Dear Shareholders:

The Mahoning Valley is known for many things, such as the birthplace of Good Humor and Handel's Homemade Ice Creams and the former Idora Amusement Park and Ballroom. It is also home to proud high school sports traditions and current recreational facilities such as Mosquito Lake State Park and Mill Creek MetroParks. The area however, is most frequently recognized as the home of coal-fired mills and blast furnaces from the Rust Belt's booming steel industry.

Once abundant, the natural resources of coal and iron that previously spurred the Valley's industrial growth have now been depleted and the heydays of steel production are long past. Since the steel industry's decline in the 1970's, it seems the area has continually been seeking to redefine itself. In doing so, the area has naturally experienced both successes and failures in bringing new business and employment opportunities to the Valley.

Past experiences

Notable missed opportunities and failures include a dirigible airship manufacturing plant, which was proposed for the area by a British company, but was never built. The announcement that the fiberglass Avanti body would be built in Youngstown was met with fanfare but the company's tenure in the Valley was short lived, and the highly anticipated DFAC –Defense, Finance and Accounting Center, estimated at bringing 4,000-7,000 jobs to the area never materialized. Additionally, the Phar-Mor discount drug chain, which had at one time grown to more than 300 stores nationally with 25,000 employees, was unable to successfully emerge from bankruptcy after significant internal improprieties were uncovered and an ensuing management shake-up unfolded.

Pointing to the Valley's successes, the presence of the General Motors' Lordstown Assembly Plant has been a boon for the area and has mitigated some of the economic impact to the Valley since the closure of the steel mills. GM's recent decision, to expand and retool the plant to manufacture the Chevrolet Cruze, was much welcomed news for the area. Downtown Youngstown, once lined with boarded up store fronts and vacant theaters, is currently experiencing a "rebirth." The city is now home to a downtown arena, several new restaurants and entertainment venues, along with a business incubator, which houses several start-up technology companies, one of which is listed as the seventh fastest growing U.S. private company. Organizations like the Trumbull-County based Raymond John Wean Foundation have made a commitment to enhance the community's well-being and vitality through its grant funding, along with its Youngstown Development Corporation partnership, which is developing initiatives aimed at transforming neighborhoods within the inner-city.

Future possibilities

Most recently, an exciting new development in the Valley has begun to emerge – one that could substantially alter the image of the Valley for years to come. The area once blessed with abundant coal and iron supplies, appears to have been presented with the rare opportunity to tap a second natural resource. A potentially vast natural gas resource – the Utica Shale - is situated thousands of feet below ground level and below the Marcellus Shale and could, by some estimates, produce an abundant supply of "wet" gases for twenty years or more.

With these specific regulatory matters behind us, we are now fully engaged in assessing opportunities to grow assets, diversify our product and service capabilities and to enhance bottom line profits.

In 2010, V&M Star, which is situated locally in the old Brier Hill Works building, broke ground on a $600 million pipe mill, and will produce tube goods for use in natural gas exploration in the Marcellus and Utica shale play areas. While many debate the 20,000 to 200,000 range in the number of jobs that will be created as a result of the shale exploration, the shale play phenomenon has begun to produce dividends for the area.

A recent news report indicated that locally-based businesses have or will create more than 1,000 jobs specifically tied to natural gas exploration. As jobs are created and as property owners negotiate leases for their mineral rights, area officials, business leaders and those residing in the local communities have begun to take notice and recognize the potential for economic development.

While it is unknown whether the shale play will "redefine" the area as something other than a once prosperous steel-region, we intend to stay abreast of developments in the natural gas exploration area and look forward to opportunities which may arise from shale play and natural gas exploration activities.

As the shale play story unfolds, our management team and I continue to direct our immediate attention to managing operations, improving overall financial performance and meeting the demands of an increasing complex regulatory environment. In regards to the regulatory environment, I am happy to report that in December 2011, our bank regulatory agencies informed management and the directorate that the Company has fulfilled the terms of the informal assurances given to the agencies back in 2009. This action signifies that our Company has emerged from the financial stresses experienced in the late 2000's, and has improved upon its position in the ranks of the safe and operationally sound banking companies.

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Financial results

The Company's financial results for 2011 were highlighted by several notable factors:

- **Net interest margin** for the year was 3.72% or 13 basis points higher than the 3.59% in 2010.

- The Company continues to excel in managing risks in the loan portfolio as **asset quality** measures are among the best for banks within our peer group.

- **Net loan charge-offs** were 0.24% of average loans in 2011 and 0.19% of average loans in 2010 and the **allowance for loan loss (ALLL) to total loan ratio** was 1.06% and 0.94% at the 2011 and 2010 year end, respectively.

- The Company's recognition of **pre-tax Other-Than-Temporary-Impairment losses on investment securities** fell dramatically in 2011 to $202,000 versus $2.7 million in 2010.

- Tangible **loan portfolio growth** was more than 9% in 2011 with the **commercial portfolio** achieving a 17% growth rate. Total loans at December 31, 2011 were $289.1 million as compared to $265.2 million a year ago.

- The Company continues to increase **capital levels** and the Company's regulatory **capital ratios** exceed the statutory well-capitalized thresholds. The Company's calculated capital ratios are as follows at December 31, 2011: a Tier 1 leverage ratio of 10.47% (compared to a "well-capitalized" threshold of 5.0%); a Tier 1 risk-based capital ratio of 13.37% (compared to a "well-capitalized" threshold of 6.00%); and a total risk-based capital ratio of 14.18% (compared to a "well-capitalized" threshold of 10.00%).

This is further supported by our results of operation for the year ended December 31, 2011. For the year, the Company recorded net income of $4.072 million, or $0.90 per share, surpassing the $3.271 million or $0.72 per share reported in 2010. The Company's financial results for 2011 were highlighted by several notable factors which include the financial results to the left of this paragraph.

Wholesale lending

In addition to the positive financial results for 2011, the Company's subsidiary bank, The Cortland Saving and Banking Company also announced plans to open a new wholesale mortgage division. The CSB Mortgage Company, Inc., officially began production March 1, 2012, and will assist the Bank in meeting strategic initiatives aimed at income diversification. CSB Mortgage will purchase high-quality mortgage loans originated by mortgage brokers, mortgage bankers and banks and credit unions in the Midwest for sale on the secondary market. With the CSB Mortgage now in operation, the Bank also intends to increase its own retail mortgage lending activity.

Investor relations

On another initiative of note, as you may know from reading the nine-month Statement of Condition, I have initiated an Investor Relations Program to promote stock ownership in Cortland Bancorp. Since undertaking this initiative the share price has continued to steadily improve and has recently traded in the price range of $7.90 - $8.25 through the date of this letter. I recently introduced a new relationship management tool to allow our directors, officers and employees to identify both investors interested in acquiring additional shares and investors looking to sell shares. This relationship management tool, CAMELS Community Link, designed and marketed by our advisory consultant, the CAMELS Consulting Group LLC, is designed to increase the liquidity of our stock, drive greater organic growth and to build stronger banking and investor relationships. I look forward to discussing this further at the shareholder meeting and during the "Invest In Your Local Bank" programs which are being scheduled regionally at our local branch offices this year.

Looking forward

As a final note, over the past few years, our management team has devoted considerable time and efforts to the areas of risk management, regulatory compliance, capital adequacy and earnings performance. Through this commitment of time and efforts, as I have noted, we have successfully fulfilled the terms of the informal assurances with the regulatory agencies. As difficult as the last few years have been, we recognize that we are a stronger company today than we were prior to agreeing to the informal assurance outlined in the regulatory memorandum. With these specific regulatory matters behind us, we are now fully engaged in assessing opportunities to grow assets, diversify our product and service capabilities and to enhance bottom line profits. We do this with a continued commitment to risk management, regulatory compliance and capital adequacy. It is our goal to be among the top performing companies in our geographic region and in our peer group. We appreciate your continued support as we pursue this goal.

As always, I want to acknowledge our loyal shareholders for their encouragement and commitment to Cortland Bancorp and I hope to see you at this year's shareholder meeting.

James M. Gasior
President and Chief Executive Officer

Cortland Bancorp
194 West Main Street
Cortland, Ohio 44410

NOTICE OF ANNUAL MEETING OF SHAREHOLDERS
PROXY STATEMENT

Annual Meeting:	May 22, 2012 10:00 a.m., EDT	Squaw Creek Country Club 761 Youngstown-Kingsville Road Vienna, Ohio 44473

Record Date and Voting: 5:00 p.m., EDT, April 4, 2012. If you were a shareholder of Cortland Bancorp (Cortland) at that time, you may vote at the 2012 Annual Meeting of Shareholders (the Annual Meeting). Each common share entitles the holder to one vote on each matter to be voted on by shareholders at the Annual Meeting. On the record date, Cortland had 4,525,528 common shares outstanding.

Agenda:

1. To elect four directors to serve on Cortland's Board of Directors (the Board) for terms of three years each until the 2015 Annual Meeting of Shareholders and thereafter until their successors are elected and qualified.

2. To ratify the appointment of S.R. Snodgrass, A.C. as Cortland's independent auditor for the fiscal year ending December 31, 2012.

3. To transact any other business that may properly come before the Annual Meeting.

Proxies: Unless you specify on the proxy card to vote differently, the management proxies will vote all signed and returned proxies "FOR" election of the Board's nominees for director and "FOR" ratification of Cortland's independent auditor. The management proxies will use their discretion on any other matters that may arise. If a named nominee cannot or will not serve as a director, the management proxies will vote for a substitute person nominated by the Board to serve as a director.

Proxies Solicited By: Proxies are being solicited by the Board. The cost of the solicitation is being borne by Cortland. Proxies will be solicited by mail and may be further solicited, for no additional compensation, by officers, directors, or employees of Cortland and its subsidiaries by mail, telephone, or personal contact. Cortland will also pay the standard charges and expenses of brokerage houses, voting trustees, banks, associations, and other custodians, nominees, and fiduciaries who are record holders of common shares not beneficially owned by them, for forwarding proxy materials to, and obtaining proxies from, the beneficial owners of such common shares.

Mailing Date: We anticipate mailing this proxy statement on or about April 6, 2012.

Revoking Your Proxy: You may revoke your proxy before it is voted at the Annual Meeting. You may revoke your proxy by:

- sending written notice revoking your proxy to Timothy Carney, Cortland's Secretary, at 194 West Main Street, Cortland, Ohio 44410, which must be received prior to the Annual Meeting;

- sending in another signed proxy card with a later date, which must be received by Cortland prior to the Annual Meeting; or

- attending the Annual Meeting and revoking your proxy in person if your common shares are held in your name. If your common shares are held in the name of your broker, financial institution, or other holder of record, you must bring an account statement or letter from the broker, financial institution, or other holder of record indicating that you were the beneficial owner of the common shares on the record date.

Attendance at the Annual Meeting will not, in and of itself, constitute revocation of a proxy.

IMPORTANT NOTICE REGARDING THE AVAILABILITY OF PROXY MATERIALS FOR THE SHAREHOLDER MEETING TO BE HELD ON MAY 22, 2012: THE PROXY STATEMENT, INCLUDING NOTICE OF THE ANNUAL MEETING OF SHAREHOLDERS, AND FORM 10-K ARE AVAILABLE AT www.cortland-banks.com/invest.

PROXY STATEMENT
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PROXY STATEMENT

Cortland Bancorp, an Ohio corporation (Cortland), is registered as a bank holding company with the Board of Governors of the Federal Reserve System and owns all of the issued and outstanding common shares of The Cortland Savings and Banking Company (the Bank). Cortland's principal executive offices are located at 194 West Main Street, Cortland, Ohio 44410. Cortland's common shares are traded on the Over the Counter Bulletin Board under the symbol CLDB. As used in this proxy statement, the terms "we," "us," and "our" refer to Cortland and/or its subsidiaries, depending on the context.

This proxy statement is furnished in connection with the solicitation by Cortland's Board of Directors (the Board) of proxies to be voted at the 2012 Annual Meeting of Shareholders, including any adjustment or postponement of such meeting (the Annual Meeting). The Annual Meeting will be held on Tuesday, May 22, 2012, at 10:00 a.m., EDT, at Squaw Creek Country Club, 761 Youngstown-Kingsville Road, Vienna, Ohio 44473. The accompanying Notice of Meeting and this proxy statement are first being mailed to shareholders on or about April 6, 2012.

SHARE OWNERSHIP BY DIRECTORS AND EXECUTIVE OFFICERS

The following table furnishes information regarding the beneficial ownership of common shares, as of March 22, 2012, for each of the current directors, each of the nominees for re-election as a director, each of the individuals named in the Summary Compensation Table, and all current directors and executive officers as a group. To the knowledge of Cortland, no person beneficially owns more than 5% of the outstanding common shares of Cortland. The mailing address of each of the current executive officers and directors of Cortland is 194 West Main Street, Cortland, Ohio 44410.

Name of Beneficial Owner	Sole Voting or Sole Investment Power	Shared Voting or Shared Investment Power	Total Shares	Percent of Common Shares Outstanding [1]
Jerry A. Carleton	-	9,093[4]	9,093	(2)
Timothy Carney [3]	13,558[5]	5[6]	13,563	(2)
David C. Cole	1,880	2,160[7]	4,040	(2)
Stanley P. Feret [3]	1,000	-	1,000	(2)
James M. Gasior [3]	9,996[8]	-	9,996	(2)
George E. Gessner	29,221	-	29,221	(2)
James E. Hoffman, III	5,159	-	5,159	(2)
Neil J. Kaback	191	-	191	(2)
Joseph E. Koch	8,457	-	8,457	(2)
Richard B. Thompson	134,345	-	134,345	2.97%
Timothy K. Woofter	2,723	77,554[9]	80,277	1.77%
All directors and executive officers as a group (17 persons)			313,456	6.93%

(1) The "Percent of Class" computation is based upon the sum of 4,525,528 common shares of Cortland outstanding as of March 22, 2012.
(2) Represents beneficial ownership of less than 1% of the outstanding common shares of Cortland.
(3) Individual named in the Summary Compensation Table under Executive Compensation.
(4) These common shares are held in a trust of which Mr. Carleton is a co-trustee.
(5) Includes 13,547 common shares held in Mr. Carney's 401(k) plan account.
(6) These common shares are owned by Mr. Carney's spouse.

(7) Includes (a) 570 common shares owned by Mr. Cole's spouse and (b) 1,590 common shares owned by Mr. Cole's children.
(8) Includes 9,724 common shares held in Mr. Gasior's 401(k) plan account.
(9) Includes (a) 4,001 common shares owned by Mr. Woofter's spouse, (b) 56,657 common shares held in a trust of which Mr. Woofter is the trustee and (c) 16,896 common shares held in a private foundation established by Mr. Woofter.

RECORD DATE AND OUTSTANDING SHARES; QUORUM

If you were a shareholder of Cortland at the close of business on April 4, 2012, you are entitled to vote at the Annual Meeting. As of April 4, 2012, there were 4,525,528 common shares of Cortland issued and outstanding. When present in person or by proxy at the Annual Meeting, the holders of a majority of the common shares of Cortland issued and outstanding and entitled to vote will constitute a quorum for the conduct of business at the Annual Meeting.

VOTE REQUIRED

Shareholders are entitled to one vote for each share held. Shareholders are not entitled to cumulate their votes in the election or removal of directors or otherwise. The director nominees receiving the greatest numbers of votes will be elected. The affirmative vote of a majority of the issued and outstanding common shares is needed to ratify the appointment of S.R. Snodgrass, A.C. as Cortland's independent auditor for 2012.

ABSTENTIONS AND BROKER NON-VOTES

Abstention may be specified on all proposals except the election of directors. Broker non-votes generally occur when shares held by a broker nominee for a beneficial owner are not voted with respect to a proposal because the nominee has not received voting instructions from the beneficial owner and lacks discretionary authority to vote the shares. Brokers normally have discretion to vote on "routine matters," such as the ratification of independent registered public accounting firms, but not on non-routine matters, such as amendments to charter documents, executive compensation proposals, and the election of directors. Although they are counted for purposes of establishing that a quorum is present, abstentions and broker non-votes are not counted as votes cast. Accordingly, abstentions and broker non-votes have no effect on the election of directors and are not expected on the ratification of the appointment of Cortland's independent auditor.

SECTION 16(a) BENEFICIAL OWNERSHIP REPORTING COMPLIANCE

Section 16(a) of the Securities Exchange Act of 1934, as amended (the Exchange Act), requires Cortland's executive officers and directors to file reports with the Securities and Exchange Commission (SEC) disclosing their initial beneficial ownership of common shares and any subsequent changes in their beneficial ownership. Specific due dates have been established by the SEC, and Cortland is required to disclose in this proxy statement any late reports. To Cortland's knowledge, based solely on a review of reports furnished to Cortland and written representations that no other reports were required, Cortland's executive officers and directors complied with all Section 16(a) filing requirements during the 2011 fiscal year.

ELECTION OF DIRECTORS
(Proposal One)

As of the date of this proxy statement, the Board currently has 10 members. Directors are divided into three classes, and directors of each class serve for three-year terms. Four directors serve in the class whose terms will expire at the Annual Meeting, three directors serve in the class whose terms expire in 2013 and three directors serve in the class whose term expires in 2014. Proxies may not be voted for more than the four nominees.

BOARD NOMINEES

Directors are individuals with knowledge and experience who serve and represent Cortland's geographic footprint throughout the counties and communities served. Current Board representation by outside directors demonstrates a background in automotive, law, manufacturing, and the accounting industries, with the expertise of these individuals covering a broad array of skills including corporate management, human resource management, strategic planning, business acquisitions, and small business operations.

The Board proposes that the four nominees identified on the following page be elected for a new term of three years. Each nominee was recommended by the Board's Nominating Committee. Each individual elected as a director at the Annual Meeting will hold office until his term expires and thereafter until his successor is duly elected and qualified, or until his earlier resignation, removal from office, or death. While it is contemplated that all nominees will stand for re-election, if a nominee who would otherwise receive the required number of votes becomes unavailable or unable to serve as a candidate for re-

election as a director, the individuals designated as proxies on the proxy card will have full discretion to vote the common shares represented by the proxies they hold for the election of the remaining nominees and for the election of any substitute nominee or nominees designated by the Board following recommendation by the Nominating Committee. The Board knows of no reason why any of the nominees named below will be unavailable or unable to serve if elected to the Board.

The biographies of each of the nominees and continuing directors below contains information regarding the person's service as a director, business experience, director positions held currently or at any time during the last five years, information regarding involvement in certain legal or administrative proceedings, if applicable, and the experiences, qualifications, attributes, or skills that caused the Nominating Committee and the Board to determine that the person should serve as a Cortland director. Director James E. Hoffman, III is a first cousin to Craig M. Phythyon, an officer of the Bank.

Nominee	Age	Biography	Director of Cortland Since	Nominee for Term Expiring In
George E. Gessner	67	Attorney. Partner, Director, and Corporate Secretary in the law firm of Gessner & Platt Co., L.P.A. Mr. Gessner has been a general practitioner of law for over 40 years and is a partner in a local law firm. He received his undergraduate (B.A.) degree at Hiram College and his Juris Doctorate (J.D.) degree from the University of Akron Law School. He became a member of the Ohio Bar in 1969. The Nominating Committee and the Board believes that Mr. Gessner's experiences, qualifications, attributes and skills allow him to provide legal expertise to the Board.	1987	2015
James E. Hoffman, III	60	Attorney. President of Hoffman & Walker Co., L.P.A. Mr. Hoffman has been a general practitioner of law for over 33 years and is a partner in a local law firm. He received his undergraduate (B.A.) degree at The Ohio State University in 1973 and his Juris Doctorate (J.D.) degree from the University of Akron Law School in 1976. The Nominating Committee and the Board believes that Mr. Hoffman's experiences, qualifications, attributes and skills allow him to provide legal expertise to the Board.	1984	2015
Joseph E. Koch	55	President, Joe Koch Construction, Inc., a homebuilding, developing and remodeling company since 1988. President, Joe Koch Realty, Inc., a real estate brokerage firm. Owner of Better Living of the Mahoning Valley, a dealer for sunrooms and installations. Member of Eagle Ridge Properties, LLC since 2002. President of Koch Family Charitable Foundation, a 501(c)3 organization. The Nominating Committee and the Board believes that Mr. Koch's experiences, qualifications, attributes and skills allow him to provide local business expertise to the Board.	2010	2015

Nominee	Age	Biography	Director of Cortland Since	Nominee for Term Expiring In
Timothy K. Woofter	61	President, CEO, and Director of Stanwade Metal Products, a manufacturer of tanks and distributor of oil equipment, and Lucky Oil Equipment, a distributor of oil equipment. Partner in the Woofter Family Limited Partnership. Owner, Jester Investments, a residential and commercial property rental company. Part owner and Vice President of Northern Ventures, a real estate rental company. Manager of Hartford Land LLC, a Real Estate Holding Company. Director of the Trade Association, Steel Tank Institute. Mr. Woofter has managed and owned a business that manufactures steel storage tanks and distributes oil-handling equipment for 40 years. He currently is the president of the Steel Tank Institute, a national trade association. He has owned and managed real estate, both residential and commercial, for over 30 years and is familiar with properties of these types and their values. The Nominating Committee and the Board believes that the experiences, qualifications, attributes and skills that Mr. Woofter has developed through his business and leadership experiences allow him to provide business and leadership insight to the Board.	1985	2015

Recommendation and Vote

Under Ohio law and Cortland's Code of Regulations, the nominees receiving the greatest number of votes **"FOR"** election will be elected to the Board. Shareholders are not entitled to cumulate votes in the election of directors. Common shares represented by properly executed and returned proxy cards will be voted **"FOR"** the election of the Board's nominees named above unless authority to vote for one or more nominees is withheld. Common shares as to which the authority to vote is withheld and broker non-votes will be counted for quorum purposes, but will not be counted toward the election of directors or toward the election of the individual nominees specified on the proxy card.

The Board recommends a vote FOR the election of the nominees.

CONTINUING DIRECTORS

Nominee	Age	Biography	Director of Cortland Since	Term Expires In
Jerry A. Carleton	69	Owner of Jerry Carleton Enterprises, Inc., a general contracting and development company, since 1972. Limited Partner in Eagle Ridge Properties LLC in Brown's Farm, a development company. Professor Emeritus at Kent State University Trumbull Campus. In addition to his experience with the building and construction trades, Mr. Carleton is involved in growth, development, and planning. The Nominating Committee and the Board believes that Mr. Carleton's experiences, qualifications, attributes and skills allow him to provide continued expertise in reviewing customer business plans and facilities development, as well as the Bank's business plans.	2004	2013
James M. Gasior	52	President and Chief Executive Officer of the Bank and Cortland since November 2, 2009, Senior Vice President, Chief Financial Officer, and Secretary of Cortland and Cortland Bank since 2005. Certified Public Accountant and member of the American Institute of CPAs and the Ohio Society of CPAs. His professional affiliation includes a background in all financial activities and financial reporting, audit preparation, budgeting, compensation reviews, and	2005	2013

Nominee	Age	Biography	Director of Cortland Since	Term Expires In
		knowledge of government regulatory requirements. The Nominating Committee and the Board believes that the experiences, qualifications, attributes and skills that Mr. Gasior has developed allow him to provide valuable accounting, strategic planning and corporate governance expertise to the Board.		
Richard B. Thompson	63	Owner and executive of Therm-O-Link, Inc., Vulkor, Inc., and Therm-O-Link of Texas, Inc., all manufacturers of electrical wire and cable. Owner and executive of Geneva Partners, a condominium development company which is no longer active. Executive of Kinsman IGA, a grocery store. Partner in Dana Partners, a real estate holding company, and Dana Gas, a gas well operation. Owner of the Heritage Hill Grain Company and Heritage Hill Enterprises, agricultural businesses, since 2003. Partner in Stratton Creek Woodworks, a maker of wood products, and Smearcase, a real estate holding company, each since 2005. Partner in Goodview, a Brazilian agricultural business. Partner in Kinsman Hardware LLC, a home improvement store. Mr. Thompson is a private investor with an extensive background in manufacturing. The Nominating Committee and the Board believes that Mr. Thompson's experiences, qualifications, attributes and skills allow him to provide assistance in understanding and evaluating manufacturing business relationships. He has owned and managed numerous small businesses in several industries in the Bank's current market area, as well as outside the immediate area.	2001	2013
David C. Cole	53	Partner and President of Cole Valley Motor Company, an automobile dealership. President of JDT, Inc., Cole Valley Chevrolet, CJB Properties, and David Tom LTD, automobile sales, since 2001. As President of a family-owned automobile dealership located in Warren, Ohio, Mr. Cole is responsible for the management and day-to-day operations of the business. He has a Bachelor of Science degree in business administration. Mr. Cole serves on the board of Forum Health. The Nominating Committee and the Board believes that Mr. Cole's experiences, qualifications, attributes and skills allow him to provide an extensive understanding of small business and retail needs.	1989	2014
Timothy Carney	46	Executive Vice President and Chief Operating Officer of Cortland and the Bank and Secretary of Cortland and the Bank since November 2, 2009. Senior Vice President and Chief Operations Officer of the Bank and Cortland since April 2008. Senior Vice President and Chief Operations Officer of the Bank since April 2005. Prior to joining the bank, Mr. Carney was employed by a major accounting firm and had experience in all financial activities and financial reporting, audit preparation, budgeting, and knowledge of government regulatory requirements. The Nominating Committee and the Board believes that the experiences, qualifications, attributes and skills that Mr. Carney has developed allow him to provide valuable accounting, strategic planning and corporate governance expertise to the Board.	2009	2014

Nominee	Age	Biography	Director of Cortland Since	Term Expires In
Neil J. Kaback	51	Mr. Kaback is Vice President of Cohen & Company, Inc., a firm that provides marketing for Cohen & Company LTD (an accounting firm where Mr. Kaback is also a Vice President). Mr. Kaback is a partner in Cohen & Company Investment Partnership, a financial planning firm and Vice President of Cohen Fund Audit Services, a mutual fund auditing firm. A member of the American Institute of CPAs and the Ohio Society of CPAs. Mr. Kaback has varied responsibilities. He focuses on high level business succession, tax, estate, and family business planning, as well as the supervision and planning of financial statement and tax return engagements. He heads the firm's Automotive Dealers Group and provides managerial, operational, financing, and tax consulting advice. He serves as Finance Chairman for the Trumbull Memorial Hospital Foundation and was the Campaign Chairman of Operation: Save our Airbase Reservists. He was a member of the Leadership Youngstown Class of 92-93, and is actively involved with the Mahoning County United Way, Trumbull 100, Youngstown Area Jewish Federation, and American Red Cross. The Nominating Committee and the Board believes that the experiences, qualifications, attributes and skills that Mr. Kaback has developed allow him to provide continued accounting and financial expertise to the Board.	2004	2014

THE BOARD OF DIRECTORS AND COMMITTEES OF THE BOARD

Independence of Directors

The Board has reviewed, considered, and discussed each director’s relationships, both direct or indirect, with Cortland and its subsidiaries and the compensation and other payments, if any, each director has, both directly or indirectly, received from or made to Cortland and its subsidiaries in order to determine whether such director qualifies as independent under Rule 5605(a)(2) of Nasdaq’s Marketplace Rules. The Board has determined that it has at least a majority of independent directors, and that each of the following directors has no financial or personal ties, either directly or indirectly, with Cortland or its subsidiaries (other than compensation as a director of Cortland and its subsidiaries, banking relationships in the ordinary course of business with the Bank, and ownership of Cortland’s common shares as described in this proxy statement) and thus qualifies as independent under Nasdaq Corporate Governance Rule 5605(a)(2): Jerry A. Carleton, David C. Cole, George E. Gessner, James E. Hoffman, III, Neil J. Kaback, Joseph E. Koch, K. Ray Mahan, Richard B. Thompson, and Timothy K. Woofter.

James M. Gasior and Timothy Carney do not qualify as independent directors because they currently serve as executive officers of Cortland and the Bank.

Meetings of the Board and Attendance at the Annual Meeting of Shareholders

In 2011, the Board held a total of thirteen (13) meetings. Each incumbent director attended at least 75% of the aggregate of the total number of meetings held by the Board and the total number of meetings held by the board committees on which he served, in each case during the period of his service.

Cortland encourages all incumbent directors and director nominees to attend each annual meeting of shareholders. All of the incumbent directors and director nominees, except Neil J. Kaback and Richard B. Thompson, attended Cortland’s last annual meeting of shareholders held on May17, 2011.

Communications with the Board

Although Cortland does not currently have formal procedures by which shareholders may communicate directly with directors, Cortland believes that its current process has adequately served the needs of the Board and its shareholders. Communications sent to the Board, either generally or in care of the Chief Executive Officer, Secretary, the Investor Relations

Officer, or another corporate officer, are forwarded to all directors. There is no screening process, and all communications that are received by officers for the Board's attention are forwarded to the Board.

Until other procedures are developed and posted on Cortland's website at www.cortland-banks.com, any communication to the Board may be mailed to the Board, in care of the Investor Relations Officer, at Cortland's headquarters in Cortland, Ohio. The mailing envelope must contain a clear notation indicating that the enclosed letter is a "Shareholder-Board Communication" or a "Shareholder-Director Communication." In addition, communication via Cortland's website may be used. Correspondence through the investor relations page of the website should also be directed to the Investor Relations Officer and indicate that the communication is a "Shareholder-Board Communication" or a "Shareholder-Director Communication." All such communications, whether via mail or website, must identify the author as a shareholder and clearly state whether the intended recipients are all directors on the Board or just certain specified individual directors or committee members. The Investor Relations Officer will make copies of all such communications and circulate them to the appropriate director or directors.

Board Committees

Audit Committee

The Board has an Audit Committee comprised of Messrs. Cole, Kaback (Chair), and Thompson. The Board has determined that each member of the Audit Committee qualifies as independent under the Nasdaq Marketplace Rules, as well as under Rule 10A-3 promulgated under the Exchange Act.

The Board has determined that the audit committee does not have an "audit committee financial expert" as that term is defined by the SEC. The Board has determined that each Audit Committee member has sufficient knowledge in financial and accounting matters to serve effectively on the Committee.

The Audit Committee conducts its business pursuant to a written charter adopted by the Board. A current copy of the charter of the Audit Committee is posted on Cortland's website at www.cortland-banks.com on the investor relations page under Governance Documents, "Audit Committee Charter." At least annually, the Audit Committee reviews and reassesses the adequacy of its charter and recommends any proposed changes to the full Board for approval as necessary.

The Audit Committee is responsible for appointing, compensating, and overseeing the independent registered public accounting firm employed by Cortland for the purpose of preparing and issuing an audit report or other audit, review, or attestation services. The Audit Committee evaluates the independence of the independent registered public accounting firm on an ongoing basis. The Audit Committee also approves audit reports and plans, accounting policies, and audit outsource arrangements, including audit scope, internal audit reports, audit fees, and certain other expenses. The Audit Committee is responsible for developing procedures for the receipt, retention, and treatment of complaints regarding accounting, internal auditing controls, or auditing matters, including procedures for the confidential, anonymous submission by employees of concerns regarding questionable accounting or auditing matters.

The Audit Committee held ten (10) meetings during 2011. The Audit Committee's report relating to the 2011 fiscal year appears on page 16 of this proxy statement.

Executive Compensation Committee

The Bank's Board of Directors has an Executive Compensation Committee which also serves as the Compensation Committee of Cortland. The Executive Compensation Committee is comprised of Messrs. Carleton, Gessner, and Woofter (Chair). Mr. Cole was a member of the Executive Compensation Committee until May 17, 2011. The Board has determined that each member of the Executive Compensation Committee qualifies as independent under Nasdaq Marketplace Rules. In addition, each member of the Compensation Committee qualifies as an "outside director" for purposes of Section 162(m) of the Internal Revenue Code of 1986, as amended (the IRC), and as a "non-employee director" for purposes of Section 16b-3 under the Exchange Act.

The Executive Compensation Committee oversees director and executive officer compensation as well as compensation under the Profit Sharing Program and the Employee Benefit Plan 401(k). The Executive Compensation Committee reviews and recommends officer compensation levels and benefit plans. In evaluating executive officer performance, the Executive Compensation Committee takes into account –

- job knowledge, initiative, and originality;

- quality and accuracy of work performed and priority setting;
- customer relations;
- subordinate feedback and ability to provide instruction to staff; and
- the relationship of these factors to Cortland and the Bank's achievement of strategic objectives and profitability.

The Executive Compensation Committee occasionally requests the Chief Executive Officer (CEO) to be present at Executive Compensation Committee meetings to discuss executive compensation and evaluate individual performance. The Executive Compensation Committee discusses the CEO's compensation with him, but final deliberations and all votes regarding his compensation are made in executive session, without the CEO present. The Executive Compensation Committee also approves the compensation for other executive officers based on the CEO's recommendations with input from outside advisors and counsel and then makes its recommendation to the Board.

The Executive Compensation Committee reviews publicly available peer data to assist with evaluating the overall compensation for the Board. From time to time, the Executive Compensation Committee will recommend changes in compensation to further the goals of the director compensation program, which strives to provide appropriate compensation to directors for their time, efforts and contributions to the Bank.

The Executive Compensation Committee uses compensation data from similar-sized financial institutions for comparative purposes from time to time to provide input on both Board and executive compensation issues, but it did not engage a consultant in setting 2011 compensation. The Executive Compensation Committee does not have a formal charter. The Executive Compensation Committee held one (1) meeting in 2011.

Nominating Committee

The Board has a Nominating Committee comprised of Messrs. Cole, Thompson, and Woofter (Chair). The Board has determined that each member of the Nominating Committee qualifies as independent under Nasdaq Marketplace Rules. The purpose of the Nominating Committee is to:

- identify qualified candidates for election, nomination, or appointment to the Board and recommend to the full Board a slate of director nominees for each annual meeting or as vacancies occur;
- make recommendations to the full Board and the Chairman of the Board regarding assignment and rotation of members and chairs of committees of the Board;
- recommend the number of directors to serve on the Board; and
- undertake such other responsibilities as may be referred to the Nominating Committee by the full Board or the Chairman of the Board.

The Nominating Committee held two (2) meetings during 2011. The charter of the Nominating Committee is reviewed annually and is available on Cortland's website at www.cortland-banks.com on the investor relations page under Governance Documents, "Nominating and Corporate Governance Committee Charter."

Nominating Procedures

As described previously, Cortland has a standing Nominating Committee that has the responsibility to identify and recommend individuals qualified to become directors. Each candidate must satisfy the eligibility requirements set forth in Cortland's Code of Regulations, Article Two, Section 2.01 "Authority and Qualifications." No person who has attained the age of 70 shall be eligible for election as a director, and each director must hold shares of stock of Cortland with an aggregate par value or stated value of $500, an aggregate shareholder equity of at least $500, or an aggregate fair market value of at least $500.

When considering potential candidates for the Board, the Nominating Committee strives to assure that the composition of the Board, as well as its practices and operation, contributes to an effective representation and advocacy of shareholders' interest. The Nominating Committee may consider those factors it deems appropriate in evaluating director candidates, including judgment, skill, strength of character, experience with business and organizations comparable in size and scope to Cortland, experience and skills relative to other Board members, and specialized knowledge or experience. Depending upon the current needs of the Board, certain factors may be weighed more heavily than others by the Nominating Committee. The Nominating Committee does not have a policy for the consideration of diversity in the nomination process, but takes into account in its deliberations all facets of a potential nominee's background, including the potential nominee's educational background, gender, business and professional experience, and his or her particular skills and other qualities. The

Nominating Committee's goal is to identify individuals who will enhance and add valuable perspective to the Board's deliberations and who will assist Cortland in its effort to capitalize on business opportunities in a challenging and highly competitive market.

In considering candidates for the Board, the Nominating Committee evaluates the entirety of each candidate's credentials and, other than the eligibility requirements set forth in Cortland's Code of Regulations, there are no specific minimum qualifications that must be met by a Nominating Committee recommended nominee. However, the Nominating Committee does believe that each director on the Board should be of the highest character and integrity; possess a reputation for working constructively with others; have sufficient time to devote to Board matters; and be without any conflict of interest that would impede the individual's performance as a director.

The Nominating Committee will consider candidates for the Board from any reasonable source, including shareholder recommendations. The Nominating Committee will not evaluate candidates differently based on who has made the recommendation. The Nominating Committee has the authority to hire and pay a fee to consultants or search firms for the purpose of identifying and evaluating candidates. No such consultants or search firms have been used to date and, accordingly, no fees have been paid to consultants, search firms, or any other individuals.

According to Section 2.03(B) of Cortland's Code of Regulations, any shareholder who desires to nominate an individual to the Board must provide timely written notice. To be timely, the notice must be mailed to the President of Cortland at least 14 days but no more than 50 days before the meeting at which directors will be elected, or 7 days after notice of the meeting is mailed to shareholders if the meeting is held within 21 days of Cortland mailing notice of the meeting.

The shareholder's notice of nomination must give:

- the name and address of the nominee;
- the principal occupation of the nominee;
- the approximate number of shares the shareholder making the nomination reasonably anticipates will be voted in favor of the proposed nominee;
- the name and address of the shareholder making the nomination; and
- the number of shares beneficially owned by the shareholder making the nomination.

The Nominating Committee will disregard a shareholder's nomination if it is not made in compliance with these rules and standards.

Board Leadership Structure and Role in Risk Oversight

The office of Chairman of the Board and the office of Chief Executive Officer have been separate at Cortland since 2005. Since November 2, 2009, James M. Gasior has held the office of Chief Executive Officer and effective April 27, 2010, Timothy K. Woofter became Chairman of the Board. Cortland believes that separation of these two offices is consistent with the Board's responsibility for oversight of management and of Cortland's affairs generally. The Board and its committees have a significant role in oversight of the risks to which Cortland is subject. Like other community banking organizations, Cortland and the Board exercise oversight of common banking risks through a loan committee that considers loan applications and credit risk, an asset and liability committee whose routine responsibilities require consideration of interest rate and liquidity risk, an audit committee that takes into account audit and regulatory compliance risks, a loan review committee that monitors non-performing assets and their ultimate outcome, and an investment management committee that sets investment strategy and monitors compliance therewith. The full Board, of course, takes these and other risks into account in its deliberations as well.

Code of Ethics

Cortland has adopted a Code of Ethics (the Code) as part of its corporate governance program. The Code applies to all of Cortland's officers and employees, including its Chief Executive Officer and Chief Financial Officer. The Code is posted on the investor relations page of Cortland's website at www.cortland-banks.com under Governance Documents, "Code of Business Conduct and Ethics." Any amendments to, or waivers from, this Code will be posted on this same website. In addition, a copy of the Code is available to shareholders upon request. Shareholders desiring a copy of the Code should address written requests to Mr. Timothy Carney, Executive Vice President, Chief Operating Officer and Secretary of Cortland Bancorp, 194 West Main Street, Cortland, Ohio 44410, and are asked to mark "Code of Business Conduct and Ethics" on the outside of the envelope containing the request.

DIRECTOR COMPENSATION IN 2011

The following table shows the compensation of Cortland directors for their service on the Board in 2011, other than Directors Gasior and Carney. The director compensation information to follow represents compensation for the full year, through December 31, 2011. The majority of the director compensation is paid by the Bank for directors' service on the Bank's board and its committees, but compensation shown in the table is aggregate compensation paid for directors' service both to Cortland and the Bank. Information about compensation paid to and earned by Directors Gasior and Carney is included elsewhere in this proxy statement.

Name	Fees Earned or Paid in Cash [(1)] ($)	All Other Compensation [(2)] ($)	Total ($)
Jerry A. Carleton	18,850	12,716	31,566
David C. Cole	22,550	4,906	27,456
George E. Gessner	19,450	6,232	25,682
James E. Hoffman, III	19,500	9,248	28,748
Neil J. Kaback	23,100	2,642	25,742
Joseph E. Koch	19,950	2,543	22,493
K. Ray Mahan (retired May 17, 2011)	7,500	263	7,763
Richard B. Thompson	23,000	5,412	28,412
Timothy K. Woofter	21,000	9,396	30,396

(1) In 2011, non-employee directors of the Bank received an $18,000 annual retainer, except Director Woofter, Chairman of the Board, who received a $19,500 annual retainer. Director Mahan retired as a director in May 2011 and received a retainer of $7,500. Beginning in 2011, non-employee directors of the Bank were paid a fee for attending committee meetings. Employee directors of the Bank received a $7,200 annual retainer.

(2) Perquisites and other personal benefits provided to each of the directors described in the table were less than $10,000 in 2011, with the exception of Director Carleton. The figures in the "all other compensation" column consist of the imputed monetary value of life insurance policies for the directors and the addition in 2011 to the liability accrual balance established by Cortland to account for Cortland's obligation to pay retirement benefits under director retirement agreements entered into with all non-employee directors. The imputed value of life insurance policies for income tax purposes in 2011 was $452 for Director Carleton, $127 for Director Cole, $405 for Director Gessner, $231 for Director Hoffman, $76 for Director Kaback, $63 for Director Koch, $263 for Director Mahan, $319 for Director Thompson, and $260 for Director Woofter. The addition to the liability accrual balance to account for the director retirement agreements in 2011 was $12,264 for Director Carleton, $4,779 for Director Cole, $5,827 for Director Gessner, $9,017 for Director Hoffman, $2,566 for Director Kaback, $2,480 for Director Koch, $5,093 for Director Thompson, and $9,136 for Director Woofter.

Retirement Agreements and Insurance for Non-Employee Directors. Directors Carleton, Cole, Gessner, Hoffman, Kaback, Mahan, Thompson, and Woofter are parties to director retirement agreements with Cortland. In December 2007, Cortland entered into amended director retirement agreements with these directors (excluding Director Mahan) for purposes of IRC Section 409A compliance. Cortland did not enter into an amended director retirement agreement with Mr. Mahan because his director retirement agreement was fully accrued and vested before the enactment of IRC Section 409A. The amended director retirement agreements promise a post-retirement benefit of $10,000 payable annually for 10 years if the director retires after reaching his normal retirement age, which is a function of years of service on the Board and attained age. Normal retirement ages for these directors are age 61 (Mr. Cole), age 62 (Mr. Hoffman), age 63 (Messrs. Mahan and Woofter), age 66 (Mr. Gessner), age 67 (Mr. Kaback), and age 70 (Messrs. Carleton and Thompson). A reduced annual retirement benefit is payable if the director terminates service or becomes disabled before reaching the normal retirement age, but the benefit is not paid until the director reaches the normal retirement age. Mr. Mahan has reached his normal retirement age. If termination of the director's service occurs within one year after a change in control of Cortland, the director will receive cash in a single lump sum equal to the retirement benefit expense accrued by Cortland. The amended director retirement agreement benefits to which a director is entitled are payable to his beneficiary after the director's death, but if the director dies in active service to

Cortland before reaching his normal retirement age, his beneficiary will be entitled to cash in a single lump sum equal to the retirement benefit expense accrued by Cortland.

Cortland purchased insurance on the lives of directors who are parties to the amended director retirement agreements and entered into split dollar agreements with them, promising to share a portion of the life insurance death benefits with the directors' designated beneficiaries. Each director's portion of the policy's death benefit is $100,000, payable to the director's beneficiary whether the director's death occurs while in active service to Cortland or after retirement. Cortland will receive any death benefits remaining after payment to the director's beneficiary. In December 2007, Cortland entered into an amended split dollar agreement and endorsement with Mr. Carleton to add a Section 2.4 pursuant to which Cortland promises to maintain the split dollar policy in full force and effect similar to the other directors' split dollar agreements.

Director Indemnification. At the 2005 Annual Meeting, the shareholders of Cortland approved the form and use of indemnification agreements with directors. On May 24, 2005, Cortland entered into indemnification agreements with each of the current directors, other than Director Koch. Director Koch entered into an indemnification agreement with Cortland in May 2010. The indemnification agreements allow a director to select the most favorable indemnification rights provided under:

- Cortland's Articles of Incorporation or Code of Regulations in effect on the date of the indemnification agreement or on the date expenses are incurred;
- state law in effect on the date of the indemnification agreement or on the date expenses are incurred;
- any liability insurance policy in effect when a claim is made against the director or on the date expenses are incurred; and
- any other indemnification arrangement otherwise available.

The indemnification agreements cover all fees, expenses, judgments, fines, penalties, and settlement amounts paid in any matter relating to the director's role as director, officer, employee, agent, or when serving as Cortland's representative with another entity. Each indemnification agreement provides for the prompt advancement of all expenses incurred in a proceeding, subject to the director's obligation to repay those advances if it is determined later that the director is not entitled to indemnification.

Retainer and Fees. Currently, the Board and the Board of Directors of the Bank consist of the same individuals. Non-employee directors of Cortland serve without retainer or fee for services on the Board. Instead, the directors are paid by the Bank for services rendered in their capacities as directors of Cortland and the Bank.

In 2011, non-employee directors of the Bank received an $18,000 annual retainer, except Director Woofter, Chairman of the Board, who received a $19,500 annual retainer. Non-employee directors of the Bank also received a fee of either $150 or $450 for each committee meeting attended, depending on the committee each non-employee director of the Bank served on in 2011. Employee directors of the Bank received a $7,200 annual retainer. Directors of the Bank (both employee and non-employee directors) may also elect to participate in the Bank's health care plans at substantially the same rates as all employees.

Director Emeritus Compensation. For up to ten years after retirement as a director, an emeritus director of the Bank is paid $600 for each meeting attended, for an annual compensation of $7,200, provided the director emeritus attends at least 75% of Board meetings. Emeritus directors are also entitled to continue participation in the Bank's health care plan, although the former director is responsible for paying 100% of the Bank's cost to maintain health care coverage. After the emeritus director's death, his or her spouse may similarly maintain health care coverage, at the spouse's cost. Emeritus directors participate in Board meetings, but are not entitled to vote on any matters coming before the Board.

EXECUTIVE COMPENSATION

Cortland does not provide any monetary compensation directly to its executive officers. Instead, the executive officers of Cortland are paid by the Bank for services rendered in their capacity as executive officers of Cortland and the Bank.

Summary Compensation Table

Name and Principal Position	Year	Salary[(1)] ($)	All Other Compensation[(2)] ($)	Total ($)
James M. Gasior	2011	205,200	74,523	279,723
President and Chief Executive Officer of Cortland and the Bank	2010	205,200	62,027	267,227
Timothy Carney	2011	193,200	59,747	252,947
Executive Vice President and Chief Operating Officer of Cortland and the Bank	2010	193,200	43,466	236,666
Stanley P. Feret*	2011	145,000	64,928	209,928
Senior Vice President and Chief Lending Officer of the Bank	2010	117,870	33,453	151,323

* Mr. Feret was appointed Senior Vice President and Chief Lending Officer of the Bank on March 10, 2010.

(1) Includes salary deferred at the election of the executive under the Bank's 401(k) retirement plan. Also includes fees for service as a director of Cortland and the Bank. In 2011, directors' fees for Messrs. Gasior and Carney were $7,200 each.

(2) The figures in the "all other compensation" column consist of the Bank's contribution to the 401(k) plan accounts for the named executive officers, the imputed monetary value of life insurance policies, vehicle-related expenses, club memberships, and accrual expense for benefits payable under the executives' salary continuation agreements. For 2011, the Bank made contributions of $10,343 to the 401(k) plan account of Mr. Gasior, $9,651 to the account of Mr. Carney and $7,533 to the account of Mr. Feret. The imputed value of life insurance policies for income tax purposes in 2011 was $1,754 for Mr. Gasior, $1,123 for Mr. Carney and $2,455 for Mr. Feret. Vehicle-related expenses in 2011 were $8,850 for Mr. Gasior, $7,000 for Mr. Carney and $4,400 for Mr. Feret. Club membership dues in 2011 were $4,878 for Mr. Gasior, $9,609 for Mr. Carney and $7,080 for Mr. Feret. The addition to the liability accrual balance to account for the salary continuation agreements in 2011 was $48,699 for Mr. Gasior, $32,364 for Mr. Carney and $43,461 for Mr. Feret.

Severance Agreements. Cortland entered into severance agreements in December 2008 with Messrs. Gasior and Carney and in June 2010 with Mr. Feret. The initial term of Messrs. Gasior and Carney's severance agreements is three years, renewing each year for an additional one-year term unless the Board gives advance written notice that the agreement will not automatically renew. Mr. Feret's severance agreement, on the other hand, provides a fixed, two-year term. However, Section 4(b) of Mr. Feret's severance agreement provides that he and Cortland will use best efforts to finalize a new severance agreement by the end of the fixed, two-year term. Messrs. Gasior and Carney's severance agreements terminate when the executive attains age 65.

The severance agreements provide that the executive is entitled to severance compensation if a change in control occurs during the term of the agreement, payable in a single lump sum. The change-in-control benefit under the severance agreements is a single-trigger benefit, in contrast to a double-trigger benefit payable solely after employment termination following a change in control. The severance compensation equals the executive's annual salary when the change in control occurs, plus the amount of any bonus earned for the last whole calendar year. For purposes of the severance agreements, the term change in control means (i) an occurrence of a change in ownership of Cortland, (ii) a change in effective control of Cortland, or (iii) a change in the ownership of a substantial portion of Cortland's assets as defined consistent with IRC Section 409A. If Messrs. Gasior or Carney's employment terminates within 24 months after a change in control, Cortland must also continue their life, health, and disability insurance coverage for up to three years, along with fringe benefits such as club memberships. Messrs. Gasior and Carney will also be entitled to out-placement services for one year, and tax and financial planning services for three years after termination. Mr. Feret's severance agreement does not provide insurance or other miscellaneous benefits for termination occurring after a change in control. However, unlike the other severance agreements, Mr. Feret's agreement alone provides for a cash severance benefit for termination outside of the context of a change in control. That is, if Mr. Feret's employment terminates involuntarily but without cause or voluntarily because of an adverse change in employment circumstances to which Mr. Feret has not agreed in advance, in either case before a change in control occurs, he will be entitled to a cash severance benefit in an amount equal to the sum of his salary plus his average cash bonus. Messrs. Gasior and Carney's severance agreements also include a promise on the part of Cortland to pay the executives' legal fees

associated with the interpretation, enforcement, or defense of the executives' rights under the severance agreements, up to a maximum of $500,000, as adjusted for inflation from time to time. Mr. Feret's severance agreement does not contain a provision for reimbursement of legal expenses.

If a change in control occurs and the total benefits or payments to which an executive is entitled constitute so-called "excess parachute payments" and are therefore subject to the 20% excise tax under Sections 280G and 4999 of the IRC (whether under the severance agreement or under any other compensation arrangement), Cortland must also make an adjusted gross-up payment to Messrs. Gasior and Carney compensating them for the excise tax as well as for income, payroll, and excise taxes imposed on that parachute payment excise tax reimbursement payment. A 20% excise tax is imposed under Section 4999 if the value of an executive's aggregate change-in-control benefits – calculated according to procedures specified in Section 280G and accompanying IRS regulations – equals or exceeds three times his or her five-year average taxable compensation. The five-year average is known as the so-called base amount. If the value of the aggregate change-in-control benefits equals or exceeds three times the base amount, a 20% excise tax is imposed on all benefits exceeding the base amount and the employer forfeits its compensation deduction for those same benefits. The total adjusted gross-up payment to Messrs. Gasior and Carney would consist of (i) a payment equal to the initial excise tax and (ii) a gross-up payment that is calculated by determining the difference between the full gross-up amount needed to provide the excise tax payment net of all income, payroll, and excise taxes and the excise tax payment multiplied by eighty percent (80%).

Mr. Feret's severance agreement does not contain a Section 280G gross-up benefit. However, Section 15 of Mr. Feret's severance agreement provides that benefits will not be reduced or "cut back" if total change-in-control benefits cause the 20% excess parachute payment excise tax to be imposed on him under IRC Section 4999, with associated loss of Cortland's compensation deduction under IRC Section 280G for payments on which the 20% excise tax is imposed.

Salary Continuation Agreements. In June 2010, the Bank entered into fourth amended salary continuation agreements with Messrs. Gasior and Carney (effective as of June 1, 2001) and a new salary continuation agreement with Mr. Feret. The salary continuation agreements provide Messrs. Gasior, Carney and Feret with annual normal retirement benefits at age 65 of $109,700, $112,500 and $92,000, respectively. Upon reaching their specified normal retirement age of 65, the Bank will make these annual benefit payments to the executives for 15 years even if separation from service does not occur at age 65.

The salary continuation agreements are intended to reinforce the executives' long-term commitment to the Bank. The full normal retirement benefit is payable if and only if the executive remains employed with the Bank to the normal retirement age. Messrs. Gasior and Carney's fourth amended salary continuation agreements provide for reduced benefits in the case of early termination on or after reaching the early retirement age (age 62), or in the case of termination due to disability occurring at any age, but early termination benefits are not payable before age 62 unless early termination is because of involuntary termination without cause or voluntary termination with good reason. Mr. Feret's salary continuation agreements also provide a reduced benefit for termination before normal retirement age. However, Mr. Feret's early termination benefit is subject to 10% annual vesting, with elimination of the vesting if a change in control occurs. No benefit is payable and an executive's severance agreement terminates if his employment terminates for cause. Under generally accepted accounting principles, the Bank must accrue a liability on its books for the obligation under the current agreements. By the time the executive attains the normal retirement age, the total liability amount accrued by the Bank must equal the present value of the Bank's obligation to the executive. Each executive's accrual balance is calculated using a level principal amount, with interest computed at a reasonable discount rate under generally accepted accounting principles.

If Mr. Feret's service with the Bank terminates involuntarily without cause or voluntarily for good reason within 24 months after a change in control occurs, the Bank will pay him a change-in-control benefit calculated as described in his salary continuation agreement. Because Mr. Feret's benefit is payable immediately after his separation from service, it is a double-trigger change-in-control benefit and is subject to the six-month payment delay imposed by IRC Section 409A. Conversely, Messrs. Gasior and Carney's fourth amended salary continuation agreements provide a single trigger change-in-control benefit, which is a benefit payable upon the mere occurrence of a change in control, regardless of whether employment termination also occurs. Messrs. Gasior and Carney's change-in-control design allows them to avoid the six-month delay imposed by IRC Section 409A for benefits payable on account of a separation from service. IRC Section 409A imposes a six-month payment delay on termination benefits payable to a so-called specified employee, meaning an executive of a publicly traded company whose annual compensation is $165,000 or more (the $165,000 figure is annually adjusted for inflation by the Internal Revenue Service). The term "change in control" is defined in the agreements in a manner identical to the way a "change of control" is defined under the executives' severance agreements (*i.e.*, consistent with IRC Section 409A). The payment for Messrs. Gasior and Carney is the accrual balance projected to exist at these executives' normal retirement age discounted to present value. The payment for Mr. Feret is the accrual balance existing when separation from service occurs. The salary continuation agreements also provide that the Bank must reimburse up to $500,000 in legal expenses incurred by each of the executives if the agreements are challenged after a change in control occurs.

If either of Messrs. Gasior or Carney dies before age 65 in active service to the Bank, instead of salary continuation agreement benefits, these individuals' beneficiaries will receive a life insurance death benefit in a fixed amount. As informal financing for the salary continuation agreement payment obligation arising out of an executive's death before retirement, the Bank has purchased life insurance policies on certain officers' lives, including Messrs. Gasior and Carney. The life insurance policies are owned by the Bank, but the Bank entered into endorsement split dollar arrangements allowing the executives to designate the beneficiary of a portion of the policy death benefits. The Bank will receive the remainder of the death benefits. Messrs. Gasior or Carney's split dollar agreements provide that the split dollar life insurance benefit expires when the nonqualified deferred compensation obligation is fully accrued at age 65, even if the executive is still working for the Bank. Although the Bank expects the split dollar life insurance policy benefits to finance the expense for the payment obligations under the fourth amended salary continuation agreements, the executives' contractual entitlements under the agreements are not funded and remain contractual liabilities of the Bank.

Under the split dollar agreements and endorsements entered into with each of Messrs. Gasior and Carney, at the executive's death before retirement at age 65, a portion of the total death benefits under the insurance policies will be paid to the executive's designated beneficiary. The death benefit that would have been payable as of December 31, 2011, to the beneficiaries of Messrs. Gasior and Carney would be $678,977 and $632,833, respectively. The split dollar agreements and endorsements terminate upon the first to occur of any of the following: (i) surrender, lapse, or other termination of the policy by the Bank, (ii) distribution of the death benefit proceeds, (iii) termination of the salary continuation agreement due to cause, misstatement, removal, bank default, or FDIC open-bank assistance, (iv) upon the executive's 65th birthday, (v) upon the executive's separation from service or (vi) the occurrence of a change in control for which benefits are paid to the executives under their salary continuation agreements.

Neither the premium amounts attributable to the policies on the executives' lives nor the potential split dollar death benefits payable to their beneficiaries are reflected in the Summary Compensation Table. The imputed dollar values of the benefit to the executives for 2011, 2010 and 2009 of the portions of the life insurance premium paid by the Bank are included in the Summary Compensation Table.

Group Term Carve Out Plan. In December 2000, the Bank purchased with a single premium payment approximately $2.8 million in life insurance on the lives of 22 officers for the Group Term Carve Out Plan. The 22 officers covered by the plan include Messrs. Gasior and Carney. Under group term split dollar endorsements, the Bank and the executives share the rights to death benefits payable under the life insurance policies. An executive's beneficiaries are entitled to one of the following death benefit amounts:

Pre-Retirement Death Benefit. If the executive dies before retirement, the death benefit is the lesser of (a) $500,000 or (b) twice the executive's current annual salary at the time of death, less $50,000; or

Post-Retirement Death Benefit. If the executive was no longer employed by the Bank at the time of death, but had terminated employment (i) within one year after a change in control, (ii) due to disability, or (iii) on or after the early retirement age of 62, the death benefit is the lesser of (a) $500,000 or (b) the Executive's most recent salary at the time of death.

The Bank receives the remainder of the life insurance policy death benefits, which should be sufficient to recover in full the Bank's life insurance investment. No benefits are payable under the plan to any executive whose employment terminates before the age of 62, unless termination is due to disability or unless termination occurs within one year after a change in control. Benefits are payable to the executives' beneficiaries in a lump sum.

Employees also have life insurance benefits under the Bank's group term life insurance program, paying benefits up to twice the executive's current annual salary at the time of death to the executive's beneficiaries if the executive dies while employed by the Bank, but limited to $50,000 for participants in the Group Term Carve Out Plan. Messrs. Gasior and Carney are limited to the $50,000 cap, while Mr. Feret's benefit is twice his salary.

Profit Sharing Program. If the Bank achieves its profit goal for the fiscal year, the Board may (but is not required to) approve profit sharing. The Bank's profit goal for profit sharing purposes was not achieved in 2011. As a result, no profit-sharing distributions were made. Should the Bank achieve its profit goal in the future, the Board may (but is not required to) approve profit sharing. If the Board does approve profit sharing, all employees in good standing are eligible.

Employee Benefit Plan 401(k). The Bank maintains a traditional 401(k) retirement plan for employees. In general, the Bank matches participants' voluntary contributions up to 5% of gross pay. Employee contributions and matching contributions under the plan accumulate tax free until distributions begin at the employee's normal retirement age. The goal of the 401(k) plan is to enable employees to provide for their own retirement and, combined with Social Security benefits, to

ensure that their aggregate post-retirement income is maintained at a percentage of pre-retirement income sufficient to sustain a long-term retirement.

Perquisites and Other Compensation. The Executive Compensation Committee annually reviews the perquisites that the management team receives. In the case of Messrs. Gasior, Carney and Feret, membership in a golf or social club is encouraged to provide an appropriate forum for entertaining existing customers, developing and promoting new business and generally interacting with influential members of the local community.

IRC Limits. Cortland considers tax and accounting implications in the design of its compensation programs. Section 162(m) of the IRC places a limit on the tax deduction for compensation in excess of $1 million paid to the chief executive officer and four most highly compensated executive officers of a corporation in a taxable year. All of the compensation Cortland paid in 2011 to the named executive officers is expected to be deductible under Section 162(m). The Executive Compensation Committee retains the flexibility, however, to pay non-deductible compensation if it believes doing so is in the best interests of Cortland.

TRANSACTIONS WITH RELATED PERSONS

During the 2011 fiscal year, executive officers and directors of Cortland, members of their immediate families, and corporations or organizations as to which directors of Cortland serve as executive officers or beneficially own more than 10% of the equity interest, were involved in banking transactions with the Bank in the ordinary course of their respective businesses and in compliance with applicable federal and state laws and regulations. It is expected that similar banking transactions will be entered into in the future. Transactions with such persons in connection with the deposit of funds or the Bank acting in an agency capacity have been made on substantially the same terms as those prevailing at the time for comparable transactions with persons not affiliated with Cortland or its subsidiaries. Loans to these persons have been made on substantially the same terms, including the interest rate charged and collateral required, as those prevailing at the time for comparable transactions with persons not affiliated with Cortland or its subsidiaries. These loans have been subject to and are presently subject to no more than a normal risk of collectability and present no other unfavorable features. As of the date of this proxy statement, all of the loans described in this paragraph were performing in accordance with their original terms.

RATIFICATION OF INDEPENDENT AUDITORS
(Proposal Two)

Cortland's independent auditor for the year ended December 31, 2011, was S.R. Snodgrass, A.C. The audit committee has selected, subject to shareholder ratification, S.R. Snodgrass, A.C. to be Cortland's independent auditor for the fiscal year ending December 31, 2012. We expect one or more representatives of S.R. Snodgrass, A.C. to be present at the Annual Meeting. The representative of S.R. Snodgrass, A.C. will have the opportunity to make a statement if desired, and will be available to respond to appropriate questions.

Fees of Independent Registered Public Accounting Firm. Fees contracted for services by S. R. Snodgrass, A.C. for each of the 2011 fiscal year and the 2010 fiscal year were as follows:

	2011	2010
Audit Fees (1)	$ 106,250	$ 102,153
Audit-Related Fees (2)	8,558	7,500
Tax Fees (3)	10,606	8,974
All Other Fees (4)	3,841	11,142

(1) Audit fees consist of fees for professional services rendered for the audits of the consolidated financial statements of Cortland and quarterly reviews of the financial statements included in Cortland's Quarterly Reports on Form 10-Q.

(2) Audit-related fees include the financial statement audit of an employee benefit plan.

(3) Tax fees include U.S. federal, state and local tax planning and advice, and U.S. federal, state and local tax compliance.

(4) All other fees relate to consulting services in relation to strategic planning.

Pre-Approval of Services Performed by Independent Registered Public Accounting Firm. The Audit Committee pre-approves all audit and non-audit services provided by the independent auditors prior to the engagement of the independent auditors with respect to such services. The Chairman of the Audit Committee has been designated the authority by the Committee to pre-approve the engagement of the independent auditors when the entire Audit Committee is unable to do so. The Chairman must report all such pre-approvals to the entire Audit Committee at its next meeting. All of the services rendered by S.R. Snodgrass, A.C. to Cortland and its subsidiaries for the 2011 and the 2010 fiscal years were pre-approved by the Audit Committee.

Auditor Independence. The Audit Committee believes that the non-audit services provided by S.R. Snodgrass, A.C. are compatible with maintaining the auditor's independence. To the best of Cortland's knowledge, none of the time devoted by S.R. Snodgrass, A.C. on its engagement to audit Cortland's financial statements for the year ended December 31, 2011, is attributable to work performed by persons other than full-time, permanent employees of S.R. Snodgrass, A.C.

Cortland's Code of Regulations do not require the submission of the selection of independent auditors to shareholders for approval. However, the Board believes it is appropriate to give shareholders the opportunity to ratify the decision of the Audit Committee to appoint S.R. Snodgrass, A.C. as Cortland's principal accountant. Neither the Audit Committee nor the Board will be bound by the shareholders' vote at the Annual Meeting, but may take the shareholders' vote into account in future determinations regarding the retention of an independent auditor.

Recommendation and Vote

The Board recommends a vote <u>FOR</u> ratification of the appointment of S.R. Snodgrass, A.C. as Cortland's independent auditor for the fiscal year ending December 31, 2012.

AUDIT COMMITTEE MATTERS

Audit Committee Report for the Fiscal Year Ended December 31, 2011

The Audit Committee has reviewed the audited financial statements for the year ended December 31, 2011, and has discussed the audited financial statements with management. The Audit Committee has also discussed with S.R. Snodgrass, A.C., Cortland's independent registered public accounting firm, the matters required to be discussed by Statement on Auditing Standards No. 61 (having to do with accounting methods used in the financial statements). The Audit Committee has received the written disclosures and the letter from S.R. Snodgrass, A.C. required by Independence Standards Board Standard No. 1 (having to do with matters that could affect the independent registered accounting firm's independence), and has discussed with S.R. Snodgrass, A.C. the independent registered accounting firm's independence. Based on this, the Audit Committee recommended to the Board that Cortland's audited consolidated financial statements be included in Cortland's Annual Report on Form 10-K for the fiscal year ended December 31, 2011, for filing with the Securities and Exchange Commission.

Submitted by the Audit Committee

David C. Cole, Neil J. Kaback, and Richard B. Thompson

SUBMISSION OF SHAREHOLDER PROPOSALS

If any Cortland shareholder wishes to submit a proposal to be included in next year's proxy statement and acted upon at Cortland's annual meeting to be held in 2013, the proposal must be received by Cortland's Secretary prior to the close of business on December 7, 2012. Upon receipt of a shareholder proposal, Cortland will determine whether or not to include the proposal in the proxy materials in accordance with applicable SEC Rules.

If a shareholder intends to present a proposal at the 2013 annual meeting, but has not sought the inclusion of such proposal in Cortland's proxy materials, such proposal must be received by the Secretary of Cortland prior to February 20, 2013, or the management proxies for the 2013 annual meeting will be entitled to use their discretionary voting authority, should such proposal then be raised, without any discussion of the matter in Cortland's proxy material.

DELIVERY OF PROXY MATERIALS TO SHAREHOLDERS SHARING AN ADDRESS

SEC rules provide for "householding," which permits Cortland to send a single annual report and a single proxy statement to any household at which two or more different shareholders reside if Cortland believes such shareholders are members of the same family or otherwise share the same address or in which one shareholder has multiple accounts, if in each case such shareholder(s) have not opted out of the householding process. Each shareholder would continue to receive a separate notice of any meeting of shareholders and a separate proxy card. The householding procedure reduces the volume of duplicate information that shareholders may receive and reduces Cortland's expense. Cortland may institute householding in the future, and will notify those registered shareholders who will be affected by householding at that time.

Many brokerage firms and other holders of record have instituted householding. If your family has one or more "street name" accounts under which you beneficially own common shares of Cortland, you may have received householding information from your broker, bank, or other nominee in the past. Please contact the holder of record directly if you have any questions, require additional copies of the proxy statement or our annual report to shareholders for the 2011 fiscal year, or to revoke your consent to household and, thereby, receive multiple copies once again. These options are available to you at any time.

OTHER BUSINESS

As of the date of this proxy statement, the Board knows of no other matters that will be presented for action at the annual meeting other than those discussed in this proxy statement. If any other business should properly arise, the persons acting under the proxies solicited by the Board have the discretionary authority to vote in accordance with their best judgement.

By Order of the Board of Directors,

Timothy Carney
Secretary
April 6, 2012

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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-K

(Mark One)

☑ **ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the fiscal year ended December 31, 2011

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

Commission File Number 0-13814

CORTLAND BANCORP

(Exact Name of Registrant as Specified in its Charter)

Ohio	**34-1451118**
(State or Other Jurisdiction of Incorporation or Organization)	(I.R.S. Employer Identification No.)
194 West Main Street, Cortland, Ohio	**44410**
(Address of Principal Executive Offices)	(Zip Code)

Registrant's telephone number, including area code: (330) 637-8040
Securities registered pursuant to Section l2(b) of the Act: None
Securities registered pursuant to Section l2(g) of the Act:
Common Stock, no par value
(Title of Class)

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. ☐ Yes ☑ No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. ☐ Yes ☑ No

Indicate by check mark whether the registrant (l) has filed all reports required to be filed by Section l3 or l5(d) of the Securities Exchange Act of l934 during the preceding l2 months (or for such shorter period that the registrant was required to file such reports) and (2) has been subject to such filing requirements for the past 90 days. ☑ Yes ☐ No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Website, if any, every Interactive Data File required to be submitted an posted pursuant to Rule405 of Regulation S-T(§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). ☑ Yes ☐ No

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K (§232.405 of this chapter) is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of the Form 10-K or any amendment to this Form 10-K. ☐

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

Large accelerated filer ☐	Accelerated filer ☐
Non-accelerated filer ☐ (Do not check if a smaller reporting company)	Smaller reporting company ☑

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

Based upon the closing price of the registrant's common stock of June 30, 2011, the aggregate market value of the voting stock held by non-affiliates of the registrant was approximately $29,478,912. For purposes of this response, directors and executive officers are considered the affiliates of the issuer at that date.

The number of shares outstanding of the issuer's classes of common stock as of March 22, 2012: 4,525,528 shares.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the Proxy Statement for the 2012 Annual Meeting of Shareholders to be held on May 22, 2012 are incorporated by reference into Part III.

Form 10-K for the Year Ended December 31, 2011
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PART I

Item l. Business

THE CORPORATION

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. 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 (Federal Reserve). As of December 31, 2011, the Bank was rated "satisfactory" for Community Reinvestment Act (CRA) purposes, and remained well capitalized.

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. The Company operates as a single line of business.

NEW RESOURCES LEASING CO.

New Resources Leasing Co. was formed in December 1987 under Ohio law as a separate entity to handle the function of commercial and consumer leasing. The wholly owned subsidiary has been inactive since incorporation.

CORTLAND BANKS

Cortland Banks is a full service, state chartered bank engaged in commercial and retail banking. 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. Commercial lending includes commercial, financial and agricultural loans, real estate construction and development loans, commercial real estate loans, small business lending and trade financing. Consumer lending includes residential real estate, home equity and installment lending. Cortland Banks also offers a variety of Internet banking options.

Business is conducted at a total of fourteen 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; two are located in the communities of Boardman and North Lima in Mahoning County, Ohio and one in Middlefield in Geauga County, Ohio.

The Bank's main administrative and banking office is located at 194 West Main Street, Cortland, Ohio. The Hubbard, Niles Park Plaza, Victor Hills and Middlefield 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, is subject to periodic examination and regulation by both the Federal Reserve and the State of Ohio Division of Financial Institutions (Ohio Division). 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). The FDIC announced that effective December 31, 2010, it will insure all

non-interest bearing transaction accounts through December 31, 2012. Insured depository institutions can no longer opt-out of this coverage. This coverage is in addition to, and separate from, the coverage of at least $250,000 available to depositors under the FDIC's general deposit insurance rules.

CSB MORTGAGE COMPANY, INC.

CSB Mortgage Company, Inc. was formed as an Ohio corporation in December 2011. It is a wholly-owned subsidiary of Cortland Banks and will function as the originator of wholesale mortgage loans and the seller of company-wide mortgage loans in the secondary mortgage market. The operations of the newly-formed subsidiary will be conducted at the Bank's main office at 194 West Main Street, Cortland, Ohio.

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, 2011, the Company, through Cortland Banks, employed 140 full-time and 26 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.

GENERAL LENDING POLICY

Cortland Banks has obligations to the communities that it serves. The Bank's lending policy is designed to provide a framework which will meet the credit needs and interests of the community and the bank.

It is the Bank's objective to make loans to credit-worthy customers which benefit their interests. Loans made by the Bank are subject to the guidelines established in the loan policy that is approved by the Bank's Board of Directors.

Cortland Banks has community banks in five Ohio counties: Trumbull, Portage, Ashtabula, Mahoning and Geauga. There are times when the Bank will go beyond its lending territory to accommodate people who have been customers of the bank and have moved out of the lending area. There are also times when excess funds are available and it is profitable to participate in loans with other banks or to participate in large projects for community development.

Each lending relationship is reviewed and graded in 6 categories which are (1) ability to pay, (2) financial condition, (3) management ability, (4) collateral and guarantors, (5) loan structure, and (6) industry and economic.

Further information can be found in Management's Discussion and Analysis of Financial Condition and Results of Operations, Item 7.

SUPERVISION AND REGULATION

The Company and the Bank are subject to Federal and state banking laws that are intended to protect depositors, not shareholders. Changes in Federal and state banking laws, including statutes, regulations, and policies of the bank regulatory agencies, could have a material adverse impact on our business and prospects. Federal and state laws applicable to holding companies and their financial institution subsidiaries regulate the range of permissible business activities, investments, reserves against deposits, capital levels, lending activities and practices, the nature and amount of collateral for loans, establishment of branches, mergers, dividends, and a variety of other important matters. The Company and the Bank are subject to detailed, complex, and sometimes overlapping Federal and state statutes and regulations affecting routine banking operations. These statutes and regulations include, but are not limited to, state usury and consumer credit laws, the Truth-in-Lending Act and Regulation Z, the Equal Credit Opportunity Act and Regulation B, the Fair Credit Reporting Act, the Truth in Savings Act, and the Community Reinvestment Act. In addition to minimum capital requirements, Federal law imposes other safety and soundness standards having to do with such things as internal controls, information systems, internal audit systems, loan documentation, credit underwriting, interest rate risk exposure, asset growth, asset quality, earnings, and compensation and benefits. The discussion to follow of bank supervision and regulation is qualified in its entirety by reference to the statutory and regulatory provisions discussed.

The Company is a bank holding company within the meaning of the Bank Holding Company Act of 1956. As such, the Company is subject to regulation, supervision, and examination by the Federal Reserve, acting primarily through the Federal Reserve Bank of Cleveland. The Company is required to file annual reports and other information with the Federal Reserve. The Bank is subject to regulation and supervision by the Ohio Division. As a member bank of the Federal Reserve, the Bank is also subject to regulation and supervision by the Federal Reserve. The Bank is examined periodically by the Federal Reserve and by the Ohio Division to test compliance with various regulatory requirements. If as a result of examination the Federal Reserve or the Ohio Division determines that a bank's financial condition, capital resources, asset quality, earnings prospects, management, liquidity, or other aspects of the bank's operations are unsatisfactory, or that the bank or its management is in violation of any law or regulation, the bank regulatory agencies may take a number of remedial actions. Bank regulatory agencies make regular use of their authority to take formal and informal supervisory actions against banks and bank holding companies for unsafe or unsound practices in the conduct of their businesses and for violations of any law, rule, or regulation, or any condition imposed in writing by the appropriate Federal banking regulatory authority. Potential supervisory and enforcement actions include appointment of a conservator or receiver, issuance of a cease-and-desist order that could be judicially enforced, termination of a bank's deposit insurance, imposition of civil money penalties, issuance of directives to increase capital, entry into formal or informal agreements, including memoranda of understanding, issuance of removal and prohibition orders against institution- affiliated parties, and enforcement of these actions through injunctions or restraining orders.

The Company has been informed by its bank regulatory agencies, which provide regulatory oversight to the Company and the Bank, that the Company has fulfilled the terms of the informal assurances given to the agencies back in 2009.

Summarized in the Company's annual reports and quarterly reports filed with the SEC since the informal assurances were first given to the Company's Federal and state supervisory agencies in 2009, the Company and the Bank had agreed to obtain regulatory approval in order to incur debt, repurchase stock, or pay dividends, as well as agreeing to submit a plan to strengthen and improve management of the overall risk exposure of the investment portfolio, a plan to maintain an adequate capital position, a plan to strengthen board oversight of the management and operations, and a plan to improve the Bank's earnings and overall condition.

Regulation of bank holding companies. A bank holding company must serve as a source of financial and managerial strength for its subsidiary banks and must not conduct operations in an unsafe or unsound manner. The Federal Reserve requires all bank holding companies to maintain capital at or above prescribed levels.

Federal Reserve policy requires that a bank holding company provide capital to its subsidiary banks during periods of financial stress or adversity and that the bank holding company maintain the financial flexibility and capital-raising capacity to obtain additional resources for assisting subsidiary banks. Bank holding companies may also be required to give written notice to and receive approval from the Federal Reserve before purchasing or redeeming common stock or other equity securities.

Acquisitions. The Bank Holding Company Act requires every bank holding company to obtain approval of the Federal Reserve to—acquire ownership or control of any voting shares of another bank or bank holding company, if after the acquisition the acquiring company would own or control more than 5% of the shares of the other bank or bank holding company (unless the acquiring company already owns or controls a majority of the shares),— acquire all or substantially all of the assets of another bank, or—merge or consolidate with another bank holding company.

The Federal Reserve will not approve an acquisition, merger, or consolidation that would have a substantially anticompetitive result unless the anticompetitive effects of the proposed transaction are clearly outweighed by a greater public interest in satisfying the convenience and needs of the community to be served. When the Federal Reserve reviews merger and acquisition applications it also considers capital adequacy and other financial and managerial factors, along with the subsidiary banks' performance under the Community Reinvestment Act of 1977. Approval of the Ohio Division is also necessary to acquire control of an Ohio-chartered bank.

The Bank Holding Company Act, the Change in Bank Control Act, and the Federal Reserve Regulation Y require advance approval of the Federal Reserve to acquire "control" of a bank holding company. Control is conclusively presumed to exist if an individual or company acquires 25% or more of a class of voting securities of the bank holding company. If the holding company has securities registered under section 12 of the Securities Exchange Act of 1934, as the Company does, or if no other person owns a greater percentage of the class of voting securities, control is presumed to exist if a person acquires 10% or more, but less than 25%, of any class of voting securities. Guidance issued by the Federal Reserve in September 2008 states that generally the Federal Reserve will be able to conclude that an investor does not have a controlling influence over a bank or bank holding company if the investor does not own more than 15% of the voting power and 33% of the total equity of the bank or bank holding company, including nonvoting equity securities. The investor may, however, be required to make passivity commitments to the Federal Reserve, promising to refrain from taking various actions that might constitute exercise of a controlling influence. Under prior Federal Reserve guidance, a board seat was generally not permitted for an investment of 10% or more of the equity or voting power without a determination that the investor was in control of the bank holding company. But, under the September 2008 guidance, the Federal Reserve may permit a non- controlling investor to have a board seat.

Under the Bank Merger Act, advance approval of the appropriate Federal bank regulatory agency is necessary for the acquisition of a bank by merger. For this purpose, the term merger is defined very broadly, including not only whole bank acquisitions by statutory merger but also acquisitions by one bank of some or all of the branches of another bank or assumption by one bank of some or all of the deposits of another bank. Under Ohio Revised Code Chapter 1115, approval of the Ohio Division is also necessary for the acquisition of an Ohio-chartered bank, whether by merger or otherwise.

Interstate banking and branching. Section 613 of the Dodd-Frank Wall Street Reform and Consumer Protection Act enacted in July 2010 amends the interstate branching provisions of the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994. The amendments authorize a state or national bank to open a de novo branch in another state if the law of the state where the branch is to be located would permit a bank chartered by that state to open the branch. Under prior law, an out-of state bank could open a de novo branch in another state if and only if the particular state permitted out-of-state banks to establish a de novo branch. Section 607 of the Dodd-Frank Act also increases the approval threshold for interstate bank acquisitions, requiring that a bank holding company be well capitalized and well managed as a condition to approval of an interstate bank acquisition, rather than being merely adequately capitalized and adequately managed, and that an acquiring bank be and remain well capitalized and well managed as a condition to approval of an interstate bank merger.

Nonbanking activities. With some exceptions, the Bank Holding Company Act has for many years prohibited a bank holding company from acquiring or retaining direct or indirect ownership or control of more than 5% of the voting shares of any company that is not a bank or bank holding company or from engaging directly or indirectly in activities other than those of banking, managing or controlling banks, or providing services for its subsidiaries. The principal exceptions to these prohibitions involve non-bank activities that, by statute or by Federal Reserve regulation or order, are held to be closely related to the business of banking or of managing or controlling banks. In its determination about whether a particular activity is closely related to the business of banking, the Federal Reserve considers whether the performance of the activities by a bank holding company can be expected to produce benefits to the public—such as greater convenience, increased competition, or gains in efficiency in resources—that will outweigh the risks of possible adverse effects such as decreased or unfair competition, conflicts of interest, or unsound banking practices. Some of the activities determined by Federal Reserve regulation to be closely related to the business of banking are: making or servicing loans or leases; engaging in insurance and discount brokerage activities; owning thrift institutions; performing data processing services; acting as a fiduciary or investment or financial advisor; and making investments in corporations or projects designed primarily to promote community welfare. Under Bank Holding Company Act section 5(e), the Federal Reserve may require a bank holding company to terminate any activity or relinquish control of a nonbank subsidiary if the Federal Reserve determines that the activity or control constitutes a serious risk to the financial safety, soundness, or stability of a subsidiary bank.

Capital. *Risk-based capital requirements*. Capital hedges risk, absorbing losses that can be predicted as well as losses that cannot be. According to the Federal Financial Institutions Examination Council's explanation of the capital component of the Uniform Financial Institutions Rating System, commonly known as the "CAMELS" rating system, a rating system employed by the Federal bank regulatory agencies, a financial institution must "maintain capital commensurate with the nature and extent of risks to the institution and the ability of management to identify, measure, monitor, and control these risks. The effect of credit, market, and other risks on the institution's financial condition should be considered when evaluating the adequacy of capital." The minimum ratio of total capital to risk-weighted assets is 8.0%, of which at least 4.0% must consist of so-called Tier 1 capital. The minimum Tier 1 leverage ratio—Tier 1 capital to average assets—is 3.0% for the highest rated institutions and at least 4.0% for all others. These ratios are absolute minimums. In practice, banks are expected to operate with more than the absolute minimum capital. The Federal Reserve may establish greater minimum capital requirements for specific institutions. Failure to satisfy capital guidelines could subject a banking institution to a variety of enforcement actions by Federal bank regulatory authorities, including the termination of deposit insurance by the FDIC and a prohibition on the acceptance of so-called brokered deposits. A bank that does not achieve and maintain the required capital levels may be issued a capital directive to ensure the maintenance of required capital levels.

Also known as core capital, Tier 1 capital consists of common shareholders' equity, non-cumulative perpetual preferred stock, and minority interests in certain subsidiaries, less most intangible assets. Tier 2 capital, also known as supplementary capital, consists of preferred stock not qualifying as Tier 1 capital, limited amounts of subordinated debt, other qualifying term debt, a limited amount of the allowance for loan and lease losses (up to a maximum of 1.25% of risk-weighted assets), and certain other instruments that have some characteristics of equity. To determine risk-weighted assets, the nominal dollar amounts of assets on the balance sheet and credit-equivalent amounts of off-balance-sheet items are multiplied by one of several risk adjustment percentages, such as 0.0% for assets considered to have low credit risk, for example cash and certain U.S. government securities, 100.0% for assets with relatively higher credit risk, such as business loans, or a risk weight exceeding 100% for selected investments that are rated below investment grade or, if not rated, that are equivalent to investments rated below investment grade. A banking organization's risk-based capital ratios are obtained by dividing its Tier 1 capital and total qualifying capital (Tier 1 capital and a limited amount of Tier 2 capital) by its total risk-adjusted assets. The Federal Reserve may also employ a market risk component in its calculation of capital requirements for nonmember banks engaged in significant trading activity. The market risk component could require additional capital for general or specific market risk of trading portfolios of debt and equity securities and other investments or assets. The Federal Reserve's evaluation of an institution's capital adequacy takes account

of a variety of other factors, including, among others, interest rate risks to which the institution is subject, the level and quality of an institution's earnings, loan and investment portfolio characteristics, and risks arising from the conduct of nontraditional activities. Accordingly, the Federal Reserve's final supervisory judgment concerning an institution's capital adequacy could differ significantly from the conclusions that might be derived from the absolute level of an institution's risk-based capital ratios. Therefore, institutions generally are expected to maintain risk-based capital ratios that exceed the minimum ratios. This is particularly true for institutions contemplating significant expansion plans and institutions that are subject to high or inordinate levels of risk.

The Federal Reserve employs similar risk-based capital guidelines in the regulation of bank holding companies and financial institutions. If capital falls below the minimum levels established by the guidelines, the bank holding company or bank may be denied approval to acquire or establish additional banks or non-bank businesses or to open new facilities. In general, bank holding companies are required to maintain the same capital ratios as banks, which is a minimum ratio of total capital to risk-weighted assets of 8% and Tier 1 capital of at least 4%. Bank holding companies are also subject to a leverage ratio requirement. The minimum required leverage ratio for the very highest rated companies is 3%, but as a practical matter the minimum required leverage ratio for most bank holding companies is 4% or higher. Bank holding companies also must serve as a source of strength for their subsidiary banking institutions. Under Bank Holding Company Act section 5(e), the Federal Reserve may require a bank holding company to terminate any activity or relinquish control of a nonbank subsidiary if the Federal Reserve determines that the activity or control constitutes a serious risk to the financial safety, soundness, or stability of a subsidiary bank.

Prompt corrective action. Every institution is classified into one of five categories, depending on the institution's total risk-based capital ratio, Tier 1 risk-based capital ratio, leverage ratio, and subjective factors. The categories are "well capitalized," "adequately capitalized," "undercapitalized," "significantly undercapitalized," and "critically undercapitalized." Capital ratios as of December 31, 2011 are as follows:

	(Amounts in thousands)			
	Cortland Bancorp		The Cortland Savings & Banking Company	
	Amount	Ratio	Amount	Ratio
Total capital to risk-weighted assets				
Actual	$54,881	14.18%	$52,261	13.59%
For capital adequacy purposes	30,967	8.00%	30,756	8.00%
To be well capitalized	38,709	10.00%	38,445	10.00%
Tier 1 capital to risk-weighted assets				
Actual	51,739	13.37%	43,119	11.22%
For capital adequacy purposes	15,484	4.00%	15,378	4.00%
To be well capitalized	23,225	6.00%	23,067	6.00%
Tier 1 leverage capital				
Actual	51,739	10.47%	43,119	8.79%
For capital adequacy purposes	19,768	4.00%	19,644	4.00%
To be well capitalized	24,711	5.00%	24,555	5.00%

An institution with a capital level that might qualify for well capitalized or adequately capitalized status may nevertheless be treated as though the institution is in the next lower capital category if the institution's primary Federal banking supervisory authority determines that an unsafe or unsound condition or practice warrants that treatment. A financial institution's operations can be significantly affected by the bank's capital classification under the prompt corrective action rules. For example, an institution that is not well capitalized generally is prohibited from accepting brokered deposits and offering interest rates on deposits higher than the prevailing rate in its market without advance regulatory approval. These deposit-funding limitations can have an adverse effect on the bank's liquidity. At each successively lower capital category an insured depository institution is subject to additional restrictions. Undercapitalized institutions are required to take specified actions to increase their capital or otherwise decrease the risks to the federal deposit insurance fund. Bank regulatory agencies generally are

required to appoint a receiver or conservator within 90 days after an institution becomes critically undercapitalized, with a leverage ratio of less than 2%. Section 38(f)(2)(I) of the Federal Deposit Insurance Act provides that a Federal bank regulatory authority may require a bank holding company to divest itself of an undercapitalized bank subsidiary if the agency determines that divestiture will improve the bank's financial condition and prospects.

A bank holding company must guarantee that a subsidiary bank that adopts a capital restoration plan will satisfy plan obligations. Any capital loans made by a bank holding company to a subsidiary bank are subordinated to the claims of depositors in the bank and to certain other indebtedness of the subsidiary bank. If bankruptcy of a bank holding company occurs, any commitment by the bank holding company to a Federal banking regulatory agency to maintain the capital of a subsidiary bank would be assumed by the bankruptcy trustee and would be entitled to priority of payment.

Federal deposit insurance. Deposits in the Bank are insured by the FDIC to applicable limits through the Deposit Insurance Fund. Insured banks must pay deposit insurance premiums assessed semiannually and paid quarterly. The insurance premium amount is based upon a risk classification system established by the FDIC. Banks with higher levels of capital and a low degree of supervisory concern are assessed lower premiums than banks with lower levels of capital or a higher degree of supervisory concern. Effective January 1, 2009, the FDIC increased assessment rates uniformly for all risk categories by 7 cents for the first quarter 2009 assessment period. In 2009, the FDIC adopted a rule that imposed a special assessment on banks payable in September 2009 and that allowed the FDIC to impose additional special assessments to replenish the Deposit Insurance Fund, which was badly depleted by bank failures. As an alternative to imposing additional special assessments on insured depository institutions or borrowing from the U.S. Treasury, on November 12, 2009, the FDIC adopted a proposal to increase deposit insurance assessments effective on January 1, 2011, and to require all insured depository institutions to prepay by the end of 2009 their deposit insurance assessments for the fourth quarter of 2009 and for the entirety of 2010 through 2012. Institutions recorded the prepaid FDIC insurance assessments as an asset as of December 31, 2009, later charging the assessments to expense in the periods to which the assessments apply. The Company and the Bank anticipate that assessment rates will continue to increase for the foreseeable future because of the significant cost of bank failures, because of the relatively large number of troubled banks, and because of the requirement of the recently enacted Dodd-Frank Act that the FDIC increase its insurance fund reserves to no less than $1.35 for each $100,000 of insured deposits (as of September 30, 2010, the reserve fund was ($0.15) for each $100,000 of insured deposits).

On November 9, 2010, the FDIC proposed to change its assessment base from total domestic deposits to average total assets minus average tangible equity, and was approved February 7, 2011, as required in the Dodd-Frank Act. The new assessment base became applicable in the second quarter of 2011, but the FDIC does not expect that the change in assessment base will change the deposit insurance premium revenue raised.

The $100,000 basic deposit insurance limit in place for many years was increased temporarily to $250,000 by the Emergency Economic Stabilization Act of 2008. On July 21, 2010, the Dodd-Frank Act made the $250,000 insurance limit permanent.

The FDIC may terminate the deposit insurance of any insured depository institution if the FDIC determines that the institution has engaged or is engaging in unsafe or unsound practices, is in an unsafe or unsound condition to continue operations, or has violated any applicable law, regulation, order, or any condition imposed in writing by or written agreement with the FDIC.

Selected regulations. *Transactions with affiliates*. The Bank must comply with section 23A and section 23B of the Federal Reserve Act, establishing rules for transactions by member banks with affiliates. These statutes protect banks from abuse in financial transactions with affiliates, preventing insured deposits from being diverted to support the activities of unregulated entities engaged in nonbanking businesses. Affiliate-transaction limits could impair a holding company's ability to obtain funds from the bank subsidiary for the holding company's cash needs, including funds for payment of dividends, interest, and operational expenses. Affiliate transactions

include, but are not limited to, extensions of credit to affiliates, investments in securities issued by affiliates, the use of affiliates' securities as collateral for loans to any borrower, and purchase of affiliate assets. An affiliate of a bank includes any company or entity that controls or is under common control with the bank. Generally, section 23A and section 23B of the Federal Reserve Act (1) limit the extent to which a bank or its subsidiaries may lend to or engage in various other kinds of transactions with any one affiliate to an amount equal to 10% of the institution's capital and surplus (2) limit the aggregate of covered transactions with all affiliates to 20% of capital and surplus, (3) impose strict collateral requirements on loans or extensions of credit by a bank to an affiliate, (4) impose restrictions on investments by a subsidiary bank in the stock or securities of its holding company, (5) impose restrictions on the use of a holding company's stock as collateral for loans by the subsidiary bank, and (6) require that affiliate transactions be on terms substantially the same as those provided to a non-affiliate.

Loans to insiders. The authority of the Bank to extend credit to insiders –meaning executive officers, directors, and greater than 10% shareholders—or to entities those persons control, is subject to section 22(g) and section 22(h) of the Federal Reserve Act and Regulation O of the Federal Reserve. These laws require that insider loans be made on terms substantially similar to those offered to unaffiliated individuals, place limits on the amount of loans a bank may make to insiders based in part on the bank's capital position, and require that specified approval procedures be adhered to. Loans to an individual insider may not exceed the Federal legal limit on loans to any one borrower, which in general terms is 15% of capital but can be higher in some circumstances. And the aggregate of all loans to all insiders may not exceed the bank's unimpaired capital and surplus. Insider loans exceeding the greater of 5% of capital or $25,000 must be approved in advance by a majority of the board, with any interested director not participating in the voting. Loans to executive officers are subject to special limitations. Executive officers may borrow in unlimited amounts to finance their children's education or to finance the purchase or improvement of their residence, but they may borrow no more than $100,000 for most other purposes. Loans to executive officers exceeding $100,000 may be allowed if the loan is fully secured by government securities or a segregated deposit account. A violation of these restrictions could result in the assessment of substantial civil monetary penalties, the imposition of a cease-and-desist order, or other regulatory sanctions.

Loans to one borrower. Under Ohio law, the total loans and extensions of credit by an Ohio-chartered bank to a person outstanding at any time generally may not exceed 15% of the bank's unimpaired capital, plus 10% of unimpaired capital for loans and extensions of credit fully secured by readily marketable collateral.

Dividends and Distributions. Shareholders of an Ohio corporation are entitled to dividends when, as, and if declared by the corporation's board of directors. This principle of Ohio Corporate Law applies both to the Company and the Bank. Future dividends will be payable at the discretion of the board of directors and will depend on our earnings, financial condition, results of operations, business prospects, capital requirements, regulatory restrictions, and other factors that the board of directors may deem relevant. A 1985 policy statement of the Federal Reserve declared that a bank holding company should not pay cash dividends on common stock unless the organization's net income for the past year is sufficient to fully fund the dividends and the prospective rate of earnings retention appears consistent with the organization's capital needs, asset quality, and overall financial condition. A bank holding company also must serve as a source of strength to its subsidiary banks, which could mean capital must be retained for further investments in subsidiary banks rather than being paid as dividends to stockholders.

The Company's ability to obtain funds for the payment of cash dividends and for other cash requirements depends on the amount of dividends that may be paid by the Bank to the Company. Under Ohio law, a dividend may be declared by a bank from surplus, meaning additional paid-in capital, with the approval of (x) the Ohio Division and (y) the holders of two-thirds of the bank's outstanding shares. Superintendent approval is also necessary for payment of a dividend if the total of all cash dividends in a year exceeds the sum of (x) net income for the year and (y) retained net income for the two preceding years. According to the Federal Reserve, it is a prudent banking practice to continue paying cash dividends if and only if the bank or holding company's net income over the past year is sufficient to fully fund the dividends and if the prospective rate of earnings retention

is consistent with the organization's capital needs, asset quality, and overall financial condition. Relying on 12 U.S.C. 1818(b), the Federal Reserve may restrict a member bank's ability to pay a dividend if the Federal Reserve has reasonable cause to believe that the dividend would constitute an unsafe and unsound practice. A bank's ability to pay dividends may be affected also by the Federal Reserve's capital maintenance requirements and prompt corrective action rules. A bank may not pay a dividend if the bank is undercapitalized or if payment would cause the bank to become undercapitalized. Moreover, regulatory authorities may prohibit banks and bank holding companies from paying dividends if payment of dividends would constitute an unsafe and unsound banking practice.

A bank holding company may not purchase or redeem its equity securities without advance written approval of the Federal Reserve under Federal Reserve Rule 225.4(b) if the purchase or redemption, when combined with all other purchases and redemptions by the bank holding company during the preceding 12 months equals or exceeds 10% of the bank holding company's consolidated net worth. However, advance approval is not necessary if the bank holding company is well managed, is not the subject of any unresolved supervisory issues, and both before and immediately after the purchase or redemption is well capitalized.

Guidance concerning commercial real estate lending. In December 2006, the Federal banking agencies issued final guidance concerning sound risk management practices for concentrations in commercial real estate lending, including acquisition and development lending, construction lending, and other land loans. Recent experience has shown that these forms of lending can be particularly high risk. According to a 2009 FDIC publication, a majority of the community banks that became problem banks or failed in 2008 had similar risk profiles: the banks often had extremely high concentrations in residential acquisition, development, and construction lending relative to their capital, the loan underwriting and credit administration functions at these institutions typically were criticized by examiners, and many of the institutions had exhibited rapid asset growth funded with brokered deposits.

The commercial real estate risk management guidance does not impose rigid limits on commercial real estate lending but does create a much sharper supervisory focus on the risk management practices of banks with concentrations in commercial real estate lending. According to the guidance, an institution that has experienced rapid growth in commercial real estate lending, has notable exposure to a specific type of commercial real estate, or is approaching or exceeds the following supervisory criteria may be identified for further supervisory analysis of the level and nature of its commercial real estate concentration risk –total reported loans for construction, land development, and other land represent 100% or more of the institution's total capital, or -total commercial real estate loans represent 300% or more of the institution's total capital and the outstanding balance of the institution's commercial real estate loan portfolio has increased by 50% or more during the prior 36 months.

These measures are intended merely to enable the banking agencies to quickly identify institutions that could have an excessive commercial real estate lending concentration, potentially requiring close supervision to ensure that the institutions have sound risk management practices in place. Conversely, these measures do not imply that banks are authorized by the December 2006 guidance to accumulate a commercial real estate lending concentration up to the 100% and 300% thresholds.

Developments affecting management and corporate governance. In June 2010, the Federal banking agencies jointly published their final Guidance on Sound Incentive Compensation Policies. The goal is to enable financial organizations to manage the safety and soundness risks of incentive compensation arrangements and to assist them with identification of improperly structured compensation arrangements. To ensure that incentive compensation arrangements do not encourage employees to take excessive risks that undermine safety and soundness, the incentive compensation guidance sets forth these key principles – -incentive compensation arrangements should provide employees incentives that appropriately balance risk and financial results in a manner that does not encourage employees to expose the organization to imprudent risk, -these arrangements should be compatible with effective controls and risk management, and -these arrangements should be supported by strong corporate governance, including active and effective oversight by the board of directors.

To implement the interagency guidance, a financial organization must regularly review incentive compensation arrangements for all executive and non-executive employees who, either individually or as part of a group, have the ability to expose the organization to material amounts of risk, as well as to regularly review the risk-management, control, and corporate governance processes related to these arrangements. The organization must immediately correct any identified deficiencies in compensation arrangements or processes that are inconsistent with safety and soundness and must ensure that incentive compensation arrangements are consistent with the principles discussed in the guidance.

In addition to numerous provisions that affect the business of banks and bank holding companies, the Dodd-Frank Act includes a number of provisions affecting corporate governance and executive compensation. The corporate governance and compensation provisions include: (1) a requirement that public companies solicit a Say-on-Pay vote, a Say-on-Frequency vote and, in the event of a merger or other extraordinary transaction, a Say-on-Golden Parachute vote; (2) requirements that the SEC adopt rules directing the securities exchanges to adopt listing standards with respect to compensation committee independence and the use of consultants; (3) provisions calling for the SEC to adopt expanded disclosure requirements for the annual proxy statement and other filings, particularly in the area of executive compensation; and (4) provisions that will require the adoption or revision of certain other policies, such as compensation recovery policies providing for the recovery of executive compensation in the event of a financial restatement. The SEC and the stock exchanges are working to adopt a number of new rules and standards in order to implement the requirements of the Dodd-Frank Act discussed above. On January 25, 2011, the SEC adopted rules for implementing Say-on-Pay and the related advisory note on executive compensation provisions. The new rules and amendments to existing rules became effective on April 4, 2011, except that the Say-on-Golden Parachute requirements became effective for filings made on or after April 25, 2011, for all issuers. The new guidelines adopted under the Dodd-Frank Act could impose additional compliance burdens beyond those already imposed by the Federal bank regulatory agency guidelines.

Consumer protection laws and regulations. Banks are subject to regular examination to ensure compliance with Federal statutes and regulations applicable to their business, including consumer protection statutes and implementing regulations, some of which are discussed below. Potential penalties under these laws include, but are not limited to, fines.

Community Reinvestment Act. Under the Community Reinvestment Act of 1977 (the "CRA") and implementing regulations of the Federal banking agencies, a financial institution has a continuing and affirmative obligation—consistent with safe and sound operation—to fulfill the credit needs of its entire community, including low- and moderate-income neighborhoods. But the CRA does not establish specific lending requirements nor does the CRA limit an institution's discretion to develop the types of products and services the institution believes are best suited to the community. The CRA requires that bank regulatory agencies conduct regular CRA examinations and provide written evaluations of institutions' CRA performance. The CRA also requires that an institution's CRA performance rating be made public. CRA performance evaluations are based on a four-tiered rating system: Outstanding, Satisfactory, Needs to Improve, and Substantial Noncompliance. Although CRA examinations occur regularly, CRA performance evaluations are used principally in the evaluation of regulatory applications submitted by an institution. Federal bank regulatory agencies consider CRA performance evaluations when they evaluate applications for such things as mergers, acquisitions, and applications to open branches. The Bank's CRA performance rating is "satisfactory," according to the evaluation dated October 17, 2011.

Equal Credit Opportunity Act. The Equal Credit Opportunity Act generally prohibits discrimination in any credit transaction, whether for consumer or business purposes, on the basis of race, color, religion, national origin, sex, marital status, age (except in limited circumstances), receipt of income from public assistance programs, or good faith exercise of any rights under the Consumer Credit Protection Act.

Truth in Lending Act. The Truth in Lending Act is designed to ensure that credit terms are disclosed in a meaningful way so that consumers may compare credit terms more readily and knowledgeably. As a result of the

Truth in Lending Act, all creditors must use the same credit terminology to express rates and payments, including the annual percentage rate, the finance charge, the amount financed, the total of payments, and the payment schedule, among other things.

Fair Housing Act. The Fair Housing Act makes it unlawful for any lender to discriminate in its housing-related lending activities against any person because of race, color, religion, national origin, sex, handicap, or familial status. A number of lending practices have been held by the courts to be illegal under the Fair Housing Act, including some practices that are not specifically mentioned in the Fair Housing Act.

Home Mortgage Disclosure Act. The Home Mortgage Disclosure Act arose out of public concern over credit shortages in urban neighborhoods. The Home Mortgage Disclosure Act requires financial institutions to collect data that enable regulatory agencies to determine whether the financial institutions are serving the housing credit needs of the neighborhoods and communities in which they are located. The Home Mortgage Disclosure Act also requires the collection and disclosure of data about applicant and borrower characteristics as a way to identify possible discriminatory lending patterns. The vast amount of information that financial institutions collect and disclose concerning applicants and borrowers receives attention not only from state and Federal banking supervisory authorities but also from community-oriented organizations and the general public.

Real Estate Settlement Procedures Act. The Real Estate Settlement Procedures Act requires that lenders provide borrowers with disclosures regarding the nature and cost of real estate settlements. The Real Estate Settlement Procedures Act also prohibits abusive practices that increase borrowers' costs, such as kickbacks and fee-splitting without providing settlement services.

Privacy. Under the Gramm-Leach-Bliley Act, all financial institutions are required to establish policies and procedures to restrict the sharing of non-public customer data with non-affiliated parties and to protect customer data from unauthorized access. In addition, the Fair Credit Reporting Act of 1971 includes many provisions concerning national credit reporting standards and permits consumers to opt out of information-sharing for marketing purposes among affiliated

Predatory lending. What is commonly referred to as predatory lending typically involves one or more of the following elements—making unaffordable loans based on a borrower's assets rather than the borrower's ability to repay an obligation,—inducing a borrower to refinance a loan repeatedly in order to charge high points and fees each time the loan is refinanced, or loan flipping, and-engaging in fraud or deception to conceal the true nature of the loan obligation from an unsuspecting or unsophisticated borrower.

The Home Ownership and Equity Protection Act of 1994 and implementing regulations adopted by the Federal Reserve require specified disclosures and extend additional protection to borrowers in closed-end consumer credit transactions, such as home repairs or renovation, that are secured by a mortgage on the borrower's primary residence. The disclosures and protections are applicable to "high cost" transactions with any of the following features—interest rates for first lien mortgage loans more than eight percentage points above the yield on U.S. Treasury securities having a comparable maturity, -interest rates for subordinate lien mortgage loans more than 10 percentage points above the yield on U.S. Treasury securities having a comparable maturity, or -total points and fees paid in the credit transaction exceed the greater of either 8% of the loan amount or a specified dollar amount that is inflation-adjusted each year.

The Home Ownership and Equity Protection Act prohibits or restricts numerous credit practices, including loan flipping by the same lender or loan servicer within a year of the loan being refinanced. Lenders are presumed to have violated the law unless they document that the borrower has the ability to repay. Lenders that violate the rules face cancellation of loans and penalties equal to the finance charges paid. The Home Ownership and Equity Protection Act also governs so-called "reverse mortgages."

Overdraft protection practices. With amendment of Regulations E and DD, Federal Reserve rules regarding overdraft charges for debit card and ATM transactions became effective on July 1, 2010. The amendments do

away with the automatic overdraft protection arrangements that had been in common use, instead requiring banks to notify and obtain the consent of customers before enrolling them in an overdraft protection plan. The amended rules restrict a bank's ability to charge fees for the payment of overdrafts for debit and ATM card transactions.

Monetary policy. The earnings of financial institutions are affected by the policies of regulatory authorities, including monetary policy of the Federal Reserve. An important function of the Federal Reserve is regulation of aggregate national credit and money supply, relying on measures such as open market transactions in securities, establishment of the discount rate on bank borrowings, and changes in reserve requirements against bank deposits. These methods are used in varying combinations to influence overall growth and distribution of financial institutions' loans, investments, and deposits, and they also affect interest rates charged on loans or paid on deposits. Monetary policy is influenced by many factors, including inflation, unemployment, short-term and long-term changes in the international trade balance, and fiscal policies of the United States government. Federal Reserve Board monetary policy has had a significant effect on the operating results of financial institutions in the past and it will continue to influence operating results in the future.

Anti-money laundering and anti-terrorism legislation. The Bank Secrecy Act of 1970 requires financial institutions to maintain records and report transactions to prevent the financial institutions from being used to hide money derived from criminal activity and tax evasion. The Bank Secrecy Act establishes (a) record-keeping requirements to assist government enforcement agencies with tracing financial transactions and flow of funds, (b) reporting requirements for Suspicious Activity Reports and Currency Transaction Reports to assist government enforcement agencies with detecting patterns of criminal activity, (c) enforcement provisions authorizing criminal and civil penalties for illegal activities and violations of the Bank Secrecy Act and its implementing regulations, and (d) safe harbor provisions that protect financial institutions from civil liability for their cooperative efforts.

The Treasury's Office of Foreign Asset Control administers and enforces economic and trade sanctions against targeted foreign countries, entities, and individuals based on U.S. foreign policy and national security goals. As a result, financial institutions must scrutinize transactions to ensure that they do not represent obligations of or ownership interests in entities owned or controlled by sanctioned targets.

Signed into law on October 26, 2001, the USA PATRIOT Act of 2001 is omnibus legislation enhancing the powers of domestic law enforcement organizations to resist the international terrorist threat to United States security. Title III of the legislation, the International Money Laundering Abatement and Financial Anti-Terrorism Act of 2001, most directly affects the financial services industry, enhancing the Federal government's ability to fight money laundering through monitoring of currency transactions and suspicious financial activities. The Act has significant implications for depository institutions and other businesses involved in the transfer of money – -a financial institution must establish due diligence policies, procedures, and controls reasonably designed to detect and report money laundering through correspondent accounts and private banking accounts, -no bank may establish, maintain, administer, or manage a correspondent account in the United States for a foreign shell bank, -financial institutions must abide by Treasury Department regulations encouraging financial institutions, their regulatory authorities, and law enforcement authorities to share information about individuals, entities, and organizations engaged in or suspected of engaging in terrorist acts or money laundering activities, -financial institutions must follow Treasury Department regulations setting forth minimum standards regarding customer identification. These regulations require financial institutions to implement reasonable procedures for verifying the identity of any person seeking to open an account, maintain records of the information used to verify the person's identity, and consult lists of known or suspected terrorists and terrorist organizations provided to the financial institution by government agencies, -every financial institution must establish anti-money laundering programs, including the development of internal policies and procedures, designation of a compliance officer, employee training, and an independent audit function.

Recent initiatives. The economic upheaval that reached crisis proportions in the third and fourth quarters of 2008 and the resulting adverse impact on the national, regional, and local economies have not ended and might not end for some time. Legislation has been enacted and the Treasury Department, the Federal Reserve, and the FDIC have taken actions in the meantime to stabilize the financial industry, promote recovery, and prevent the recurrence of a similar crisis. The purpose of these legislative and regulatory initiatives is to stabilize U.S. financial markets. The legislative and regulatory actions already taken or that could be taken might not have the intended beneficial impact on the financial

markets or the banking industry. We cannot assure you that these initiatives will improve economic conditions generally or the financial markets or financial services industry in particular. The failure of legislative and regulatory initiatives to stabilize the financial markets could materially adversely affect our access to the capital and credit markets, our business, our financial condition, our results of operations, and the market price of our common stock.

AVAILABLE INFORMATION

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

Item 1A. Risk Factors—Not applicable to the Company because it is a smaller reporting company.

Item 1B. Unresolved Staff Comments—Not applicable to the Company because it is a smaller reporting company.

Item 2. Properties

The Company owns no property. Its operations are conducted at 194 West Main Street, Cortland, Ohio.

The Bank's business is conducted at a total of fourteen offices, including:

BOARDMAN Victor Hills Plaza 6538 South Avenue Boardman, Ohio 44512 330-629-9151	MANTUA 11661 State Route 44 Mantua, Ohio 44255 330-274-3111	VIENNA 4434 Warren-Sharon Road Vienna, Ohio 44473 330-394-1438
BRISTOL 6090 State Route 45 Bristolville, Ohio 44402 330-889-3062	MIDDLEFIELD 15561 West High Street Middlefield, Ohio 44062 440-632-0099	WARREN 2935 Elm Road Warren, Ohio 44483 330-372-1520
BROOKFIELD 7202 Warren-Sharon Road Brookfield, Ohio 44403 330-448-6814	NILES PARK PLAZA 815 Youngstown-Warren Road Suite 1 Niles, Ohio 44446 330-652-8700	WILLIAMSFIELD 5917 U.S. Route 322 Williamsfield, Ohio 44093 440-293-7502
CORTLAND 194 West Main Street Cortland, Ohio 44410 330-637-8040	NORTH BLOOMFIELD 8837 State Route 45 North Bloomfield, Ohio 44450 440-685-4731	WINDHAM 8950 Maple Grove Road Windham, Ohio 44288 330-326-2340
HUBBARD 890 West Liberty Street Hubbard, Ohio 44425 330-534-2265	NORTH LIMA 9001 Market Street North Lima, Ohio 44452 330-758-5884	

The Bank's main and administrative office is located at 194 West Main Street, Cortland, Ohio. The Hubbard, Niles Park Plaza, Victor Hills and Middlefield offices are leased, while all of the other offices are owned by Cortland Banks.

Item 3. Legal Proceedings

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

Item 4. Mine Safety Disclosures—Not applicable

PART II

Item 5. Market for Registrant's Common Equity, Related Shareholder Matters and Issuer Purchase of Equity Securities

The following is information regarding market information, holders and dividends.

The Company files quarterly reports on Form 10-Q, an annual report on Form 10-K, current reports on Form 8-K, and proxy statements, as well as any amendments to those reports and statements, with the SEC pursuant to section 13(a) or (15)d of the Exchange Act on Schedule 14A. In 2012, the Company's quarterly reports will be filed within 45 days of the end of each quarter, and the Company's annual report will be filed within 90 days of the end of the year. Any person may access these reports and statements free of charge, as soon as reasonably practicable after such material is electronically filed with or furnished to the SEC, by visiting our web site at www.cortland-banks.com or by writing to:

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

The SEC also maintains a website at www.sec.gov where our filings and other information may be obtained free of charge.

The Company's common shares trade on the NASDAQ OTC market under the symbol CLDB. The following brokerage firm is known to be relatively active in trading the Company's common shares:

Boenning & Scattergood
9916 Brewster Lane
Powell, OH 43065
Telephone: 866-326-3113

The following table shows the prices at which the common shares of the Company have actually been purchased and sold in market transactions during the periods indicated. The range of market prices is compiled from data available through Yahoo Finance, Historical Prices. Figures shown for 2009 have been adjusted to give retroactive effect to the 1% stock dividend paid as of April l, 2009. As of March 22, 2012, the Company has approximately 1,568 shareholders of record.

	Price Per Share		
	High	Low	Close
2011			
Fourth Quarter	**$ 7.60**	**$6.50**	**$6.80**
Third Quarter	**7.55**	**7.01**	**7.36**
Second Quarter	**7.90**	**5.91**	**7.15**
First Quarter	**6.25**	**5.30**	**6.00**
2010			
Fourth Quarter	$ 5.65	$5.01	$5.30
Third Quarter	5.25	4.55	5.11
Second Quarter	6.35	4.51	4.80
First Quarter	6.12	4.10	5.00
2009			
Fourth Quarter	$ 4.70	$4.00	$4.25
Third Quarter	5.90	3.60	4.25
Second Quarter	6.95	4.10	4.30
First Quarter	12.38	3.00	5.28

For current share prices, please access our website at www.cortland-banks.com.

The Company did not pay a cash dividend in any years presented.

The Bank is subject to a dividend restriction that generally limits the amount of dividends that can be paid by an Ohio state-chartered bank. Under the Ohio Banking Code, cash dividends may not exceed net profits as defined for that year combined with retained net profits for the two preceding years less any required transfers to surplus. Under this formula, the amount available for payment of dividends in 2012 is $7,517,000 plus 2012 profits retained up to the date of the dividend declaration.

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

Shareholder and General Inquiries

Cortland Bancorp
194 West Main Street
Cortland, Ohio 44410
(330) 637-8040
Attention: Deborah L. Eazor
Vice President
DLEazor@cortland-banks.com

Transfer Agent

IST Shareholder Services
209 West Jackson Boulevard, Suite 903
Chicago, Illinois 60606
(312) 427-2953

Please contact our transfer agent directly for assistance in changing your address, elimination of duplicate mailings, transferring shares or replacing lost, stolen or destroyed share certificates. Other questions regarding your status as a shareholder of the Company may be addressed to the Company at the address above.

The Company did not repurchase any of its common shares during the fourth quarter of 2011.

Item 6. Selected Financial Data

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

	Years Ended December 31,				
	2011	2010	2009	2008	2007
SUMMARY OF OPERATIONS					
Total interest income	**$ 21,110**	$ 21,872	$ 23,623	$ 27,559	$ 28,992
Total interest expense	**4,732**	6,367	9,234	12,177	13,985
Net interest income (NII)	**16,378**	15,505	14,389	15,382	15,007
Provision for loan losses	**1,196**	505	427	1,785	40
NII after loss provision	**15,182**	15,000	13,962	13,597	14,967
Security gains (losses) including impairment losses	**680**	(1,694)	(14,070)	(1,112)	77
Mortgage banking gains	**162**	236	265	30	88
Other income	**2,716**	2,791	3,001	2,941	2,924
Total non-interest income	**3,558**	1,333	(10,804)	1,859	3,089
Total non-interest expenses	**13,475**	12,441	13,648	12,815	12,595
Income (Loss) Before Tax	**5,265**	3,892	(10,490)	2,641	5,461
Federal income tax expense (benefit)	**1,193**	621	(4,155)	288	1,111
Net Income (loss)	**$ 4,072**	$ 3,271	$ (6,335)	$ 2,353	$ 4,350
PER COMMON SHARE DATA (1)					
Net income (loss), both basic and diluted	**$ 0.90**	$ 0.72	$ (1.40)	$ 0.52	$ 0.95
Cash dividends declared	**—**	—	—	0.86	0.85
Book value	**10.10**	9.25	8.16	8.01	10.90
BALANCE SHEET DATA					
Assets	**$519,830**	$500,273	$497,299	$493,365	$492,694
Investments	**185,916**	188,458	171,924	191,754	238,622
Total loans	**289,096**	265,179	248,248	246,017	223,109
Allowance for loan losses	**3,058**	2,501	2,437	2,470	1,621
Deposits	**422,765**	391,509	387,495	379,953	364,788
Borrowings	**42,273**	57,901	63,366	68,148	70,413
Subordinated debt	**5,155**	5,155	5,155	5,155	5,155
Shareholders' equity	**45,719**	41,852	36,908	36,028	48,824
AVERAGE BALANCES					
Assets	**$493,728**	$486,588	$498,250	$488,371	$489,047
Investments	**186,872**	191,546	176,524	223,077	238,904
Total loans	**261,080**	237,624	238,290	222,440	215,496
Deposits	**395,561**	378,242	383,858	361,922	366,834
Borrowings	**43,734**	58,317	68,307	70,961	66,175
Subordinated debt	**5,155**	5,155	5,155	5,155	2,175
Shareholders' equity	**44,589**	39,480	36,073	45,119	50,088
ASSET QUALITY RATIOS					
Loan charge-offs	**$ (832)**	$ (616)	$ (620)	$ (1,100)	$ (728)
Recoveries on loans	**193**	175	160	164	98
Net charge-offs	**$ (639)**	$ (441)	$ (460)	$ (936)	$ (630)
Net charge-offs as a percentage of average total loans	**0.24%**	0.19%	0.19%	0.42%	0.29%
Loans 30+ days delinquent as a percentage of total loans	**1.40%**	1.38%	0.80%	0.57%	1.32%
Nonperforming loans	**$ 4,714**	$ 3,858	$ 2,034	$ 1,290	$ 2,831
Nonperforming securities	**1,542**	3,767	2,154	—	—
Other real estate owned	**437**	848	687	809	282
Total nonperforming assets	**$ 6,693**	$ 8,473	$ 4,875	$ 2,099	$ 3,113
Allowance for loan losses as a percentage of non-performing loans	**64.87%**	64.83%	119.81%	191.47%	57.26%
Nonperforming assets as a percentage of:					
Total assets	**1.29%**	1.69%	0.98%	0.43%	0.63%
Equity plus allowance for loan losses	**13.70**	19.07	12.37	5.45	6.17
Tier I capital	**12.94**	18.11	10.59	4.03	6.38
FINANCIAL RATIOS					
Return on average equity	**9.13%**	8.29%	(17.56)%	5.22%	8.68%
Return on average assets	**0.82**	0.67	(1.27)	0.48	0.89
Effective tax rate	**22.66**	15.96	(39.61)	10.90	20.34
Average equity-to-average asset ratio	**9.03**	8.11	7.24	9.24	10.24
Tangible equity ratio	**10.47**	9.59	9.09	10.58	11.00
Cash dividend payout ratio	**—**	—	—	165.38	89.69
Net interest margin	**3.72**	3.59	3.19	3.49	3.45

(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.

For more information see Item 7, Management's Discussion and Analysis of Financial Condition and Results of Operations and Item 8, Financial Statements and Supplementary Data.

Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations

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)

	2011			2010			2009		
	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
Interest-earning assets:									
Interest-earning deposits and other earning assets	**$ 12,738**	**$ 51**	**0.40%**	$ 24,898	$ 92	0.36%	$ 59,923	$ 155	0.27%
Investment securities:									
U.S. Treasury and other U.S. Government agencies and corporations	**27,590**	**808**	**2.93%**	34,610	1,228	3.55%	26,069	1,410	5.41%
U.S. Government mortgage-backed pass through certificates	**101,347**	**3,141**	**3.10%**	98,657	3,824	3.88%	89,715	4,407	4.91%
States of the U.S. and political subdivisions (Note 1, 2, 3)	**36,534**	**2,118**	**5.80%**	34,687	2,250	6.49%	28,569	2,000	7.00%
Other securities	**21,401**	**424**	**1.98%**	23,592	505	2.14%	32,171	1,148	3.57%
TOTAL INVESTMENT SECURITIES	**186,872**	**6,491**	**3.47%**	191,546	7,807	4.08%	176,524	8,965	5.08%
Loans (Note 1, 2, 3, 4)	**261,080**	**15,314**	**5.87%**	237,624	14,765	6.21%	238,290	15,229	6.39%
TOTAL INTEREST-EARNING ASSETS	**460,690**	**$21,856**	**4.74%**	454,068	$22,664	4.99%	474,737	$24,349	5.13%
Noninterest-earning assets:									
Cash and due from banks	**7,175**			6,570			6,661		
Premises and equipment	**6,612**			6,918			7,392		
Other	**19,251**			19,032			9,460		
TOTAL ASSETS	**$493,728**			$486,588			$498,250		
Interest-bearing liabilities:									
Deposits:									
Interest-bearing demand deposits	**$ 73,809**	**$ 176**	**0.24%**	$ 69,295	$ 256	0.37%	$ 65,266	$ 436	0.67%
Savings	**94,160**	**141**	**0.15%**	89,049	212	0.24%	84,933	516	0.61%
Time	**161,280**	**2,976**	**1.85%**	158,578	3,611	2.28%	175,153	5,342	3.05%
TOTAL INTEREST-BEARING DEPOSITS	**329,249**	**3,293**	**1.00%**	316,922	4,079	1.29%	325,352	6,294	1.93%
Borrowings:									
Securities sold under agreement to repurchase	**5,236**	**5**	**0.10%**	6,924	10	0.14%	6,218	9	0.14%
Subordinated debt	**5,155**	**92**	**1.79%**	5,155	93	1.81%	5,155	127	2.46%
Other borrowings under one year	**6,458**	**95**	**1.47%**	17,134	847	4.94%	11,285	620	5.49%
Other borrowings over one year	**32,040**	**1,247**	**3.89%**	34,259	1,338	3.91%	50,804	2,184	4.30%
TOTAL BORROWINGS	**48,889**	**1,439**	**2.94%**	63,472	2,288	3.60%	73,462	2,940	4.00%
TOTAL INTEREST-BEARING LIABILITIES	**378,138**	**$ 4,732**	**1.25%**	380,394	$ 6,367	1.67%	398,814	$ 9,234	2.32%
Non interest-bearing liabilities:									
Demand deposits	**66,312**			61,320			58,506		
Other liabilities	**4,689**			5,394			4,857		
Shareholders' equity	**44,589**			39,480			36,073		
TOTAL LIABILITIES AND SHAREHOLDERS EQUITY	**$493,728**			$486,588			$498,250		
Net interest income		**$17,124**			$16,297			$15,115	
Net interest rate spread (Note 5)			**3.49%**			3.32%			2.81%
Net interest margin (Note 6)			**3.72%**			3.59%			3.19%

Note 1— Includes both taxable and tax exempt securities and loans.

Note 2— The amounts are presented on a fully taxable equivalent basis using the statutory tax rate of 34%, and have been adjusted to reflect the effect of disallowed interest expense related to carrying tax-exempt assets. Tax-free income from states of the U.S. and political subdivisions and loans amounted to $1.4 million and $100,000 for 2011, $1.5 million and $121,000 for 2010, $1.4 million and $166,000 for 2009.

Note 3— Average balance outstanding includes the average amount outstanding of all non-accrual investment securities and loans. Investment securities consist of average total principal adjusted for amortization of premium and accretion of discount and include both taxable and tax-exempt securities. Loans consist of average total loans, including loans held for sale, less average unearned income.

Note 4— Interest earned on loans includes net loan fees of $295,000 in 2011, $264,000 in 2010, $245,000 in 2009.

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 net interest income by total interest-earning assets.

FINANCIAL REVIEW

The following is management's discussion and analysis of the financial condition and results of operations of 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 materials filed or to be filed by the Company with the SEC (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, including the impact of the impairment of securities; changes in customer preferences and consumer behavior; increased competitive pressures or changes in either the nature or composition of competitors; changes in the legal and regulatory environment; changes in factors influencing liquidity, such as expectations regarding the rate of inflation or deflation, currency exchange rates, and other factors influencing market volatility; and unforeseen risks associated with other global economic, political and financial factors.

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

CRITICAL ACCOUNTING POLICIES AND ESTIMATES

The discussion and analysis of the Company's financial condition and results of operation are based upon the Consolidated Financial Statements, which have been prepared in accordance with U.S. generally accepted accounting principles (GAAP). The preparation of these consolidated financial statements requires management

to make estimates and judgments that affect the reported amounts of assets and liabilities, revenues and expenses, and related disclosures of contingent assets and liabilities at the date of the Company's consolidated financial statements. Actual results may differ from these estimates under different assumptions or conditions.

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

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

Accounting for the Allowance for Loan Losses

The determination of the allowance for loan losses and the resulting amount of the provision for loan losses charged to operations reflects management's current judgment about the credit quality of the loan portfolio and takes into consideration changes in lending policies and procedures, changes in economic and business conditions, changes in the nature and volume of the portfolio and, in the terms of loans, changes in the experience, ability and depth of lending management, changes in the volume and severity of past due, non-accrual and adversely classified or graded loans, changes in the quality of the loan review system, changes in the value of underlying collateral for collateral-dependent loans, the existence and effect of any concentrations of credit and the effect of competition, legal and regulatory requirements and other external factors. The nature of the process by which we determine the appropriate allowance for loan losses requires the exercise of considerable judgment. While management utilizes its best judgment and information available, the ultimate adequacy of the allowance is dependent upon a variety of factors beyond our control, including the performance of the loan portfolio, the economy, changes in interest rates and the view of the regulatory authorities toward loan classifications. The allowance is increased by the provision for loan losses and decreased by charge-offs when management believes the uncollectibility of a loan is confirmed. Subsequent recoveries, if any, are credited to the allowance. A weakening of the economy or other factors that adversely affect asset quality could result in an increase in the number of delinquencies, bankruptcies or defaults and a higher level of non-performing assets, net charge offs, and provision for loan losses in future periods. The Company's allowance for loan losses methodology consists of three elements: (i) specific valuation allowances based on probable losses on specific loans; (ii) valuation allowances based on historical loan loss experience for similar loans with similar characteristics and trends; and (iii) general valuation allowances based on general economic conditions and other qualitative risk factors both internal and external to the Company. These elements support the basis for determining allocations between the various loan categories and the overall adequacy of our allowance to provide for probable losses inherent in the loan portfolio.

With these methodologies, a general allowance is established for each loan type based on historical losses for each loan type in the portfolio. Additionally, management allocates a specific allowance for "Impaired Credits," which is based on current information and events, it is probable the Company will not collect all amounts due according to the original contractual terms of the loan agreement. The level of the general allowance is established to provide coverage for management's estimate of the credit risk in the loan portfolio by various loan segments not covered by the specific allowance. Additional information regarding allowance for credit losses can be found in Item 8, Note 3 to the Consolidated Financial Statements and in this Management's Discussion and Analysis.

Investment Securities and Impairment

The classification and accounting for investment securities is discussed in detail in Item 8, Notes 1 and 2 to the Consolidated Financial Statements. Investment securities must be classified as held-to-maturity, available-for-sale, or trading. The appropriate classification is based partially on the Company's ability to hold the securities to maturity and largely on management's intentions, if any, with respect to either holding or selling

the securities. The classification of investment securities is significant since it directly impacts the accounting for unrealized gains and losses on securities. Unrealized gains and losses on trading securities, if any, flow directly through earnings during the periods in which they arise, whereas available-for-sale securities are recorded as a separate component of shareholders' equity (accumulated other comprehensive income or loss) and do not affect earnings until realized. The fair values of the Company's investment securities are generally determined by reference to quoted market prices and reliable independent sources. At each reporting date, the Company assesses whether there is an "other-than-temporary" impairment to the Company's investment securities. Such impairment must be recognized in current earnings rather than in other comprehensive income (loss).

The Company reviews investment debt securities on an ongoing basis for the presence of other-than-temporary impairment (OTTI) with formal reviews performed quarterly. OTTI losses on individual investment securities were recognized during 2011 in accordance with FASB ASC topic 320, *Investments—Debt and Equity Securities*. The purpose of this ASC is to provide greater clarity to investors about the credit and noncredit component of an OTTI event and to communicate more effectively when an OTTI event has occurred. This ASC amends the OTTI guidance in GAAP for debt securities, improves the presentation and disclosure of OTTI on investment securities and changes the calculation of the OTTI recognized in earnings in the financial statements. This ASC does not amend existing recognition and measurement guidance related to OTTI of equity securities.

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

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

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

Additional information regarding investment securities can be found in Item 8, Notes 2 and 11 to the Consolidated Financial Statements and further more in this Management's Discussion and Analysis.

Income Taxes

The provision for income taxes is based on income reported for financial statement purposes and differs from the amount of taxes currently payable, since certain income and expense items are reported for financial statement purposes in different periods than those for tax reporting purposes. Taxes are discussed in more detail in Item 8, Note 10, to the Consolidated Financial Statements. Accrued taxes represent the net estimated amount due or to be received from taxing authorities. In estimating accrued taxes, the Company assesses the relative merits and risks of the appropriate tax treatment of transactions taking into account statutory, judicial and regulatory guidance in the context of our tax position.

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

CORPORATE PROFILE

The Company is a bank holding company headquartered in Cortland, Ohio whose principle activity is to manage, supervise and otherwise serve as a source of strength to the Bank.

Cortland Banks, with total assets of approximately $519.8 million at December 31, 2011, is a state chartered bank engaged in commercial and retail banking services. The Bank offers a full range of financial services to its local communities with an ongoing strategic focus on commercial banking relationships.

CSB Mortgage Company, Inc. (CSB) is a wholly-owned subsidiary of Cortland Banks, and will function as the originator of wholesale mortgage loans and the seller of company-wide mortgage loans in the secondary mortgage market.

The Bank's results of operations depend primarily on net interest income, which in part, is a direct result of the market interest rate environment. Net interest income is the difference between the interest income earned on interest-earning assets and the interest paid on interest-bearing liabilities. Net interest income is affected by the shape of the market yield curve, the repricing of interest-earning assets and interest-bearing liabilities and the prepayment rate of mortgage-related assets. Results of operations may be affected significantly by general and local economic conditions, particularly those with respect to changes in market interest rates, credit quality, governmental policies and actions of regulatory authority.

2011 OVERVIEW

Net income for 2011 was $4.072 million, or $0.90 per share, representing an increase of $0.18 from the $0.72 per share in 2010.

Amid more rigorous regulatory standards and an uncertain economy, the Company continues to follow its core strategic direction. Operating results reflect its commitment to growing loans and deposits in the markets in which it operates and in producing consistent positive earnings. On the heels of the financial crisis, the Company now has posted positive earnings in each of the last nine quarters dating back to the fourth quarter of 2009.

The Company's financial results for 2011 were affected by these notable specific factors:

- Core earnings for the year which exclude non-recurring items such as impairment loss and gain on securities sales were $4.0 million compared to $4.2 million for 2010, a decrease of 4.2% mainly attributed to the start-up costs of the mortgage banking subsidiary.
- The Company's recognition of pre-tax OTTI losses on investment securities fell dramatically in 2011 to $202,000 versus $2.7 million in 2010.
- Net interest margin for the full year 2011 was 3.72%, or 13 basis points higher than the 3.59% in 2010. The Company continues to optimally manage its balance sheet in this historically low interest rate environment.
- The Company continues to excel in managing risks in the loan portfolio as asset quality measures are among the best for banks with similar asset totals. Net loan charge-offs were 0.24% of average loans in 2011 and 0.19% of average loans in 2010 and the allowance for loan loss (ALLL) to total loans ratio was 1.06% and 0.94% at the 2011 and 2010 year end, respectively. The Company's allowance for loan losses covers 86.0% of nonaccrual loans at December 31, 2011.

The Company, to date, has not experienced notable deterioration in credit quality despite less than favorable economic conditions over the past several years. Nonperforming loans (which includes other real estate owned (OREO)) were $5.2 million at December 31, 2011, or 1.78% of loans, up slightly from $4.7 million at December 31, 2010. Included in these totals is a single loan of $1.0 million fully secured by collateral for which no loss is expected to be incurred. Loans considered as potential problem loans increased from $6.8 million at December 31, 2010 to $8.9 million at December 31, 2011. For the year ending December 31, 2011, the provision for loan losses was $1.2 million, more than double the prior year provision of $505,000, and far exceeding the net charge-offs for the year of $639,000. Provision expense during 2011 was increased in recognition of loan growth and a changing composition of the loan portfolio as the Company takes aim at managing its balance sheet with a commercially-oriented focus. With the fragile state of today's economy, it is prudent to address the potential for losses based upon worsening conditions. The Company was able to do this and still achieve improved earnings results.

Total loans at December 31, 2011 were $289.1 million as compared to $265.2 million a year ago, a 9.0% increase. Total assets of $519.8 million at December 31, 2011 reflect a modest increase of 3.9% from asset totals of $500.3 million at December 31, 2010, as management orchestrates balance sheet strategies designed to reinvest cash flows from its investment portfolio and increase loan balances with no material change in composite asset totals. This balance sheet strategy is designed to improve net interest income margins and overall profitability while maintaining assets which support the Company's current capital position.

In addition to building loan loss reserves, the Company has also continued to increase its capital levels. With capital as the ultimate cushion to absorb any unforeseen negative consequences of the struggling economy, capital levels for banks across the industry have been closely monitored by Federal and state bank regulators. The Company's regulatory capital ratios exceed the statutory well capitalized thresholds by a comfortable margin. In the current regulatory environment, regulatory oversight bodies expect banks to maintain ratios above the statutory levels as a margin of safety. The Company's calculated capital ratios are as follows at December 31, 2011: a Tier 1 leverage ratio of 10.47% (compared to a "well-capitalized" threshold of 5.0%); a Tier 1 risk-based capital ratio of 13.37% (compared to a "well-capitalized" threshold of 6.00%); and a total risk-based capital ratio of 14.18% (compared to a "well-capitalized" threshold of 10.00%).

In the midst of earnings pressures brought on by the economic downturn, interest rate compression and investment impairment issues, the Company devoted substantial attention in 2011 to profit improvement measures, balance sheet restructuring and a reorganization of its management structure. The Company's management team continues to focus on measures designed to enhance capital and to provide for adequate liquidity for lending and business development purposes. New strategies are being pursued to improve market penetration and product expansion, with the objective of increasing both the interest income and non-interest income revenue base.

The Company incurred over $200,000 in non-interest expenses in 2011 associated with the anticipated start-up of the mortgage banking subsidiary, CSB. As its operations ramp up in 2012, CSB is expected to enhance the Company's non-interest income. CSB anticipates partnering with mortgage brokers in contiguous states to originate mortgage loans. It is expected the loans will be sold to investors in the secondary market, generating a profit margin.

Total shareholders' equity at December 31, 2011 was $45.7 million, representing a ratio of equity capital to total assets of 8.79%. In comparison, total shareholders' equity was $41.9 million at December 31, 2010, representing a ratio of equity capital to total assets of 8.37%. A component of shareholders' equity is accumulated other comprehensive income or loss, which includes the net after-tax impact of unrealized gains or losses on investment securities classified as available-for-sale. Net unrealized losses on available-for-sale investment securities were $2.7 million at December 31, 2011 as compared with net unrealized losses of $2.5 million at December 31, 2010. Such unrealized losses represent the difference, net of applicable income tax effect, between the estimated fair value and amortized cost of investment securities classified as available-for-sale. The increase in net unrealized losses resulted primarily from a decreased market value of trust preferred securities at December 31, 2011.

No cash dividends on the Company's common stock were paid in 2011 or 2010.

Return on average equity was 9.1% in 2011 compared to 8.3% in 2010, while return on average assets measured 0.8% in 2011 compared to 0.7% in 2010. Book value per share increased by $0.85 to $10.10 at December 31, 2011 from $9.25 at December 31, 2010. The price of the Company's common shares traded in a range between a low of $5.30 and a high of $7.90, closing the year at $6.80 per share.

CERTAIN NON-GAAP MEASURES

Certain financial information has been determined by methods other than 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 referenced as part of management's discussion and analysis of quarterly and year-to-date financial results of operations.

Core earnings, which exclude the OTTI charge, FDIC special assessment and certain other non-recurring items, were $4.0 million in 2011 compared to $4.2 million in 2010. Core earnings per share were $0.88 in 2011, $0.92 in 2010 and $0.77 in 2009.

The following is a reconciliation between core earnings and earnings (loss) under GAAP:

	(Amounts in thousands, except per share data) Years Ended December 31,		
	2011	2010	2009
GAAP earnings (loss)	**$4,072**	$3,271	$ (6,335)
Impairment losses on investment securities	**202**	2,712	14,502
Investment gains not in the ordinary course of business *	**(344)**	(920)	—
FDIC special assessment	**—**	—	224
(Credits) expenses relating to reorganization—net	**—**	(457)	120
Tax effect of adjustments	**48**	(454)	(5,048)
Core earnings	**$3,978**	$4,152	$ 3,463
Core earnings per share	**$ 0.88**	$ 0.92	$ 0.77

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

RECENT MARKET AND INDUSTRY DEVELOPMENTS

The economic turmoil that began in the middle of 2007 and continued through 2008 and 2009 has now settled into a slow economic recovery in 2010 and 2011. At this time, the recovery has somewhat uncertain prospects. The risks associated with the Company's business become more acute in periods of a slowing economy or slow growth. Financial institutions continue to be affected by declines in the real estate market and constrained financial markets. While the Company is taking steps to decrease and limit exposure to problem loans, it nonetheless retains direct exposure to the residential and commercial real estate markets, and is affected by these events. This has been accompanied by dramatic changes in the competitive landscape of the financial services industry and a wholesale reformation of the legislative and regulatory landscape with the passage of the Dodd-Frank Act.

The Dodd-Frank Act is extensive, complex and comprehensive legislation that impacts many aspects of banking organizations. Certain provisions of the Dodd-Frank Act are expected to have a near-term impact on the Company. In July 2011, the Dodd-Frank Act eliminated the federal prohibitions on paying interest on demand deposits, thus allowing businesses to have interest-bearing checking accounts. Depending on competitive responses, this significant change to existing law could have an adverse impact on the Company's net interest margin. The Dodd-Frank Act also broadens the base for FDIC insurance assessments. Assessments are now based on the average consolidated total assets less tangible equity capital of a financial institution. The Dodd-Frank Act also permanently increased the maximum amount of deposit insurance for banks, savings institutions and credit unions to $250,000 per depositor and non-interest bearing transaction accounts have unlimited deposit insurance through December 31, 2012.

The Dodd-Frank Act created a new Consumer Financial Protection Bureau with broad powers to supervise and enforce consumer protection laws. The Consumer Financial Protection Bureau has broad rule-making authority for a wide range of consumer protection laws that apply to all banks and savings institutions, including the authority to prohibit "unfair, deceptive or abusive" acts and practices.

Until such time as the regulatory agencies issue proposed and final regulations implementing the numerous provisions of the Dodd-Frank Act, a process that will extend at least over the next twelve months and may last several years, management will not be able to fully assess the impact the legislation will have on its business.

BALANCE SHEET COMPOSITION

The following table illustrates, during the years presented, the mix of the Company's funding sources and the assets in which those funds are invested as a percentage of the Company's average total assets at December 31 for the period indicated. Average assets totaled $493.7 million in 2011 compared to $486.6 million in 2010 and $498.3 million in 2009.

	2011	2010	2009
Sources of Funds:			
Deposits:			
Non-interest bearing	**13.4%**	12.6%	11.8%
Interest bearing	**66.7**	65.1	65.3
Federal funds purchased and repurchase agreements	**—**	—	—
Long-term debt and other borrowings	**8.9**	12.0	13.7
Subordinated debt	**1.0**	1.1	1.0
Other non-interest bearing liabilities	**1.0**	1.1	1.0
capital	**9.0**	8.1	7.2
	100.0%	100.0%	100.0%
Uses of Funds:			
Loans	**52.9%**	48.8%	47.8%
Securities	**37.8**	39.4	35.4
Interest-earning deposits and other assets	**2.6**	5.1	12.0
Bank-owned life insurance	**2.6**	2.6	2.6
Other non-interest earning assets	**4.1**	4.1	2.2
Total	**100.0%**	100.0%	100.0%

Deposits continue to be the Company's primary source of funding. During 2011, the relative mix of deposits has remained steady with interest-bearing being the main source. Average non-interest bearing deposits totaled 16.8% of total average deposits in 2011, compared to 16.2% in 2010 and 15.2% in 2009. Additional information regarding deposits can be found in Item 8, Note 5 to the Consolidated Financial Statements and in this Management's Discussion and Analysis.

The Company primarily invests funds in loans and securities. Prior to 2008, securities were the largest component of the Company's mix of invested assets. Since then, loans have become the largest component. Average securities decreased $4.7 million, or 2.4%, to $186.9 million during 2011 from $191.5 million in 2010, while average loans increased by $23.5 million, or 9.9%, to $261.1 million during 2011 from $237.6 million in 2010. Interest-earning deposits and other earning asset components decreased in 2011 to 2.6% from 5.1% in 2010 because the average balance decreased to $12.7 million in 2011 from $24.9 million in 2010. Bank management had elected to employ a higher level of deposits at the Federal Reserve Bank which are now interest bearing to achieve a higher level of short-term liquidity needed to support loan demand and compensate for poorly functioning credit markets. Beginning in June 2009, management began investing a portion of liquid funds into short-term investment grade securities.

ASSET QUALITY

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

Additionally, as part of the Company's loan review process, management routinely evaluates risks which could potentially affect the ability to collect loan balances in their entirety. Reviews of individual credits, aggregate account relationships or any concentration of credits in particular industries are subject to a detailed loan review.

In addition to nonperforming loans, nonperforming assets include nonperforming investment securities, restructured loans and real estate acquired in satisfaction of debts previously contracted. Gross income that would have been recorded in 2011 on these nonperforming loans, had they been in compliance with their original terms, was $390,000. Interest income that actually was included in income on these loans amounted to $260,000. Gross income that would have been recorded in 2011 on nonperforming investments, had they been in compliance with their original terms, was $779,000. Income that actually was included in income on these investments amounted to $290,000. There are no accruing loans which are contractually past due 90 days or more as to principal or interest payments. The following table depicts the trend in these potentially problematic asset categories at December 31:

	(Amounts in thousands)				
	2011	2010	2009	2008	2007
Non-accrual loans:					
Commercial real estate	**$1,470**	$ 307	$ 350	$ 469	$1,572
Commercial loans	**70**	132	116	140	146
Residential real estate	**842**	1,040	718	237	499
Consumer loans	**1,073**	1,085	46	12	17
Home equity loans	**111**	47	—	—	51
Total non-accrual loans	**3,566**	2,611	1,230	858	2,285
Investment securities	**1,542**	3,767	2,154	—	—
Other real estate owned	**437**	848	687	809	282
Restructured loans	**1,148**	1,247	804	432	546
Nonperforming assets	**$6,693**	$8,473	$4,875	$2,099	$3,113

The table below provides a number of asset quality ratios based on this data. Problem loans accounted for on a non-accrual basis ranged from a high of $3.6 million in 2011 to a low of $858,000 in 2008. The total for non-accrual loans in 2011 of $3.6 million is slightly higher than the average of the five years, which is $2.1 million. The ratio of non-accrual loans to total loans, which was 1.02% at December 31, 2007, improved to 0.35% at December 31, 2008, then increased to 0.50% at December 31, 2009 and further increased to 0.98% at December 31, 2010 and 1.23% at December 31, 2011. In 2010, a single consumer loan of $1.0 million secured by collateral for which no loss was expected to be incurred, was included as non-accrual. The total of all loans past due more than 30 days were in excess of $2.9 million, or 1.32%, of loan balances at December 31, 2007, then declined to $1.4 million, or 0.57%, at December 31, 2008, increased to $2.0 million, or 0.80%, at December 31, 2009 and further increased to $3.6 million, or 1.38%, at December 31, 2010 and $4.1 million, or 1.40%, at December 31, 2011. Loans charged-off, net of recoveries, increased to $639,000 for 2011, compared to $630,000 for 2007, $936,000 for 2008 and $460,000 for 2009 and $441,000 for 2010.

The Company recognizes that an extraordinary amount of uncertainty currently exists regarding credit quality as a result of the rapid deterioration of the U.S. economy beginning in the final quarter of 2008. Regionally, the housing market continues to be negatively impacted by a high level of bankruptcy filings and home foreclosures, while unemployment levels have shown little improvement and business failures are now being reported on a more routine basis. Accordingly, loan loss reserves were increased by $1.8 million in 2008 to account for charge-offs against the allowance and to give recognition to the economy's steep slide into a serious and likely long lasting recession, with expectations for deterioration on credit quality arising from faltering economic and financial conditions. In 2011 and 2010, the loan loss reserve was further increased by $1.2 million and $505,000, respectively. Additional information regarding loans can be found in Item 8, Note 3 to the Consolidated Financial Statements and in this Management's Discussion and Analysis.

At December 31, 2011, there was $1.5 million of the Company's holdings in trust preferred securities considered to be in non-accrual status. Through December 31, 2011, the Company's management was notified that the quarterly interest payments for 15 of its 29 investments in trust preferred securities had been placed in "payment in kind" status. Payment in kind status results in a temporary delay in the payment of interest. As a result of a delay in the collection of the interest payments, management placed these securities in non-accrual status. Current estimates indicate that the interest payment delays may exceed ten years. All the other trust preferred securities remain in accrual status.

	2011	2010	2009	2008	2007
Non-accrual loans as a percentage of total loans	**1.23%**	0.98%	0.50%	0.35%	1.02%
Nonperforming assets as a percentage of total assets	**1.29%**	1.69%	0.98%	0.43%	0.63%
Nonperforming assets as a percentage of equity capital plus allowance for loan losses	**13.70%**	19.07%	12.37%	5.45%	6.17%

RESULTS OF OPERATIONS

Analysis of Net Interest Income—Years Ended December 31, 2011 and 2010

(Amounts in thousands)

	December 31, 2011			December 31, 2010		
	Average Balance	Interest	Average Rate	Average Balance	Interest	Average Rate
INTEREST-EARNING ASSETS						
Interest-earning deposits and other earning assets	**$ 12,738**	**$ 51**	**0.40%**	$ 24,898	$ 92	0.36%
Investment securities (1)(2)(3)	**186,872**	**6,491**	**3.47%**	191,546	7,807	4.08%
Loans (1)(2)(3)(4)	**261,080**	**15,314**	**5.87%**	237,624	14,765	6.21%
Total interest-earning assets	**$460,690**	**$21,856**	**4.74%**	$454,068	$22,664	4.99%
INTEREST-BEARING LIABILITIES						
Interest-bearing demand and money market deposits	**$ 73,809**	**$ 176**	**0.24%**	$ 69,295	$ 256	0.37%
Savings	**94,160**	**141**	**0.15%**	89,049	212	0.24%
Time	**161,280**	**2,976**	**1.85%**	158,578	3,611	2.28%
Total interest-bearing deposits	**329,249**	**3,293**	**1.00%**	316,922	4,079	1.29%
Other borrowings	**43,734**	**1,347**	**3.08%**	58,317	2,195	3.76%
Subordinated debt	**5,155**	**92**	**1.79%**	5,155	93	1.81%
Total interest-bearing liabilities	**$378,138**	**$ 4,732**	**1.25%**	$380,394	$ 6,367	1.68%
Net interest income		**$17,124**			$16,297	
Net interest rate spread (5)			**3.49%**			3.31%
Net interest margin (6)			**3.72%**			3.59%

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

(2) The amounts are presented on a fully taxable equivalent basis using the statutory tax rate of 34%, and have been adjusted to reflect the effect of disallowed interest expense related to carrying tax-exempt assets. Tax-free income from states of the U.S. and political subdivisions and loans amounted to $1.4 million and $100,000 for 2011 and $1.5 million and $121,000 for 2010, respectively.

(3) Average balance outstanding includes the average amount outstanding of all non-accrual investment securities and loans. Investment securities consist of average total principal adjusted for amortization of premium and accretion of discount and include both taxable and tax-exempt securities. Loans consist of average total loans, including loans held for sale, less average unearned income.

(4) Interest earned on loans includes net loan fees of $295,000 in 2011 and $264,000 in 2010.

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

(6) Net interest margin is calculated by dividing the net interest income by total interest-earning assets.

Net interest income, which continued to be the principal source of the Company's earnings in 2011, is the amount by which interest and fees generated by interest-earning assets, primarily loans and investment securities, exceed the interest cost of deposits and borrowed funds. Net interest income provides the core earnings base for the Company and increased 5.6% to $16.4 million in 2011 versus $15.5 million in 2010. During this extended period of historically low interest rates, the repricing of deposits initially trailed the pace of declining rates on assets. As liabilities continue to mature and reprice at lower rates, the net interest margin has, and is expected to continue to improve. Net interest income on a fully tax-equivalent basis measured $17.1 million in the year ended 2011 and $16.3 million in the year ended 2010, generating a net interest margin of 3.72% in 2011 and 3.59% in 2010.

The decrease in interest income, on a fully taxable equivalent basis, of $808,000 was the product of a 1.5% year-over-year increase in average earning assets and a 25 basis point decrease in interest rates earned. The decrease in interest expense of $1.6 million was a product of a 0.6% decrease in interest-bearing liabilities and a 42 basis point decrease in rates paid. The net result was a 5.1% increase in net interest income on a fully tax-equivalent basis and a 13 basis point increase in the Company's net interest margin.

On a fully tax-equivalent basis, income on investment securities decreased by $1.3 million, or 16.9%. The average invested balances decreased by $4.7 million from the levels of a year ago. The decrease in the average balance of investment securities was accompanied by a 61 basis point decrease in the tax-equivalent yield of the portfolio. The decrease in the average balance of investment securities resulted from management's decision to divert the cash flows generated from the investment portfolio in the fourth quarter of 2011 into the commercial loan and mortgage banking portfolios. During the year ended December 31, 2011, $57.7 million in investment securities were purchased while $44.4 million were called by the issuer or matured. During the year ended December 31, 2010, $85.8 million in investment securities were purchased while $53.7 million were called by the issuer or matured. As the Company managed its balance sheet for asset growth, asset mix and liquidity, as well as current interest rates and interest rate forecasts, several securities in the investment portfolio were sold for $14.5 million in mid-2011. The sale was intended to reduce the interest rate risk in the portfolio given the eventual interest rate increases expected post-economic recovery as well as dispose of smaller balance securities. Sales of $15.2 million were made in 2010. The Company expects to continue re-deployment of liquidity into loans and investments. Additional information regarding investment securities can be found in Item 8, Notes 2 and 11 to the Consolidated Financial Statements and in this Management's Discussion and Analysis.

Interest and fees on loans increased by $549,000 on a fully tax-equivalent basis, or 3.7%, for the twelve months of 2011 compared to 2010. A $23.5 million increase in the average balance of the loan portfolio, or 9.9%, was accompanied by a 34 basis point decrease in the portfolio's tax equivalent yield. Additional information regarding loans can be found in Item 8, Note 3 to the Consolidated Financial Statements and in this Management's Discussion and Analysis.

Other interest income decreased by $41,000 from the same period a year ago. The average balance of interest-earning deposits and other earning assets decreased by $12.2 million, or 48.8%, reflecting the re-deployment of liquidity held during the recession. The yield increased by 4 basis points during 2011 compared to 2010.

Average interest-bearing demand deposits and money market accounts increased by $4.5 million, and savings increased by $5.1 million. The average rate paid on these products decreased by 11 basis points in the aggregate. The average balance of time deposit products increased by $2.7 million, as the average rate paid decreased by 43 basis points, from 2.28% to 1.85%. Total interest paid on these products was $3.0 million, a $635,000 decrease from a year ago. Additional information regarding deposits can be found in Item 8, Note 5 to the Consolidated Financial Statements and in this Management's Discussion and Analysis.

Average borrowings and subordinated debt decreased by $14.6 million while the average rate paid on borrowings decreased by 66 basis points. FHLB borrowings of $20.5 million were paid off at their due dates in 2011, of which $8.5 million was long term notes maturing. In the fourth quarter of 2011, the Bank borrowed $5.0 million in short-term FHLB borrowings to assist in funding the high commercial loan demand at year end. Management plans to pay down individual long term borrowings at their respective due dates in the future using current liquidity and utilizing short-term borrowings during peak demand. Additional information regarding FHLB Advances and Other Borrowings and Subordinated Debt can be found in Item 8, Notes 6 and 7 to the Consolidated Financial Statements and in this Management's Discussion and Analysis.

Analysis of Net Interest Income—Years Ended December 31, 2010 and 2009

	(Amounts in thousands)					
	December 31, 2010			December 31, 2009		
	Average Balance	Interest	Average Rate	Average Balance	Interest	Average Rate
INTEREST-EARNING ASSETS						
Interest-earning deposits and other earning assets	$ 24,898	$ 92	0.36%	$ 59,923	$ 155	0.27%
Investment securities (1)(2)(3)	191,546	7,807	4.08%	176,524	8,965	5.08%
Loans (1)(2)(3)(4)	237,624	14,765	6.21%	238,290	15,229	6.39%
Total interest-earning assets	$454,068	$22,664	4.99%	$474,737	$24,349	5.13%
INTEREST-BEARING LIABILITIES						
Interest-bearing demand and money market deposits	$ 69,295	$ 256	0.37%	$ 65,266	$ 436	0.67%
Savings	89,049	212	0.24%	84,933	516	0.61%
Time	158,578	3,611	2.28%	175,153	5,342	3.05%
Total interest-bearing deposits	316,922	4,079	1.29%	325,352	6,294	1.93%
Other borrowings	58,317	2,195	3.76%	68,307	2,813	4.12%
Subordinated debt	5,155	93	1.81%	5,155	127	2.46%
Total interest-bearing liabilities	$380,394	$ 6,367	1.68%	$398,814	$ 9,234	2.32%
Net interest income		$16,297			$15,115	
Net interest rate spread (5)			3.31%			2.81%
Net interest margin (6)			3.59%			3.19%

(1) Includes both taxable and tax exempt securities and loans.
(2) The amounts are presented on a fully taxable equivalent basis using the statutory tax rate of 34%, and have been adjusted to reflect the effect of disallowed interest expense related to carrying tax-exempt assets. Tax-free income from states of the U.S. and political subdivisions and loans amounted to $1.5 million and $121,000 for 2010 and $1.4 million and $166,000 for 2009, respectively.
(3) Average balance outstanding includes the average amount outstanding of all non-accrual investment securities and loans. Investment securities consist of average total principal adjusted for amortization of premium and accretion of discount and include both taxable and tax-exempt securities. Loans consist of average total loans, including loans held for sale, less average unearned income.
(4) Interest earned on loans includes net loan fees of $264,000 in 2010 and $245,000 in 2009.
(5) Net interest rate spread represents the difference between the yield on earning assets and the rate paid on interest-bearing liabilities.
(6) Net interest margin is calculated by dividing the net interest income by total interest-earning assets.

Net interest income, which continued to be the principal source of the Company's earnings in 2010, is the amount by which interest and fees generated by interest-earning assets, primarily loans and investment securities, exceed the interest cost of deposits and borrowed funds. Net interest income provides the core earnings base for the Company and increased 7.6% to $15.5 million in 2010 versus $14.4 million in 2009. During this extended period of historically low interest rates, the repricing of deposits initially trailed the pace of declining rates on assets. As liabilities continue to mature and reprice at lower rates, the net interest margin has, and is expected to continue to improve. Net interest income on a fully tax-equivalent basis measured $16.3 million in the year ended 2010 and $15.5 million in the year ended 2009, generating a net interest margin of 3.59% in 2010 and 3.19% in 2009.

The decrease in interest income, on a fully taxable equivalent basis, of $1.7 million was the product of a 4.4% year-over-year decrease in average earning assets and a 14 basis point decrease in interest rates earned. The decrease in interest expense of $2.9 million was a product of a 4.6% decrease in interest-bearing liabilities and a 64 basis point decrease in rates paid. The net result was a 7.8% increase in net interest income on a fully tax-equivalent basis and a 40 basis point increase in the Company's net interest margin.

On a fully tax-equivalent basis, income on investment securities decreased by $1.2 million, or 12.9%. The average invested balances increased by $15.0 million from the levels of a year ago. The increase in the average balance of investment securities was accompanied by a 100 basis point decrease in the tax-equivalent yield of the portfolio. The increase in the average balance of investment securities resulted from a management decision to steadily invest liquid funds into short-term investment grade securities beginning in the second half of 2009. During the year ended December 31, 2010, $85.8 million in investment securities were purchased while $53.7 million were called by the issuer or matured. During the year ended December 31, 2009, $51.5 million in investment securities were purchased while $63.9 million were called by the issuer or matured. As the Company managed its balance sheet for asset growth, asset mix and liquidity, as well as current interest rates and interest rate forecasts, several securities in the investment portfolio were sold for $15.2 million in mid-2010. The sale was intended to reduce the interest rate risk in the portfolio given the eventual interest rate increases expected post-economic recovery. Sales of $3.7 million were made late in 2009. The Company expects to continue re-deployment of liquidity into loans and investments. Additional information regarding investment securities can be found in Item 8, Notes 2 and 11 to the Consolidated Financial Statements and in this Management's Discussion and Analysis.

Interest and fees on loans decreased by $464,000 on a fully tax-equivalent basis, or 3.0%, for the twelve months of 2010 compared to 2009. A $666,000 decrease in the average balance of the loan portfolio, or 0.3%, was accompanied by an 18 basis point decrease in the portfolio's tax equivalent yield. Additional information regarding loans can be found in Item 8, Note 3 to the Consolidated Financial Statements and in this Management's Discussion and Analysis.

Other interest income decreased by $63,000 from the same period a year ago. The average balance of interest-earning deposits and other earning assets decreased by $35.0 million, or 58.5%, reflecting the re-deployment of liquidity held during the recession. The yield increased by 9 basis points during 2010 compared to 2009.

Average interest-bearing demand deposits and money market accounts increased by $4.0 million, and savings increased by $4.1 million. The average rate paid on these products decreased by 34 basis points in the aggregate. The average balance of time deposit products decreased by $16.6 million, as the average rate paid decreased by 77 basis points, from 3.05% to 2.28%. Total interest paid on these products was $3.6 million, a $1.7 million decrease from a year ago. Additional information regarding deposits can be found in Item 8, Note 5 to the Consolidated Financial Statements and in this Management's Discussion and Analysis.

Average borrowings, federal funds purchased and subordinated debt decreased by $10.0 million while the average rate paid on borrowings decreased by 40 basis points. FHLB borrowings of $15.5 million were paid off at their due dates in 2010. In the fourth quarter of 2010, the Bank borrowed $12.0 million in short-term FHLB borrowings to assist in funding the high commercial loan demand at year end. Management plans to pay down individual borrowings at their respective due dates in the future using current liquidity. Additional information regarding FHLB Advances and Other Borrowings and Subordinated Debt can be found in Item 8, Notes 6 and 7 to the Consolidated Financial Statements and in this Management's Discussion and Analysis.

The following table provides a detailed analysis of changes in net interest income on a tax equivalent basis, 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.

	(Amounts in thousands) 2011 Compared to 2010			2010 Compared to 2009		
	Volume	Rate	Total	Volume	Rate	Total
Increase (decrease) in interest income:						
Interest-earning deposits and other money markets	**$ (48)**	**$ 7**	**$ (41)**	$ (113)	$ 50	$ (63)
Investment securities:						
U.S. Government agencies and corporations	**(226)**	**(194)**	**(420)**	384	(566)	(182)
Mortgage-backed and related securities	**102**	**(785)**	**(683)**	410	(993)	(583)
Obligations of states and political subdivisions	**116**	**(248)**	**(132)**	405	(155)	250
Other securities	**(45)**	**(36)**	**(81)**	(257)	(386)	(643)
Loans	**1,405**	**(856)**	**549**	(43)	(421)	(464)
Total interest income change	**1,304**	**(2,112)**	**(808)**	786	(2,471)	(1,685)
Increase (decrease) in interest expense:						
Interest-bearing demand deposits	**16**	**(96)**	**(80)**	25	(205)	(180)
Savings deposits	**12**	**(83)**	**(71)**	24	(328)	(304)
Time deposits	**61**	**(696)**	**(635)**	(471)	(1,260)	(1,731)
Securities sold under agreements to repurchase	**(3)**	**(2)**	**(5)**	1	—	1
Other borrowings under one year	**(354)**	**(398)**	**(752)**	294	(67)	227
Other borrowings over one year	**(86)**	**(5)**	**(91)**	(660)	(186)	(846)
Subordinated debt	**—**	**(1)**	**(1)**	—	(34)	(34)
Total interest expense change	**(354)**	**(1,281)**	**(1,635)**	(787)	(2,080)	(2,867)
Increase (decrease) in net interest income on a taxable equivalent basis	**$1,658**	**$ (831)**	**$ 827**	$1,573	$ (391)	$ 1,182

The following table provides a detailed analysis of other income, other expense and federal income tax.

	(Amounts in thousands) 2011	2010	2009
Fees for other customer services	**$2,229**	$ 2,234	$ 2,298
Mortgage banking gains	**162**	236	265
Other real estate (losses) gains	**(113)**	(55)	15
Earnings on bank-owned life insurance	**496**	525	553
Other operating income	**104**	87	135
Other income, excluding investment gains	**2,878**	3,027	3,266
Investment securities net gains	**882**	1,018	432
Impairment losses on investment securities	**(202)**	(2,712)	(14,502)
Total other income (loss)	**$3,558**	$ 1,333	$(10,804)

Total other income, excluding investment gains or losses, decreased by $149,000, or 4.9%, for 2011 compared to a decrease of $239,000, or 7.3%, for 2010. After impairment losses and gains on investment securities, other income increased by $2.2 million in 2011 compared to an increase of $12.1 million in 2010.

Fees for customer services decreased by $5,000, or 0.2%, compared to a decrease of $64,000, or 2.8%, in the prior year. In November 2009, the Federal Reserve issued a final rule that, effective July 1, 2010, prohibits financial institutions from charging consumers fees for paying overdrafts on automated teller machine and

one-time debit card transactions, unless a consumer consents, or opts in, to the overdraft service for those types of transactions. Consumers were provided a notice that explains the Bank's overdraft services, including the fees associated with the service, and the consumer's choices. The Bank's customers have to provide advance consent to the overdraft service for automated teller machine and one-time debit card transactions. The decrease in fee income is a result of customers' choices. Loans originated for sale in the secondary market showed gains of $162,000 in 2011 compared to $236,000 in 2010 and $265,000 in 2009. With the creation of a mortgage banking subsidiary and the addition of wholesale lending, future gains on loans sold are expected to substantially exceed historical levels.

Gains on securities called and net gains on the sale of available-for-sale investment securities decreased by $136,000 in 2011 compared to an increase of $586,000 in 2010. In 2011, gains of $344,000 are due to the bankruptcy settlement on General Motors Corporation bonds. Several securities in the investment portfolio were sold mainly in the second quarter of 2010, along with calls and maturities, resulting in a gain of $1.0 million in 2010. Gains in 2011 and 2010 were offset by impairment losses of $202,000 and $2.7 million, respectively. These losses are attributable to trust preferred securities, primarily issued by bank holding companies. Additional information regarding investment securities can be found in Item 8, Notes 2 and 11 to the Consolidated Financial Statements and in this Management's Discussion and Analysis.

The following table provides a summary of non-interest expenses.

	(Amounts in thousands)		
	2011	2010	2009
Salaries and benefits	**$ 7,366**	$ 6,389	$ 7,434
Net occupancy and equipment expense	**1,734**	1,801	1,849
State and local taxes	**465**	430	415
FDIC insurance expense	**673**	867	962
Office supplies	**339**	344	357
Professional fees	**761**	750	727
Other operating expense	**2,137**	1,860	1,904
Total non-interest expenses	**$13,475**	$12,441	$13,648

Total non-interest expenses increased by $1.0 million, or 8.3%, in 2011. This compares to a decrease of $1.2 million, or 8.8%, in 2010. During 2011, expenditures for salaries and employee benefits increased by $977,000, or 15.3%. The Company completed its management reorganization during 2010 and recorded credits of $457,000 related to various compensation plans, net of severance costs. Absent these credits, salaries and benefits increased $520,000 from 2010 to 2011. Full-time equivalent employment averaged 151 in 2011 compared to 147 in 2010 and 160 in 2009. The addition of five employees throughout the third and fourth quarters of 2011 were related to CSB.

Salaries and employee benefits represent 54.7% of all non-interest expenses in 2011, 51.4% in 2010 and 54.5% in 2009. The following table details components of these increases and decreases.

	Amounts (in thousands)			Percentages		
	2011	2010	2009	2011	2010	2009
Salaries	**$294**	$ (263)	$135	**5.6%**	(4.7)%	2.5%
Benefits	**696**	(773)	109	**57.5**	(39.0)	5.8
	990	(1,036)	244	**15.2**	(13.7)	3.3
Deferred loan origination fees	**(13)**	(9)	34	**10.8**	—	23.4
Total	**$977**	$(1,045)	$278	**15.3%**	(14.1)%	3.9%

Wage and salary expense per employee averaged $37.0 million in 2011, $36.0 million in 2010 and $34.8 million in 2009. Average earning assets per employee measured $3.0 million in 2011, $3.1 million in 2010 and $3.0 million in 2009.

The Company incurred over $200,000 in non-interest expenses in 2011 associated with the start-up of CSB. As its operations ramp up in 2012, CSB is expected to enhance the Company's noninterest income. CSB anticipates partnering with mortgage brokers in contiguous states to originate mortgage loans. The loans may be sold to investors in the secondary market generating a profit margin.

Insurance premiums paid to the FDIC decreased by $194,000. Deposits are insured by the FDIC up to a maximum amount, which is generally $250,000 per depositor subject to aggregation rules. As an FDIC-insured institution, the Bank is required to pay deposit insurance premium assessments to the FDIC. The FDIC adopted a Restoration Plan to restore the reserve ratio of the Deposit Insurance Fund to 1.15%. Effective April 1, 2009, the Restoration Plan provides base assessment rate adjustments. In addition, under an interim rule, the FDIC imposed a five basis point emergency special assessment on insured depository institutions on June 30, 2009, which was $224,000. The special assessment was payable on September 30, 2009. Pursuant to a final rule adopted by the FDIC in November 2009, the Bank was required to prepay its estimated quarterly risk-based assessments to the FDIC for the fourth quarter 2009 and for all of 2010, 2011 and 2012. The Bank prepaid the amount of $3.0 million in December 2009 and had a remaining balance of $1.5 million at December 31, 2011. The prepaid assessment amounts are included in other assets on the Consolidated Balance Sheets of the Company. The Bank will be assessed quarterly premiums by the FDIC, and such assessments will be charged against the prepaid asset until such time as the prepaid asset has been fully expensed, at which point the Bank will resume paying premiums to the FDIC. Concurrently with the effects of the FDIC restoration plan, the Bank was also subject to higher insurance premiums due to its informal agreement with its regulatory agencies. As a result of its fulfillment of all the terms of the agreement, FDIC insurance expense is expected to decline 50% in 2012.

Income (loss) before income tax expense amounted to $5.3 million for the year ended 2011 compared to $3.9 million and $(10.5) million for the similar periods of 2010 and 2009, respectively. The effective tax rate was 22.66% in 2011, 15.96% in 2010 and (39.61%) in 2009, resulting in income tax expense (benefit) of $1.2 million, $621,000 and $(4.2) million, respectively.

	December 31,		
	2011	2010	2009
Provision at statutory rate	**34.00%**	34.00%	(34.00)%
Add (Deduct) tax effects of:			
Earnings on bank-owned life insurance-net	**(2.49)**	(3.65)	(1.50)
Other non-taxable income	**(9.82)**	(15.91)	(4.45)
Non-deductible expense	**0.97**	1.52	0.34
Federal income tax effective rate	**22.66%**	15.96%	(39.61)%

Net income (loss) registered $4.1 million in 2011, $3.3 million in 2010 and $(6.3) million in 2009, representing per share amounts of $0.90 in 2011, $0.72 in 2010 and $(1.40) in 2009. There were no cash dividends in 2011, 2010 and 2009.

The following table shows unaudited financial results by quarter.

	(Amounts in thousands) For the 2011 Quarter Ended				For the 2010 Quarter Ended			
	Dec. 31	Sept. 30	June 30	Mar. 31	Dec. 31	Sept. 30	June 30	Mar. 31
Interest income	**$5,177**	**$5,275**	**$5,338**	**$5,320**	$5,334	$ 5,370	$5,619	$5,549
Interest expense	**1,118**	**1,158**	**1,203**	**1,253**	1,416	1,567	1,624	1,760
Net interest income	**4,059**	**4,117**	**4,135**	**4,067**	3,918	3,803	3,995	3,789
Loan loss provision	**324**	**324**	**374**	**174**	180	30	120	175
Net security gains	**9**	**92**	**698**	**83**	10	45	963	—
Impairment losses	**—**	**—**	**—**	**(202)**	(91)	(1,464)	(613)	(544)
Mortgage banking gains	**42**	**25**	**20**	**16**	131	63	38	4
Other real estate (losses) gains	**(42)**	**28**	**(71)**	**(28)**	5	(56)	—	(4)
Other income	**806**	**725**	**693**	**664**	711	701	726	708
Other expenses	**3,508**	**3,291**	**3,321**	**3,355**	3,205	3,287	3,210	2,739
Income (loss) before tax	**1,042**	**1,372**	**1,780**	**1,071**	1,299	(225)	1,779	1,039
Federal income tax expense (benefit)	**214**	**318**	**459**	**202**	263	(242)	455	145
income	**$ 828**	**$1,054**	**$1,321**	**$ 869**	$1,036	$ 17	$1,324	$ 894
Net income per share	**$ 0.18**	**$ 0.24**	**$ 0.29**	**$ 0.19**	$ 0.23	$ —	$ 0.29	$ 0.20
Net interest income (fully tax-equivalent basis)	**$4,241**	**$4,293**	**$4,319**	**$4,273**	$4,148	$ 4,011	$4,180	$3,958
Net interest rate spread	**3.42%**	**3.48%**	**3.56%**	**3.53%**	3.42%	3.24%	3.41%	3.19%
Net interest margin	**3.64%**	**3.72%**	**3.78%**	**3.74%**	3.67%	3.52%	3.68%	3.47%

ALLOWANCE FOR LOAN LOSSES

The allowance for loan losses is a reserve established through a provision for loan losses charged to expense, which represents management's best estimate of probable losses that have been incurred within the existing portfolio of loans. The allowance, in the judgment of management, is necessary to reserve for estimated loan losses on risks inherent in the loan portfolio. Accordingly, the methodology to establish the amount of the allowance is based on historical loss experience by type of credit and internal risk grade, specific homogeneous risk pools, and specific loss allocations, with adjustments for current events and conditions. The Company's process for determining the appropriate level of the allowance for loan losses is designed to account for credit deterioration as it occurs.

The Company's allowance for loan loss methodology consists of three elements: (i) specific valuation allowances on probable losses on specific loans; (ii) historical valuation allowances based on historical loan loss experience for similar loans with similar characteristics and trends; and (iii) general valuation allowances based on general economic conditions and other qualitative risk factors both internal and external to the Company.

The allowances established for probable losses on specific loans are based on recurring analyses and evaluations of classified loans. Loans are categorized into risk grade classifications based on an internal credit risk grading process that evaluates, among other things: (i) the obligor's ability to repay; (ii) the underlying collateral, if any; and (iii) the economic environment and industry in which the borrower operates. The Bank currently divides the loan and lease portfolio into the following major categories: 1) Pooled Loans (unclassified) with similar risk characteristics; 2) Substandard Loans (classified) defined as being inadequately protected by current sound net worth, paying capacity of the borrower, or pledged collateral; 3) Special Mention (classified) defined as having potential weaknesses that deserve management's close attention. If left uncorrected, these potential weaknesses may, at some future date, result in the deterioration of the repayment prospects for the credit or the Bank's credit position; 4) Loss or doubtful loans (classified) have all the weaknesses of the previous classifications, with the added characteristic that the weaknesses make collection or liquidation in full, on the basis of currently existing

facts, conditions, and values highly questionable and improbable; 5) Impaired Loans which generally include non-accrual loans. Once a loan is assigned a risk grade of classified, the loan review officer assesses whether the loan is to be evaluated for impairment based on the Company policy. A portion of the allowance for loan loss is specifically allocated to those loans which are evaluated for impairment and determined to be impaired. Specific valuation allowances are determined by analyzing the borrower's ability to repay amounts owed, collateral deficiencies, the relative risk grade of the loan and economic conditions affecting the borrower's industry, among other things. If after review, the loan is not considered to be impaired, the loan is included with a pool of similar loans that is assigned a valuation allowance calculated based on the historical loss experience of the pool type. The valuation allowance is calculated based on the historical loss experience of specific types of classified loans. The Company calculates historical loss ratios for pools of loans with similar characteristics based on the proportion of actual charge-offs experienced to the total population of loans in the pool. The historical loss ratios are periodically updated based on actual charge-off experience.

A general valuation allowance is established for pools of homogeneous loans based upon the product of the historical loss ratio adjusted for qualitative factors and the total dollar amount of the loans in the pool. Specific qualitative factors considered by management include trends in volume or terms, changes in lending policy levels and trends in charge-offs, classification and non-accrual loans, concentrations of credit and local and national economic factors. The Company's pools of similar loans include similarly risk-graded groups of commercial loans, commercial real estate loans, consumer loans and residential real estate loans and home equity loans. Additional factors are used on pools of loans considered special mention; specifically, levels and trends in classification, declining trends in financial performance, structure and lack of performance measures and migration from special mention to substandard. For loans graded as substandard, a separate historical loss rate is calculated as a percent of charge-offs net of recoveries to the balance of substandard loans, which results in a significantly higher historical loss factor. This is also adjusted for the qualitative factors discussed previously.

Loans identified as losses by management, internal loan review and/or bank examiners are charged-off. Furthermore, consumer loan accounts are charged-off in accordance with regulatory requirements.

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 consolidated balance sheets within other liabilities, while the corresponding provision for these losses is recorded as a component of other operating expenses. At both December 31, 2011 and 2010, this allowance was $84,000. Portions of the allowance may be allocated for specific credits; however, the entire allowance is available for any credit that, in management's judgment, should be charged off. While management utilizes its best judgment and information available, the ultimate adequacy of the allowance is dependent upon a variety of factors beyond the Company's control, including the performance of the Company's loan portfolio, the economy, changes in interest rates and the view of the regulatory authorities toward loan classifications.

Although we believe we use the best information available to make loan loss allowance determinations, future adjustments could be necessary if circumstances or economic conditions differ substantially from the assumptions used in making our initial determinations. Continued levels of job loss and high unemployment, home foreclosures and business failures could result in increased levels of nonperforming assets and charge-offs, increased loan loss provisions and reductions in income. Additionally, as an integral part of their examination process, bank regulatory agencies periodically review our allowance for loan losses. The banking agencies could require the recognition of additions to the loan loss allowance based on their judgment of information available to them at the time of their examination.

	(Amounts in thousands)				
	2011	2010	2009	2008	2007
Balance at beginning of year	**$2,501**	$2,437	$2,470	$ 1,621	$2,211
Loan losses:					
Commercial real estate	**(211)**	(204)	(233)	(624)	(395)
Commercial loans	**—**	(1)	(5)	(20)	(1)
Residential real estate	**(362)**	(229)	(87)	(184)	(92)
Consumer and other loans	**(168)**	(168)	(198)	(255)	(232)
Home equity loans	**(91)**	(14)	(97)	(17)	(8)
Total	**(832)**	(616)	(620)	(1,100)	(728)
Recoveries on previous loan losses:					
Commercial real estate	**118**	58	55	3	5
Commercial loans	**3**	—	4	35	1
Residential real estate	**6**	18	1	—	—
Consumer and other loans	**66**	99	100	126	92
Total	**193**	175	160	164	98
Net loan losses	**(639)**	(441)	(460)	(936)	(630)
Provision charged to operations	**1,196**	505	427	1,785	40
Balance at end of year	**$3,058**	$2,501	$2,437	$ 2,470	$1,621
Ratio of net loan losses to average total loans outstanding	**0.24%**	0.19%	0.19%	0.42%	0.29%
Ratio of loan loss allowance to total loans	**1.06%**	0.94%	0.98%	1.00%	0.73%

The spike in charge-offs during 2008 primarily reflected certain impaired commercial real estate loan credits for which specific loss reserves had been established.

The following is an allocation of the year end allowance for loan losses. The allowance has been allocated according to the amount deemed to be reasonably necessary to provide for the possibility of losses being incurred within the following categories of loans as of December 31:

	(Amounts in thousands)				
	2011	2010	2009	2008	2007
Commercial real estate	**$1,803**	$1,611	$1,666	$1,663	$ 954
Commercial loans	**565**	249	209	257	194
Residential real estate	**470**	418	315	287	258
Consumer and other loans	**92**	112	176	226	214
Home equity loans	**128**	111	71	37	1
Total	**$3,058**	$2,501	$2,437	$2,470	$1,621

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

LOAN PORTFOLIO

The following table represents the composition of the loan portfolio as of December 31:

	2011		2010		2009		2008		2007	
	(Amounts in thousands)									
	Balance	%	Balance	%	Balance	%	Balance	%	Balance	%
Commercial real estate	**$160,319**	**55.5**	$146,389	55.2	$126,507	51.0	$128,705	52.4	$120,950	54.3
Commercial loans	**60,233**	**20.8**	42,349	16.0	38,498	15.5	27,750	11.3	14,981	6.7
Residential real estate	**45,780**	**15.8**	52,262	19.7	60,904	24.5	68,985	28.0	68,135	30.5
Consumer loans	**5,848**	**2.0**	7,216	2.7	7,770	3.1	8,162	3.3	8,484	3.8
Home equity loans	**16,916**	**5.9**	16,963	6.4	14,569	5.9	12,179	5.0	10,559	4.7
Total loans	**$289,096**		$265,179		$248,248		$245,781		$223,109	

The following schedule sets forth maturities based on remaining scheduled repayments of principal or next re-pricing opportunity for loans (excluding residential real estate, consumer and home equity loans) as of December 31, 2011:

	(Amounts in thousands)			
	1 Year or Less	1 to 5 Years	Over 5 Years	Total
Commercial real estate	**$55,328**	**$ 88,876**	**$16,115**	**$160,319**
Commercial loans	**34,358**	**16,253**	**9,622**	**60,233**
Total loans (excluding residential real estate, consumer and home equity loans)	**$89,686**	**$105,129**	**$25,737**	**$220,552**

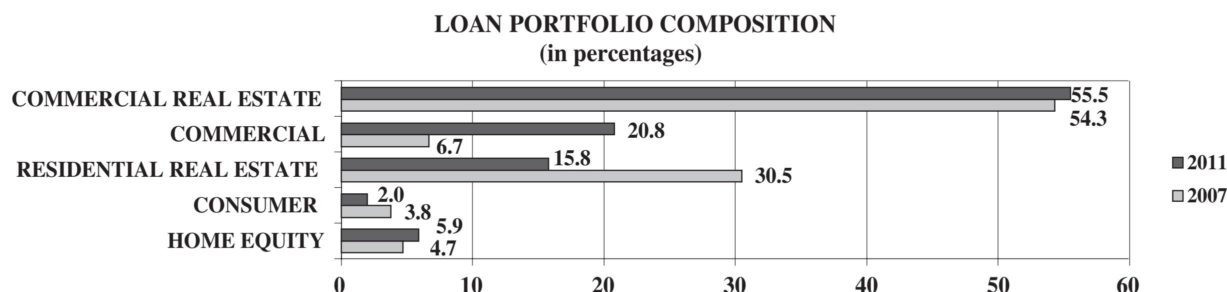
The following schedule sets forth loans as of December 31, 2011 based on next re-pricing opportunity for floating and adjustable interest rate products, and by remaining scheduled principal payments for loan products with fixed rates of interest. Residential real estate, consumer and home equity loans have again been excluded.

	(Amounts in thousands)		
	1 Year or Less	Over 1 Year	Total
Floating or adjustable rates of interest	**$63,604**	**$ 94,006**	**$157,610**
Fixed rates of interest	**26,082**	**36,860**	**62,942**
Total loans (excluding residential real estate, consumer and home equity loans)	**$89,686**	**$130,866**	**$220,552**

The Company recorded an increase of $23.9 million in the loan portfolio from the level of $265.2 million recorded at December 31, 2010. Gross loans as a percentage of earning assets stood at 59.9% as of December 31, 2011 and 57.4% at December 31, 2010. The loan-to-deposit ratio at the end of 2011 was 68.4% as compared to 67.7% at the end of 2010. The increase in loans primarily resulted from strategic efforts initiated in the second half of 2010 designed to shift low earning investments into loans while increasing customer market share. The Company substantially restructured and expanded its commercial lending staff in the second half of 2010 with the specific objective of growing commercial-related loans and deposits while maintaining the Company's commitment to credit quality. Despite the slow economic recovery in the region, the Bank posted year-over-year growth in total loans of 9.0% while growth in commercial-related loans was recorded at 16.9%, or $31.8 million. As the balance sheet is adequately structured to accommodate additional loan growth, management remains committed to fulfilling the credit needs of creditworthy customers. The year-end increase in total loans is also

partially attributed to short-term, 60-day loans closed in 2011 for $19.5 million, compared to $16.9 million in 2010. At December 31, 2011 the loan loss allowance of $3.1 million represented approximately 1.1% of outstanding loans, and at December 31, 2010, the loan loss allowance of $2.5 million represented approximately 1.0% of outstanding loans.

Between 2010 and 2011, the balance of residential real estate loans declined from 19.7% to 15.8% of the loan portfolio as borrowers looked to the secondary market in order to take advantage of historically low interest rates while management elected not to portfolio historically low yields. The portion of the loan portfolio represented by commercial loans (including commercial real estate) increased from 71.2% in 2010 to 76.3% in 2011. Consumer loans (including home equity loans) decreased from 9.1% in 2010 to 7.9% in 2011 and was representative of what the banking industry experienced with consumers deleveraging their household since the economic downturn of 2008-2009. The following table offers a comparison of loan composition for the time period 2007 to 2011:



Commercial, commercial real estate and residential real estate loans continue to comprise the largest share of the Company's loan portfolio. At the end of 2011, commercial and residential real estate loans comprised a combined 92.1% of the portfolio compared to 91.5% at December 31, 2007. The portfolio at December 31, 2011 also included home equity loans at 5.9% and consumer installment loans at 2.0%. These percentages compare to home equity loans at 4.7% and consumer installment loans at 3.8% on December 31, 2007.

The balance of the commercial loan portfolio, which includes commercial mortgages, is $220.6 million at December 31, 2011, an increase of $31.8 million from the balance of $188.7 million recorded at December 31, 2010 and represents a 16.9% growth. Short-term, asset-based commercial loans, including lines of credits, increased during the year. Commercial loans reflected the largest component growth from the prior period of $17.9 million or 42.2%. This was a direct result of increased focus on commercial and industrial customers, commercial customers utilizing their commercial lines of credit and an increase in 60-day commercial loans closed in December 2011 totaling $19.5 million and in December 2010 totaling $16.9 million, which were fully secured by segregated deposit accounts with the Bank. The focus on commercial and industrial relationships also assisted a 42.0% growth in commercial deposits from the period ending 2010 to 2011. As previously stated, the Company expanded its commercial lending staff in 2010 with the specific objective of growing commercial loans and deposits.

Loan personnel will continue to aggressively pursue both commercial and small business opportunities supported by product incentives and marketing efforts. When necessary, management will continue to offer competitive fixed rate commercial real estate products to qualifying customers in an effort to establish new business relationships, retain existing relationships, and capture additional market share. 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 industrial accounts such as health care facilities, grocery stores, manufacturers, trucking companies, physicians and medical groups, service contractors, restaurants, hospitality industry companies, retailers, wholesalers, educational institutions and other political subdivisions as well as commercial and residential real estate builders.

Commercial and small business loans are originated by commercial loan personnel and other loan personnel assigned to the Bank's offices within various geographical regions. These loans are all 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 current loan balances including executed commitments to fund and do not reflect existing commitments that have not been accepted or executed.

	(Amounts in thousands)					
	2011		2010		2009	
	Balances	% of Portfolio	Balances	% of Portfolio	Balances	% of Portfolio
Non-residential building/apartment building	**$26,724**	**12.12**	$21,036	11.15	$14,594	8.84
Skilled nursing	**20,356**	**9.23**	22,039	11.68	7,743	4.69
Hotels/motels	**17,247**	**7.82**	18,057	9.57	20,805	12.61
Eating establishments	**15,805**	**7.17**	16,463	8.72	14,519	8.80
Nursing and personal care	**14,433**	**6.54**	4,179	2.21	5,014	3.04

The above referenced table reflects an increase in commercial real estate which consists of a wide variety of property held as investments and which are non-owner occupied. The most substantial increase in concentrations comes from skilled nursing and nursing and personal care which were significantly enhanced in late 2010 and 2011. The single largest customer relationship had an aggregate balance at year end 2011 of $11.4 million compared to $11.7 million in 2010. This balance represented approximately 5.1% of the total commercial portfolio compared to 6.2% in 2010. It is important to note that within this relationship, there is a 60-day note for $8.0 million in 2011 and $8.2 million in 2010, which are fully secured by segregated deposit accounts with the Bank.

For the fiscal year ended 2011, approximately $8.3 million in new residential real estate loans were originated by the Company, a decrease of approximately $7.0 million from 2010 originations.

The following shows the disposition of real estate loans originated during 2009 to 2011 (in millions):

	2011	2010	2009
Retained in portfolio	**$3.5**	$ 3.7	$ 4.2
Loans sold to investors with servicing rights released	**$4.8**	$11.6	$15.1

The Company's product offerings continue to include a service released sales program, which extends the Company the ability to offer competitive long-term fixed interest rates without incurring additional credit or interest rate risk.

During 2011, the Company sold less residential real estate loans under the service release sales program and retained fewer portfolio loans in comparison to 2010 and 2009 totals. Real estate loan originations are typically qualified for sale to investors in the secondary market, but are occasionally retained in the portfolio when requested by a customer or to enhance account relationships for certain customers. The mix of portfolio retained to those sold to investors will vary from year to year.

In late 2011, the Company implemented a wholesale mortgage operation that will be serviced through CSB. Management expects to capitalize on the expertise of CSB's newly hired personnel to substantially increase loans sold on the secondary market.

The Bank continues to be active in home equity financing. Home equity term loans and credit lines (HELOCs) remain popular with consumers wishing to finance home improvement costs, education expenses, vacations and consumer goods purchased at favorable interest rates.

In order to improve customer retention and provide better overall balance, management will continue to evaluate and reposition the Company's portfolio product offerings during 2012.

In the consumer lending area, the Company provides financing for a variety of consumer purchases, such as: 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 balances and other existing debt into term payouts continues to remain a popular financing option among consumers.

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

INVESTMENT 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. The Company currently does not maintain held-to-maturity or trading portfolios.

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

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.

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

The following table shows the book value of investment securities by type of obligation at December 31:

	(Amounts in thousands)		
	2011	2010	2009
U.S. Treasury and U.S. Government agencies and corporations	**$ 20,675**	$ 31,571	$ 26,673
U.S. Government mortgage-backed and related securities	**113,283**	101,496	99,493
Private-label mortgage-backed and related securities	**381**	780	1,003
Obligations of states and political subdivisions	**39,019**	38,496	28,595
Trust preferred securities	**9,145**	12,779	12,124
Corporate securities	**—**	287	287
General Motors equity investments	**364**	—	—
Regulatory stock	**3,049**	3,049	3,749
Total book value of investments	**$185,916**	$188,458	$171,924

Impairment Analysis of Investment Securities

Item 8, Note 2 in the Notes to the Consolidated Financial Statements contains the accounting and disclosures for securities impairment pursuant to FASB ASC Topic 320, *Investments—Debt and Equity Securities*.

Fair Value

The Company owns 31 trust preferred securities totaling $34.6 million (par value) issued by banks, thrifts, insurance companies and real estate investment trusts. Two securities totaling $5.9 million were determined worthless for book and tax purposes in 2010. The market for the remaining 29 securities at December 31, 2011 is not active and markets for similar securities are also not active. Given conditions in the debt markets today and the absence of observable transactions in the secondary and new issue markets, the Company determined the few observable transactions and market quotations that are available are not reliable for purposes of determining fair value at December 31, 2011. It was decided that an income valuation approach technique (present value technique) that maximizes the use of relevant observable inputs and minimizes the use of unobservable inputs would be more representative of fair value than the market approach valuation technique used at measurement dates prior to 2008.

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

1. Estimate the credit quality of the collateral using average probability of default values for each issuer (adjusted for rating levels).

2. Consider the potential for correlation among issuers within the same industry for default probabilities (e.g. banks with other banks).

3. Forecast the cash flows for the underlying collateral and apply to each trust preferred security tranche to determine the resulting distribution among the securities.

4. Discount the expected cash flows to calculate the present value of the security.

The effective discount rates on an overall basis generally range from 17.08% to 44.38% and are highly dependent upon the credit quality of the collateral, the relative position of the tranche in the capital structure of the trust preferred securities and the prepayment assumptions.

Based upon the results of the analysis, the Company currently believes that a weighted average price of approximately $0.32 per $1.00 of par value is representative of the fair value of the 29 trust preferred securities.

The Company considered all information available as of December 31, 2011 to estimate the impairment and resulting fair value of the trust preferred securities. These securities are supported by a number of banks and insurance companies located throughout the country. The FDIC has recently indicated that there are many financial institutions still considered troubled banks even after the numerous failures in 2010 and 2011. If the conditions of the underlying banks in the trust preferred securities worsen, there may be additional impairment to recognize in 2012 or later.

A summary of securities held at December 31, 2011, classified according to the earlier of next re-pricing 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.

	(Amounts in thousands)	
	Book Value	Weighted Average Yield (1)
U.S. Government agencies and corporations:		
Maturing or repricing within one year	$ —	— %
Maturing or repricing after one year but within five years	9,847	3.299
Maturing or repricing after five years but within ten years	7,780	4.173
Maturing or repricing after ten years	3,048	5.764
Total U.S. Government agencies and corporations	$ 20,675	3.991%
U.S. Government mortgage-backed and related securities:		
Maturing or repricing within one year	$ 31,267	2.674%
Maturing or repricing after one year but within five years	65,186	2.485
Maturing or repricing after five years but within ten years	14,526	3.084
Maturing or repricing after ten years	2,304	3.519
Total U.S. Government mortgage-backed and related securities	$113,283	2.635%
Private-label mortgage-backed and related securities:		
Maturing or repricing within one year	$ 302	2.259%
Maturing or repricing after one year but within five years	72	4.580
Maturing or repricing after five years but within ten years	7	4.580
Maturing or repricing after ten years	—	—
Total private-label mortgage-backed and related securities	$ 381	2.740%
Obligations of states and political subdivisions:		
Maturing or repricing within one year	$ 288	7.763%
Maturing or repricing after one year but within five years	2,165	4.665
Maturing or repricing after five years but within ten years	5,476	5.788
Maturing or repricing after ten years	31,090	5.678
Total obligations of states and political subdivisions	$ 39,019	5.652%
Other securities (2):		
Maturing or repricing within one year	$ 8,148	2.225%
Maturing or repricing after one year but within five years	—	—
Maturing or repricing after five years but within ten years	—	—
Maturing or repricing after ten years	4,410	3.933
Total other securities	$ 12,558	2.825%

(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 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 $8,000, $31,000, $97,000 and $530,000 for the four ranges of maturities, respectively.

(2) Regulatory stock is included in the maturing or repricing after ten years maturity bucket.

As of December 31, 2011, there were $13.2 million in callable U.S. Government agencies and $1.5 million in callable obligations of states and political subdivisions that given current and expected interest rate environments, are likely to be called within the one year time horizon. These securities are categorized according

to their contractual maturities, with $7.8 million classified as maturing after one year but within five years, $3.9 million classified as maturing after five years but within ten years and $3.0 million classified as maturing after 10 years.

As of December 31, 2011, there were $5.2 million in callable U.S. Government agencies, $12.6 million in callable obligations of states and political subdivisions that given current and expected interest rate environments having the possibility of being called within the time frame defined as after one year but within five years. These securities are categorized according to their contractual maturities, with $8.1 million maturing after five years but within ten years and $9.7 million maturing after 10 years.

As of December 31, 2011, the carrying value of all investment securities totaled $185.9 million, a decrease of $2.5 million, or 1.3%, from the prior year. The Bank's management elected to reinvest the majority of the called and paid-down securities that were realized during the twelve months ended December 31, 2011. Additionally, by utilizing the available liquidity, the Bank was able to pay off FHLB advances and fund commercial loans. The investment portfolio represents 44.0% of each deposit dollar, down from 48.1% of year end levels. The allocation between single maturity investment securities and mortgage-backed securities shifted to a 38/62 split versus the 45/55 division of the previous year, as mortgage-backed securities increased by $11.4 million, or 11.1% from 2010.

Holdings of obligations of states and political subdivisions showed an increase of $523,000, or 1.4%, as purchases were largely offset by calls during the year. Amortization of purchase premiums resulted in the increase of holdings of U.S. Treasury securities by approximately $9,000, or 7.3%. Investments in U.S. government agencies and corporations decreased by approximately $10.9 million, or 34.7%. Holdings of corporate securities decreased by $287,000 as the bonds therein were converted to equity investment as part of a bankruptcy settlement. This accounts for the increase of $364,000 in General Motors equity investments.

Holdings of trust preferred securities decreased by $3.6 million, as the fair value decreased during the year. The Company recognized $202,000 of OTTI on its trust preferred securities that flowed through non-interest income. The change in losses recorded in other comprehensive income increased by $3.1 million.

Holdings of other securities remained relatively unchanged during the year.

The mix of mortgage-backed securities remained weighted in favor of fixed rate securities in 2011. The portion of the mortgage-backed portfolio allocated to fixed-rate securities rose to 96.0% in 2011 versus 90.0% in 2010. Floating rate and adjustable rate mortgage-backed securities provide some degree of protection against rising interest rates, while fixed-rate securities perform better in periods of stable-to-slightly declining interest rates. Included in the mortgage-backed securities portfolio are investments in collateralized mortgage obligations, which totaled $39.4 million and $19.3 million at December 31, 2011 and 2010, respectively. There were $585,000 in collateralized mortgage obligations sold in 2011 and none were sold in 2010.

At December 31, 2011, a net unrealized loss of $2.7 million, net of tax, was included in shareholders' equity as a component of other comprehensive loss, as compared to a net unrealized loss of $2.5 million, net of tax, as of December 31, 2010. Lower interest rates generally translate into more favorable market prices for debt securities; conversely, rising interest rates generally result in depreciation in the market value of debt securities. As the trust preferred securities are in an illiquid market, their valuation is driven by a discounted cash flow model, and the losses therein are the primary determinant of the overall loss position.

The Company has $1.5 million in investments considered to be structured notes as of December 31, 2011, a decrease of $1.5 million, or 50.4% from one year ago. The Company has no investments in inverse floating rate securities or other derivative products.

Additional information regarding investment securities can be found in Item 8, Notes 1 and 2 to the Consolidated Financial Statements.

DEPOSITS

The Company's deposits are derived from the individuals and businesses located in its primary market area. Total deposits at year-end exhibited an increase of 8.0% to $422.8 million at December 31, 2011, as compared to $391.5 million at December 31, 2010.

The Company's deposit base consists of demand deposits, savings, money market and time deposit accounts. Average noninterest-bearing deposits increased 15.3 % during 2011, while average interest-bearing deposits decreased by 6.6%.

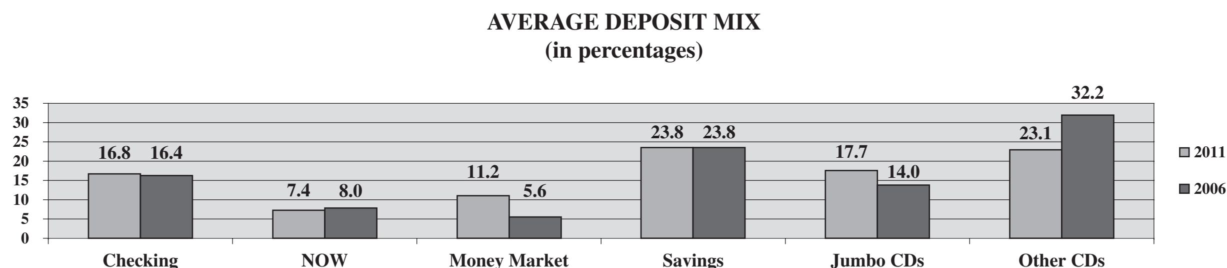
During 2011, noninterest-bearing deposits averaged $66.3 million, or 16.8%, of total average deposits compared to $61.3 million, or 16.2%, of total deposits in 2010. Core deposits defined as deposits less than $100,000, averaged $325.4 million for the year ended December 31, 2011, an increase of $7.8 million from the average level in 2010. During 2010, core deposits had averaged $317.7 million, a decrease of $1.4 million from the preceding year.

Historically, the deposit base of the Company has been characterized by a significant aggregate amount of core deposits. Core deposits represents 82.3% of average total deposits in 2011 compared to 84.0% in 2010. Non-core deposits consist of Jumbo CDs, which are certificates of deposit in the amount of $100,000 or more.

The Company's portfolio of certificates of deposit is sourced primarily from customers in the Bank's immediate market area and does not include brokered deposits.

Over the past five years, noninterest-bearing and interest-bearing checking accounts have been fairly consistent as a percentage of total deposits. These products now comprise 24.2% of total deposits compared to 24.4% five years ago. The following graph depicts how the deposit mix has shifted during this five-year time frame.

AVERAGE DEPOSIT MIX
(in percentages)



Additional information regarding interest-bearing deposits can be found in Item 8, Note 5 to the Consolidated Financial Statements.

OTHER ASSETS AND OTHER LIABILITIES

Premises and equipment totaled $6.5 million at December 31, 2011, a decrease of $246,000 from $6.7 million at December 31, 2010. Bank-owned life insurance had a cash surrender value of $12.9 million at December 31, 2011 and $12.5 million at December 31, 2010. Other assets decreased to $11.3 million at December 31, 2011 from $13.9 million at December 31, 2010. Included in other assets is a prepaid assessment paid to the FDIC in December of 2009. This prepayment is the estimate, based on projected assessment rates and assessment base, made by the FDIC of premiums due until December 31, 2012. On a quarterly basis, this prepayment will be reduced, and at that time expensed, until the prepayment is depleted. The balance was $1.5 million at December 31, 2011 and $2.1 million at December 31, 2010. Other real estate decreased to $437,000 at December 31, 2011 compared to $848,000 at December 31, 2010. Net deferred tax assets measured $6.4 million at December 31, 2011 compared to $6.3 million at December 31, 2010.

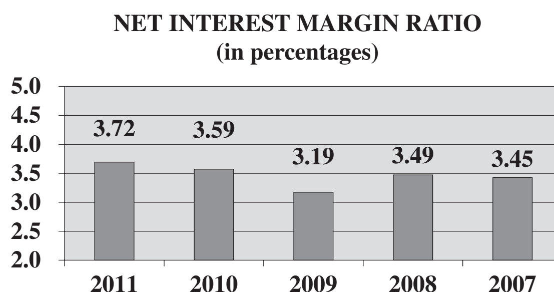
Other liabilities remain fairly consistent measuring $3.9 million at both December 31, 2011 and 2010. The major components are accrued interest on deposits and borrowings which measured $441,000 and $535,000 in 2011

and 2010. Accrued expenses measure $2.5 million at both December 31, 2011 and 2010, respectively. Post-retirement benefits is the largest accrued expense item. Completion of reorganization in 2010 resulted in a reduction in the accrual for post-retirement of $542,000.

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 income 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 has averaged 3.49% ranging between 3.72% and 3.19% as depicted in the following graph.

NET INTEREST MARGIN RATIO
(in percentages)



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.

During 2011, the effective maturities of earning assets tended to shorten as rates in the credit markets remained extremely low. Federal Reserve policy makers kept the short-term rates in the range of 0.00% to 0.25% during all of 2011 in an attempt to ease strains in the financial market, soften the effects of the housing correction and help avoid a recession. With rates low during the year, prepayments on loans and mortgage-backed securities remained high, causing the effective maturities of existing earning assets to shorten during 2011. During the year, management invested the excess overnight funds (federal funds sold balances), with an allocation towards municipal bonds and mortgage-backed securities.

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 3.19% to 3.72% 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 a low of 0.00% to 5.25%, as Federal Reserve monetary policy turned from guarding against deflation to warding off inflationary threats to attempting to recover from a recession and softening the effects of the housing correction.

LIQUIDITY

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

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

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

Anticipated principal repayments on mortgage-backed securities along with investment securities maturing, re-pricing, or expected to be called in one year or less amounted to $54.7 million at December 31, 2011, representing 29.4% of the total combined portfolio, compared to $82.2 million, or 43.6%, of the portfolio a year ago.

In order to address the concern of FDIC insurance of larger depositors, the Bank became a member of the Certificate of Deposit Account Registry Service (CDARS®) program in 2009 and the Insured Cash Sweep (ICS) program in 2011. Through CDARS®, the Bank's customers can increase their FDIC insurance by up to $50.0 million through reciprocal certificate of deposit accounts and likewise through ICS, they can accomplish the same through money market savings accounts. This is accomplished by the Bank entering into reciprocal depository relationships with other member banks. The individual customer's large deposit is broken into amounts below $250,000 and placed with other banks that are members of the network. The reciprocal member bank issues certificates of deposit or money market savings accounts in amounts that ensure that the entire deposit is eligible for FDIC insurance. At December 31, 2011, the Bank did not have any deposits in either program. For regulatory purposes, CDARS® and ICS are considered a brokered deposit even though reciprocal deposits are generally from customers in the local market.

Along with its liquid assets, the Bank has other sources of liquidity available to it which help to ensure that adequate funds are available as needed. These other sources include, but are not limited to, the ability to obtain deposits through the adjustment of interest rates, the purchasing of federal funds, correspondent bank lines of credit and access to the Federal Reserve Discount Window. The Bank is also a member of the FHLB, which provides yet another source of liquidity. At December 31, 2011, the Bank had approximately $10.8 million available of collateral-based borrowing capacity at FHLB of Cincinnati and $0.8 million of availability at the Federal Reserve Discount window. Additionally, the FHLB has committed a $24.1 million cash management line subject to posting additional collateral. The Bank has access to approximately 10% of total deposits in brokered certificates of deposit that could be used as an additional source of liquidity. At December 31, 2011 and 2010, there was no outstanding balance in brokered certificates of deposit. The Company was also granted a total of $8.5 million in unsecured, discretionary Federal Funds lines of credit with no funds drawn upon as of December 31, 2011 and 2010. Unpledged securities of $66.9 million are also available for borrowing under repurchase agreements or as additional collateral for FHLB lines of credit.

CSB will obtain its funding through the Bank. It is anticipated that the Bank will utilize short term borrowings under its FHLB cash management line to fund the needs of CSB. Upon establishing an inventory of loans held for sale, such loans may be used as additional collateral for FHLB borrowings.

The Company has other more limited sources of liquidity. In addition to its existing liquid assets, it can raise funds in the securities market through debt or equity offerings or it can receive dividends from its bank subsidiary. Generally, the Bank may pay dividends without prior approval as long as the dividend is not more than the total of the current calendar year-to-date earnings plus any earnings from the previous two years not already paid out in dividends, as long as the Bank remains well-capitalized after the dividend payment. The

amount of dividends in 2012 is $7.5 million plus 2012 profits retained up to the date of the dividend declaration. Future dividend payments by the Bank to the Company are based upon future earnings. The Company has cash of $456,000 at December 31, 2011 available to meet cash needs. It also holds a $6.0 million note receivable, the cash flow from which approximates the debt service on the Junior Subordinated Debentures. Cash is generally used by the Company to pay quarterly interest payment on the debentures, pay dividends to common shareholders and to fund operating expenses.

In May 2012, the Bank plans to close its North Bloomfield branch in an effort to consolidate it with the Bristol branch approximately five miles away. Any loss of deposits or customers is not expected to have a material effect on liquidity or consolidated deposit totals.

Cash and cash equivalents increased from $15.8 million in 2010 to $16.2 million in 2011. The following table details the cash flows from operating activities for years ended 2011, 2010 and 2009.

	(Amounts in thousands) December 31,		
	2011	2010	2009
Net income	**$4,072**	$ 3,271	$ (6,335)
Adjustments to reconcile net income to net cash flows from operating activities:			
Depreciation, amortization and accretion	**2,411**	1,807	808
Provision for loan losses	**1,196**	505	427
Investment securities gains	**(882)**	(1,018)	(432)
Impairment losses	**202**	2,712	14,502
Other real estate (gains) losses	**113**	55	(15)
Mortgage banking	**(685)**	(262)	236
Proceeds from IRS tax refund	**1,400**	(1,400)	—
Changes in:			
Deferred tax (benefit) expense	**(61)**	766	(5,016)
Prepaid FDIC assessment	**647**	809	(2,915)
Other assets and liabilities	**(157)**	(1,270)	560
Net cash flows from operating activities	**$8,256**	$ 5,975	$ 1,820

Key variations stem from: 1) Amortization on investments measured $1.8 million at December 31, 2011 compared to $1.2 million at December 31, 2010 and $142,000 at December 31, 2009, reflecting more securities purchased at a premium in this low rate environment. 2) Provision for loan losses increased by $78,000 from 2009 to 2010 and $691,000 from 2010 to 2011. The increase is due to increased loan volume and changing economic conditions. 3) Gains were recognized on the sale, call or maturity of investments of $882,000 in 2011 compared to $1.0 million in the same period of 2010 and $432,000 in 2009. 4) Impairment losses of $202,000 were recognized in 2011 compared to $2.7 million in 2010 and $14.5 million in 2009. 5) In 2011, a refund of $1.4 million was received from the IRS. This was recorded at December 31, 2010 as a receivable as a result of $6.0 million of impaired security expense considered permanent for tax purposes. 6) A prepaid assessment of $2.9 million was paid to the FDIC in December 2009 and $809,000 and $647,000 was expensed in 2010 and 2011, respectively. 7) Other liabilities decreased in 2010 due in part to a net $457,000 reduction in accrued post-retirement and accrued severance as a result of management reorganization completed in 2010. Refer to the Consolidated Statements of Cash Flows, in Item 8 for a summary of the sources and uses of cash for 2011, 2010 and 2009.

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, 2011, 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 Item 8, Notes to the Consolidated Financial Statements.

		(Amounts in thousands) Payments Due in:				
	See Note	One Year or Less	One to Three Years	Three to Five Years	Over Five Years	Total
Non-interest bearing deposits		**$ 70,726**	**$ —**	**$ —**	**$ —**	**$ 70,726**
Interest bearing deposits (a)	5	**194,445**	**—**	**—**	**—**	**194,445**
Average rate (b)		**0.13%**				**0.13%**
Certificates of deposit (a)	5	**93,992**	**37,730**	**9,118**	**16,754**	**157,594**
Average rate (b)		**1.05%**	**2.41%**	**2.88%**	**3.39%**	**1.73%**
Federal funds purchased and security repurchase agreements (a)	6	**4,773**	**—**	**—**	**—**	**4,773**
Average rate (b)		**0.07%**				**0.07%**
FHLB advances (a)	6	**6,500**	**9,000**	**6,000**	**16,000**	**37,500**
Average rate (b)		**1.08%**	**3.81%**	**3.31%**	**4.12%**	**3.39%**
Subordinated debt	7	**—**	**—**	**—**	**5,155**	**5,155**
Average rate (b)					**2.00%**	**2.00%**
Operating leases	8	**99**	**198**	**158**	**89**	**544**

(a) Excludes present and future accrued interest.
(b) Variable rate obligations reflect interest rates in effect at December 31, 2011.

The Company's operating lease obligations represent short and long-term lease and rental payments for the Bank's branch facilities.

The Company also has obligations under its supplemental retirement plans as described in Item 8, Note 9 to the Consolidated Financial Statements. The postretirement benefit payments represent actuarially-determined future benefit payments to eligible plan participants. The Corporation does not have any commitments or obligations to the defined contribution retirement plan (401(k) plan) at December 31, 2011 due to the funded status of the plan. Additional information regarding benefit plans can be found in Item 8, Note 9 to the Consolidated Financial Statements.

Commitments: The following table details the amounts and expected maturities of significant off-balance sheet commitments as of December 31, 2011. Additional information regarding commitments can be found in Item 8, Note 8 to the Consolidated Financial Statements.

	(Amounts in thousands)				
	One Year or Less	One to Three Years	Three to Five Years	Over Five Years	Total
Commitments to extend credit:					
Commercial (including commercial real estate)	**$21,399**	**$1,301**	**$—**	**$22,699**	**$45,399**
Revolving home equity	**13,558**	**—**	**—**	**—**	**13,558**
Overdraft protection	**10,098**	**—**	**—**	**—**	**10,098**
Other	**794**	**—**	**—**	**—**	**794**
Residential real estate	**12,287**	**—**	**—**	**—**	**12,287**
Standby letters of credit	**538**	**36**	**110**	**30**	**714**

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

CAPITAL RESOURCES

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

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

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

As a result of the decline in the value of the Bank's trust preferred securities, the regulatory capital levels of the Bank have declined. As a result of investment downgrades by the rating agencies, all of the 31 trust preferred securities and a private label CMO were rated as "highly speculative grade" debt securities. As a consequence, the Bank is required to maintain higher levels of regulatory risk-based capital for these securities due to the greater perceived risk of default by the underlying bank and insurance company issuers. Specifically, regulatory guidance requires the Bank to apply a higher "risk weighting formula" for these securities to calculate its regulatory capital ratios. The result of that calculation increases the Bank's risk-weighted assets for these securities to $74.0 million, well above the $34.7 million in amortized cost of these securities as of December 31, 2011, thereby significantly diluting the regulatory capital ratios.

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

	Actual Regulatory Capital Ratios as of:		Regulatory Capital Ratio requirements to be:	
	December 31, 2011	December 31, 2010	Well Capitalized	Adequately Capitalized
Total risk-based capital to risk-weighted assets	**14.18%**	13.42%	10.00%	8.00%
Tier I capital to risk-weighted assets	**13.37%**	12.72%	6.00%	4.00%
Tier I capital to average assets	**10.47%**	9.59%	5.00%	4.00%

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

The Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA) requires banking regulatory agencies to revise risk-based capital standards to ensure that they adequately account for the following additional risks: interest rate, concentration of credit, and non- traditional activities. Accordingly, regulators will

subjectively consider an institution's exposure to declines in the economic value of its capital due to changes in interest rates in evaluating capital adequacy. The following table illustrates the Company's components of risk weighted capital ratios and the excess over amounts considered well-capitalized at December 31:

	(Amounts in thousands) 2011	2010
Tier 1 Capital	**$ 51,739**	$ 46,787
Tier 2 Capital	**3,142**	2,585
QUALIFYING CAPITAL	**$ 54,881**	$ 49,372
Risk-Adjusted Total Assets (*)	**$387,091**	$367,798
Tier 1 Risk- Based Capital Excess	**$ 28,514**	$ 24,719
Total Risk- Based Capital Excess	**16,172**	12,592
Total Leverage Capital Excess	**27,028**	22,406

(*) Includes off-balance sheet exposures

Average total assets for leverage capital purposes is calculated as average assets less intangibles, disallowed deferred tax assets and the net unrealized market value adjustment of year end investment securities available-for-sale, which averaged $494.2 million and $487.6 million for the years ended December 31, 2011 and December 31, 2010, respectively.

Regulations require that investments designated as available-for-sale are marked-to-market with corresponding entries to the deferred tax account and shareholders' equity. Regulatory agencies, however, exclude these adjustments in computing risk-based capital, as their inclusion would tend to increase the volatility of this important measure of capital adequacy. Additional information regarding regulatory matters can be found in Item 8, Note 12 to the Consolidated Financial Statements.

REGULATORY MATTERS

The Company has been informed by its bank regulatory agencies, which provide regulatory oversight to the Company and the Bank, that the Company has fulfilled the terms of the informal assurances given to the agencies back in 2009.

Summarized in the Company's annual reports and quarterly reports filed with the SEC since the informal assurances were first given to the Company's Federal and state supervisory agencies in 2009, the Company and the Bank had agreed to obtain regulatory approval in order to incur debt, repurchase stock, or pay dividends, as well as agreeing to submit a plan to strengthen and improve management of the overall risk exposure of the investment portfolio, a plan to maintain an adequate capital position, a plan to strengthen board oversight of the management and operations, and a plan to improve the Bank's earnings and overall condition.

INTEREST RATE RISK

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

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

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

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

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

During 2011, the Federal Reserve kept its target rate for overnight federal funds constant. At December 31, 2011, the difference between the yield on the ten-year Treasury and the three-month Treasury had decreased to a positive 187 from the positive 318 basis points that existed at December 31, 2010, indicating that the yield curve had become less steeply upward sloping. At December 31, 2011, rates peaked at the 30-year point on the Treasury yield curve. The yield curve remains positively sloping as interest rates continue to increase with a lengthening of maturities, with rates peaking at the long-end of the Treasury yield curve.

The base case against which interest rate sensitivity is measured assumes no change in short-term rates. The base case also assumes no growth in assets and liabilities and no change in asset or liability mix. Under these simulated conditions, the base case projects net interest income of $15.7 million for the year ending December 31, 2012.

	(Amounts in thousands)		
	Net Interest Income	$ Change	% Change
Change in interest rates:			
Graduated increase of +300 basis points	$17,380	$ 1,659	10.6%
Short-term rates unchanged (base case)	15,721		
Graduated decrease of -300 basis points	13,316	(2,405)	-15.3%

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

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

IMPACT OF INFLATION

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

Item 7A. Quantitative and Qualitative Disclosures About Market Risk—Not applicable to the Company because it is a smaller reporting company.

Item 8. Financial Statements and Supplementary Data

Consolidated Financial Statements:

Management's Annual Report on Internal Control Over Financial Reporting	54
Report of Independent Registered Public Accounting Firm	55
Consolidated Balance Sheets as of December 31, 2011 and 2010	56
Consolidated Statements of Income for the Years Ended December 31, 2011, 2010 and 2009	57
Consolidated Statements of Shareholders' Equity for the Years Ended December 31, 2011, 2010 and 2009	58-59
Consolidated Statements of Cash Flows for the Years Ended December 31, 2011, 2010 and 2009	60
Notes to Consolidated Financial Statements	61-96

MANAGEMENT'S ANNUAL REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING

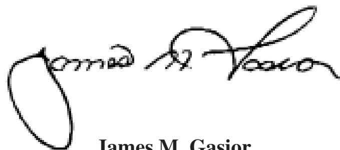
Management of the Company is responsible for establishing and maintaining adequate internal control over financial reporting as defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act. The Company's internal control over financial reporting is designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles.

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.

A material weakness is a significant deficiency (as defined in Public Company Accounting Oversight Board Auditing Standard No. 2), or a combination of significant deficiencies, that results in there being more than a remote likelihood that a material misstatement of the annual or interim financial statements will not be prevented or detected on a timely basis by management or employees in the normal course of performing their assigned functions.

Management assessed the effectiveness of the Company's internal control over financial reporting as of December 31, 2011. In making this assessment, management used the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) in Internal Control-Integrated Framework. Based on this assessment, management believes that, as of December 31, 2011, the Company's internal control over financial reporting was effective.

This annual report does not include an attestation report of the Company's registered public accounting firm regarding internal control over financial reporting. Management's report was not subject to attestation by the Company's registered public accounting firm pursuant to a provision of the Dodd-Frank Act which eliminates such requirements for "smaller reporting companies" as defined by the Securities and Exchange Commission regulations.



James M. Gasior
President and Chief Executive Officer

Cortland, Ohio
March 29, 2012

David J. Lucido
Senior Vice President and Chief Financial Officer

Cortland, Ohio
March 29, 2012

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Shareholders
Cortland Bancorp
Cortland, Ohio

We have audited the accompanying consolidated balance sheets of Cortland Bancorp (the "Company") and subsidiaries as of December 31, 2011 and 2010, and the related consolidated statements of income, changes in shareholders' equity and cash flows for each of the three years in the period ended December 31, 2011. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements 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 audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. The Company is not required to have, nor were we engaged to perform an audit of its internal control over financial reporting. Our audit included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes 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, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of the Cortland Bancorp and subsidiaries as of December 31, 2011 and 2010, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2011, in conformity with U.S. generally accepted accounting principles.

S.R. Snodgrass, A.C.

S.R. Snodgrass, A.C.
Wexford, Pennsylvania
March 29, 2012

CORTLAND BANCORP AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS

(Amounts in thousands, except per share data)

	2011	2010
ASSETS		
Cash and due from banks	**$ 9,805**	$ 6,894
Interest-earning deposits and other earning assets	**6,371**	8,910
Total cash and cash equivalents	**16,176**	15,804
Investment securities available-for-sale (Note 2)	**185,916**	168,158
Investment securities held-to-maturity (estimated fair value of $20,941 in 2010) (Note 2)	**—**	20,300
Loans held for sale	**947**	262
Total loans (Note 3)	**289,096**	265,179
Less allowance for loan losses (Note 3)	**(3,058)**	(2,501)
Net loans	**286,038**	262,678
Premises and equipment (Note 4)	**6,474**	6,720
Bank-owned life insurance	**12,937**	12,491
Other assets	**11,342**	13,860
Total assets	**$519,830**	$500,273
LIABILITIES		
Noninterest-bearing deposits	**$ 70,726**	$ 61,362
Interest-bearing deposits (Note 5)	**352,039**	330,147
Total deposits	**422,765**	391,509
Federal Home Loan Bank advances—short term (Note 6)	**6,500**	20,500
Federal Home Loan Bank advances—long term (Note 6)	**31,000**	32,500
Other short-term borrowings	**4,773**	4,901
Subordinated debt (Note 7)	**5,155**	5,155
Other liabilities	**3,918**	3,856
Total liabilities	**474,111**	458,421
Commitments and contingent liabilities (Notes 8 and 16)		
SHAREHOLDERS' EQUITY		
Common stock—$5.00 stated value—authorized 20,000,000 shares; issued 4,728,267 shares in 2011 and 2010; outstanding shares, 4,525,530 in 2011 and 4,525,541 in 2010 (Note 1)	**23,641**	23,641
Additional paid-in capital (Note 1)	**20,850**	20,850
Retained earnings	**7,485**	3,413
Accumulated other comprehensive loss (Note 1)	**(2,663)**	(2,458)
Treasury stock, at cost, 202,737 shares in 2011 and 202,726 shares in 2010	**(3,594)**	(3,594)
Total shareholders' equity (Note 14)	**45,719**	41,852
Total liabilities and shareholders' equity	**$519,830**	$500,273

See accompanying notes to consolidated financial statements

CORTLAND BANCORP AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF INCOME

(Amounts in thousands, except per share data)

	2011	2010	2009
INTEREST INCOME			
Interest and fees on loans	**$15,264**	$14,706	$ 15,147
Interest and dividends on investment securities:			
Taxable interest	**4,241**	5,397	6,789
Nontaxable interest	**1,421**	1,517	1,356
Dividends	**133**	160	176
Other interest income	**51**	92	155
Total interest income	**21,110**	21,872	23,623
INTEREST EXPENSE			
Deposits	**3,293**	4,079	6,294
Other short-term borrowings	**5**	10	9
Federal Home Loan Bank advances—short term	**95**	847	620
Federal Home Loan Bank advances—long term	**1,247**	1,338	2,184
Subordinated debt	**92**	93	127
Total interest expense	**4,732**	6,367	9,234
Net interest income	**16,378**	15,505	14,389
PROVISION FOR LOAN LOSSES (Note 3)	**1,196**	505	427
NET INTEREST INCOME AFTER PROVISION FOR LOAN LOSSES	**15,182**	15,000	13,962
NON-INTEREST INCOME			
Fees for customer services	**2,229**	2,234	2,298
Investment securities gains—net	**882**	1,018	432
Impairment losses on investment securities:			
Total other-than-temporary impairment losses	**(141)**	(43)	(18,904)
Portion of (gains) losses recognized in other comprehensive income (before tax)	**(61)**	(2,669)	4,402
Net impairment losses recognized in earnings	**(202)**	(2,712)	(14,502)
Mortgage banking gains	**162**	236	265
Other real estate (losses) gains—net	**(113)**	(55)	15
Earnings on bank-owned life insurance	**496**	525	553
Other non-interest income	**104**	87	135
Total non-interest income (loss)	**3,558**	1,333	(10,804)
NON-INTEREST EXPENSES			
Salaries and employee benefits	**7,366**	6,389	7,434
Net occupancy and equipment expense	**1,734**	1,801	1,849
State and local taxes	**465**	430	415
FDIC insurance expense	**673**	867	962
Professional fees	**761**	750	727
Office supplies	**339**	344	357
Other operating expenses	**2,137**	1,860	1,904
Total non-interest expenses	**13,475**	12,441	13,648
INCOME (LOSS) BEFORE FEDERAL INCOME TAX (BENEFIT)	**5,265**	3,892	(10,490)
Federal income tax expense (benefit) (Note 10)	**1,193**	621	(4,155)
NET INCOME (LOSS)	**$ 4,072**	$ 3,271	$ (6,335)
EARNINGS PER SHARE, BOTH BASIC AND DILUTED (Note 1)	**$ 0.90**	$ 0.72	$ (1.40)
CASH DIVIDENDS DECLARED PER SHARE	**$ —**	$ —	$ —

See accompanying notes to consolidated financial statements

CORTLAND BANCORP AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY

(Amounts in thousands, except per share data)

	Common Stock	Additional Paid-in Capital	Retained Earnings	Accumulated Other Comprehensive Loss	Treasury Stock	Total Shareholders' Equity
Balance at December 31, 2008	$23,641	$21,078	$ 6,480	$(11,078)	$(4,093)	$36,028
Comprehensive income:						
Net loss			(6,335)			(6,335)
Other comprehensive income, net of tax:						
Unrealized gains on available-for-sale securities, net of reclassification adjustment, net of tax of $5,075				9,852		9,852
Other comprehensive loss related to securities for which other-than-temporary impairment has been recognized in earnings, net of tax of $(1,497)				(2,905)		(2,905)
Total comprehensive income						612
Common stock transactions:						
Treasury shares reissued—28,172 shares		(228)			500	272
Treasury shares purchased—88 shares					(1)	(1)
Cash paid in lieu of fractional shares			(3)			(3)
Balance at December 31, 2009	23,641	20,850	142	(4,131)	(3,594)	36,908
Comprehensive income:						
Net income			3,271			3,271
Other comprehensive income, net of tax:						
Unrealized losses on available-for-sale securities, net of reclassification adjustment, net of tax of $(46)				(89)		(89)
Other comprehensive gain related to securities which other-than-temporary impairment has been recognized in earnings, net of tax of $907				1,762		1,762
Total comprehensive income						4,944
Balance at December 31, 2010	23,641	20,850	3,413	(2,458)	(3,594)	41,852
Comprehensive income:						
Net income			**4,072**			**4,072**
Other comprehensive loss, net of tax:						
Unrealized losses on available-for-sale securities, net of reclassification adjustment, net of tax of $(126)				**(245)**		**(245)**
Other comprehensive gain related to securities which other-than-temporary impairment has been recognized in earnings, net of tax of $21				**40**		**40**
Total comprehensive income						**3,867**
Balance at December 31, 2011	**$23,641**	**$20,850**	**$ 7,485**	**$ (2,663)**	**$(3,594)**	**$45,719**

(Amounts in thousands)	2011	2010	2009
COMPONENTS OF OTHER COMPREHENSIVE INCOME (LOSS)			
Net unrealized holding gains (losses) on available-for-sale securities arising during the period, net of taxes of $126, $286 and $(1,205), respectively	**$ 244**	$ 555	$(2,339)
Reclassification adjustment for net gains realized in net income (loss), net of taxes of $300, $346 and $147, respectively	**(582)**	(672)	(285)
Reclassification adjustment for other-than-temporary impairment losses on debt securities, net of taxes of $69, $922 and $4,931, respectively	**133**	1,790	9,571
Net unrealized gains (losses) on available-for-sale securities, net of tax	**(205)**	1,673	6,947
Net income (loss)	**4,072**	3,271	(6,335)
Total comprehensive income	**$3,867**	$4,944	$ 612

See accompanying notes to consolidated financial statements

CORTLAND BANCORP AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS

(Amounts in thousands)

	2011	2010	2009
Cash flows from operating activities			
Net income (loss)	**$ 4,072**	$ 3,271	$ (6,335)
Adjustments to reconcile net income (loss) to net cash flows from operating activities:			
Depreciation, amortization and accretion	**2,411**	1,807	808
Provision for loan loss	**1,196**	505	427
Deferred tax benefit	**(61)**	766	(5,016)
Investment securities gains, net	**(882)**	(1,018)	(432)
Impairment losses on investment securities	**202**	2,712	14,502
Other real estate losses (gains)	**113**	55	(15)
Loans originated for sale	**(5,410)**	(11,856)	(15,054)
Proceeds from sale of loans originated for sale	**4,887**	11,830	15,555
Mortgage banking income	**(162)**	(236)	(265)
Earnings on bank-owned life insurance	**(496)**	(525)	(553)
Federal income tax refund	**1,400**	(1,400)	—
Changes in:			
Interest receivable	**205**	(12)	525
Interest payable	**(94)**	(190)	(246)
Prepaid FDIC assessment	**647**	809	(2,915)
Other assets and liabilities	**228**	(543)	834
Net cash flows from operating activities	**8,256**	5,975	1,820
Cash (deficit) flow from investing activities			
Purchases of available-for-sale securities	**(57,746)**	(85,753)	(49,422)
Purchases of held-to-maturity securities	**—**	—	(2,040)
Proceeds from sales of securities	**14,458**	15,153	3,734
Proceeds from call, maturity and principal payments on securities	**44,370**	53,682	63,872
Net increase in loans made to customers	**(24,636)**	(17,737)	(3,277)
Proceeds from disposition of other real estate	**378**	149	487
Purchases of premises and equipment	**(336)**	(175)	(222)
Proceeds from bank-owned life insurance	**—**	1,138	—
Net cash (deficit) flow from investing activities	**(23,512)**	(33,543)	13,132
Cash flow (deficit) from financing activities			
Net increase in deposit accounts	**31,256**	4,014	7,542
Repayments of Federal Home Loan Bank advances	**(23,500)**	(15,500)	(6,000)
Proceeds from Federal Home Loan Bank	**8,000**	12,000	—
Net (decrease) increase in other short-term borrowings	**(128)**	(1,965)	1,218
Dividends paid	**—**	—	(3)
Purchases of treasury stock	**—**	—	(1)
Treasury shares reissued	**—**	—	272
Net cash flow (deficit) from financing activities	**15,628**	(1,451)	3,028
Net change in cash and cash equivalents	**372**	(29,019)	17,980
Cash and cash equivalents			
Beginning of year	**15,804**	44,823	26,843
End of year	**$ 16,176**	$ 15,804	$ 44,823
Supplemental disclosures:			
Cash paid during the period for:			
Income taxes	**$ 1,490**	$ 1,395	$ 810
Interest	**$ 4,826**	$ 6,557	$ 9,475
Transfer of loans to other real estate owned	**$ 80**	$ 365	$ 350

See accompanying notes to consolidated financial statements

CORTLAND BANCORP AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 1—SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

The accounting and financial reporting policies of Cortland Bancorp, and its bank subsidiary, The Cortland Savings and Banking Company, 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 the 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. ASC Topic 280 *Segment Reporting* requires that an enterprise report selected information about operating segments in its financial reports issued to its shareholders. Based on the analysis performed by the Company, management has determined that the Company only has one operating segment, which is commercial banking. The chief operating decision-makers use consolidated results to make operating and strategic decisions, and therefore, are not required to disclose any additional segment information.

Use of Estimates: The preparation of financial statements in conformity with U.S. 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 and amounts due from banks, both interest and non-interest bearing. The Company reports net cash flows for customer loan transactions, deposit transactions and deposits made with other financial institutions.

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

Held-to-maturity securities are stated at cost, adjusted for amortization of premiums and accretion of discounts, with such amortization or accretion included in interest income. Available-for-sale securities are carried at fair value with unrealized gains and losses recorded as a separate component of shareholders' equity, net of tax effects. Realized gains or losses on dispositions are based on net proceeds and the adjusted carrying amount of securities sold, using the specific identification method. Interest income includes amortization of purchase premium or discount premiums. Discounts on securities are amortized on the level-yield method without anticipating payments, except for both U.S. Government and private-label mortgage-backed and related securities where twelve months of historical prepayments are taken into consideration.

Other-than-Temporary Investment Security Impairment: Securities are evaluated periodically to determine whether a decline in value is other-than-temporary. Management utilizes criteria such as the magnitude and duration of the decline, along with the reasons underlying the decline, to determine whether the loss in value is other-than-temporary. The term "other-than-temporary" is not intended to indicate that the decline in value is permanent, but indicates that the prospect for a near-term recovery of value is not necessarily favorable and that there is a lack of evidence to support a realizable value equal to or greater than the carrying value of the

investment. Unrealized losses on investments have not been recognized into income. However, once a decline in value is determined to be other-than-temporary, the credit related other-than-temporary impairment (OTTI) is recognized in earnings while the non-credit related OTTI on securities not expected to be sold is recognized in other comprehensive income (loss).

Loans: Loans are stated at the principal amount outstanding net of the unamortized balance of deferred loan origination fees and costs. Deferred loan origination fees and costs are amortized as an adjustment to the related loan yield over the contractual life using the level-yield method. Interest income on loans is accrued over the term of the loans based on the amount of principal outstanding. The accrual of interest is discontinued on a loan when management determines that the collection of interest is doubtful. Generally a loan is placed on non-accrual 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 non-accrual is reversed through interest income. Cash payments received while a loan is classified as non-accrual are recorded as a reduction to principal or reported as interest income according to management's judgment as to 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. The same treatment is applied to impaired loans.

Loans Held for Sale: The Company originates certain residential mortgage loans for sale in the secondary mortgage loan market. The Company concurrently sells the rights to service the related loans. These loans are classified as loans held for sale, and carried at the estimated fair value based on secondary market prices. Adjustments to the fair value of loans held for sale are included in "mortgage banking gains" in the consolidated statements of income. Deferred fees and costs related to loans held for sale are not amortized, but included in the cost basis at the time of sale.

Allowance for Loan Losses (ALLL) and Allowance for Losses on Lending Related Commitments: Management establishes the allowance for loan losses based upon its evaluation of the pertinent factors underlying the types and quality of loans in the portfolio. Commercial loans and commercial real estate loans are reviewed on a regular basis with a focus on larger loans, along with loans which have experienced past payment or financial deficiencies. Larger commercial loans and commercial real estate loans are evaluated for impairment in accordance with the Bank's loan review policy. These loans are analyzed to determine if they are "impaired," which means that it is probable that all amounts will not be collected according to the contractual terms of the loan agreement. All loans that are delinquent 90 days and are placed on non-accrual status are evaluated on an individual basis. 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, or in most cases, the estimated fair value of the underlying collateral. If the analysis indicates a collection shortfall, a specific reserve is allocated to loans on an individual basis which are reviewed for impairment. The remaining loans are evaluated and classified as groups of loans with similar risk characteristics.

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. Estimates of credit losses should reflect consideration of all significant factors that affect collectability of the portfolio. While historical loss experience provides a reasonable starting point, historical losses, or even recent trends in losses are not, by themselves, a sufficient basis to determine the appropriate level for the ALLL. Management will also consider any factors that are likely to cause estimated credit losses associated with the Bank's current portfolio to differ from historical loss experience. Factors include, but are not limited to, changes in lending policies and procedures, including underwriting standards and collection, charge-offs, and recovery practices; changes in economic trends; changes in the nature and volume of the portfolio; changes in the experience and ability of lending management and the depth of staff; changes in the trend, volume and severity of past-due and classified loans, and trends in the volume of non-accrual loans; the existence and

effect of any concentrations of credit and changes in the level of such concentrations; levels and trends in classification; declining trends in performance; structure and lack of performance measures and migration between risk classifications.

Key risk factors and assumptions are updated to reflect actual experience and changing circumstances. While management may periodically allocate portions of the ALLL for specific problem loans, the entire ALLL is available for any charge-offs that occur.

Certain collateral dependent 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.

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 consolidated balance sheet within accrued expenses and other liabilities, while the corresponding provision for these losses is recorded as a component of other expense.

Loan Charge-off Policies: Consumer loans are generally fully or partially charged down to the fair value of collateral securing the asset prior to the loan becoming 180 days past due, unless the loan is well secured and in the process of collection. All other loans are generally charged down to the net realizable value when the loan is 90 days past due.

Troubled Debt Restructurings (TDR): A loan is classified as a TDR when management grants a concession for other than an insignificant period of time to the borrower that would not otherwise be considered, except in situations of economic difficulties. Management strives to identify borrowers in financial difficulty early and work with them to modify to more affordable terms before their loan reaches non-accrual status. These modified terms may include rate reductions, principal forgiveness, payment forbearance and other actions intended to minimize the economic loss and to avoid foreclosure or repossession of the collateral. In cases where borrowers are granted new terms that provide for a reduction of either interest or principal, management measures any impairment on the restructuring as noted above for impaired loans. In addition to the allowance for the pooled portfolios, management has developed a separate allowance for loans that are identified as impaired through a TDR. These loans are excluded from pooled loss forecasts and a separate reserve is provided under the accounting guidance for loan impairment.

Premises and Equipment: Land is carried at cost. Premises and equipment are stated at cost less accumulated depreciation. Depreciation is computed generally on the straight-line method over the estimated useful lives (5 to 40 years) 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 on the consolidated balance sheets. 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 was fully amortized at December 31, 2010, and was included in other assets on the consolidated balance sheets. The annual expense was $24,000 in 2010 and $37,000 in 2009.

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 on the consolidated balance sheets. 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.

Endorsement Split-Dollar Life Insurance Arrangement: The Company maintains a liability for the death benefit promised under split-dollar life insurance arrangements.

Derivative Instruments and Hedging Activities: To mitigate interest rate risk associated with commitments made to borrowers for mortgage loans that have not yet closed and that are intended for sale in the secondary markets, the Company may enter into commitments to sell loans or mortgage-backed securities, considered to be derivatives, to limit exposure to potential movements in market interest rates. The Company also enters into contracts for the future delivery of residential mortgage loans when interest rate locks are entered into in order to economically hedge potential adverse effects of changes in interest rates. These contracts are also derivative instruments. All derivative instruments are recognized as either other assets or other liabilities at fair value in the consolidated balance sheets. Gains or losses are recorded as part of mortgage banking gains on the consolidated statements of income.

Advertising: The Company expenses advertising costs as incurred.

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

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

Per Share Amounts: Basic and diluted earnings per common share are based on weighted average shares outstanding.

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

	Years Ended December 31,		
	2011	2010	2009
Net income (loss) (amounts in thousands)	**$ 4,072**	$ 3,271	$ (6,335)
Weighted average common shares outstanding	**4,525,538**	4,525,546	4,525,516
Basic earnings per common share	**$ 0.90**	$ 0.72	$ (1.40)
Diluted earnings per common share	**$ 0.90**	$ 0.72	$ (1.40)

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

Reclassifications: Certain items in the financial statements for 2010 and 2009 have been reclassified to conform to the 2011 presentation.

Authoritative Accounting Guidance:

In April 2011, the FASB issued ASU 2011-02, *Receivables (Topic 310): A Creditor's Determination of Whether a Restructuring Is a Troubled Debt Restructuring*. The amendments in this Update provide additional guidance or clarification to help creditors in determining whether a creditor has granted a concession and whether a debtor is experiencing financial difficulties for purposes of determining whether a restructuring constitutes a troubled debt restructuring. The amendments in this Update are effective for the first interim or annual reporting period beginning on or after June 15, 2011, and should be applied retrospectively to the beginning annual period of adoption. As a result of applying these amendments, an entity may identify receivables that are newly considered impaired. For purposes of measuring impairment of those receivables, an entity should apply the amendments prospectively for the first interim or annual period beginning on or after June 15, 2011. The Company has provided the necessary disclosures in Note 3.

In May 2011, the FASB issued ASU 2011-04, *Fair Value Measurement (Topic 820): Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs.* The amendments in this Update result in common fair value measurement and disclosure requirements in U.S. GAAP and IFRSs. Consequently, the amendments change the wording used to describe many of the requirements in U.S. GAAP for measuring fair value and for disclosing information about fair value measurements. The amendments in this Update are to be applied prospectively. For public entities, the amendments are effective during interim and annual periods beginning after December 15, 2011. For nonpublic entities, the amendments are effective for annual periods beginning after December 15, 2011. Early application by public entities is not permitted. This ASU is not expected to have a significant impact on the Company's financial statements.

In June 2011, the FASB issued ASU 2011-05, *Comprehensive Income (Topic 220): Presentation of Comprehensive Income.* The amendments in this Update improve the comparability, clarity, consistency, and transparency of financial reporting and increase the prominence of items reported in other comprehensive income. To increase the prominence of items reported in other comprehensive income and to facilitate convergence of U.S. GAAP and IFRS, the option to present components of other comprehensive income as part of the statement of changes in stockholders' equity was eliminated. The amendments require that all non-owner changes in stockholders' equity be presented either in a single continuous statement of comprehensive income or in two separate but consecutive statements. In the two-statement approach, the first statement should present total net income and its components followed consecutively by a second statement that should present total other comprehensive income, the components of other comprehensive income, and the total of comprehensive income. All entities that report items of comprehensive income, in any period presented, will be affected by the changes in this Update. For public entities, the amendments are effective for fiscal years, and interim periods within those years, beginning after December 15, 2011. For nonpublic entities, the amendments are effective for fiscal years ending after December 15, 2012, and interim and annual periods thereafter. The amendments in this Update should be applied retrospectively, and early adoption is permitted. The Company is currently evaluating the impact the adoption of the standard will have on the Company's financial statements.

In December 2011, the FASB issued ASU 2011-12, *Comprehensive Income (Topic 220): Deferral of the Effective Date for Amendments to the Presentation of Reclassifications of Items Out of Accumulated Other Comprehensive Income in Accounting Standards Update No. 2011-05*. In order to defer only those changes in Update 2011-05 that relate to the presentation of reclassification adjustments, the paragraphs in this Update supersede certain pending paragraphs in Update 2011-05. Entities should continue to report reclassifications out of accumulated other comprehensive income consistent with the presentation requirements in effect before Update 2011-05. All other requirements in Update 2011-05 are not affected by this Update, including the requirement to report comprehensive income either in a single continuous financial statement or in two separate but consecutive financial statements. Public entities should apply these requirements for fiscal years, and interim

periods within those years, beginning after December 15, 2011. Nonpublic entities should begin applying these requirements for fiscal years ending after December 15, 2012, and interim and annual periods thereafter. The Company is currently evaluating the impact the adoption of the standard will have on the Company's financial statements.

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, 2011				
Investment securities available-for-sale				
U.S. Treasury securities	**$ 119**	**$ 14**	**$ —**	**$ 133**
U.S. Government agencies and corporations	**20,280**	**262**	**—**	**20,542**
Obligations of states and political subdivisions	**37,419**	**1,602**	**2**	**39,019**
U.S. Government-sponsored mortgage-backed securities	**71,078**	**3,102**	**91**	**74,089**
U.S. Government-sponsored collateralized mortgage obligations	**39,131**	**318**	**255**	**39,194**
Private-label mortgage-backed securities	**127**	**3**	**—**	**130**
Private-label collateralized mortgage obligations	**518**	**—**	**267**	**251**
Trust preferred securities	**17,600**	**4**	**8,459**	**9,145**
Total debt securities	**186,272**	**5,305**	**9,074**	**182,503**
Regulatory stock	**3,049**	**—**	**—**	**3,049**
General Motors equity investments	**631**	**—**	**267**	**364**
Total available-for-sale	**$189,952**	**$5,305**	**$9,341**	**$185,916**
December 31, 2010				
Investment securities available-for-sale				
U.S. Government agencies and corporations	$ 28,913	$ 541	$ —	$ 29,454
Obligations of states and political subdivisions	27,332	42	1,485	25,889
U.S. Government-sponsored mortgage-backed securities	77,754	2,663	175	80,242
U.S. Government-sponsored collateralized mortgage obligations	16,202	89	47	16,244
Private-label mortgage-backed securities	205	6	—	211
Private-label collateralized mortgage obligations	3	—	—	3
Trust preferred securities	18,137	101	5,459	12,779
Corporate securities	287	—	—	287
Total debt securities	168,833	3,442	7,166	165,109
Regulatory stock	3,049	—	—	3,049
Total available-for-sale	$171,882	$3,442	$7,166	$168,158
Investment securities held-to-maturity				
U.S. Treasury securities	$ 124	$ 15	$ —	$ 139
U.S. Government agencies and corporations	1,993	107	—	2,100
Obligations of states and political subdivisions	12,607	385	10	12,982
U.S. Government-sponsored mortgage-backed and related securities	2,546	206	—	2,752
U.S. Government-sponsored collateralized mortgage obligations	2,464	132	1	2,595
Private-label collateralized mortgage obligations	566	—	193	373
Total held-to-maturity	$ 20,300	$ 845	$ 204	$ 20,941

At December 31, 2011 and 2010, regulatory stock consisted of $2.8 million and $226,000, respectively, in Federal Home Loan Bank (FHLB) stock and 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.

The Bank is a member of the FHLB of Cincinnati and as such, is required to maintain a minimum investment in stock of the FHLB that varies with the level of advances outstanding with the FHLB. The stock is bought from and sold to the FHLB based upon its $100 par value. The stock does not have a readily determinable fair value and as such is classified as restricted stock, carried at cost and evaluated by management. The stock's value is determined by the ultimate recoverability of the par value rather than by recognizing temporary declines. The determination of whether the par value will ultimately be recovered is influenced by criteria such as the following: (a) the significance of the decline in net assets of the FHLB as compared to the capital stock amount and the length of time this situation has persisted, (b) commitments by the FHLB to make payments required by law or regulation and the level of such payments in relation to the operating performance, (c) the impact of legislative and regulatory changes on the customer base of the FHLB and (d) the liquidity position of the FHLB.

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

The amortized cost and fair value of debt securities at December 31, 2011, by contractual maturity, are shown below. Actual maturities will differ from contractual maturities because issuers may have the right to call or prepay obligations with or without call or prepayment penalties.

	(Amounts in thousands)	
	Amortized Cost	Estimated Fair Value
Investment securities available-for-sale		
Due in one year or less	**$ 276**	**$ 288**
Due after one year through five years	**11,782**	**12,012**
Due after five years through ten years	**12,926**	**13,256**
Due after ten years	**50,434**	**43,283**
Total investment securities available-for-sale	**75,418**	**68,839**
U.S. Government-sponsored mortgage-backed and related securities	**110,209**	**113,283**
Private-label mortgage-backed and related securities	**645**	**381**
Total investment securities	**$186,272**	**$182,503**

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)		
	2011	2010	2009
Proceeds on securities sold	**$14,458**	$15,153	$ 3,734
Gross realized gains	**562**	920	217
Gross realized losses	**33**	—	—
Proceeds on securities called	**$ 1,939**	$ 7,914	$27,784
Gross realized gains	**9**	98	215
Gross realized losses	**—**	—	—
Exchange on General Motors transaction:			
Gross realized gains	**$ 344**	$ —	$ —
Gross realized losses	**—**	—	—

Available-for-sale securities, carried at fair value, totaled $185.9 million at December 31, 2011 and $168.2 million at December 31, 2010. These securities represent 100.00% and 89.23% of all investment securities in 2011 and 2010, respectively. In management's opinion, these percentages provide an adequate level of liquidity.

As of March 31, 2011, in order to maintain maximum flexibility in managing the investment portfolio and to improve liquidity options, management opted to reclassify all investments in the held-to-maturity classification into the available-for-sale portfolio. The reclassification resulted in the recording of an unrealized gain of $522,000, an increase of $344,000 net of tax to other comprehensive income.

Investment securities with a carrying value of approximately $106.4 million at December 31, 2011 and $108.5 million at December 31, 2010 were pledged to secure deposits and for other purposes.

The following is a summary of the fair value of securities with unrealized losses and an aging of those unrealized losses at December 31, 2011:

	(Amounts in thousands)					
	Less than 12 Months		12 Months or More		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
U.S. Government-sponsored mortgage-backed and related securities	**$13,593**	**$ 91**	**$ —**	**$ —**	**$13,593**	**$ 91**
U.S. Government-sponsored collateralized mortgage obligations	**14,866**	**220**	**1,858**	**35**	**16,724**	**255**
Private-label collateralized mortgage obligation	**—**	**—**	**249**	**267**	**249**	**267**
Obligations of states and political subdivisions	**—**	**—**	**1,064**	**2**	**1,064**	**2**
Trust preferred securities	**—**	**—**	**8,628**	**8,459**	**8,628**	**8,459**
General Motors equity investments	**364**	**267**	**—**	**—**	**364**	**267**
Total	**$28,823**	**$578**	**$11,799**	**$8,763**	**$40,622**	**$9,341**

The above table represents 45 investment securities where the fair value is less than the related amortized cost.

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

	(Amounts in thousands)					
	Less than 12 Months		12 Months or More		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
U.S. Government-sponsored mortgage-backed and related securities	$18,455	$ 175	$ 33	$ 1	$18,488	$ 176
U.S. Government-sponsored collateralized mortgage obligations	8,083	47	—	—	8,083	47
Private-label collateralized mortgage obligation	—	—	373	193	373	193
Obligations of states and political subdivisions	20,075	1,351	4,290	144	24,365	1,495
Trust preferred securities	—	—	11,997	5,459	11,997	5,459
Total	$46,613	$1,573	$16,693	$5,797	$63,306	$7,370

The above table represents 89 investment securities where the current value is less than the related amortized cost.

The unrealized loss on trust preferred securities represents pools of trust preferred debt primarily issued by bank holding companies and insurance companies. The unrealized loss on these securities at December 31, 2011 was $8.5 million, compared to a $5.5 million loss at December 31, 2010.

The unrealized losses on the Company's investment in obligations of states and political subdivisions, U.S. Government-sponsored mortgage-backed securities, U.S. Government-sponsored collateralized mortgage obligations, private-label mortgage-backed securities and private-label collateralized mortgage obligations (CMO) were caused by changes in market rates and related spreads, as well as reflecting current distressed conditions in the credit markets and the market's on-going reassessment of appropriate liquidity and risk premiums. It is expected that the securities would not be settled at less than the amortized cost of the Company's investment because the decline in market value is attributable to changes in interest rates and relative spreads and not credit quality. Also, the Company does not intend to sell those investments and it is not more-likely-than-not that the Company will be required to sell the investments before recovery of its amortized cost basis less any current period credit loss. The Company does not consider those investments to be other-than-temporarily impaired at December 31, 2011.

Among the Company's numerous mortgage-backed securities is one private-label CMO. The security was valued on December 31, 2011 at $0.48 on a dollar and is scheduled to reprice in February of 2012. The Company had the security tested by a third party for subprime mortgage containment and none was found. As government intervention takes hold and the market in general somewhat settles, the CMO market has begun a slow recovery. At March 31, 2009, this security priced at $0.39 on a dollar and at December 31, 2010 at $0.66 on a dollar. The sizable fluctuation in the value since March 2009 provides evidence that the impairment is temporary. General market liquidity has been improving, even with the government phasing out of its many assertive programs. The security carries a credit rating of "CCC" indicating some probability of default. The security's underlying delinquency rate is 6.77%. A current analysis of this security indicates at the current delinquency and default rates, no loss is projected on this security through its maturity. The structure of this security is such that it contains both senior and subordinate tranches. The Company owns the 1A2 tranche, subordinate only to the super senior 1A1 tranche. There were originally 4 tranches below the 1A2, but only two remain. Given this scenario, the structure of this security plays into its value as much as the underlying collateral itself. From a structural standpoint, the subordination and resulting support requirements are ultra- sensitive to prepayments. The higher the prepayment (CPR) rate, the lower the probability of impairment because prepayments are applied pari passu through the structure (not subordinate). For analysis purposes, the Company uses a third party credit profile that presents a price/yield credit stress table which contains 36 different scenarios. Each scenario is driven by CDR (default rate), loss severity, and CPR assumptions, with the results being any expected loss and the year any first loss may occur. In reviewing the occurrence of losses throughout each of the profiles, there is not a consistent range of results leading to any certainty of impairment. The Company will continue to monitor these stress results and upon noting a consistency in negative results, will seek to run present value cash flows to quantify an estimated loss.

This CMO is in the available-for-sale portfolio and it is not more-likely-than-not that the Company will be required to sell the debt security before its anticipated recovery. As a result of all the facts presented, the Company does not consider this investment to be other-than-temporarily impaired.

During September 2008, the U.S. government placed mortgage finance companies Federal National Mortgage Association (FNMA) and Federal Home Loan Mortgage Corporation (FHLMC), under conservatorship, giving management control to their regulator, the Federal Housing Finance Agency (FHFA) and providing both companies with access to credit from the U.S. Treasury. Debt obligations now provide an explicit guarantee of the full faith and credit of the United States government to existing and future debt holders of Fannie Mae and Freddie Mac limited to the period under which they are under conservatorship. The Company's investment in FNMA and FHLMC is $2.5 million and $2.0 million, respectively. In response to the takeover, the Federal Deposit Insurance Corporation (FDIC) tentatively approved a rule, proposed by all four federal bank regulators, that eases capital requirements for federally insured depository institutions that hold FNMA and FHLMC corporate debt, subordinated debt, mortgage guarantees and derivatives.

Securities Deemed to be Other-Than-Temporarily Impaired

The Company reviews investment debt securities on an ongoing basis for the presence of other-than-temporary impairment (OTTI) with formal reviews performed quarterly. OTTI losses on individual investment securities are recognized in accordance with FASB ASC topic 320, *Investments—Debt and Equity Securities*. For debt securities, ASC topic 320 requires an entity to assess whether (a) it has the intent to sell the debt security, or (b) it is more-likely-than-not that it will be required to sell the debt security before its anticipated recovery. If either of these conditions is met, an OTTI on the security must be recognized.

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

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

As more fully disclosed in Note 11, the Company assessed the impairment of certain securities currently in an illiquid market. Through the impairment assessment process, the Company determined that the investments presented below were other-than-temporarily impaired at December 31, 2011 and 2010. The Company recorded impairment credit losses in earnings on available-for-sale securities of $202,000, $2,712,000 and $14,502,000 for the years ended December 31, 2011, 2010 and 2009, respectively. The $61,000, $2,669,000, and $4,402,000 non-credit portion of impairment recognized during the years ended December 31, 2011, 2010 and 2009 respectively, was recorded in other comprehensive income (loss).

	(Amounts in thousands) December 31,		
	2011	2010	2009
Trust preferred securities	**$202**	$2,712	$13,687
General Motors corporate securities	**—**	—	815
Total	**$202**	$2,712	$14,502

As of December 31, 2011, the Company recognized cumulative OTTI of $16.6 million attributable to 20 trust preferred securities with a cost basis of $22.6 million. As of December 31, 2010, the Company recognized cumulative OTTI of $16.4 million attributable to 20 trust preferred securities with a cost basis of $22.7 million. The impairment charges were recognized after determining the likely future cash flows of these securities had been adversely impacted. Refer to Note 11 for additional discussion of trust preferred securities impairment.

The following provides a cumulative roll forward of credit losses recognized in earnings for trust preferred securities held and not intended to be sold:

	(Amounts in thousands) For the Year Ended December 31,		
	2011	2010	2009
Beginning balance	**$16,399**	$13,687	$ —
Reduction for debt securities for which other-than-temporary impairment has been previously recognized and there is no related other comprehensive income	**(5,927)**	—	—
Credit losses on debt securities for which other-than-temporary impairment has been previously recognized	**—**	97	13,687
Additional credit losses on debt securities for which other-than-temporary impairment was previously recognized	**202**	2,615	—
Ending balance	**$10,674**	$16,399	$13,687

In April 2011, as approved by the U.S. Bankruptcy court, unsecured bondholders of General Motors Corporation ("GM") received partial distributions in accordance with the Amended Joint Chapter 11 Plan (the "Plan"). The Company owned $2.4 million par value of unsecured bonds determined to be other than temporarily impaired in 2008 and written down to $1.3 million in 2008 and $815,000 in 2009 to a value of $287,000. In accordance with the Plan, the Company received in exchange for the bonds 9,564 shares of GM common shares, 8,694 GM Class A Warrants exercisable at $10.00 per share, 8,694 GM Class B Warrants exercisable at $18.33 per share. The market value of the equity securities was $631,000, generating a recognizable gain of $344,000 over the fully written down value. The Company holds escrow stubs representing any remaining distributions from the bankruptcy trust. The fair value of the equity securities at December 31, 2011 was $364,000. In reviewing GM's recent share price history, targets prices of analysts, GM's achievement of the number one automaker in terms of sales and the Company's ability to hold the securities for a period of time to allow for recovery, the securities are not considered other-than-temporarily impaired.

At December 31, 2011, there was $1.5 million of investment securities considered to be in non-accrual status. This balance is comprised of 15 of its 29 investments in trust preferred securities. As a result of the delay in the collection of interest payments, management placed these securities in non-accrual status. Current estimates indicate that the interest payment delays may exceed ten years. All other trust preferred securities remain in accrual status.

NOTE 3—LOANS AND ALLOWANCE FOR LOAN LOSSES

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

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

	(Amounts in thousands) December 31,			
	2011		2010	
	Balance	%	Balance	%
Commercial real estate	**$160,319**	**55.5**	$146,389	55.2
Commercial	**60,233**	**20.8**	42,349	16.0
Residential real estate	**45,780**	**15.8**	52,262	19.7
Consumer	**5,848**	**2.0**	7,216	2.7
Home equity	**16,916**	**5.9**	16,963	6.4
Total loans	**$289,096**		$265,179	

Management has an established methodology to determine the adequacy of the allowance for loan losses that assesses the risks and losses inherent in the loan portfolio. For purposes of determining the allowance for loan losses, the Company has segmented loans in the portfolio by product type. Loans are segmented into the following pools: commercial loans, commercial real estate loans, residential real estate loans, consumer loans and home equity loans. The Company also sub-segments the consumer loan portfolio into the following two classes: home equity loans and other consumer loans. Historical loss percentages for each risk category are calculated and used as the basis for calculating allowance allocations. These historical loss percentages are calculated over multiple periods for all portfolio segments. Management evaluates these results and utilizes the most reflective period in the calculation. Certain qualitative factors are then added to the historical allocation percentage to get the adjusted factor.

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

Factor Considered:	Risk Trend:
Levels of and trends in charge-offs, classifications and non-accruals	Decreasing
Trends in volume and terms	Increasing
Changes in lending policies and procedures	Stable
Experience, depth and ability of management	Increasing
Economic trends	Stable
Concentrations of credit	Increasing

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

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

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

	(Amounts in thousands) December 31,		
	2011	2010	2009
Balance at beginning of period	**$2,501**	$2,437	$2,470
Loan charge-offs	**(832)**	(616)	(620)
Recoveries	**193**	175	160
Net loan charge-offs	**(639)**	(441)	(460)
Provision charged to operations	**1,196**	505	427
Balance at end of year	**$3,058**	$2,501	$2,437

The total allowance of $3,058,000 reflects management's estimate of loan losses inherent in the loan portfolio at the consolidated balance sheet date.

The following tables present a full breakdown by portfolio segment, the changes in the allowance for loan losses and the recorded investment in loans for the years ended December 31, 2011 and 2010:

(Amounts in thousands)

December 31, 2011	Commercial	Commercial Real Estate	Consumer	Home Equity	Residential	Total
Allowance for credit losses:						
Beginning balance	**$ 249**	**$ 1,611**	**$ 112**	**$ 111**	**$ 418**	**$ 2,501**
Charge-offs	**—**	**(211)**	**(168)**	**(91)**	**(362)**	**(832)**
Recoveries	**3**	**118**	**60**	**6**	**6**	**193**
Provision and Reallocation	**313**	**285**	**88**	**102**	**408**	**1,196**
Ending Balance	**$ 565**	**$ 1,803**	**$ 92**	**$ 128**	**$ 470**	**$ 3,058**
Individually evaluated for impairment	**$ 69**	**$ 55**	**$ —**	**$ —**	**$ —**	**$ 124**
Collectively evaluated for impairment	**496**	**1,748**	**92**	**128**	**470**	**2,934**
Loan Portfolio:						
Ending Balance	**$60,233**	**$160,319**	**$5,848**	**$16,916**	**$45,780**	**$289,096**
Individually evaluated for impairment	**$ 69**	**$ 2,618**	**$ —**	**$ —**	**$ —**	**$ 2,687**
Collectively evaluated for impairment	**60,164**	**157,701**	**5,848**	**16,916**	**45,780**	**286,409**

December 31, 2010	Commercial	Commercial Real Estate	Consumer	Home Equity	Residential	Total
Allowance for credit losses:						
Beginning balance	$ 209	$ 1,666	$ 157	$ 90	$ 315	$ 2,437
Charge-offs	(1)	(204)	(168)	(14)	(229)	(616)
Recoveries	—	58	96	3	18	175
Provision and Reallocation	41	91	27	32	314	505
Ending Balance	$ 249	$ 1,611	$ 112	$ 111	$ 418	$ 2,501
Individually evaluated for impairment	$ 103	$ 94	$ —	$ —	$ —	$ 197
Collectively evaluated for impairment	146	1,517	112	111	418	2,304
Loan Portfolio:						
Ending Balance	$42,349	$146,389	$7,216	$16,963	$52,262	$265,179
Individually evaluated for impairment	$ 155	$ 1,738	$ —	$ —	$ —	$ 1,893
Collectively evaluated for impairment	42,194	144,651	7,216	16,963	52,262	263,286

The following tables represent credit exposures by internally assigned grades for years ended December 31, 2011 and 2010, respectively. The grading analysis estimates the capability of the borrower to repay the contractual obligations of the loan agreements as scheduled or at all. The Company's internal credit risk grading system is based on experiences with similarly graded loans.

The Company's internally assigned grades are as follows:

- *Pass*—loans which are protected by the current net worth and paying capacity of the obligor or by the value of the underlying collateral. Within this category, there are grades of exceptional, quality, acceptable and pass monitor.
- *Special Mention*—loans where a potential weakness or risk exists, which could cause a more serious problem if not corrected.
- *Substandard*—loans that have a well-defined weakness based on objective evidence and are characterized by the distinct possibility that the Bank will sustain some loss if the deficiencies are not corrected.

- *Doubtful*—loans classified as doubtful have all the weaknesses inherent in a substandard asset but with the severity which make collection in full highly questionable and improbable, based on existing circumstances.
- *Loss*—loans classified as a loss are considered uncollectible, or of such value that continuance as an asset is not warranted. This rating does not mean that the assets have no recovery or salvage value but rather that the assets should be charged off now, even though partial or full recovery may be possible in the future.

The following is a summary of credit quality indicators by internally assigned grade as of December 31:

	(Amounts in thousands)		
2011	Commercial	Commercial Real Estate	Total
Pass	**$57,545**	**$142,781**	**$200,326**
Special Mention	**503**	**8,269**	**8,772**
Substandard	**2,185**	**9,269**	**11,454**
Doubtful/Loss	**—**	**—**	**—**
Ending Balance	**$60,233**	**$160,319**	**$220,552**

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

The Bank evaluates the classification of consumer, home equity and residential loans primarily on a pooled basis. If the Bank becomes aware that adverse or distressed conditions exist that may affect a particular loan, the loan is downgraded following the above definitions of special mention and substandard.

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

Troubled Debt Restructuring

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

There were $1.2 million in TDRs at December 31, 2011 and $1.3 million at December 31, 2010. The total interest recognized on these loans was $69,000, $90,000 and $64,000 at December 31, 2011, 2010 and 2009, respectively. Had the loans at December 31, 2011 not been restructured, interest would have increased pretax income by $16,000 at December 31, 2011, $12,000 at December 31, 2010, and $26,000 at December 31, 2009.

The following presents by class, information related to loans modified in a TDR during the periods ended:

(Amounts in thousands)

	Loans Modified as a TDR for the Year Ended December 31, 2011(1)			Loans Modified as a TDR for the Year Ended December 31, 2010(1)		
	Number of Contracts	Recorded Investment (as of period end)	Increase in the Allowance (as of period end)	Number of Contracts	Recorded Investment (as of period end)	Increase in the Allowance (as of period end)
Commercial real estate	—	$—	$—	1	$1,155	$23
Total	—	$—	$—	1	$1,155	$23

(1) The period end balances are inclusive of all partial paydowns and charge-offs since the modification date. Loans modified in a TDR that were fully paid down, charged-off, or foreclosed upon by period end are not reported.

There were no loans modified in a TDR from January 1, 2011 through December 31, 2011 that subsequently defaulted (i.e., 60 days or more past due following a modification) during the years ended December 31, 2011 and 2010.

The following is a summary of consumer credit exposure as of December 31:

(Amounts in thousands)

	Residential	Consumer - home equity	Consumer-other
2011			
Performing	**$44,938**	**$16,805**	**$4,775**
Nonperforming	**842**	**111**	**1,073**
Total	**$45,780**	**$16,916**	**$5,848**
2010			
Performing	$51,222	$16,916	$6,131
Nonperforming	1,040	47	1,085
Total	$52,262	$16,963	$7,216

The following is an aging analysis of the recorded investment of past due loans as of December 31:

(Amounts in thousands)

	31-59 Days Past Due	60-89 Days Past Due	90 Days Or Greater	Total Past Due	Current	Total Loans	Recorded Investment > 90 Days and Accruing
2011							
Commercial real estate	**$ 50**	**$—**	**$ 515**	**$ 565**	**$159,754**	**$160,319**	**$—**
Commercial	**1**	**—**	**69**	**70**	**60,163**	**60,233**	**—**
Residential	**296**	**112**	**667**	**1,075**	**44,705**	**45,780**	**—**
Consumer:							
Consumer—home equity	**—**	**3**	**90**	**93**	**16,823**	**16,916**	**—**
Consumer—other	**54**	**33**	**1,039**	**1,126**	**4,722**	**5,848**	**—**
Total	**$401**	**$148**	**$2,380**	**$2,929**	**$286,167**	**$289,096**	**$—**
2010							
Commercial real estate	$418	$ 55	$ 102	$ 575	$145,814	$146,389	$—
Commercial	—	—	132	132	42,217	42,349	—
Residential	41	282	902	1,225	51,037	52,262	—
Consumer:							
Consumer—home equity	169	—	47	216	16,747	16,963	—
Consumer—other	69	4	1,047	1,120	6,096	7,216	—
Total	$697	$341	$2,230	$3,268	$261,911	$265,179	$—

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

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

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

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

Any loan evaluated for impairment is excluded from the general pool of loans in the ALLL calculation regardless if a specific reserve was determined.

If management determines that the value of the impaired loan is less than the recorded investment in the loan (net of previous charge-offs, deferred loan fees or costs and unamortized premium or discount), impairment is recognized through an allowance estimate or a charge-off to the allowance.

The following table presents the recorded investment and unpaid principal balances for impaired loans, excluding homogenous loans for which impaired analyses are not necessarily performed, with the associated allowance amount, if applicable, at December 31, 2011 and 2010. Also presented are the average recorded investments in the impaired balances and interest income recognized after impairment. The average balances are calculated based on the quarter-end balances of the loans of the period reported.

	(Amounts in thousands)				
	Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Recorded Investment	Interest Income Recognized
2011					
With no related allowance recorded:					
Commercial real estate	**$1,218**	**$1,218**	**$—**	**$ 951**	**$ 66**
Commercial	**—**	**—**	**—**	**42**	**—**
With an allowance recorded:					
Commercial real estate	**$1,400**	**$1,400**	**$ 55**	**$1,320**	**$ 74**
Commercial	**69**	**69**	**69**	**83**	**—**
Total:					
Commercial real estate	**$2,618**	**$2,618**	**$ 55**	**$2,271**	**$140**
Commercial	**69**	**69**	**69**	**125**	**—**
2010					
With no related allowance recorded:					
Commercial real estate	$ 501	$ 501	$—	$ 233	$ 2
Commercial	45	45	—	18	—
With an allowance recorded:					
Commercial real estate	$1,237	$1,237	$ 94	$ 364	$ 2
Commercial	110	110	103	128	3
Total:					
Commercial real estate	$1,738	$1,738	$ 94	$ 597	$ 4
Commercial	155	155	103	146	3

In 2009, the average recorded investment in impaired loans was $695,000 for commercial real estate and $155,000 for commercial. The interest income recognized during the period the loans were impaired was $52,000 at December 31, 2009.

The following is a summary of classes of loans on non-accrual status as of December 31:

	(Amounts in thousands) 2011	2010
Commercial real estate	**$1,470**	$ 307
Commercial	**70**	132
Residential	**842**	1,040
Consumer		
Consumer—home equity	**111**	47
Consumer—other	**1,073**	1,085
Total	**$3,566**	$2,611

Gross income that should have been recorded in income on nonaccrual loans was $305,000, $177,000 and $118,000 as of December 31, 2011, 2010 and 2009, respectively. Actual interest included in income on these nonaccrual loans amounts to $191,000, $71,000 and $52,000 in 2011, 2010 and 2009, respectively.

As of December 31, 2011 and 2010, there were $8.9 million and $6.8 million, respectively, in loans that were neither classified as non-accrual or considered impaired but which can be considered potential problem loans.

NOTE 4—PREMISES AND EQUIPMENT

The following is a summary of premises and equipment:

	(Amounts in thousands) December 31,	
	2011	2010
Land	**$ 1,387**	$ 1,387
Premises	**8,068**	8,065
Equipment	**7,634**	7,402
Leasehold improvements	**263**	261
Total premises and equipment	**17,352**	17,115
Less accumulated depreciation	**10,878**	10,395
Net book value	**$ 6,474**	$ 6,720

Depreciation expense was $582,000 in 2011 and 2010 and $666,000 in 2009.

NOTE 5—DEPOSITS

The following is a summary of interest-bearing deposits:

	(Amounts in thousands) December 31,	
	2011	2010
Demand	**$ 32,406**	$ 31,165
Money market	**63,127**	51,991
Savings	**98,912**	90,358
Time:		
In denominations under $100,000	**87,995**	93,500
In denominations of $100,000 or more	**69,599**	63,133
Total	**$352,039**	$330,147

Stated maturities of time deposits were as follows:

	(Amounts in thousands) 2011
2012	**$ 93,992**
2013	**28,237**
2014	**9,493**
2015	**5,685**
2016	**3,433**
2017 and beyond	**16,754**
Total	**$157,594**

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

	(Amounts in thousands) December 31,					
	2011			2010		
	Certificates of Deposit	Other Time Deposits	Total	Certificates of Deposit	Other Time Deposits	Total
Three months or less	**$16,767**	**$1,834**	**$18,601**	$12,862	$ 2,364	$15,226
Three to six months	**15,083**	**1,203**	**16,286**	9,202	477	9,679
Six to twelve months	**8,330**	**1,876**	**10,206**	14,498	586	15,084
One through five years	**16,195**	**2,604**	**18,799**	13,955	5,789	19,744
Over five years	**3,726**	**1,981**	**5,707**	2,265	1,135	3,400
Total	**$60,101**	**$9,498**	**$69,599**	$52,782	$10,351	$63,133

NOTE 6—FEDERAL HOME LOAN BANK (FHLB) ADVANCES AND OTHER BORROWINGS

The following is a summary of FHLB advances and other borrowings:

	Weighted Average Interest Rate	(Amounts in thousands) December 31, 2011	2010
FHLB Advances			
Fixed rate payable and convertible fixed rate FHLB advances, with monthly interest payments:			
2011		**$ —**	$ 8,500
2012	**4.4500%**	**1,500**	1,500
2013	**2.9140%**	**2,500**	2,500
2014	**4.1585%**	**6,500**	6,500
2015	**2.9300%**	**4,000**	4,000
2016	**4.0700%**	**2,000**	2,000
2017	**4.1216%**	**16,000**	16,000
	3.9014%	**32,500**	41,000
FHLB Cash Management Advance	**0.0700%**	**5,000**	12,000
Total FHLB advances	**3.3905%**	**37,500**	53,000
Other short-term borrowings			
Securities sold under repurchase agreements	**0.0652%**	**4,773**	4,344
U.S. Treasury interest-bearing demand note	**0.0000%**	**—**	557
Total other short-term borrowings	**0.0652%**	**4,773**	4,901
Total FHLB advances and other short-term borrowings	**3.0151%**	**$42,273**	$57,901

The following is a summary of other short-term borrowings:

	(Amounts in thousands)		
	2011	2010	2009
Average balance during the year	**$ 5,598**	$ 7,214	$ 6,527
Average interest rate during the year	**0.0889%**	0.1356%	0.1346%
Maximum month-end balance during the year	**$ 6,566**	$ 8,515	$ 9,301
Weighted average interest rate at year end	**0.0652%**	0.1370%	0.0993%

Securities sold under repurchase agreements represent arrangements the Bank has entered into with certain deposit customers within its local market areas. These borrowings are collateralized with securities. At December 31, 2011 and 2010, securities allocated for this purpose, owned by the Bank and held in safekeeping accounts at independent correspondent banks amounted to $9.1 million and $10.2 million, respectively.

At December 31, 2011, FHLB advances were collateralized by FHLB stock owned by the Bank with a carrying value of $2.8 million, a blanket lien against the Bank's qualified mortgage loan portfolio of $30.0 million, $6.4 million in collateralized mortgage obligations, $5.2 million in Federal Agency securities and $16.6 million in mortgage-backed securities. In comparison, FHLB advances at December 31, 2010 were collateralized by FHLB stock owned by the Bank with a carrying value of $2.8 million, a blanket lien against the Bank's qualified mortgage loan portfolio of $34.4 million, $4.3 million in collateralized mortgage obligations, $13.2 million in Federal Agency securities and $15.2 million in mortgage-backed securities. Maximum borrowing capacities from FHLB totaled $48.3 million and $56.4 million at December 31, 2011 and 2010, respectively.

As of December 31, 2010, $5.0 million of the FHLB fixed rate advances was convertible to a quarterly LIBOR floating rate advance on or after certain specified dates at the option of the FHLB. If the FHLB would have elected to convert, the Company would then have acquired the right to prepay any or all of the borrowing at the time of the conversion, and on any interest payment due date, thereafter, without penalty. Three advances matured during 2011 at an average of 4.46% and were paid off.

As of both December 31, 2011 and 2010, $32.5 million of the FHLB fixed rate advances are putable on or after certain specified dates at the option of the FHLB. Should the FHLB elect to exercise the put, the Company is required to pay the advance off on that date without penalty.

NOTE 7—SUBORDINATED DEBT

In July 2007, a trust formed by the Company issued $5.0 million of floating rate trust preferred securities as part of a pooled offering of such securities due December 2037. The Company owns all $155,000 of the common securities issued by the trust. The securities bear interest at the 3-month LIBOR rate plus 1.45%. The rates at December 31, 2011 and 2010 were 2.00% and 1.75%, respectively. The Company issued subordinated debentures to the trust in exchange for the proceeds of the trust preferred offering. The debentures represent the sole assets of this trust. The Company may redeem the subordinated debentures, in whole or in part, at a premium declining ratably to par in September 2012.

In accordance with FASB ASC, Topic 942, *Financial Services—Depository and Lending* the trust is not consolidated with the Company's financial statements. Accordingly, the Company does not report the securities issued by the trust as liabilities, but instead reports as liabilities the subordinated debentures issued by the Company and held by the trust. The subordinated debentures qualify as Tier 1 capital for regulatory purposes in determining and evaluating the Company's capital adequacy.

NOTE 8—COMMITMENTS AND CONTINGENCIES

The Bank occupies office facilities under operating leases extending to 2018. Most of these leases contain an option to renew at the then fair rental value for periods of five and ten years. These options enable the Bank to

retain use of facilities in desirable operating areas. In most cases, management expects that in the normal course of business, leases will be renewed or replaced by other leases. Rental and lease expense was $162,000 for 2011 and $187,000 for 2010 and 2009.

The following is a summary of remaining future minimum lease payments under current non-cancelable operating leases for office facilities:

	(Amounts in thousands)
Years ending:	
December 31, 2012	**$ 99**
December 31, 2013	**99**
December 31, 2014	**99**
December 31, 2015	**99**
December 31, 2016	**59**
Later years	**89**
Total	**$544**

At December 31, 2011, the Bank was required to maintain aggregate cash reserves amounting to $4.4 million in order to satisfy federal regulatory requirements. The reserves are held in useable vault cash and interest-earning balances at the Federal Reserve Bank of Cleveland.

The Bank grants commercial and industrial loans, commercial and residential mortgages, and consumer loans to customers in Northeast Ohio and Western Pennsylvania. Although the Bank has a diversified portfolio, exposure to credit loss can be adversely impacted by downturns in local economic and employment conditions. Approximately 1.51% of total loans are unsecured at December 31, 2011 compared to 0.87% at December 31, 2010.

The Company enters into derivative financial instruments in the form of interest rate locks with potential mortgage loan borrowers, and likewise enters into contracts for the future delivery of residential mortgage loans into the secondary markets. Although not utilized through December 31, 2011, the Company also intends to enter into commitments to sell loans or mortgage-backed securities to limit exposure to potential movements in market interest rates. Both the loan and delivery commitments are generally for periods less than 60 days. Included in other assets in the consolidated balance sheets at fair value at December 31, 2011 is $66,000 relating to the commitments to make loans.

Although residential mortgage loans originated and sold are without recourse as to performance, third parties to which the loans are sold can require repurchase of loans in the event noncompliance with the representations and warranties included in the sales agreements exists. These repurchases are typically those for which the borrower is in a nonperforming status, diminishing the prospects for future collection on the loan. The Company historically has not been required to repurchase any loans, however, provision is made for the contingent probability of this occurrence. At December 31, 2011, $19,000 is included in other liabilities in the consolidated balance sheets for this contingency.

The Bank is a party to financial instruments with off-balance sheet risk in the normal course of business to meet the financing needs of its customers. These financial instruments include commitments to extend credit, standby letters of credit and financial guarantees. Such instruments involve, to varying degrees, elements of credit risk in excess of the amount recognized on the consolidated balance sheets. The contract or notional amounts 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) December 31,	
	2011	2010
Commitments to extend credit:		
Fixed rate	**$20,012**	$ 7,395
Variable rate	**52,026**	36,717
Standby letters of credit	**714**	444

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

The 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 Bank reserves the right to discontinue this service without prior notice. The available amount of overdraft protection on depositors' accounts at December 31, 2011, totaled $10.1 million. The total average daily balance of overdrafts used in 2011 was $120,000, or less than 2% of the total aggregate overdraft protection available to depositors. The balance at December 31, 2011 of all deposit overdrafts included in total loans was $115,000, and the balance at December 31, 2010 was $147,000.

The Company also does not participate in any partnerships or other special purpose entities that might give rise to off-balance sheet liabilities.

NOTE 9—BENEFIT PLANS

The Bank has a contributory defined contribution retirement plan (a 401(k) plan) which covers substantially all employees. Total expense under the plan was $228,000 for 2011, $212,000 for 2010 and $226,000 for 2009. 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 $16,500 ($17,000 in 2012) with an additional $5,500 catch-up 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 Company provides 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. 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 Company accrues the cost of these post-retirement benefits during the working careers of the officers and directors. At December 31, 2011, the accumulated liability for these benefits totaled $2.0 million, with $1.6 million accrued for the officers' plan and $456,000 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,	
	2011	2010
Beginning balance	**$1,897**	$2,127
Benefit expense	**282**	259
Benefit payments	**(130)**	(132)
Benefit reductions—due to reorganization	**—**	(357)
Ending balance	**$2,049**	$1,897

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 2012, is expected to be approximately $300,000. The benefits expected to be paid in the next year are approximately $133,000.

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 Company 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.

The Company accrues for the monthly benefit expense of postretirement cost of insurance for split-dollar life insurance coverage. Total net amount expensed for the years ended December 31, 2011, 2010 and 2009 was $22,000, $46,000 and $42,000, respectively. The accumulated liability at December 31, 2011 is $509,000. The expense for the year ended December 31, 2012 is expected to be under $30,000.

NOTE 10—FEDERAL INCOME TAXES

The composition of income tax expense (benefit) is as follows:

	(Amounts in thousands) Years Ended December 31,		
	2011	2010	2009
Current	**$1,254**	$(145)	$ 861
Deferred	**(61)**	766	(5,016)
Total	**$1,193**	$ 621	$(4,155)

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

	(Amounts in thousands) December 31,	
	2011	2010
Gross deferred tax assets:		
Provision for loan and other real estate losses	**$ 910**	$ 527
Loan origination cost—net	**192**	154
Impairment loss on securities	**4,332**	4,263
Unrealized loss on available-for-sale securities	**1,372**	1,266
AMT credit carryforward	**—**	387
Other items	**908**	825
Total gross deferred tax assets	**7,714**	7,422
Valuation allowance	**(106)**	(106)
Total net deferred tax assets	**7,608**	7,316
Gross deferred tax liabilities:		
Depreciation	**(507)**	(482)
Other items	**(669)**	(569)
Total net deferred tax liabilities	**(1,176)**	(1,051)
Net deferred tax asset	**$ 6,432**	$ 6,265

At December 31, 2011, the Company assessed its earnings history and trend over the prior two years, its estimate of future earnings, and the expiration dates of its potential net operating loss carry-forwards. Based on this assessment, the Company determined that it was more-likely-than-not that the deferred tax assets will be realized before their expiration. A valuation allowance is recorded in the Parent Company relating to impaired losses incurred therein. Because of the Parent Company's inability to generate taxable income, realization of the deferred tax asset therein is not probable.

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

	(Amounts in thousands) Years Ended December 31,		
	2011	2010	2009
Statutory tax expense (benefit)	**$1,790**	$1,323	$(3,567)
Tax effect of non-taxable income	**(517)**	(619)	(467)
Tax effect of earnings on bank-owned life insurance-net	**(131)**	(142)	(157)
Tax effect of non-deductible expenses	**51**	59	36
Federal income tax expense (benefit)	**$1,193**	$ 621	$(4,155)

The related income tax expense on investment securities gains amounted to $300,000 for 2011, $346,000 for 2010 and $147,000 for 2009, and is included in the Federal income tax expense (benefit).

The Company adopted the provisions of ASC Topic 740, *Accounting for Uncertainty in Income Taxes*, which prescribe a recognition threshold and a measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. Benefits from tax positions should be recognized in the financial statements only when it is more-likely-than-not that the tax position will be sustained upon examination by the appropriate taxing authority that would have full knowledge of all relevant information. A tax position that meets the more-likely-than-not recognition threshold is measured at the largest amount of benefit that is greater than fifty percent likely of being realized upon ultimate settlement. Tax positions that previously failed to meet the more-likely-than-not recognition threshold should be recognized in the first

subsequent financial reporting period in which that threshold is met. Previously recognized tax positions that no longer meet the more-likely-than-not recognition threshold should be derecognized in the first subsequent financial reporting period in which that threshold is no longer met. The provision also provides guidance on the accounting for and disclosure of unrecognized tax benefits, interest and penalties. There were no significant unrecognized tax benefits at December 31, 2011 and the Company does not expect any significant increase in unrecognized tax benefits in the next twelve months. No interest or penalties were incurred for income taxes which would have been recorded as a component of income tax expense.

There is currently no liability for uncertain tax positions and no known unrecognized tax benefits. The Company's federal and state income tax returns for taxable years through 2007 have been closed for purposes of examination by the Internal Revenue Service and the Ohio Department of Revenue.

NOTE 11—FAIR VALUE

Measurements

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

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

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

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

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

The following tables present the assets reported on the consolidated balance sheets at their fair value as of December 31, 2011 and December 31, 2010 by level within the fair value hierarchy. Financial assets and liabilities are classified in their entirety based on the lowest level of input that is significant to the fair value measurement.

		(Amounts in thousands) Fair Value Measurements at 12/31/11 Using		
Description	December 31, 2011	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
U.S. Treasury securities	**$ 133**	**$—**	**$ 133**	**$ —**
U.S. Government agencies and corporations	**20,542**	**—**	**20,542**	**—**
Obligations of states and political subdivisions	**39,019**	**—**	**39,019**	**—**
U.S. Government-sponsored mortgage-backed and CMO securities	**113,283**	**—**	**113,283**	**—**
Private-label mortgage-backed and related securities	**381**	**—**	**381**	**—**
Trust preferred securities	**9,145**	**—**	**—**	**9,145**
General Motors equity investments	**364**	**364**	**—**	**—**
Loans held for sale	**947**	**—**	**947**	**—**
Derivatives—commitments to make loans	**66**	**—**	**66**	**—**

		(Amounts in thousands) Fair Value Measurements at 12/31/10 Using		
Description	December 31, 2010	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
U.S. Government agencies and corporations	$29,454	$—	$29,454	$ —
Obligations of states and political subdivisions	25,889	—	25,889	—
U.S. Government-sponsored mortgage-backed and CMO securities	96,486	—	96,486	—
Private-label mortgage-backed and related securities	214	—	214	—
Trust preferred securities	12,779	—	—	12,779
Corporate securities	287	—	287	—
Loans held for sale	262	—	262	—

The following tables present the changes in the Level 3 fair value category for the years ended December 31, 2011 and 2010. The Company classifies financial instruments in Level 3 of the fair-value hierarchy when there is reliance on at least one significant unobservable input to the valuation model. In addition to these unobservable

inputs, the valuation models for Level 3 financial instruments typically also rely on a number of inputs that are readily observable either directly or indirectly.

(Amounts in thousands)

Description	January 1, 2011	Net realized/unrealized gains/(losses) included in		Transfers in and/or out of Level 3	Purchases, issuances and settlements	December 31, 2011	Losses included in net income for the period relating to assets held at December 31, 2011
		Noninterest income	Other comprehensive loss				
Trust preferred securities	**$12,779**	**$ (202)**	**$(3,097)**	**$—**	**$(335)**	**$ 9,145**	**$ (202)**

Description	January 1, 2010	Net realized/unrealized gains/(losses) included in		Transfers in and/or out of Level 3	Purchases, issuances and settlements	December 31, 2010	Losses included in net income for the period relating to assets held at December 31, 2010
		Noninterest income	Other comprehensive income				
Trust preferred securities	$12,124	$(2,712)	$ 3,586	$—	$(219)	$12,779	$(2,712)

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

The Company also considers the issuer's financial condition, capital strength and near-term prospects. In addition, for debt securities the Company recognizes that the cause of the price decline (general level of interest rates and industry- and issuer-specific factors), current ability to make future payments in a timely manner and the issuer's ability to service debt, the assessment of a security's ability to recover any decline in market value, the ability of the issuer to meet contractual obligations and the Company's intent and ability to retain the security require considerable judgment.

Trust Preferred Securities

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

The Company holds 31 trust preferred securities totaling $34.6 million (par value) that are backed by pooled trust preferred debt issued by banks, thrifts, insurance companies and real estate investment trusts. These securities were all rated investment grade at inception. Beginning during the second half of 2008 and through 2011, factors

outside the Company's control impacted the fair value of these securities and will likely continue to do so for the foreseeable future. These factors include, but are not limited to, the following: guidance on fair value accounting, issuer credit deterioration, issuer deferral and default rates, potential failure or government seizure of underlying financial institutions or insurance companies, ratings agency actions, or regulatory actions. As a result of changes in these and various other factors during 2009 through 2011, Moody's Investors Service, Fitch Ratings and Standards and Poors downgraded multiple trust preferred securities, including securities held by the Company. All 31 of the trust preferred securities held by the Company are now considered to be below investment grade. The deteriorating economic, credit and financial conditions experienced in 2008 and through 2011 have resulted in illiquid and inactive financial markets and severely depressed prices for these securities. Two securities totaling $5.9 million were determined worthless for book and tax purposes in 2010. The Company analyzed the cash flow characteristics of the remaining 29 securities. For 11 of these securities, the Company does not consider the investment in these assets to be OTTI at December 31, 2011. The Company does not intend to sell the securities and it is more-likely-than-not that the Company will be required to sell the securities before recovery of its amortized cost basis. There was no adverse change in the cash flows. Although the Company does not consider the investment in these assets to be OTTI at December 31, 2011, there is a risk that subsequent evaluations could result in recognition of OTTI charges in the future. The remaining 18 securities had life-to-date impairment losses of $14.1 million, of which $10.7 million was recorded as expense, and $3.4 million was recorded in other comprehensive loss. The securities subjected to FASB ASC Topic 320 accounted for the entire $8.5 million of gross unrealized losses in the trust preferred securities category at December 31, 2011.

The following table details the 18 debt securities with OTTI, their credit ratings at December 31, 2011 and the related losses recognized in earnings:

			(Amounts in thousands)				
	Moody's/ Fitch Rating	Amount of OTTI related to credit loss at Jan. 1, 2011	Additions in the Quarter Ended:				Amount of OTTI related to credit loss at Dec. 31, 2011
			March 31	June 30	Sept. 30	Dec. 31	
MM Community Funding II Class B	Ba1/CC	**$ 11**	**$—**	**$—**	**$—**	**$—**	**$ 11**
PreTSL I Mezzanine	Ca/C	**430**	**—**	**—**	**—**	**—**	**430**
PreTSL II Mezzanine	Ca/C	**1,274**	**142**	**—**	**—**	**—**	**1,416**
PreTSL V Mezzanine	Ba3/D	**97**	**—**	**—**	**—**	**—**	**97**
PreTSL VIII B-3	C/C	**1,635**	**—**	**—**	**—**	**—**	**1,635**
PreTSL IX Class B-2	Ca/C	**274**	**—**	**—**	**—**	**—**	**274**
PreTSL XV Class B-2	C/C	**267**	**10**	**—**	**—**	**—**	**277**
PreTSL XV Class B-3	C/C	**269**	**10**	**—**	**—**	**—**	**279**
PreTSL XVI D	NR/C	**518**	**—**	**—**	**—**	**—**	**518**
PreTSL XVI D	NR/C	**991**	**—**	**—**	**—**	**—**	**991**
PreTSL XVII Class C	Ca/C	**978**	**—**	**—**	**—**	**—**	**978**
PreTSL XVII Class D	NR/C	**930**	**—**	**—**	**—**	**—**	**930**
PreTSL XVIII Class D	NR/C	**513**	**—**	**—**	**—**	**—**	**513**
PreTSL XXIII Class C-FP	C/C	**211**	**—**	**—**	**—**	**—**	**211**
PreTSL XXV Class D	NR/C	**1,001**	**—**	**—**	**—**	**—**	**1,001**
PreTSL XXVI Class D	NR/C	**465**	**—**	**—**	**—**	**—**	**465**
Trapeza CDO II Class C-1	Ca/C	**598**	**—**	**—**	**—**	**—**	**598**
Trapeza IX B-1	Ca/CC	**10**	**40**	**—**	**—**	**—**	**50**
Total		**$10,472**	**$202**	**$—**	**$—**	**$—**	**$10,674**

The following table details the 20 debt securities with OTTI, their credit ratings at December 31, 2010 and the related losses recognized in earnings:

	Moody's/ Fitch Rating	Amount of OTTI related to credit loss at Jan. 1, 2010	Additions in the Quarter Ended: March 31	June 30	Sept. 30	Dec. 31	Amount of OTTI related to credit loss at Dec. 31, 2010
		(Amounts in thousands)					
Alesco Preferred Funding VIII Class E Notes 1	C/C	$ 1,500	$—	$—	$ —	$—	$ 1,500
MM Community Funding III Class B	Ba1/CC	6	5	—	—	—	11
PreTSL I Mezzanine	Ca/C	103	1	77	249	—	430
PreTSL II Mezzanine	Ca/C	816	364	94	—	—	1,274
PreTSL V Mezzanine	Ba3/D	—	—	—	96	1	97
PreTSL VIII B-3	C/C	1,390	—	—	165	80	1,635
PreTSL IX Class B-2	Ca/C	247	—	27	—	—	274
PreTSL XV Class B-2	C/C	84	39	—	144	—	267
PreTSL XV Class B-3	C/C	84	40	—	145	—	269
PreTSL XVI D	NR/C	518	—	—	—	—	518
PreTSL XVI D	NR/C	991	—	—	—	—	991
PreTSL XVII Class C	Ca/C	94	56	196	632	—	978
PreTSL XVII Class D	NR/C	930	—	—	—	—	930
PreTSL XVIII Class D	NR/C	513	—	—	—	—	513
PreTSL XXIII Class C-FP	C/C	204	7	—	—	—	211
PreTSL XXV Class D	NR/C	1,001	—	—	—	—	1,001
PreTSL XXVI Class D	NR/C	464	—	1	—	—	465
Trapeza CDO II Class C-1	Ca/C	317	31	218	32	—	598
Tropic CDO V Class B-1L	C/C	4,425	1	—	1	—	4,427
Trapeza IX B-1	Ca/CC	—	—	—	—	10	10
Total		$13,687	$544	$613	$1,464	$ 91	$16,399

The following table provides additional information related to the Company's trust preferred securities as of December 31, 2011 used to evaluate other-than-temporary impairments:

(Amounts in thousands)

Deal	Class	Book Value	Fair Value	Unrealized Gain/(Loss)	Moody's/ Fitch Rating	Number of Issuers Currently Performing	Deferrals and Defaults as a % of Current Collateral	Excess Subordination as a % of Current Performing Collateral
PreTSL I	Mezzanine	$ 513	$ 517	$ 4	Ca/C	17	38.07%	— %
PreTSL II	Mezzanine	688	480	(208)	Ca/C	16	48.26	—
PreTSL IV	Mezzanine	183	175	(8)	Ca/CCC	4	27.07	19.56
PreTSL V	Mezzanine	22	11	(11)	Ba3/D	—	100.00	—
PreTSL VIII	B-3	365	91	(274)	C/C	21	45.91	—
PreTSL IX	B-2	719	249	(470)	Ca/C	33	31.02	—
PreTSL XV	B-2	224	55	(169)	C/C	51	31.31	—
PreTSL XV	B-3	224	55	(169)	C/C	51	31.31	—
PreTSL XVI	D	—	—	—	NR/C	34	42.55	—
PreTSL XVI	D	—	—	—	NR/C	34	42.55	—
PreTSL XVII	C	—	—	—	Ca/C	36	32.11	—
PreTSL XVII	D	—	—	—	NR/C	36	32.11	—
PreTSL XVIII	D	—	—	—	NR/C	52	26.46	—
PreTSL XXIII	C-2	1,011	99	(912)	C/C	95	26.81	—
PreTSL XXIII	C-FP	1,550	472	(1,078)	C/C	95	26.81	—
PreTSL XXV	D	—	—	—	NR/C	48	33.52	—
PreTSL XXVI	D	—	—	—	NR/C	48	28.26	—
I-PreTSL I	B-1	985	603	(382)	NR/CCC	15	16.80	2.63
I-PreTSL I	B-2	1,000	603	(397)	NR/CCC	15	16.80	2.63
I-PreTSL I	B-3	1,000	603	(397)	NR/CCC	15	16.80	2.63
I-PreTSL II	B-3	2,991	2,383	(608)	NR/B	26	5.09	13.16
I-PreTSL III	B-2	1,000	621	(379)	B2/CCC	22	12.35	7.56
I-PreTSL III	C	1,000	383	(617)	NR/CCC	22	12.35	—
I-PreTSL IV	B-1	1,000	485	(515)	Ba2/CCC	27	8.44	10.46
I-PreTSL IV	B-2	1,000	484	(516)	Ba2/CCC	27	8.44	10.46
I-PreTSL IV	C	480	136	(344)	Caa1/CC	27	8.44	5.48
MM Community Funding III	B	280	216	(64)	Ba1/CC	5	41.11	2.76
Trapeza II	C-1	414	278	(136)	Ca/C	23	33.43	—
Trapeza IX	B-1	951	146	(805)	Ca/CC	40	12.99	—
Total		$17,600	$9,145	$(8,455)				

The following table provides additional information related to the Company's trust preferred securities as of December 31, 2010 used to evaluate other-than-temporary impairments:

(Amounts in thousands)

Deal	Class	Book Value	Fair Value	Unrealized Gain/(Loss)	Moody's/ Fitch Rating	Number of Issuers Currently Performing	Deferrals and Defaults as a % of Current Collateral	Excess Subordination as a % of Current Performing Collateral
PreTSL I	Mezzanine	$ 515	$ 617	$ 102	Ca/C	21	36.22%	— %
PreTSL II	Mezzanine	835	664	(171)	Ca/C	23	37.71	—
PreTSL IV	Mezzanine	183	136	(47)	Ca/CCC	4	27.07	19.28
PreTSL V	Mezzanine	22	14	(8)	Ba3/D	—	100	—
PreTSL VIII	B-3	365	120	(245)	C/C	22	44.82	—
PreTSL IX	B-2	722	437	(285)	Ca/C	34	30.33	—
PreTSL XV	B-2	234	49	(185)	C/C	52	23.58	—
PreTSL XV	B-3	234	49	(185)	C/C	52	35.01	—
PreTSL XVI	D	—	—	—	NR/C	36	41.87	—
PreTSL XVI	D	—	—	—	NR/C	36	41.87	—
PreTSL XVII	C	—	—	—	Ca/C	38	31.46	—
PreTSL XVII	D	—	—	—	NR/C	38	31.46	—
PreTSL XVIII	D	—	—	—	NR/C	54	24.57	—
PreTSL XXIII	C-2	1,011	198	(813)	C/C	93	27.05	—
PreTSL XXIII	C-FP	1,546	746	(800)	C/C	93	27.05	—
PreTSL XXV	D	—	—	—	NR/C	49	35.86	—
PreTSL XXVI	D	—	—	—	NR/C	50	30.23	—
I-PreTSL I	B-1	985	829	(156)	NR/CCC	16	9.04	9.11
I-PreTSL I	B-2	1,000	829	(171)	NR/CCC	16	9.04	9.11
I-PreTSL I	B-3	1,000	829	(171)	NR/CCC	16	9.04	9.11
I-PreTSL II	B-3	2,990	2,973	(17)	NR/B	29	—	14.33
I-PreTSL III	B-2	1,000	820	(180)	B2/CCC	24	5.81	10.75
I-PreTSL III	C	1,000	614	(386)	NR/CCC	24	5.81	3.19
I-PreTSL IV	B-1	1,000	608	(392)	Ba2/CCC	29	11.58	2.82
I-PreTSL IV	B-2	1,000	608	(392)	Ba2/CCC	29	11.58	2.82
I-PreTSL IV	C	500	202	(298)	Caa1/CC	29	11.58	—
Alesco VIII	E	—	—	—	C/C	56	35.62	—
MM Community Funding III	B	426	420	(6)	Ba1/CC	7	32.17	0.77
MM Community Funding II	B	165	165	—	Baa2/BB	5	29.31	17.32
Tropic V	B-1L	—	—	—	C/C	53	39.68	—
Trapeza II	C-1	414	384	(30)	Ca/C	23	37.04	—
Trapeza IX	B-1	990	468	(522)	Ca/CC	41	10.96	21.82
Total		$18,137	$12,779	$(5,358)				

The market for these securities at December 31, 2011 and 2010 is not active and markets for similar securities are also not active. The inactivity was evidenced first by a significant widening of the bid-ask spread in the brokered markets in which trust preferred securities trade and then by a significant decrease in the volume of trades relative to historical levels. The new issue market is also inactive as no new trust preferred securities have been issued since 2007. There are currently very few market participants who are willing and/or able to transact for these securities. The pooled market value for these securities remains very depressed relative to historical levels. Although there has been marked improvement in the credit spread premium in the corporate bond space, no such improvement has been noted in the market for trust preferred securities.

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

- The few observable transactions and market quotations that are available are not reliable for purposes of determining fair value at December 31, 2011;
- An income valuation approach technique (present value technique) that maximizes the use of relevant observable inputs and minimizes the use of unobservable inputs will be equally or more representative of fair value than the market approach valuation technique used at measurement dates prior to 2008; and
- The trust preferred securities will be classified within Level 3 of the fair value hierarchy because the Company determined that significant judgments are required to determine fair value at the measurement date.

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

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

The effective discount rates on an overall basis generally range from 17.08% to 44.38% and are highly dependent upon the credit quality of the collateral, the relative position of the tranche in the capital structure of the trust preferred security and the prepayment assumptions.

With the passage of the Dodd-Frank Act, trust preferred securities issued by institutions with assets greater than $15.0 billion will no longer be included in Tier 1 capital after 2013. As a result, prepayment assumptions were adjusted to include early redemptions by all institutions meeting this criteria. As the vast majority of institutions in the trust preferred securities collateral base fall below this threshold, the revised assumption did not materially impact the valuation results.

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

	(Amounts in thousands) December 31, 2011			
	Level 1	Level 2	Level 3	Total
Assets measured on a nonrecurring basis:				
Impaired loans	**$—**	**$—**	**$2,563**	**$2,563**
Other real estate owned	**—**	**—**	**437**	**437**

	December 31, 2010			
	Level 1	Level 2	Level 3	Total
Assets measured on a nonrecurring basis:				
Impaired loans	$—	$—	$1,696	$1,696
Other real estate owned	—	—	848	848

Impaired loans: A loan is considered to be impaired when, based on current information and events, it is probable that the Company will be unable to collect all amounts due (both interest and principal) according to the contractual terms of the loan agreement. Impaired loans are measured, as a practical expedient, at the loan's observable market price or the fair market value of the collateral if the loan is collateral dependent. At December 31, 2011, the recorded investment in impaired loans was $2,687,000 with a related reserve of $124,000 resulting in a net balance of $2,563,000. At December 31, 2010, the recorded investment in impaired loans was $1,893,000 with a related reserve of $197,000 resulting in a net balance of $1,696,000.

Other real estate owned (OREO): Real estate acquired through foreclosure or deed-in-lieu of foreclosure is included in other assets. Such real estate is carried at fair value less estimated costs to sell. Any reduction from the carrying value of the related loan to fair value at the time of acquisition is accounted for as a loan loss. Any subsequent reduction in fair market value is reflected as a valuation allowance through a charge to income. Costs of significant property improvements are capitalized, whereas costs, relating to holding and maintaining the property, are charged to expense. At December 31 2011, the recorded investment in OREO was $560,000 with a valuation allowance of $123,000 resulting in a net balance of $437,000. At December 31, 2010, the recorded investment in OREO was $883,000 with a valuation allowance of $35,000 resulting in a net balance of $848,000.

Financial Instruments:

The FASB ASC Topic 825, *Financial Instruments*, requires disclosure of fair value information about financial instruments, whether or not recognized in the Consolidated Balance Sheets, for which it is practicable to estimate the value. In cases where quoted market prices are not available, fair values are based on estimates using present value or other estimation techniques. Those techniques are significantly affected by the assumptions used, including the discount rate and estimates of future cash flows.

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

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

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

Loans, net of allowance for loan loss—Market quotations are generally not available for loan portfolios. The fair value is estimated by discounting future cash flows using current market inputs at which loans with similar terms and qualities would be made to borrowers of similar credit quality.

Loans held for sale—Loans held for sale consist of residential mortgage loans originated for sale. Loans held for sale are recorded at fair value based on the price secondary markets are currently offering for loans with similar characteristics.

Mortgage banking derivatives—The Company enters into derivative financial instruments in the form of interest rate locks with potential mortgage loan borrowers, and likewise enters into contracts for the future delivery of residential mortgage loans into the secondary markets. These derivative instruments are recognized as either assets or liabilities at fair value on a recurring basis in the consolidated balance sheets as indicated in the ensuing table. Fair value adjustments relating to these mortgage banking derivatives are recorded in current year earnings as a component of mortgage banking gains.

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

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

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

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

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

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

Accrued interest payable—The carrying amount is a reasonable estimate of these liabilities' fair value.

The fair value of unrecorded commitments at December 31, 2011 and December 31, 2010 is not material.

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

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

	(Amounts in thousands)			
	December 31, 2011		December 31, 2010	
	Carrying Amount	Estimated Fair Value	Carrying Amount	Estimated Fair Value
ASSETS:				
Cash and cash equivalents	**$ 16,176**	**$ 16,176**	$ 15,804	$ 15,804
Investment securities available-for-sale	**185,916**	**185,916**	168,158	168,158
Investment securities held-to-maturity	**—**	**—**	20,300	20,941
Loans held for sale	**947**	**947**	262	262
Loans, net of allowance for loan losses	**286,038**	**291,681**	262,678	268,295
Accrued interest receivable	**1,919**	**1,919**	2,124	2,124
Mortgage banking derivatives	**66**	**66**	—	—
LIABILITIES:				
Demand, savings and money market deposits	**$265,171**	**$265,171**	$234,876	$234,876
Time deposits	**157,594**	**160,978**	156,633	160,750
FHLB advances	**37,500**	**41,113**	53,000	56,216
Other short-term borrowings	**4,773**	**4,773**	4,901	4,901
Subordinated debt	**5,155**	**3,508**	5,155	3,962
Accrued interest payable	**441**	**441**	535	535

NOTE 12—REGULATORY MATTERS

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

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

Under the regulatory framework for prompt corrective action, the Company is categorized as well capitalized, which requires minimum capital ratios of 10% for total risk-based capital to risk-weighted assets, 6% for Tier I risk-based capital to risk-weighted assets and 5% for Tier I risk-based capital to average assets (also known as the leverage ratio). There are no conditions or events since the most recent communication from regulators that management believes would change the Company's capital classification. Management believes as of December 31, 2011, the Company meets all capital adequacy requirements to which it is subject.

	(Amounts in thousands) December 31,			
	2011		2010	
	Amount	Ratio	Amount	Ratio
Total Risk-Based Capital	**$54,881**		$49,372	
Ratio to Risk-Weighted Assets		**14.18%**		13.42%
Tier I Risk-Based Capital	**$51,739**		$46,787	
Ratio to Risk-Weighted Assets		**13.37%**		12.72%
Ratio to Average Assets		**10.47%**		9.59%

Tier I risk-based capital is shareholders' equity, noncumulative and cumulative perpetual preferred stock, qualifying trust preferred securities and non-controlling interests less intangibles, disallowed deferred tax assets 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.

NOTE 13—RELATED PARTY TRANSACTIONS

Certain directors, executive officers and companies with whom they are affiliated were loan customers during 2011. The following is an analysis of such loans:

	(Amounts in thousands)
Total related-party loans at December 31, 2010	$ 3,233
New related-party loans	**1,164**
Repayments or other	**(1,219)**
Total related-party loans at December 31, 2011	**$ 3,178**

Deposits from executive officers, directors, and their affiliates at December 31, 2011 and 2010 were $2.6 million and $2.9 million, respectively.

The banking relationships were made in the ordinary course of business with the Bank.

NOTE 14—CONDENSED FINANCIAL INFORMATION—PARENT COMPANY

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, adjusted for any unrealized gains or losses on available-for-sale securities.

BALANCE SHEETS

(Amounts in thousands)

	December 31, 2011	December 31, 2010
ASSETS		
Cash	**$ 456**	$ 599
Investment securities available-for-sale	**54**	42
Investment in bank subsidiary	**41,765**	37,766
Investment in non-bank subsidiary	**15**	15
Subordinated note from subsidiary bank	**6,000**	6,000
Other assets	**3,302**	3,234
Total assets	**$51,592**	$47,656
LIABILITIES		
Other liabilities	**$ 718**	$ 649
Subordinated debt (Note 7)	**5,155**	5,155
Total liabilities	**5,873**	5,804
SHAREHOLDERS' EQUITY		
Common stock	**23,641**	23,641
Additional paid-in capital	**20,850**	20,850
Retained earnings	**7,485**	3,413
Accumulated other comprehensive loss	**(2,663)**	(2,458)
Treasury stock	**(3,594)**	(3,594)
Total shareholders' equity	**45,719**	41,852
Total liabilities & shareholders' equity	**$51,592**	$47,656

STATEMENTS OF INCOME

(Amounts in thousands)

	Years ended December 31, 2011	2010	2009
Interest and dividend income	**$ 98**	$ 100	$ 148
Investment securities gains (losses)	**51**	—	(124)
Other income	**114**	125	120
Interest on subordinated debt	**(92)**	(93)	(127)
Other expenses	**(362)**	(279)	(314)
Loss before income tax and equity in undistributed earnings (loss) of subsidiaries	**(191)**	(147)	(297)
Income tax benefit	**85**	79	89
Equity in undistributed earnings (loss) of subsidiaries	**4,178**	3,339	(6,127)
Net income (loss)	**$4,072**	$3,271	$(6,335)

STATEMENTS OF CASH FLOWS

(Amounts in thousands)

	Years ended December 31,		
	2011	2010	2009
Cash (deficit) flows from operating activities			
Net income (loss)	**$ 4,072**	$ 3,271	$(6,335)
Adjustments to reconcile net income (loss) to net cash (deficit) flows from operating activities:			
Equity in undistributed net (income) loss of subsidiaries	**(4,178)**	(3,339)	6,127
Deferred tax benefit	**(14)**	(14)	(12)
Investment securities (gains) losses	**(51)**	—	124
Change in other assets and liabilities	**28**	(109)	(13)
Net cash deficit from operating activities	**(143)**	(191)	(109)
Cash flows from investing activities			
Net cash flows from investing activities	**—**	—	—
Cash flows (deficit) from financing activities			
Dividends paid	**—**	—	(3)
Purchases of treasury stock	**—**	—	(1)
Treasury shares reissued	**—**	—	272
Net cash flows from financing activities	**—**	—	268
Net change in cash	**(143)**	(191)	159
Cash			
Beginning of year	**599**	790	631
End of year	**$ 456**	$ 599	$ 790

NOTE 15—DIVIDEND RESTRICTIONS

The Bank is subject to a dividend restriction that generally limits the amount of dividends that can be paid by an Ohio state-chartered bank. Under the Ohio Banking Code, cash dividends may not exceed net profits as defined for that year combined with retained net profits for the two preceding years less any required transfers to surplus. Under this formula, the amount available for payment of dividends in 2012 is $7,517,000 plus 2012 profits retained up to the date of the dividend declaration.

NOTE 16—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.

NOTE 17—MEMORANDUM OF UNDERSTANDING

The Company has been informed by its bank regulatory agencies, which provide regulatory oversight to the Company and the Bank, that the Company has fulfilled the terms of the informal assurances given to the agencies back in 2009.

Summarized in the Company's annual reports and quarterly reports filed with the SEC since the informal assurances were first given to the Company's Federal and state supervisory agencies in 2009, the Company and the Bank had agreed to obtain regulatory approval in order to incur debt, repurchase stock, or pay dividends, as well as agreeing to submit a plan to strengthen and improve management of the overall risk exposure of the investment portfolio, a plan to maintain an adequate capital position, a plan to strengthen board oversight of the management and operations, and a plan to improve the Bank's earnings and overall condition.

Item 9. Changes in and Disagreements with Accountants on Accounting and Financial Disclosures—None

Item 9A. Controls and Procedures

Evaluation of Disclosure Controls and Procedures. With the supervision and participation by management, including the Company's principal executive officer and principal financial officer, the effectiveness of disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) of the Securities Exchange Act of 1934 (the "Exchange Act")) has been evaluated as of the end of the period covered by this report. Based upon that evaluation, the Company's principal executive officer and principal financial officer have concluded that these controls and procedures are designed to ensure that the information required to be disclosed by the Company in reports that it files or submits under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and regulations and are operating in an effective manner.

Management's Annual Report on Internal Control Over Financial Reporting. The report on management's assessment of internal control over financial reporting is included in Item 8.

Changes in Internal Control Over Financial Reporting. Our Chief Executive Officer and Chief Financial Officer have concluded that there have been no changes during the fourth quarter of 2011 in the Company's internal control over financial reporting (as defined in Rules 13a-13 and 15d-15 of the Exchange Act) that have materially affected, or are reasonable likely to materially affect, internal control over financial reporting.

Item 9B. Other Information

Item 5.02(e) Compensatory Arrangements of Certain Officers

On March 20, 2012, the Bank's Board of Directors approved entry into Fifth Amended Salary Continuation Agreements with President and Chief Executive Officer James M. Gasior and Executive Vice President and Chief Operating Officer Tim Carney. Messrs. Gasior and Carney's annual normal retirement benefit amounts remain unchanged under the fifth amended salary continuation agreements. The fifth amended salary continuation agreements provide a normal retirement age benefit of $109,700 for Mr. Gasior and $112,500 for Mr. Carney, payable in each case in monthly installments beginning at the age 65 normal retirement age and continuing for 15 years. Rather, Messrs. Gasior and Carney's salary continuation agreements were revised to (i) eliminate the age 62 cliff vesting requirement associated with receipt of the early retirement benefit and (ii) contain a two-year non-solicitation/ noncompetition provision due to the enhanced early retirement benefits being provided to the executives.

Finally, on March 20, 2012, the Bank's Board of Directors approved entry into an Endorsement Split Dollar Agreement with Senior Vice President and Chief Financial Officer David J. Lucido, providing for division of the death proceeds of a life insurance policy on his life. The Endorsement Split Dollar Agreement replaces the existing arrangement whereby the Bank maintains term insurance on Mr. Lucido's life, with Mr. Lucido designating the beneficiary of a portion of the death proceeds payable under the term life insurance policy. Under the terms of Mr. Lucido's Endorsement Split Dollar Agreement, his beneficiary(ies) are entitled to life insurance policy proceeds in an amount equal to the lesser of (i) 100% of the net death proceeds or (ii) a portion of the net death proceeds equal to 100% of the accrual balance required at normal retirement age under his June 1, 2010 Salary Continuation Agreement. The Executive's Endorsement Split Dollar Agreement terminates at the earliest of his separation from service or his attainment of age 65.

Exhibits. The foregoing descriptions of Messrs. Gasior and Carney's fifth amended salary continuation agreements (provided herein as Exhibits 10.19 and 10.17, respectively) and Mr. Lucido's Endorsement Split Dollar Agreement (provided herein as Exhibit 10.16) do not purport to be complete and are qualified in their entirety by reference to the exhibits attached hereto or incorporated herein by reference.

PART III

Item l0. Directors, Executive Officers and Corporate Governance

Information relating to this item will be set forth in the Company's definitive proxy statement to be filed on or about April 6, 2012 in connection with the annual meeting of shareholders to be held May 22, 2012 (the "Proxy Statement"). The information contained in the Proxy Statement under the following captions is incorporated herein by reference: "Board Nominees," "Continuing Directors," "The Board of Directors and Committees of the Board," and "Section 16(a) Beneficial Ownership Reporting Compliance."

Executive Officers of the Registrant

The names, ages and positions of the executive officers as of March 29, 2012 are as follows:

Name	Age	Position Held
James M. Gasior	52	President, Chief Executive Officer and Director
Timothy Carney	46	Executive Vice President, Chief Operations Officer, Secretary and Director
David J. Lucido	54	Senior Vice President and Chief Financial Officer
Stanley P. Feret	51	Senior Vice President and Chief Lending Officer

The directors listed above will hold office until the next annual meeting of shareholders and until their successors are duly elected and qualified.

Principal Occupation and Business Experience of Executive Officers

During the past five years the business experience of each of the executive officers has been as follows:

Mr. Gasior succeeded Mr. Fantauzzi as President and Chief Executive Officer of the Company and the Bank beginning November 2, 2009. Mr. Gasior is a Certified Public Accountant, a member of the American Institute of CPA's and the Ohio Society of CPA's, and has been a member of the Board of Directors since November of 2005. Previously, Mr. Gasior served as Senior Vice President, Chief Financial Officer and Secretary of the Company, and as Senior Vice President, Chief Financial Officer and Secretary of the Bank. He had been in these positions since November, 2005. Mr. Gasior served as Senior Vice President of Lending and Administration of the Company and the Bank from April 1999 to October 2005.

Mr. Carney was elected as Executive Vice President, Chief Operating Officer and Secretary of both the Company and the Bank on November 2, 2009. Mr. Carney was also appointed to the Board of Directors on November 2, 2009 to serve the unexpired term of Lawrence Fantauzzi. Mr. Carney was elected as Senior Vice President and Chief Operations Officer of the Company on April 22, 2008. He was Senior Vice President and Chief Operations of the Bank beginning in 2000.

Mr. Lucido was appointed Senior Vice President and Chief Financial Officer of the Company and the Bank on January 18, 2010. Previously, Mr. Lucido served as Corporate Vice President and Treasurer of First Place Bank (2008-2010) and Vice President and Manager of Holding Company Accounting for National City Bank (1994-2007).

Mr. Feret was appointed Senior Vice President and Chief Lending Officer of the Company and the Bank on March 10, 2010. Previously, Mr. Feret served as Senior Vice President of Huntington National Bank from June 2007 to March 2010 and Senior Vice President of Sky Bank from August 2004 to June 2007.

Item ll. Executive Compensation

Information relating to this item is incorporated herein by reference to the information in the Proxy Statement that is set forth under the following captions of “Executive Compensation” and “Directors Compensation in 2011.”

Item l2. Security Ownership of Certain Beneficial Owners and Management and Related Shareholders Matters

Information relating to this item is incorporated herein by reference to the information in the Proxy Statement that is set forth under the caption “Share Ownership by Directors and Executive Officers.”

Item l3. Certain Relationships and Related Transactions, and Director Independence

Information relating to this item is incorporated herein by reference to the information in the Proxy Statement that is set forth under the captions of “Transactions with Related Persons” and “The Board of Directors and Committees of the Board.”

Item l4. Principal Accountant Fees and Services

Information relating to this item is incorporated herein by reference to the information in the Proxy Statement that is set forth under the caption “Ratification of Independent Auditors.”

PART IV

Item 15. Exhibits, Financial Statement Schedules

(a) 1. Financial Statements

Included in Part II of this report:

Item 8., Financial Statements

Consolidated Financial Statements included in this Annual Report:

Management's Annual Report on Internal Control Over Financial Reporting 54
Report of Independent Registered Public Accounting Firm 55
Consolidated Balance Sheets as of December 31, 2011 and 2010 56
Consolidated Statements of Income for the Years Ended December 31, 2011, 2010 and 2009 57
Consolidated Statements of Shareholders' Equity for the Years Ended December 31, 2011, 2010 and 2009 58-59
Consolidated Statements of Cash Flows for the Years Ended December 31, 2011, 2010 and 2009 . . . 60
Notes to Consolidated Financial Statements 61-96

(a) 2. Financial Statement Schedules

Financial statements schedules are omitted because the required information is either not applicable, not required or is not shown in the respective financial statements or in the notes thereto.

(a) 3. Exhibits Required by Item 601 of Regulation S-K

All exhibits omitted.

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

CORTLAND BANCORP

Date: March 29, 2012

By: /s/ JAMES M. GASIOR

James M. Gasior
President, Chief Executive Officer, Director
(Principal Executive Officer)

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacities and on the dates indicated.

Signature	Title	Date
/s/ TIMOTHY K. WOOFTER **Timothy K. Woofter**	Director and Chairman of the Board	March 29, 2012 Date
/s/ JAMES M. GASIOR **James M. Gasior**	President, Chief Executive Officer and Director (Principal Executive Officer)	March 29, 2012 Date
/s/ JERRY A. CARLETON **Jerry A. Carleton**	Director	March 29, 2012 Date
/s/ TIMOTHY CARNEY **Timothy Carney**	Director	March 29, 2012 Date
/s/ DAVID C. COLE **David C. Cole**	Director	March 29, 2012 Date
/s/ GEORGE E. GESSNER **George E. Gessner**	Director	March 29, 2012 Date
/s/ JAMES E. HOFFMAN, III **James E. Hoffman, III**	Director	March 29, 2012 Date
/s/ NEIL J. KABACK **Neil J. Kaback**	Director	March 29, 2012 Date
/s/ RICHARD B. THOMPSON **Richard B. Thompson**	Director	March 29, 2012 Date
/s/ DAVID J. LUCIDO **David J. Lucido**	Chief Financial Officer (Principal Financial Officer) (Principal Accounting Officer)	March 29, 2012 Date

CORTLAND BANCORP

BOARD OF DIRECTORS

TIMOTHY K. WOOFTER
Chairman

JERRY A. CARLETON

TIMOTHY CARNEY

DAVID C. COLE

JAMES M. GASIOR

GEORGE E. GESSNER

JAMES E. HOFFMAN III

NEIL J. KABACK

JOSEPH E. KOCH

RICHARD B. THOMPSON

WILLIAM A. HAGOOD
Director Emeritus

K. RAY MAHAN
Director Emeritus

OFFICERS

JAMES M. GASIOR
President and
Chief Executive Officer

TIMOTHY CARNEY
Executive Vice President
Chief Operating Officer and
Secretary

DAVID J. LUCIDO
Senior Vice President and
Chief Financial Officer

STANLEY P. FERET
Senior Vice President and
Chief Lending Officer

THE CORTLAND SAVINGS AND BANKING COMPANY

BOARD OF DIRECTORS

JERRY A. CARLETON
President, Carleton Enterprises Inc.

TIMOTHY CARNEY
Executive Vice President,
Chief Operating Officer and Corporate Secretary

DAVID C. COLE
Partner and President,
Cole Valley Pontiac-Cadillac

JAMES M. GASIOR
President and Chief Executive Officer

GEORGE E. GESSNER
Attorney

JAMES E. HOFFMAN III
Attorney

NEIL J. KABACK
Partner, Cohen & Company

JOSEPH E. KOCH
President, Joe Koch Construction

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

TIMOTHY K. WOOFTER
President, Stan-Wade Metal Products
and Chairman of the Board

WILLIAM A. HAGOOD
Director Emeritus

K. RAY MAHAN
Director Emeritus

OFFICERS

JAMES M. GASIOR
President and Chief Executive Officer

TIMOTHY CARNEY
Executive Vice President,
Chief Operating Officer and Corporate Secretary

MARCEL P. ARNAL
Assistant Vice President

GRACE J. BACOT
Assistant Vice President

PEGGY BAILEY
Assistant Vice President

NICHOLAS P. BERARDINO
Vice President

HEATHER J. BOWSER
Assistant Vice President

CHARLES J. COMMONS
Vice President

DEAN S. EVANS
Vice President

DEBORAH L. EAZOR
Vice President

JOAN M. FRANGIAMORE
Vice President

DAVID J. LUCIDO
Senior Vice President and Chief Financial Officer

STANLEY P. FERET
Senior Vice President and Chief Lending Officer

DARLENE MACK
Assistant Vice President
and Trust Officer

STANLEY MAGIELSKI
Vice President

JOSEPH A. MARINO
Vice President

KAREN MILLER
Assistant Secretary

KEITH MROZEK
Vice President

CRAIG M. PHYTHYON
Vice President

JUDY RUSSELL
Vice President

BARBARA R. SANDROCK
Vice President

CARRIE STACKHOUSE
Assistant Vice President

JOHN HEWITT
Assistant Vice President

JAMES HUGHES
Assistant Vice President

WILLIAM J. HOLLAND
Vice President

JANET K. HOUSER
Assistant Vice President

MICHELE LEE
Assistant Vice President

MARLENE LENIO
Vice President

PAUL SYNDERMAN
Vice President

LADI STIMPFEL
Assistant Vice President

RUSSELL E. TAYLOR
Assistant Vice President

STEVE TELEGO
Vice President

SHIRLEY A. WADE
Assistant Vice President

NICOLE WHITSEL
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