CORTLAND BANCORP INC
Form 10-Q
November 09, 2007

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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: September 30, 2007

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 is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer o Accelerated filer þ Non-accelerated filer o

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act. (Check One): 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	at November 8, 2007 4,363,171 Shares

PART I FINANCIAL INFORMATION

PART II OTHER INFORMATION

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

	(Unaudited) SEPTEMBER 30, 2007	(Audited) DECEMBER 31, 2006
ASSETS		
Cash and due from banks	**$ 8,338**	$ 10,100
Federal funds sold	**3,450**	4,275
Total cash and cash equivalents	**11,788**	14,375
Investment securities available for sale (Note 3)	**122,352**	108,484
Investment securities held to maturity (approximate market value of $122,127 at September 30, 2007 and $124,136 at December 31, 2006) (Note 3)	**121,813**	124,619
Total loans (Note 4)	**220,637**	205,208
Less allowance for loan losses (Note 4)	**(1,744)**	(2,211)
Net loans	**218,893**	202,997
Premises and equipment	**5,672**	4,780
Other assets	**18,171**	16,496
Total assets	**$ 498,689**	$ 471,751
LIABILITIES		
Noninterest-bearing deposits	**$ 55,436**	$ 60,983
Interest-bearing deposits	**317,110**	294,835
Total deposits	**372,546**	355,818
Federal Home Loan Bank advances and other borrowings	**68,893**	62,015
Subordinated debt	**5,155**	
Other liabilities	**3,367**	3,326
Total liabilities	**449,961**	421,159
SHAREHOLDERS EQUITY		
Common stock $5.00 stated value authorized 20,000,000 shares; issued 4,594,344 shares in both 2007 and 2006 (Note 1)	**22,972**	22,972
Additional paid-in capital (Note 1)	**20,631**	20,835
Retained earnings	**9,849**	9,553
Accumulated other comprehensive income (loss) (Note 1)	**(619)**	(455)

Treasury shares at cost, 208,455 at September 30, 2007 and 95,809 at December 31, 2006		**(4,105)**		(2,313)
Total shareholders equity		**48,728**		50,592
Total liabilities and shareholders equity	**$**	**498,689**	$	471,751

See accompanying notes to 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 SEPTEMBER 30,		NINE MONTHS ENDED SEPTEMBER 30,	
	2007	2006	**2007**	2006
INTEREST INCOME				
Interest and fees on loans	**$ 3,976**	$ 3,780	**$ 11,677**	$ 10,538
Interest and dividends on investment securities:				
Taxable interest income	**1,729**	1,507	**4,985**	4,374
Nontaxable interest income	**446**	506	**1,385**	1,555
Dividends	**55**	47	**169**	145
Interest on mortgage-backed securities	**1,071**	927	**2,956**	2,913
Other interest income	**67**	29	**353**	83
Total interest income	**7,344**	6,796	**21,525**	19,608
INTEREST EXPENSE				
Deposits	**2,764**	2,174	**7,804**	6,135
Borrowed funds	**826**	806	**2,497**	2,281
Subordinated debt	**61**		**61**	
Total interest expense	**3,651**	2,980	**10,362**	8,416
Net interest income	**3,693**	3,816	**11,163**	11,192
Provision for loan losses		45		175
NET INTEREST INCOME AFTER PROVISION FOR LOAN LOSSES	**3,693**	3,771	**11,163**	11,017
OTHER INCOME				
Fees for other customer services	**581**	587	**1,697**	1,655
Investment securities gains net	**5**		**37**	18
Gain on sale of loans net	**35**	13	**78**	69
Loss on sale of other real estate owned net		(7)	**(1)**	(35)
Earnings on bank owned life insurance	**130**	97	**388**	291
Other non-interest income	**38**	19	**79**	65
Total other income	**789**	709	**2,278**	2,063
OTHER EXPENSES				
Salaries and employee benefits	**1,803**	1,715	**5,435**	5,084
Net occupancy and equipment expense	**473**	444	**1,399**	1,350

State and local taxes	**146**	139	**439**	417
Bank exam and audit expense	**112**	115	**308**	365
Office supplies	**110**	100	**295**	274
Other operating expenses	**488**	528	**1,525**	1,569
Total other expenses	**3,132**	3,041	**9,401**	9,059
INCOME BEFORE FEDERAL INCOME TAXES	**1,350**	1,439	**4,040**	4,021
Federal income taxes	**275**	296	**806**	627
NET INCOME	**$ 1,075**	$ 1,143	**$ 3,234**	$ 3,394
BASIC EARNINGS PER COMMON SHARE (NOTE 6)	**$ 0.24**	$ 0.26	**$ 0.72**	$ 0.76
DILUTED EARNINGS PER COMMON SHARE (NOTE 6)	**$ 0.24**	$ 0.26	**$ 0.72**	$ 0.76
CASH DIVIDENDS DECLARED PER SHARE	**$ 0.22**	$ 0.22	**$ 0.66**	$ 0.65

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

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CORTLAND BANCORP AND SUBSIDIARIES
CONSOLIDATED STATEMENT OF SHAREHOLDERS EQUITY (UNAUDITED)
(Amounts in thousands)

	COMMON STOCK	ADDITIONAL PAID-IN CAPITAL	RETAINED EARNINGS	ACCUMULATED OTHER COMPREHENSIVE INCOME	TREASURY STOCK	TOTAL SHARE-HOLDERS EQUITY
NINE MONTHS ENDED SEPTEMBER 30 2006:						
BALANCE AT JANUARY 1, 2006	$ 22,523	$ 20,211	$ 10,310	$ (877)	$ (3,842)	$ 48,325
Comprehensive income:						
Net income			3,394			3,394
Other comprehensive income, net of tax:						
Unrealized gains or (losses) on available-for-sale securities, net of reclassification adjustment				266		266
Total comprehensive income						3,660
Common stock transactions:						
Treasury shares reissued		(278)			1,188	910
Cash dividends declared			(2,894)			(2,894)
BALANCE AT SEPTEMBER 30, 2006	$ 22,523	$ 19,933	$ 10,810	$ (611)	$ (2,654)	$ 50,001
NINE MONTHS ENDED SEPTEMBER 30, 2007						
BALANCE AT JANUARY 1, 2007	**$ 22,972**	**$ 20,835**	**$ 9,553**	**$ (455)**	**$ (2,313)**	**$ 50,592**
Comprehensive income:						
Net income			**3,234**			**3,234**
Other comprehensive income, net of tax:						

Unrealized gains or (losses) on available-for-sale securities, net of reclassification adjustment				**(164)**		**(164)**
Total comprehensive income						**3,070**
Common stock transactions:						
Treasury shares reissued		**(204)**			**913**	**709**
Treasury shares purchased					**(2,705)**	**(2,705)**
Cash dividends declared			**(2,938)**			**(2,938)**
BALANCE AT SEPTEMBER 30, 2007	**$ 22,972**	**$ 20,631**	**$ 9,849**	**$ (619)**	**$ (4,105)**	**$ 48,728**

	SEPTEMBER 30,	
	2007	2006
DISCLOSURE OF RECLASSIFICATION FOR AVAILABLE FOR SALE SECURITY GAINS AND LOSSES:		
Net unrealized holding gains or (losses) on available-for-sale securities arising during the period, net of tax	**$ (139)**	$ 278
Less: Reclassification adjustment for net gains realized in net income, net of tax	**25**	12
Net unrealized gains (losses) on available- for-sale securities, net of tax	**$ (164)**	$ 266

See accompanying notes to 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 NINE MONTHS ENDED SEPTEMBER 30,	
	2007	2006
NET CASH FLOWS FROM OPERATING ACTIVITIES	**$ 2,600**	$ 2,595
CASH FLOWS FROM INVESTING ACTIVITIES		
Purchases of securities held to maturity	**(13,502)**	(8,385)
Purchases of securities available for sale	**(28,765)**	(6,332)
Proceeds from sales of securities available for sale		1,006
Proceeds from call, maturity and principal payments on securities	**30,815**	17,577
Net increase in loans made to customers	**(16,288)**	(10,424)
Proceeds from disposition of other real estate	**34**	135
Purchase of premises and equipment	**(1,308)**	(686)
Net cash flows from investing activities	**(29,014)**	(7,109)
CASH FLOWS FROM FINANCING ACTIVITIES		
Net increase (decrease) in deposit accounts	**16,728**	3,265
Net (decrease) increase in borrowings	**6,878**	1,814
Proceeds from subordinated debt issuance	**5,155**	
Dividends paid	**(2,938)**	(2,894)
Treasury shares purchased	**(2,705)**	
Treasury shares reissued	**709**	910
Net cash flows from financing activities	**23,827**	3,095
NET CHANGE IN CASH AND CASH EQUIVALENTS	**(2,587)**	(1,419)
CASH AND CASH EQUIVALENTS		
Beginning of period	**14,375**	19,237
End of period	**$ 11,788**	$ 17,818
SUPPLEMENTAL DISCLOSURES		
Interest paid	**$ 10,238**	$ 8,285
Income taxes paid	**$ 750**	$ 870

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

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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 generally accepted accounting principles 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 nine months ended September 30, 2007 are not necessarily indicative of the results that may be expected for the year ending December 31, 2007. These interim unaudited consolidated financial statements should be read in conjunction with our annual audited financial statements as of December 31, 2006, included in our Form 10-K for the year ended December 31, 2006, filed with the United States Securities and Exchange Commission. The accompanying consolidated balance sheet at December 31, 2006, 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 2006 financial statements have been reclassified to conform to the presentation for 2007. Such reclassifications had no effect on the net results of operations.

3.) Investment Securities:

Securities classified as held to maturity are those that management has the positive intent and ability to hold to maturity. Securities held to maturity are stated at cost, adjusted for amortization of premiums and accretion of discounts, with such amortization or accretion included in interest income.

Securities classified as available for sale are those that could be sold for liquidity, investment management, or similar reasons even though management has no present intentions to do so. Securities available for sale are carried at fair value using the specific identification method. Changes in the unrealized gains and losses on available for sale securities are recorded net of tax effect as a component of comprehensive income.

Trading securities are principally held with the intention of selling in the near term. Trading securities are carried at fair value with changes in fair value reported in the Consolidated Statements of Income.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

(Dollars in thousands, except for per share amounts)

Realized gains or losses on dispositions are based on net proceeds and the adjusted carrying amount of securities sold, using the specific identification method. The table below sets forth the proceeds, gains and losses realized on securities sold or called for the period ended:

	THREE MONTHS September 30,		NINE MONTHS September 30,	
	2007	2006	2007	2006
Proceeds on securities sold	$None	$None	$None	$1,006
Gross realized gains	None	None	None	6
Gross realized losses	None	None	None	None
Proceeds on securities called	$170	$None	$3,001	$ 480
Gross realized gains	5	None	37	12
Gross realized losses	None	None	None	None

Securities available for sale, carried at fair value, totaled $122,352 at September 30, 2007 and $108,484 at December 31, 2006 representing 50.1% and 46.5%, respectively, of all investment securities. These levels provide an adequate level of liquidity in management s opinion.

Investment securities with a carrying value of approximately $94,074 at September 30, 2007 and $75,489 at December 31, 2006 were pledged to secure deposits and for other purposes.

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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 estimated market value of debt securities at September 30, 2007, by contractual maturity, are shown below. Expected maturities may differ from contractual maturities because borrowers have the right to call or prepay certain obligations with or without call or prepayment penalties.

Investment securities available for sale	AMORTIZED COST	ESTIMATED FAIR VALUE
Due in one year or less	$ 2,505	$ 2,502
Due after one year through five years	6,043	6,046
Due after five years through ten years	4,342	4,185
Due after ten years	40,407	40,257
	53,297	52,990
Mortgage-backed securities	66,412	65,781
	$ 119,709	$ 118,771

Investment securities held to maturity	AMORTIZED COST	ESTIMATED FAIR VALUE
Due in one year or less	$ 1,525	$ 1,538
Due after one year through five years	5,432	5,444
Due after five years through ten years	36,270	36,286
Due after ten years	61,286	61,820
	104,513	105,088
Mortgage-backed securities	17,300	17,039
	$ 121,813	$ 122,127

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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 estimated fair value of investment securities available for sale and investment securities held to maturity as of September 30, 2007, are as follows:

Investment securities available for sale	AMORTIZED COST	GROSS UNREALIZED GAINS	GROSS UNREALIZED LOSSES	ESTIMATED FAIR VALUE
U.S. Government agencies and corporations	$ 13,420	$ 146	$ 28	$ 13,538
Obligations of states and political subdivisions	8,839	277	3	9,113
Mortgage-backed and related securities	66,412	260	891	65,781
Corporate securities	31,038	6	705	30,339
Total debt securities	119,709	689	1,627	118,771
Other securities	3,581			3,581
Total available for sale	$ 123,290	$ 689	$ 1,627	$ 122,352

Investment securities held to maturity	AMORTIZED COST	GROSS UNREALIZED GAINS	GROSS UNREALIZED LOSSES	ESTIMATED FAIR VALUE
U.S. Treasury Securities	$ 140	$ 2	$	$ 142
U.S. Government agencies and corporations	76,172	85	305	75,952
Obligations of states and political subdivisions	28,201	812	19	28,994
Mortgage-backed and related securities	17,300	20	281	17,039
Total held to maturity	$ 121,813	$ 919	$ 605	$ 122,127

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

The following provides a summary of the amortized cost and estimated fair value of investment securities available for sale and investment securities held to maturity as of December 31, 2006:

Investment securities available for sale	AMORTIZED COST	GROSS UNREALIZED GAINS	GROSS UNREALIZED LOSSES	ESTIMATED FAIR VALUE
U.S. Government agencies and corporations	$ 12,919	$ 13	$ 136	$ 12,796
Obligations of states and political subdivisions	9,451	348	1	9,798
Mortgage-backed and related securities	55,062	192	1,057	54,197
Corporate securities	28,160	101	149	28,112
Total debt securities	105,592	654	1,343	104,903
Other securities	3,581			3,581
Total available for sale	$ 109,173	$ 654	$ 1,343	$ 108,484

Investment securities held to maturity	AMORTIZED COST	GROSS UNREALIZED GAINS	GROSS UNREALIZED LOSSES	ESTIMATED FAIR VALUE
U.S. Treasury Securities	$ 143	$	$	$ 143
U.S. Government agencies and corporations	73,743		1,239	72,504
Obligations of states and political subdivisions	31,009	1,067	13	32,063
Mortgage-backed and related securities	19,724		298	19,426
Total held to maturity	$ 124,619	$ 1,067	$ 1,550	$ 124,136

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CORTLAND BANCORP AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

(Dollars in thousands, except for per share amounts)

4.) Concentration of Credit Risk and Off Balance Sheet Risk:

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 that might give rise to off-balance sheet liabilities.

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 balance sheet. 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.

	CONTRACT OR NOTIONAL AMOUNT	
	September 30, 2007	December 31, 2006
Financial instruments whose contract amount represents credit risk:		
Commitments to extend credit:		
Fixed rate	$ 2,987	$ 3,102
Variable	34,930	44,422
Standby letters of credit	1,445	1,810

Standby letters of credit are conditional commitments issued by the Company s subsidiary bank to guarantee the performance of a customer to a third party. 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. Since many of these commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements.

The Company s subsidiary bank also offers limited overdraft protection as a non-contractual courtesy which is available to demand deposit accounts owned accounts in good standing for business, 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 not included in the table above at September 30, 2007 totaled $11,659 and $9,827 at December 31, 2006. The total average daily balance of overdrafts used in 2007 was $148 and $151 in 2006, or approximately 1.3% of the total aggregate overdraft protection available to depositors at September 30, 2007 and 1.5% at December 31, 2006.

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CORTLAND BANCORP AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

(Dollars in thousands, except for per share amounts)

The Company, through its subsidiary bank, grants residential, consumer and commercial loans, and also offers a variety of saving plans to customers located primarily in Northeast Ohio and Western Pennsylvania. The following represents the composition of the loan portfolio:

	September 30, 2007	December 31, 2006
1-4 family residential mortgages	31.0%	30.7%
Commercial mortgages	53.1%	51.7%
Consumer loans	4.1%	3.8%
Commercial loans	6.7%	8.5%
Home equity loans	5.1%	5.3%

There are no mortgage loans held for sale included in 1-4 family residential mortgages as of September 30, 2007, and $109 at December 31, 2006. These loans are carried, in the aggregate, at the lower of cost or estimated market value based on secondary market prices.

The following table sets forth the aggregate balance of underperforming loans for each of the following categories at September 30, 2007 and December 31, 2006:

	September 30, 2007	December 31, 2006
Loans accounted for on a non-accrual basis	$ 2,818	$ 3,923
Loans contractually past due 90 days or more as to interest or principal payments (not included in non-accrual loans above)	NONE	NONE
Loans considered troubled debt restructurings (not included in non-accrual loans or loans contractually past due above)	104	NONE

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

The following shows the amounts of contractual interest income and interest income actually reflected in income on loans accounted for on a non-accrual basis and loans considered troubled debt restructuring for the nine months ended September 30, 2007 and 2006.

	September 30, 2007	September 30, 2006
Gross interest income that would have been recorded if the loans had been current in accordance with their original terms (contractual interest income)	$ 204	$ 304
Interest income actually included in income on the loans	35	36

A loan is placed on a non-accrual basis whenever sufficient information is received to question the collectibility of the loan or any time legal proceedings are initiated involving a loan. When a loan is placed on non-accrual status, any interest that has been accrued and not collected on the loan is charged against earnings. Cash payments received while a loan is classified as non-accrual are recorded as a reduction to principal or reported as interest income according to management s judgment as to collectibility of principal.

A loan is returned to accrual status when either, all of the principal and interest amounts contractually due are brought current and future payments are, in management s opinion, collectible, or when it otherwise becomes well secured and in the process of collection. When a loan is charged-off, any interest accrued but not collected on the loan is charged against earnings.

Impaired loans are generally included in non-accrual loans. Management does not individually evaluate certain smaller balance loans for impairment as such loans are evaluated on an aggregate basis. These loans include 1 4 family, consumer and home equity loans. Impaired loans were evaluated using the fair value of collateral as the measurement method. At September 30, 2007, the recorded investment in impaired loans was $1,996 while the related portion of the allowance for loan losses was $818. At December 31, 2006, there were $1,939 in loans considered impaired while the allocated portion of the allowance for loan losses for such loans was $815.

Loans in the amount of $14,685 as of September 30, 2007, and $13,765 as of December 31, 2006 were not included in any of the above categories and were not currently considered impaired, but which can be considered to be potential problem loans.

Any loans classified for regulatory purposes as loss, doubtful, substandard, or special mention that have not been disclosed above do not (i) represent or result from trends or uncertainties which management reasonably expects will materially impact future operating results, liquidity, or capital resources, or (ii) represent material credits about which management is aware of any information which causes management to have serious doubts as to the ability of such borrowers to comply with the loan repayment terms.

CORTLAND BANCORP AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

(Dollars in thousands, except for per share amounts)

The following is an analysis of the allowance for loan losses for the periods ended September 30, 2007 and September 30, 2006:

	THREE MONTHS		NINE MONTHS	
	2007	2006	2007	2006
Balance at beginning of period	$ 2,041	$ 2,180	$ 2,211	$ 2,168
Loan charge-offs:				
1-4 family residential mortgages	31		45	5
Commercial mortgages	209		324	20
Consumer loans and other loans	81	58	168	157
Commercial loans		2		39
Home equity loans				
	321	60	537	221
Recoveries on previous loan losses				
1 - 4 family residential mortgages				
Commercial mortgages	1		2	
Consumer loans and other loans	23	42	67	81
Commercial loans		2	1	6
Home equity loans				
	24	44	70	87
Net charge-offs	(297)	(16)	(467)	(134)
Provision charged to operations		45		175
Balance at end of period	$ 1,744	$ 2,209	$ 1,744	$ 2,209
Ratio of annualized net charge-offs to average loans outstanding	0.54%	0.03%	0.29%	0.09%

Charge-offs in 2007 include three impaired commercial mortgage loans in the amount of $307 for which a specific loss reserve for the total amount had previously been established.

For each of the periods presented above, the provision for loan losses charged to operations is based on management s judgment after taking into consideration all known factors connected with the collectibility of the existing portfolio. Management evaluates the portfolio in light of economic conditions, changes in the nature and volume of the portfolio, industry standards and other relevant factors. Specific factors considered by management in determining the amounts charged to operations include previous loan loss experience; the status of past due interest and principal payments; the quality of financial information supplied by customers; the cash flow coverage and trends evidenced by financial information supplied by customers; the nature and estimated value of any collateral supporting specific loan credits; risk classifications determined by the Company s loan review systems or as the result of the regulatory examination process; and general economic conditions in the lending area of the Company s bank subsidiary. Key risk factors and assumptions are systematically updated to reflect actual experience and changing circumstances.

The Company maintains an allowance for losses on unfunded commercial lending commitments to provide for the risk of loss inherent in these arrangements. The allowance is computed using a methodology similar to that used to determine the allowance for loan losses. This allowance is reported as a liability on the balance sheet within accrued expenses and other liabilities, while the corresponding provision for these losses is recorded as a component of other expense.

Certain asset-specific loans are evaluated individually for impairment, based on management s best estimate of discounted cash repayments and the anticipated proceeds from liquidating collateral. The actual timing and amount of repayments and the ultimate realizable value of the collateral may differ from management s estimates.

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

The expected loss for certain other commercial credits utilizes internal risk ratings. These loss estimates are sensitive to changes in the customer s risk profile, the realizable value of collateral, other risk factors and the related loss experience of other credits of similar risk. Consumer credits generally employ statistical loss factors, adjusted for other risk indicators, applied to pools of similar loans stratified by asset type. These loss estimates are sensitive to changes in delinquency status and shifts in the aggregate risk profile.

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.

	THREE MONTHS ENDED September 30,		NINE MONTHS ENDED September 30,	
	2007	2006	2007	2006
Net Income	$ 1,075	$ 1,143	$ 3,234	$ 3,394
Weighted average common shares outstanding*	4,426,720	4,484,450	4,476,659	4,471,425
Basic earnings per share*	$ 0.24	$ 0.26	$ 0.72	$ 0.76
Diluted earnings per share*	$ 0.24	$ 0.26	$ 0.72	$ 0.76
Dividends declared per share*	$ 0.22	$ 0.22	$ 0.66	$ 0.65

* Average shares outstanding and the resulting per share amounts have been restated to give retroactive effect to the 2% stock dividend of January 1, 2007

7.) Stock Repurchase Program

On February 27, 2007, the Company s Board of Directors approved a Stock Repurchase Program which permitted the Company to repurchase up to 100,000 shares of its outstanding common shares in the over-the-counter market or in privately negotiated transactions in accordance with applicable regulations of the Securities and Exchange Commission. Based on the value of the Company s stock on February 27, 2007, the commitment to repurchase the stock over the program was approximately $1,715. Subsequently, on August 14, 2007, the Company s Board of Directors authorized the repurchase of up to an additional 100,000 shares of its outstanding common shares in over-the-counter market or in privately negotiated transactions. Based on the value of the Company s stock on August 14, 2007, the commitment to repurchase these additional shares over the program was approximately $1,635. The repurchase program will terminate on February 28, 2009 or upon the purchase of 200,000 shares, if earlier.

Repurchased shares are designated as treasury shares, available for general corporate purposes, including possible use in connection with the Company s dividend reinvestment program, employee benefit plans, acquisitions or other distributions. Under the program the Company has repurchased 152,143 shares. The Company has also reissued 39,497 shares to existing shareholders through its dividend reinvestment program during 2007, net of repurchased fractional shares.

CORTLAND BANCORP AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

(Dollars in thousands, except for per share amounts)

8.) 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 securities bear interest at the 3-month LIBOR rate plus 1.45%. 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 Interpretation NO.46, as revised in December 2003, 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.

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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								
	September 30, 2007			December 31, 2006			September 30, 2006		
	Average Balance (1)	**Interest**	**Average Rate**	Average Balance (1)	Interest	Average Rate	Average Balance (1)	Interest	Average Rate
ASSETS									
Federal funds sold and earning assets	**$ 8,971**	**$ 353**	**5.3%**	$ 4,228	$ 215	5.1%	$ 2,306	$ 83	4.8%
Investment securities (1) (2)	**237,659**	**10,123**	**5.7%**	234,969	12,935	5.5%	236,304	9,705	5.5%
Loans (2) (3)	**213,234**	**11,731**	**7.3%**	195,838	14,381	7.4%	193,522	10,607	7.3%
Total interest-earning assets	**459,864**	**$ 22,207**	**6.4%**	435,035	$ 27,531	6.3%	432,132	$ 20,395	6.3%
Cash and due from banks	**8,278**			8,733			8,872		
Bank premises and equipment	**5,159**			4,226			4,154		
Other assets	**13,950**			12,365			12,070		
Total non-interest-earning assets	**27,387**			25,324			25,096		
Total Assets	**$ 487,251**			$ 460,359			$ 457,228		
LIABILITIES AND SHAREHOLDERS EQUITY									
Interest-bearing demand deposits	**$ 46,175**	**$ 653**	**1.9%**	$ 47,415	$ 752	1.6%	$ 47,121	$ 527	1.5%
Savings	**78,996**	**602**	**1.0%**	82,845	850	1.0%	83,735	643	1.0%
Time	**184,395**	**6,549**	**4.7%**	161,050	6,907	4.3%	158,296	4,965	4.2%
Total interest-bearing deposits	**309,566**	**7,804**	**3.4%**	291,310	8,509	2.9%	289,152	6,135	2.8%
Federal funds purchased	**9**			478	25	5.3%	640	25	5.2%
Other borrowings	**64,552**	**2,497**	**5.2%**	58,773	3,048	5.2%	58,427	2,256	5.1%
Subordinated Debt	**1,171**	**61**	**6.9%**						
Total interest-bearing liabilities	**375,298**	**$ 10,362**	**3.7%**	350,561	$ 11,582	3.3%	348,219	$ 8,416	3.2%
Demand deposits	**57,658**			57,271			56,985		
Other liabilities	**3,842**			3,214			3,083		
Shareholders equity	**50,453**			49,313			48,941		
	$ 487,251			$ 460,359			$ 457,228		

Total liabilities and Shareholders equity			
Net interest income	**$ 11,845**	$ 15,949	$ 11,979
Net interest rate spread (4)	**2.7%**	3.0%	3.2%
Net interest margin (5)	**3.4%**	3.7%	3.7%
Ratio of interest-earning assets to interest-bearing liabilities	**1.23**	1.24	1.24

(1) Includes both taxable and tax exempt securities

(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 investment is $54 and $628 for 2007, $90 and $944 for December 31, 2006, and $69 and $718 for September 2006.

(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 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								
	September 30, 2007			June 30, 2007			September 30, 2006		
	Average Balance (1)	**Interest**	**Average Rate**	Average Balance (1)	Interest	Average Rate	Average Balance (1)	Interest	Average Rate
ASSETS									
Federal funds sold and other earning assets	**$ 5,141**	**$ 67**	**5.2%**	$ 13,042	$ 172	5.3%	$ 2,058	$ 29	5.3%
Investment securities (1) (2)	**242,352**	**3,503**	**5.8%**	239,114	3,367	5.6%	233,177	3,218	5.5%
Loans (2) (3)	**218,102**	**3,993**	**7.3%**	212,630	3,935	7.3%	199,105	3,800	7.4%
Total interest-earning assets	**465,595**	**$ 7,563**	**6.5%**	464,786	$ 7,474	6.4%	434,340	$ 7,047	6.5%
Cash and due from banks	**7,940**			8,457			8,678		
Bank premises and equipment	**5,381**			5,194			4,201		
Other assets	**14,160**			14,128			12,339		
Total non-interest-earning assets	**27,481**			27,779			25,218		
Total Assets	**$ 493,076**			$ 492,565			$ 459,558		
LIABILITIES AND SHAREHOLDERS EQUITY									
Interest-bearing demand deposits	**$ 48,277**	**$ 258**	**2.1%**	$ 45,843	$ 206	1.8%	$ 46,971	$ 182	1.5%
Savings	**77,330**	**200**	**1.0%**	79,444	201	1.0%	81,850	212	1.0%
Time	**190,345**	**2,306**	**4.8%**	189,221	2,251	4.8%	161,001	1,780	4.4%
Total interest-bearing deposits	**315,952**	**2,764**	**3.5%**	314,508	2,658	3.4%	289,822	2,174	3.0%
Federal funds purchased	**27**						438	6	5.2%
Other borrowings	**63,190**	**826**	**5.2%**	64,941	837	5.2%	60,252	800	5.3%
Subordinated Debt	**3,474**	**61**	**6.9%**						
Total interest-bearing liabilities	**382,643**	**$ 3,651**	**3.8%**	379,449	$ 3,495	3.7%	350,512	$ 2,980	3.4%
Demand deposits	**57,261**			57,156			56,513		
Other liabilities	**3,765**			4,138			3,135		
Shareholders equity	**49,407**			51,822			49,398		

Total liabilities and Shareholders equity	**$ 493,076**	$ 492,565	$ 459,558
Net interest income	**$ 3,912**	$ 3,979	$ 4,067
Net interest rate spread (4)	**2.7%**	2.7%	3.1%
Net interest margin (5)	**3.4%**	3.4%	3.7%
Ratio of interest-earning assets to interest-bearing liabilities	**1.22**	1.22	1.24

(1) Includes both taxable and tax exempt securities

(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 investment is $16 and $202 for September 30, 2007, $19 and $204 for June 30, 2007 and $20 and $231 for September 30, 2006

(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 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)

	September 30, 2007	June 30, 2007	March 31, 2007	December 31, 2006	September 30, 2006
SUMMARY OF OPERATIONS					
Total interest income	**$ 7,344**	$ 7,251	$ 6,930	$ 6,889	$ 6,796
Total interest expense	**3,651**	3,495	3,216	3,166	2,980
NET INTEREST INCOME (NII)	**3,693**	3,756	3,714	3,723	3,816
Provision for loan losses				50	45
NII after loss provision	**3,693**	3,756	3,714	3,673	3,771
Security gains (losses)	**5**	20	12		
Gain on sale of loans	**35**	27	16	37	13
Total other income (including security and loan gains)	**789**	765	724	772	709
Total other expense	**3,132**	3,206	3,063	2,962	3,041
Income before tax	**1,350**	1,315	1,375	1,483	1,439
Net income	**$ 1,075**	$ 1,057	$ 1,102	$ 1,182	$ 1,143
Core earnings (1)	**$ 1,049**	$ 1,028	$ 1,086	$ 1,166	$ 1,139
Net income (Rolling 4 Quarters) (2)	**$ 4,416**	$ 4,484	$ 4,503	$ 4,576	$ 4,487
Core earnings (Rolling 4 Quarters)	**$ 4,329**	$ 4,419	$ 4,448	$ 4,383	$ 4,292
PER COMMON SHARE DATA (3)					
Net income, both basic and diluted	**$ 0.24**	$ 0.24	$ 0.24	$ 0.26	$ 0.26
Net income, both basic and diluted (Rolling 4 Quarters)	**0.99**	1.00	1.00	1.02	1.01
Core income, both basic and diluted	**0.24**	0.23	0.24	0.26	0.25
Core income, both basic and diluted (Rolling 4 Quarters)	**0.97**	0.98	0.99	0.98	0.96
Cash dividends declared	**0.22**	0.22	0.22	0.22	0.21
Cash dividends declared (Rolling 4 Quarters)	**0.88**	0.87	0.86	0.85	1.05
Book value	**11.11**	11.09	11.33	11.25	11.15
BALANCE SHEET DATA					
Assets	**$498,689**	$485,636	$480,854	$471,751	$466,633
Investments	**244,165**	240,271	231,234	233,103	230,819
Net loans	**218,893**	213,624	207,019	202,997	196,555
Deposits	**372,546**	371,809	359,478	355,818	353,640
Borrowings	**68,893**	61,188	66,815	62,015	59,925
Subordinated Debt (See Note 8 - Subordinated Debt)	**5,155**				
Shareholders equity	**48,728**	49,259	51,116	50,592	50,001

AVERAGE BALANCES					
Assets	**$493,076**	$492,565	$475,780	$469,753	$459,558
Investments	**242,352**	239,114	231,391	231,009	233,177
Net loans	**216,233**	210,568	206,736	200,502	196,915
Deposits	**373,213**	371,664	355,788	355,836	346,335
Borrowings	**63,190**	64,941	65,550	59,795	60,690
Subordinated Debt	**3,474**				
Shareholders equity	**49,407**	51,822	50,969	50,518	49,398
ASSET QUALITY RATIOS					
Underperforming assets as a percentage of:					
Total assets	**0.64%**	0.62%	0.71%	0.84%	0.83%
Equity plus allowance for loan losses	**6.35**	5.89	6.45	7.50	7.44
Tier I capital	**5.91**	6.04	6.69	7.77	7.70
FINANCIAL RATIOS					
Return on average equity	**8.70%**	8.16%	8.65%	9.36%	9.26%
Return on average equity (Rolling 4 Quarters)	**8.71**	8.85	9.02	9.26	9.15
Return on average assets	**0.87**	0.86	0.93	1.01	0.99
Return on average assets (Rolling 4 Quarters)	**0.91**	0.95	0.97	0.99	0.98
Effective tax rate (4)	**20.37**	19.62	19.85	20.29	20.56
Net interest margin ratio	**3.38**	3.38	3.51	3.55	3.69

(1) Core earnings are earnings before gains on loans sold, investment securities sold or called, trading security gains, other real estate losses and certain other non recurring items.

(2) Rolling 4 quarters is calculated by using the current quarter plus the preceding 3 quarters.

(3) Basic and diluted earnings per share are based on

weighted average shares outstanding adjusted retroactively for stock dividends.

Cash dividends per common share are based on actual cash dividends declared, adjusted retroactively for the stock dividends.

Book value per common share is based on shares outstanding at each period , adjusted retroactively for the stock dividends.

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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 included elsewhere in this 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 Quarterly Report on Form 10-Q 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 herein, the forward-looking statements that involve risks and uncertainties. The words believes, expects, may, will, should, projects, contemplates, anticipates, forecasts, intends, or similar terminology identify forward-looking statement 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; 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; 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.

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 quarterly and year-to-date financial results of operations.

Critical Accounting Policies and Estimates

The Company s consolidated financial statements are prepared in accordance with accounting principles generally accepted in the United States and follow general practices within the industries in which it operates. The most significant accounting policies followed by the Company are presented in Notes to Consolidated Financial Statements Summary of Significant Accounting Policies in the 2006 annual report on Form 10-K. Application of these principles requires management to make estimates, assumptions and judgments that affect the amounts reported in the financial statements and accompanying notes. Some of these policies and related methodologies are more critical than others. There has been no material change in critical accounting estimates since those presented in the 2006 annual report on Form 10-K.

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CORTLAND BANCORP AND SUBSIDIARIES

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

(Dollars in thousands, except for per share amounts)

The Company has identified its policy on the allowance for loan losses as being critical because it requires management to make particularly difficult, subjective and/or complex judgments about matters that are inherently uncertain, and because of the likelihood that materially different amounts would be reported under different conditions or by using different assumptions. In determining the appropriate amount to reserve for potential credit losses, the Company s banking subsidiary also considers unfunded commitments, such as loan commitments, letter of credit and unused lines of credit.

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.

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.

Along with its liquid assets, the Company 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, borrowings from the Federal Home Loan Bank of Cincinnati and access to the Federal Reserve Discount Window.

Cash and cash equivalents decreased by $6,030 from September 30, 2006 and by $2,587 from levels measured at year-end. The decrease is mainly attributable to a decrease in federal funds sold. Operating activities provided cash of $2,600 and $2,595 during the nine months ended September 30, 2007 and 2006, respectively. Key differences stem mainly from: 1) a decrease in net income of $160 compared to September 30, 2006; 2) loans held for sale decreased by $109 at September 30, 2007 as compared to an increase of $416 at September 30, 2006; 3) gains on the sale of investments was $37 at September 30, 2007 where there was $18 at September 30, 2006; 4) amortization on securities was $179 in 2007 compared to $388 in 2006; 5) provision for loan loss was $175 at September 30, 2006 compared to none at September 30, 2007; and 6) other real estate losses of $35 was recorded at September 30, 2006 and only $1 at September 30,2007. Refer to the Consolidated Statements of Cash Flows for a summary of the sources and uses of cash for September 30, 2007 and 2006, and the following table which details the cash flows from operating activities.

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

	Nine Months Ended September 30, 2007	2006
Net Income	$ 3,234	$ 3,394
Adjustments to reconcile net income to net cash flows from operating activities:		
Depreciation, amortization and accretion	591	746
Provision for loan loss		175
Investment securities gains	(37)	(18)
Other real estate losses	1	35
Impact of loans held for sale	109	(416)
Changes in other assets and liabilities	(1,298)	(1,321)
Net cash flows from operating activities	$ 2,600	$ 2,595

Capital Resources

The capital management function is a continuous process which consists of providing capital for both the current financial position and the anticipated future growth of the Company. Central to this process is internal equity generation, particularly through earnings retention. Internal capital generation is measured as the annualized rate of return on equity, exclusive of any appreciation or depreciation relating to available for sale securities, multiplied by the percentage of earnings retained. Internally generated capital retained by the Company measured 0.8% for the nine months ended September 30, 2007 and 1.3% for the nine months ended September 30, 2006. Overall capital (a figure which reflects earnings, dividends paid, common stock issued, treasury shares purchased, treasury shares reissued and the net change in the estimated fair value of available for sale securities) decreased at an annual rate of 4.9%. Capital ratios remained well in excess of regulatory minimums.

Risk-based standards for measuring capital adequacy require banks and bank holding companies to maintain capital based on risk-adjusted assets. Categories of assets with potentially higher credit risk require more capital 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.

These standards also classify capital into two tiers, referred to as Tier 1 and Tier 2. The Company s Tier 1 capital consists of common shareholders equity (excluding any gain or loss on available for sale debt securities) plus subordinated notes payable to the unconsolidated trust that issued trust preferred securities net of the bank holding Company s investment in the trust less intangible assets and the net unrealized loss on equity securities with readily determinable fair values. Tier 2 capital includes the allowance for loan and lease losses and the allowance for credit losses on off balance sheet credit exposures reduced for certain regulatory limitations.

Risk based capital standards require a minimum ratio of 8% of qualifying total capital to risk-adjusted total assets with at least 4% constituting Tier 1 capital. Capital qualifying as Tier 2 capital is limited to 100% 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% to 4%, subject to regulatory guidelines.

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

The Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA) required 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 table below illustrates the Company s risk weighted capital ratios at September 30, 2007 and December 31, 2006.

	September 30, 2007	December 31, 2006
Tier 1 Capital	$ 54,240	$ 50,913
Tier 2 Capital	1,747	2,238
TOTAL QUALIFYING CAPITAL	$ 55,987	$ 53,151
Risk Adjusted Total Assets (*)	$ 284,611	$ 266,686
Tier 1 Risk-Based Capital Ratio	19.06%	19.09%
Total Risk-Based Capital Ratio	19.67%	19.93%
Tier 1 Risk-Based Capital to Average Assets (Leverage Capital Ratio)	11.12%	11.04%

(*) Includes off-balance sheet exposures.

Assets, less intangibles and the net unrealized market value adjustment of investment securities available for sale, averaged $487,706 for the nine months ended September 30, 2007 and $461,215 for the year ended December 31, 2006.

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

In management s opinion, as supported by the data in the table below, the Company met all capital adequacy requirements to which it was subject as of September 30, 2007 and December 31, 2006. As of those dates, Cortland Bancorp was well capitalized under regulatory prompt corrective action provisions.

	Actual Regulatory Capital Ratios as of:		Regulatory Capital Ratio requirements to be:	
	Sept. 30, 2007	Dec. 31, 2006	Well Capitalized	Adequately Capitalized
Total risk-based capital to risk-weighted assets	19.67%	19.93%	10.00%	8.00%
Tier 1 capital to risk-weighted assets	19.06%	19.09%	6.00%	4.00%
Tier 1 capital to average assets	11.12%	11.04%	5.00%	4.00%

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CORTLAND BANCORP AND SUBSIDIARIES

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

(Dollars in thousands, except for per share amounts)

First Nine Months of 2007 as Compared to First Nine Months of 2006

Analysis of Net Interest Income

	INTEREST MARGIN YTD					
	September 30, 2007			September 30, 2006		
	Average Balance (1)	**Interest**	**Average Rate**	Average Balance (1)	Interest	Average Rate
INTEREST-EARNING ASSETS						
Federal funds sold and other earning assets	$ 8,971	$ 353	5.3%	$ 2,306	$ 83	4.8%
Investment securities (1) (2)	237,659	10,123	5.7%	236,304	9,705	5.5%
Loans (2) (3)	213,234	11,731	7.3%	193,522	10,607	7.3%
Total interest-earning assets	$ 459,864	$ 22,207	6.4%	$ 432,132	$ 20,395	6.3%
INTEREST-BEARING LIABILITIES						
Interest-bearing demand deposits	$ 46,175	$ 653	1.9%	$ 47,121	$ 527	1.5%
Savings	78,996	602	1.0%	83,735	643	1.0%
Time	184,395	6,549	4.7%	158,296	4,965	4.2%
Total interest-bearing deposits	309,566	7,804	3.4%	289,152	6,135	2.8%
Federal funds purchased	9			640	25	5.2%
Subordinated Debt	1,171	61	6.9%			
Other borrowings	64,552	2,497	5.2%	58,427	2,256	5.1%
Total interest-bearing liabilities	$ 375,298	$ 10,362	3.7%	$ 348,219	$ 8,416	3.2%
Net interest income		$ 11,845			$ 11,979	
Net interest rate spread (4)			2.7%			3.2%
Net interest margin (5)			3.4%			3.7%

(1)

Includes both taxable and tax exempt securities

(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 $54 and $628 for September 2007 and $69 and $718 for September 2006.

(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 deposits.

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

interest-earning
assets.

The increase in interest income, on a fully tax equivalent basis, of $1,812 was the product of a 6.4% year-over-year increase in average earning assets and a 13 basis point increase in interest rates earned. Also contributing to interest income in 2006 was $136 in back interest and loan fees collected on two problem loans, while in 2007 $75 was collected on two such loans, all of which were either in foreclosure or loan workout. The increase in interest expense of $1,946 was a product of a 7.8% increase in interest-bearing liabilities and a 46 basis point increase in rates paid. The net result was a 1.1% decrease in net interest income on a fully tax equivalent basis and a 28 basis point decrease in the Company s net interest margin ratio.

Interest and dividend income on securities registered an increase of $508, or 5.7%, during the nine months ended September 30, 2007 when compared to 2006. On a fully tax equivalent basis, income on investment securities increased by $418, or 4.3%. The average invested balances increased by $1,355, or 0.6%, from the levels of a year ago. The increase in the average balance of investment securities was accompanied by a 20 basis point increase in the tax equivalent yield of the portfolio.

Interest and fees on loans increased by $1,139, or 10.8%, while on a fully tax equivalent basis, income on loans increased by $1,124, or 10.6%, for the nine months of 2007 compared to 2006. A $19,712 increase in the average balance of the loan portfolio, or 10.2%, was accompanied by a 3 basis point decrease in the portfolio s tax equivalent yield.

Other interest income increased by $270 from the same period a year ago. The average balance of federal funds sold and other money market funds increased by $6,665, or 289.0%. The yield increased by 47 basis points during the first nine months of 2007 compared to 2006.

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

Average interest-bearing demand deposits and money market accounts decreased by $946, while savings decreased by $4,739. The average rate paid on these products increased by 15 basis points in the aggregate. The average balance on time deposit products increased by $26,099, as the average rate paid increased by 55 basis points, from 4.2% to 4.7%.

Compared to last year, average borrowings, subordinated debt and federal funds purchased increased by $6,665, while the average rate paid on borrowings increased by 3 basis points. Included in this increase is an average balance of $1,171 in subordinated debt issued in July of 2007.

Net interest income after provision for loan losses benefited from improving asset quality negating the need for any additional provision for loan loss, and contributed an additional $175 compared to a year ago.

Analysis of Other Income, Other Expense and Federal Income Tax

Other income from all sources increased by $215 from the same period a year ago. Gains on 1-4 residential mortgage loans sold in the secondary mortgage market increased by $9 from the same period a year ago. Gains on securities called and net gains on the sale of available for sale investment securities increased by $19 from year ago levels. Fees for other customer services increased by $42 due in part to a $23 increase in service charge income on deposits. Earnings on bank owned life insurance increased by $97, reflecting increases in the investment yields associated with these policies. Loss on the sale of Other Real Estate Owned (OREO) was $1 at September 30, 2007, a decrease of $34 from the loss of $35 recorded at September 30, 2006. Other sources of non-recurring non-interest income increased by $14 from the same period a year ago. This latter income category is subject to fluctuation due to the non-recurring nature of the items.

Loan charge-offs during the first nine months were $537 in 2007 compared to $221 in 2006, while the recovery of previously charged-off loans amounted to $70 in 2007 compared to $87 in 2006. The increase in charge-offs in 2007 includes three loans in the aggregate amount of $307 for which specific loss reserves had previously been established. Non-accrual loans at September 30, 2007 represented 1.3% of the loan portfolio compared to 1.9% at September 30, 2006.

Total other expenses in the first nine months were $9,401 in 2007 compared to $9,059 in 2006, an increase of $342 or 3.8%. Full time equivalent employment averaged 165 during the first nine months of 2007, a 3.1% increase compared to 160 at September 30, 2006. Salaries and benefits increased by $351 or 6.9%, from the similar period a year ago. This increase is a combination of regular staff salary and benefit increases and the increase in full-time equivalent employment.

For the first nine months of 2007, state and local taxes increased by $22. Occupancy and equipment expense increased by $49 or 3.6%. Office supplies increased by $21. Bank exam and audit expense decreased by $57, due to differences in the timing of expenditures. All other expense categories decreased by 2.8%, or $44 as a group. This expense category is subject to fluctuation due to non-recurring items.

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

Income before income tax expense amounted to $4,040 for the first nine months of 2007 compared to $4,021 for the similar period of 2006. The effective tax rate for the first nine months was 20.0% in 2007 compared to 15.6% in 2006, resulting in income tax expense of $806 and $627, respectively. The difference in the effective tax rate primarily reflects a one-time adjustment to tax expense of $145 due to a change in tax accrual estimate made in the first quarter of 2006. The effective tax rate before the $145 adjustment was 19.2% at September 30, 2006. The provision for income taxes differs from the amount of income tax determined applying the applicable U.S. statutory federal income tax rate to pre-tax income as a result of the following differences:

	NINE MONTHS ENDED September 30, 2007	NINE MONTHS ENDED September 30, 2006
Provision at statutory rate	$ 1,374	$ 1,367
Add (Deduct):		
Tax effect of non-taxable income	(642)	(678)
Tax effect of non-deductible expense	74	83
Tax effect of change in estimate*		(145)
Federal income taxes	$ 806	$ 627

*A one-time adjustment to tax accrual estimate made in the first quarter of 2006.

Net income for the first nine months registered $3,234 in 2007 compared to $3,394 in 2006, representing per share amounts of $0.72 in 2007 and $0.76 in 2006. Dividends declared per share were $0.66 in 2007 and $0.65 in 2006.

Core earnings (earnings before gains on loans sold, investment securities sold or called, other real estate losses and certain other non-recurring items) decreased by $56, or 1.7%, in the first nine months of 2007 compared to 2006. Core earnings for the nine months of 2007 were $3,161 compared to last year s $3,217. Core earnings per share were $0.71 in 2007 and $0.72 in 2006. The following is reconciliation between core earnings and earnings as reported under generally accepted accounting principles in the United States (GAAP earnings):

	Nine Months Ended September 30, 2007	Nine Months Ended September 30, 2006
GAAP Earnings	$ 3,234	$ 3,394
Investment security gains	(37)	(18)
Gain on sale of loans	(78)	(69)
Loss on sale of other real estate	1	35
Loss on disposition of fixed assets	4	3

Other non-recurring items*		(145)
Tax effect of adjustments	37	17
Core Earnings	$ 3,161	$ 3,217
Core earnings per share	$ 0.71	$ 0.72

*Includes a one-time change in tax accrual estimate made in the first quarter of 2006.

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

Analysis of Assets and Liabilities

Total cash and cash equivalents decreased by $2,587 from year-end, and $6,030 from the twelve month period ending September 30, 2006. This decrease is due mainly to federal funds sold, which decreased by $825 from year-end and $5,200 from September 30, 2006.

Investment securities increased by $11,062 from year-end levels and by $13,346 from the same quarter a year ago. The purchases primarily represented discounted callable U.S. Government agencies that contain a lock-out period prior to the first call date and also mortgage-backed securities and corporate debt securities with floating rate repricing characteristics. The investment portfolio represented 65.5% of each deposit dollar, up from 65.3% a year ago and equal to year end levels.

Loans net of the allowance for losses increased by $22,338 during the twelve month period from September 30, 2006 to September 30, 2007, and increased by $15,896 from year-end. Gross loans as a percentage of earning assets stood at 47.1% as of September 30, 2007 and 45.4% at September 30, 2006. The loan to deposit ratio at the end of the first nine months of 2007 was 59.2% and 56.2% for the same period a year ago. The increase in loans has primarily resulted from a marketing campaign designed to increase market share for commercial and small business loans secured by real estate. At September 30, 2007 the loan loss allowance of $1,744 represented approximately 0.8% of outstanding loans, and at September 30, 2006, the loan loss allowance of $2,209 represented approximately 1.1% of outstanding loans.

Premises and equipment increased by $892 from year-end and $1,259 from September 30, 2006. This is mainly due to construction of a 2,500 square foot banking facility. The banking office replaced an existing leased bank location in the village of Windham. The newly constructed office opened in May of 2007.

Other assets increased by $1,675 or 10.2% from year-end and $1,143 or 6.7% from September 30, 2006. This increase is due in part to a $155 investment in Cortland Statutory Trust. Other real estate owned also increased to $284 in September 2007 as compared to $35 at December 31, 2006 and $55 at September 30, 2006. Interest receivable on investments and loans stood at $3,734 at September 30, 2007, $3,039 at December 31, 2006 and $3,526 at September 30, 2006, as investments have increased $13,346 or 5.8% and total loans have increased $21,873 or 11.0% since September 30, 2006. Also included in other assets is bank owned life insurance with a cash surrender value of $12,165 at September 30, 2007, $11,814 at December 31, 2006 and $11,679 at September 30, 2006.

Non interest-bearing deposits decreased by $5,547 from year-end and increased $347 from twelve months ago. Interest-bearing deposits increased by $22,275 from year-end and $18,559 from September 30, 2006. The increase is due primarily to an increase in certificates of deposit in the amount of $100 or more, which increased by $8,875 from September 30, 2006, and an increase of certificates of deposit in an amount less than $100 of $9,924 from September 30, 2006. There are no brokered deposits among the Company s deposit totals.

Borrowings, mainly from the Federal Home Loan Bank, increased by $6,878 from year-end and $8,968 from September 30, 2006 as the Company was able to obtain advances at competitive rates to assist in funding the asset growth. Subordinated debt of $5,155 was recorded at September 30, 2007 which was issued in July 2007. This is a new category, as the Company had no subordinated debt at December 31, 2006 or September 30, 2006. Other liabilities remained relatively stable ranging from $3,367 at September 30 2006 to $3,326 at December 31, 2006 and $3,067 at September 30, 2007.

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(Dollars in thousands, except for per share amounts)

Third Quarter of 2007 as Compared to Third Quarter of 2006

Analysis of Net Interest Income

	INTEREST MARGIN QTD					
	September 30, 2007			September 30, 2006		
	Average Balance (1)	**Interest**	**Average Rate**	Average Balance (1)	Interest	Average Rate
INTEREST-EARNING ASSETS						
Federal funds sold and other earning assets	$ 5,141	$ 67	5.2%	$ 2,058	$ 29	5.3%
Investment securities (1) (2)	242,352	3,503	5.8%	233,177	3,218	5.5%
Loans (2) (3)	218,102	3,993	7.3%	199,105	3,800	7.4%
Total interest-earning assets	$ 465,595	$ 7,563	6.5%	$ 434,340	$ 7,047	6.5%
INTEREST-BEARING LIABILITIES						
Interest-bearing demand deposits	$ 48,277	$ 258	2.1%	$ 46,971	$ 182	1.5%
Savings	77,330	200	1.0%	81,850	212	1.0%
Time	190,345	2,306	4.8%	161,001	1,780	4.4%
Total interest-bearing deposits	315,952	2764	3.5%	289,822	2,174	3.0%
Federal funds purchased	27			438	6	5.2%
Subordinated Debt	3,474	61	6.9%			
Other borrowings	63,190	826	5.2%	60,252	800	5.3%
Total interest-bearing liabilities	$ 382,643	$ 3,651	3.8%	$ 350,512	$ 2,980	3.4%
Net interest income		$ 3,912			$ 4,067	
Net interest rate spread (4)			2.7%			3.1%
Net interest margin (5)			3.4%			3.7%

(1) Includes both taxable and tax

exempt securities

(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 $16 and $202 for September 2007 and $20 and $231 for September 2006.

(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 deposits.

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

Tax equivalent net interest income for the Company during the third quarter of 2007 decreased by $155, a 3.8% decrease from the third quarter of 2006. The yield on earning assets increased by 9 basis points while third quarter average earning assets increased by 7.2%, or $31,255, when compared to a year ago. The result was an increase in tax equivalent interest income of $516, or 7.3%. Included in the September 30, 2006 loan interest is $136 in back interest realized in the third quarter of 2006 for two loans, one of which had been in foreclosure and the second of which represented a loan workout. The rate paid on interest-bearing liabilities increased by 41 basis points from the same quarter a year ago, while third quarter average interest-bearing liabilities increased by $32,131 when compared to a year ago, resulting in an increase in total interest expense of $671. The net interest margin ratio for the quarter registered 3.38%, down 31 basis points from last year s third quarter.

CORTLAND BANCORP AND SUBSIDIARIES
ITEM 2. MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL
(Dollars in Thousands, except for per share amounts)

Analysis of Other Income, Other Expense and Federal Income Tax

Loan charge-offs during the quarter were $321 in 2007 compared to $60 in 2006, while the recovery of previously charged-off loans amounted to $24 during the third quarter of 2007 compared to $44 in the same period of 2006. Charge-offs in the third quarter of 2007 include two loans in the aggregate amount of $209 for which specific loss reserves for the total charged-off amount had previously been established. The Company s provision for loan losses during the quarter ended September 30 2006 was $45. Improving asset quality negated the need for any additional provision for loan loss in the third quarter of 2007.

Other income increased by $80 from a year ago. Fees for customer service decreased by $6. Non-taxable income on bank owned life insurance policies increased by $33 reflecting increases in the investment yields associated with these policies. The net gain on loans sold during the quarter amounted to $35, compared to $13 a year ago. Loss on the sale of other real estate decreased from $7 in 2006 to none in 2007. Investment securities gains of $5 were realized in the third quarter of 2007 compared to none in the same quarter of 2006.

Total other non-interest expenses in the third quarter were $3,132 in 2007 compared to $3,041 in 2006, an increase of $91 or 2.7%. Salaries and benefits constituted an $88 increase, or 5.1%. Other expenses increased by $3 or 0.2%.

Income before income tax during the third quarter amounted to $1,350 in 2007 compared to $1,439 in 2006. Income tax expense for the third quarter of 2007 was $275 compared to $296 in 2006. Third quarter net income was $1,075 in 2007 compared to $1,143 in 2006, representing a decrease of $68, or 5.9%.

Earnings per share for the third quarter, adjusted for the 2% stock dividend paid January 1, 2007, were $0.24 in 2007 and $0.26 in 2006.

Core earnings (earnings before gains on loans sold, investment securities sold or called and certain other non-recurring items) decreased by 7.9% in the third quarter of 2007 compared to 2006. Core earnings for the third quarter of 2007 were $1,049 compared to last year s $1,139. Core earnings per share were $0.24 in 2007 and $0.25 in 2006.

The following is a reconciliation between core earnings and earnings under generally accepted accounting principles in the United States (GAPP earnings):

	Three Months Ended September 30,	
	2007	2006
GAAP Earnings	$ 1,075	$ 1,143
Investment security gains	(5)	
Gain on sale of loans	(35)	(13)
Loss on sale of other real estate		7
Loss on disposition of fixed assets		
Tax effect of adjustments	14	2
Core Earnings	$ 1,049	$ 1,139
Core earnings per share	$ 0.24	$ 0.25

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CORTLAND BANCORP AND SUBSIDIARIES

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

(Dollars in thousands, except for per share amounts)

Regulatory Matters

On March 13, 2000, the Board of Governors of the Federal Reserve System approved the Company s application to become a financial holding company. As a financial holding company, the Company may engage in activities that are financial in nature or incidental to a financial activity, as authorized by the Gramm-Leach-Bliley Act of 1999 (The Financial Services Reform Act). Under the Financial Services Reform Act, the Company may continue to claim the benefits of financial holding company status as long as each depository institution that it controls remains well capitalized and well managed.

The Company is required to provide notice to the Board of Governors of the Federal Reserve System when it becomes aware that any depository institution controlled by the Company ceases to be well capitalized or well managed. Furthermore, current regulation specifies that prior to initiating or engaging in any new activities that are authorized for financial holding companies, the Company s insured depository institutions must be rated satisfactory or better under the Community Reinvestment Act (CRA). The Company s bank subsidiary is rated satisfactory for CRA purposes, and remains well capitalized and well managed in Management s opinion.

CORTLAND BANCORP AND SUBSIDIARIES

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

(Dollars in thousands, except for per share amounts)

New Accounting Standards

In September 2006, the FASB issued SFAS No. 157, Fair Value Measurements. SFAS No. 157 defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles and expands disclosures about fair value measurements. The provisions of this standard apply to other accounting pronouncements that require or permit fair value measurements. SFAS No. 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. The Company believes that the adoption of SFAS No. 157 will not have a material impact on the financial statements.

In September 2006, the Emerging Issues Task Force (EITF) reached a final consensus on Issue 06-4, Accounting for Deferred Compensation and Postretirement Benefit Aspects of Endorsement Split-Dollar Life Insurance Arrangements . The consensus stipulates that an agreement by an employer to share a portion of the proceeds of a life insurance policy with an employee during the postretirement period is a postretirement benefit arrangement required to be accounted for under SFAS No. 106 (postretirement benefit plans) or APB No. 12 (deferred compensation plan). The consensus concludes that the purchase of a split-dollar life insurance policy does not constitute a settlement; therefore, a liability should be recognized for future benefits. Issue 06-4 is effective for years beginning after December 15, 2007. Management is currently in the process of evaluating the impact of adopting Issue 06-4.

In September 2006, the Emerging Issues Task Force (EITF) ratified the consensus on Issue 06-5, Accounting for Purchases of Life Insurance-Determining the Amount that Could be Realized in Accordance with FASB Technical Bulletin No. 85-4. The consensus stipulates that the policy owner should consider the cash surrender value as well as any additional amounts included in the contractual terms of the policy in determining the amount recognized as an asset pursuant to FASB Technical Bulletin No. 85-4. The consensus in this Issue is effective for fiscal years beginning after December 15, 2006. The Company has determined that its adoption will not have a material impact on its earnings, cash flow and financial position.

In October 2006, the FASB issued SFAS No. 158, Employers Accounting for Defined Benefit Pension and Other Postretirement Plans. SFAS No. 158 requires an employer to recognize the funded status of each of its defined pension and postretirement benefit plans in the balance sheet, to recognize changes in the funded status in the year in which changes occur through comprehensive income, and to measure the funded status as of the balance sheet date. The requirement to recognize the funded status of benefit plans and the disclosure requirements are effective for fiscal years ending after December 15, 2006. The requirement to measure the funded status as of the date of the balance sheet is effective for fiscal years ending after December 15, 2008. The Company has determined that its adoption of SFAS No. 158 will not have a material impact on its earnings, cash flows and financial position.

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

In February 2007, the FASB issued Statement No. 159, The Fair Value Option for Financial Assets and Financial Liabilities (SFAS 159). SFAS 159 would allow the Company an irrevocable election to measure certain financial assets and liabilities at fair value, with unrealized gains and losses on the elected items recognized in earnings at each reporting period. The fair value option may only be elected at the time of initial recognition of a financial asset or financial liability or upon the occurrence of certain specified events. The election is applied on an instrument by instrument basis, with a few exceptions, and is applied only to entire instruments and not to portions of instruments. SFAS 159 also provides expanded disclosure requirements regarding the effects of electing the fair value option on the financial statements. SFAS 159 is effective prospectively for fiscal years beginning after November 15, 2007. The Company is currently evaluating this Statement and has not yet determined the financial assets and liabilities, if any, for which the fair value option would be elected or the potential impact on the consolidated financial statements, if such election were made.

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)

Management considers interest rate risk to be the Company s principal source of market risk. 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 typically 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 most significant assumptions used in the simulation relate to the cash flows and re-pricing characteristics of the Company s balance sheet. Re-pricing and runoff rate assumptions are based on a detailed interface with actual customer information and investment data stored on the subsidiary bank s information systems. Consensus prepayment speeds derived from an independent third party source are used to adjust the runoff cash flows for the impact of the specific interest rate environments under consideration. Simulated results are benchmarked against historical results. 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 on the following page shows the Company s current estimate of interest rate sensitivity based on the composition of the balance sheet at September 30, 2007 and December 31, 2006. 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 subsequent twelve months reaching a level 300 basis points higher (lower) than the rates in effect at September 30, 2007 and December 31, 2006 for the respective simulations. Under both the rising rate scenario and the falling rate scenario, the yield curve is assumed to exhibit a parallel shift.

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CORTLAND BANCORP AND SUBSIDIARIES
ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK
(CONTINUED)
(Dollars in thousands, except for per share amounts)

Over the past twelve months, the Federal Reserve has lowered by 50 basis points the overnight federal funds rate. At September 30, 2007, the difference between the yield on the ten-year Treasury and the three-month Treasury was a positive 77 basis points compared to a negative 31 basis points at December 31, 2006. With longer-term rates exceeding short-term rates the yield curve is now generally positive, although some degree of inversion remains at the front-end and back-end of the yield curve.

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 $15,089 for the twelve month period ending September 30, 2008.

Simulated Net Interest Income (NII) Scenarios
Fully Taxable Equivalent Basis
For the Twelve Months Ending

	Net Interest Income		$ Change in NII		% Change in NII	
Changes in Interest Rates	Sept 30, 2008	Dec. 31, 2007	Sept 30, 2008	Dec. 31, 2007	Sept 30, 2008	Dec. 31, 2007
Graduated increase of +300 basis points	$ 15,145	$ 15,357	$ 56	$ 3	0.4%	0.0%
Short term rates unchanged	15,089	15,354				
Graduated decrease of -300 basis points	14,822	15,391	(267)	37	(1.8)%	0.3%

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 assurance 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, floors or other similar instruments.

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CORTLAND BANCORP AND SUBSIDIARIES

ITEM 4. CONTROLS AND PROCEDURES

Evaluation of Disclosure Controls and Procedures. With the supervision and participation of management, including the Company s principal executive officer and principal financial officer, the effectiveness of disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) 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 principal financial officer have 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 March 15, 2007

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

Company s Common Stock. The following table shows information relating to the repurchase of shares of the Company s common stock during the three months ended September 30, 2007:

	Total Number of Shares Purchased	Average Price Paid Per Share	Total Number of Shares Purchased as Part Of Publicly Announced Plans or Programs	Maximum Number of Shares That May Yet Be Purchased Under the Plans or Programs*
July	None	$ N/A	None	14,786
Aug	61,929	16.89	61,929	52,857
Sept	5,000	17.00	5,000	47,857
Total	66,929	$ 16.90	66,929	47,857

* On February 27, 2007 the Company s Board of Directors approved a Stock Repurchase Program. The program allowed the Company to purchase up to 100,000 shares. On August 14, 2007, the Company s Board of Directors subsequently approved the repurchase of an additional

100,000 shares. This program will terminate upon the earlier to occur of the purchase of 200,000 shares or February 28, 2009. (See footnote 7)

Item 3. Defaults upon Senior Securities

Not applicable

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

Not applicable

Item 5. Other Information

Not applicable

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CORTLAND BANCORP AND SUBSIDIARIES

PART II OTHER INFORMATION (CONTINUED)

Item 6. Exhibits

Exhibit 2	Not applicable
Exhibit 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. (1)
Exhibit 3.2	Code of Regulations for the Bancorp, as amended (1) Code of Regulations, Cortland Savings and Banking (2)
Exhibit 4	The rights of holders of equity securities are defined in portions of the Articles of Incorporation and Code of Regulations as referenced in 3.1 and 3.2. (1)
* Exhibit 10.1	Group Term Carve Out Plan dated February 23,2001 and form of endorsement entered into in 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 (1)
* Exhibit 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. (1)
* Exhibit 10.3	Director Retirement Agreement between Cortland Bancorp and Jerry A. Carleton, dated as of July 26, 2005 (1)
* Exhibit 10.4	Director Retirement Agreement between Cortland Bancorp and David C. Cole, dated as of March 1, 2001, as amended by letter amendment dated February 12, 2004 (1)
* Exhibit 10.5	Director Retirement Agreement between Cortland Bancorp and George E. Gessner, dated as of March 1, 2001, as amended by letter amendment dated February 12, 2004 (1)
* Exhibit 10.6	Amended Director Retirement Agreement between Cortland Bancorp and William A. Hagood, dated as of October 12, 2003 (1)
* Exhibit 10.7	Director Retirement Agreement between Cortland Bancorp and James E. Hoffman III, dated as of March 1, 2001, as amended by letter amendment dated February 12, 2004 (1)
* Exhibit 10.8	Director Retirement Agreement between Cortland Bancorp and Neil J. Kaback, dated as of March 1, 2004 (1)
* Exhibit 10.9	Director Retirement Agreement between Cortland Bancorp and K. Ray Mahan, dated as of March 1, 2001 (1)
* Exhibit 10.10	Amended and Restated Director Retirement Agreement between Cortland Bancorp and Richard B. Thompson, dated as of May 1, 2004 (1)

* Exhibit 10.11	Director Retirement Agreement between Cortland Bancorp and Timothy K. Woofter, dated as of March 1, 2001, as amended by letter amendment dated February 12, 2004 (1)

CORTLAND BANCORP AND SUBSIDIARIES
PART II OTHER INFORMATION (CONTINUED)

* Exhibit 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; as amended on December 26, 2006, for Directors Cole, Gessner, Hoffman, Mahan, Thompson and Woofter (2) and Split Dollar Agreement and Endorsement entered into by Cortland Bancorp as of July 26, 2005 with Director Jerry A. Carleton (1)
* Exhibit 10.13	Split Dollar Agreement between The Cortland Savings and Banking Company and Rodger W. Platt dated of as February 23, 2001, as amended on August 15, 2002 and September 29, 2005 (1)
* Exhibit 10.14	Endorsement Split Dollar Agreement between The Cortland Savings and Banking Company and Rodger W. Platt dated as of September 29, 2005 (1)
* Exhibit 10.15	Form of Indemnification Agreement entered into by Cortland Bancorp with each of its directors as of May 24, 2005 and with James M. Gasior as of November 5, 2005 (1)
* Exhibit 10.16	Amended Salary Continuation Agreement between The Cortland Savings and Banking Company and Rodger W. Platt, dated as of August 15, 2002 (1)
* Exhibit 10.17	Second Amended and Restated Salary Continuation Agreement between The Cortland Savings and Banking Company and Timothy Carney, dated as of December 17, 2003 (1)
* Exhibit 10.18	Second Amended and Restated Salary Continuation Agreement between The Cortland Savings and Banking Company and Lawrence A. Fantauzzi, dated as of December 16, 2003 (1)
* Exhibit 10.19	Second Amended and Restated Salary Continuation Agreement between The Cortland Savings and Banking Company and James M. Gasior, dated as of December 15, 2003 (1)
* Exhibit 10.20	Amended Salary Continuation Agreement between The Cortland Savings and Banking Company and Marlene Lenio, dated as of September 9, 2002 (1)
* Exhibit 10.21	Salary Continuation Agreement between The Cortland Savings and Banking Company and Craig Phythyon, dated as of December 15, 2003 (1)
* Exhibit 10.22	Second Amended and Restated Salary Continuation Agreement between The Cortland Savings and Banking Company and Stephen A. Telego, Sr., dated as of December 15, 2003 (1)
* Exhibit 10.23	Second Amended and Restated Salary Continuation Agreement between The Cortland Savings and Banking Company and Danny L. White, dated as of December 15, 2003 (1)
* Exhibit 10.24	Second Amended Split Dollar Agreement and Endorsement between The Cortland Savings and Banking Company and Timothy Carney, dated as of December 17, 2003 (1)

CORTLAND BANCORP AND SUBSIDIARIES
PART II OTHER INFORMATION (Continued)

* Exhibit 10.25	Second Amended Split Dollar Agreement and Endorsement between The Cortland Savings and Banking Company and Lawrence A. Fantauzzi, dated as of December 16, 2003 (1)
* Exhibit 10.26	Second Amended Split Dollar Agreement and Endorsement between The Cortland Savings and Banking Company and James M. Gasior, dated as of December 15, 2003 (1)
* Exhibit 10.27	Amended Split Dollar Agreement between The Cortland Savings and Banking Company and Marlene Lenio, dated as of September 9, 2002 (1), as amended on December 11, 2006. (2)
* Exhibit 10.28	Split Dollar Agreement and Endorsement between The Cortland Savings and Banking Company and Craig Phythyon, dated as of December 15, 2003 (1)
* Exhibit 10.29	Second Amended Split Dollar Agreement and Endorsement between The Cortland Savings and Banking Company and Stephen A. Telego, Sr., dated as of December 15, 2003 (1)
* Exhibit 10.30	Second Amended Split Dollar Agreement and Endorsement between The Cortland Savings and Banking Company and Danny L. White, dated as of December 15, 2003 (1)
* Exhibit 10.31	Severance Agreement Due to Change in Control of Cortland Bancorp entered by Cortland Bancorp and The Cortland Savings and Banking Company in January 2001 with each of Timothy Carney, Lawrence A. Fantauzzi, James M. Gasior, and Stephen A. Telego, Sr. (1)
* Exhibit 10.32	Severance Agreement Due to Change in Control of Cortland Bancorp entered by Cortland Bancorp and The Cortland Savings and Banking Company in January 2001 with each of Marlene Lenio, Barbara Sandrock, and Danny L. White (1)
Exhibit 11	See Note (6) of the Financial Statements
Exhibit 15	Not applicable
Exhibit 18	Not applicable
Exhibit 19	Not applicable
Exhibit 22	Not applicable
Exhibit 23	Not applicable
Exhibit 24	Not applicable
Exhibit 31.1	CEO certification (Filed herewith)

Exhibit 31.2	CFO certification (Filed herewith)
Exhibit 32	Certifications of Chief Executive Officer and Chief Financial Officer required under Section 906 of Sarbanes-Oxley Act of 2002 (Filed herewith)

* Management contract or compensatory plan or arrangement

(1) Filed previously as an Exhibit to form 10-K filed on March 15, 2006

(2) Filed previously as an Exhibit to form 10-K filed on March 15, 2007

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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)
DATED: November 8, 2007	/s/ Lawrence A. Fantauzzi
	Lawrence A. Fantauzzi President (Chief Executive Officer)
DATED: November 8, 2007	/s/ James M. Gasior
	James M. Gasior Secretary (Chief Financial Officer)

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