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# ANNUAL REPORT

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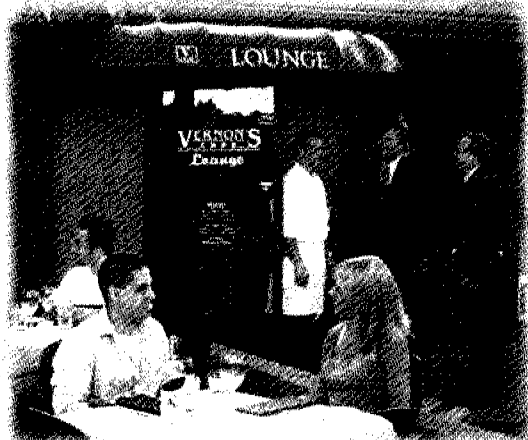
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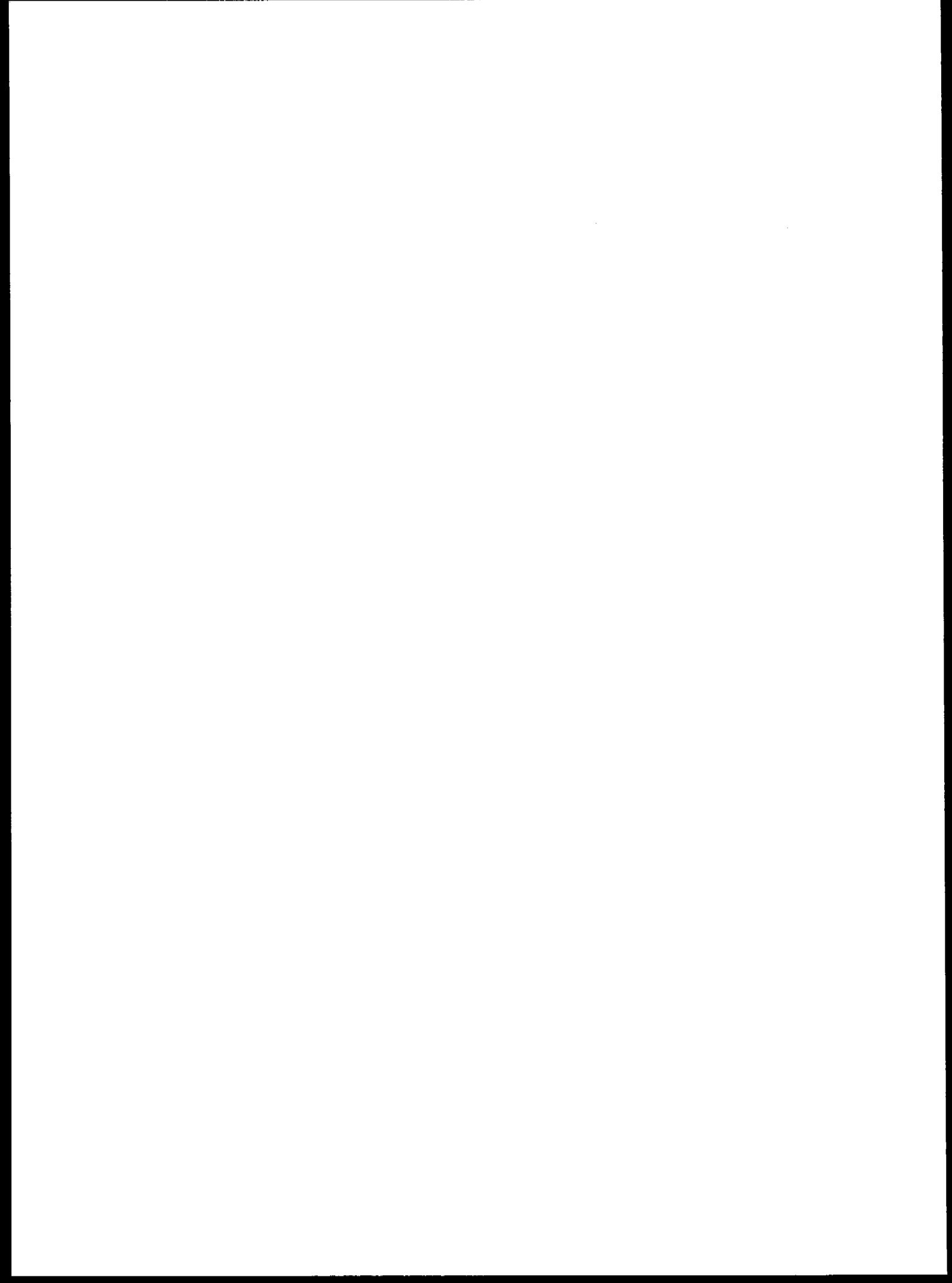
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# CORTLAND BANCORP 2005





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## CHAIRMAN'S MESSAGE

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### TO OUR SHAREHOLDERS AND CUSTOMERS:

This section of the annual report has long been reserved for the letter from the Company's President and Chief Executive Officer Rodger W. Platt. After forty-two years of employment with the Cortland Savings and Banking Company, over twenty-seven as Company President and Chief Executive Officer, Rodger W. Platt completed his service with the Company retiring November 1, 2005.

During his tenure, the Company has experienced many successes and has led the charge through a number of challenging periods. As Bank President, Rodger has committed himself to the Company, its employees, customers and shareholders. In fact, many employees, customers and shareholders alike have known Rodger to be much more than the Company President — he has been a mentor to some, a counselor to others and a friend to many. On behalf of the directors, officers and employees of the Company and the banking subsidiary, we congratulate Rodger on his retirement and wish him good health and prosperity as he begins a new chapter in his life.

As is spoken many times — life shall go on and the business at hand continues. As such, a new chapter in the Company's annals begins. With this Chairman's letter I am at the beginning of my term as Chairman of the Board. I would like to take this opportunity to thank the full board for their vote of confidence in nominating me to this position.

Joining me in the transition is a new Bank President and Chief Executive Officer. After eighteen years as the Company's Chief Financial Officer, Treasurer and Corporate Secretary, the Board of Directors appointed Lawrence A. Fantauzzi as its new President and Chief Executive Officer. As Board Chairman, I am looking forward to working with Mr. Fantauzzi as he takes on his new responsibilities with the Company. Having had the opportunity to work with Larry as a fellow board member over the last several years, I can assure our customers and shareholders that he will approach the responsibilities and challenges he faces with the same dedication and commitment as Rodger did.

Joining Mr. Fantauzzi on the management team is James M. Gasior, a Certified Public Accountant, who has been with the Company since 1990, most recently as Senior Vice President and Chief Lending Officer. Mr. Gasior will be assuming the responsibilities of Chief Financial Officer and Corporate Secretary and has been appointed by the Board of Directors to fill the Director vacancy created by Mr. Platt's retirement.

One of the immediate challenges that the Company faces is the challenge of managing the net interest margin. The Company's net interest margin, which is the difference between what it earns on its loans and investments and what it pays for its deposits and borrowings, improved slightly in the past year increasing from 3.74% to 3.83%. Despite the improvement, the Company's margins continue to be affected by short term and long term interest rate pricing decisions of the Federal Reserve Board, the aggressive pricing strategies among our competitors and the continued lag in economic recovery throughout the geographic areas of Northeast Ohio in which our branches operate.

Another challenge that the Company continues to face is an increase in compliance requirements associated with provisions of the Sarbanes-Oxley Act. Although there has been recent discussion that the compliance requirements of Sarbanes-Oxley may be limited or eliminated for smaller public companies in the future, additional expenses were recorded in 2005 as a result of an increase in professional service fees to perform the compliance examinations. Despite these increases, non-interest expenses have been particularly well controlled during the last several years. Excluding certain management transition costs, non-interest expenses increased by less than 1.00% in 2005. Over the last five years non-interest expenses increased at a compounded annual growth rate of less than 1.50%.

The Company's asset quality measures remain in a range that management considers acceptable. However, adverse trends in delinquency, foreclosure and bankruptcies have impacted the Company's loan portfolio. Additional provisions of \$545,000 were made to the allowance for loan losses to reflect management's evaluation of specific portfolio risks and probable loss experience on existing credits in the months ahead. The provisions, which are charged against income, represent an increase of \$130,000 over the previous year. The allowance now stands at \$2.168 million or 1.15% of total loans. Prior to the charge off of several problem credits in 2005, the allowance had been \$2.629 million or 1.37% of total loans in 2004.

Net Income for 2005 was \$4.334 million or \$1.00 per share. The Company earned \$4.843 million or \$1.13 per share in 2004. Return on average assets was 0.98% and return on average equity was 8.73%.

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As of December 31, 2005 total assets are \$459 million as compared to \$446 million at December 31, 2004. Total loans decreased year-over-year by \$3.6 million or 1.9% while deposits increased by \$5.5 million or 1.6%.

Total shareholders' equity at December 31, 2005 is \$48.3 million, which is below the \$49.4 million recorded at December 31, 2004. This decrease has primarily resulted from the \$0.85 per share cash dividends, the \$0.22 per share special dividend and the 3% stock dividend.

The overall outlook of the local economy, the compression of the interest margin, increases in employee healthcare costs and other operational issues were considered as factors when preparing our annual performance budgets. As such, the actual 2005 operating results were not significantly different from the expectations established at the beginning of the year. Many of these same factors will continue to affect our operating results in 2006. Faced with the challenge of addressing these and other issues, the Board of Directors and the Company's management team is, nonetheless, committed to improving upon the profit results realized in 2005.

As planning for 2006 begins, management and the board have begun to focus on implementing short term and long term strategic initiatives. Eventually these initiatives will be incorporated into a comprehensive corporate strategic plan. Integral to the plan will be specific initiatives to grow loan and deposit portfolios, maximize core earnings and enhance shareholder value.

Among the strategic initiatives are product enhancement strategies targeting loan and deposit growth. In regard to product enhancements in the lending area, a 10 year fixed rate commercial real estate product designed to attract new customers and to build portfolio balances is currently being marketed through the subsidiary bank. Initial lender field reports indicate that there is considerable interest in this product. The mortgage area of the bank will also continue to promote the Welcome Home program, a down payment assistance program offered through the Federal Home Loan Bank of Cincinnati. Additional enhancements to loan products will also be considered for the home equity and consumer loan areas.

In terms of branching strategies, management and the board are performing an assessment of each branching location. For some branch locations, tangible improvements are being made to existing facilities so that the offices are aesthetically appealing and promote an invitation to bank with the Cortland Savings and Banking Company. For other branch locations, construction of more modern facilities is being considered. Finally, opportunities to expand to new communities is also under consideration.

Cash dividends, as adjusted to give retroactive effect to the 3% stock dividend, of \$1.07 per share in 2005 represents a 5.26% yield. In 2004, cash dividends, again adjusted to give retroactive effect to the 3% stock dividend, were \$1.04 per share, representing a 4.45% yield. Through the years, shareholder value has been enhanced through favorable dividend payouts including a special dividend paid in each of the last 12 years. Although the special dividend was never intended to be a permanent dividend, it has become popular with shareholders, nonetheless. Although dividends for future periods will obviously be affected by company performance, we anticipate that the dividends paid to our shareholders will be among some of the better payouts for banks in our area. And of course, to add value, shareholders will continue to have the option to have their dividends automatically reinvested in the common stock of the Company.

Whether the objective be to improve products, service or shareholder value, management and the board will continue to evaluate and implement those initiatives that meet the short term and long term performance goals of the Company. It is our intent to develop a comprehensive strategic plan which defines the Company's mission as a community bank and which will lead to prosperity in 2006 and for years to come. On behalf of the Board of Directors, I thank you for your continued confidence and support.

Sincerely,



Karl R. Mahan  
Chairman

## BRIEF DESCRIPTION OF THE BUSINESS

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### **CORTLAND BANCORP**

Cortland Bancorp (the "Company") was incorporated under the laws of the State of Ohio in 1984, as a one bank holding company registered under the Bank Holding Company Act of 1956, as amended. 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 authorized by the Gramm-Leach-Bliley Act of 1999. The principal activity of the Company is to own, manage and supervise the Cortland Savings and Banking Company ("Cortland Banks" or the "Bank"). The Company owns all of the outstanding shares of the Bank.

The Company is subject to supervision and regulation by the Board of Governors of the Federal Reserve System (the "Federal Reserve Board"). 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). As of December 31, 2005, the Company's bank subsidiary was rated "satisfactory" for CRA purposes, and remained well capitalized and, in management's opinion, well managed. Cortland Bancorp owns no property. Operations are conducted at 194 West Main Street, Cortland, Ohio.

The business of the Company and the Bank is not seasonal to any significant extent and is not dependent on any single customer or group of customers.

### **NEW RESOURCES LEASING COMPANY**

New Resources Leasing Company was formed in December 1988 as a separate entity to handle the function of commercial and consumer lending. The wholly owned subsidiary has been inactive since incorporation.

### **THE CORTLAND SAVINGS AND BANKING COMPANY**

The Cortland Savings and Banking Company is a full service state bank engaged in commercial and retail banking and trust services. The Bank's services include checking accounts, savings accounts, time deposit accounts, commercial, mortgage and installment loans,

night depository, automated teller services, safe deposit boxes and other miscellaneous services normally offered by commercial banks. Cortland Banks also offers a variety of Internet Banking products as well as discount brokerage services.

Business is conducted at a total of thirteen offices, eight of which are located in Trumbull County, Ohio. Two offices are located in the communities of Windham and Mantua, in Portage County, Ohio. One office is located in the community of Williamsfield, Ashtabula County, Ohio, while two are located in the community of Boardman, Mahoning County, Ohio.

Cortland Bank's main office (as described in its charter) is located at 194 West Main Street, Cortland, Ohio. Administrative offices are located at the main office. The Brookfield, Windham, Hubbard, Niles Park Plaza and both Boardman offices are leased, while all of the other offices are owned by Cortland Banks.

The Bank, as a state chartered banking organization and member of the Federal Reserve System, is subject to periodic examination and regulation by both the Federal Reserve Bank of Cleveland and the State of Ohio Division of Financial Institutions. These examinations, which include such areas as capital, liquidity, asset quality, management practices and other aspects of the Bank's operations, are primarily for the protection of the Bank's depositors. In addition to these regular examinations, the Bank must furnish periodic reports to regulatory authorities containing a full and accurate statement of its affairs. The Bank's deposits are insured by the Federal Deposit Insurance Corporation (FDIC) up to the statutory limit of \$100,000 per customer.

### **COMPETITION**

Cortland Banks actively competes with state and national banks located in Northeast Ohio and Western Pennsylvania. It also competes for deposits, loans and other service business with a large number of other financial institutions, such as savings and loan associations, credit unions, insurance companies, consumer finance companies and commercial finance companies. Also, money market mutual funds, brokerage houses and similar institutions provide in a relatively unregulated environment many of the financial services offered by banks. In the opinion of management, the principal methods of competition are the rates of interest charged on loans, the rates of interest paid on deposit funds, the fees charged for services, and the convenience, availability, timeliness and quality of the customer services offered.

### **EMPLOYEES**

As of December 31, 2005 the Company through its subsidiary bank, employed 144 full-time and 30 part-time employees. The Company provides its employees with a full range of benefit plans, and considers its relations with its employees to be satisfactory.

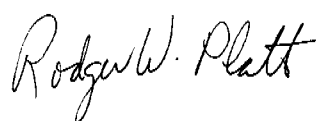
**REPORT ON MANAGEMENT'S ASSESSMENT OF  
INTERNAL CONTROL OVER FINANCIAL REPORTING**

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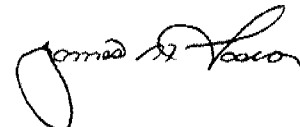
Cortland Bancorp is responsible for the preparation, integrity, and fair presentation of the consolidated financial statements included in this annual report. The consolidated financial statements and notes included in this annual report have been prepared in conformity with United States generally accepted accounting principles and necessarily include some amounts that are based on management's best estimates and judgments.

We, as management of Cortland Bancorp, are responsible for establishing and maintaining effective internal control over financial reporting that is designed to produce reliable financial statements in conformity with United States generally accepted accounting principles. The system of internal control over financial reporting as it relates to the financial statements is evaluated for effectiveness by management and tested for reliability through a program of internal audits. Actions are taken to correct potential deficiencies as they are identified. Any system of internal control, no matter how well designed, has inherent limitations, including the possibility that a control can be circumvented or overridden and misstatements due to error or fraud may occur and not be detected. Also, because of changes in conditions, internal control effectiveness may vary over time. Accordingly, even an effective system of internal control will provide only reasonable assurance with respect to financial statement preparation.

Management assessed the Company's system of internal control over financial reporting as of December 31, 2005, in relation to criteria for effective internal control over financial reporting as described in *Internal Control-Integrated Framework*, issued by the Committee of Sponsoring Organization of the Treadway Commission. Based on this assessment, management concludes that, as of December 31, 2005, its system of internal control over financial reporting is effective and meets the criteria of the *Internal Control-Integrated Framework*. Packer Thomas, independent registered public accounting firm, has issued an attestation report on management's assessment of the Company's internal control over financial reporting.



Rodger W. Platt  
Interim President and  
Chief Executive  
Officer



James M. Gasior  
Secretary  
Chief Financial  
Officer

Cortland, Ohio  
February 3, 2006

REPORT OF PACKER THOMAS  
INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

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SHAREHOLDERS AND BOARD OF DIRECTORS  
Cortland Bancorp

We have audited the accompanying consolidated balance sheets of Cortland Bancorp and subsidiaries as of December 31, 2005 and 2004, and the related consolidated statements of income, stockholders' equity, and cash flows for each of the years in the three-year period ended December 31, 2005. We also have audited management's assessment, included in the accompanying Report on Management's Assessment of Internal Control Over Financial Reporting, that Cortland Bancorp and subsidiaries maintained effective internal control over financial reporting as of December 31, 2005, based on criteria established in *Internal Control-Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Cortland Bancorp's management is responsible for these financial statements, for maintaining effective internal control over financial reporting, and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express an opinion on these financial statements, an opinion on management's assessment, and an opinion on the effectiveness of the company's internal control over financial reporting based on our audits.

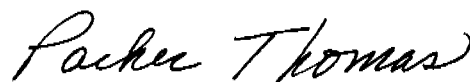
We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement and whether effective internal control over financial reporting was maintained in all material respects. Our audit of financial statements included examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. Our audit of internal control over financial reporting included obtaining an understanding of internal control over financial reporting, evaluating management's assessment, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we considered necessary in the circumstances. We believe that our audits provide a reasonable basis for our opinions.

A company's internal control over financial reporting is a process designed to provide reasonable assurance re-

garding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of Cortland Bancorp and subsidiaries as of December 31, 2005 and 2004, and the consolidated results of its operations and its cash flows for each of the years in the three-year period ended December 31, 2005 in conformity with accounting principles generally accepted in the United States of America. Also, in our opinion, management's assessment that Cortland Bancorp and subsidiaries maintained effective internal control over financial reporting as of December 31, 2005 is fairly stated, in all material respects, based on criteria established in *Internal Control-Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Furthermore, in our opinion, Cortland Bancorp and subsidiaries maintained, in all material respects, effective internal control over financial reporting as of December 31, 2005, based on criteria established in *Internal Control-Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).



Packer Thomas

Youngstown, Ohio  
February 3, 2006



CORTLAND BANCORP AND SUBSIDIARIES  
CONSOLIDATED STATEMENTS OF INCOME  
Years ended December 31, 2005, 2004 and 2003

(Amounts in thousands except per share data)

	<u>2005</u>	<u>2004</u>	<u>2003</u>
<b>Interest income</b>			
Interest and fees on loans .....	<b>\$12,941</b>	\$12,383	\$13,039
Interest and dividends on investment securities:			
Taxable interest .....	<b>4,387</b>	3,501	3,068
Nontaxable interest .....	<b>2,162</b>	2,553	2,473
Dividends .....	<b>167</b>	135	132
Interest on mortgage-backed securities .....	<b>3,810</b>	3,633	4,009
Interest on trading account securities .....			69
Other interest income .....	<b>119</b>	83	117
Total interest income .....	<b><u>23,586</u></b>	<u>22,288</u>	<u>22,907</u>
<b>Interest expense</b>			
Deposits .....	<b>6,159</b>	5,787	5,819
Borrowed funds .....	<b>2,506</b>	2,223	2,313
Total interest expense .....	<b>8,665</b>	8,010	8,132
Net interest income .....	<b>14,921</b>	14,278	14,775
Provision for loan losses (Note 4) .....	<b>545</b>	415	240
<b>Net interest income after provision for loan losses .....</b>	<b><u>14,376</u></b>	<u>13,863</u>	<u>14,535</u>
<b>Other income</b>			
Fees for other customer services .....	<b>2,254</b>	2,327	1,636
Investment securities gains - net .....	<b>308</b>	1,052	946
Trading securities gains - net .....			265
Gain on sale of loans - net .....	<b>89</b>	54	470
Other real estate losses - net .....	<b>(3)</b>	(171)	
Other non-interest income .....	<b>467</b>	569	532
Total other income .....	<b><u>3,115</u></b>	<u>3,831</u>	<u>3,849</u>
<b>Other expenses</b>			
Salaries and employee benefits .....	<b>7,052</b>	6,722	6,586
Net occupancy and equipment expense .....	<b>1,870</b>	1,853	1,963
State and local taxes .....	<b>548</b>	544	524
Office supplies .....	<b>338</b>	346	347
Legal and litigation expense (Note 16) .....	<b>119</b>	103	152
Bank exam and audit expense .....	<b>427</b>	515	349
Marketing expense .....	<b>245</b>	182	177
Other operating expenses .....	<b>1,601</b>	1,596	1,431
Total other expenses .....	<b><u>12,200</u></b>	<u>11,861</u>	<u>11,529</u>
<b>Income before federal income taxes .....</b>	<b>5,291</b>	5,833	6,855
Federal income taxes (Note 10) .....	<b>957</b>	990	1,371
<b>Net income .....</b>	<b><u>\$ 4,334</u></b>	<u>\$ 4,843</u>	<u>\$ 5,484</u>
<b>Net income per share, both basic and diluted (Note 1) .....</b>	<b><u>\$ 1.00</u></b>	<u>\$ 1.13</u>	<u>\$ 1.26</u>
<b>Dividends declared per share .....</b>	<b><u>\$ 1.07</u></b>	<u>\$ 1.04</u>	<u>\$ 1.01</u>

See accompanying notes to consolidated financial statements

CORTLAND BANCORP AND SUBSIDIARIES  
CONSOLIDATED BALANCE SHEETS  
As of December 31, 2005 and 2004

(Amounts in thousands except per share data)

	<u>2005</u>	<u>2004</u>
<b>ASSETS</b>		
Cash and due from banks .....	\$ 14,587	\$ 9,397
Federal funds sold .....	4,650	3,500
Total cash and cash equivalents .....	<u>19,237</u>	<u>12,897</u>
Investment securities available for sale (Note 2) .....	113,247	121,348
Investment securities held to maturity (approximate market value of \$121,395 in 2005 and \$106,210 in 2004) (Note 2) .....	121,405	104,493
Total loans (Note 3) .....	188,202	191,777
Less allowance for loan losses (Note 4) .....	<u>(2,168)</u>	<u>(2,629)</u>
Net loans .....	<u>186,034</u>	<u>189,148</u>
Premises and equipment (Note 5) .....	4,088	4,369
Other assets .....	<u>15,690</u>	<u>14,138</u>
<b>Total assets</b> .....	<u><b>\$459,701</b></u>	<u><b>\$446,393</b></u>
<b>LIABILITIES</b>		
Noninterest-bearing deposits .....	\$ 61,782	\$ 58,394
Interest-bearing deposits (Note 6) .....	<u>288,593</u>	<u>286,525</u>
Total deposits .....	<u>350,375</u>	<u>344,919</u>
Federal Home Loan Bank advances and other borrowings (Note 7) .....	58,111	47,889
Other liabilities .....	<u>2,890</u>	<u>4,187</u>
<b>Total liabilities</b> .....	<u><b>411,376</b></u>	<u><b>396,995</b></u>
Commitments and contingent liabilities (Notes 8 and 16)		
<b>SHAREHOLDERS' EQUITY</b>		
Common stock - \$5.00 stated value - authorized 20,000,000 shares; issued 4,504,576 shares in 2005 and 4,373,735 shares in 2004 (Note 1) .....	22,523	21,869
Additional paid-in capital (Note 1) .....	20,211	18,531
Retained earnings .....	10,310	13,131
Accumulated other comprehensive (loss) income (Note 1) .....	(877)	1,061
Treasury stock, at cost, 155,945 shares in 2005 and 204,635 shares in 2004 .....	<u>(3,842)</u>	<u>(5,194)</u>
<b>Total shareholders' equity</b> (Notes 15 and 17) .....	<u><b>48,325</b></u>	<u><b>49,398</b></u>
<b>Total liabilities and shareholders' equity</b> .....	<u><b>\$459,701</b></u>	<u><b>\$446,393</b></u>

See accompanying notes to consolidated financial statements

CORTLAND BANCORP AND SUBSIDIARIES  
 CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY  
 Years ended December 31, 2005, 2004 and 2003

(Amounts in thousands except per share data)

	Common Stock	Additional Paid-In Capital	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Treasury Stock	Total Share- holders Equity
<b>Balance at December 31, 2002</b> .....	\$20,617	\$ 13,323	\$17,810	\$ 3,165	\$(2,876)	\$52,039
<b>Comprehensive Income:</b>						
Net income .....			5,484			5,484
Other comprehensive income, net of tax:						
Unrealized losses on available for sale securities, net of reclassification adjustment .....				(962)		(962)
Total comprehensive income .....						<u>4,522</u>
<b>Common Stock Transactions:</b>						
Treasury shares repurchased net of shares reissued .....		230			(2,550)	(2,320)
Cash dividends declared (\$.79 per share) .....			(3,485)			(3,485)
Special cash dividend (\$.22 per share) .....			(864)			(864)
3% stock dividend .....	617	2,916	(3,533)			(11)
Cash paid in lieu of fractional shares .....			(11)			(11)
<b>Balance at December 31, 2003</b> .....	21,234	16,469	15,401	2,203	(5,426)	49,881
<b>Comprehensive Income:</b>						
Net income .....			4,843			4,843
Other comprehensive income, net of tax:						
Unrealized losses on available for sale securities, net of reclassification adjustment .....				(1,142)		(1,142)
Total comprehensive income .....						<u>3,701</u>
<b>Common Stock Transactions:</b>						
Treasury shares reissued net of shares repurchased .....		30			232	262
Cash dividends declared (\$.82 per share) .....			(3,547)			(3,547)
Special cash dividend (\$.22 per share) .....			(890)			(890)
3% stock dividend .....	635	2,032	(2,667)			(9)
Cash paid in lieu of fractional shares .....			(9)			(9)
<b>Balance at December 31, 2004</b> .....	21,869	18,531	13,131	1,061	(5,194)	49,398
<b>Comprehensive Income:</b>						
Net income .....			4,334			4,334
Other comprehensive income, net of tax:						
Unrealized losses on available for sale securities, net of reclassification adjustment .....				(1,938)		(1,938)
Total comprehensive income .....						<u>2,396</u>
<b>Common Stock Transactions:</b>						
Treasury shares reissued net of shares repurchased .....		(184)			1,352	1,168
Cash dividends declared (\$.85 per share) .....			(3,701)			(3,701)
Special cash dividend (\$.22 per share) .....			(929)			(929)
3% stock dividend .....	654	1,864	(2,518)			(7)
Cash paid in lieu of fractional shares .....			(7)			(7)
<b>Balance at December 31, 2005</b> .....	<u>\$22,523</u>	<u>\$ 20,211</u>	<u>\$10,310</u>	<u>\$ (877)</u>	<u>\$(3,842)</u>	<u>\$48,325</u>

**DISCLOSURE OF RECLASSIFICATION FOR AVAILABLE  
 FOR SALE SECURITY GAINS AND LOSSES:**

	2005	2004	2003
Unrealized holding (losses) on available for sale securities arising during the period net of tax of \$(894), \$(231), and \$(174) .....	\$ (1,735)	\$ (448)	\$ (338)
Less: Reclassification adjustment for gains realized in net income, net of tax of \$105, \$358, and \$322, .....	203	694	624
Net unrealized (losses) on available for sale securities, net of tax .....	<u>\$ (1,938)</u>	<u>\$(1,142)</u>	<u>\$ (962)</u>

See accompanying notes to consolidated financial statements

CORTLAND BANCORP AND SUBSIDIARIES  
CONSOLIDATED STATEMENTS OF CASH FLOWS  
Years ended December 31, 2005, 2004 and 2003

(Amounts in thousands)

	<u>2005</u>	<u>2004</u>	<u>2003</u>
<b>Cash flows from operating activities</b>			
Net income .....	\$ 4,334	\$ 4,843	\$ 5,484
Adjustments to reconcile net income to net cash flows from operating activities:			
Depreciation, amortization and accretion .....	1,469	2,176	2,382
Provision for loan loss .....	545	415	240
Deferred tax expense (benefit) .....	50	(129)	135
Investment securities gains .....	(308)	(1,052)	(946)
Gains on sales of loans .....	(89)	(54)	(470)
Other real estate losses .....	3	171	
Loans originated for sale .....	(6,618)	(3,993)	(25,757)
Proceeds from sale of loans originated for sale .....	6,707	4,150	28,146
Changes in:			
Interest and fees receivable .....	(341)	148	131
Interest payable .....	(30)	(111)	49
Other assets and liabilities .....	(1,447)	818	(2,346)
Net cash flows from operating activities .....	<u>4,275</u>	<u>7,382</u>	<u>7,048</u>
<b>Cash flows from investing activities</b>			
Purchases of securities available for sale .....	(19,593)	(68,146)	(64,960)
Purchases of securities held to maturity .....	(47,280)	(43,601)	(62,165)
Proceeds from sales of securities available for sale .....	1,479	32,523	8,114
Proceeds from call, maturity and principal payments on securities .....	53,082	73,934	93,982
Net decrease (increase) in loans made to customers .....	2,462	(2,812)	(866)
Proceeds from disposition of other real estate .....	22	815	21
Purchases of premises and equipment .....	(316)	(127)	(333)
Net cash flows from investing activities .....	<u>(10,144)</u>	<u>(7,414)</u>	<u>(26,207)</u>
<b>Cash flows from financing activities</b>			
Net increase (decrease) in deposit accounts .....	5,456	7,363	1,798
Net increase (decrease) in borrowings .....	10,222	3	1,217
Dividends paid .....	(4,637)	(4,446)	(4,360)
Purchases of treasury stock .....	(3)	(1,032)	(3,641)
Treasury shares reissued .....	1,171	1,294	1,321
Net cash flows from financing activities .....	<u>12,209</u>	<u>3,182</u>	<u>(3,665)</u>
<b>Net change in cash and cash equivalents</b> .....	<u>6,340</u>	<u>3,150</u>	<u>(22,824)</u>
<b>Cash and cash equivalents</b>			
Beginning of year .....	<u>12,897</u>	<u>9,747</u>	<u>32,571</u>
End of year .....	<u>\$ 19,237</u>	<u>\$ 12,897</u>	<u>\$ 9,747</u>

See accompanying notes to consolidated financial statements

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**NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

Principles of Consolidation: The consolidated financial statements include the accounts of Cortland Bancorp (the Company) and its wholly-owned subsidiaries, Cortland Savings and Banking Company (the Bank) and New Resources Leasing Co. All significant intercompany balances and transactions have been eliminated.

Industry Segment Information: The Company and its subsidiaries operate in the domestic banking industry which accounts for substantially all of the Company's assets, revenues and operating income. The Company, through its subsidiary bank, grants residential, consumer, and commercial loans and offers a variety of saving plans to customers located primarily in the Northeastern Ohio and Western Pennsylvania area.

Use of Estimates: The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenue and expenses during the reporting period. Actual results could differ from those estimates.

Cash Flow: Cash and cash equivalents include cash on hand, amounts due from banks and federal funds sold. Generally, federal funds are purchased and sold for one-day periods. The Company reports net cash flows for customer loan transactions, deposit transactions and deposits made with other financial institutions.

The Company paid interest of \$8,695,000, \$8,121,000, and \$8,083,000 in 2005, 2004 and 2003, respectively. Cash paid for income taxes was \$993,000 in 2005, \$1,005,000 in 2004 and \$1,320,000 in 2003. Transfers of loans to other real estate were, \$107,000 in 2005, \$196,000 in 2003 and none in 2004.

Investment Securities: Investments in debt and equity securities are classified as held to maturity, trading or available for sale. Securities classified as held to maturity are those that management has the positive intent and ability to hold to maturity. Securities classified as available for sale are those that could be sold for liquidity, investment management, or similar reasons, even though management has no present intentions to do so.

Securities 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 available for sale are carried at fair value with unrealized gains and losses recorded as a separate component of shareholders' equity, net of tax effects. Realized gains or losses on dispositions are based on net proceeds and the adjusted carrying amount of securities sold, using the specific identification method. Interest on securities is accrued and credited to operations based on the principal balance outstanding, adjusted for amortization of premiums and accretion of discounts.

Unrealized losses on corporate bonds have not been recognized into income. Management has the intent and ability to hold these securities for the foreseeable future. The fair value is expected to recover as the bonds approach their maturity date and/or market conditions become more favorable to the bonds' intrinsic value.

Trading Securities: Trading securities are principally held with the intention of selling in the near term and are carried at market value. Realized and unrealized gains and losses on trading account securities are recognized in the Statement of Income as they occur. The Company did not hold any trading securities at December 31, 2005 or 2004. During 2003, trading activity produced purchases of \$23,680,000 and sales of \$23,945,000, resulting in a net gain of \$265,000. There was no trading activity in 2005 or 2004.

Loans: Loans are stated at the principal amount outstanding net of the unamortized balance of deferred loan origination fees and costs. Deferred loan origination fees and costs are amortized as an adjustment to the related loan yield over the contractual life using the level yield method. Interest income on loans is accrued over the term of the loans based on the amount of principal outstanding. The accrual of interest is

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(Continued)

**NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)**

discontinued on a loan when management determines that the collection of interest is doubtful. Generally a loan is placed on nonaccrual status once the borrower is 90 days past due on payments, or whenever sufficient information is received to question the collectability of the loan or any time legal proceedings are initiated involving a loan. Interest income accrued up to the date a loan is placed on nonaccrual is reversed through interest income. Cash payments received while a loan is classified as nonaccrual are recorded as a reduction to principal or reported as interest income according to management's judgment as to the 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 judgment, collectable, 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.

Loans Held for Sale: The Company originates certain residential mortgage loans for sale in the secondary mortgage loan market. For the majority of loan sales, the Company concurrently sells the rights to service the related loans. In addition, the Company may periodically identify other loans which may be sold. These loans are classified as loans held for sale, and carried, in the aggregate, at the lower of cost or estimated market value based on secondary market prices. To mitigate interest rate risk, the Company may obtain fixed commitments to sell such loans at the time loans are originated or identified as being held for sale. Such a commitment would be referred to as a derivative loan commitment if the loan that will result from exercise of the commitment will be held for sale upon funding under Statement of Financial Accounting Standards No. 133 ("SFAS 133"), *Accounting for Derivative Instruments and Hedging Activities*, as amended by Statement of Financial Accounting Standards No. 149 ("SFAS 149"), *Amendment of Statement 133 on Derivative Instruments and Hedging Activities*. No such commitments existed as of December 31, 2005.

Allowance for Loan Losses and Allowance for Losses on Lending Related Commitments: Because some loans may not be repaid in full, an allowance for loan losses is recorded. Increases to the allowance consist of provisions for loan losses charged to expense and recoveries of previously charged-off loans. Reductions to the allowance result from the charge-off of loans deemed uncollectable by management. After a loan is charged-off, collection efforts continue and future recoveries may occur.

A loan is considered impaired when it appears probable that all principal and interest amounts will not be collected according to the loan contract. Allowances for loan losses on impaired loans are determined using the estimated future cash flows of the loan, discounted to their present value using the loan's effective interest rate. Allowances for loan losses for impaired loans that are collateral dependent are generally determined based on the estimated fair value of the underlying collateral. Smaller balance homogeneous loans are evaluated for impairment in the aggregate. Such loans include one-to-four family residential, home equity and consumer loans. Commercial loans and commercial mortgage loans are evaluated individually for impairment. Impaired loans are generally classified as nonaccrual loans.

Estimating the risk of loss and the amount of loss on any loan is necessarily subjective. Accordingly, the allowance is maintained by management at a level considered adequate to cover possible losses that are currently anticipated. 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 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

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(Continued)

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**NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES** (Continued)

by the Company's loan review systems or as the result of regulatory examination process; and general economic conditions in the lending area of the Company's bank subsidiary. Key risk factors and assumptions are dynamically updated to reflect actual experience and changing circumstances. While management may periodically allocate portions of the allowance for specific problem loans, the entire allowance is available for any charge-offs that occur.

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.

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.

Premises and Equipment: Premises and equipment are stated at cost less accumulated depreciation. Depreciation is computed generally on the straight-line method over the estimated useful lives of the various assets. Maintenance and repairs are expensed and major improvements are capitalized.

Other Real Estate: Real estate acquired through foreclosure or deed-in-lieu of foreclosure is included in other assets. Such real estate is carried at the lower of cost or fair value less estimated costs to sell. Any reduction from the carrying value of the related loan to fair value at the time of acquisition is accounted for as a loan loss. Any subsequent reduction in fair market value is reflected as a valuation allowance through a charge to income. Costs of significant property improvements are capitalized, whereas costs relating to holding and maintaining the property are charged to expense.

Intangible Asset: A core deposit intangible asset resulting from a branch acquisition is being amortized over a 15 year period. The intangible asset, net of accumulated amortization, was \$171,000 and \$208,000 at December 31, 2005 and 2004, respectively, and is included in other assets. The annual expense was \$37,000 at December 31, 2005, 2004 and 2003. The estimated aggregate amortization expense for the next four years is \$37,000 per year, and \$23,000 in the fifth year.

Cash Surrender Value of Life Insurance: Bank-owned life insurance ("BOLI") represents life insurance on the lives of certain Company employees, officers and directors who have provided positive consent allowing the Company to be the co-beneficiary of such policies. Since the Company is the owner of the insurance policies, increases in the cash value of the policies, as well as its share of insurance proceeds received, are recorded in other noninterest income, and are not subject to income taxes. The cash value of the policies is included in other assets. The Company reviews the financial strength of the insurance carriers prior to the purchase of BOLI and quarterly thereafter. The amount of BOLI with any individual carrier is limited to 15% of Tier I Capital. The Company has purchased BOLI to provide a long-term asset to offset long-term benefit liabilities, while generating competitive investment yields.

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(Continued)

CORTLAND BANCORP AND SUBSIDIARIES  
 NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS  
 Years ended December 31, 2005, 2004 and 2003

**NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES** (Continued)

Advertising: The Company expenses advertising costs as incurred.

Income Taxes: A deferred tax liability or asset is determined at each balance sheet date. It is measured by applying currently enacted tax laws to future amounts that result from differences in the financial statement and tax bases of assets and liabilities.

Other Comprehensive Income: Accumulated other comprehensive income for the Company is comprised solely of unrealized holding gains (losses) on available for sale securities, net of tax.

Per Share Amounts: The Board of Directors declared 3% common stock dividends payable as of January 1, 2006, 2005 and 2004. The 3% common stock dividend issued on January 1, 2006 resulted in the issuance of 130,841 shares of common stock, which have been included in the 4,504,576 shares reported as issued at December 31, 2005.

Basic and diluted earnings per share are based on weighted average shares outstanding. Average shares outstanding and per share amounts have been restated to give retroactive effect to the 3% common stock dividend of January 1, 2006. Average shares outstanding and per share amounts similarly reflect the impact of the Company's stock repurchase program (see Note 17).

The following table sets forth the computation of basic earnings per common share and diluted earnings per common share:

	Years Ended December 31,		
	2005	2004	2003
Net income (\$000 omitted) .....	\$ 4,334	\$ 4,843	\$ 5,484
Weighted average common shares outstanding .....	4,330,483	4,278,628	4,337,472
Basic earnings per share .....	\$ 1.00	\$ 1.13	\$ 1.26
Diluted earnings per share .....	\$ 1.00	\$ 1.13	\$ 1.26

Off Balance Sheet Financial Instruments: Financial instruments include off-balance sheet credit instruments, such as commitments to make loans and commercial letters of credit, issued to meet customer financing needs. The face amount for these items represents the exposure to loss, before considering customer collateral or ability to repay. Such financial instruments are recorded when they are funded.

Reclassifications: Certain items in the financial statements for 2004 and 2003 have been reclassified to conform to the 2005 presentation.

New Accounting Standards: In November 2005, the Financial Accounting Standards Board (FASB) issued FASB Staff Position (FSP) 115-and 124-1, "The Meaning of Other-Than-Temporary Impairment and its Application to Certain Investments". This FSP provides guidance on when an investment in a debt or equity security should be considered impaired, when that impairment should be considered other-than-temporary, and measurement of the impairment loss. An investment is considered impaired if the fair value of the investment is less than its cost. If, after consideration of all available evidence to evaluate the realizable value of the investment, impairment is determined to be other-than-temporary, then an impairment loss should be recognized equal to the difference between the investment's cost and its fair value. The guidance also clarifies that an impairment loss should be recognized no later than when the impairment is deemed other-than-temporary, even if a decision to sell has not been made. This FSP nullifies certain provisions of Emerging Issues Task Force (EITF) Issue No. 03-1, "The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments," while retaining the disclosure

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**NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES** (Continued)

requirements of EITF 03-1 which were adopted in 2003. FSP 115-1 and 124-1 is effective for reporting periods beginning after December 15, 2005. The Company applied the guidance in this FSP in 2005.

In May 2005, the FASB issued Statement of Financial Accounting Standards (SFAS) No. 154 "Accounting Changes and Error Corrections," a replacement of APB Opinion No. 20, "Accounting Changes" and FASB Statement No. 3, "Reporting Accounting Changes in Interim Financial Statements." SFAS No. 154 applies to all voluntary changes in accounting principle and changes the accounting for and reporting of a change in accounting principle. SFAS No. 154 requires retrospective application to prior periods' financial statements of a voluntary change in accounting principle unless it is impracticable. APB No. 20 previously required that most voluntary changes in accounting principle be recognized by including in net income of the period of the change the cumulative effect of changing to the new accounting principle. SFAS No. 154 is effective for accounting changes made in fiscal years beginning after December 15, 2005. The Company does not believe there will be any material impact on its earnings, cash flows and/or financial position upon adoption of SFAS No. 154.

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(Continued)

CORTLAND BANCORP AND SUBSIDIARIES  
 NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS  
 Years ended December 31, 2005, 2004 and 2003

**NOTE 2 - INVESTMENT SECURITIES**

The following is a summary of investment securities:

	(Amounts in thousands)			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
<b>December 31, 2005</b>				
<b>Investment securities available for sale</b>				
U.S. Government agencies and corporations . . . . .	\$ 14,010	\$ 34	\$ 196	\$ 13,848
Obligations of states and political subdivisions . . . . .	11,372	506	6	11,872
Mortgage-backed and related securities . . . . .	61,494	314	1,174	60,634
Corporate securities . . . . .	24,307	50	857	23,500
Total debt securities . . . . .	111,183	904	2,233	109,854
Other securities . . . . .	3,393			3,393
Total available for sale . . . . .	<u>\$114,576</u>	<u>\$ 904</u>	<u>\$2,233</u>	<u>\$113,247</u>
<b>Investment securities held to maturity</b>				
U.S. Treasury securities . . . . .	\$ 148	\$ 2	\$	\$ 150
U.S. Government agencies and corporations . . . . .	66,057	5	943	65,119
Obligations of states and political subdivisions . . . . .	32,842	1,307	23	34,126
Mortgage-backed and related securities . . . . .	22,358	14	372	22,000
Total held to maturity . . . . .	<u>\$121,405</u>	<u>\$1,328</u>	<u>\$1,338</u>	<u>\$121,395</u>
<b>December 31, 2004</b>				
<b>Investment securities available for sale</b>				
U.S. Treasury securities . . . . .	\$ 1,192	\$ 254	\$	\$ 1,446
U.S. Government agencies and corporations . . . . .	21,687	215	40	21,862
Obligations of states and political subdivisions . . . . .	10,900	741		11,641
Mortgage-backed and related securities . . . . .	66,643	802	302	67,143
Corporate securities . . . . .	16,081	22	87	16,016
Total debt securities . . . . .	116,503	2,034	429	118,108
Other securities . . . . .	3,240			3,240
Total available for sale . . . . .	<u>\$119,743</u>	<u>\$2,034</u>	<u>\$429</u>	<u>\$121,348</u>
<b>Investment securities held to maturity</b>				
U.S. Treasury securities . . . . .	\$ 152	\$ 5	\$	\$ 157
U.S. Government agencies and corporations . . . . .	46,210	172	192	46,190
Obligations of states and political subdivisions . . . . .	34,048	1,870	21	35,897
Mortgage-backed and related securities . . . . .	24,083	103	220	23,966
Total held to maturity . . . . .	<u>\$104,493</u>	<u>\$2,150</u>	<u>\$433</u>	<u>\$106,210</u>

At December 31, 2005 and 2004, other securities consisted of \$3,167,000 and \$3,014,000 in Federal Home Loan Bank (FHLB) stock, respectively, and \$226,000 in Federal Reserve Board (FED) stock. Each investment is carried at cost, and the Company is required to hold such investments as a condition of membership in order to transact business with the FHLB and the FED.

(Continued)

CORTLAND BANCORP AND SUBSIDIARIES  
 NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS  
 Years ended December 31, 2005, 2004 and 2003

**NOTE 2 - INVESTMENT SECURITIES (Continued)**

The amortized cost and estimated market value of debt securities at December 31, 2005, by contractual maturity, are shown below. Actual maturities will differ from contractual maturities because issuers may have the right to call or prepay obligations with or without call or prepayment penalties.

(Amounts in thousands)

	<u>December 31, 2005</u>	
	<u>Amortized Cost</u>	<u>Estimated Fair Value</u>
<b>Investment securities available for sale</b>		
Due in one year or less.....	\$	\$
Due after one year through five years.....	11,082	11,001
Due after five years through ten years.....	3,381	2,690
Due after ten years.....	<u>35,226</u>	<u>35,529</u>
Subtotal.....	49,689	49,220
Mortgage-backed securities.....	61,494	60,634
Total.....	<u>\$111,183</u>	<u>\$109,854</u>
<b>Investment securities held to maturity</b>		
Due in one year or less.....	\$ 48	\$ 47
Due after one year through five years.....	3,217	3,145
Due after five years through ten years.....	34,453	34,256
Due after ten years.....	<u>61,329</u>	<u>61,947</u>
Subtotal.....	99,047	99,395
Mortgage-backed securities.....	<u>22,358</u>	<u>22,000</u>
Total.....	<u>\$121,405</u>	<u>\$121,395</u>

The following table sets forth the proceeds, gains and losses realized on securities sold or called for each of the years ended December 31:

(Amounts in thousands)

	<u>2005</u>	<u>2004</u>	<u>2003</u>
<b>Proceeds</b> .....	\$13,563	\$43,339	\$20,115
Gross realized gains.....	308	1,074	948
Gross realized losses.....		22	2

Investment securities with a carrying value of approximately \$64,082,000 at December 31, 2005 and \$48,114,000 at December 31, 2004 were pledged to secure deposits and for other purposes.

(Continued)

CORTLAND BANCORP AND SUBSIDIARIES  
 NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS  
 Years ended December 31, 2005, 2004 and 2003

**NOTE 2 - INVESTMENT SECURITIES** (Continued)

The following is a summary of the fair value of securities with unrealized losses and an aging of those unrealized losses at December 31, 2005:

(Amounts in thousands)

	<u>Less than 12 Months</u>		<u>12 Months or More</u>		<u>Total</u>	
	<u>Fair Value</u>	<u>Unrealized Losses</u>	<u>Fair Value</u>	<u>Unrealized Losses</u>	<u>Fair Value</u>	<u>Unrealized Losses</u>
U.S. Government agencies and corporations . . . . .	\$53,229	\$ 734	\$19,359	\$ 405	\$ 72,588	\$1,139
Obligations of states and political subdivisions . . . . .	893	8	857	21	1,750	29
Mortgage-backed and related securities . . . . .	33,976	522	32,556	1,024	66,532	1,546
Corporate securities . . . . .	9,928	840	2,996	17	12,924	857
	<u>\$98,026</u>	<u>\$2,104</u>	<u>\$55,768</u>	<u>\$1,467</u>	<u>\$153,794</u>	<u>\$3,571</u>

The following is a summary of the fair value of securities with unrealized losses and an aging of those unrealized losses at December 31, 2004:

(Amounts in thousands)

	<u>Less than 12 Months</u>		<u>12 Months or More</u>		<u>Total</u>	
	<u>Fair Value</u>	<u>Unrealized Losses</u>	<u>Fair Value</u>	<u>Unrealized Losses</u>	<u>Fair Value</u>	<u>Unrealized Losses</u>
U.S. Government agencies and corporations . . . . .	\$14,692	\$135	\$ 8,099	\$ 97	\$ 22,791	\$232
Obligations of states and political subdivisions . . . . .			859	21	859	21
Mortgage-backed and related securities . . . . .	27,317	247	19,591	275	46,908	522
Corporate securities . . . . .	7,004	61	2,000	26	9,004	87
	<u>\$49,013</u>	<u>\$443</u>	<u>\$30,549</u>	<u>\$419</u>	<u>\$ 79,562</u>	<u>\$862</u>

The above table represents 207 investment securities where the current value is less than the related amortized cost.

The unrealized losses on the Bank's investment in mortgage-backed and related securities were caused by interest rate increases. Accordingly, it is expected that the securities would not be settled at a price less than the amortized cost of the Bank's investment because the decline in market value is attributable to changes in interest rates and not credit quality, and because the Company has the ability and intent to hold those investments until a recovery of fair value, which may be maturity. The Bank does not consider those investments to be other than temporarily impaired at December 31, 2005.

The Bank's unrealized loss on investments in corporate securities relates to a \$2,350,000 investment in the General Motors Corporation. The unrealized loss was primarily caused by (a) a recent decrease in profitability and profit forecasts by industry analysts resulting from intense competitive pressure in the automotive industry and (b) recent sector downgrade by industry analysts. The contractual terms of those investments do not permit General Motors Corporation to settle the security at a price less than the

(Continued)

**NOTE 2 - INVESTMENT SECURITIES (Continued)**

amortized cost of the investment. While the General Motors Corporation credit rating has decreased from A3 to B1 (Moody's), the Bank believes it is probable that it will be able to collect all amounts due according to the contractual terms of the investment. Therefore, it is expected that the bonds would not be settled at a price less than the amortized cost of the investment. Because the Bank has the ability and intent to hold the investments until a recovery of fair value, which may be maturity, it does not consider the investment in the General Motors Corporate notes to be other-than-temporarily impaired at December 31, 2005.

**NOTE 3 - LOANS RECEIVABLE**

The following is a summary of loans:

(Amounts in thousands)

	December 31,	
	<u>2005</u>	<u>2004</u>
1-4 family residential mortgage loans .....	\$ 59,910	\$ 61,238
Commercial mortgage loans .....	90,983	94,019
Consumer loans .....	6,714	6,087
Commercial loans .....	19,767	19,188
Home equity loans .....	10,828	11,245
Total loans .....	<u>\$188,202</u>	<u>\$191,777</u>

**NOTE 4 - ALLOWANCE FOR LOAN LOSSES**

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

(Amounts in thousands)

	December 31,		
	<u>2005</u>	<u>2004</u>	<u>2003</u>
Balance at beginning of year .....	\$ 2,629	\$2,408	\$3,134
Loan charge-offs .....	(1,119)	(264)	(1,120)
Recoveries .....	113	70	154
Net loan charge-offs .....	(1,006)	(194)	(966)
Provision charged to operations .....	545	415	240
Balance at end of year .....	<u>\$ 2,168</u>	<u>\$2,629</u>	<u>\$2,408</u>

Loans on which the accrual of interest has been discontinued because circumstances indicate that collection is questionable amounted to \$3,746,000, \$3,395,000 and \$2,067,000 at December 31, 2005, 2004 and 2003, respectively. Interest income on these loans, if accrued, would have increased pretax income by approximately \$266,000, \$195,000 and \$135,000 for 2005, 2004 and 2003, respectively.

Impaired loans are generally included in nonaccrual loans. Management does not individually evaluate certain smaller balance loans for impairment as such loans are evaluated on an aggregate basis. These loans generally include 1-4 family, consumer and home equity loans. Impaired loans are generally evaluated using the fair value of collateral as the measurement method. At December 31, 2005, December 31, 2004 and

(Continued)

CORTLAND BANCORP AND SUBSIDIARIES  
 NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS  
 Years ended December 31, 2005, 2004 and 2003

**NOTE 4 - ALLOWANCE FOR LOAN LOSSES (Continued)**

December 31, 2003, the recorded investment in impaired loans was \$1,857,000, \$2,985,000 and \$871,000 while the allocated portion of the allowance for loan losses for such loans was \$714,000, \$1,355,000 and \$177,000, respectively. Interest income recognized on impaired loans using the cash basis was \$51,000 for 2005, \$100,000 for 2004 and \$42,000 for 2003.

There were no renegotiated loans for which interest has been reduced and that are still accruing interest at December 31, 2005, December 31, 2004 and December 31, 2003.

As of December 31, 2005, 2004 and 2003, there were \$5,304,000, \$5,622,000 and \$2,113,000 in loans that were neither classified as nonaccrual nor considered impaired, but which can be considered 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.

**NOTE 5 - PREMISES AND EQUIPMENT**

The following is a summary of premises and equipment:

(Amounts in thousands)

	December 31,	
	<u>2005</u>	<u>2004</u>
Land . . . . .	\$ 703	\$ 692
Premises . . . . .	5,668	5,550
Equipment . . . . .	9,430	9,263
Leasehold improvements . . . . .	<u>281</u>	<u>281</u>
	16,082	15,786
Less accumulated depreciation . . . . .	<u>11,994</u>	<u>11,417</u>
Net book value . . . . .	<u>\$ 4,088</u>	<u>\$ 4,369</u>

Depreciation expense was \$597,000 for 2005, \$630,000 for 2004 and \$737,000 for 2003.

(Continued)



**NOTE 6 - DEPOSITS**

The following is a summary of interest-bearing deposits:

(Amounts in thousands)

	December 31,	
	<u>2005</u>	<u>2004</u>
Demand .....	\$ 29,677	\$ 28,723
Money Market .....	17,866	18,971
Savings .....	86,359	90,432
Time:		
In denominations under \$100,000 .....	109,488	113,522
In denominations of \$100,000 or more .....	45,203	34,877
Total .....	<u>\$288,593</u>	<u>\$286,525</u>

The following is a summary of time deposits of \$100,000 or more by remaining maturities:

(Amounts in thousands)

	December 31,					
	2005			2004		
	<u>Certificates of Deposit</u>	<u>Other Time Deposits</u>	<u>Total</u>	<u>Certificates of Deposit</u>	<u>Other Time Deposits</u>	<u>Total</u>
Three months or less .....	\$10,760	\$ 100	\$10,860	\$ 7,480	\$ 805	\$ 8,285
Three to six months .....	11,521	334	11,855	4,397	263	4,660
Six to twelve months .....	6,428	350	6,778	4,490	100	4,590
One through five years .....	7,195	1,647	8,842	9,250	1,523	10,773
Over five years .....	1,829	5,039	6,868	1,899	4,670	6,569
Total .....	<u>\$37,733</u>	<u>\$7,470</u>	<u>\$45,203</u>	<u>\$27,516</u>	<u>\$7,361</u>	<u>\$34,877</u>

(Continued)

CORTLAND BANCORP AND SUBSIDIARIES  
 NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS  
 Years ended December 31, 2005, 2004 and 2003

**NOTE 7 - FEDERAL HOME LOAN BANK ADVANCES AND OTHER BORROWINGS**

The following is a summary of total Federal Home Loan Bank advances and other borrowings:

(Amounts in thousands)

	Weighted Average Interest Rate	December 31,	
		2005	2004
<b>Federal Home Loan Bank advances</b>			
Variable rate Prime based Federal Home Loan Bank advances, with monthly interest payments:			
Due in 2007 .....	4.6000%	\$ 5,000	\$
Fixed rate and convertible fixed rate Federal Home Loan Bank advances, with monthly interest payments:			
Due in 2006 .....	4.6600%	2,000	
Due in 2007 .....	4.2580%	10,000	6,000
Due in 2008 .....	5.6340%	5,000	5,000
Due in 2009 .....	5.1600%	10,000	10,000
Due in 2010 .....	5.9293%	13,500	13,500
Due in 2011 .....	4.9553%	9,500	9,500
Total Federal Home Loan Bank advances .....	5.1235%	55,000	44,000
<b>Other borrowings</b>			
Securities sold under repurchase agreements .....	2.9570%	2,336	2,675
U.S. Treasury interest-bearing demand note .....	3.9520%	775	1,214
Total other borrowings .....	3.2049%	3,111	3,889
Total Federal Home Loan Bank advances and other borrowings .....	5.0207%	\$58,111	\$47,889

Securities sold under repurchase agreements represent arrangements that the Bank has entered into with certain deposit customers within its local market areas. These borrowings are collateralized with securities. There are \$6.8 million in securities, allocated for this purpose, owned by the Bank and held in safekeeping accounts at independent correspondent banks.

Federal Home Loan Bank (FHLB) advances are collateralized by the FHLB stock owned by the Bank, which had a carrying value of \$3,167,200 at December 31, 2005, and a blanket lien against the Bank's qualified mortgage loan portfolio, \$17,097,000 in collateralized mortgage obligations and \$5,415,000 in Federal Agency Securities. Maximum borrowing capacity from the FHLB totaled \$60,814,000 at December 31, 2005.

As of both December 31, 2005 and 2004, \$38,000,000 of the FHLB fixed rate advances are convertible to quarterly LIBOR floating rate advances on or after certain specified dates at the option of the FHLB. Should the FHLB elect to convert, the Company acquires the right to prepay any or all of the borrowing at the time of conversion and on any interest payment due date, thereafter, without penalty.

**NOTE 8 - COMMITMENTS**

The Bank occupies office facilities under operating leases extending to 2008. Most of these leases contain an option to renew at the then fair rental value for periods of five and ten years. These options enable the Bank to retain use of facilities in desirable operating areas. In most cases, management expects that in the normal course of business, leases will be renewed or replaced by other leases. Rental and lease expense was

(Continued)



**NOTE 8 - COMMITMENTS (Continued)**

\$295,000 for 2005, \$287,000 for 2004, and \$286,000 for 2003. The following is a summary of remaining future minimum lease payments under current noncancelable operating leases for office facilities:

(Amounts in thousands)

Years ending:	
December 31, 2006 .....	<b>\$188</b>
December 31, 2007 .....	<b>83</b>
December 31, 2008 .....	<b><u>27</u></b>
Total .....	<b><u>\$298</u></b>

At December 31, 2005, the Bank was required to maintain aggregate cash reserves amounting to \$5,296,000 in order to satisfy federal regulatory requirements. These amounts do not earn interest.

The Bank grants commercial and industrial loans, commercial and residential mortgages, and consumer loans to customers in Northeast Ohio and Western Pennsylvania. Although the Bank has a diversified portfolio, exposure to credit loss can be adversely impacted by downturns in local economic and employment conditions. Approximately 3.31% of total loans are unsecured at December 31, 2005, compared to 2.84% at December 31, 2004.

The Company currently does not enter into derivative financial instruments including futures, forwards, interest rate risk swaps, option contracts, or other financial instruments with similar characteristics. The Company also does not participate in any partnerships or other special purpose entities that might give rise to off-balance sheet liabilities.

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 or 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.

(Continued)

CORTLAND BANCORP AND SUBSIDIARIES  
 NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS  
 Years ended December 31, 2005, 2004 and 2003

**NOTE 8 - COMMITMENTS** (Continued)

The following is a summary of such contractual commitments:

(Amounts in thousands)

	<u>December 31,</u>	
	<u>2005</u>	<u>2004</u>
Financial instruments whose contract amounts represent credit risk:		
Commitments to extend credit		
Fixed rate .....	<b>\$ 2,101</b>	\$ 1,506
Variable rate .....	<b>39,180</b>	30,400
Standby letters of credit .....	<b>1,195</b>	1,455

Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Generally these financial arrangements have fixed expiration dates or other termination clauses and may require payment of a fee. Standby letters of credit are conditional commitments issued by the Bank to guarantee the performance of a customer to a third party. Since many of the commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. The Bank evaluates each customer's creditworthiness on a case-by-case basis. The amount of collateral obtained, if deemed necessary by the Bank upon extension of credit, is based on management's credit evaluation of the counterparty. Collateral held varies but may include accounts receivable, inventory, property, plant and equipment and income-producing commercial properties.

The Company's subsidiary bank also offers limited overdraft protection as a non-contractual courtesy which is available to individually/jointly owned accounts in good standing for personal or household use. The Company reserves the right to discontinue this service without prior notice. The available amount of overdraft protection on depositors' accounts at December 31, 2005, totaled \$6,191,000. The total average daily balance of overdrafts used in 2005 was \$126,000, or approximately 2% of the total aggregate overdraft protection available to depositors.

**NOTE 9 - BENEFIT PLANS**

The Bank has a contributory defined contribution retirement plan (a 401(k) plan) which covers substantially all employees. Total expense under the plan was \$224,000 for 2005, \$215,000 for 2004 and \$211,000 for 2003. The Bank matches participants' voluntary contributions up to 5% of gross pay. Participants may make voluntary contributions to the plan up to a maximum of 15% of gross wages or \$14,000, whichever is less. The Bank makes monthly contributions to this plan equal to amounts accrued for plan expense.

The Bank and Bancorp provide supplemental retirement benefit plans for the benefit of certain officers and non officer directors. The plan for officers is designed to provide post-retirement benefits to supplement other sources of retirement income such as social security and 401(k) benefits. The benefits will be paid for a period of 15 years after retirement. The amount of each officer's benefit is determined by their salary at retirement as well as their other sources of retirement income. Director Retirement Agreements provide for a benefit of \$10,000 annually on or after the director reaches normal retirement age, which is based on a combination of age and years of service. Director retirement benefits are paid over a period of 10 years

(Continued)

**NOTE 9 - BENEFIT PLANS (Continued)**

following retirement. The Bank and Bancorp accrue the cost of these post-retirement benefits during the working careers of the officers and directors. At December 31, 2005, the cumulative expense accrued for these benefits totaled \$1,283,000, with \$1,052,000 accrued for the officers' plan and \$231,000 for the directors' plan.

The Bank has purchased insurance contracts on the lives of the participants in the supplemental retirement benefit plan and has named the Bank as the beneficiary. Similarly, the Bancorp has purchased insurance contracts on the lives of the directors with the Bancorp as beneficiary. While no direct linkage exists between the supplemental retirement benefit plan and the life insurance contracts, it is management's current intent that the revenue from the insurance contracts be used as a funding source for the plan. At December 31, 2005, the cumulative income accrued on these contracts totaled \$1,681,000 on a tax equivalent basis, with \$1,166,000 accrued on the officers' contracts and \$515,000 on the directors' contracts.

**NOTE 10 - FEDERAL INCOME TAXES**

The composition of income tax expense is as follows:

(Amounts in thousands)

	Years Ended December 31,		
	<u>2005</u>	<u>2004</u>	<u>2003</u>
Current .....	\$ 907	\$1,119	\$1,236
Deferred .....	50	(129)	135
Total .....	<u>\$ 957</u>	<u>\$ 990</u>	<u>\$1,371</u>

The following is a summary of net deferred taxes included in other assets (liabilities):

(Amounts in thousands)

	December 31,		
	<u>2005</u>	<u>2004</u>	<u>2003</u>
Gross deferred tax assets:			
Provision for loan and other real estate losses...	\$ 413	\$ 570	\$ 495
AMT credit .....	29	29	
Other items .....	641	494	386
Loan origination cost - net .....	28	6	(2)
Unrealized loss (gain) on available for sale securities .....	452	(547)	(1,135)
Gross deferred tax liabilities:			
Depreciation .....	(387)	(389)	(343)
Other items .....	(498)	(434)	(389)
Net deferred tax asset (liability) .....	<u>\$ 678</u>	<u>\$ (271)</u>	<u>\$ (988)</u>

The Company has an alternative minimum tax credit which can be carried forward indefinitely.

(Continued)

CORTLAND BANCORP AND SUBSIDIARIES  
 NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS  
 Years ended December 31, 2005, 2004 and 2003

**NOTE 10 - FEDERAL INCOME TAXES (Continued)**

The following is a reconciliation between tax expense using the statutory tax rate of 34% and the income tax provision:

(Amounts in thousands)

	Years Ended December 31,		
	2005	2004	2003
Statutory tax .....	\$ 1,798	\$ 1,983	\$ 2,331
Effect of non-taxable income .....	(921)	(1,084)	(1,052)
Effect of non-deductible expense .....	80	91	92
Total income taxes .....	<u>\$ 957</u>	<u>\$ 990</u>	<u>\$ 1,371</u>

The related income tax expense on investment securities gains and losses amounted to \$105,000 for 2005, \$358,000 for 2004 and \$321,000 for 2003, and is included in the total federal income tax provision.

**NOTE 11 - FAIR VALUE OF FINANCIAL INSTRUMENTS**

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

(Amounts in thousands)

	December 31, 2005		December 31, 2004	
	Carrying Amount	Estimated Fair Value	Carrying Amount	Estimated Fair Value
<b>ASSETS:</b>				
Cash and cash equivalents .....	\$ 14,587	\$ 14,587	\$ 9,397	\$ 9,397
Federal Funds sold .....	4,650	4,650	3,500	3,500
Investment securities .....	234,652	234,642	225,841	227,558
Loans, net of allowance for loan losses .....	186,034	184,389	189,148	188,508
<b>LIABILITIES:</b>				
Demand and savings deposits .....	\$195,684	\$195,684	\$196,520	\$196,520
Time deposits .....	154,691	154,608	148,399	150,362
FHLB advances .....	55,000	54,957	44,000	44,305
Other borrowings .....	3,111	3,111	3,889	3,889

For purposes of the above disclosures of estimated fair value, the following assumptions were used as of December 31, 2005 and 2004. The estimated fair value for cash and cash equivalents is considered to approximate cost. The estimated fair value for securities is based on quoted market values for individual securities or for equivalent securities when specific quoted prices are not available. Carrying value is considered to approximate fair value for loans, FHLB advances and other borrowings that reprice frequently and for deposit liabilities subject to immediate withdrawal. The fair values of loans, FHLB advances and other borrowings and time deposits that reprice less frequently are approximated by a discount rate

(Continued)



**NOTE 11 - FAIR VALUE OF FINANCIAL INSTRUMENTS (Continued)**

valuation technique utilizing estimated market interest rates as of December 31, 2005 and 2004. The fair value of unrecorded commitments at December 31, 2005 and 2004, is not material.

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

**NOTE 12 - REGULATORY MATTERS**

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

Quantitative measures established by regulation to ensure capital adequacy require the Company to maintain: (1) a minimum ratio of 4% both for total Tier I risk-based capital to risk-weighted assets and for Tier I risk-based capital to average assets, and (2) a minimum ratio of 8% for total risk-based capital to risk-weighted assets.

Under the regulatory framework for prompt corrective action, the Company is categorized as well capitalized, which requires minimum capital ratios of 10% for total risk-based capital to risk-weighted assets, 6% for Tier I risk-based capital to risk-weighted assets, and 5% for Tier I risk-based capital to average assets (also known as the leverage ratio). There are no conditions or events since the most recent communication from regulators that management believes would change the Company's category.

(Amounts in thousands)

	December 31, 2005		December 31, 2004	
	<u>Amount</u>	<u>Ratio</u>	<u>Amount</u>	<u>Ratio</u>
Total Risk-Based Capital . . . . .	\$51,220		\$50,793	
Ratio to Risk-Weighted Assets . . . . .		21.16%		22.07%
Tier I Risk-Based Capital . . . . .	\$49,031		\$48,129	
Ratio to Risk-Weighted Assets . . . . .		20.25%		20.91%
Ratio to Average Assets . . . . .		11.05%		10.88%

Tier I risk-based capital is shareholders' equity less intangibles and the unrealized market value adjustment of investment securities available for sale. Total risk-based capital is Tier I risk-based capital plus the qualifying portion of the allowance for loan losses. Assets and certain off balance sheet items adjusted in

(Continued)

CORTLAND BANCORP AND SUBSIDIARIES  
 NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS  
 Years ended December 31, 2005, 2004 and 2003

**NOTE 12 - REGULATORY MATTERS (Continued)**

accordance with risk classification comprise risk-weighted assets of \$242,106,000 and \$230,133,000 as of December 31, 2005 and 2004, respectively. Assets less intangibles and the net unrealized market value adjustment of investment securities available for sale averaged \$443,677,000 and \$442,428,000 for the years ended December 31, 2005 and 2004, respectively.

**NOTE 13 - RELATED PARTY TRANSACTIONS**

Certain directors, executive officers and companies with which they are affiliated were loan customers during 2005. The following is an analysis of such loans:

(Amounts in thousands)

Total loans at December 31, 2004 .....	\$ 630
New loans .....	1,335
Repayments or other .....	(115)
Total loans at December 31, 2005 .....	<u>\$1,850</u>

**NOTE 14 - CONDENSED FINANCIAL INFORMATION**

Below is condensed financial information of Cortland Bancorp (parent company only). In this information, the parent's investment in subsidiaries is stated at cost, including equity in the undistributed earnings of the subsidiaries since inception, adjusted for any unrealized gains or losses on available for sale securities.

BALANCE SHEETS

(Amounts in thousands)

	<u>December 31,</u>	
	<u>2005</u>	<u>2004</u>
<b>Assets:</b>		
Cash .....	\$ 3,102	\$ 3,201
Investment securities available for sale .....	587	836
Investment in bank subsidiary .....	42,435	43,368
Investment in non-bank subsidiary .....	15	15
Other assets .....	2,447	2,336
	<u>\$48,586</u>	<u>\$49,756</u>
<b>Liabilities:</b>		
Other liabilities .....	\$ 261	\$ 358
<b>Shareholders' equity:</b>		
Common stock (Note 1) .....	22,523	21,869
Additional paid-in capital (Note 1) .....	20,211	18,531
Retained earnings .....	10,310	13,131
Accumulated other comprehensive income .....	(877)	1,061
Treasury stock .....	<u>(3,842)</u>	<u>(5,194)</u>
Total shareholders' equity .....	<u>48,325</u>	<u>49,398</u>
	<u>\$48,586</u>	<u>\$49,756</u>

(Continued)

**NOTE 14 - CONDENSED FINANCIAL INFORMATION (Continued)**

**STATEMENTS OF INCOME**

(Amounts in thousands)

	Years ended December 31,		
	<u>2005</u>	<u>2004</u>	<u>2003</u>
Dividends from bank subsidiary .....	\$ 3,500	\$ 3,500	\$ 4,000
Interest and dividend income .....	56	166	180
Investment securities gains .....	0	88	192
Other income.....	70	81	77
Other expenses .....	<u>(270)</u>	<u>(299)</u>	<u>(184)</u>
Income before income tax and equity in undistributed net income of subsidiaries .....	3,356	3,536	4,265
Income tax benefit (expense) .....	72	12	(63)
Equity in undistributed net income of subsidiaries .....	<u>906</u>	<u>1,295</u>	<u>1,282</u>
<b>Net income</b> .....	<u><b>\$ 4,334</b></u>	<u><b>\$ 4,843</b></u>	<u><b>\$ 5,484</b></u>

**STATEMENTS OF CASH FLOWS**

(Amounts in thousands)

	Years ended December 31,		
	<u>2005</u>	<u>2004</u>	<u>2003</u>
<b>Cash flows from operating activities</b>			
Net income .....	\$ 4,334	\$ 4,843	\$ 5,484
Adjustments to reconcile net income to net cash flows from operating activities:			
Equity in undistributed net income of subsidiaries .....	(906)	(1,295)	(1,282)
Investment securities gains .....		(88)	(192)
Accretion on securities .....	3	38	31
Deferred tax benefit .....	(7)	(7)	(24)
Change in other assets and liabilities .....	<u>(148)</u>	<u>(570)</u>	<u>95</u>
Net cash flows from operating activities .....	<u>3,276</u>	<u>2,921</u>	<u>4,112</u>
<b>Cash flows from investing activities</b>			
Purchases of investment securities available for sale .....	(356)		(3,007)
Purchases of investment securities held to maturity .....			
Proceeds from sales of securities available for sale .....		2,295	1,204
Proceeds from call, maturity and principal payments on securities .....	<u>450</u>		<u>1,305</u>
Net cash flows from investing activities .....	<u>94</u>	<u>2,295</u>	<u>(498)</u>
<b>Cash flows from financing activities</b>			
Dividends paid .....	(4,637)	(4,446)	(4,360)
Net treasury shares (repurchased) reissued .....	<u>1,168</u>	<u>262</u>	<u>(2,320)</u>
Net cash flows from financing activities .....	<u>(3,469)</u>	<u>(4,184)</u>	<u>(6,680)</u>
Net change in cash .....	(99)	1,032	(3,066)
<b>Cash</b>			
Beginning of year .....	3,201	2,169	5,235
End of year .....	<u><b>\$ 3,102</b></u>	<u><b>\$ 3,201</b></u>	<u><b>\$ 2,169</b></u>

(Continued)

CORTLAND BANCORP AND SUBSIDIARIES  
 NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS  
 Years ended December 31, 2005, 2004 and 2003

**NOTE 15 - DIVIDEND RESTRICTIONS**

The Bank is subject to regulations of the Ohio Division of Banks which restrict dividends to retained earnings (as defined by statute) of the current and prior two years. Under this restriction, at December 31, 2005, approximately \$3,482,000 is available for the payment of dividends by the Bank without seeking prior regulatory approval. In addition, dividend payments may not reduce capital levels below minimum regulatory guidelines.

**NOTE 16 - LITIGATION**

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

**NOTE 17 - STOCK REPURCHASE PROGRAM**

On February 6, 2004, the Company concluded the fourth consecutive year of stock repurchase programs. These programs were approved and authorized each year by the Company's Board of Directors. The following table shows the results of these programs.

<u>Program</u>	<u>Date Board Authorized</u>	<u>Date Expired</u>	<u>Number of Shares Repurchased</u>	<u>Cost of Shares Repurchased</u>	<u>Weighted Average Price Per Share</u>
"2000 Program" . . . . .	January 26, 2000	February 3, 2001	138,218	\$ 2,284	\$16.51
"2001 Program" . . . . .	January 23, 2001	February 6, 2002	51,321	987	19.32
"2002 Program" . . . . .	January 22, 2002	February 6, 2003	114,073	2,848	25.02
"2003 Program" . . . . .	January 28, 2003	February 6, 2004	<u>137,869</u>	<u>4,170</u>	<u>30.24</u>
Total . . . . .			<u>441,481</u>	<u>\$10,289</u>	<u>\$23.31</u>

Currently, there is no stock repurchase program in effect.

(Continued)



CORTLAND BANCORP AND SUBSIDIARIES  
SELECTED FINANCIAL DATA

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

SUMMARY OF OPERATIONS	Years Ended December 31,				
	2005	2004	2003	2002	2001
Total Interest Income	\$ 23,586	\$ 22,288	\$ 22,907	\$ 26,911	\$ 29,799
Total Interest Expense	8,665	8,010	8,132	10,004	13,823
<b>NET INTEREST INCOME (NII)</b>	<b>14,921</b>	<b>14,278</b>	<b>14,775</b>	<b>16,907</b>	<b>15,976</b>
Provision for Loan Losses	545	415	240	460	220
NII After Loss Provision	14,376	13,863	14,535	16,447	15,756
Security gains (losses)	308	1,052	946	215	386
Gain on sale of loans	89	54	470	318	269
Total Other Income	2,718	2,725	2,433	2,167	2,068
<b>INCOME BEFORE EXPENSE</b>	<b>17,491</b>	<b>17,694</b>	<b>18,384</b>	<b>19,147</b>	<b>18,479</b>
Total Other Expenses	12,200	11,861	11,529	11,826	11,205
<b>INCOME BEFORE TAX</b>	<b>5,291</b>	<b>5,833</b>	<b>6,855</b>	<b>7,321</b>	<b>7,274</b>
Federal Income Tax	957	990	1,371	1,579	1,728
<b>NET INCOME</b>	<b>\$ 4,334</b>	<b>\$ 4,843</b>	<b>\$ 5,484</b>	<b>\$ 5,742</b>	<b>\$ 5,546</b>
<b>BALANCE SHEET DATA</b>					
Assets	\$459,701	\$446,393	\$438,392	\$437,598	\$439,921
Investments	234,652	225,841	222,775	199,903	193,424
Total Loans	188,202	191,777	189,262	191,477	206,255
Allowance for loan losses	2,168	2,629	2,408	3,134	2,998
Deposits	350,375	344,919	337,556	335,758	337,661
Borrowings	58,111	47,889	47,886	46,669	49,362
Shareholders' Equity	48,325	49,398	49,881	52,039	50,524
<b>AVERAGE BALANCES</b>					
Assets	\$444,487	\$444,275	\$436,239	\$439,730	\$434,830
Investments	221,844	216,560	204,599	197,679	189,672
Net Loans	190,329	191,428	188,360	198,049	205,585
Deposits	341,575	343,969	335,133	336,792	331,449
Borrowings	49,932	46,093	44,905	47,518	49,646
Shareholders' Equity	49,665	49,828	51,807	51,797	50,000
<b>PER COMMON SHARE DATA (1)</b>					
Net Income, both Basic and Diluted	\$ 1.00	\$ 1.13	\$ 1.26	\$ 1.30	\$ 1.25
Cash Dividends Declared	1.07	1.04	1.01	0.98	0.88
Book Value	11.11	11.50	11.65	11.92	11.45
<b>ASSET QUALITY RATIOS</b>					
Loans 30 days or more beyond their contractual due date as a percent of total loans	2.95%	2.45%	1.77%	1.89%	1.38%
Underperforming Assets as a Percentage of:					
Total Assets	0.83	0.76	0.70	0.51	0.26
Equity plus Allowance for Loan Losses	7.58	6.52	5.84	4.07	2.12
Tier I Capital	7.81	7.05	6.44	4.62	2.34
<b>FINANCIAL RATIOS</b>					
Return on Average Equity	8.73%	9.72%	10.59%	11.09%	11.09%
Return on Average Assets	0.98	1.09	1.26	1.31	1.28
Effective Tax Rate	18.09	16.97	20.00	21.56	23.76
Average Equity to Average Assets	11.17	11.22	11.88	11.78	11.50
Equity to Asset Ratio	10.51	11.07	11.38	11.89	11.48
Tangible Equity to Tangible Asset Ratio	10.48	11.02	11.33	11.84	11.42
Cash Dividend Payout Ratio	107.00	91.45	79.85	74.83	70.92
Net Interest Margin Ratio	3.83	3.74	3.94	4.39	4.14

(1) Basic and diluted earnings per common 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.

THREE YEAR SUMMARY  
AVERAGE BALANCE SHEET, YIELDS AND RATES

The following schedules show average balances of interest-earning and non interest-earning assets and liabilities, and Shareholders' equity for the years indicated. Also shown are the related amounts of interest earned or paid and the related average yields or interest rates paid for the years indicated. The averages are based on daily balances.

(Fully taxable equivalent basis in thousands of dollars)

	2005		
	Average Balance Outstanding	Interest Earned or Paid	Yield or Rate
Interest-earning assets:			
Federal funds sold and other money markets .....	\$ 3,619	\$ 119	3.3%
Investment securities:			
U.S. Treasury and other U.S.			
Government agencies and corporations .....	67,402	3,259	4.8%
U.S. Government mortgage-backed pass through certificates .....	84,928	3,810	4.5%
States of the U.S. and political subdivisions (Note 1, 2, 3) .....	44,756	3,184	7.1%
Other securities .....	24,758	1,294	5.2%
<b>TOTAL INVESTMENT SECURITIES .....</b>	<b>221,844</b>	<b>11,547</b>	<b>5.2%</b>
Loans (Note 2, 3, 4) .....	192,873	13,040	6.8%
Trading Account Securities .....			
<b>TOTAL INTEREST-EARNING ASSETS .....</b>	<b>418,336</b>	<b>\$24,706</b>	<b>5.9%</b>
Non interest-earning assets:			
Cash and due from banks .....	9,417		
Premises and equipment .....	4,316		
Other .....	12,418		
<b>TOTAL ASSETS .....</b>	<b>\$444,487</b>		
Interest-bearing liabilities:			
Deposits:			
Interest-bearing demand deposits .....	\$ 49,355	\$ 389	0.8%
Savings .....	89,107	647	0.7%
Time .....	144,793	5,123	3.5%
<b>TOTAL INTEREST-BEARING DEPOSITS .....</b>	<b>283,255</b>	<b>6,159</b>	<b>2.2%</b>
Borrowings:			
Federal funds purchased .....	428	15	3.5%
Securities sold under agreement to repurchase .....	2,540	59	2.3%
Other borrowings under one year .....	599	21	3.5%
Other borrowings over one year .....	46,365	2,411	5.2%
<b>TOTAL BORROWINGS .....</b>	<b>49,932</b>	<b>2,506</b>	<b>5.0%</b>
<b>TOTAL INTEREST-BEARING LIABILITIES .....</b>	<b>333,187</b>	<b>\$ 8,665</b>	<b>2.6%</b>
Non interest-bearing liabilities:			
Demand deposits .....	58,320		
Other liabilities .....	3,315		
Shareholders equity .....	49,665		
<b>TOTAL LIABILITIES AND SHAREHOLDERS EQUITY .....</b>	<b>\$444,487</b>		
Net interest income .....		<b>\$16,041</b>	
Net interest rate spread (Note 5) .....			<u>3.3%</u>
Net interest margin (Note 6) .....			<u>3.8%</u>

Note 1 - Includes both taxable and tax exempt securities.

Note 2 - The amounts are presented on a fully taxable equivalent basis using the statutory tax rate of 34% in 2005, 2004 and 2003, and have been adjusted to reflect the effect of disallowed interest expense related to carrying tax exempt assets. Tax-free income from states of the U.S. and political subdivisions, and loans amounted to \$2,156 and \$209 for 2005, \$2,545 and \$193 for 2004 and \$2,466 and \$214 for 2003, respectively.

Note 3 - Average balance outstanding includes the average amount outstanding of all nonaccrual investment securities and loans. States and political subdivisions consist of average total principal adjusted for amortization of premium and accretion of discount less average allowance for estimated losses, and include both taxable and tax exempt securities. Loans consist of average total loans less average unearned income.

(Fully taxable equivalent basis in thousands of dollars)

2004			2003		
Average Balance Outstanding	Interest Earned or Paid	Yield or Rate	Average Balance Outstanding	Interest Earned or Paid	Yield or Rate
\$ 5,623	\$ 83	1.5%	\$ 10,338	\$ 118	1.1%
62,418	2,920	4.7%	52,587	2,640	5.0%
85,357	3,634	4.3%	89,652	4,009	4.5%
53,832	3,764	7.0%	51,363	3,649	7.1%
14,953	716	4.8%	10,997	559	5.1%
216,560	11,034	5.1%	204,599	10,857	5.3%
193,927	12,474	6.4%	191,392	13,141	6.9%
			1,190	68	5.7%
416,110	<u>\$23,591</u>	5.7%	407,519	<u>\$24,184</u>	5.9%
9,276			10,140		
4,637			5,119		
14,252			13,461		
<u>\$444,275</u>			<u>\$436,239</u>		
\$ 48,945	\$ 263	0.5%	\$ 50,714	\$ 249	0.5%
90,584	501	0.6%	88,953	540	0.6%
147,662	5,023	3.4%	139,568	5,030	3.6%
287,191	5,787	2.0%	279,235	5,819	2.1%
289	4	1.4%	57	1	1.8%
2,698	26	1.0%	1,999	17	0.9%
2,781	37	1.3%	3,671	160	4.4%
40,325	2,156	5.3%	39,178	2,135	5.4%
46,093	2,223	4.8%	44,905	2,313	5.2%
333,284	<u>\$ 8,010</u>	2.4%	324,140	<u>\$ 8,132</u>	2.5%
56,778			55,898		
4,385			4,394		
49,828			51,807		
<u>\$444,275</u>			<u>\$436,239</u>		
	<u>\$15,581</u>			<u>\$16,052</u>	
		<u>3.3%</u>			<u>3.4%</u>
		<u>3.7%</u>			<u>3.9%</u>

Note 4 - Interest earned on loans includes net loan fees of \$242 in 2005, \$203 in 2004 and \$241 in 2003.

Note 5 - Net interest rate spread represents the difference between the yield on earning assets and the rate paid on interest bearing liabilities.

Note 6 - Net interest margin is calculated by dividing the difference between total interest earned and total interest expensed by total interest-earning assets.

CORTLAND BANCORP AND SUBSIDIARIES  
MANAGEMENT'S DISCUSSION AND ANALYSIS

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

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## FINANCIAL REVIEW

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

## NOTE REGARDING FORWARD-LOOKING STATEMENTS

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

Economic circumstances, the Company's operations and actual results could differ significantly from those discussed in any forward-looking statements. Some of the factors that could cause or contribute to such differences are changes in the economy and interest rates either nationally or in the Company's market area; 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.

## OVERVIEW and OUTLOOK

Net income for 2005 was \$4,334. The performance represented a decrease of \$509 from the \$4,843 earned in 2004. Earnings per share measured \$1.00, down \$0.13 or 11.5% from \$1.13 in 2004.

Core earnings, which exclude the net gains on loans sold and investment securities either sold or called, loss on other real estate, and certain other non recurring items, were \$4.234 million in 2005, compared to the \$4.238 million earned in 2004. Core earnings per share were \$0.98 in 2005 and \$0.99 in 2004, down \$0.01 or 1.0%.

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CORTLAND BANCORP AND SUBSIDIARIES  
MANAGEMENT'S DISCUSSION AND ANALYSIS

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

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

	Years Ended December 31,	
	2005	2004
GAAP earnings	\$4,334	\$4,843
Investment security gains	(308)	(1,052)
Gain on sale of loans	(89)	(54)
Other real estate loss	3	171
Other non-recurring items*	243	19
Tax effect of adjustments	51	311
Core earnings	<u>\$4,234</u>	<u>\$4,238</u>

\* Includes one-time cash bonus declared in recognition of the Bank's performance under the retiring C.E.O.

The Company did experience a moderate improvement in its net interest margin in 2005. The Company's net interest margin, on a fully taxable equivalent basis, increased by \$460,000 from the preceding year, as the net interest margin ratio improved from 3.74% to 3.83%.

Thus far however, the yield remains relatively flat as long-term rates have not followed the same course as short term rates which increased from 1.00% to 4.25% over the eighteen month period ending December 31, 2005. As a result of the sustained flattening of the yield curve, the Company anticipates that continued pressure on the net interest margin will continue into 2006.

As of December 31, 2005, the ratio of equity capital to total assets remained well above regulatory minimums at 10.51%, but down from 11.07% a year ago, primarily due to a decline in the amount of the unrealized gain in available-for-sale securities. Risk-based capital measured 21.16% compared to 22.07% at December 31, 2004. All capital ratios continue to register well in excess of required regulatory minimums.

Return on average equity was 8.73% in 2005 compared to 9.72% in 2004, while the return on average assets decreased from 1.09% to 0.98%. Book value

per share decreased by \$0.39 to \$11.11. The price of the Company's common stock decreased during the year, trading in a range between a fourth quarter low of \$17.50 and a first quarter high of \$22.58, closing the year at \$18.25 per share. The Company continued its aggressive cash dividend policy, paying out 107.0% of 2005 earnings in cash dividends, compared to 91.5% in the prior year. Dividends per share increased by 2.9%, reflecting the effect of the annual stock dividend.

The Company is committed to investing in technology such that its infrastructure effectively delivers to consumers and small-to-medium-sized business owners leading edge financial products and services. The Company's integrated approach to technology includes internet banking services; an Integrated Voice Response system that provides customers with remote access to banking services; platform products that enhance both productivity and customer service; and check and document-imaging products, which further capitalize on the Company's Internet banking cash management initiative. Technology is a core ingredient for the Company, enabling it to extend services to customers beyond geographic boundaries, while increasing employee productivity. These flexible and robust product solutions also offer customers capabilities which enable them to streamline their own operations and to bank around the clock.

The Company's Internet based banking solution, NetTeller, delivers interactive information by providing customers the following capabilities: access to account information, statement information and check imaging; on-line bill payment and electronic loan payments; and the ability to remotely transfer money between accounts and to initiate wire transfers and ACH transactions. Consumers, retail and commercial customers, alike, are offered such services 24 hours a day, 365 days a year with a high level of functionality, security and ease of operation.

The Check Clearing for the 21st Century Act, or "Check 21" as it is commonly known, became effective October 28, 2004. Check 21 facilitates check collection by creating a new negotiable in-

CORTLAND BANCORP AND SUBSIDIARIES  
MANAGEMENT'S DISCUSSION AND ANALYSIS

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

strument called a "substitute check," which permits, but does not require, banks to replace original checks with substitute checks or information from the original check and process check information electronically. Banks that do use substitute checks must comply with certain notice and recredit rights. Check 21 is expected to cut the time and cost involved in physically transporting paper items and reduce float, i.e., the time between the deposit of a check in a bank and its actual payment, in those cases where items are not already being delivered same-day or overnight. The Company intends to utilize the Check 21 authority and expects to incur additional costs for technology necessary to process check information electronically.

**BALANCE SHEET COMPOSITION**

The following table illustrates, during the years presented, the mix of the Company's funding sources and the assets in which those funds are invested as a percentage of the Company's average total assets for the period indicated. Average assets totaled \$444,487 in 2005 compared to \$444,275 in 2004 and \$436,239 in 2003.

	2005	2004	2003
<b>Sources of Funds:</b>			
Deposits:			
Non-interest-bearing	13.1%	12.8%	12.8%
Interest-bearing	63.7	64.6	64.0
Federal funds purchased and repurchase agreements	0.7	0.7	0.5
Long-term debt and other borrowings	10.6	9.7	9.8
Other non-interest-bearing liabilities	0.7	1.0	1.0
Equity capital	11.2	11.2	11.9
<b>Total</b>	<b>100.0%</b>	<b>100.0%</b>	<b>100.0%</b>
<b>Uses of Funds:</b>			
Loans	43.4%	43.7%	43.9%
Securities	49.9	48.7	47.1
Federal funds sold, and other money market instruments	0.8	1.3	2.4
Bank owned life insurance	2.5	2.3	1.9
Other non-interest-earning assets	3.4	4.0	4.7
<b>Total</b>	<b>100.0%</b>	<b>100.0%</b>	<b>100.0%</b>

Deposits continue to be the Company's primary source of funding. During 2005, the relative mix of deposits has remained steady with interest-bearing being the main source. However, the Company has been able to increase its non-interest bearing de-

mand deposits. Average non-interest bearing deposits totaled 17.1% of total average deposits in 2005 compared to 16.5% in 2004 and 16.7% in 2003. (Also see section captioned "Deposits" included elsewhere in this discussion).

The Company primarily invests funds in loans and securities. Securities have been the largest component of the Company's mix of invested assets since 2003. During 2005 average securities increased by \$5,284 or 2.4%, while average loans decreased by \$1,054 or 0.5%.

The Company has also purchased bank owned life insurance policies on the lives of directors, certain employees and key members of management in conjunction with the Company's benefit plans. The average balance increased from \$8,366 in 2003 to \$11,145 in 2005, reflecting the purchase of additional policies and the buildup of cash surrender value. (See additional information regarding the Company's loan and securities portfolio in the sections captioned "Loan Portfolio" and "Investment Securities" included elsewhere in this discussion.)

**ASSET QUALITY**

The Company's management regularly monitors and evaluates trends and developments in asset quality. Loan review systems require detailed monthly analysis of delinquencies, nonperforming assets and other sensitive credits. Mortgage, commercial and consumer loans are moved to nonaccrual status once they reach 90 days past due or when analysis of a borrower's creditworthiness indicates the collection of interest and principal is in doubt.

In addition to nonperforming loans, total nonperforming assets include nonperforming investment securities and real estate acquired in satisfaction of debts previously contracted. Total underperforming assets add to this amount loans which have been restructured to provide for a reduction of interest or principal because of a deterioration in the financial condition of the borrower. Also included as underperforming assets are



**CORTLAND BANCORP AND SUBSIDIARIES  
MANAGEMENT'S DISCUSSION AND ANALYSIS**

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

loans which are more than 89 days past due that continue to accrue interest income. The following table depicts the trend in these potentially problematic asset categories.

	2005	2004	2003	2002	2001
Nonaccrual loans:					
1-4 residential mortgages	\$ 719	\$ 661	\$ 529	\$ 474	\$ 293
Commercial mortgages	2,472	2,734	1,538	600	368
Commercial loans	210			327	129
Consumer loans	41			5	32
Home equity loans	304				7
<b>Total Nonaccrual Loans</b>	<b>3,746</b>	<b>3,395</b>	<b>2,067</b>	<b>1,406</b>	<b>829</b>
Other real estate owned	82		986	811	170
<b>Nonperforming Assets</b>	<b>3,828</b>	<b>3,395</b>	<b>3,053</b>	<b>2,217</b>	<b>999</b>
Loans ninety days past due and still accruing interest					
Restructured loans				26	134
<b>Underperforming Assets</b>	<b>\$3,828</b>	<b>\$3,395</b>	<b>\$3,053</b>	<b>\$2,243</b>	<b>\$1,133</b>

The following table provides a number of asset quality ratios based on this data. Overall, asset quality reflected the cumulative effects of general economic weakness evidenced since 2001 in the local area markets where the Company operates, but remained within limits that management considers acceptable.

	2005	2004	2003	2002	2001
Nonperforming loans as a percentage of total loans	1.99%	1.77%	1.09%	0.73%	0.40%
Nonperforming assets as a percentage of total assets	0.83%	0.76%	0.70%	0.51%	0.23%
Underperforming assets as a percentage of total assets	0.83%	0.76%	0.70%	0.51%	0.26%
Underperforming assets as a percentage of equity capital plus allowance for loan losses	7.58%	6.52%	5.84%	4.07%	2.12%

Gross income that would have been recorded in 2005 on these loans, had they been in compliance with their original terms, was \$321,000. Interest

income that actually was included in income on these loans amounted to \$55,000.

Additionally, as part of the Company's loan review process, management seeks to identify loans which, although not classified as either nonperforming or underperforming assets, contain inherent weaknesses that suggest that they can be considered potential problem loans. The amount of such loans totalled \$5,304 as of December 31, 2005 compared to \$5,622 as of December 31, 2004.

**RESULTS OF OPERATIONS**

Common comparative ratios for results of operations are the return on average equity and the return on average assets. The return on average equity amounted to 8.7%, 9.7% and 10.6% for 2005, 2004 and 2003, respectively. The return on average assets amounted to 1.0% in 2005, 1.1% in 2004 and 1.3% in 2003.

Net interest income, the principal source of the Company's earnings, is the amount by which interest and fees generated by interest-earning assets, primarily loans and investment securities, exceed the interest cost of deposits and borrowed funds. The net interest margin ratio registered 3.8% in 2005, 3.7% in 2004 and 3.9% in 2003.

Compression in the Company's net interest margin during 2005 and 2004 resulted from the increased levels of nonperforming assets which has occurred over the past three years and a sustained flattening of the yield curve. The significant increase in refinancing activity considerably accelerated the rate at which the Company's earning assets repriced. Meanwhile, interest bearing liabilities bumped up against a natural limit in their ability to reprice as short term rates approached zero.

CORTLAND BANCORP AND SUBSIDIARIES  
MANAGEMENT'S DISCUSSION AND ANALYSIS  
(In thousands of dollars, except for per share amounts)

	NET INTEREST MARGIN FOR YEAR ENDED					
	December 31, 2005			December 31, 2004		
	Average Balance(1)	Interest	Average Rate	Average Balance(1)	Interest	Average Rate
<b>INTEREST-EARNING ASSETS</b>						
Federal funds sold and other money market funds	\$ 3,619	\$ 119	3.3%	\$ 5,623	\$ 83	1.5%
Investment securities(1)(2)	221,844	11,547	5.2%	216,560	11,034	5.1%
Loans(2)(3)	192,873	13,040	6.8%	193,927	12,474	6.4%
<b>Total interest-earning assets</b>	<b>\$418,336</b>	<b>\$24,706</b>	<b>5.9%</b>	<b>\$416,110</b>	<b>\$23,591</b>	<b>5.7%</b>
<b>INTEREST-BEARING LIABILITIES</b>						
Interest-bearing demand deposits	\$ 49,355	\$ 389	0.8%	\$ 48,945	\$ 263	0.5%
Savings	89,107	647	0.7%	90,584	501	0.6%
Time	144,793	5,123	3.5%	147,662	5,023	3.4%
<b>Total interest-bearing deposits</b>	<b>283,255</b>	<b>6,159</b>	<b>2.2%</b>	<b>287,191</b>	<b>5,787</b>	<b>2.0%</b>
Federal funds purchased	428	15	3.5%	289	4	1.4%
Other borrowings	49,504	2,491	5.0%	45,804	2,219	4.8%
<b>Total interest-bearing liabilities</b>	<b>\$333,187</b>	<b>\$ 8,665</b>	<b>2.6%</b>	<b>\$333,284</b>	<b>\$ 8,010</b>	<b>2.4%</b>
Net interest income		<b>\$16,041</b>			<b>\$15,581</b>	
Net interest rate spread(4)			<b>3.3%</b>			<b>3.3%</b>
Net interest margin(5)			<b>3.8%</b>			<b>3.7%</b>

(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%.

(3) Includes loan origination and commitment fees.

(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.

The increase in net interest income was the product of a 0.5% year-over-year increase in average earning assets and a 24 basis point increase in interest rates earned.

The average rate paid on interest sensitive liabilities increased by 20 basis points year-over-year. The average balance of interest sensitive liabilities decreased by only \$97. Compared to last year, average borrowings increased by \$3,839 while the average rate paid on borrowings increased by 20 basis points.

Average interest-bearing demand deposits and money market accounts increased by \$410, while savings decreased by \$1,477. The average rate paid on these products increased by 20 basis points in the aggregate. The average balance on time deposit products decreased by \$2,869, as the average rate paid increased by 14 basis points, from 3.4% to 3.5%.

Interest and dividend income on securities registered an increase of \$704, or 7.2%, during the year

ended December 31, 2005 when compared to 2004. On a fully tax equivalent basis, income on investment securities increased by \$513, or 4.6%. The average invested balances increased by \$5,284 from the levels of a year ago. The increase in the average balance of investment securities was accompanied by a 11 basis point increase in the tax equivalent yield of the portfolio.

Interest and fees on loans increased by \$566 on a fully tax equivalent basis, or 4.5%, for the twelve months of 2005 compared to 2004. A \$1,054 decrease in the average balance of the loan portfolio, or 0.5%, was accompanied by a 33 basis point increase in the portfolio's tax equivalent yield.

Other interest income increased by \$36 from the same period a year ago. The average balance of Federal Funds sold and other money market funds decreased by \$2,004, or 35.6%. The yield increased by 181 basis points during 2005 compared to 2004.



CORTLAND BANCORP AND SUBSIDIARIES  
MANAGEMENT'S DISCUSSION AND ANALYSIS

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

The following table provides a detailed analysis of changes in net interest income, identifying that portion of the change that is due to a change in the volume of average assets and liabilities outstanding versus that portion which is due to a change in the average yields on earning assets and average rates on interest-bearing liabilities. Changes in interest due to both rate and volume which cannot be segregated have been allocated to rate and volume changes in proportion to the relationship of the absolute dollar amounts of the change in each.

**Analysis of Net Interest Income Changes (Taxable Equivalent Basis)**

	2005 Compared to 2004			2004 Compared to 2003		
	Volume	Rate	Total	Volume	Rate	Total
Increase (Decrease) in Interest Income:						
Federal funds sold and other money markets .....	\$ (38)	\$ 74	\$ 36	\$ (64)	\$ 29	\$ (35)
Investment Securities						
U.S. Treasury and other U.S. Government agencies and corporations .....	239	100	339	469	(189)	280
U.S. Government mortgage-backed pass-through certificates .....	(18)	194	176	(188)	(187)	(375)
States of the U.S. and political subdivisions .....	(645)	65	(580)	173	(58)	115
Other securities .....	507	71	578	191	(34)	157
Trading account securities .....				(68)		(68)
Loans .....	(68)	634	566	172	(839)	(667)
<b>Total Interest Income Change .....</b>	<b>(23)</b>	<b>1,138</b>	<b>1,115</b>	<b>685</b>	<b>(1,278)</b>	<b>(593)</b>
Increase (Decrease) in Interest Expense:						
Interest-bearing demand deposits .....	2	124	126	(9)	23	14
Savings deposits .....	(8)	154	146	10	(49)	(39)
Time deposits .....	(99)	199	100	283	(290)	(7)
Federal funds purchased .....	3	8	11	3		3
Securities sold under agreements to repurchase .....	(1)	34	33	7	2	9
Other borrowings under one year .....	(44)	28	(16)	(32)	(91)	(123)
Other borrowings over one year .....	315	(60)	255	62	(41)	21
<b>Total Interest Expense Change .....</b>	<b>168</b>	<b>487</b>	<b>655</b>	<b>324</b>	<b>(446)</b>	<b>(122)</b>
<b>Increase (Decrease) in Net Interest Income on a Taxable Equivalent Basis .....</b>	<b>\$(191)</b>	<b>\$ 651</b>	<b>\$ 460</b>	<b>\$ 361</b>	<b>\$ (832)</b>	<b>\$(471)</b>

CORTLAND BANCORP AND SUBSIDIARIES  
MANAGEMENT'S DISCUSSION AND ANALYSIS

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

Total other income for 2005 decreased \$716, or 18.7% compared to a decrease of \$18, or 3.7% in 2004. Fees for customer services decreased by \$73 or 3.1% compared to an increase of \$691 in the prior year, which was primarily due to the introduction of a new deposit product first offered to customers late in the third quarter of 2003. This years decrease is primarily due to a decline in service charge income.

Loans originated for sale in the secondary market showed gains of \$89 in 2005, compared to \$54 and \$470 in 2004 and 2003, respectively. In 2003 gains on the sale of trading securities amounted to \$265, with no activity in 2005 or 2004. The early call of held to maturity securities, and transactions involving available for sale securities, combined to produce net gains of \$308 in 2005, \$1,052 in 2004 and \$946 in 2003.

Other real estate losses amounted to \$3 in 2005 and \$171 in 2004 with no losses on other real estate recorded in 2003. Other non-interest income decreased by \$102 during 2005 following a \$37 increase in 2004. This income category is subject to fluctuation due to nonrecurring items, but the difference in 2005 is due mainly to a \$103 decrease in non-taxable income on bank owned life insurance policies.

	<u>Other Income</u>		
	<u>2005</u>	<u>2004</u>	<u>2003</u>
Fees for other customer services	<b>\$2,254</b>	\$2,327	\$1,636
Gain on sale of loans	<b>89</b>	54	470
Gain on sale of trading securities			265
Other real estate losses	<b>(3)</b>	(171)	
Other operating income	<b>467</b>	569	532
	<b>2,807</b>	2,779	2,903
Investment securities net gains	<b>308</b>	1,052	946
Total other income	<b>\$3,115</b>	\$3,831	\$3,849

Total other expenses increased by \$339 or 2.9% in 2005. This compares to an increase of \$332 or 2.9% in 2004. Full time equivalent employment averaged 162 employees in 2005. During 2005, expenditures for salaries and employee benefits increased by \$330 or 4.9%. This increase is a combination of regular staff salary and benefit increases and a one-time cash bonus of \$243 awarded to the retiring President and CEO in recognition of 42 years of service to the bank and the growth and profitability achieved by the bank under his leadership. Occupancy and equipment expense increased by \$17 or 0.9% during 2005.

Legal and litigation expense in 2005 increased by \$16 compared to a decrease of \$49 in 2004. State and local taxes increased \$4. Bank exam and audit expense decreased by \$88 or 17.1% compared to an increase of \$166 in 2004 primarily due to expenses associated with the requirements of Section 404 of the Sarbanes-Oxley Act of 2002. Marketing expense increased by \$63 or 34.6%, primarily due to an increase in expenses related to a customer testimonial advertising campaign initiated mid year. All other categories of non-interest expense decreased by \$3 in 2005 or 0.1% in the aggregate. This expense category is subject to fluctuation due to non-recurring items.

	<u>Non-Interest Expense</u>		
	<u>2005</u>	<u>2004</u>	<u>2003</u>
Salaries and benefits	<b>\$ 7,052</b>	\$ 6,722	\$ 6,586
Net occupancy and equipment expense	<b>1,870</b>	1,853	1,963
State and local taxes	<b>548</b>	544	524
Office supplies	<b>338</b>	346	347
Marketing expense	<b>245</b>	182	177
Legal and litigation	<b>119</b>	103	152
Bank exam and audit	<b>427</b>	515	349
Other operating expense	<b>1,601</b>	1,596	1,431
Total other expenses	<b>\$12,200</b>	\$11,861	\$11,529

CORTLAND BANCORP AND SUBSIDIARIES  
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(In thousands of dollars, except for per share amounts)

Salaries and employee benefits represented 57.8% of all non-interest expenses in 2005. Salaries and employee benefits increased by \$330 in 2005 following an increase of \$136 in 2004. The following details components of these increases:

	Analysis of Changes in Salaries & Benefits					
	Amounts			Percent		
	2005	2004	2003	2005	2004	2003
Salaries	\$317	\$(28)	\$ 67	6.1%	(1.14)%	1.3%
Benefits	(29)	85	112	(1.7)	5.2	7.3
Profit Sharing			(336)			(100.0)
	288	57	(157)	4.2	0.8	(2.2)
Def'd Loan						
Origination	42	79	(55)	23.3	30.5	27.0
	\$330	\$136	\$(212)	4.9%	2.1%	(3.1%)

Wage and salary expense per employee averaged \$33,942 in 2005, \$31,981 in 2004 and \$31,192 in

2003. Excluding the \$243 bonus, the average would be \$32,444 in 2005. Full-time equivalent employment averaged 162 employees in 2005 and 2004 and 167 employees in 2003. Average earning assets per employee measured \$2,582 in 2005, \$2,569 in 2004 and \$2,440 in 2003.

Income before income tax expense amounted to \$5,291 for the year ended 2005 compared to \$5,833 and \$6,855 for the similar periods of 2004 and 2003 respectively. The effective tax rate was 18.1% in 2005 compared to 17.0% and 20.0% in 2004 and 2003 respectively, resulting in income tax expenses of \$957, \$990 and \$1,371, respectively. 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:

	December 31,		
	2005	2004	2003
Provision at statutory rate .....	\$1,798	\$ 1,983	\$ 2,331
Add (Deduct):			
Tax effect of non-taxable income .....	(921)	(1,084)	(1,052)
Tax effect of non-deductible expense .....	80	91	92
Federal income taxes .....	\$ 957	\$ 990	\$ 1,371

Net income registered \$4,334 in 2005 compared to \$4,843 in 2004 and \$5,484 in 2003, representing per share amounts of \$1.00 in 2005, \$1.13 in 2004 and \$1.26 in 2003. Dividends declared per share

were \$1.07 in 2005, \$1.04 in 2004 and \$1.01 in 2003. Per share amounts have been restated to give retroactive effect to the 3% common stock dividends of January 1, 2006.

CORTLAND BANCORP AND SUBSIDIARIES  
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The following table shows financial results by quarter for the years ending December 31, 2005 and 2004:

**FINANCIAL RESULTS BY QUARTER**  
**(Unaudited)**

	2005				2004			
	For the Quarter Ended				For the Quarter Ended			
	Dec. 31	Sept. 30	June 30	March 31	Dec. 31	Sept. 30	June 30	March 31
Interest Income	\$ 6,212	\$ 5,884	\$ 5,829	\$ 5,661	\$ 5,660	\$ 5,649	\$ 5,439	\$ 5,540
Interest Expense	2,439	2,197	2,024	2,005	2,046	2,024	1,974	1,966
<b>Net Interest Income</b>	<b>3,773</b>	<b>3,687</b>	<b>3,805</b>	<b>3,656</b>	3,614	3,625	3,465	3,574
Loan Loss Provision	(135)	(160)	(138)	(112)	(140)	(175)	(25)	(75)
Net Security Gains			2	302	378	366	76	232
Trading Securities Gain		4						
<b>Net Gain on Loans</b>	<b>30</b>	<b>28</b>	<b>22</b>	<b>9</b>	13	18	12	11
Other real estate losses	(3)					(3)	(52)	(116)
Other Income	665	700	677	679	739	762	704	691
Other Expenses	(2,990)	(3,288)	(2,972)	(2,950)	(2,999)	(2,986)	(2,919)	(2,957)
<b>Income Before Tax</b>	<b>1,340</b>	<b>971</b>	<b>1,396</b>	<b>1,584</b>	1,605	1,607	1,261	1,360
Federal Income Tax	247	120	264	326	300	292	179	219
<b>Net Income</b>	<b>\$ 1,093</b>	<b>\$ 851</b>	<b>\$ 1,132</b>	<b>\$ 1,258</b>	\$ 1,305	\$ 1,315	\$ 1,082	\$ 1,141
Net Income Per Share	\$ 0.25	\$ 0.20	\$ 0.26	\$ 0.29	\$ 0.30	\$ 0.31	\$ 0.25	\$ 0.27
Net Core Income	\$ 1,075	\$ 990	\$ 1,116	\$ 1,053	\$ 1,047	\$ 1,064	\$ 1,058	\$ 1,057
Net Core Income Per Share	\$ 0.25	\$ 0.23	\$ 0.26	\$ 0.24	\$ 0.25	\$ 0.24	\$ 0.25	\$ 0.25
Net Interest Income (tax equivalent basis)	\$ 4,049	\$ 3,964	\$ 4,088	\$ 3,939	\$ 3,936	\$ 3,960	\$ 3,793	\$ 3,892
Net Interest Rate Spread	3.3%	3.3%	3.4%	3.2%	3.3%	3.3%	3.2%	3.3%
Net Interest Margin	3.8%	3.8%	3.9%	3.8%	3.7%	3.8%	3.6%	3.8%

**LOAN LOSS EXPERIENCE**

For each year presented in the table on the following page, the provision for loan losses charged to operations is based on management's judgment after taking into consideration all known factors connected with the collectability 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 cashflow 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 dynamically 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.

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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.

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.

	<u>2005</u>	<u>2004</u>	<u>2003</u>	<u>2002</u>	<u>2001</u>
Balance at beginning of year .....	<b>\$ 2,629</b>	\$2,408	\$ 3,134	\$2,998	\$2,974
Loan losses:					
1-4 family residential mortgages .....	(87)	(80)	(101)	(97)	(10)
Commercial mortgages .....	(734)	(108)	(589)		
Consumer and other loans .....	(203)	(66)	(160)	(157)	(168)
Commercial loans .....	(89)	(10)	(270)	(187)	(94)
Home equity loans .....	(6)				(3)
	<u>(1,119)</u>	<u>(264)</u>	<u>(1,120)</u>	<u>(441)</u>	<u>(275)</u>
Recoveries on previous loan losses:					
1-4 family residential mortgages .....					5
Commercial mortgages .....			40		
Consumer and other loans .....	100	65	108	93	69
Commercial loans .....	13	5	6	24	3
Home equity loans .....					2
	<u>113</u>	<u>70</u>	<u>154</u>	<u>117</u>	<u>79</u>
Net loan losses .....	<u>(1,006)</u>	<u>(194)</u>	<u>(966)</u>	<u>(324)</u>	<u>(196)</u>
Provision charged to operations .....	<u>545</u>	415	240	460	220
Balance at end of year .....	<u><b>\$ 2,168</b></u>	<u>\$2,629</u>	<u>\$ 2,408</u>	<u>\$3,134</u>	<u>\$2,998</u>
Ratio of net loan losses to average net loans outstanding .....	<u>0.53%</u>	<u>0.10%</u>	<u>0.51%</u>	<u>0.16%</u>	<u>0.10%</u>
Ratio of loan loss allowance to total loans .....	<u>1.15%</u>	<u>1.37%</u>	<u>1.27%</u>	<u>1.64%</u>	<u>1.45%</u>

The spike in charge-offs during 2005 and 2003 primarily reflected certain impaired commercial loan credits for which specific loss reserves had previously been established. Based on its analysis and review of all known factors, management has determined the current level of the allowance to be adequate.

CORTLAND BANCORP AND SUBSIDIARIES  
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The following is an allocation of the allowance for loan losses. The allowance has been allocated according to the amount deemed to be reasonably necessary to provide for the possibility of losses being incurred within the following categories of loans as of December 31, for the years indicated:

	<u>2005</u>	<u>2004</u>	<u>2003</u>	<u>2002</u>	<u>2001</u>
<b>Types of Loans</b>					
1-4 family residential mortgages .....	\$ 203	\$ 238	\$ 217	\$ 338	\$ 407
Commercial mortgages .....	1,173	1,623	1,740	2,047	1,927
Consumer loans .....	149	42	48	100	162
Commercial loans .....	322	475	144	359	312
Home equity loans .....	3	1	1	21	20
Unallocated portion .....	318	250	258	269	170
	<u>\$2,168</u>	<u>\$2,629</u>	<u>\$2,408</u>	<u>\$3,134</u>	<u>\$2,998</u>

The allocations of the allowance as shown in the table above should not be interpreted as an indication that future loan losses will occur in the same proportions or that the allocations indicate future loan loss trends. Furthermore, the portion allocated to each loan category is not the total amount available for future losses that might occur within such categories since the total allowance is applicable to the entire portfolio.



CORTLAND BANCORP AND SUBSIDIARIES  
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**LOAN PORTFOLIO**

The following table represents the composition of the loan portfolio as of December 31, for the years indicated:

	2005		2004		2003		2002		2001	
	Balance	%	Balance	%	Balance	%	Balance	%	Balance	%
<b>Types of Loans</b>										
1-4 family residential mortgages	\$ 59,910	31.8	\$ 61,238	31.9	\$ 57,854	30.6	\$ 62,365	32.6	\$ 77,478	37.6
Commercial mortgages	90,983	48.3	94,019	49.0	92,822	49.0	86,929	45.4	83,753	40.6
Consumer loans	6,714	3.6	6,087	3.2	7,231	3.8	9,792	5.1	14,850	7.2
Commercial loans	19,767	10.5	19,188	10.0	21,711	11.5	22,016	11.5	22,230	10.8
Home equity loans	10,828	5.8	11,245	5.9	9,541	5.0	8,353	4.4	7,944	3.8
1-4 family residential loans held for sale					103	0.1	2,022	1.0		
<b>Total loans</b>	<b>\$188,202</b>		<b>\$191,777</b>		<b>\$189,262</b>		<b>\$191,477</b>		<b>\$206,255</b>	

The following schedule sets forth maturities based on remaining scheduled repayments of principal or next repricing opportunity for loans (excluding mortgage and consumer loans) as of December 31, 2005:

	<u>1 Year or Less</u>	<u>1 to 5 Years</u>	<u>Over 5 Years</u>	<u>Total</u>
<b>Types of Loans</b>				
Commercial loans	\$12,416	\$5,550	\$1,801	\$19,767
Home Equity	10,828			10,828
Total loans (excluding mortgage and consumer loans)	<u>\$23,244</u>	<u>\$5,550</u>	<u>\$1,801</u>	<u>\$30,595</u>

The following schedule sets forth loans as of December 31, 2005 based on next repricing opportunity for floating and adjustable interest rate products, and by remaining scheduled principal payments for loan products with fixed rates of interest. Mortgage and consumer loans have again been excluded.

	<u>1 Year or Less</u>	<u>Over 1 Year</u>	<u>Total</u>
<b>Types of Loans</b>			
Floating or adjustable rates of interest	\$21,063	\$3,192	\$24,255
Fixed rates of interest	1,166	5,174	6,340
Total loans	<u>\$22,229</u>	<u>\$8,366</u>	<u>\$30,595</u>

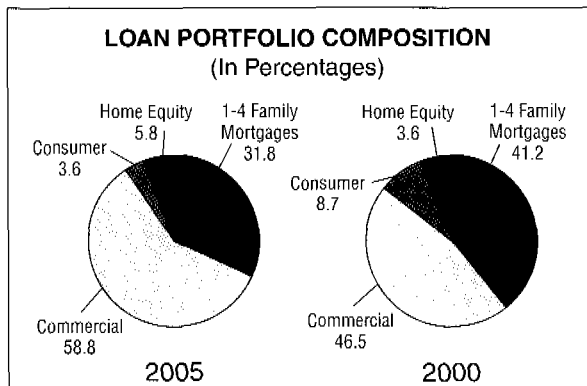
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The Company recorded a decrease of \$3,575 in the loan portfolio from the level of \$191,777 recorded at December 31, 2004.

Between 2004 and 2005, the balance of residential mortgage loans remained relatively unchanged. 1-4 family residential mortgages represent 31.8% of total loans in the loan portfolio compared to 31.9% in 2004. The portion of the loan portfolio represented by commercial loans (including commercial real estate) decreased from 59.0% to 58.8%. Consumer loans (including home equity loans) increased from 9.1% to 9.4%.

Real estate loans which include residential loans and commercial loans continue to comprise the largest share of the Company's loan portfolio. At the end of 2005, residential loans and commercial loans comprised a combined 90.6% of the portfolio, compared to 87.7% five years ago. Home equity loans at 5.8% and consumer installment at 3.6% comprise the remainder of the portfolio in 2005. Five years ago in 2000, home equity loans comprised 3.6% of the overall loan portfolio, while consumer installment loans comprised 8.7%.



During 2005, approximately \$14.2 million in new mortgage loans were originated by the Company, an increase of \$2.2 million from 2004. The Company's product offerings continue to include a service release sales program, which permits the Company to offer competitive long-term fixed interest rates without incurring additional credit or interest rate risk.

The following shows the disposition of mortgage loans originated during 2005 and 2004 (in millions):

	2005	2004
Retained in Portfolio . . . . .	\$7.6	\$8.0
Loans Sold to Investors with Servicing Rights Released . . . . .	\$6.6	\$4.0

During 2005, the Company originated and retained in portfolio a larger percentage of residential mortgage loans than it sold in the secondary market. These retained loans met the Company's asset quality criteria. Although management anticipates that secondary market originations will continue as an important aspect of loan administration, loans which are retained by the Bank portfolio will become more predominant as portfolio lending strategies are developed to enhance overall customer relationships.

The Bank is also active in home equity financing. Home Equity term loans and credit lines remain popular with consumers wishing to finance home improvements, educational costs, vacations and consumer good purchases at favorable interest rates.

In order to improve customer retention and provide better overall balance, management also will continue to revamp and reposition the Company's In-Portfolio product offerings during 2006.

The balance of the commercial loan portfolio as of December 31, 2005 was \$110,750, a decrease of \$2,457 from the balance of \$113,207 recorded at December 31, 2004. Short term, asset based, commercial loans including lines of credit increased by \$579. Commercial real estate loans decreased by \$3,036 during the same period. The competitive interest rate environment had a direct effect on commercial loan financing products, particularly on commercial real estate loans.

Management is expanding commercial real estate product offerings in an effort to establish new business relationships and capture more of the market share. Loan personnel will continue to aggressively pursue both commercial and small business opportunities supported by product incentives and marketing efforts. The Bank's lending



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function continues to provide business services to a wide array of medium and small businesses, including but not limited to commercial and residential real estate builders, automobile dealers, manufacturers, trucking companies, nursing homes, physicians and medical groups, funeral homes, general contractors, service contractors, restaurants, hotels/motels, retailers, wholesalers, as well as area educational institutions and other political subdivisions. For those businesses electing to finance business assets through a lease instrument the Bank also offers lease financing through a third party vendor.

Small business loans are originated by loan personnel assigned to the Community Bank offices. These loans are processed through the Commercial Loan Department in accordance with established business loan underwriting standards and practices.

The following table provides an overview of commercial loans by various business sectors reflecting the areas of largest concentration. It should be noted that these are open balances and do not reflect existing commitments that may be currently outstanding but unfunded.

**Commercial Loan Concentrations**

Sector	2005		2004	
	Balances	% of Portfolio	Balances	% of Portfolio
Hotels/Motels	\$15,005	13.65%	\$16,043	14.2%
Eating Places	5,669	5.16%	5,818	5.1%
Steel Related Industries	5,317	4.84%	7,183	6.3%
Nursing Home & Personal Care	3,721	3.38%	4,370	3.9%
Medical Doctors	1,747	1.59%	3,699	3.3%
New/Used Car Dealers	1,366	1.24%	1,898	1.7%
Funeral Services	135	0.12%	2,623	2.3%

The single largest customer balance at year end had a balance of \$4.5 million in 2005 compared to \$4.7 million in 2004. This balance represented approximately 4.1% of the total commercial portfolio, compared to 4.2% in 2004.

In the consumer lending area, the Company provides financing for a variety of consumer

purchases: fixed rate amortizing mortgage products that consumers utilize for home improvements; the purchase of consumer goods of all types; education, travel and other personal expenditures. The consolidation of credit card and other existing debt into term payout continues to remain a popular financing option among consumers.

Additional information regarding the loan portfolio can be found in the Notes to the Consolidated Financial Statements (NOTES 1, 3, 8, 11 and 13).

**INVESTMENT SECURITIES**

In accordance with Statement of Financial Accounting Standards No. 115 (SFAS 115), "Accounting for Certain Investments in Debt and Equity Securities," investment securities are segregated into three separate portfolios: held to maturity, available for sale, and trading. Each portfolio type has its own method of accounting.

Held to maturity securities are recorded at historical cost, adjusted for amortization of premiums and accretion of discounts. Trading securities are marked-to-market, with any gain or loss reflected in the determination of income. Securities designated as available for sale are similarly carried at their fair market value. However, any unrealized gain or loss (net of tax) is recorded as an adjustment to shareholders' equity as a component of Other Comprehensive Income.

One effect of SFAS 115 is to expose shareholders' equity to fluctuations resulting from market volatility related to the available for sale portfolio. The potential adverse impact of this volatility is somewhat mitigated as bank regulatory agencies measure capital adequacy for regulatory purposes without regard to the effects of SFAS 115.

Securities designated by the Company as held to maturity tend to be higher yielding but less liquid either due to maturity, size or other characteristics of the issue. The Company must have both the intent and the ability to hold such securities to maturity.

Securities the Company has designated as available for sale may be sold prior to maturity in order

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to fund loan demand, to adjust for interest rate sensitivity, to reallocate bank resources, or to reposition the portfolio to reflect changing economic conditions and shifts in the relative values of mar-

ket sectors. Available for sale securities tend to be more liquid investments and generally exhibit less price volatility as interest rates fluctuate.

The following table shows the book value of investment securities by type of obligation at the dates indicated:

	December 31,		
	2005	2004	2003
U.S. Treasury and other U.S. Government agencies and corporations . . . . .	\$ 80,053	\$ 69,670	\$ 62,524
U.S. Government mortgage-backed pass-through certificates . . . . .	82,992	91,226	92,499
States of the U.S. and political subdivisions . . . . .	44,714	45,689	53,503
Other securities . . . . .	26,893	19,256	14,249
	<u>\$234,652</u>	<u>\$225,841</u>	<u>\$222,775</u>

A summary of securities held at December 31, 2005, classified according to the earlier of next repricing or the maturity date and the weighted average yield for each range of maturities, is set forth below. Fixed rate mortgage-backed securities are classified by their estimated contractual cash flow, adjusted for current prepayment assumptions. Actual maturities may differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

Type and Maturity Grouping	December 31, 2005	
	Book Value	Weighted Average Yield(1)
<b>U.S. Treasury and other U.S. Government agencies and corporations:</b>		
Maturing within one year . . . . .	\$ 2,048	3.670%
Maturing after one year but within five years . . . . .	17,021	4.421
Maturing after five years but within ten years . . . . .	26,895	5.382
Maturing after ten years . . . . .	34,089	5.842
Total U.S. Treasury and other U.S. Government agencies and corporations . . . . .	<u>\$80,053</u>	<u>5.330%</u>
<b>U.S. Government mortgage-backed pass-through certificates, REMICS &amp; CMO's:</b>		
Maturing within one year . . . . .	\$49,272	4.716%
Maturing after one year but within five years . . . . .	30,940	4.759
Maturing after five years but within ten years . . . . .	1,430	4.620
Maturing after ten years . . . . .	1,350	4.520
Total U.S. Government mortgage-backed pass-through certificates, REMICS & CMO's . . . . .	<u>\$82,992</u>	<u>4.727%</u>
<b>States of the U.S. and political subdivisions:</b>		
Maturing within one year . . . . .	\$ 47	8.178%
Maturing after one year but within five years . . . . .	932	7.845
Maturing after five years but within ten years . . . . .	5,108	7.376
Maturing after ten years . . . . .	38,627	7.270
Total States of the U.S. and political subdivisions . . . . .	<u>\$44,714</u>	<u>7.295%</u>
<b>Other securities:</b>		
Maturing within one year . . . . .	\$13,946	5.885%
Maturing after one year but within five years . . . . .	8,007	5.344
Maturing after five years but within ten years . . . . .	1,547	7.182
Maturing after ten years . . . . .	3,393	5.809
Total other securities . . . . .	<u>\$26,893</u>	<u>5.789%</u>

(1) The weighted average yield has been computed by dividing the total interest income adjusted for amortization of premium or accretion of discount over the life of the security by the amortized cost of the securities outstanding. The weighted average yield of tax-exempt obligations of states of the U.S. and political subdivisions has been calculated on a fully taxable equivalent basis. The amounts of adjustments to interest which are based on the statutory tax rate of 34% were \$1, \$23, \$118 and \$862 for the four ranges of maturities.

CORTLAND BANCORP AND SUBSIDIARIES  
MANAGEMENT'S DISCUSSION AND ANALYSIS  
(In thousands of dollars, except for per share amounts)

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As of December 31, 2005, there were \$2,017 in callable U.S. Government Agencies, \$6,273 in callable obligations of states and political subdivisions that given current and expected interest rate environments are likely to be called within the one year time horizon. These securities are categorized according to their contractual maturities, with \$3,620 classified as maturing after five years but within ten years, and \$4,670 classified as maturing after 10 years.

Additionally, as of December 31, 2005, there were \$17,122 in callable U.S. Government Agencies and \$26,326 in callable obligations of states and political subdivisions that given current and expected interest rate environments are likely to be called within the time frame defined as after one year but within five years. These securities are categorized according to their contractual maturities, with \$5,864 maturing after five years but within ten years and \$37,584 maturing after 10 years.

As of December 31, 2005, the carrying value of all investment securities, both available for sale and held to maturity, tallied \$234,652, an increase of \$8,811 or 3.90% from the prior year. The allocation between single maturity investment securities and mortgage-backed securities shifted to a 64/36 split versus the 59/41 division of the previous year, as mortgage-backed securities decreased by \$8,234, or 9.0%.

Holdings of obligations of states and political subdivisions showed a decrease of \$975 or 2.1%.

The Company decreased its holdings of U.S. Treasury securities by approximately \$1,450, or 90.7%, as a U.S. Treasury Security was sold during the year to reduce the portfolio's duration in response to shifting monetary policy. The proceeds on this sale totaled \$1,478. Investments in U.S. government agencies and sponsored corporations increased by approximately \$11,833, or 17.4%. The Company also purchased \$8,275 in corporate debt securities during 2005 to take advantage of the floating rate repricing characteristics of some of the securities and the high yield that was obtained on three General Motors Corporate

issues. The purchases were partially offset by an \$808 unrealized loss on the General Motors bonds at December 31, 2005. The net result was an increase in the corporate portfolio of \$7,484.

Holdings of other securities increased by \$153 primarily reflecting stock dividends received from the Federal Home Loan Bank of Cincinnati.

The mix of mortgage-backed securities remained weighted in favor of fixed rate securities in 2005, although at a reduced level. The portion of the mortgage-backed portfolio allocated to fixed rate securities fell to 64% in 2005 versus 69% in 2004. Floating rate and adjustable rate mortgage-backed securities provide some degree of protection against rising interest rates, while fixed rate securities perform better in periods of stable to slightly declining interest rates. Included in the mortgage-backed securities portfolio are investments in collateralized mortgage obligations which totaled \$20,554 and \$22,963 at December 31, 2005 and 2004, respectively. No collateralized mortgage obligations were sold in 2005.

At December 31, 2005, a net unrealized loss of \$877, net of tax, was included in shareholders' equity as a component of Other Comprehensive Income, as compared to a net unrealized gain of \$1,061, net of tax, as of December 31, 2004. This \$1,938 decrease reflects the decreased market value of debt securities resulting from rising short and intermediate term interest rates over most of the year, as well as the credit quality concerns of the General Motors issues. Lower interest rates generally translate into more favorable market prices for debt securities; conversely rising interest rates generally result in a depreciation in the market value of debt securities.

The Company had \$8,680 in investments considered to be structured notes as of December 31, 2005. The Company had no investments in inverse floating rate securities or other derivative products.

Additional information regarding investments can be found in the Notes to the Consolidated Financial Statements (NOTES 1 and 2).

## DEPOSITS

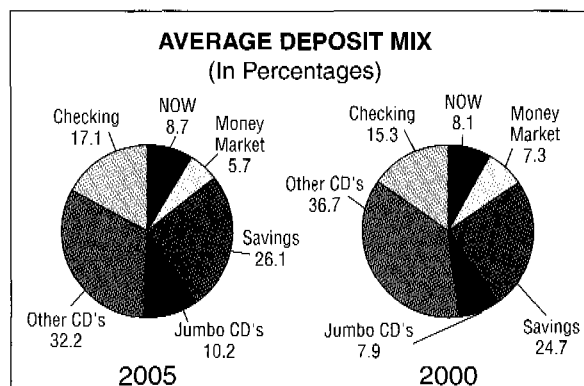
The Company's deposits are derived from the individuals and businesses located in its primary market area. Total deposits at year-end exhibited an increase of 1.6% to \$350,375 at December 31, 2005, as compared to \$344,919 at December 31, 2004.

The Company's deposit base consists of demand deposits, savings, money market and time deposit accounts. Average noninterest-bearing deposits increased 2.7% during 2005, while average interest-bearing deposits decreased by 1.4%.

During 2005, noninterest-bearing deposits averaged \$58,320 or 17.1% of total average deposits as compared to \$56,778 or 16.5% of total deposits in 2004. Core deposits averaged \$306,626 for the year ended December 31, 2005, a decrease of \$4,674 from the average level of 2004. During 2004, core deposits had averaged \$311,300, an increase of \$3,028 from the preceding year.

Historically, the deposit base of the Company has been characterized by a significant aggregate amount of core deposits. Core deposits represented 89.8% of average total deposits in 2005 compared to 90.5% in 2004 and 92.0% in 2003.

Over the past five years, the Company has successfully increased the share of deposits represented by noninterest-bearing and NOW checking accounts. These products now comprise 25.8% of total deposits compared to 23.4% five years ago. The following depicts how the deposit mix has shifted during this five-year time frame.



Additional information regarding interest-bearing deposits is presented in the Notes to the Consolidated Financial Statements (NOTE 6).

## FOURTH QUARTER 2005 AS COMPARED TO FOURTH QUARTER 2004

Tax equivalent net interest income for the Company during the fourth quarter of 2005 increased by \$113, a 2.9% increase from the fourth quarter of 2004. The yield on earning assets increased by 38 basis points while fourth quarter average earning assets increased by 1.4%, or \$6 million, when compared to a year ago. The result was an increase in tax equivalent interest income of \$506. The rate paid on interest-bearing liabilities increased by 41 basis points, while fourth quarter average interest-bearing liabilities increased by \$5.3 million when compared to a year ago, resulting in an increase in total interest expense of \$393. The net interest margin for the quarter registered 3.79%, up 5 basis points from the same quarter a year ago.

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(Unaudited)	NET INTEREST MARGIN FOR QUARTER ENDED					
	December 31, 2005			December 31, 2004		
	Average Balance(1)	Interest	Average Rate	Average Balance(1)	Interest	Average Rate
<b>INTEREST-EARNING ASSETS</b>						
Federal funds sold and other money market funds .....	\$ 4,409	\$ 44	3.9%	\$ 10,159	\$ 48	1.9%
Investment securities(1)(2) .....	232,498	3,104	5.3%	218,495	2,805	5.2%
Loans(2)(3) .....	190,592	3,340	7.0%	192,851	3,129	6.4%
<b>Total interest-earning assets</b> .....	<b>\$427,499</b>	<b>\$6,488</b>	<b>6.1%</b>	<b>\$421,505</b>	<b>\$5,982</b>	<b>5.7%</b>
<b>INTEREST-BEARING LIABILITIES</b>						
Interest-bearing demand deposits .....	\$ 50,587	\$ 136	1.1%	\$ 51,625	\$ 84	0.6%
Savings .....	86,974	209	1.0%	91,001	127	0.6%
Time .....	148,925	1,398	3.7%	149,395	1,274	3.4%
<b>Total interest-bearing deposits</b> .....	<b>286,486</b>	<b>1,743</b>	<b>2.4%</b>	<b>292,021</b>	<b>1,485</b>	<b>2.0%</b>
Federal funds purchased .....	644	7	4.2%			
Other borrowings .....	54,642	689	5.0%	44,419	561	5.0%
<b>Total interest-bearing liabilities</b> .....	<b>\$341,772</b>	<b>\$2,439</b>	<b>2.8%</b>	<b>\$336,440</b>	<b>\$2,046</b>	<b>2.4%</b>
Net interest income .....		<b>\$4,049</b>			<b>\$3,936</b>	
Net interest rate spread(4) .....			<b>3.3%</b>			<b>3.3%</b>
Net interest margin(5) .....			<b>3.8%</b>			<b>3.7%</b>

(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%.

(3) Includes loan origination and commitment fees.

(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.

Loan charge-offs during the quarter were \$185 in 2005 compared to \$135 in 2004, while the recovery of previously charged-off loans amounted to \$14 during the fourth quarter of 2005 compared to \$16 in the same period of 2004. The Company's provision for loan losses during the quarter was \$135 compared to \$140 a year ago.

Other income decreased by \$74 from a year ago, due primarily to a decline in service charge income of \$52 and a \$22 decrease in non-taxable income on bank owned life insurance policies, reflecting declines in the investment yields associated with these policies. Investment securities gains of \$378 were realized in 2004, compared to none realized in the fourth quarter of 2005. The net gain on loans sold during the quarter amounted to \$30, compared to \$13 a year ago.

Total other non-interest expenses in the fourth quarter were \$2,990 in 2005 compared to \$2,999 in 2004, a decrease of \$9 or 0.3%. Salaries and

benefits constituted an \$11 increase, or 0.6%. Occupancy and equipment, office supplies and marketing expenses decreased by \$16 or 2.7%. State and local tax assessments increased by \$21 or 18.6%. Bank exam and audit fees decreased by \$21 or 13.5% mainly due to the expense associated with the implementation of the requirements of Section 404 of the Sarbanes-Oxley Act of 2002 in 2004. Other expenses decreased by \$4 or 0.9%.

Income before income tax during the fourth quarter amounted to \$1,340 in 2005 compared to \$1,605 in 2004. Income tax expense for the fourth quarter of 2005 was \$247 as compared to \$300 in 2004. Fourth quarter net income was \$1,093 in 2005 compared to \$1,305 in 2004, representing a decrease of \$212, or 16.2%.

Earnings per share for the fourth quarter, adjusted for the 3% stock dividend paid January 1, 2006, were \$0.25 in 2005 and \$0.30 in 2004.

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**Fourth Quarter of 2005 Compared to 2004  
(Unaudited)**

	Three Months Ended Dec. 31,	
	2005	2004
Interest Income .....	\$6,212	\$5,660
Interest Expense .....	2,439	2,046
<b>Net Interest Income</b> .....	<b>3,773</b>	3,614
Loan Loss Provision .....	(135)	(140)
Net security gains .....		378
Net gain on loans .....	30	13
Other real estate loss .....	(3)	
Other Income .....	665	739
Other Expenses .....	(2,990)	(2,999)
<b>Income Before Tax</b> .....	<b>1,340</b>	1,605
Federal Income Tax .....	247	300
<b>Net Income</b> .....	<b>\$1,093</b>	\$1,305
Net Income Per Share .....	\$ 0.25	\$ 0.30

Core earnings (earnings before gains on loans sold, investment securities sold or called and certain other non recurring items) increased by 2.7% in the fourth quarter of 2005 compared to 2004. Core earnings for the fourth quarter of 2005 were \$1.075 million compared to last year's \$1.047 mil-

lion. Core earnings per share were \$0.25 in 2005 and 2004. The following is a reconciliation between core earnings and earnings under generally accepted accounting principles in the United States (GAAP earnings):

	Three Months Ended December 31,	
	2005	2004
GAAP Earnings .....	\$1,093	\$1,305
Investment security gains ....		(378)
Gain on sale of loans .....	(30)	(13)
Other real estate loss .....	3	
Tax effect of adjustments ....	9	133
<b>Core Earnings</b> .....	<b>\$1,075</b>	\$1,047

Realized gains or losses on securities are based on net proceeds and the adjusted carrying amount of the securities, 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 December 31, 2005	Twelve Months December 31, 2005
Proceeds on securities sold or called .....	\$34	\$13,563
Gross realized gains ....		308
Gross realized losses ....		

**ASSET-LIABILITY MANAGEMENT**

The Company's executive management and Board of Directors routinely review the Company's balance sheet structure for stability, liquidity and capital adequacy. The Company has defined a set of key control parameters which provide various measures of the Company's exposure to changes in interest rates. The Company's asset-liability management goal is to produce a net interest margin that is relatively stable despite interest rate volatility while maintaining an acceptable level of earnings. Net Interest Margin is the difference between total interest earned on a fully taxable equivalent basis and total interest expensed. The Net Interest Margin Ratio expresses this difference as a percentage of average earning assets. In the past five years, the net interest margin ratio has averaged 4.01% ranging between 3.74% and 4.39%.

Included among the various measurement techniques used by the Company to identify and manage exposure to changing interest rates is the use of computer based simulation models. Computerized simulation techniques enable the Company to explore and measure net interest income volatility under alternative asset deployment strategies, different interest rate environments, various product offerings and changing growth patterns.

**GAP TABLE**  
December 31, 2005

	Maturity or Repricing Interval				Total
	3 Months or Less	3 to 12 Months	1 to 5 Years	Non Rate Sensitive or >5 Years	
<b>Interest-Earning Assets</b>					
Investments .....	\$ 38,991	\$ 34,612	\$100,348	\$ 60,701	\$234,652
Loans & Leases .....	64,554	31,478	70,717	21,453	188,202
Federal Fund Sold .....	4,650				4,650
<b>Total Earning Assets .....</b>	<b>108,195</b>	<b>66,090</b>	<b>171,065</b>	<b>82,154</b>	<b>427,504</b>
Other Assets .....				32,197	32,197
<b>Total Assets .....</b>	<b>\$108,195</b>	<b>\$ 66,090</b>	<b>\$171,065</b>	<b>\$114,351</b>	<b>\$459,701</b>
<b>Interest-Bearing Liabilities</b>					
Interest-bearing Checking .....	\$ 29,677	\$	\$	\$	\$ 29,677
Money Market Accounts .....	17,866				17,866
Passbook Savings .....	86,359				86,359
Time Deposits <100,000 .....	21,390	34,150	33,941	20,007	109,488
Time Deposits ≥100,000 .....	11,338	18,633	8,364	6,868	45,203
Repurchase Agreements .....	2,336				2,336
U.S. Treasury Demand .....	775				775
Other Borrowings .....	5,000	2,000	38,500	9,500	55,000
<b>Total Interest-Bearing Liabilities .....</b>	<b>174,741</b>	<b>54,783</b>	<b>80,805</b>	<b>36,375</b>	<b>346,704</b>
Demand Deposits .....				61,782	61,782
Other Liabilities .....				2,890	2,890
Shareholders' Equity .....				48,325	48,325
<b>Total Liabilities &amp; Equity .....</b>	<b>\$174,741</b>	<b>\$ 54,783</b>	<b>\$ 80,805</b>	<b>\$149,372</b>	<b>\$459,701</b>
Rate Sensitivity Gap .....	\$ (66,546)	\$ 11,307	\$ 90,260	\$ 45,779	
Cumulative Gap .....	\$ (66,546)	\$ (55,239)	\$ 35,021	\$ 80,800	
Cumulative Gap to Total Assets .....	(14.5)%	(12.0)%	7.6%	17.6%	

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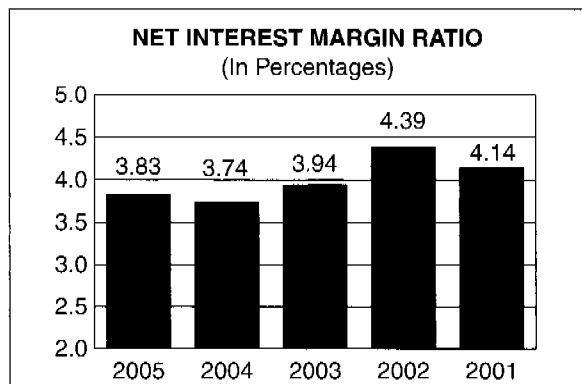
The preceding Gap Table presents an analysis of the Company's earliest repricing opportunity for each of its interest-earning assets and interest-bearing liabilities. Assets are distributed according to the earlier of interest rate repricing opportunity or expected cash flows. Time deposits and liabilities with defined maturities are distributed according to the earlier of the repricing interval or contractual maturity. Other core deposit accounts (Interest-bearing checking, Money Market and Savings accounts) are shown as being available for repricing in the earliest time frame, although management can exert considerable influence over the timing and manner of repricing such core deposits. Therefore, these accounts may reprice in later time intervals and reflect smaller incremental changes than other interest-earning assets and interest-bearing liabilities. Since management may reprice these accounts at its discretion, the impact of changing rates on net interest income is likely to be considerably different than inferred by this table.

During 2005, the effective maturities of earning assets tended to lengthen as short and intermediate rates in the credit markets rose sharply. Federal Reserve policy makers increased short-term interest rates eight times during the year, from 2.25% to 4.25% in an attempt to avoid an unwelcome rise in inflation. With rates rising throughout the year, the volume of investment securities eligible to be called decreased significantly, while prepayments on loans and mortgage-backed securities similarly decreased, causing the effective maturities of existing earning assets to lengthen. Accordingly, in order to maintain duration, management invested excess overnight funds (federal funds sold balances), and increased the allocation towards hybrid adjustable rate mortgage-backed securities, adjustable rate corporate bonds and U.S. Government agencies purchased at a discount that contain a lock-out period prior to the first call date.

While the preceding Gap Table provides a general indication of the potential effect that changing interest rates may have on net interest income, it does not by itself present a complete picture of

interest rate sensitivity. Because the repricing of the various categories of assets and liabilities is subject to competitive pressures, customer preferences and other factors, such assets and liabilities may in fact reprice in different time periods and in different increments than assumed.

The computerized simulation techniques utilized by management provide a more sophisticated measure of the degree to which the Company's interest sensitive assets and liabilities may be impacted by changes in the general level of interest rates. These analyses show the Company's net interest income remaining relatively neutral within the economic and interest rate scenarios anticipated by management. In fact, as previously noted, the Company's net interest margin has remained relatively stable in the range of 3.74% to 4.39% over the past five years, despite significant shifts in the mix of earning assets and the direction and level of interest rates.



## 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



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loans, investment securities and mortgage-backed securities.

Cash and cash equivalents, which includes federal funds sold increased by \$6,340 compared to year-end 2004. Anticipated principal repayments on mortgage-backed securities along with investment securities maturing, repricing, or expected to be called in one year or less amounted to \$73,603 at December 31, 2005, representing 31.4% of the total combined portfolio, as compared to \$96,471 or 42.7% of the portfolio a year ago.

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, and access to the Federal Reserve Discount Window. The Company is also a member of the Federal Home Loan Bank of Cincinnati, which provides yet another source of liquidity.

Cash and cash equivalents increased from \$9,747 in 2003, \$12,897 in 2004 to \$19,237 in 2005 as the Company increased its level of Federal Funds Sold. Operating activities provided cash of \$4,275 in 2005, \$7,382 in 2004 and \$7,048 in 2003. Key differences stem mainly from: 1) a decrease in net income of \$509 between 2005 and 2004 and \$641 between 2004 and 2003; 2) there were no loans held for sale at December 31, 2005 and 2004, \$103 at 2003 and \$2,022 at December 31, 2002, which favorably impacts the proceeds and gains on loans realized in 2004 by \$103 and 2003 by \$1,919; 3) gains on the sale of investments was \$308 at December 31, 2005, compared to \$1,052 at December 31, 2004 and \$946 at December 31, 2003; 4) amortization on securities was \$872 in December 31, 2005 compared to \$1,546 in 2004 and \$1,644 in 2003; 5) loss on the sale of other real estate totaled \$171 in 2004 compared to \$3 in 2005 and none in 2003; 6) the purchase of an additional

\$2.5 million insurance contracts on the lives of the participants in the supplemental post retirement benefit plan in 2003 compared to \$0.5 million in 2004 and none in 2005; 7) a liability for securities purchased yet to settle totaled \$1,270 at December 31, 2004, with none at December 31, 2005 or 2003. Refer to the Consolidated Statements of Cash Flows for a summary of the sources and uses of cash for 2005, 2004 and 2003, and the following table which details the cash flows from operating activities.

	December 31,		
	2005	2004	2003
Net income	\$ 4,334	\$ 4,843	\$ 5,484
Adjustments to reconcile net income to net cash flows from operating activities:			
Depreciation, amortization and accretion	1,469	2,176	2,382
Provision for loan loss	545	415	240
Investment securities gains	(308)	(1,052)	(946)
Other real estate losses	3	171	
Impact of loans held for sale		103	1,919
Changes in:			
Securities to settle and securities sold to settle	(1,270)	1,270	
Purchase of insurance contracts		(500)	(2,500)
Other assets and liabilities	(498)	(44)	469
Net cash flows from operating activities	<u>\$ 4,275</u>	<u>\$ 7,382</u>	<u>\$ 7,048</u>

**CONTRACTUAL OBLIGATIONS AND COMMITMENTS**

The Corporation has various obligations, including contractual obligations and commitments that may require future cash payments.

Contractual Obligations: The following table presents, as of December 31, 2005, significant fixed and determinable contractual obligations to third parties by payment date. Further discussion of the nature of each obligation is included in the referenced note to the consolidated financial statements.

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	See Note	Contractual Obligations as of December 31, 2005				
		Payments Due in				
		One Year or Less	One to Three Years	Three to Five Years	Over Five Years	Total
Non-interest bearing deposits.....		\$ 61,782	\$	\$	\$	\$ 61,782
Interest bearing deposits(a) .....	6	133,902				133,902
Average Rate(b) .....		1.16%				1.16%
Certificates of deposit(a) .....	6	76,857	40,739	9,698	27,397	154,691
Average Rate(b) .....		3.44%	4.02%	4.35%	4.84%	3.90%
Federal funds purchased and security repurchase agreements(a) .....	7	2,336				2,336
Average Rate(b) .....		2.96%				2.96%
U.S. Treasury interest-bearing demand note(a) .....	7	775				775
Average Rate(b) .....		3.95%				3.95%
Federal Home Loan Bank advances(a) ...	7	2,000	20,000	23,500	9,500	55,000
Average Rate(b) .....		4.66%	4.69%	5.60%	4.96%	5.12%
Operating leases.....	8	188	110			298

(a) Excludes present and future accrued interest.

(b) Variable rate obligations reflect interest rates in effect at December 31, 2005.

The Corporation's operating lease obligations represent short and long-term lease and rental payments for the subsidiary bank's branch facilities.

The Corporation also has obligations under its supplemental retirement plans as described in Note 9 to the consolidated financial statements. The postretirement benefit payments represent actuarially determined future benefit payments to eligible plan participants. The Corporation does not have any commitments or obligations to the defined contribution retirement plan (401(k) plan) at December 31, 2005 due to the funded status of the plan. (See further discussion in Note 9.)

**Commitments:** The following table details the amounts and expected maturities of significant commitments as of December 31, 2005. (Further discussion of these commitments is included in Note 8 to the consolidated financial statements.)

	Expected Maturities of Commitments as of December 31, 2005				
	One Year or Less	One to Three Years	Three to Five Years	Over Five Years	Total
Commitments to extend credit:					
Commercial	\$28,473	\$1,024	\$ 10	\$1,799	\$31,306
Residential real estate	306				306
Revolving home equity	9,102				9,102
Overdraft protection	6,191				6,191
Other	567				567
Standby letters of credit	1,195				1,195

Commitments to extend credit, including loan commitments, standby letters of credit, and commercial letters of credit do not necessarily represent future cash requirements, in that these commitments often expire without being drawn upon.

### CAPITAL RESOURCES

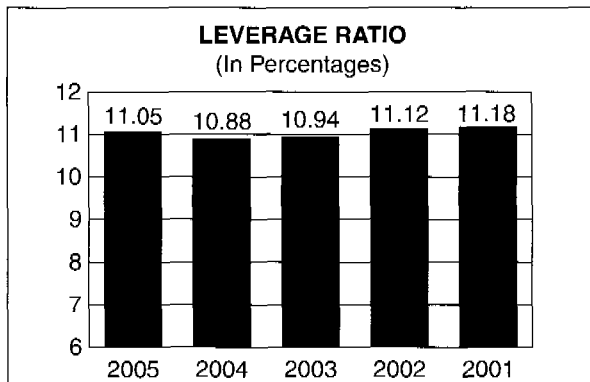
Regulatory standards for measuring capital adequacy require banks and bank holding companies to maintain capital based on "risk-adjusted" assets so that categories of assets of potentially higher credit risk require more capital backing than assets with lower risk. In addition, banks and bank holding companies are required to maintain capital to

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support, on a risk-adjusted basis, certain off-balance sheet activities such as standby letters of credit and interest rate swaps.

The risk-based standards classify capital into two tiers. Tier 1 capital consists of common shareholders' equity, noncumulative and cumulative perpetual preferred stock, and minority interests less goodwill. Tier 2 capital consists of a limited amount of the allowance for loan and lease losses, perpetual preferred stock (not included in Tier 1), hybrid capital instruments, term subordinated debt, and intermediate-term preferred stock.

The following graph, which is not "risk-adjusted," depicts Tier 1 capital as a percentage of total average assets over the past several years. This measure of capital adequacy is known as the "leverage ratio." The ratio increased from 10.88% in 2004 to 11.05% in 2005, and remains well above regulatory minimums.



The Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA) required banking regulatory agencies to revise risk-based capital standards to ensure that they take adequate account of interest rate risk. Accordingly, regulators subjectively consider an institution's exposure to declines in the economic value of its capital due to changes in interest rates in evaluating capital adequacy.

The following table illustrates the Company's risk-weighted capital ratios at December 31, 2005 and 2004. Banks are required to maintain a minimum ratio of 8% of qualifying total capital to risk-adjusted total assets. The Tier 1 capital ratio must

be at least 4%. Capital qualifying as Tier 2 capital is limited to 100% of Tier 1 capital. As the table indicates, the Company maintains both Tier 1 and total risk-based capital well in excess of the required regulatory minimum ratios.

	<b>Risk-Based Capital</b>	
	<b>December 31, 2005</b>	<b>December 31, 2004</b>
Tier 1 Capital	\$ 49,031	\$ 48,129
Tier 2 Capital	2,189	2,664
<b>QUALIFYING CAPITAL</b>	<b>\$ 51,220</b>	<b>\$ 50,793</b>
Risk-Adjusted Total Assets(*)	<b>\$242,106</b>	<b>\$230,133</b>
Tier 1 Risk-Based Capital Ratio	20.25%	20.91%
Total Risk-Based Capital Ratio	21.16%	22.07%
Total Leverage Capital Ratio	11.05%	10.88%

(\*) Includes off-balance sheet exposures

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 December 31, 2005 and December 31, 2004. As of those dates, the Company was "well capitalized" under regulatory prompt corrective action provisions.

	<b>Actual Regulatory Capital Ratios as of:</b>		<b>Regulatory Capital Ratio requirements to be:</b>	
	<b>Dec. 31, 2005</b>	<b>Dec. 31, 2004</b>	<b>Well Capitalized</b>	<b>Adequately Capitalized</b>
Total risk-based capital to risk-weighted assets	21.16%	22.07%	10.00%	8.00%
Tier I capital to risk-weighted assets	20.25%	20.91%	6.00%	4.00%
Tier I capital to average assets	11.05%	10.88%	5.00%	4.00%

SFAS 115, "Accounting for Certain Investments in Debt and Equity Securities," requires that investments designated as available for sale be marked-to-market with corresponding entries to the deferred tax account and shareholders' equity. Regulatory agencies, however, exclude these adjustments in computing risk-based capital, as their inclusion would tend to increase the volatility

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of this important measure of capital adequacy. Additional information regarding regulatory matters can be found in the Notes to the Consolidated Financial Statements (NOTE 12.)

### 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). As of December 31, 2005, the Company's bank subsidiary was rated "satisfactory" for CRA purposes, and remained well capitalized and well managed, in management's opinion.

### MARKET RISK

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 repricing risk, basis risk and yield curve risk. Repricing risk arises due to timing differences in the repricing of assets and liabilities as interest rate changes occur. Basis risk occurs when repricing 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 repricing intervals and maturities, emphasize the acquisition of floating rate over fixed rate assets, and lengthen the maturities of liability funding sources. When the risk of falling rates is perceived, management will consider strategies that shorten the maturities of funding sources, lengthen the repricing 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 repricing characteristics of the Company's balance sheet. Repricing and runoff rate assumptions are based upon specific product parameters modified by historical trends and internal projections. These assumptions are periodically reviewed and 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.

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The following table shows the Company's current estimate of interest rate sensitivity based on the composition of its balance sheet at December 31, 2005. For purposes of this analysis, short term interest rates as measured by the federal funds rate and the prime lending rate are assumed to increase (decrease) gradually over the next twelve months reaching a level 300 basis points higher (lower) than the rates in effect at December 31, 2005. Under both the rising rate scenario and the falling rate scenario, the yield curve is assumed to exhibit a parallel shift.

During 2005, the Federal Reserve increased its target rate for overnight federal funds by 200 basis points. At year end December 31, 2005, the difference between the yield on the ten year Treasury and the three month Treasury had decreased to a positive 31 basis points from the positive 202 basis points that existed at December 31, 2004, indicating that the yield curve was "flattening." At December 31, 2005, the yield curve was inverted, as interest rate yields for three years through ten years were below those of the two year yield. However, rates did peak at the long-end of the Treasury 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 \$15,377 for the year ending December 31, 2006.

<b>Simulated Net Interest Income Sensitivity For the Twelve Months Ending December 31, 2006</b>			
<b>Change in Interest Rates</b>	<b>Net Interest Income</b>	<b>\$ Change</b>	<b>% Change</b>
Graduated increase of +300 basis points	\$15,385	\$ 8	0.1%
Short term rates unchanged (base case)	15,377		
Graduated decrease of -300 basis points	14,643	(734)	(4.8)%

The level of interest rate risk indicated is within limits that management considers acceptable. However, given that interest rate movements can

be sudden and unanticipated, and are increasingly influenced by global events and circumstances beyond the purview of the Federal Reserve, no assurances can be made that interest rate movements will not impact key assumptions and parameters in a manner not presently embodied by the model.

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

**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." 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. 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.

The allowance for loan losses represents management's estimate of probable credit losses inherent in the loan portfolio. Determining the amount of the allowance for loan losses is considered a critical accounting estimate because it requires significant judgment and the use of subjective measurements including management's assessment of the internal

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risk classifications of loans, changes in the nature of the loan portfolio, industry concentrations and the impact of current local, regional and national economic factors on the quality of the loan portfolio. Changes in these estimates and assumptions are reasonably possible and may have a material impact on the Company's consolidated financial statements, results of operations or liquidity.

Accordingly, the Company has developed and maintains a comprehensive, systematic and consistently applied process to determine the appropriate amounts of the allowance for loan losses, and resultant provision for loan losses, necessary to absorb estimated credit losses inherent in the loan portfolio. The allowance for loan losses represents management's best estimate from within an acceptable range of estimated losses that it considers appropriate and prudent, but not excessive.

While management's evaluation of the allowance for loan losses as of December 31, 2005 has determined the allowance to be adequate, under adversely different conditions or assumptions, the Company would most likely need to increase the allowance. The assumptions and estimates used by the Company in its internal review of non-performing loans and potential problem loans, as well as the associated evaluation of the related collateral coverage for these loans, can have a significant impact on the overall assessment of the adequacy of the allowance for loan losses. While management has concluded that the current valuation of

loan collateral is reasonable under present circumstances, if collateral valuations were significantly reduced due to either new information or other changing circumstances, additional provisions to the allowance for loan losses would most likely be necessary.

All accounting policies are important and the reader of these financial statements is encouraged to review the summary of significant accounting policies described in Note 1 of the Consolidated Financial Statements, in order to gain a better understanding of how the Company's financial performance is reported.

For additional information regarding the allowance for loan losses, its relation to the provision for loan losses and risk related to asset quality, see sections of the "Notes to the Consolidated Financial Statements" and "Management Discussion and Analysis" related to the allowance for loan losses.

#### **IMPACT OF INFLATION**

Consolidated financial information included herein has been prepared in accordance with generally accepted accounting principles, which require the Company to measure financial position and operating results in terms of historical dollars. Changes in the relative value of money due to inflation are generally not considered. Neither the price, timing nor the magnitude of changes directly coincide with changes in interest rates.

INFORMATION AS TO STOCK PRICES AND DIVIDENDS OF CORTLAND BANCORP

**OTHER INFORMATION**

The Company files quarterly reports, (Forms 10-Q, an annual report (Form 10-K), current reports on Form 8-K and all amendments to those reports with the Securities and Exchange Commission (SEC) pursuant to section 13(a) or (15)d of the Exchange Act. In 2006, the quarterly reports will be filed within 40 days of the end of each quarter, while the annual report is filed within 75 days of the end of the year. Any individual requesting copies of such reports may obtain these free of charge, as soon as reasonably practicable after such material is electronically filed with or furnished to the SEC by visiting our web site at [www.cortland-banks.com](http://www.cortland-banks.com) or by writing to:

Deborah L. Eazor  
 Cortland Bancorp  
 194 West Main Street  
 Cortland, Ohio 44410

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](http://www.sec.gov).

The Company's stock trades on the NASDAQ OTC market under the symbol CLDB. The following brokerage firms are known to be relatively active in trading the Company's stock:

Community Banc Investments, Inc.  
 Columbus, Ohio

Contact: Greig A. McDonald  
 Telephone: 1-800-224-1013

McDonald & Company Securities, Inc.  
 6575 Seville Drive  
 2nd Floor

P.O. Box 119  
 Canfield, Ohio 44406  
 Telephone: 1-330-746-2993

Smith Barney Citigroup, Inc.  
 5048 Belmont Ave.  
 Youngstown, Ohio 44505  
 Telephone: 1-800-535-0017

Stifel, Nicholas & Co., Inc.  
 655 Metro Place South  
 Suite 200  
 Dublin, Ohio 43017  
 Telephone: 1-877-875-9352

UBS Financial Services

3701 Boardman Canfield Rd  
 P.O. Box 100  
 Canfield, Ohio 44406  
 Telephone: 330-533-7191

The following table shows the prices at which the common stock of the Company has actually been purchased and sold in market transactions during the periods indicated. The range of market price is compiled from data provided by brokers based on limited trading. Also shown in the table are the dividends per share on the outstanding common stock. All figures shown have been adjusted to give retroactive effect to the 3% stock dividend paid as of January 1, 2006, 2005 and 2004. The Company currently has approximately 1,733 shareholders.

HIGH OR LOW TRADING PRICE PER QUARTER			
	Price Per Share		Cash Dividends Per Share
	High	Low	
<b>2005</b>			
Fourth Quarter	\$20.39	\$17.50	\$0.44
Third Quarter	20.39	18.45	0.21
Second Quarter	21.75	19.42	0.21
First Quarter	22.58	20.58	0.21
<b>2004</b>			
Fourth Quarter	\$23.57	\$20.41	\$0.44
Third Quarter	23.33	19.94	0.20
Second Quarter	25.69	20.74	0.20
First Quarter	28.76	24.52	0.20
<b>2003</b>			
Fourth Quarter	\$28.83	\$27.34	\$0.44
Third Quarter	30.67	27.69	0.19
Second Quarter	29.98	24.72	0.19
First Quarter	24.94	23.21	0.19

For the convenience of shareholders, the Company has established a plan whereby shareholders may have their dividends automatically reinvested in the common stock of Cortland Bancorp. Participation in the plan is completely voluntary and shareholders may withdraw at any time.

For current stock prices you may access our home page at [www.cortland-banks.com](http://www.cortland-banks.com).

For more information on the dividend reinvestment plan, you may contact Deborah L. Eazor at the following telephone number: (330) 637-8040 Ext. 130 or E-mail address [DLEAZOR@cortland-banks.com](mailto:DLEAZOR@cortland-banks.com).

# **CORTLAND BANCORP**

## **BOARD OF DIRECTORS**

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Chairman

**JERRY A. CARLETON**

**DAVID C. COLE**

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**JAMES M. GASIOR**

**GEORGE E. GESSNER**

**JAMES E. HOFFMAN III**

**NEIL J. KABACK**

**RICHARD B. THOMPSON**

**TIMOTHY K. WOOFER**

**WILLIAM A. HAGOOD**  
Director Emeritus

**RODGER W. PLATT**  
Director Emeritus

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Chief Executive Officer

**JAMES M. GASIOR**  
Senior Vice President  
Chief Financial Officer and  
Corporate Secretary

**CRAIG M. PHYTHON**  
Senior Vice President  
Chief Investment Officer  
and Treasurer



**THE CORTLAND SAVINGS AND BANKING COMPANY****BOARD OF DIRECTORS**

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**DAVID C. COLE**  
Partner and President  
Cole Valley Motor Company

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President and Chief Executive Officer

**JAMES M. GASIOR**  
Senior Vice President, Chief Financial Officer  
and Secretary

**GEORGE E. GESSNER**  
Attorney

**JAMES E. HOFFMAN III**  
Attorney

**NEIL J. KABACK**  
Partner, Cohen & Company

**K. RAY MAHAN**  
President, Mahan Packing Co.  
and Chairman of the Board

**RICHARD B. THOMPSON**  
Executive, Therm-O-Link, Inc.

**TIMOTHY K. WOOFER**  
President, Stan-Wade Metal Products

\* \* \* \* \*

**WILLIAM A. HAGOOD**  
Director Emeritus

**RODGER W. PLATT**  
Director Emeritus

\* \* \* \* \*

**OFFICERS**

**LAWRENCE A. FANTAUZZI**  
President and Chief Executive Officer

**JAMES M. GASIOR**  
Senior Vice President, Chief Financial Officer  
and Secretary

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Senior Vice President and Director of Human Resources and  
Corporate Administration

**TIMOTHY CARNEY**  
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**CRAIG M. PHYTHYON**  
Senior Vice President, Chief Investment Officer and Treasurer

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Senior Vice President and Chief Lending Officer

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Vice President

**GERALD L. THOMPSON**  
Vice President

**MARLENE LENIO**  
Vice President

**EMMA JEAN WOLLAM**  
Vice President

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Vice President

**JUDY RUSSELL**  
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**JAMES DUFF**  
Vice President

**KEITH MROZEK**  
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**DEBORAH L. EAZOR**  
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**KAREN CLOWER**  
Vice President

**ROBERT A. COGGESHALL**  
Vice President

**GREG YURCO**  
Vice President

**MARCEL P. ARNAL**  
Assistant Vice President

**GRACE J. BACOT**  
Assistant Vice President

**SHIRLEY F. ROOT**  
Assistant Vice President

**DARLENE MACK**  
Assistant Vice President  
and Trust Officer

**BARBARA R. SANDROCK**  
Assistant Vice President

**JANET K. HOUSER**  
Assistant Vice President

**RUSSELL E. TAYLOR**  
Assistant Vice President

**JOAN M. FRANGIAMORE**  
Assistant Vice President

**DAVID MAY**  
Assistant Vice President

**BARBARA MCKENZIE**  
Assistant Vice President

**STEVE J. MACK**  
Assistant Vice President

**JAMES HUGHES**  
Assistant Vice President

**WILLIAM J. HOLLAND**  
Assistant Vice President

**JENNIFER HANIGOSKY**  
Assistant Vice President

**PATRICK J. McELHANEY**  
Assistant Vice President

**LANA MUIR**  
Assistant Secretary-Treasurer

**HEATHER J. BOWSER**  
Assistant Secretary-Treasurer

**KAREN MILLER**  
Assistant Secretary

## CORTLAND BANKS OFFICES AND LOCATIONS

*Thirteen Offices Serving These Fine Communities*

### BOARDMAN

8580 South Avenue  
Youngstown, Ohio 44514  
330-758-5884

### HUBBARD

890 West Liberty Street  
Hubbard, Ohio 44425  
330-534-2265

### VIENNA

4434 Warren-Sharon Road  
Vienna, Ohio 44473  
330-394-1438

### BOARDMAN

Victor Hills Plaza  
6538 South Avenue  
Boardman, Ohio 44512  
330-629-9151

### MANTUA

11661 State Route 44  
Mantua, Ohio 44255  
330-274-3111

### WARREN

2935 Elm Road  
Warren, Ohio 44483  
330-372-1520

### BRISTOL

6090 State Route 45  
Bristolville, Ohio 44402  
330-889-3062

### NILES PARK PLAZA

815 Youngstown-Warren Road  
Suite 1  
Niles, Ohio 44446  
330-652-8700

### WILLIAMSFIELD

5917 U.S. Route 322  
Williamsfield, Ohio 44093  
440-293-7502

### BROOKFIELD

7325 Warren-Sharon Road  
Brookfield, Ohio 44403  
330-448-6814

### CORTLAND

194 West Main Street  
Cortland, Ohio 44410  
330-637-8040

### NORTH BLOOMFIELD

8837 State Route 45  
North Bloomfield, Ohio 44450  
440-685-4731

### WINDHAM

9690 East Center Street  
Windham, Ohio 44288  
330-326-2340

Member  
Federal Reserve System  
and  
Federal Deposit Insurance Corporation

Visit us at our home page on the world wide web at  
[www.cortland-banks.com](http://www.cortland-banks.com)  
or e-mail us at [cbinfo@cortland-banks.com](mailto:cbinfo@cortland-banks.com)