | **15.83** | 17.60 | 19.07 | 12.31 | 11.85 |
| Tier I capital | **15.37** | 17.26 | 18.11 | 11.71 | 10.52 |
| | | | | | |
| **FINANCIAL RATIOS** | | | | | |
| Return on average equity | **11.73%** | 8.14% | 10.45% | 0.17% | 13.25% |
| Return on average assets | **1.07** | 0.71 | 0.86 | 0.01 | 1.08 |
| Efficiency ratio | **69.52** | 71.10 | 67.26 | 72.87 | 67.45 |
| Effective tax rate | **25.79** | 18.86 | 20.25 | (107.56) | 25.58 |
| Net interest margin | **3.78** | 3.74 | 3.67 | 3.52 | 3.68 |

(1) Basic and diluted earnings per share are based on weighted average shares outstanding. Book value per common share is based on shares outstanding at each period.

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CORTLAND BANCORP AND SUBSIDIARIES

ITEM 2. MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

(Dollars in thousands, except for per share amounts)

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 annual 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, anticipa 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; 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; and unforeseen 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 and Liabilities***

Earning assets are comprised of investment securities, loans and deposits at financial institutions, including the Federal Reserve Bank. Earning assets were $448,530 at June 30, 2011, an increase of 1.7% from the June 30, 2010 balance of $441,062, and a decrease of 3.1% from the December 31, 2010 balance of $462,809.

Total cash and cash equivalents increased by $4,929 from year-end and decreased by $11,035 from the balance at June 30, 2010. This occurred mainly in deposits held at the Federal Reserve Bank, which increased by $6,031 from year-end and decreased by $7,477 from June 30, 2010. Throughout 2010, excess liquidity was employed into the investment portfolio, while in 2011, liquidity has been increased to fund the increase in lending activity.

Investment securities are classified as available-for-sale to give management the flexibility to sell the securities prior to maturity, if needed, based on fluctuating interest rates or changes in funding requirements. As of March 31, 2011, management opted to reclassify all investments in the held-to-maturity classification into the available-for-sale portfolio. The reclassification resulted in the recording of an unrealized gain of $522, an increase of $344 net of tax to other comprehensive income

At June 30, 2011, the investment securities portfolio was $176,689 compared to $178,970 at June 30, 2010, a decrease of $2,281, or 1.3%. Investment securities decreased $11,769 compared to December 31, 2010, a decrease of 6.2%. This decrease was primarily the result of management s decision not to reinvest all the principal and interest proceeds received during the first six months back into the investment portfolio. Investment securities represented 39.4% of earning assets at June 30, 2011, compared to 40.6% at June 30, 2010 and 40.7% at December 31, 2010. As the Company manages its balance sheet for loan growth, asset mix, liquidity and for current interest rates and interest rate forecasts, the investment portfolio is a primary source of liquidity. Management has also used funds to decrease borrowings as they mature. The investment portfolio represented 45.2% of each deposit dollar, down from 48.3% a year ago and 48.1% of year-end levels.

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(Dollars in thousands, except for per share amounts)

The investment securities available-for-sale portfolio had net unrealized losses of $2,705 at June 30, 2011, a decrease of $1,897 compared to net unrealized losses of $4,602 at June 30, 2010, and a decrease of $1,019 compared to net unrealized losses of $3,724 at December 31, 2010. Contributing to the volatility in net unrealized losses over the past twelve months are changes in interest rates and an inactive market for certain securities as discussed in Note 9 to the financial statements.

The Company s investment portfolio contains trust preferred securities, which have resulted in valuation charges against income of $13.7 million in 2009, $2.7 million in 2010, and $202 in the first quarter of 2011. The Company continues to value these securities consistent with valuation techniques prescribed under accounting standards. The market for these securities and similar securities, which had been relatively active since 2003, became illiquid during the financial crisis of 2008 and is still currently not active. Since 2008, the Company has modeled and analyzed the cash flow characteristics and has concluded that a major portion of these devalued securities were not recoverable. There was no charge for this other than temporary impairment for the second quarter of 2011 versus $613 in the second quarter of 2010.

Totals loans at June 30, 2011 were $258,904 as compared to $237,211 a year ago, a 9.1% increase. Total assets of $484,623 at June 30, 2011 reflect a slight increase of 1.2% from year ago asset totals of $478,872 as management orchestrates balance sheet strategies designed to reinvest cash flows from its investment portfolio and increase loan balances with no material change in composite asset totals. This balance sheet strategy is designed to improve net interest income margins and overall profitability while maintaining assets which support the Company s current capital position.

Loans net of the allowance for losses increased by $21,354 during the twelve month period from June 30, 2010 to June 30, 2011, and decreased by $6,889 from December 31, 2010. Gross loans as a percentage of earning assets stood at 57.7% as of June 30, 2011, 53.8% at June 30, 2010 and 57.4% as of December 31, 2010. The loan to deposit ratio was 66.2% at June 30, 2011 and 64.0% at June 30, 2010. The increase in loans has primarily resulted from efforts designed to increase market share. The Company substantially restructured and expanded its commercial lending staff in the second half of 2010 with the specific objective of growing loans while maintaining credit quality. The decrease in loans from year-end was due in part to 60-day term commercial loans for a total of $16,915 that closed in December 2010 and was fully secured by segregated deposit accounts with the Bank. The loans matured in the first quarter of 2011. At June 30, 2011, the loan loss allowance of $2,853 represented approximately 1.10% of outstanding loans, and at June 30, 2010 the loan loss allowance of $2,514 represented approximately 1.06% of outstanding loans. The loan loss allowance at December 31, 2010 of $2,501 represented approximately 0.94% of outstanding loans.

During the first six months, loan charge-offs were $347 in 2011 compared to $329 in 2010, while the recovery of previously charged-off loans amounted to $151 in 2011 and $111 in 2010. 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-off associated with account balances vary from period to period as loans are deemed uncollectible by management.

Loans accounted for on a non-accrual basis increased up from $2,611 at December 31, 2010 to $2,637 at the recent quarter ended June 30, 2011 and increased from $1,361 at June 30, 2010. Non-accrual loans at June 30, 2011 represented 1.0% of the loan portfolio compared to 0.98% at December 31, 2010 and 0.57% at June 30, 2010. The increase from June 30, 2010 is a single loan for $1,009, fully secured by collateral, for which no loss is expected to be incurred.

Bank-owned life insurance had a cash surrender value of $12,747 at June 30, 2011, $12,491 at December 31, 2010 and $12,287 at June 30, 2010. Other assets decreased to $11,828 at June 30, 2011 from $13,860 at December 31, 2010 and $14,261 at June 30, 2010. Included in other assets is a prepaid assessment paid to the FDIC in December of 2009. This prepayment is the estimate, based on projected assessment rates and assessment base, made by the FDIC of premiums due until December 31, 2012. On a quarterly basis, this prepayment is reduced through a charge to expense until the prepayment is depleted. The balance is $1,750 at June 30, 2011, $2,106 at December 31, 2010 and $2,506 at June 30, 2010. Other real estate decreased to $562 at June 30, 2011 compared to $848 at December 31, 2010 and $760 at June 30, 2010.

Noninterest-bearing deposits measured $64,137 at June 30, 2011 from $61,362 at December 31, 2010 and $59,411 at June 30, 2010. Interest-bearing deposits decreased $3,302 to $326,845 at June 30, 2011 from $330,147 at December 31, 2010. The decrease in interest bearing deposits from year end is due in part to segregated deposit accounts with the Bank which fully collateralized $16,915 in 60-day term commercial loans that closed in December 2010. The deposits were released when the loans matured in the first quarter of 2011.

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CORTLAND BANCORP AND SUBSIDIARIES

ITEM 2. MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

(Dollars in thousands, except for per share amounts)

Federal Home Loan Bank advances and other short term borrowings decreased to $39,749 at June 30, 2011 compared to $57,901 at December 31, 2010 and $58,515 at June 30, 2010. The decrease is due to management s decision to pay down individual borrowings at their respective maturities rather than refinancing. Future maturities are also expected to be paid off.

Other liabilities remain fairly consistent measuring $4,022 at June 30, 2011 compared to $3,856 at December 31, 2010 and $4,493 at June 30, 2010. Other accrued expenses were $2,556 at June 30, 2011, $2,469 at December 31, 2010 and $2,428 at June 30, 2010.

The Company s total shareholders equity increased from $41.9 million on December 31, 2010 to $44.7 million at June 30, 2011, an increase of $2.8 million. The Company continues to remain well capitalized under all regulatory measures. The Company s total risk-based capital is $14.1 million in excess of the 10% well capitalized threshold.

Capital Resources

Regulatory standards for measuring capital adequacy require banks and bank holding companies to maintain capital based on risk-adjusted assets so that categories of assets of potentially higher credit risk require more capital backing than assets with lower risk. In addition, banks and bank holding companies are required to maintain capital to support, on a risk-adjusted basis, certain off-balance sheet activities such as standby letters of credit and interest rate swaps.

The risk-based standards classify capital into two tiers. Tier 1 capital consists of common shareholders equity, noncumulative and cumulative perpetual preferred stock, qualifying trust preferred securities and minority interests less intangibles, disallowed deferred tax assets and the unrealized market value adjustment of investment securities available-for-sale. Tier 2 capital consists of a limited amount of the allowance for loan and lease losses, perpetual preferred stock (not included in Tier 1), hybrid capital instruments, term subordinated debt, and intermediate-term preferred stock.

In April 2009, the FFIEC issued additional instructions for reporting of direct credit substitutions that have been downgraded below investment grade. Included in the definition of a direct credit substitute are mezzanine and subordinated tranches of trust preferred securities and non-agency collateralized mortgage obligations. Adopting these instructions results in an increase in total risk-weighted assets with an attendant decrease in the risk-based capital and Tier 1 risk-based capital ratios.

As a result of the decline in the value of the Bank s trust preferred securities, the regulatory capital levels of the Bank have declined. As a result of investment downgrades by the rating agencies during 2010, all of the 32 trust preferred securities were rated as highly speculative grade debt securities. As a consequence, the Bank is required to maintain higher levels of regulatory risk-based capital for these securities due to the greater perceived risk of default by the underlying bank and insurance company issuers. Specifically, regulatory guidance requires the Bank to apply a higher risk weighting formula for these securities to calculate its regulatory capital ratios. The result of that calculation increases the Bank s risk-weighted assets for these securities to $78.7, well above the $34.5 in amortized cost of these securities as of June 30, 2011, thereby significantly diluting the regulatory capital ratios.

Regardless of the trust preferred securities risk weighting, the Company met all capital adequacy requirements to which it was subject as of June 30, 2011 and December 31, 2010, as supported by the data in the following table. As of those dates, the Company was well capitalized under regulatory prompt corrective action provisions.

| | Actual Regulatory Capital Ratios as of: | | Regulatory Capital Ratio requirements to be: | |
|---|---|---|---|---|
| | **June 30, 2011** | December 31, 2010 | Well Capitalized | Adequately Capitalized |

| | | | | |
|---|---|---|---|---|
| Total risk-based capital to risk-weighted assets | **13.73%** | 13.42% | 10.00% | 8.00% |
| Tier I capital to risk-weighted assets | **12.95%** | 12.72% | 6.00% | 4.00% |
| Tier I capital to average assets | **10.00%** | 9.59% | 5.00% | 4.00% |

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(Dollars in thousands, except for per share amounts)

Risk based capital standards require a minimum ratio of 8.00% of qualifying total capital to risk-adjusted total assets with at least 4.00% constituting Tier 1 capital. Capital qualifying as Tier 2 capital is limited to 100.00% of Tier 1 capital. All banks and bank holding companies are also required to maintain a minimum leverage capital ratio (Tier 1 capital to total average assets) in the range of 3.00% to 4.00%, subject to regulatory guidelines. Capital ratios remain above regulatory minimums for well capitalized financial institutions.

The Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA) require banking regulatory agencies to revise risk-based capital standards to ensure that they adequately account for the following additional risks: interest rate, concentration of credit, and non-traditional activities. Accordingly, regulators will subjectively consider an institution s exposure to declines in the economic value of its capital due to changes in interest rates in evaluating capital adequacy. The following table illustrates the Company s components of risk weighted capital ratios and the excess over amounts considered well-capitalized at June 30, 2011 and December 31, 2010.

| | **June 30, 2011** | December 31, 2010 |
|---|---|---|
| Tier 1 Capital | **$ 49,086** | $ 46,787 |
| Tier 2 Capital | **2,937** | 2,585 |
| QUALIFYING CAPITAL | **$ 52,023** | $ 49,372 |
| Risk-Adjusted Total Assets (*) | **$ 378,935** | $ 367,798 |
| Tier 1 Risk- Based Capital Excess | **$ 26,350** | $ 24,719 |
| Total Risk- Based Capital Excess | **14,130** | 12,592 |
| Total Leverage Capital Excess | **24,545** | 22,406 |

(*) Includes off-balance sheet exposures

Average total assets for leverage capital purposes is calculated as average assets, less disallowed deferred tax assets, less intangibles and the net unrealized market value adjustment of quarter end June 30, 2011 investment securities available for sale, which averaged $490,818 for the six months ended June 30, 2011 and $487,620 for the year ended December 31, 2010.

Regulations require that Investments designated as available-for-sale are marked-to-market with corresponding entries to the deferred tax account and shareholders equity. Regulatory agencies, however, exclude these adjustments in computing risk-based capital, as their inclusion would tend to increase the volatility of this important measure of capital adequacy.

*Analysis of Earnings*

Executive Summary

Net income for the six months ended June 30, 2011 was $2,190, or $0.48 per share, compared to $2,218 or $0.49 per share, a year ago.

Core earnings for the six months which exclude non-recurring items such as impairment loss, investment gains not in the ordinary course of business and reductions in retirement expense were $2,113 at June 30, 2011 compared to $2,073 for the same period in 2010.

Net interest margin of 3.78% for the quarter is an improvement on both a linked quarter basis from 3.74% and year-over-year from 3.68% as the Company continues to optimally manage its balance sheet in this historically low interest rate environment.

Net interest income provides the core earnings base for the Company and increased 3.5% to $4,135 in the second quarter of 2011 versus $3,995 in 2010. The Company has benefited from increasing balances in the loan portfolio yielding 5.96% during the quarter while reducing balances in the investment portfolio earning 3.70%. Also, as liabilities continue to mature and reprice at lower rates, the net interest margin has, and is expected to continue to improve.

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(Dollars in thousands, except for per share amounts)

The Company continues to excel in managing risks in the loan portfolio as asset quality measures are among the best for banks with similar asset totals. Net loan charge-offs (annualized) were 0.15% of average loans in 2011 and 0.18% in the second quarter of 2010. The allowance for loan loss (ALLL) to total loans ratio was 1.10% at June 30, 2011 versus 1.06% a year ago. The Company s allowance for loan losses covers 108% of nonperforming loans at June 30, 2011.

The Company, to date, has not experienced notable deterioration in credit quality despite less than favorable economic conditions over the past several years. Nonperforming loans were $3,804 at June 30, 2011 or 1.47% of loans, relatively unchanged from $3,858 at December 31, 2010. Included in these totals is a single loan of $1,009 fully secured by collateral for which no loss is expected to be incurred. For the quarters ending June 30, 2011 and 2010 provisions for loan loss were $374 and $120 respectively, more than covering the net charge-offs for the respective periods. Provision expense during the most recent quarter end, was increased in recognition of loan growth and a changing composition of the loan portfolio as the Company takes aim at managing its balance sheet with a commercially -oriented focus.

The Company had no other-than-temporary impairment ( OTTI ) losses on investment securities in the quarter versus $613 thousand in the same 2010 quarter. Year to date OTTI totaled $202 in 2011 compared to $1,157 in 2010.

Non-Interest Income for the quarter, excluding impairment (OTTI) charges and securities gains, decreased by $122 from a year ago. This is mainly due to a decline in Fees for Customer Services of $23 and the recognition of losses on Other Real Estate of $71 in the second quarter of 2011. Fees for Customer Services, which approximate $2,200 per year, were negatively affected by new banking regulations that limit the ability of financial institutions to charge on overdraft protection products.

Non-Interest Expenses for the second quarter of 2011 were $3,321 as compared to $3,210 for the same period in 2010. For the six month periods, Non-Interest Expenses increased from $5,949 in 2010 to $6,676 in 2011. The addition of seasoned lenders to the commercial lending staff and a one-time credit of $457 in the first quarter 2010 relating to reductions in supplemental retirement benefits, net of severance, were the major factors contributing to the expense differential.

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Certain Non GAAP Measures

Certain financial information has been 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 is shown as part of management s discussion and analysis of financial results of operations.

Core earnings (earnings before other-than-temporary-impairment charge and certain other non-recurring items) increased for the six months ended June 30, 2011, and remained flat for the three months ended June 30, 2011 as compared to the comparable 2010 periods. Core earnings for the second quarter of 2011 was $1,110, or $0.25 per share, compared to $1,121, or $0.25 per share in the second quarter of 2010. Year-to-date June 30, 2011 core earnings stood at $2,113, or $0.47 per share compared to $2,073, or $0.46 per share a year ago.

The following is a reconciliation between core earnings and earnings under GAAP.

| | THREE MONTHS ENDED June 30, | | SIX MONTHS ENDED June 30, | |
|---|---|---|---|---|
| | **2011** | 2010 | **2011** | 2010 |
| GAAP earnings (loss) | **$ 1,321** | $ 1,324 | **$ 2,190** | $ 2,218 |
| Impairment losses on investment securities | | 613 | **202** | 1,157 |
| Investment gains not in the ordinary course of business * | **(319)** | (920) | **(319)** | (920) |
| Credits relating to reorganization net | | | | (457) |
| Tax effect of adjustments | **108** | 104 | **40** | 75 |
| Core earnings | **$ 1,110** | $ 1,121 | **$ 2,113** | $ 2,073 |
| Core earnings per share | **$ 0.25** | $ 0.25 | **$ 0.47** | $ 0.46 |

* *Gains in 2010 were attributable to sales made to achieve a risk reduction strategy, while the gains in 2011 are due to the settlement on General Motors Corporation bonds.*

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***Analysis of Net Interest Income Six months ended June 30, 2011 and 2010***

| | June 30, 2011 | | | June 30, 2010 | | |
|---|---|---|---|---|---|---|
| | Average Balance (1) | Interest | Average Rate | Average Balance (1) | Interest | Average Rate |
| INTEREST-EARNING ASSETS | | | | | | |
| Interest-earning deposits and other earning assets | **$ 16,103** | **$ 35** | **0.43%** | $ 29,795 | $ 43 | 0.29% |
| Investment securities(1)(2) | **182,798** | **3,378** | **3.70%** | 185,314 | 4,043 | 4.36% |
| Loans(1)(2)(3) | **258,346** | **7,636** | **5.94%** | 240,039 | 7,436 | 6.22% |
| Total interest-earning assets | **$ 457,247** | **$ 11,049** | **4.85%** | $ 455,148 | $ 11,522 | 5.08% |
| INTEREST-BEARING LIABILITIES | | | | | | |
| Interest-bearing demand and money market deposits | **$ 72,750** | **$ 96** | **0.27%** | $ 69,786 | $ 137 | 0.40% |
| Savings | **92,388** | **79** | **0.17%** | 88,267 | 134 | 0.31% |
| Time | **160,761** | **1,530** | **1.92%** | 160,207 | 1,891 | 2.38% |
| Total interest-bearing deposits | **325,899** | **1,705** | **1.05%** | 318,260 | 2,162 | 1.37% |
| Other borrowings | **48,818** | **706** | **2.92%** | 61,061 | 1,177 | 3.89% |
| Subordinated debt | **5,155** | **45** | **1.78%** | 5,155 | 45 | 1.73% |
| Total interest-bearing liabilities | **$ 379,872** | **$ 2,456** | **1.30%** | $ 384,476 | $ 3,384 | 1.77% |
| Net interest income | | **$ 8,593** | | | $ 8,138 | |
| Net interest rate spread(4) | | | **3.55%** | | | 3.31% |
| Net interest margin(5) | | | **3.76%** | | | 3.58% |

(1) Includes both taxable and tax exempt securities and loans.

(2) The amounts are presented on a fully taxable equivalent basis using the statutory tax rate of 34%, and have been adjusted to reflect the effect of disallowed interest expense related to carrying tax-exempt assets. Tax-free income from loans and states of the U.S. and political subdivisions amounted to $24 and $367 for 2011 and $33 and $321 for 2010, respectively.

(3) Includes applicable loan origination and commitment fees, net of deferred origination cost amortization.

(4) Net 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 the net interest income by total interest-earning assets.

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 $8,593 at June 30, 2011 and $8,138 at June 30, 2010. During the recent reporting period the net interest margin registered 3.76% at June 30, 2011 and 3.58% at June 30, 2010.

The decrease in interest income, on a fully taxable equivalent basis, of $473 is the product of a 23 basis point decrease in interest rates earned and a 0.5% year-over-year increase in average earning assets. The decrease in interest expense of $928 was a product of a 47 basis point decrease in rates paid and a 1.2% decrease in interest-bearing liabilities. The net result was a 5.6% increase in net interest income on a fully taxable equivalent basis, and an 18 basis point increase in the Company s net interest margin on an asset base of similar size, but different mix.

On a fully taxable equivalent basis, income on investment securities decreased by $665, or 16.5%. The average invested balances in securities decreased by $2,516, or 1.4%, from the levels of a year ago. The decrease in the average balance of investment securities was accompanied by a 66 basis point decrease in the tax equivalent yield of the portfolio. The Company expects to continue redeployment of liquidity into loans.

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On a fully taxable equivalent basis, income on loans increased by $200, or 2.7%, for the six months of 2011 compared to the same period in 2010. An $18,307 increase in the average balance of the loan portfolio, or 7.6%, was accompanied by a 28 basis point decrease in the portfolio s tax equivalent yield.

Other interest income decreased by $8, or 18.6%, from the same period a year ago. The average balance of interest earning deposits decreased by $13,692, or 46.0%. The yield increased by 14 basis points during the first six months of 2011 compared to 2010.

Average interest-bearing demand deposits and money market accounts increased by $2,964, or 4.2%, while average savings balances increased by $4,121, or 4.7%. Average total interest paid on interest-bearing demand deposits and money market account was $96, a $41 decrease from last year. The average rate paid on these products decreased by 13 basis points. Average total interest paid on savings accounts was $79, a $55 decrease from last year. The average rate paid on savings accounts decreased by 14 basis points. The average balance of time deposit products increased by $554, or 0.4%, as the average rate paid decreased by 46 basis points, from 2.38% to 1.92%. Interest expense decreased on time deposits by $361 from the prior year. As time deposits mature, the balances are reinvested at the lower current rates. As the Federal Reserve has no immediate intent to raise short-term interest rates, the Company expects the cost of deposits to continue declining.

Average borrowings and subordinated debt decreased by $12,243 while the average rate paid on borrowings decreased by 91 basis points. FHLB borrowings, net of new short term advances taken in 2011, of $18,500 were paid off at their due dates in 2011. Management plans to pay down individual borrowings at their respective due dates in the future using current liquidity.

*Impairment Analysis of Investment Securities*

The Company owns 32 trust preferred securities totaling $34,920 (par value) issued by banks, thrifts, insurance companies and real estate investment trusts. The market for these securities at June 30, 2011 is not active and markets for similar securities are also not 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 June 30, 2011. 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 would 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 effective discount rates on an overall basis generally range from 18.16% to 43.99% and are highly dependent upon the credit quality of the collateral, the relative position of the tranche in the capital structure of the trust preferred securities and the prepayment assumptions.

Based upon the results of the analysis, the Company currently believes that a weighted average price of approximately $0.34 per $1.00 of par value is representative of the fair value of the 32 trust preferred securities, with individual securities therein ranging from zero to $0.99.

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The Company considered all information available as of June 30, 2011 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. The FDIC has recently indicated that there are many financial institutions still considered troubled banks even after the numerous failures in 2010. If the conditions of the underlying banks in the trust preferred securities worsen, there may be additional impairment to recognize in 2011 or later.

*Analysis of Other Income, Other Expense and Federal Income Tax for the First Six Months*

Total other income, excluding investment gains and impairment losses, decreased by $178. After impairment losses and gains on investment securities, other income increased by $595 from the same period a year ago.

Gains on 1-4 residential mortgage loans sold in the secondary mortgage market decreased by $6 from the same period a year ago. Fees for other customer services decreased by $55. In November 2009, the Federal Reserve Board issued a final rule that was effective July 1, 2010, which prohibited financial institutions from charging consumers fees for paying overdrafts on automated teller machine and one-time debit card transactions, unless a consumer consents, or opts in, to the overdraft service for those types of transactions. Consumers were provided a notice that explained the financial institution s overdraft services, including the fees associated with the service, and the consumer s choices. Because the Banks customers had to provide advance consent to the overdraft service for automated teller machine and one-time debit card transactions, the Company cannot provide any assurance as to the ultimate impact of this rule on the amount of overdraft/insufficient funds charges reported in future periods. Loss on the sale of Other Real Estate Owned (OREO) was $99 at June 30, 2011, a decrease to income of $95 from the loss of $4 recorded at June 30, 2010. Other sources of non-recurring non-interest income decreased by $22 from the same period a year ago. This latter income category is subject to fluctuation due to the non-recurring nature of the items.

Gains on securities called and net gains on the sale of available for sale investment securities decreased by $182 from year ago levels. Gains were offset by impairment losses attributable to trust preferred securities primarily issued by bank holding companies. Losses of $202 were recognized in 2011 as compared to $1,157 in 2010.

Total other expenses in the first six months were $6,676 in 2011 compared to $5,949 in 2010, an increase of $727, or 12.2 %. Full time equivalent employment averaged 148 during the first six months of 2011 and 146 in 2010. Salaries and benefits increased by $675, or 23.1%, from the similar period a year ago. The Company completed its management reorganization during 2010 and recorded credits of $457 related to various compensation plans, net of severance costs. Absent this credit, other expenses increased 6.5% between the comparable periods.

Charges for insurance premiums paid to the FDIC decreased by $66. Deposits are insured by the Federal Deposit Insurance Corporation (FDIC) up to a maximum amount, which is generally $250 per depositor subject to aggregation rules. As an FDIC-insured institution, the Bank is required to pay deposit insurance premium assessments to the FDIC. Pursuant to a final rule adopted by the FDIC in November 2009, the Bank was required to prepay its estimated quarterly risk-based assessments to the FDIC for the fourth quarter of 2009 and for all of 2010, 2011 and 2012. The Bank prepaid the amount of $2,974 in December 2009 and had a remaining balance of $1,750 at June 30, 2011. These prepaid assessment amounts are included in other assets of the Company. The Bank will be assessed quarterly premiums by the FDIC and such assessments will be charged against the prepaid asset until such time as the prepaid asset has been fully expensed, at which point the Bank will resume paying premiums to the FDIC. The change in the basis used to calculate the assessment resulted in the decrease in expense in 2011. The Company anticipates its FDIC insurance expense will continue to adversely impact operating expenses for the year ended December 31, 2011.

All other expense categories increased by 4.6%, or $118 in the aggregate. These expense categories are subject to fluctuation due to non-recurring items. The increase in 2011 is mainly due to third party fees for system upgrades.

Income before tax amounted to $2,851 for the first six months of 2011 comparable to $2,818 for the similar period of 2010. The effective tax rate for the first six months was 23.2% in 2011 and 21.3% in 2010, resulting in income tax expense of $661 and $600, respectively.

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

| | SIX MONTHS ENDED | | | | | |
|---|---|---|---|---|---|---|
| | June 30, 2011 | | | June 30, 2010 | | |
| | | Balance | % | | Balance | % |
| Provision at statutory rate | **$** | **969** | **34.0%** | **$** | 958 | 34.0% |
| Add (Deduct): | | | | | | |
| Tax effect of earnings on bank-owned life insurance-net | | **(67)** | **(2.4%)** | | (75) | (2.6%) |
| Tax effect of other non-taxable income | | **(272)** | **(9.5%)** | | (315) | (11.2%) |
| Tax effect of non-deductible expense | | **31** | **1.1%** | | 32 | 1.1% |
| Federal income taxes | **$** | **661** | **23.20%** | $ | 600 | 21.30% |

The majority of non-taxable income consists of interest on obligations of states and political subdivisions.

Net income registered $2,190 for the six months ended June 30, 2011 and $2,218 for the similar period of 2010, representing per share amounts of $0.48 in 2011 and $0.49 in 2010.

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***Analysis of Net Interest Income Second quarter ended June 30, 2011 and 2010***

| | June 30, 2011 | | | June 30, 2010 | | |
|---|---|---|---|---|---|---|
| | Average Balance | Interest | Average Rate | Average Balance | Interest | Average Rate |
| INTEREST-EARNING ASSETS | | | | | | |
| Interest-earning deposits and other earning assets | **$ 19,553** | **$ 18** | **0.39%** | $ 25,320 | $ 20 | 0.33% |
| Investment securities(1)(2) | **177,703** | **1,644** | **3.70%** | 190,654 | 2,044 | 4.28% |
| Loans(1)(2)(3) | **259,415** | **3,860** | **5.96%** | 238,058 | 3,740 | 6.29% |
| Total interest-earning assets | **$ 456,671** | **$ 5,522** | **4.84%** | $ 454,032 | $ 5,804 | 5.12% |
| INTEREST-BEARING LIABILITIES | | | | | | |
| Interest-bearing demand and money market deposits | **$ 71,050** | **$ 47** | **0.27%** | $ 70,190 | $ 64 | 0.36% |
| Savings | **93,461** | **41** | **0.17%** | 88,992 | 60 | 0.27% |
| Time | **160,919** | **753** | **1.88%** | 158,691 | 922 | 2.33% |
| Total interest-bearing deposits | **325,430** | **841** | **1.04%** | 317,873 | 1,046 | 1.32% |
| Other borrowings | **46,322** | **340** | **2.95%** | 59,222 | 555 | 3.76% |
| Subordinated debt | **5,155** | **22** | **1.77%** | 5,155 | 23 | 1.76% |
| Total interest-bearing liabilities | **$ 376,907** | **$ 1,203** | **1.28%** | $ 382,250 | $ 1,624 | 1.70% |
| Net interest income | | **$ 4,319** | | | $ 4,180 | |
| Net interest rate spread(4) | | | 3.56% | | | 3.42% |
| Net interest margin(5) | | | 3.78% | | | 3.68% |

1) Includes both taxable and tax exempt securities and loans.

(2) The amounts are presented on a fully taxable equivalent basis using the statutory tax rate of 34%, and have been adjusted to reflect the effect of disallowed interest expense related to carrying tax-exempt assets. Tax-free income from loans and states of the U.S. and political subdivisions amounted to $11 and $173 for 2011 and $16 and $169 for 2010, respectively.

(3) Includes applicable loan origination and commitment fees, net of deferred origination cost amortization.

(4)

Net 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 the net interest income by total interest-earning assets.

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 $4,319 at June 30, 2011 and $4,180 at June 30, 2010. During the recent reporting period the net interest margin registered 3.78% at June 30, 2011 and 3.68% at June 30, 2010.

The decrease in interest income, on a fully taxable equivalent basis, of $282 is the product of a 28 basis point decrease in interest rates earned and a 0.6 % year-over-year increase in average earning assets. The decrease in interest expense of $421 was a product of a 42 basis point decrease in rates paid and a 1.4% decrease in interest-bearing liabilities. The net result was a 3.3% 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 an asset base of similar size, but different mix.

On a fully taxable equivalent basis, income on investment securities decreased by $400, or 19.6 %. The average invested balances in securities decreased by $12,951, or 6.8% from the levels of a year ago. The decrease in the average balance of investment securities was accompanied by a 58 basis point decrease in the tax equivalent yield of the portfolio. The Company expects to continue redeployment of liquidity into loans.

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On a fully taxable equivalent basis, income on loans increased by $120, or 3.2%, for the six months of 2011 compared to the same period in 2010. A $21,357 increase in the average balance of the loan portfolio, or 9.0%, was accompanied by a 33 basis point decrease in the portfolio s tax equivalent yield.

Other interest income decreased by $2, or 10.0%, from the same period a year ago. The average balance of interest earning deposits decreased by $5,767, or 22.8%. The yield increased by 6 basis points during the first six months of 2011 compared to 2010.

Average interest-bearing demand deposits and money market accounts increased by $860, or 1.2%, while savings balances increased by $4,469, or 5.0%. Average total interest paid on interest-bearing demand deposits and money market account was $47, a $17 decrease from last year. The average rate paid on these products decreased by 9 basis points. Average total interest paid on savings accounts was $41, a $19 decrease from last year. The average rate paid on savings accounts decreased by 10 basis points. The average balance of time deposit products increased by $2,228 as the average rate paid decreased by 45 basis points, from 2.33% to 1.88%. Interest expense decreased on time deposits by $169 from the prior year. As time deposits mature, the balances are reinvested at the lower current rates. As the Federal Reserve has no immediate intent to raise short-term interest rates, the Company expects the cost of deposits to continue declining.

Average borrowings and subordinated debt decreased by $12,900 while the average rate paid on borrowings decreased by 81 basis points. FHLB borrowings of $11,500 were paid off at their due dates in the second quarter of 2011. Management plans to pay down individual borrowings at their respective due dates in the future using current liquidity.

***Analysis of Other Income, Other Expense and Federal Income Tax for the Second Quarter***

Loan charge-offs during the quarter were $290 in 2011 compared to $134 in 2010, while the recovery of previously charged-off loans amounted to $128 during the second quarter of 2011 compared to $81 in the same period of 2010. The Company s provision for loan losses during the quarter ended June 30, 2011 was $374 and $120 in the second quarter of 2010. 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. The balance of the allowance for loan loss and provisions to the loan loss allowance are based on an assessment of both the risk of loss and the amount of loss on loans within the loan portfolio. During the first two quarters of both 2010 and 2011, the amount charged to operations as a provision for loan loss was increased to account for the increase in 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 has allocated a portion of the allowance for a number of specific problem loans through the first six months of 2011, but 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.

Other income increased by $226 from a year ago. The reason for this increase is an other than temporary impairment loss in the amount of $613 recorded in the second quarter of 2010 attributable to CDO s, with none recognized in 2011. The impairment was offset by a decrease in gains on investment securities which measured $698 in the second quarter of 2011 and $963 in the same quarter of 2010. Fees for customer services decreased by $23. Non-taxable income on bank owned life insurance policies decreased by $2. The net gain on loans sold during the quarter amounted to $20, compared to $38 a year ago, a decrease of $18 due to a decrease in loan sales activity. There was a $71 loss on the sale of other real estate in 2011 and none in 2010.

Total other non-interest expenses in the second quarter were $3,321 in 2011 compared to $3,210 in 2010, an increase of $111 or 3.5%. Salaries and benefits constituted a $141 increase, or 8.5%. FDIC expense decreased by $52 due to a change in the base used to calculate premiums assessments. Other expenses increased by $22 or 1.6%. This expense category is subject to fluctuation due to non-recurring items.

Income before income tax expense during the second quarter amounted to $1,780 in 2011 compared to $1,779 in 2010. Income tax expense for the second quarter of 2011 was $459 compared to $455 in 2010. Second quarter net income was $1,321 in 2011 compared $1,324 in 2010. Income per share for the second quarter was $0.29 in both June 2011 and 2010.

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

Concerns over deposit fluctuations with respect to the overall banking industry were addressed by the FDIC in September and October 2008. The FDIC temporarily increased the individual account deposit insurance from $100 per account to $250 per account through December 31, 2009, which has subsequently been made permanent. The FDIC also implemented the Transaction Account Guarantee Program (TAGP), which provides for full FDIC coverage for transaction accounts, regardless of dollar amounts. The Company elected to opt-in to this program, thus, customers received full coverage for transaction accounts under the program. The TAGP expired December 31, 2010. It was replaced by a final rule to implement the section of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) that provides temporary unlimited coverage for non-interest bearing transaction accounts at all FDIC-insured depository institutions. The separate coverage for non-interest bearing transaction accounts became effective on December 31, 2010 and terminates on December 31, 2012. This provision is similar to the TAGP, except it does not include low-interest Negotiable Order of Withdrawal (NOW) accounts. The Dodd-Frank provision also differs significantly from the TAGP in that it applies to all FDIC-insured depository institutions with qualifying deposits. Concerns regarding the overall banking industry or the Company could have an adverse effect on future deposit levels.

In order to address the concern of FDIC insurance of larger depositors, the Bank became a member of the Certificate of Deposit Account Registry Service (CDARS®) program late in 2009. Through CDARS®, the Bank s customers can increase their FDIC insurance by up to $50 million through reciprocal certificate of deposit 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 and placed with other banks that are members of the network. The reciprocal member bank issues certificate of deposits in amounts that ensure that the entire deposit is eligible for FDIC insurance. At June 30, 2011, the Bank did not have any deposits in the CDARS® program. For regulatory purposes, CDARS® is considered a brokered deposit even though reciprocal deposits can be generated from customers in the local market. The Bank also joined the ICS program which expands the CDARS concept to money market deposit accounts. The Bank had a balance of $392 in the ICS program at June 30, 2011.

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 yet another source of liquidity. At June 30, 2011, the Bank had approximately $17.3 million available of collateral-based borrowing capacity at FHLB of Cincinnati, supplementing the $833 of availability with the Federal Reserve Discount window. Additionally, the FHLB has committed a $23.8 million cash management line subject to posting additional collateral. The Bank has access to approximately 10% of total assets in brokered certificates of deposit that could be used as an additional source of liquidity. At June 30, 2011, there was no outstanding balance in brokered certificates of deposit. The Company was also granted a total of $8.5 million in unsecured, discretionary Federal Funds lines of credit with no funds drawn upon as of June 30, 2011. Unpledged securities of $53,790 are also available for borrowing under repurchase agreements or as additional collateral for FHLB lines of credit.

CORTLAND BANCORP AND SUBSIDIARIES

ITEM 2. MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

(Dollars in thousands, except for per share amounts)

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. As of June 30, 2011, the Bank can pay no dividends to the Company without regulatory approval. Future dividend payments by the Bank to the Company are based upon future earnings and the approval of the regulators. The Company has cash of $380 at June 30, 2011 available to meet cash needs. It also holds a $6 million note receivable, the cash flow from which approximates the debt service on the Junior Subordinated Debentures. Cash is generally used by the Company to pay quarterly interest payments on the debentures, pay dividends to common shareholders and to fund operating expenses. Currently, any debt offerings or cash dividends to shareholders require prior approval of the regulators.

Cash and cash equivalents decreased from $31,768 in June 2010 to $20,733 in June 2011. This decrease occurred mainly in deposits held at the Federal Reserve Bank, which decreased by $7,477 from June 30, 2010.

The following table details the cash flows from operating activities for the six months ended:

| | June 30, 2011 | June 30, 2010 |
|---|---|---|
| Net income | **$ 2,190** | $ 2,218 |
| Adjustments to reconcile net income to net cash flows from operating activities: | | |
| Depreciation, amortization and accretion | **1,099** | 721 |
| Provision for loan loss | **548** | 295 |
| Investment securities gains | **(781)** | (963) |
| Impairment losses | **202** | 1,157 |
| Other real estate (gains) losses | **99** | 4 |
| Originations of loans held for sale | **(1,586)** | (2,108) |
| Proceeds from the sale of loans | **1,795** | 2,113 |
| Proceeds from IRS tax refund | **1,400** | |
| Net gain on the sale of loans | **(36)** | (42) |
| Changes in: | | |
| Deferred tax (benefit) expense | **(347)** | (314) |
| Prepaid FDIC assessment | **355** | 409 |
| Other assets and liabilities | **(98)** | (1,009) |
| Net cash flows from operating activities | **$ 4,840** | $ 2,481 |

Key variations stem from: 1) Amortization on investments measured $816 at June 30, 2011 compared to $427 at June 30, 2010. 2) Gains were recognized on the sale, call or maturity of investments of $781 in 2011 compared to $963 in the same period of 2010. 3) Impairment losses of $202 were recognized in 2011 compared to $1,157 in 2010. 4) In 2011 a refund of $1,400 was received from the IRS. This was recorded at December 31, 2010 as a receivable as a result of $6.0 million of impaired security expense considered permanent for tax purposes. 5) Other liabilities decreased in 2010 due in part to a net $457 reduction in accrued post retirement and accrued severance as a result of management reorganization completed in 2010. Refer to the Consolidated Statements of Cash Flows for a summary of the sources and uses of cash for 2011 and 2010.

CORTLAND BANCORP AND SUBSIDIARIES

ITEM 2. MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

(Dollars in thousands, except for per share amounts)

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 accounting principles generally accepted in the United States of America. 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 our 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: (i) specific valuation allowances based on probable losses on specific loans; (ii) valuation allowances based on historical loan loss experience for similar loans with similar characteristics and trends; and (iii) 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 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 further more in Management s Discussion and Analysis.

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ITEM 2. MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS
(Dollars in thousands, except for per share amounts)

***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, we assess whether there is an other-than-temporary impairment to our 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 were recognized during 2011 and 2010 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, we assess the relative merits and risks of the appropriate tax treatment of transactions taking into account statutory, judicial and regulatory guidance in the context of our tax position.

We account 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. We conduct periodic assessments of deferred tax assets to determine if it is more-likely-than-not that they will be realized. In making these assessments, we consider 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.

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ITEM 2. MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

(Dollars in thousands, except for per share amounts)

***Authoritative Accounting Guidance***

In January 2010, the FASB issued ASU No. 2010-06, *Fair Value Measurements and Disclosures (Topic 820): Improving Disclosures about Fair Value Measurements*. ASU 2010-06 amends Subtopic 820-10 to clarify existing disclosures, require new disclosures, and includes conforming amendments to guidance on employers disclosures about postretirement benefit plan assets. ASU 2010-06 is effective for interim and annual periods beginning after December 15, 2009, except for disclosures about purchases, sales, issuances, and settlements in the roll forward of activity in Level 3 fair value measurements. Those disclosures are effective for fiscal years beginning after December 15, 2010 and for interim periods within those fiscal years. The Company has presented the necessary disclosures in Note 9 herein. The Company does not expect the adoption of the remaining provisions of this ASU to have a material impact on the Company s consolidated financial statements.

In July 2010, FASB issued ASU No. 2010-20, *Receivables (Topic 310): Disclosures about the Credit Quality of Financing Receivables and the Allowance for Credit Losses.* ASU 2010-20 is intended to provide additional information to assist financial statement users in assessing an entity s credit risk exposures and evaluating the adequacy of its allowance for credit losses. The disclosures as of the end of a reporting period are effective for interim and annual reporting periods ending on or after December 15, 2010. The disclosures about activity that occurs during a reporting period are effective for interim and annual reporting periods beginning on or after December 15, 2010. The amendments in ASU 2010-20 encourage, but do not require, comparative disclosures for earlier reporting periods that ended before initial adoption. However, an entity should provide comparative disclosures for those reporting periods ending after initial adoption. Refer to Note 4.

In April 2011, the FASB issued ASU 2011-02, *Receivables (Topic 310): A Creditor s Determination of Whether a Restructuring Is a Troubled Debt Restructuring*. The amendments in this Update provide additional guidance or clarification to help creditors in determining whether a creditor has granted a concession and whether a debtor is experiencing financial difficulties for purposes of determining whether a restructuring constitutes a troubled debt restructuring. The amendments in this Update are effective for the first interim or annual reporting period beginning on or after June 15, 2011, and should be applied retrospectively to the beginning annual period of adoption. As a result of applying these amendments, an entity may identify receivables that are newly considered impaired. For purposes of measuring impairment of those receivables, an entity should apply the amendments prospectively for the first interim or annual period beginning on or after June 15, 2011. This ASU is not expected to have a significant impact on the Company s financial statements.

In June 2011, the FASB issued ASU 2011-05, *Presentation of Comprehensive Income.* The amendments in this Update improve the comparability, clarity, consistency, and transparency of financial reporting and increase the prominence of items reported in other comprehensive income. To increase the prominence of items reported in other comprehensive income and to facilitate convergence of U.S. GAAP and IFRS, the option to present components of other comprehensive income as part of the statement of changes in stockholders equity was eliminated. The amendments require that all non-owner changes in stockholders equity be presented either in a single continuous statement of comprehensive income or in two separate but consecutive statements. In the two-statement approach, the first statement should present total net income and its components followed consecutively by a second statement that should present total other comprehensive income, the components of other comprehensive income, and the total of comprehensive income. All entities that report items of comprehensive income, in any period presented, will be affected by the changes in this Update. For public entities, the amendments are effective for fiscal years, and interim periods within those years, beginning after December 15, 2011. For nonpublic entities, the amendments are effective for fiscal years ending after December 15, 2012, and interim and annual periods thereafter. The amendments in this Update should be applied retrospectively, and early adoption is permitted. The Company is currently evaluating the impact the adoption of the standard will have on the Company s financial position or results of operations.

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CORTLAND BANCORP AND SUBSIDIARIES

## ITEM 2. MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

(Dollars in thousands, except for per share amounts)

### Available Information

The Company files an annual report on Form 10K, quarterly reports on Form 10Q, current reports on Form 8K and amendments to those reports with the Securities and Exchange Commission (SEC) pursuant to Section 13 (a) or (15) d of the Exchange Act. The Company s Internet address is www.cortland-banks.com. The Company makes available through this address, free of charge, the reports filed, as soon as reasonably practicable after such material is electronically filed, or otherwise furnished to the SEC. The SEC also maintains an Internet site that contains reports, proxy and information statements, and other information regarding issuers that file electronically with the SEC at www.sec.gov.

CORTLAND BANCORP AND SUBSIDIARIES

## ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

(Dollars in thousands, except for per share amounts)

Interest rate risk is measured as the impact of interest rate changes on the Company s net interest income. Components of interest rate risk comprise re-pricing risk, basis risk and yield curve risk. Re-pricing risk arises due to timing differences in the re-pricing of assets and liabilities as interest rate changes occur. Basis risk occurs when re-pricing assets and liabilities reference different key rates. Yield curve risk arises when a shift occurs in the relationship among key rates across the maturity spectrum.

The effective management of interest rate risk seeks to limit the adverse impact of interest rate changes on the Company s net interest margin, providing the Company with the best opportunity for maintaining consistent earnings growth. Toward this end, management uses computer simulation to model the Company s financial performance under varying interest rate scenarios. These scenarios may reflect changes in the level of interest rates, changes in the shape of the yield curve, and changes in interest rate relationships.

The simulation model allows management to test and evaluate alternative responses to a changing interest rate environment. Typically when confronted with a heightened risk of rising interest rates, the Company will evaluate strategies that shorten investment and loan re-pricing intervals and maturities, emphasize the acquisition of floating rate over fixed rate assets, and lengthen the maturities of liability funding sources. When the risk of falling rates is perceived, management will consider strategies that shorten the maturities of funding sources, lengthen the re-pricing intervals and maturities of investments and loans, and emphasize the acquisition of fixed rate assets over floating rate assets. The Company does not currently use financial derivatives, such as interest rate options, swaps, caps, floors or other similar instruments.

Run off rate assumptions for loans are based on the consensus speeds for the various loan types. Investment speeds are based on the characteristics of each individual investment. Re-pricing characteristics are based upon actual information obtained from the Bank s information system data and other related programs. Actual results may differ from simulated results not only due to the timing, magnitude and frequency of interest rate changes, but also due to changes in general economic conditions, changes in customer preferences and behavior, and changes in strategies by both existing and potential competitors.

The table below shows the Company s current estimate of interest rate sensitivity based on the composition of its balance sheet at June 30, 2011 and December 31, 2010. For purposes of this analysis, short-term interest rates as measured by the federal funds rate and the prime lending rate are assumed to increase (decrease) gradually over the next twelve months reaching a level 300 basis points higher (lower) than the rates in effect at June 30, 2011. Under both the rising rate scenario and the falling rate scenario, the yield curve is assumed to exhibit a parallel shift.

During the previous twelve months, the Federal Reserve kept its target rate for overnight federal funds constant. At June 30, 2011, the difference between the yield on the ten-year Treasury and the three-month Treasury had decreased to a positive 315 from the positive 318 basis points that existed at December 31, 2010, indicating that the yield curve had become less steeply upward sloping. At June 30, 2011, rates peaked at the 30-year point on the Treasury yield curve. The yield curve remains positively sloping as interest rates continue to increase with a lengthening of maturities, with rates peaking at the long-end of the Treasury yield curve.

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ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

(Dollars in thousands, except for per share amounts)

The base case against which interest rate sensitivity is measured assumes no change in short-term rates. The base case also assumes no growth in assets and liabilities and no change in asset or liability mix. Under these simulated conditions, the base case projects net interest income of $15,756 for the twelve month period ending June 30, 2012.

| | Net Interest Income | | $ Change | | % Change | |
|---|---|---|---|---|---|---|
| | June 30, 2012 | December 31, 2011 | June 30, 2012 | December 31, 2011 | June 30, 2012 | December 31, 2011 |
| Change in Interest Rates: | | | | | | |
| Graduated increase of +300 basis points | $ 17,525 | $ 16,610 | $ 1,769 | $ 1,477 | 11.23% | 9.80% |
| Short-term rates unchanged (base case) | 15,756 | 15,133 | | | | |
| Graduated decrease of -300 basis points | 13,410 | 12,642 | (2,346) | (2,491) | -14.89% | -16.5% |

The level of interest rate risk indicated is within limits that management considers acceptable. However, given that interest rate movements can be sudden and unanticipated and are increasingly influenced by global events and circumstances beyond the purview of the Federal Reserve, no assurances can be made that interest rate movements will not impact key assumptions and parameters in a manner not presently embodied by the model.

It is management s opinion that hedging instruments currently available are not a cost effective means of controlling interest rate risk for the Company. Accordingly, the Company does not currently use financial derivatives, such as interest rate options, swaps, caps, floors or other similar instruments.

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CORTLAND BANCORP AND SUBSIDIARIES
ITEM 4. CONTROLS AND PROCEDURES
(Dollars in thousands, except for per share amounts)

Evaluation of Disclosure Controls and Procedures. With the supervision and participation of management, including the Company s principal executive officer and chief financial officer, the effectiveness of disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) of 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 chief financial officer has concluded that such disclosure controls and procedures are, to the best of their knowledge, effective as of the end of the period covered by this report to ensure that material information relating to the Company and its consolidated subsidiaries is made known to them, particularly during the period for which our periodic reports, including this report, are being prepared.

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.

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CORTLAND BANCORP AND SUBSIDIARIES

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 from the risk factors previously disclosed in response to Item 1A of Part 1 of Form 10-K filed June 30, 2011.

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

Not applicable

Company s Common Stock.

There were no repurchases of shares of the Company s common stock during the three months ended June 30, 2011.

Item 3. Defaults upon Senior Securities

Not applicable

Item 4. (Removed and Reserved)

Item 5. Other Information

Not applicable

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CORTLAND BANCORP AND SUBSIDIARIES

INDEX TO 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 May 18, 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: | | | | |
| | For the Bancorp | 10-K(1) | 3.2 | 03/16/06 | |
| | For Cortland Savings and Banking | 10-K | 3.2 | 03/15/07 | |
| 4 | The rights of holders of equity securities are defined in portions of the Articles of Incorporation and Code of Regulations as referenced in Exhibits 3.1 and 3.2 | 10-K(1) | 4 | 03/16/06 | |
| *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 | |
| *10.2 | Group Term Carve Out Plan Amended Split Dollar Policy Endorsement entered into by The Cortland Savings and Banking Company on December 15, 2003 with Stephen A. Telego, Sr. | 10-K(1) | 10.2 | 03/16/06 | |
| *10.3 | Amended Director Retirement Agreement between Cortland Bancorp and Jerry A. Carleton, dated as of December 18, 2007 | 10-K | 10.3 | 03/17/08 | |
| *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 | Amended Director Retirement Agreement between Cortland Bancorp and George E. Gessner, dated as of December 18, 2007 | 10-K | 10.5 | 03/17/08 | |
| *10.6 | Amended Director Retirement Agreement between Cortland Bancorp and William A. Hagood, dated as of October 12, 2003 | 10-K(1) | 10.6 | 03/16/06 | |
| *10.7 | Amended Director Retirement Agreement between Cortland Bancorp and James E. Hoffman III, dated as of December 18, | 10-K | 10.7 | 03/17/08 | |

| | | | | |
|---|---|---|---|---|
| | 2007 | | | |
| *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 | Director Retirement Agreement between Cortland Bancorp and K. Ray Mahan, dated as of March 1, 2001 | 10-K(1) | 10.9 | 03/16/06 |
| *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, George E. Gessner, William A. Hagood, James E. Hoffman III, K. Ray Mahan, 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, Gessner, Hoffman, Mahan, Thompson, and Woofter; | 10-K | 10.12 | 03/15/07 |
| | Amended Split Dollar Agreement and Endorsement entered into by Cortland Bancorp as of December 18, 2007, with Director Jerry A. Carleton | 10-K | 10.12 | 03/17/08 |

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CORTLAND BANCORP AND SUBSIDIARIES
INDEX TO EXHIBITS (continued)

| Exhibit No. | Exhibit Description | Incorporated by Reference Form | Exhibit | Filing Date | Filed Herewith |
|---|---|---|---|---|---|
| 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 | |
| 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 | Reserved | | | | |
| *10.17 | Fourth Amended Salary Continuation Agreement between The Cortland Savings and Banking Company and Timothy Carney, dated as of June 1, 2010 | 8-K | 10.17 | 06/02/10 | |
| *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 | Fourth Amended Salary Continuation Agreement between The Cortland Savings and Banking Company and James M. Gasior, dated as of June 1, 2010 | 8-K | 10.19 | 06/02/10 | |
| *10.20 | Second Amended Salary Continuation Agreement between The Cortland Savings and Banking Company and Marlene Lenio, dated as of December 3, 2008 | 8-K | 10.20 | 12/12/08 | |
| *10.20.1 | Amendment of the December 3, 2008 Second Amended Salary Continuation Agreement between The Cortland Savings and Banking Company and Marlene J. Lenio | 10-Q | 10.20.1 | 05/17/10 | |
| *10.21 | Amended Salary Continuation Agreement between The Cortland Savings and Banking Company and Craig Phythyon, dated as of December 3, 2008 | 8-K | 10.21 | 12/12/08 | |
| *10.21.1 | Amendment of the December 3, 2008 Second Amended Salary Continuation Agreement between The Cortland Savings and Banking Company and Craig M. Phythyon | 10-Q | 10.21.1 | 05/17/10 | |
| *10.22 | | 8-K | 10.22 | 12/12/08 | |

| | | | | |
|---|---|---|---|---|
| | Third Amended Salary Continuation Agreement between The Cortland Savings and Banking Company and Stephen A. Telego, Sr., dated as of December 3, 2008 | | | |
| *10.22.1 | Amendment of the December 3, 2008 Third Amended Salary Continuation Agreement between The Cortland Savings and Banking Company and Stephen A. Telego, Sr. | 10-Q | 10.22.1 | 05/17/10 |
| *10.23 | Salary Continuation Agreement between The Cortland Savings and Banking Company and David J. Lucido dated as of June 1, 2010 | 8-K | 10.23 | 06/02/10 |
| *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 June 1, 2010 | 8-K | 10.25 | 06/02/10 |
| *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 |

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CORTLAND BANCORP AND SUBSIDIARIES
INDEX TO EXHIBITS (continued)

| Exhibit No. | Exhibit Description | Incorporated by Reference Form | Exhibit | Filing Date | Filed Herewith |
|---|---|---|---|---|---|
| *10.27 | Second Amended Split Dollar Agreement between The Cortland Savings and Banking Company and Marlene Lenio, dated as of December 3, 2008 | 8-K | 10.27 | 12/12/08 | |
| *10.27.1 | Termination of Split Dollar Agreement and Endorsement between The Cortland Savings and Banking Company and Marlene Lenio | 10-Q | 10.27.1 | 05/17/10 | |
| *10.28.1 | Termination of the Split Dollar Agreement and Endorsement between The Cortland Savings and Banking Company and Craig Phythyon | 10-Q | 10.28.1 | 05/17/10 | |
| *10.29 | Third Amended Split Dollar Agreement and Endorsement between The Cortland Savings and Banking Company and Stephen A. Telego, Sr., dated as of December 3, 2008 | 8-K | 10.29 | 12/12/08 | |
| *10.29.1 | Termination of the Split Dollar Agreement and Endorsement between The Cortland Savings and Banking Company and Stephen A. Telego, Sr. | 10-Q | 10.29.1 | 05/17/10 | |
| 10.30 | Reserved | | | | |
| *10.31 | Severance Agreement entered into by Cortland Bancorp with each of Messrs. Timothy Carney, James M. Gasior and David J. Lucido | 8-K | 10.31 | 12/12/08 | |
| *10.32 | Severance Agreement entered into by Cortland Bancorp and The Cortland Savings and Banking Company in December 3, 2008, with each of Marlene J. Lenio, Craig M. Phythyon and Barbara R. Sandrock | 8-K | 10.32 | 12/12/08 | |
| *10.32.1 | Termination of Severance Agreement entered into by each of Mses. Marlene J. Lenio and Barbara R. Sandrock and Messrs. Craig M. Phythyon and Stephen A. Telego, Sr. | 10-Q | 10.32.1 | 05/17/10 | |
| *10.33 | Agreement and General Release with Lawrence A. Fantauzzi | 8-K | 10.1 | 10/22/09 | |

| | | | | | |
|---|---|---|---|---|---|
| *10.34 | Severance Agreement between Cortland Bancorp and Stanley P. Feret | 8-K | 10.34 | 06/02/10 | |
| 11 | Statement of re-computation of per share earnings | See Note 6 of Financial Statements | | | |
| 15 | Letter re unaudited interim financial statements | N/A | | | |
| 18 | Letter re change in accounting principles | N/A | | | |
| 19 | Reports furnished to security holders | N/A | | | |
| 22 | Published report regarding matters submitted to vote of security holders | N/A | | | |
| 23 | Consents of experts and counsel Consent of Independent Registered Public Accounting firms | N/A | | | |
| 24 | Power of attorney | N/A | | | |
| 31.1 | Certification of the Chief Executive Officer under Rule 13a-14(a) | | | | ü |
| 31.2 | Certification of Chief Financial Officer under Rule 13a-14(a) | | | | ü |
| 32 | Section 1350 Certification of Chief Executive Officer and Chief Financial Officer required under section 906 of the Sarbanes-Oxley Act of 2002 | | | | ü |
| 101 | The following materials from Cortland Bancorp s Quarterly Report on Form 10-Q for the quarter ended June 30, 2011, formatted in Extensible Business Reporting Language (XBRL): (a) Consolidated Balance Sheets; (b) Consolidated Statements of Income; (c) Consolidated Statements of Changes in Shareholders Equity; (d) Consolidated Statements of Cash Flows; and (e) Notes to Consolidated Financial Statements** | | | | |

(1) Film number 06691632

* Management contract or compensatory plan or arrangement

** Pursuant to Rule 406T of Regulation S-T, these interactive date files are deemed not filed or part of a registration statement or prospectus for purposes of Sections 11 or 12 of the Securities Act of 1933 or Section 18 of the Securities Exchange Act of 1934, as amended, and otherwise are not subject to liability under those sections.

Copies of any exhibits will be furnished to shareholders upon written request. Requests should be directed to Tim Carney, Secretary, Cortland Bancorp, 194 West Main Street, Cortland, Ohio 44410.

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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 | Date: August 15, 2011 |
| James M. Gasior<br>President and<br>Chief Executive Officer<br>(Principal Executive Officer) | |
| /s/ David J. Lucido | Date: August 15, 2011 |
| David J. Lucido<br>Senior Vice President and<br>Chief Financial Officer<br>(Principal Financial Officer) | |

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