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CORTLAND BANCORP

Annual Report
2007

Filings Services

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THE MISSION STATEMENT OF CORTLAND BANKS

Cortland Banks' mission is to earn the enthusiastic, long-term Loyalty of customers by being responsive to their needs for products, convenience and personal service in a manner that routinely exceeds expectations. In building long-lasting relationships with our customers, we will generate solid financial returns for our shareholders, rewarding careers for our employees, and economic benefits for our communities. Success in this mission is vital to our continued independence as a community bank. Our success will require relentless focus on identifying and meeting the wants and needs of our constituents, as we demonstrate a genuine caring for customers, employees, shareholders and community.

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CHAIRMAN'S MESSAGE

To Our Shareholders:

In a period of economic uncertainty headlined by disruptions in the credit market and an overall weakening of the mortgage and housing market, I am pleased to report that Cortland Bancorp remains a sound and profitable community bank.

Our net income for 2007 totaled \$4,350,000 or \$0.97 per share which represents a return on average assets of 0.89%. Return on average equity measured 8.68%. This level of profitability is below the net income amount reported for the previous year, but in line with peer group measures of 0.87% for return on average assets and 8.51% for return on average equity.

The Company's capital position also remains strong. Capital ratios exceed all regulatory thresholds for capital adequacy, and consistently fall in the upper tiers among all financial institutions in our peer group.

OTHER HIGHLIGHTS FOR 2007 INCLUDE:

- Our Company's assets topped \$500 million during the year, before closing at \$492.7 million, an increase of more than 4% from the level reported at year end 2006.
- Loans grew more than twice as fast as overall assets, producing an increase of approximately 9% in the loan portfolio, with residential real estate, commercial real estate and consumer loans all reflecting increases in portfolio balances.
- The most significant loan growth came in the area of new commercial relationships, with commercial real estate originations increasing by approximately 14% from the previous year.
- Asset quality improved during the year, as non-performing loans as a percentage of total loans decreased from 1.91% at year end 2006 to 1.02% at year end 2007. The improvement in asset quality had a direct and positive impact on the Company's net income, as the loan loss provision required decreased from \$225,000 in 2006 to \$40,000 in 2007.

- The Company repurchased 205,986 shares of its common stock. This Stock Repurchase Program, approved by the Board of Directors in February of 2007, initially permitted the Company to repurchase up to 100,000 shares. In August, the directorate increased the authorization by an additional 100,000 shares, and followed that up with an identical increase in November. There are 94,014 shares remaining that may yet be purchased under the program.
- The Company's dividend payout remains aggressive as 89.7% of 2007 earnings were distributed to shareholders as cash dividends compared to 84.3% in the prior year. In addition, shareholders continued to receive an annual stock dividend as well.
- Construction was completed on a new 2,500 square foot full service office in the Village of Windham. Our newest branch facility opened in May of 2007.
- The Company's market footprint and physical plant will continue to grow, with the Board of Directors approving to open a fourteenth office in Middlefield. Our newest community banking office is expected to open in May of 2008.
- Additionally during 2007, property was purchased in Brookfield to replace an aging rental facility housing our existing branch office. Our Brookfield office will relocate to a newly constructed bank building in June of 2008.
- Property was also purchased for a new branch location in southern Mahoning County, and an existing branch office will relocate to this property located in North Lima by the early fall of 2008.
- Selection and installation of a customer relationship management (CRM) platform to accommodate growing demand while preserving responsive and personalized service was completed. The CRM platform will enable lenders and customer service personnel to better match customer needs with products and services and facilitate opportunities to extend or increase credit for business-related accounts.

- All of our branches were converted to electronic delivery during the year, eliminating the need to physically transport paper checks. Also during the year a pilot Remote Merchant Capture program was developed with plans for broad-scale introduction in 2008.
- Our Bank continues to give back generously to the communities we serve. Bank employees raised more than \$10,000 for Relay for Life. The Bank also finished on top in Second Harvest Food's first-ever bank challenge, providing more in donations than our much larger competitors. The Bank also continued to contribute generously to Children's Rehabilitation, various United Way campaigns, and numerous local non profit organizations.

The Board of Directors and I believe that the Company has made significant progress in meeting the strategic plan initiatives which I outlined for you last year. While we are proud of our many accomplishments, and remain optimistic regarding the success of our Strategic Plan, we do realize that these are difficult times for consumers and businesses alike. Deteriorating economic conditions stemming from financial turbulence in the credit and housing markets will prove to be a challenge in our efforts to further grow Company assets and improve profitability.

In addition to these deteriorating economic conditions, profitability across the banking industry has been adversely affected by Federal Reserve monetary policy efforts directed at containing inflation. Banks throughout the region and the nation have reported declining net interest margin ratios. Our own Company's net interest margin ratio narrowed from the 3.67% reported at year end 2006 to 3.45% at year end 2007.

To compensate for this margin compression, the Company remains highly focused on asset quality issues, establishing fundamentally sound internal controls, maintaining effective and timely loan

review practices, identifying and addressing problem loans on a timely basis, and subscribing to conservative lending practices and stringent underwriting standards.

Both lenders and borrowers have struggled with the consequences of the deteriorating market for residential real estate. Foreclosure activity, restructuring of mortgage business units and the building of loan loss reserves have become quite notable in reviewing recent public records and competitor press releases and earning reports.

I am pleased to report that, unlike many in the industry, our Company has noted no significant deterioration in its residential real estate portfolio. As a matter of fact, contrary to general financial industry trends, our Company has experienced improvements in its overall asset quality. This is reflected in the reduction of problem loans, as I have previously noted. We are cautiously optimistic that these trends will continue, allowing us to remain an extremely safe and sound financial institution, and contributing to our efforts to improve profitability.

In closing, I would like to thank our officers and employees for their many contributions to our success, and to tell them that we are proud of them. For our customers, we wish to thank you for your loyalty and commitment to Cortland Banks and its philosophy of community banking. Finally, the support and encouragement of our shareholders is sincerely appreciated, for it is what makes everything else possible. Thank you for your investment in Cortland Bancorp.

Sincerely,



Karl Ray Mahan
Chairman of the Board

BRIEF DESCRIPTION OF THE BUSINESS

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, 2007, 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 leasing. 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 chartered 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, 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. Individual Retirement Account deposits are insured by the FDIC to \$250,000 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, 2007 the Company through its subsidiary bank, employed 143 full-time and 34 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

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, 2007, 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, 2007, 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 the Company's internal control over financial reporting.

Lawrence A. Fantauzzi
President and
Chief Executive
Officer

James M. Gasior
Secretary
Chief Financial
Officer

Cortland, Ohio
February 29, 2008

SHAREHOLDERS AND BOARD OF DIRECTORS
Cortland Bancorp

We have audited the accompanying consolidated balance sheets of Cortland Bancorp and subsidiaries as of December 31, 2007 and 2006, 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, 2007. We also have audited Cortland Bancorp and subsidiaries internal control over financial reporting as of December 31, 2007, 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, and an opinion on the company's internal control over financial reporting based on our audits.

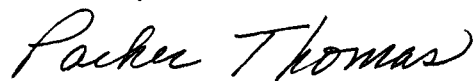
We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement and whether effective 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.

Youngstown, Ohio
February 29, 2008

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding 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, 2007 and 2006, and the consolidated results of their operations and their cash flows for each of the years in the three-year period ended December 31, 2007 in conformity with accounting principles generally accepted in the United States of America. In our opinion, Cortland Bancorp and subsidiaries maintained, in all material respects, effective internal control over financial reporting as of December 31, 2007, based on criteria established in *Internal Control-Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).



Packer Thomas

CORTLAND BANCORP AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF INCOME
Years ended December 31, 2007, 2006 and 2005

(Amounts in thousands except per share data)

	<u>2007</u>	<u>2006</u>	<u>2005</u>
Interest income			
Interest and fees on loans	\$15,784	\$14,291	\$12,941
Interest and dividends on investment securities:			
Taxable interest	6,788	5,943	4,387
Nontaxable interest	1,811	2,051	2,162
Dividends	235	202	167
Interest on mortgage-backed securities	4,008	3,795	3,810
Other interest income	366	215	119
Total interest income	<u>28,992</u>	<u>26,497</u>	<u>23,586</u>
Interest expense			
Deposits	10,456	8,509	6,159
Borrowed funds	3,375	3,073	2,506
Subordinated debt	154		
Total interest expense	<u>13,985</u>	<u>11,582</u>	<u>8,665</u>
Net interest income	15,007	14,915	14,921
Provision for loan losses (Note 4)	40	225	545
Net interest income after provision for loan losses	<u>14,967</u>	<u>14,690</u>	<u>14,376</u>
Other income			
Fees for other customer services	2,307	2,239	2,254
Investment securities gains - net	77	18	308
Gain on sale of loans - net	88	106	89
Other real estate losses - net	(1)	(47)	(3)
Earnings on bank owned life insurance	521	433	341
Other non-interest income	97	86	126
Total other income	<u>3,089</u>	<u>2,835</u>	<u>3,115</u>
Other expenses			
Salaries and employee benefits	7,199	6,776	7,052
Net occupancy and equipment expense	1,871	1,811	1,870
State and local taxes	580	552	548
Office supplies	396	367	338
Bank exam and audit expense	443	486	427
Other operating expenses	2,106	2,029	1,965
Total other expenses	<u>12,595</u>	<u>12,021</u>	<u>12,200</u>
Income before federal income taxes	5,461	5,504	5,291
Federal income taxes (Note 11)	1,111	928	957
Net income	<u>\$ 4,350</u>	<u>\$ 4,576</u>	<u>\$ 4,334</u>
Net income per share, both basic and diluted (Note 1)	<u>\$ 0.97</u>	<u>\$ 1.01</u>	<u>\$ 0.97</u>
Dividends declared per share	<u>\$ 0.87</u>	<u>\$ 0.85</u>	<u>\$ 1.04</u>

See accompanying notes to consolidated financial statements

CORTLAND BANCORP AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS
As of December 31, 2007 and 2006

(Amounts in thousands except per share data)

	<u>2007</u>	<u>2006</u>
ASSETS		
Cash and due from banks	\$ 9,441	\$ 10,100
Federal funds sold		4,275
Total cash and cash equivalents	<u>9,441</u>	<u>14,375</u>
Investment securities available for sale (Note 2)	126,507	108,484
Investment securities held to maturity (approximate market value of \$113,087 in 2007 and \$124,136 in 2006) (Note 2)	112,115	124,619
Total loans (Note 3)	223,109	205,208
Less allowance for loan losses (Note 4)	<u>(1,621)</u>	<u>(2,211)</u>
Net loans	<u>221,488</u>	<u>202,997</u>
Premises and equipment (Note 5)	6,206	4,780
Other assets	<u>16,937</u>	<u>16,496</u>
Total assets	<u>\$492,694</u>	<u>\$471,751</u>
LIABILITIES		
Noninterest-bearing deposits	\$ 58,224	\$ 60,983
Interest-bearing deposits (Note 6)	<u>306,564</u>	<u>294,835</u>
Total deposits	<u>364,788</u>	<u>355,818</u>
Federal Home Loan Bank advances and other borrowings (Note 7)	70,413	62,015
Subordinated debt (Note 8)	5,155	
Other liabilities	<u>3,514</u>	<u>3,326</u>
Total liabilities	<u>443,870</u>	<u>421,159</u>
Commitments and contingent liabilities (Notes 9 and 17)		
SHAREHOLDERS' EQUITY		
Common stock - \$5.00 stated value - authorized 20,000,000 shares; issued 4,639,973 shares in 2007 and 4,594,344 shares in 2006 (Note 1)	23,200	22,972
Additional paid-in capital (Note 1)	20,976	20,835
Retained earnings	9,386	9,553
Accumulated other comprehensive (loss) income (Note 1)	(94)	(455)
Treasury stock, at cost, 250,545 shares in 2007 and 95,809 shares in 2006	<u>(4,644)</u>	<u>(2,313)</u>
Total shareholders' equity (Note 16)	<u>48,824</u>	<u>50,592</u>
Total liabilities and shareholders' equity	<u>\$492,694</u>	<u>\$471,751</u>

See accompanying notes to consolidated financial statements

CORTLAND BANCORP AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY
Years ended December 31, 2007, 2006 and 2005

	(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
Balance at December 31, 2004	\$21,869	\$18,531	\$13,131	\$ 1,061	\$(5,194)	\$49,398
Comprehensive Income:						
Net income			4,334			4,334
Other comprehensive income, net of tax:						
Unrealized gains on available for sale securities, net of reclassification adjustment				(1,938)		(1,938)
Total comprehensive income						2,396
Common Stock Transactions:						
Treasury shares reissued net of shares repurchased		(184)			1,352	1,168
Cash dividends declared (\$0.83 per share)			(3,701)			(3,701)
Special cash dividend (\$0.21 per share)			(929)			(929)
3% stock dividend	654	1,864	(2,518)			(7)
Cash paid in lieu of fractional shares			(7)			(7)
Balance at December 31, 2005	22,523	20,211	10,310	(877)	(3,842)	48,325
Comprehensive Income:						
Net income			4,576			4,576
Other comprehensive income, net of tax:						
Unrealized gains on available for sale securities, net of reclassification adjustment				422		422
Total comprehensive income						4,998
Common Stock Transactions:						
Treasury shares reissued net of shares repurchased		(390)			1,529	1,139
Cash dividends declared (\$0.85 per share)			(3,865)			(3,865)
2% stock dividend	449	1,014	(1,463)			(5)
Cash paid in lieu of fractional shares			(5)			(5)
Balance at December 31, 2006	22,972	20,835	9,553	(455)	(2,313)	50,592
Comprehensive Income:						
Net income			4,350			4,350
Other comprehensive income, net of tax:						
Unrealized gains on available for sale securities, net of reclassification adjustment				361		361
Total comprehensive income						4,711
Common Stock Transactions:						
Treasury shares reissued		(249)			1,195	946
Treasury shares purchased					(3,526)	(3,526)
Cash dividends declared (\$0.87 per share)			(3,895)			(3,895)
1% stock dividend	228	390	(618)			(4)
Cash paid in lieu of fractional shares			(4)			(4)
Balance at December 31, 2007	<u>\$23,200</u>	<u>\$20,976</u>	<u>\$ 9,386</u>	<u>\$ (94)</u>	<u>\$(4,644)</u>	<u>\$48,824</u>

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

	2007	2006	2005
Unrealized holding gains (losses) on available for sale securities arising during the period net of tax of \$212, \$224 and \$(894)	\$412	\$434	\$(1,735)
Less: Reclassification adjustment for gains realized in net income, net of tax of \$26, \$6 and \$105	51	12	203
Net unrealized gains (losses) on available for sale securities, net of tax	<u>\$361</u>	<u>\$422</u>	<u>\$(1,938)</u>

See accompanying notes to consolidated financial statements

CORTLAND BANCORP AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS
Years ended December 31, 2007, 2006 and 2005

(Amounts in thousands)			
	<u>2007</u>	<u>2006</u>	<u>2005</u>
Cash flows from operating activities			
Net income	\$ 4,350	\$ 4,576	\$ 4,334
Adjustments to reconcile net income to net cash flows from operating activities:			
Depreciation, amortization and accretion	775	991	1,469
Provision for loan loss	40	225	545
Deferred tax expense (benefit)	189	(205)	50
Investment securities gains	(77)	(18)	(308)
Gains on sales of loans	(88)	(106)	(89)
Loss on the sale or disposal of fixed assets	4	3	
Other real estate losses	1	47	3
Loans originated for sale	(6,199)	(6,978)	(6,618)
Proceeds from sale of loans originated for sale	6,396	6,975	6,707
Changes in:			
Interest and fees receivable	(59)	(245)	(341)
Interest payable	174	185	(30)
Other assets and liabilities	(497)	(368)	(1,447)
Net cash flows from operating activities	<u>5,009</u>	<u>5,082</u>	<u>4,275</u>
Cash flows from investing activities			
Purchases of securities available for sale	(13,502)	(13,339)	(19,593)
Purchases of securities held to maturity	(36,283)	(12,017)	(47,280)
Proceeds from sales of securities available for sale		1,006	1,479
Proceeds from call, maturity and principal payments on securities	44,692	26,050	53,082
Net (increase) decrease in loans made to customers	(18,922)	(17,223)	2,462
Proceeds from disposition of other real estate	34	143	22
Purchases of premises and equipment	(2,006)	(1,180)	(316)
Net cash flows from investing activities	<u>(25,987)</u>	<u>(16,560)</u>	<u>(10,144)</u>
Cash flows from financing activities			
Net increase in deposit accounts	8,970	5,443	5,456
Net increase in borrowings	8,398	3,904	10,222
Proceeds from subordinated debt issuance	5,155		
Dividends paid	(3,899)	(3,870)	(4,637)
Purchases of treasury stock	(3,526)		(3)
Treasury shares reissued	946	1,139	1,171
Net cash flows from financing activities	<u>16,044</u>	<u>6,616</u>	<u>12,209</u>
Net change in cash and cash equivalents	<u>(4,934)</u>	<u>(4,862)</u>	<u>6,340</u>
Cash and cash equivalents			
Beginning of year	<u>14,375</u>	<u>19,237</u>	<u>12,897</u>
End of year	<u>\$ 9,441</u>	<u>\$ 14,375</u>	<u>\$ 19,237</u>

See accompanying notes to consolidated financial statements



NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

The accounting and reporting policies of Cortland Bancorp, and its bank subsidiary, Cortland Savings and Banking Co., reflect banking industry practices and conform to U.S. generally accepted accounting principles. A summary of the significant accounting policies followed by the Company in the preparation of the accompanying consolidated financial statements is set forth below.

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 \$13,810,000, \$11,397,000 and \$8,695,000 in 2007, 2006 and 2005, respectively. Cash paid for income taxes was \$950,000 in 2007, \$1,120,000 in 2006 and \$993,000 in 2005. Transfers of loans to other real estate were \$282,000 in 2007, \$144,000 in 2006 and \$107,000 in 2005.

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, 2007, 2006 or 2005. There was no trading activity in 2007, 2006 or 2005.

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

(Continued)

NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

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 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 collectability 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*. Loans held for sale was \$109,000 at December 31, 2006, and none at December 31, 2007.

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 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

(Continued)

NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

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 \$98,000 and \$134,000 at December 31, 2007 and 2006, respectively, and is included in other assets. The annual expense was \$37,000 at December 31, 2007, 2006 and 2005. The estimated aggregate amortization expense for the next two years is \$37,000 per year, and \$24,000 in the third 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.

Advertising: The Company expenses advertising costs as incurred.

(Continued)

CORTLAND BANCORP AND SUBSIDIARIES
 NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS
 Years ended December 31, 2007, 2006 and 2005

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
December 31, 2007				
Investment securities available for sale				
U.S. Government agencies and corporations	\$ 12,365	\$ 314	\$ 2	\$ 12,677
Obligations of states and political subdivisions	8,428	344		8,772
Mortgage-backed and related securities	66,508	607	268	66,847
Corporate securities	35,769	36	1,175	34,630
Total debt securities	123,070	1,301	1,445	122,926
Other securities	3,581			3,581
Total available for sale	<u>\$126,651</u>	<u>\$1,301</u>	<u>\$1,445</u>	<u>\$126,507</u>
Investment securities held to maturity				
U.S. Treasury securities	\$ 139	\$ 7	\$	\$ 146
U.S. Government agencies and corporations	71,179	361	24	71,516
Obligations of states and political subdivisions	23,990	886	7	24,869
Mortgage-backed and related securities	16,807	63	314	16,556
Total held to maturity	<u>\$112,115</u>	<u>\$1,317</u>	<u>\$ 345</u>	<u>\$113,087</u>
December 31, 2006				
Investment securities available for sale				
U.S. Government agencies and corporations	\$ 12,919	\$ 13	\$ 136	\$ 12,796
Obligations of states and political subdivisions	9,451	348	1	9,798
Mortgage-backed and related securities	55,062	192	1,057	54,197
Corporate securities	28,160	101	149	28,112
Total debt securities	105,592	654	1,343	104,903
Other securities	3,581			3,581
Total available for sale	<u>\$109,173</u>	<u>\$ 654</u>	<u>\$1,343</u>	<u>\$108,484</u>
Investment securities held to maturity				
U.S. Treasury securities	\$ 143	\$	\$	\$ 143
U.S. Government agencies and corporations	73,743		1,239	72,504
Obligations of states and political subdivisions	31,009	1,067	13	32,063
Mortgage-backed and related securities	19,724		298	19,426
Total held to maturity	<u>\$124,619</u>	<u>\$1,067</u>	<u>\$1,550</u>	<u>\$124,136</u>

At December 31, 2007 and 2006, other securities consisted of \$3,355,000 in Federal Home Loan Bank (FHLB) stock and \$226,000 in Federal Reserve Bank (FED) stock. Each investment is carried at cost, and the Company is required to hold such investments as a condition of membership in order to transact business with the FHLB and the FED.

(Continued)



NOTE 2 - INVESTMENT SECURITIES (Continued)

The amortized cost and estimated market value of debt securities at December 31, 2007, 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, 2007</u>	
	<u>Amortized Cost</u>	<u>Estimated Fair Value</u>
Investment securities available for sale		
Due in one year or less	\$ 3,447	\$ 3,459
Due after one year through five years	4,048	4,110
Due after five years through ten years	4,506	4,282
Due after ten years	<u>44,561</u>	<u>44,228</u>
Subtotal	56,562	56,079
Mortgage-backed securities	<u>66,508</u>	<u>66,847</u>
Total	<u>\$123,070</u>	<u>\$122,926</u>
Investment securities held to maturity		
Due in one year or less	\$ 17,780	\$ 17,784
Due after one year through five years	4,443	4,473
Due after five years through ten years	22,048	22,213
Due after ten years	<u>51,037</u>	<u>52,061</u>
Subtotal	95,308	96,531
Mortgage-backed securities	<u>16,807</u>	<u>16,556</u>
Total	<u>\$112,115</u>	<u>\$113,087</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>2007</u>	<u>2006</u>	<u>2005</u>
Proceeds	\$9,991	\$1,526	\$13,563
Gross realized gains	77	18	308
Gross realized losses			

Investment securities with a carrying value of approximately \$95,137,000 at December 31, 2007 and \$75,489,000 at December 31, 2006 were pledged to secure deposits and for other purposes.

(Continued)

CORTLAND BANCORP AND SUBSIDIARIES
 NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS
 Years ended December 31, 2007, 2006 and 2005

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, 2007:

(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	\$ 3,466	\$ 23	\$ 2,741	\$ 3	\$ 6,207	\$ 26
Obligations of states and political subdivisions			391	7	391	7
Mortgage-backed and related securities	105	1	29,695	581	29,800	582
Corporate securities	<u>24,930</u>	<u>761</u>	<u>5,949</u>	<u>414</u>	<u>30,879</u>	<u>1,175</u>
	<u>\$28,501</u>	<u>\$785</u>	<u>\$38,776</u>	<u>\$1,005</u>	<u>\$67,277</u>	<u>\$1,790</u>

The above table represents 123 investment securities where the current value is less than the related amortized cost.

The following is a summary of the fair value of securities with unrealized losses and an aging of those unrealized losses at December 31, 2006:

(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	\$11,716	\$125	\$ 69,233	\$1,250	\$ 80,949	\$1,375
Obligations of states and political subdivisions			1,043	14	1,043	14
Mortgage-backed and related securities	10,812	159	52,351	1,196	63,163	1,355
Corporate securities	<u>2,012</u>	<u>6</u>	<u>4,215</u>	<u>143</u>	<u>6,227</u>	<u>149</u>
	<u>\$24,540</u>	<u>\$290</u>	<u>\$126,842</u>	<u>\$2,603</u>	<u>\$151,382</u>	<u>\$2,893</u>

The above table represents 201 investment securities where the current value is less than the related amortized cost.

The unrealized losses on the Bank's investment in U.S. Government agencies and corporations, obligations of states and political subdivisions, and 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, 2007.

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) the decrease in profitability and

(Continued)



NOTE 2 - INVESTMENT SECURITIES (Continued)

profit forecasts by industry analysts resulting from intense competitive pressure in the automotive industry and (b) a 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 amortized cost of the investment. While the General Motors Corporation credit rating has decreased from A3 to Caa1 (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, 2007.

The remaining loss on investments in corporate securities relates to a \$31,410,000 investment at December 31, 2007, in Collateralized Debt Obligations, (CDO's), representing pools of trust preferred debt. The credit ratings on the securities range from Aa3 to Baa3 at Moody's, with none of the securities experiencing downgrades at December 31, 2007.

NOTE 3 - LOANS RECEIVABLE

The following is a summary of loans:

(Amounts in thousands)

	December 31,	
	<u>2007</u>	<u>2006</u>
1-4 family residential mortgage loans	\$ 68,135	\$ 62,882
1-4 family residential mortgage loans held for sale		109
Commercial mortgage loans	120,950	106,160
Consumer loans	8,484	7,745
Commercial loans	14,981	17,505
Home equity loans	10,559	10,807
Total loans	<u>\$223,109</u>	<u>\$205,208</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>2007</u>	<u>2006</u>	<u>2005</u>
Balance at beginning of year	\$2,211	\$2,168	\$2,629
Loan charge-offs	(728)	(288)	(1,119)
Recoveries	98	106	113
Net loan charge-offs	(630)	(182)	(1,006)
Provision charged to operations	40	225	545
Balance at end of year	<u>\$1,621</u>	<u>\$2,211</u>	<u>\$2,168</u>

Loans on which the accrual of interest has been discontinued because circumstances indicate that collection is questionable amounted to \$2,285,000, \$3,923,000 and \$3,746,000 at December 31, 2007, 2006 and 2005,

(Continued)

NOTE 4 - ALLOWANCE FOR LOAN LOSSES (Continued)

respectively. Interest income on these loans, if accrued, would have increased pretax income by approximately \$188,000, \$315,000 and \$266,000 for 2007, 2006 and 2005, 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, 2007, December 31, 2006 and December 31, 2005, the recorded investment in impaired loans was \$2,274,000, \$1,939,000 and \$1,857,000 while the allocated portion of the allowance for loan losses for such loans was \$716,000, \$815,000 and \$714,000, respectively. Interest income recognized on impaired loans using the cash basis was \$68,000 for 2007, \$44,000 for 2006 and \$51,000 for 2005.

There were \$546,000 in renegotiated loans at December 31, 2007 and none at December 31, 2006 and 2005. The total interest recognized on these loans was \$12,000 at December 31, 2007.

There were no renegotiated loans for which interest has been reduced at December 31, 2007, December 31, 2006 and December 31, 2005.

As of December 31, 2007, 2006 and 2005, there were \$14,691,000, \$13,765,000 and \$5,304,000 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>2007</u>	<u>2006</u>
Land	\$ 1,384	\$ 877
Premises	6,522	5,720
Equipment	7,789	7,488
Leasehold improvements	275	291
Construction in progress	<u>280</u>	<u>349</u>
	16,250	14,725
Less accumulated depreciation	<u>10,044</u>	<u>9,945</u>
Net book value	<u>\$ 6,206</u>	<u>\$ 4,780</u>

Depreciation expense was \$576,000 in 2007, \$485,000 in 2006 and \$597,000 for 2005.

(Continued)

NOTE 6 - DEPOSITS

The following is a summary of interest-bearing deposits:

(Amounts in thousands)

	December 31,	
	2007	2006
Demand	\$ 23,460	\$ 27,136
Money Market	19,698	19,117
Savings	74,024	79,585
Time:		
In denominations under \$100,000	120,864	114,052
In denominations of \$100,000 or more	68,518	54,945
Total	<u>\$306,564</u>	<u>\$294,835</u>

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

(Amounts in thousands)

	December 31,					
	2007			2006		
	Certificates of Deposit	Other Time Deposits	Total	Certificates of Deposit	Other Time Deposits	Total
Three months or less	\$17,572	\$ 435	\$18,007	\$17,997	\$	\$17,997
Three to six months	12,811	288	13,099	7,775	543	8,318
Six to twelve months	24,193	340	24,533	11,786	749	12,535
One through five years	4,668	5,316	9,984	8,219	2,087	10,306
Over five years	1,381	1,514	2,895	1,529	4,260	5,789
Total	<u>\$60,625</u>	<u>\$7,893</u>	<u>\$68,518</u>	<u>\$47,306</u>	<u>\$7,639</u>	<u>\$54,945</u>

(Continued)

NOTE 9 - COMMITMENTS (Continued)

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.

The following is a summary of such contractual commitments:

(Amounts in thousands)

	<u>December 31,</u>	
	<u>2007</u>	<u>2006</u>
Financial instruments whose contract amounts represent credit risk:		
Commitments to extend credit		
Fixed rate	\$ 2,125	\$ 3,102
Variable rate	36,576	44,422
Standby letters of credit	1,179	1,810

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

The Company's subsidiary bank also offers limited overdraft protection as a non-contractual courtesy which is available to businesses as well as individually/jointly owned accounts in good standing for personal or household use. The Company reserves the right to discontinue this service without prior notice. The available amount of overdraft protection on depositors' accounts at December 31, 2007, totaled \$11,698,000. The total average daily balance of overdrafts used in 2007 was \$153,000, or less than 2% of the total aggregate overdraft protection available to depositors.

(Continued)



NOTE 10 - 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 \$244,000 for 2007, \$229,000 for 2006 and \$224,000 for 2005. 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 \$15,500 with an additional \$5,000 catchup deferral for plan participants over the age of 50. 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 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, 2007, the cumulative expense accrued for these benefits totaled \$1,689,000, with \$1,386,000 accrued for the officers' plan and \$303,000 for the directors' plan.

The following table reconciles the accumulated liability for the benefit obligation of these agreements:

(Amounts in thousands)

	Years Ended December 31,	
	<u>2007</u>	<u>2006</u>
Beginning balance	\$1,484	\$1,283
Benefit expense	275	263
Benefit payments	(70)	(62)
Ending balance	<u>\$1,689</u>	<u>\$1,484</u>

Supplemental executive retirement agreements are unfunded plans and have no plan assets. The benefit obligation represents the vested net present value of future payments to individuals under the agreements. The benefit expense, as specified in the agreements for the entire year 2007, is expected to be under \$300,000. The benefits expected to be paid in the next year is \$70,000.

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, 2007, the cumulative income accrued on these contracts totaled \$2,542,000 on a tax equivalent basis, with \$1,750,000 accrued on the officers' contracts and \$792,000 on the directors' contracts.

In accordance with the Emerging Issues Task Force issue 06-04 "Accounting for Deferred Compensation and Postretirement Benefit Aspects of Endorsement Split-Dollar Life Insurance Arrangements" the Bank and the Bancorp will begin to accrue for the monthly benefit expense of postretirement cost of insurance for split-dollar life insurance coverage. The accrual for the year ended December 31, 2008 is expected to be under \$50,000. Also,

(Continued)

CORTLAND BANCORP AND SUBSIDIARIES
 NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS
 Years ended December 31, 2007, 2006 and 2005

NOTE 10 - BENEFIT PLANS (Continued)

as of January 1, 2008, the Bank and Bancorp will record the cumulative effect of a change in accounting principle for recognizing a liability for the death benefit promised under a split-dollar life insurance arrangement. The total liability will be \$539,000 with the offset to retained earnings.

NOTE 11 - FEDERAL INCOME TAXES

The composition of income tax expense is as follows:

(Amounts in thousands)

	Years Ended December 31,		
	<u>2007</u>	<u>2006</u>	<u>2005</u>
Current	\$ 922	\$1,133	\$907
Deferred	189	(205)	50
Total	<u>\$1,111</u>	<u>\$ 928</u>	<u>\$957</u>

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

(Amounts in thousands)

	December 31,		
	<u>2007</u>	<u>2006</u>	<u>2005</u>
Gross deferred tax assets:			
Provision for loan and other real estate losses . . .	\$ 227	\$ 428	\$ 413
AMT credit*		47	29
Other items	776	764	641
Loan origination cost - net	141	103	28
Unrealized loss (gain) on available for sale securities	49	235	452
Gross deferred tax liabilities:			
Depreciation	(330)	(350)	(387)
Other items	(572)	(561)	(498)
Net deferred tax asset (liability)	<u>\$ 291</u>	<u>\$ 666</u>	<u>\$ 678</u>

* Represents the Company's cumulative alternative minimum tax credit which was used in 2007.

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,		
	<u>2007</u>	<u>2006</u>	<u>2005</u>
Statutory tax	\$1,857	\$1,871	\$1,798
Tax effect of non-taxable income	(846)	(909)	(921)
Tax effect of non-deductible expense	100	111	80
Tax effect of change in estimate*		(145)	
Total income taxes	<u>\$1,111</u>	<u>\$ 928</u>	<u>\$ 957</u>

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

The related income tax expense on investment securities gains and losses amounted to \$26,000 for 2007, \$6,000 for 2006 and \$105,000 for 2005, and is included in the total federal income tax provision.

(Continued)

NOTE 12 - FAIR VALUE OF FINANCIAL INSTRUMENTS

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

(Amounts in thousands)

	<u>December 31, 2007</u>		<u>December 31, 2006</u>	
	<u>Carrying Amount</u>	<u>Estimated Fair Value</u>	<u>Carrying Amount</u>	<u>Estimated Fair Value</u>
ASSETS:				
Cash and cash equivalents	\$ 9,441	\$ 9,441	\$ 10,100	\$ 10,100
Federal Funds sold			4,275	4,275
Investment securities	238,766	239,594	233,792	232,620
Loans, net of allowance for loan losses	221,488	220,692	202,997	201,269
LIABILITIES:				
Demand and savings deposits	\$175,406	\$175,406	\$186,821	\$186,821
Time deposits	189,382	190,656	168,997	169,113
FHLB advances	64,000	64,952	55,000	54,917
Other borrowings	6,413	6,413	7,015	7,015
Subordinated Debt	5,155	5,155		

For purposes of the above disclosures of estimated fair value, the following assumptions were used as of December 31, 2007 and 2006. 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 valuation technique utilizing estimated market interest rates as of December 31, 2007 and 2006. The fair value of unrecorded commitments at December 31, 2007 and 2006, 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 13 - 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.

(Continued)

NOTE 13 - REGULATORY MATTERS (Continued)

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 capital classification.

(Amounts in thousands)

	December 31, 2007		December 31, 2006	
	<u>Amount</u>	<u>Ratio</u>	<u>Amount</u>	<u>Ratio</u>
Total Risk-Based Capital	\$55,455		\$53,151	
Ratio to Risk-Weighted Assets		19.18%		19.93%
Tier I Risk-Based Capital	\$53,820		\$50,913	
Ratio to Risk-Weighted Assets		18.62%		19.09%
Ratio to Average Assets		10.99%		11.04%

Tier I risk-based capital is shareholders' equity, noncumulative and cumulative perpetual preferred stock, qualifying trust preferred securities and minority interests 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 accordance with risk classification comprise risk-weighted assets of \$289,081,000 and \$266,686,000 as of December 31, 2007 and 2006, respectively. Assets less intangibles and the net unrealized market value adjustment of investment securities available for sale averaged \$489,443,000 and \$461,215,000 for the years ended December 31, 2007 and 2006, respectively.

NOTE 14 - RELATED PARTY TRANSACTIONS

Certain directors, executive officers and companies with which they are affiliated were loan customers during 2007. The following is an analysis of such loans:

(Amounts in thousands)

Total related-party loans at December 31, 2006	\$1,648
New related-party loans	858
Repayments or other	<u>121</u>
Total related-party loans at December 31, 2007 . . .	<u><u>\$2,385</u></u>

(Continued)

NOTE 15 - 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>2007</u>	<u>2006</u>
Assets:		
Cash	\$ 2,293	\$ 2,949
Investment securities available for sale	650	684
Investment in bank subsidiary	42,500	44,638
Investment in non-bank subsidiary	15	15
Subordinated note from subsidiary bank	6,000	
Other assets	2,837	2,507
	<u>\$54,295</u>	<u>\$50,793</u>
Liabilities:		
Other liabilities	\$ 316	\$ 201
Subordinated debt	5,155	
Shareholders' equity:		
Common stock (Note 1)	23,200	22,972
Additional paid-in capital (Note 1)	20,976	20,835
Retained earnings	9,386	9,553
Accumulated other comprehensive income	(94)	(455)
Treasury stock	(4,644)	(2,313)
Total shareholders' equity	48,824	50,592
	<u>\$54,295</u>	<u>\$50,793</u>

STATEMENTS OF INCOME

(Amounts in thousands)

	<u>Years ended December 31,</u>		
	<u>2007</u>	<u>2006</u>	<u>2005</u>
Dividends from bank subsidiary	\$ 7,000	\$2,800	\$3,500
Interest and dividend income	51	46	56
Other income	110	89	70
Interest on subordinated debt	(154)		
Other expenses	(257)	(283)	(270)
Income before income tax and equity in undistributed net income of subsidiaries	6,750	2,652	3,356
Income tax benefit (expense)	120	78	72
Equity in undistributed net income of subsidiaries	(2,520)	1,846	906
Net income	\$ 4,350	\$4,576	\$4,334

(Continued)

NOTE 15 - CONDENSED FINANCIAL INFORMATION (Continued)

STATEMENTS OF CASH FLOWS

(Amounts in thousands)

	<u>Years ended December 31,</u>		
	<u>2007</u>	<u>2006</u>	<u>2005</u>
Cash flows from operating activities			
Net income	\$ 4,350	\$ 4,576	\$ 4,334
Adjustments to reconcile net income to net cash flows from operating activities:			
Equity in undistributed net income of subsidiaries	2,520	(1,846)	(906)
Accretion on securities	2	2	3
Deferred tax benefit	(12)	(13)	(7)
Change in other assets and liabilities	(192)	(141)	(148)
Net cash flows from operating activities	<u>6,668</u>	<u>2,578</u>	<u>3,276</u>
Cash flows from investing activities			
Purchases of investment securities available for sale			(356)
Purchases of investment securities held to maturity			
Proceeds from sales of securities available for sale			
Proceeds from call, maturity and principal payments on securities			450
Purchase of subordinated note from subsidiary bank	(6,000)		
Net cash flows from investing activities	<u>(6,000)</u>		<u>94</u>
Cash flows from financing activities			
Proceeds from subordinated debt	5,155		
Dividends paid	(3,899)	(3,870)	(4,637)
Net treasury shares (repurchased) reissued	(2,580)	1,139	1,168
Net cash flows from financing activities	<u>(1,324)</u>	<u>(2,731)</u>	<u>(3,469)</u>
Net change in cash	(656)	(153)	(99)
Cash			
Beginning of year	<u>2,949</u>	<u>3,102</u>	<u>3,201</u>
End of year	<u>\$ 2,293</u>	<u>\$ 2,949</u>	<u>\$ 3,102</u>

NOTE 16 - 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, 2007, approximately \$232,000 is available for the payment of dividends by the Bank without seeking prior regulatory approval. In addition, regulations specify that dividend payments may not reduce capital levels below minimum regulatory guidelines.

NOTE 17 - LITIGATION

The Bank is involved in 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.

(Continued)



NOTE 18 - STOCK REPURCHASE PROGRAM

On February 27, 2007, the Company's Board of Directors approved a Stock Repurchase Program which permitted the Company to repurchase up to 100,000 shares of its outstanding common shares in the over-the-counter market or in privately negotiated transactions in accordance with applicable regulations of the Securities and Exchange Commission. Based on the value of the Company's stock on February 27, 2007, the commitment to repurchase the stock over the program was approximately \$1,715,000. Subsequently, on August 14, 2007, the Company's Board of Directors authorized the repurchase of up to an additional 100,000 shares of its outstanding common shares in over-the-counter market or in privately negotiated transactions. Based on the value of the Company's stock on August 14, 2007, the commitment to repurchase these additional shares over the program was approximately \$1,635,000. Once again, on November 27, 2007, the Company's Board of Directors increased to 300,000 shares the size of its current stock buyback program by authorizing the repurchase of up to an additional 100,000 of its outstanding common shares in the over-the-counter market or in privately negotiated transactions. Based on the value of the Company's stock on November 27, 2007, the commitment to repurchase these additional shares over the program was approximately \$1,375,000. The repurchase program will terminate on February 28, 2009 or upon the purchase of 300,000 shares, if earlier. Repurchased shares are designated as treasury shares, available for general corporate purposes, including possible use in connection with the Company's dividend reinvestment program, employee benefit plans, acquisitions or other distributions. Under the program the Company has repurchased 205,986 shares. The Company has also reissued 53,670 shares to existing shareholders through its dividend reinvestment program during 2007, net of repurchased fractional shares. The 1% common stock dividend paid January 1, 2008 increased treasury shares by an additional 2,420 shares. Based on the price of the Company's stock at December 31, 2007, the remaining commitment to repurchase the 94,014 remaining shares of stock was approximately \$1,170,000.

The following table shows information relating to the repurchase of shares of the Company's common stock during 2007:

	Total Number of Shares Purchased	Average Price Paid Per Share	Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs	Maximum Number of Shares That May Yet Be Purchased Under the Plans or Programs
October	22,000	\$ 15.40	22,000	25,857
November	25,843	15.12	25,843	100,014
December	<u>6,000</u>	<u>15.00</u>	<u>6,000</u>	<u>94,014</u>
Fourth Quarter	<u>53,843</u>	<u>\$ 15.22</u>	<u>53,843</u>	<u>94,014</u>
Third Quarter	<u>66,929</u>	<u>\$ 16.90</u>	<u>66,929</u>	<u>47,857</u>
Second Quarter	<u>85,214</u>	<u>\$ 18.47</u>	<u>85,214</u>	<u>14,786</u>
First Quarter	<u>NONE</u>	<u>NONE</u>	<u>NONE</u>	<u>NONE</u>
TOTAL	<u>205,986</u>	<u>\$ 17.11</u>	<u>205,986</u>	<u>94,014</u>

FIVE 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)

	2007			2006		
	Average Balance Outstanding	Interest Earned or Paid	Yield or Rate	Average Balance Outstanding	Interest Earned or Paid	Yield or Rate
Interest-earning assets:						
Federal funds sold and other money markets	\$ 6,950	\$ 366	5.3%	\$ 4,228	\$ 215	5.1%
Investment securities:						
U.S. Treasury and other U.S.						
Government agencies and corporations	87,867	4,772	5.4%	83,615	4,257	5.1%
U.S. Government mortgage-backed pass through certificates	80,689	4,008	5.0%	79,317	3,795	4.8%
States of the U.S. and political subdivisions (Note 1, 2, 3)	37,488	2,633	7.0%	42,409	2,995	7.1%
Other securities	32,860	2,251	6.9%	29,628	1,888	6.4%
TOTAL INVESTMENT SECURITIES	238,904	13,664	5.7%	234,969	12,935	5.5%
Loans (Note 2, 3, 4)	215,496	15,856	7.4%	195,838	14,381	7.4%
Trading account securities						
TOTAL INTEREST-EARNING ASSETS	461,350	\$29,886	6.5%	435,035	\$27,531	6.3%
Non interest-earning assets:						
Cash and due from banks	8,220			8,733		
Premises and equipment	5,374			4,226		
Other	14,103			12,365		
TOTAL ASSETS	\$489,047			\$460,359		
Interest-bearing liabilities:						
Deposits:						
Interest-bearing demand deposits	\$ 46,508	\$ 888	1.9%	\$ 47,415	\$ 752	1.6%
Savings	78,072	799	1.0%	82,845	850	1.0%
Time	184,586	8,769	4.8%	161,050	6,907	4.3%
TOTAL INTEREST-BEARING DEPOSITS	309,166	10,456	3.4%	291,310	8,509	2.9%
Borrowings:						
Federal funds purchased	605	29	4.8%	478	25	5.3%
Securities sold under agreement to repurchase	5,764	243	4.2%	3,991	158	4.0%
Subordinated debt	2,175	154	7.1%			
Other borrowings under one year	13,963	715	5.1%	7,924	365	4.6%
Other borrowings over one year	45,843	2,388	5.2%	46,858	2,525	5.4%
TOTAL BORROWINGS	68,350	3,529	5.2%	59,251	3,073	5.2%
TOTAL INTEREST-BEARING LIABILITIES	377,516	\$13,985	3.7%	350,561	\$11,582	3.3%
Non interest-bearing liabilities:						
Demand deposits	57,668			57,271		
Other liabilities	3,775			3,214		
Shareholders equity	50,088			49,313		
TOTAL LIABILITIES AND SHAREHOLDERS EQUITY	\$489,047			\$460,359		
Net interest income		\$15,901			\$15,949	
Net interest rate spread (Note 5)			2.8%			3.0%
Net interest margin (Note 6)			3.5%			3.7%

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 2007, 2006, 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 \$1,809 and \$155 for 2007, \$2,045 and \$192 for 2006, \$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)

2005			2004			2003		
Average Balance Outstanding	Interest Earned or Paid	Yield or Rate	Average Balance Outstanding	Interest Earned or Paid	Yield or Rate	Average Balance Outstanding	Interest Earned or Paid	Yield or Rate
\$ 3,619	\$ 119	3.3%	\$ 5,623	\$ 83	1.5%	\$ 10,338	\$ 118	1.1%
67,402	3,259	4.8%	62,418	2,920	4.7%	52,587	2,640	5.0%
84,928	3,810	4.5%	85,357	3,634	4.3%	89,652	4,009	4.5%
44,756	3,184	7.1%	53,832	3,764	7.0%	51,363	3,649	7.1%
24,758	1,294	5.2%	14,953	716	4.8%	10,997	559	5.1%
221,844	11,547	5.2%	216,560	11,034	5.1%	204,599	10,857	5.3%
192,873	13,040	6.8%	193,927	12,474	6.4%	191,392	13,141	6.9%
						1,190	68	5.7%
418,336	<u>\$24,706</u>	5.9%	416,110	<u>\$23,591</u>	5.7%	407,519	<u>\$24,184</u>	5.9%
9,417			9,276			10,140		
4,316			4,637			5,119		
12,418			14,252			13,461		
<u>\$444,487</u>			<u>\$444,275</u>			<u>\$436,239</u>		
\$ 49,355	\$ 389	0.8%	\$ 48,945	\$ 263	0.5%	\$ 50,714	\$ 249	0.5%
89,107	647	0.7%	90,584	501	0.6%	88,953	540	0.6%
144,793	5,123	3.5%	147,662	5,023	3.4%	139,568	5,030	3.6%
283,255	6,159	2.2%	287,191	5,787	2.0%	279,235	5,819	2.1%
428	15	3.5%	289	4	1.4%	57	1	1.8%
2,540	59	2.3%	2,698	26	1.0%	1,999	17	0.9%
599	21	3.5%	2,781	37	1.3%	3,671	160	4.4%
46,365	2,411	5.2%	40,325	2,156	5.3%	39,178	2,135	5.4%
49,932	2,506	5.0%	46,093	2,223	4.8%	44,905	2,313	5.2%
333,187	<u>\$ 8,665</u>	2.6%	333,284	<u>\$ 8,010</u>	2.4%	324,140	<u>\$ 8,132</u>	2.5%
58,320			56,778			55,898		
3,315			4,385			4,394		
49,665			49,828			51,807		
<u>\$444,487</u>			<u>\$444,275</u>			<u>\$436,239</u>		
	<u>\$16,041</u>			<u>\$15,581</u>			<u>\$16,052</u>	
		<u>3.3%</u>			<u>3.3%</u>			<u>3.4%</u>
		<u>3.8%</u>			<u>3.7%</u>			<u>3.9%</u>

Note 4 – Interest earned on loans includes net loan fees of \$219 in 2007, \$291 in 2006, \$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
SELECTED FINANCIAL DATA

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

SUMMARY OF OPERATIONS	Years Ended December 31,				
	2007	2006	2005	2004	2003
Total Interest Income	\$ 28,992	\$ 26,497	\$ 23,586	\$ 22,288	\$ 22,907
Total Interest Expense	13,985	11,582	8,665	8,010	8,132
NET INTEREST INCOME (NII)	15,007	14,915	14,921	14,278	14,775
Provision for Loan Losses	40	225	545	415	240
NII After Loss Provision	14,967	14,690	14,376	13,863	14,535
Security Gains (losses)	77	18	308	1,052	946
Gain on Sale of Loans	88	106	89	54	470
Total Other Income	2,924	2,711	2,718	2,725	2,433
INCOME BEFORE EXPENSE	18,056	17,525	17,491	17,694	18,384
Total Other Expenses	12,595	12,021	12,200	11,861	11,529
INCOME BEFORE TAX	5,461	5,504	5,291	5,833	6,855
Federal Income Tax	1,111	928	957	990	1,371
NET INCOME	\$ 4,350	\$ 4,576	\$ 4,334	\$ 4,843	\$ 5,484
BALANCE SHEET DATA					
Assets	\$492,694	\$471,751	\$459,701	\$446,393	\$438,392
Investments	238,622	233,103	234,652	225,841	222,775
Total Loans	223,109	205,208	188,202	191,777	189,262
Allowance for Loan losses	1,621	2,211	2,168	2,629	2,408
Deposits	364,788	355,818	350,375	344,919	337,556
Borrowings	70,413	62,015	58,111	47,889	47,886
Subordinated Debt	5,155				
Shareholders' Equity	48,824	50,592	48,325	49,398	49,881
AVERAGE BALANCES					
Assets	\$489,047	\$460,359	\$444,487	\$444,275	\$436,239
Investments	238,904	234,969	221,844	216,560	204,599
Net Loans	213,568	193,648	190,329	191,428	188,360
Deposits	366,834	348,581	341,575	343,969	335,133
Subordinated Debt	2,175				
Borrowings	66,175	59,251	49,932	46,093	44,905
Shareholders' Equity	50,088	49,313	49,665	49,828	51,807
PER COMMON SHARE DATA (1)					
Net Income, both Basic and Diluted	\$ 0.97	\$ 1.01	\$ 0.97	\$ 1.10	\$ 1.23
Cash Dividends Declared	0.87	0.85	1.04	1.01	0.98
Book Value	11.12	11.14	10.78	11.17	11.31
ASSET QUALITY RATIOS					
Loans 30 days or more beyond their contractual due date as a percent of total loans	1.32%	2.26%	2.95%	2.45%	1.77%
Underperforming Assets as a Percentage of:					
Total Assets	0.63	0.84	0.83	0.76	0.70
Equity plus Allowance for Loan Losses	6.17	7.50	7.58	6.52	5.84
Tier I Capital	6.38	7.78	7.81	7.05	6.44
FINANCIAL RATIOS					
Return on Average Equity	8.68%	9.28%	8.73%	9.72%	10.59%
Return on Average Assets	0.89	0.99	0.98	1.09	1.26
Effective Tax Rate	20.34	16.86	18.09	16.97	20.00
Average Equity to Average Assets	10.24	10.71	11.17	11.22	11.88
Equity to Asset Ratio	9.91	10.72	10.51	11.07	11.38
Tangible Equity to Tangible Asset Ratio	9.89	10.70	10.48	11.02	11.33
Cash Dividend Payout Ratio	89.69	84.31	107.00	91.45	79.85
Net Interest Margin Ratio	3.45	3.67	3.83	3.74	3.94

(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.

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 2007 was \$4,350. The performance represented a decrease of \$226 from the \$4,576 earned in 2006. Earnings per share measured \$0.97, down \$0.04 or 4.0% from \$1.01 in 2006.

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 \$4.244 million in 2007, compared to the \$4.382 million earned in 2006. Core earnings per share were \$0.94 in 2007 and \$0.97 in 2006, down \$0.03 or 3.0%.

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

Analysis of Net Interest Income — Years Ended December 31, 2006 and 2005

	NET INTEREST MARGIN FOR YEAR ENDED					
	December 31, 2006			December 31, 2005		
	Average Balance(1)	Interest	Average Rate	Average Balance(1)	Interest	Average Rate
INTEREST-EARNING ASSETS						
Federal funds sold and other money market funds	\$ 4,228	\$ 215	5.1%	\$ 3,619	\$ 119	3.3%
Investment securities(1)(2)	234,969	12,935	5.5%	221,844	11,547	5.2%
Loans(2)(3)	195,838	14,381	7.4%	192,873	13,040	6.8%
Total interest-earning assets	\$435,035	\$27,531	6.3%	\$418,336	\$24,706	5.9%
INTEREST-BEARING LIABILITIES						
Interest-bearing demand deposits	\$ 47,415	\$ 752	1.6%	\$ 49,355	\$ 389	0.8%
Savings	82,845	850	1.0%	89,107	647	0.7%
Time	161,050	6,907	4.3%	144,793	5,123	3.5%
Total interest-bearing deposits	291,310	8,509	2.9%	283,255	6,159	2.2%
Federal funds purchased	478	25	5.3%	428	15	3.5%
Other borrowings	58,773	3,048	5.2%	49,504	2,491	5.0%
Total interest-bearing liabilities	\$350,561	\$11,582	3.3%	\$333,187	\$ 8,665	2.6%
Net interest income		\$15,949			\$16,041	
Net interest rate spread(4)			3.0%			3.3%
Net interest margin(5)			3.7%			3.8%

(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 interest income was the product of a 4.0% year-over-year increase in average earning assets and a 43 basis point increase in interest rates earned, while the increase in interest expense was a product of a 5.2% increase in interest-bearing liabilities and a 70 basis point increase in rates paid. The net result was a 0.6% decrease in net interest income on a fully tax equivalent basis and a 16 basis point decrease in the net interest margin.

Interest and dividend income on securities registered an increase of \$1,465, or 13.9%, during the year ended December 31, 2006 when compared to 2005. On a fully tax equivalent basis, income on investment securities increased by \$1,388, or 12.0%. The average invested balances increased by \$13,125 from the levels of a year ago. The increase in the average balance of investment securities was accompanied by a 30 basis point increase in the tax equivalent yield of the portfolio.

Interest and fees on loans increased by \$1,341 on a fully tax equivalent basis, or 10.3%, for the twelve months of 2006 compared to 2005. A \$2,965 increase in the average balance of the loan portfolio, or 1.5%,

was accompanied by a 60 basis point increase in the portfolio's tax equivalent yield. Also contributing to the increase in loan income in 2006 was \$185 in back interest and loan fees collected on three loans which had been in foreclosure.

Other interest income increased by \$96 from the same period a year ago. The average balance of federal funds sold and other money market funds increased by \$609, or 16.8%. The yield increased by 180 basis points during 2006 compared to 2005.

Average interest-bearing demand deposits and money market accounts decreased by \$1,940, and savings decreased by \$6,262. The average rate paid on these products increased by 48 basis points in the aggregate. The average balance on time deposit products increased by \$16,257, as the average rate paid increased by 75 basis points, from 3.5% to 4.3%.

Compared to last year, average borrowings and federal funds purchased increased by \$9,319 while the average rate paid on borrowings increased by 17 basis points.



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)

	2007 Compared to 2006			2006 Compared to 2005		
	Volume	Rate	Total	Volume	Rate	Total
Increase (Decrease) in Interest Income:						
Federal funds sold and other money markets	\$ 143	\$ 8	\$ 151	\$ 23	\$ 73	\$ 96
Investment Securities						
U.S. Treasury and other U.S. Government agencies and corporations	223	292	515	818	180	998
U.S. Government mortgage-backed pass-through certificates	66	147	213	(260)	245	(15)
States of the U.S. and political subdivisions	(346)	(16)	(362)	(166)	(23)	(189)
Other securities	215	148	363	281	313	594
Loans	1,446	29	1,475	203	1,138	1,341
Total Interest Income Change	1,747	608	2,355	899	1,926	2,825
Increase (Decrease) in Interest Expense:						
Interest-bearing demand deposits	(14)	150	136	(16)	379	363
Savings deposits	(49)	(2)	(51)	(48)	251	203
Time deposits	1,072	790	1,862	617	1,167	1,784
Federal funds purchased	6	(2)	4	2	8	10
Securities sold under agreements to repurchase	74	11	85	44	55	99
Other borrowings under one year	305	45	350	335	9	344
Other borrowings over one year	(54)	(83)	(137)	26	88	114
Subordinated debt	154		154			
Total Interest Expense Change	1,494	909	2,403	960	1,957	2,917
Increase (Decrease) in Net Interest Income on a Taxable Equivalent Basis	\$ 253	\$(301)	\$ (48)	\$ (61)	\$ (31)	\$ (92)

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

Analysis of Other Income, Other Expense and Federal Income Tax

Total other income for 2007 increased \$254, or 9.0% compared to a decrease of \$280, or 9.0% in 2006. Fees for customer services increased by \$68, or 3.0%, compared to a decrease of \$15 or 0.7% in the prior year. The increase is primarily due to an increase in service charge income.

Loans originated for sale in the secondary market showed gains of \$88 in 2007, compared to \$106 and \$89 in 2006 and 2005, respectively. The early call of held to maturity securities, and transactions involving available for sale securities, combined to produce net gains of \$77 in 2007, \$18 in 2006 and \$308 in 2005.

Other real estate losses amounted to \$1 in 2007, \$47 in 2006 and \$3 in 2005. Earnings on bank owned life insurance showed an increase of \$88 in 2007 compared to an increase of \$92 in 2006. Other non-interest income increased by \$11 during 2007 following a \$40 decrease in 2006. This income category is subject to fluctuation due to nonrecurring items.

Other Income					
	<u>2007</u>	<u>2006</u>	<u>2005</u>	<u>2004</u>	<u>2003</u>
Fees for other customer services	\$2,307	\$2,239	\$2,254	\$2,327	\$1,636
Gain on sale of loans	88	106	89	54	470
Other real estate losses	(1)	(47)	(3)	(171)	
Gain on sale of trading Securities					265
Earnings on bank owned life insurance	521	433	341	444	409
Other operating income	97	86	126	125	123
	3,012	2,817	2,807	2,779	2,903
Investment securities net gains	77	18	308	1,052	946
Total other income	\$3,089	\$2,835	\$3,115	\$3,831	\$3,849

Total other expenses increased by \$574 or 4.8% in 2007. This compares to a decrease of \$179 or 1.5% in 2006. During 2007, expenditures for salaries and employee benefits increased by \$423 or 6.2%. This increase is a combination of regular staff salary and benefit increases. In 2006 these expenditures

decreased by \$276 or 3.9%. This is due mainly to a one time cash bonus of \$243 awarded to the retiring President and CEO in 2005. Occupancy and equipment expense increased by \$60, or 3.3%, during 2007 and decreased by \$59, or 3.2%, in 2006. The increase in 2007 is due in part to construction of a banking facility to replace an existing leased bank location. The decrease in 2006 is due mainly to a \$112 decrease in depreciation expense as some assets became fully depreciated, and a \$36 increase in equipment and building maintenance.

State and local taxes stayed fairly consistent from 2005 to 2007. Bank exam and audit expense decreased by \$43 or 8.8% in 2007 following an increase of \$59 or 13.8% in 2006 primarily due to expenses associated with the requirements of Section 404 of the Sarbanes-Oxley Act of 2002. All other categories of non-interest expense increased by \$106 in 2007 following an increase of \$93 in 2006. This expense category is subject to fluctuation due to non-recurring items. The increase in 2007 is due in part to expenses associated with the Company's Strategic Growth Plan. These expenses include costs for professional consulting, information system software licensing and maintenance and educational programs for the Company's employees. The increase in 2006 is due partly to an increase in collection and foreclosure expense of \$41, a one-time sundry charge-off of \$22, and a \$29 increase in office supplies expense.

Non-Interest Expense					
	<u>2007</u>	<u>2006</u>	<u>2005</u>	<u>2004</u>	<u>2003</u>
Salaries and benefits	\$ 7,199	\$ 6,776	\$ 7,052	\$ 6,722	\$ 6,586
Net occupancy and equipment expense	1,871	1,811	1,870	1,853	1,963
State and local taxes	580	552	548	544	524
Office supplies	396	367	338	346	347
Bank exam and audit	443	486	427	515	349
Other operating expense	2,106	2,029	1,965	1,881	1,760
Total other expenses	\$12,595	\$12,021	\$12,200	\$11,861	\$11,529

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

Salaries and employee benefits represented 57.2% of all non-interest expenses in 2007, 56.4% in 2006 and 57.8% in 2005. Salaries and employee benefits

decreased by \$276 in 2006 followed by an increase of \$423 in 2007. The following details components of these increases:

	Analysis of Changes in Salaries & Benefits									
	Amounts					Percent				
	2007	2006	2005	2004	2003	2007	2006	2005	2004	2003
Salaries	\$252	\$(176)	\$317	\$(28)	\$ 67	4.7%	(3.2)%	6.1%	(1.14)%	1.3%
Benefits	145	(77)	(29)	85	112	9.0	(4.6)	(1.7)	5.2	7.3
Profit Sharing					(336)					(100.0)
	397	(253)	288	57	(157)	5.7	(3.5)	4.2	0.8	(2.2)
Def'd Loan Origination	26	(23)	42	79	(55)	16.1	(16.7)	23.3	30.5	(27.0)
	\$423	\$(276)	\$330	\$136	\$(212)	6.2%	(3.9)%	4.9%	2.1%	(3.1)%

Wage and salary expense per employee averaged \$33,994 in 2007, \$33,063 in 2006, and \$33,942 in 2005. Excluding the one-time retirement bonus, the average per employee would have been \$32,444 in 2005. Full-time equivalent employment averaged 164 employees in 2007, 161 employees in 2006 and 162 employees in 2005. Average earning assets per employee measured \$2,813 in 2007, \$2,702 in 2006 and \$2,582 in 2005.

Income before income tax expense amounted to \$5,461 for the year ended 2007 compared to \$5,504 and \$5,291 for the similar periods of 2006 and 2005, respectively. The effective tax rate was

20.3% in 2007, 16.9% in 2006 and 18.1% in 2005, resulting in income tax of \$1,111, \$928 and \$957, respectively. The decrease in the effective tax rate in 2006 reflects a one time adjustment to tax expense of \$145 due to a change in tax accrual estimate. The effective tax rate before the \$145 adjustment was 19.5%. The increase in 2007 is an increase from prior years because of a reduction in tax free income. 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,				
	2007	2006	2005	2004	2003
Provision at statutory rate	\$1,857	\$1,871	\$1,798	\$ 1,983	\$ 2,331
Add (Deduct):					
Tax effect of non-taxable income	(846)	(909)	(921)	(1,084)	(1,052)
Tax effect of non-deductible expense	100	111	80	91	92
Tax effect of change in estimate*		(145)			
Federal income taxes	\$1,111	\$ 928	\$ 957	\$ 990	\$ 1,371

* One time adjustment to tax accrual estimate

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

Net income registered \$4,350 in 2007, \$4,576 in 2006 and \$4,334 in 2005 representing per share amounts of \$0.97 in 2007, \$1.01 in 2006 and \$0.97 in 2005. Dividends declared per share were \$0.87 in 2007, \$0.85 in 2006 and \$1.04 in 2005. The decrease in

2007 and 2006 is due to elimination of the special dividend. Per share amounts have been restated to give retroactive effect to the 1% common stock dividend of January 1, 2008.

**FOURTH QUARTER 2007 AS
COMPARED TO FOURTH QUARTER 2006**

	NET INTEREST MARGIN FOR QUARTER ENDED					
	December 31, 2007			December 31, 2006		
	Average Balance(1)	Interest	Average Rate	Average Balance(1)	Interest	Average Rate
(Unaudited)						
INTEREST-EARNING ASSETS						
Federal funds sold and other money market funds	\$ 951	\$ 13	5.2%	\$ 9,882	\$ 132	5.3%
Investment securities(1)(2)	242,596	3,541	5.8%	231,009	3,231	5.6%
Loans(2)(3)	222,208	4,125	7.4%	202,709	3,773	7.3%
Total interest-earning assets	\$465,755	\$7,679	6.6%	\$443,600	\$7,136	6.4%
INTEREST-BEARING LIABILITIES						
Interest-bearing demand deposits	\$ 47,497	\$ 235	2.0%	\$ 48,286	\$ 225	1.9%
Savings	75,332	197	1.0%	80,207	207	1.0%
Time	185,152	2,220	4.8%	169,222	1,942	4.6%
Total interest-bearing deposits	307,981	2,652	3.4%	297,715	2,374	3.2%
Federal funds purchased	2,374	29	4.8%			
Other borrowings	68,589	849	4.9%	59,795	792	5.2%
Subordinated debt	5,155	93	7.0%			
Total interest-bearing liabilities	\$384,099	\$3,623	3.7%	\$357,510	\$3,166	3.5%
Net interest income		\$4,056			\$3,970	
Net interest rate spread(4)			2.9%			2.9%
Net interest margin(5)			3.5%			3.5%

(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.

Tax equivalent net interest income for the Company during the fourth quarter of 2007 increased by \$86, a 2.2% increase from the fourth quarter of 2006. The yield on earning assets increased by 19 basis points while fourth quarter average earning assets increased by 5.0%, or \$22,155, when compared to a year ago. The result was an increase in tax equivalent interest

income of \$543. The rate paid on interest-bearing liabilities increased by 23 basis points, while fourth quarter average interest-bearing liabilities increased by \$26,589 when compared to a year ago, resulting in an increase in total interest expense of \$457. The net interest margin for the quarter registered 3.49%, down 6 basis points from the same quarter a year ago.

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

The following table shows financial results by quarter for the years ending December 31, 2007 and 2006:

FINANCIAL RESULTS BY QUARTER
(Unaudited)

	2007				2006			
	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	\$ 7,467	\$ 7,344	\$ 7,251	\$ 6,930	\$ 6,889	\$ 6,796	\$ 6,493	\$ 6,319
Interest Expense	3,623	3,651	3,495	3,216	3,166	2,980	2,783	2,653
Net Interest Income	3,844	3,693	3,756	3,714	3,723	3,816	3,710	3,666
Loan Loss Provision	(40)				(50)	(45)	(64)	(66)
Net Security Gains	40	5	20	12			18	
Net Gain on Loans	10	35	27	16	37	13	42	14
Other real estate losses			(1)		(12)	(7)	(28)	
Other Income	761	749	719	696	747	703	700	608
Other Expenses	(3,194)	(3,132)	(3,206)	(3,063)	(2,962)	(3,041)	(3,049)	(2,969)
Income Before Tax	1,421	1,350	1,315	1,375	1,483	1,439	1,329	1,253
Federal Income Tax	305	275	258	273	301	296	253	78
Net Income	\$ 1,116	\$ 1,075	\$ 1,057	\$ 1,102	\$ 1,182	\$ 1,143	\$ 1,076	\$ 1,175
Net Income Per Share	\$ 0.25	\$ 0.24	\$ 0.24	\$ 0.24	\$ 0.26	\$ 0.25	\$ 0.24	\$ 0.26
Net Core Income	\$ 1,083	\$ 1,048	\$ 1,027	\$ 1,086	\$ 1,166	\$ 1,139	\$ 1,057	\$ 1,020
Net Core Income Per Share	\$ 0.24	\$ 0.23	\$ 0.23	\$ 0.24	\$ 0.26	\$ 0.25	\$ 0.24	\$ 0.23
Net Interest Income (fully taxable equivalent basis)	\$ 4,056	\$ 3,911	\$ 3,984	\$ 3,950	\$ 3,970	\$ 4,067	\$ 3,973	\$ 3,939
Net Interest Rate Spread	2.9%	2.7%	2.7%	2.8%	2.9%	3.1%	3.0%	3.1%
Net Interest Margin	3.5%	3.4%	3.5%	3.5%	3.5%	3.7%	3.7%	3.7%

Loan charge-offs during the quarter were \$191 in 2007 compared to \$67 in 2006, while the recovery of previously charged-off loans amounted to \$28 during the fourth quarter of 2007 compared to \$19 in the same period of 2006. The Company's provision for loan losses during the quarter was \$40 compared to \$50 a year ago.

Other income increased by \$14 or 1.9% from a year ago. The net gain on loans sold during the quarter amounted to \$10, compared to \$37 a year ago. Loss on the sale of other real estate decreased from \$12 in 2006 to none in 2007. The early call of held to maturity securities, and transactions involving available for sale securities produced gains of \$40 in the fourth quarter of 2007 compared to none in the same quarter of 2006.

Total other non-interest expenses in the fourth quarter were \$3,194 in 2007 compared to \$2,962 in 2006, an increase of \$232 or 7.8%. Salaries and benefits constituted a \$72 increase, or 4.3%. Bank exam and audit fees increased by \$14 or 11.6% mainly due to the timing of expenses associated with the

implementation of the requirements of Section 404 of the Sarbanes-Oxley Act of 2002. Other expenses increased by \$146 or 12.7%. The increase is due in part to expenses associated with the Company's Strategic Growth Plan. These expenses include costs for professional consulting, information system software licensing and maintenance and educational programs for Company's employees.

Income before income tax during the fourth quarter amounted to \$1,421 in 2007 compared to \$1,483 in 2006. Income tax expense for the fourth quarter of 2007 was \$305 as compared to \$301 in 2006. Fourth quarter net income was \$1,116 in 2007 compared to \$1,182 in 2006, representing a decrease of \$66, or 5.6%.

Earnings per share for the fourth quarter, adjusted for the 1% stock dividend paid January 1, 2008, were \$0.25 in 2007 and \$0.26 in 2006.

Core earnings (earnings before gains on loans sold, investment securities sold or called and certain other non recurring items) decreased by 7.1% in the fourth quarter of 2007 compared to 2006. Core earnings for the fourth quarter of 2007 were \$1,083 compared to

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

LOAN PORTFOLIO

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

Types of Loans	2007		2006		2005		2004		2003	
	Balance	%	Balance	%	Balance	%	Balance	%	Balance	%
1-4 family residential mortgages	\$ 68,135	30.5	\$ 62,882	30.6	\$ 59,910	31.8	\$ 61,238	31.9	\$ 57,854	30.6
Commercial mortgages	120,950	54.3	106,160	51.7	90,983	48.3	94,019	49.0	92,822	49.0
Consumer loans	8,484	3.8	7,745	3.8	6,714	3.6	6,087	3.2	7,231	3.8
Commercial loans	14,981	6.7	17,505	8.5	19,767	10.5	19,188	10.0	21,711	11.5
Home equity loans	10,559	4.7	10,807	5.3	10,828	5.8	11,245	5.9	9,541	5.0
1-4 family residential loans held for sale			109	0.1					103	0.1
Total loans	\$223,109		\$205,208		\$188,202		\$191,777		\$189,262	

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, 2007:

Types of Loans	1 Year or Less	1 to 5 Years	Over 5 Years	Total
Commercial loans	\$ 4,737	\$4,560	\$5,684	\$14,981
Home equity	10,559			10,559
Total loans (excluding mortgage and consumer loans)	\$15,296	\$4,560	\$5,684	\$25,540

The following schedule sets forth loans as of December 31, 2007 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.

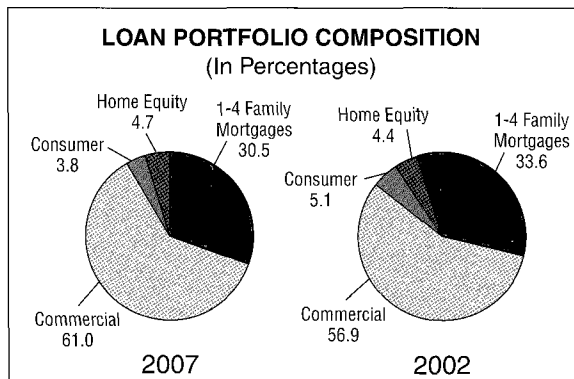
Types of Loans	1 Year or Less	Over 1 Year	Total
Floating or adjustable rates of interest	\$14,962	\$ 1,243	\$16,205
Fixed rates of interest	334	9,001	9,335
Total loans (excluding mortgage and consumer loans)	\$15,296	\$10,244	\$25,540

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

The Company recorded an increase of \$17,901 in the loan portfolio from the level of \$205,208 recorded at December 31, 2006.

Between 2006 and 2007, the balance of residential mortgage loans remained relatively unchanged. 1-4 family residential mortgages represent 30.5% of total loans in the loan portfolio compared to 30.7% in 2006. The portion of the loan portfolio represented by commercial loans (including commercial real estate) increased from 60.2% in 2006 to 61.0% in 2007. Consumer loans (including home equity loans) decreased from 9.1% in 2006 to 8.5% in 2007.

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 2007, residential loans and commercial loans comprised a combined 91.5% of the portfolio, compared to 90.5% five years ago. Home equity loans at 4.7% and consumer installment at 3.8% comprise the remainder of the portfolio in 2007.



During 2007, approximately \$16,300 in new mortgage loans were originated by the Company, an increase of approximately \$1,100 from 2006.

The following shows the disposition of mortgage loans originated during 2003 to 2007 (in millions):

	2007	2006	2005	2004	2003
Retained in Portfolio	\$10.1	\$8.3	\$7.6	\$8.0	\$11.6
Loans Sold to Investors with Servicing Rights Released	\$ 6.2	\$6.9	\$6.6	\$4.0	\$27.3

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.

During 2007, the Company sold fewer residential mortgage loans under the service release sales program but originated and retained approximately \$1.5 million more in portfolio loans in comparison to 2006 totals. Mortgage loan originations are typically qualified for sale to investors in the secondary market, but are occasionally retained in portfolio when requested by a customer or to enhance account relationship for certain customers. The mix of portfolio retained to those sold to investors will vary from year to year.

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 goods purchased 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 2008.

The balance of the commercial loan portfolio as of December 31, 2007 was \$135,931, an increase of \$12,266 from the balance of \$123,665 recorded at December 31, 2006. Short term, asset based commercial loans including lines of credit decreased by \$2,524. Commercial real estate loans increased by \$14,790 during the same period. The increase in these loans has primarily resulted from a marketing campaign and an aggressive calling program designed to increase market share for commercial and small business loans secured by real estate.

Management in recent years has offered longer term fixed rate commercial real estate products to qualifying customers in an effort to establish new business relationships and capture additional market share. Loan personnel will continue to aggressively pursue both commercial and small business opportunities supported by product incentives and

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marketing efforts. The Bank's lending 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.

Small business loans are originated by loan personnel assigned to the Community Bank offices. These loans are processed 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	2007		2006	
	Balances	% of Portfolio	Balances	% of Portfolio
Non Residential				
Building/ Apartment				
Building	\$25,879	19.36%	\$17,963	14.82%
Hotels/Motels	23,608	17.66%	12,374	10.21%
Real Property				
Lessors	7,175	5.37%	8,315	6.86%
Eating Places	6,925	5.18%	7,575	6.25%
Steel Related				
Industries	5,268	3.94%	5,200	4.29%

The single largest customer balance at year end had a balance of \$7,047 in 2007 compared to \$4,900 in 2006. This balance represented approximately 5.2% of the total commercial portfolio, compared to 4.0% in 2006.

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, 9, 12 and 14).

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

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

	December 31,				
	2007	2006	2005	2004	2003
U.S. Treasury and other U.S. Government agencies and corporations	\$ 83,995	\$ 86,682	\$ 80,053	\$ 69,670	\$ 62,524
U.S. Government mortgage-backed pass-through certificates	83,654	73,921	82,992	91,226	92,499
States of the U.S. and political subdivisions	32,762	40,807	44,714	45,689	53,503
Other securities	38,211	31,693	26,893	19,256	14,249
	<u>\$238,622</u>	<u>\$233,103</u>	<u>\$234,652</u>	<u>\$225,841</u>	<u>\$222,775</u>

A summary of securities held at December 31, 2007, 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 or Repricing Grouping	December 31, 2007	
	Book Value	Weighted Average Yield(1)
U.S. Treasury and other U.S. Government agencies and corporations:		
Maturing or repricing within one year	\$21,084	5.484%
Maturing or repricing after one year but within five years	8,108	4.581
Maturing or repricing after five years but within ten years	19,114	5.305
Maturing or repricing after ten years	35,689	6.104
Total U.S. Treasury and other U.S. Government agencies and corporations . . .	<u>\$83,995</u>	<u>5.620%</u>
U.S. Government mortgage-backed pass-through certificates, REMICS & CMO's:		
Maturing or repricing within one year	\$48,570	5.271%
Maturing or repricing after one year but within five years	33,670	4.963
Maturing or repricing after five years but within ten years	1,414	4.713
Maturing or repricing after ten years		
Total U.S. Government mortgage-backed pass-through certificates, REMICS & CMO's	<u>\$83,654</u>	<u>5.138%</u>
States of the U.S. and political subdivisions:		
Maturing or repricing within one year	\$ 155	8.376%
Maturing or repricing after one year but within five years	445	7.525
Maturing or repricing after five years but within ten years	5,185	6.998
Maturing or repricing after ten years	26,977	7.234
Total States of the U.S. and political subdivisions	<u>\$32,762</u>	<u>7.206%</u>
Other securities:		
Maturing or repricing within one year	\$28,192	6.953%
Maturing or repricing after one year but within five years	2,403	5.733
Maturing or repricing after five years but within ten years	2,031	7.182
Maturing or repricing after ten years	5,585	7.629
Total other securities	<u>\$38,211</u>	<u>6.987%</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 \$5, \$10, \$111 and \$585 for the four ranges of maturities.

As of December 31, 2007, there were \$42,156 in callable U.S. Government Agencies, and \$9,591 in callable obligations of states and political subdivisions that given current and expected interest rate

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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 3.73% ranging between 3.45% and 3.94%.

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, 2007

	<u>Maturity or Repricing Interval</u>				<u>Total</u>
	<u>3 Months or Less</u>	<u>3 to 12 Months</u>	<u>1 to 5 Years</u>	<u>Non Rate Sensitive or >5 Years</u>	
Interest-Earning Assets					
Interest-Bearing Balance from Depository					
Institution	\$ 76	\$	\$	\$	\$ 76
Investments	91,432	58,316	78,811	10,063	238,622
Loans & Leases	65,819	56,225	89,847	11,218	223,109
Investment in Nonconsolidated Subsidiary	155				155
Total Earning Assets	157,482	114,541	168,658	21,281	461,962
Other Assets				30,732	30,732
Total Assets	<u>\$ 157,482</u>	<u>\$114,541</u>	<u>\$168,658</u>	<u>\$ 52,013</u>	<u>\$492,694</u>
Interest-Bearing Liabilities					
Interest-bearing Checking	\$ 23,460	\$	\$	\$	\$ 23,460
Money Market Accounts	19,698				19,698
Passbook Savings	74,024				74,024
Time Deposits ≥100,000	18,522	37,527	9,574	2,895	68,518
Time Deposits <100,000	26,729	49,914	32,047	12,174	120,864
Repurchase Agreements	4,644				4,644
U.S. Treasury Demand	594				594
Federal Funds Purchased	1,175				1,175
Subordinated Debt	5,155				5,155
Other Borrowings	5,500	6,000	28,000	24,500	64,000
Total Interest-Bearing Liabilities	179,501	93,441	69,621	39,569	382,132
Demand Deposits				58,224	58,224
Other Liabilities				3,514	3,514
Shareholders' Equity				48,824	48,824
Total Liabilities & Equity	<u>\$ 179,501</u>	<u>\$ 93,441</u>	<u>\$ 69,621</u>	<u>\$ 150,131</u>	<u>\$492,694</u>
Rate Sensitivity Gap	\$ (22,019)	\$ 21,100	\$ 99,037	(\$18,288)	
Cumulative Gap	(\$22,019)	(\$919)	\$ 98,118	\$ 79,830	
Cumulative Gap to Total Assets	(4.5)%	(0.2)%	19.9%	16.2%	



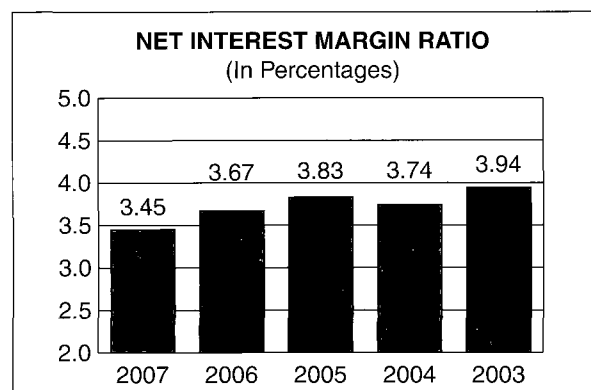
The preceding Gap Table presents an analysis of the Company's earliest repricing opportunity for each of its interest-earning assets and interest-bearing liabilities. Assets are distributed according to the earlier of interest rate repricing opportunity or expected cash flows. Time deposits and liabilities 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 2007, the effective maturities of earning assets tended to shorten as rates in the credit markets fell sharply. Federal Reserve policy makers decreased short-term interest rates three times during the year, from 5.25% to 4.25% in an attempt to ease strains in the financial market, soften the effects of the housing correction and to help avoid a recession. With rates falling during the year, the volume of investment securities eligible to be called increased, while prepayments on loans and mortgage-backed securities similarly increased, causing the effective maturities of existing earning assets to shorten. Management invested excess overnight funds (federal funds sold balances), with an increased allocation towards adjustable and floating rate corporate bonds, and U.S. Government agencies purchased at a discount that contain a lock-out period prior to the first call date and mortgage-backed securities.

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. As previously noted, the Company's net interest margin has remained in the range of 3.45% to 3.94% over the past five years, a period characterized by significant shifts in the mix of earning assets and the direction and level of interest rates. The targeted federal funds rate during that period ranged from 1.00% to 5.25%, as Federal Reserve monetary policy turned from guarding against deflation to warding off inflationary threats and now back to attempting to avoid a recession.



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

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interest-bearing deposits in other banks, federal funds sold, cash and due from banks, as well as cash flows from maturities and repayments of loans, investment securities and mortgage-backed securities.

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 \$149.748 at December 31, 2007, representing 62.8% of the total combined portfolio, as compared to \$77,463 or 33.2% 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 decreased from \$19,237 in 2005 to \$14,375 in 2006, then to \$9,441 in 2007. Operating activities provided cash of \$5,009 in 2007, \$5,082 in 2006 and \$4,275 in 2005. Key differences stem mainly from: 1) a decrease in net income of \$226 between 2007 and 2006 and a \$242 increase between 2005 and 2006; 2) there were no loans held for sale at December 31, 2007 and 2005 and \$109 at 2006; 3) gains on the sale of investments, was \$308 at December 31, 2005, \$18 at December 31, 2006 and \$77 in 2007; 4) amortization on securities was \$199 in 2007 compared to \$506 in 2006 and \$872 in 2005 ; 5) loss on the sale of other real estate totaled \$47 in 2006 and \$3 in 2005 compared to \$1 in 2007; 6) the purchase of an additional \$128 of insurance contracts on the lives of participants in the supplemental post retirement benefit plan in 2006 and none in 2007 or 2005; 7) a liability for securities purchased yet to settle totaled \$1,270 at December 31, 2004, with none at December 31, 2005, 2006 or 2007. Refer to the

Consolidated Statements of Cash Flows for a summary of the sources and uses of cash for 2007, 2006 and 2005. The following table details the cash flows from operating activities.

	December 31,				
	2007	2006	2005	2004	2003
Net income	\$4,350	\$4,576	\$4,334	\$4,843	\$5,484
Adjustments to reconcile net income to net cash flows from operating activities:					
Depreciation, amortization and accretion	775	991	1,469	2,176	2,382
Provision for loan loss	40	225	545	415	240
Investment securities gains	(77)	(18)	(308)	(1,052)	(946)
Other real estate losses	1	47	3	171	
Impact of loans held for sale	109	(109)		103	1,919
Changes in:					
Securities to settle and securities sold to settle			(1,270)	1,270	
Purchase of insurance contracts		(128)		(500)	(2,500)
Other assets and liabilities	(189)	(502)	(498)	(44)	469
Net cash flows from operating activities	\$5,009	\$5,082	\$4,275	\$7,382	\$7,048

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, 2007, 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.

	See Note	Contractual Obligations as of December 31, 2007				
		Payments Due in				
		One Year or Less	One to Three Years	Three to Five Years	Over Five Years	Total
Non-interest bearing deposits		\$ 58,224	\$	\$	\$	\$ 58,224
Interest bearing deposits(a)	6	117,182				117,182
Average Rate(b)		1.33%				1.33%
Certificates of deposit(a)	6	124,637	29,772	18,989	15,984	189,382
Average Rate(b)		4.69%	4.63%	5.01%	4.63%	4.71%
Federal funds purchased and security repurchase agreements(a)	7	5,819				5,819
Average Rate(b)		3.80%				3.80%
U.S. Treasury interest-bearing demand note(a)	7	594				594
Average Rate(b)		3.59%				3.59%
Federal Home Loan Bank advances(a)	7	6,000	24,000	9,500	24,500	64,000
Average Rate(b)		5.24%	5.50%	5.09%	4.13%	4.89%
Subordinated debt	8				5,155	5,155
Average Rate(b)					6.44%	6.44%
Operating leases	9	131	168	45		344

(a) Excludes present and future accrued interest.

(b) Variable rate obligations reflect interest rates in effect at December 31, 2007.

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 10 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, 2007 due to the funded status of the plan. (See further discussion in Note 10.)

Commitments: The following table details the amounts and expected maturities of significant commitments as of December 31, 2007. (Further discussion of these commitments is included in Note 9 to the consolidated financial statements.)

	Expected Maturities of Commitments as of December 31, 2007				
	One Year or Less	One to Three Years	Three to Five Years	Over Five Years	Total
Commitments to extend credit:					
Commercial	\$ 8,672	\$1,522	\$348	\$16,007	\$26,549
Residential real estate	224				224
Revolving home equity	11,468				11,468
Overdraft protection	11,698				11,698
Other	460				460
Standby letters of credit	1,179				1,179

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.

THE CORTLAND SAVINGS AND BANKING COMPANY

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Assistant Secretary-Treasurer

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Assistant Secretary-Treasurer

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Assistant Secretary

CORTLAND BANKS OFFICES AND LOCATIONS

Thirteen Offices Serving These Fine Communities

BOARDMAN

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

CORTLAND

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

VIENNA

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

BOARDMAN

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

HUBBARD

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

WARREN

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

BRISTOL

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

MANTUA

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

WILLIAMSFIELD

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

BROOKFIELD

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

NILES PARK PLAZA

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

WINDHAM

8950 Maple Grove Road
Windham, Ohio 44288
330-326-2340

NORTH BLOOMFIELD

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

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