
**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, 2013

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
(State or Other Jurisdiction
of Incorporation or Organization)

34-1451118
(I.R.S. Employer
Identification No.)

194 West Main Street, Cortland, Ohio
(Address of Principal Executive Offices)

44410
(Zip Code)

Registrant's telephone number, including area code: **(330) 637-8040**

Securities registered pursuant to Section 12(b) of the Act: **None**

Securities registered pursuant to Section 12(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 (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports) and (2) has been subject to such filing requirements for the past 90 days. Yes 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 and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes 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 on June 30, 2013, the aggregate market value of the voting stock held by non-affiliates of the registrant was approximately \$41,525,605. 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 21, 2014: 4,527,848 shares

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the Proxy Statement for the 2014 Annual Meeting of Shareholders to be held on May 27, 2014 are incorporated by reference into Part III.

Form 10-K for the Year Ended December 31, 2013
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PART I

Item 1. 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.

As a financial holding company and a bank holding company, the Company is regulated under the Bank Holding Company Act of 1956, as amended (BHC Act), and its subsidiaries are subject to inspection, examination and supervision by the Board of Governors of the Federal Reserve System (Federal Reserve), the Ohio Division of Financial Institutions and the Consumer Financial Protection Bureau. The BHC Act provides generally for “umbrella” regulation of financial holding companies such as the Company by the Federal Reserve Board, and for functional regulation of banking activities by bank regulators, securities activities by securities regulators, and insurance activities by insurance regulators. The Company is also under the jurisdiction of the Securities and Exchange Commission (SEC) and is subject to the disclosure and regulatory requirements of the Securities Act of 1933, as amended, and the Securities Exchange Act of 1934, as amended, as administered by the SEC.

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 and mobile banking options.

Full service banking business is conducted at a total of twelve offices, seven 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. A mortgage origination office is located in Canfield, also in Mahoning County.

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

The Bank, as a state chartered banking organization and member of the Federal Reserve, is subject to periodic examination and regulation by the Federal Reserve, the State of Ohio Division of Financial Institutions (Ohio Division) and the Consumer Financial Protection Bureau (CFPB). 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 Bank provides brokerage and investment services through an arrangement with Investment Professionals, Inc. Under this arrangement, financial advisors can offer customers an extensive range of investment products and services, including estate planning, qualified retirement plans, mutual funds, annuities, life insurance, fixed income and equity securities and equity research and recommendations. Through Investment Professionals, Inc., the Bank also offers asset management services to customers.

CSB MORTGAGE COMPANY, INC.

CSB Mortgage Company, Inc. (CSB) was formed as an Ohio corporation in December 2011. It is a wholly-owned subsidiary of Cortland Banks and functioned as the originator of wholesale mortgage loans and the seller of company-wide mortgage loans in the secondary mortgage market. Its operations were significantly curtailed in September 2013, and substantially all loans were sold during the fourth quarter of 2013. The operations of the subsidiary were conducted at the Bank's main office at 194 West Main Street, Cortland, Ohio.

COMPETITION

The Bank actively competes with state and national banks located in Northeastern 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, 2013, the Company, through the Bank, employed 139 full-time and 18 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

The Bank 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. The 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.

The Bank has community branches in four Ohio counties: Trumbull, Portage, Ashtabula and Mahoning. 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 economics.

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 financial holding company and 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. In addition, the Bank is subject to regulation and examination by the CFPB established by the Dodd-Frank Wall Street Reform and Consumer Protection Act enacted in July 2010 (the Dodd-Frank Act). 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.

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 under certain circumstances to give written notice to and receive approval from the Federal Reserve before purchasing or redeeming common stock or other equity securities or paying dividends.

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 consider anticompetitive effects of the proposed transaction, 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. Under certain circumstances, control may also be presumed to exist if a person acquires 10% or more, but less than 25%, of any class of voting securities.

Interstate banking and branching. Section 613 of the Dodd-Frank Act 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. A bank holding company may become a financial holding company if each of its subsidiary banks is well capitalized under the Federal Deposit Insurance Corporation Act of 1991 prompt corrective action provisions, is well managed, and has at least a satisfactory rating under the Community Reinvestment Act, by filing a declaration that the bank holding company elects to become a financial holding company. The Company is a financial holding company subject to regulation by the Federal Reserve Board. No regulatory approval is required for a financial holding company to acquire a company, other than a bank or savings association, engaged in activities that are financial in nature or incidental to activities that are financial in nature, as determined by the Federal Reserve Board.

The Financial Services Modernization Act defines “financial in nature” to include:

- securities underwriting, dealing and market making;
- sponsoring mutual funds and investment companies;
- insurance underwriting and agency;
- merchant banking; and
- activities that the Federal Reserve Board has determined to be closely related to banking.

Capital. *Risk-based capital requirements.* Capital hedges risk, absorbing losses that can, as well as losses that cannot, be predicted. 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 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 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. In addition to the capital adequacy requirements set forth above, every financial institution is classified into one of five categories based upon the institution's capital ratios, the results of regulatory examinations of the institution and whether the institution is subject to enforcement agreements with its regulatory authorities. The categories are "well capitalized," "adequately capitalized," "undercapitalized," "significantly undercapitalized," and "critically undercapitalized." The capital of the Company and the Bank as of December 31, 2013 were as follows:

| | (Amounts in thousands) | | | |
|---|------------------------|--------|--|--------|
| | Cortland Bancorp (1) | | The Cortland Savings & Banking Company | |
| | Amount | Ratio | Amount | Ratio |
| Total capital to risk-weighted assets | | | | |
| Actual | \$ 58,774 | 14.19% | \$ 56,277 | 13.68% |
| For capital adequacy purposes | 33,138 | 8.00% | 32,909 | 8.00% |
| To be well capitalized | 41,423 | 10.00% | 41,136 | 10.00% |
| Tier 1 capital to risk-weighted assets | | | | |
| Actual | 54,927 | 13.26% | 46,430 | 11.29% |
| For capital adequacy purposes | 16,569 | 4.00% | 16,454 | 4.00% |
| To be well capitalized | 24,854 | 6.00% | 24,682 | 6.00% |
| Tier 1 leverage capital | | | | |
| Actual | 54,927 | 10.35% | 46,430 | 8.80% |
| For capital adequacy purposes | 21,635 | 4.00% | 21,510 | 4.00% |
| To be well capitalized | 27,044 | 5.00% | 26,887 | 5.00% |

(1) The amounts and percentages set forth for the Company to be deemed "well capitalized" are required for the Company to remain a financial holding company.

A bank with a capital level that might qualify for well capitalized or adequately capitalized status may nevertheless be treated as though the bank is in the next lower capital category if the bank's primary federal banking supervisory authority determines that an unsafe or unsound condition or practice warrants that treatment. A bank's operations can be significantly affected by its capital classification under the prompt corrective action rules. For example, a bank 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 banks 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 a bank 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.

The current capital requirements are based on the 1998 capital accord of the Basel Committee on Banking Supervision (the Basel Committee). In December 2010 and January 2011, the Basel Committee released a new framework, referred to as Basel III. After first adopting new capital requirements for larger financial institutions, in July 2013, the United States banking regulators issued final (or, in the case of the FDIC, interim final) new capital rules applicable to smaller banking organizations. Community banking organizations, including the Company and the Bank, will begin transitioning to the new rules on January 1, 2015. The new minimum capital requirements are effective on January 1, 2015, whereas a new capital conservation buffer and deductions from common equity capital phase in from January 1, 2016, through January 1, 2019, and most deductions from common equity tier 1 capital will phase in from January 1, 2015, through January 1, 2019.

The following is a summary of the major changes from the current general risk-based capital rule:

1. higher minimum capital requirements, including a new common equity tier 1 capital ratio of 4.5 percent and criteria instruments must meet in order to be considered common equity tier 1 capital; a tier 1 capital ratio of 6.0 percent; the retention of a total capital ratio of 8.0 percent; and a minimum leverage ratio of 4.0 percent;
2. stricter eligibility criteria for regulatory capital instruments;
3. restrictions on the payment of capital distributions, including dividends, and certain discretionary bonus payments to executive officers, if the organization does not hold a capital conservation buffer of greater than 2.5 percent composed of common equity tier 1 capital above its minimum risk-based capital requirements, or if its eligible retained income is negative in that quarter and its capital conservation buffer ratio was less than 2.5 percent at the beginning of the quarter;
4. replacement of the external credit ratings approach to standards of creditworthiness with a simplified supervisory formula approach;
5. stricter limitations on the extent to which mortgage servicing assets, deferred tax assets and significant investments in unconsolidated financial institutions may be included in common equity tier 1 capital and the risk weight to be assigned to any amounts of such assets not deducted; and
6. increased risk weights for past-due loans, certain commercial real estate loans and some equity exposures, and selected other changes in risk weights and credit conversion factors.

Federal deposit insurance. Deposits in the Bank are insured by the FDIC up 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 and the assessment base of each institution, which is the institution's average total assets minus average tangible equity. 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 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 provisions protect banks from abuse in financial transactions with affiliates. 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 specified approval procedures. Loans to an individual insider may not exceed the general legal limit on loans to any one borrower. 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 additional imitations based on the purpose of the loan. A violation of these restrictions could result in the assessment of substantial civil money 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. Future dividends will depend on earnings, financial condition, results of operations, business prospects, capital requirements, regulatory restrictions, and other factors that the board of directors may deem relevant.

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 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.

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 have adopted rules implementing many of these requirements, while still others are proposed or yet to be proposed.

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. The Dodd-Frank Act established the CFPB, which has extensive regulatory and enforcement powers over consumer financial products and services. Since the appointment of a director for the CFPB in January 2012, the CFPB has adopted numerous rules with respect to consumer protection laws, amending some existing regulations and adopting new ones. It has also commenced enforcement actions. The following are just some of the consumer protection laws applicable to the Bank.

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. 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 most recent CRA performance rating is “satisfactory.”

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.

Home Mortgage Disclosure Act. 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.

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 entities.

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 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.

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 enhances 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. Financial institutions must establish due diligence policies, procedures, and controls reasonably designed to detect and report money laundering through correspondent accounts and private banking accounts, share information with law enforcement about individuals, entities, and organizations engaged in or suspected of engaging in terrorist acts or money laundering activities, and comply with 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.

Volcker Rule. In December 2013, five federal agencies adopted a final regulation implementing the Volcker Rule provision of the Dodd-Frank Act (the “Volcker Rule”). The Volcker Rule places limits on the trading activity of insured depository institutions and entities affiliated with a depository institution, subject to certain exceptions. The trading activity includes a purchase or sale as principal of a security, derivative, commodity future or option on any such instrument in order to benefit from short-term price movements or to realize short-term profits. The Volcker Rule exempts specified U.S. Government, agency and/or municipal obligations, and it excepts trading conducted in certain capacities, including as a broker or other agent, through a deferred compensation or pension plan, as a fiduciary on behalf of customers, to satisfy a debt previously contracted, repurchase and securities lending agreements and risk-mitigating hedging activities.

The Volcker Rule also prohibits a banking entity from having an ownership interest in, or certain relationships with, a hedge fund or private equity fund, with a number of exceptions. Included among those prohibited investments are certain collateralized debt obligations (CDOs) collateralized by trust preferred securities (TruPS). While the five regulatory agencies issued an Interim Final Rule on January 14, 2014, granting relief from the prohibition against holding certain CDOs secured by TruPS issued by bank or thrift holding companies, the relief does not extend to CDOs collateralized by TruPS issued by insurance companies (iTruPS). The Company maintains a position in nine iTruPS. The Company will be required to divest those securities by July 21, 2015, unless the Federal Reserve grants an extension to July 21, 2017. As a result of that requirement, a \$2.0 million other-than-temporary impairment loss (\$1.3 million after tax) was recognized in the Company’s fourth quarter 2013 financial statements.

The Company has no other investments prohibited by the Volcker Rule and does not engage in any of the trading activities governed by the Volcker Rule.

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

Like all financial companies, the Company’s business and results of operations are subject to a number of risks, many of which are outside of our control. In addition to the other information in this report, readers should carefully consider that the following important factors could materially impact our business and future results of operations.

Our business may be adversely affected by current conditions in the financial markets, the real estate market and economic conditions generally.

Negative developments in the capital markets in recent years resulted in uncertainty in the financial markets and an economic downturn. The housing market declined, resulting in decreasing home prices and increasing delinquencies and foreclosures. The credit performance of mortgage and construction loans resulted in significant write-downs of asset values by financial institutions, including government-sponsored entities and major commercial and investment banks. The declines in the performance and value of mortgage assets encompassed all mortgage and real estate asset types, leveraged bank loans and nearly all other asset classes, including equity securities. These write-downs have caused many financial institutions to seek additional capital or to merge with larger and stronger institutions. Some financial institutions have failed. Although some improvements in the U.S. economy have occurred, housing prices are still depressed and continue to decline in some markets and unemployment remains high compared to levels prior to the recession. Debt concerns in Europe have added to volatility in the capital markets and concerns over whether such improvements in the U.S. economy will continue. Moreover, the economy could be severely negatively affected by disagreements in the federal government with respect to the budget and the debt ceiling.

In addition to the increases in delinquencies and foreclosures on existing loans and the reductions in the value of collateral, the slowing of business activity and the high unemployment rates have had an adverse effect on loan demand from both businesses and consumers. A worsening of current conditions would likely adversely affect our business and results of operations, as well as those of our customers. As a result, we may experience increased foreclosures, delinquencies and customer bankruptcies, as well as decreased loan demand.

The enactment of new legislation and increased regulatory oversight may significantly affect our financial condition and results of operations.

The Federal Reserve Board, Congress, the Treasury, the FDIC and others have taken numerous actions to address the current liquidity and credit situation in the financial markets. These measures include actions to encourage loan restructuring and modification for homeowners; the establishment of significant liquidity and credit facilities for financial institutions and investment banks; the lowering of the federal funds rate; and coordinated efforts to address liquidity and other weaknesses in the banking sector. The long-term effect of actions already taken as well as new legislation is unknown. Continued or renewed instability in the financial markets could weaken public confidence in financial institutions and adversely affect our ability to attract and retain new customers.

On July 21, 2010, President Obama signed into law the Dodd-Frank Act. This law is significantly changing the regulation of financial institutions and the financial services industry. The Dodd-Frank Act requires various federal agencies to adopt a broad range of regulations with significant discretion. While some of the provisions have already been implemented, many still have not, and the effects they will have on our company will not be known for years.

Many of the provisions of the Dodd-Frank Act apply directly only to institutions much larger than ours, and some will affect only institutions with different charters than ours or institutions that engage in activities in which we do not engage. Among the provisions already implemented that have had or many have an effect on our business are the following:

- the Dodd-Frank Act created a Consumer Financial Protection Bureau with broad powers to adopt and enforce consumer protection regulations;
- new capital regulations for bank holding companies have been adopted, which impose stricter requirements, and any new trust preferred securities will no longer count toward Tier I capital;
- the federal law prohibition on the payment of interest on commercial demand deposit accounts was eliminated effective in July 2011;
- the standard maximum amount of deposit insurance per customer is permanently increased to \$250,000, and non-interest bearing transaction accounts had unlimited insurance through December 31, 2012;
- the assessment base for determining deposit insurance premiums has been expanded to include liabilities other than just deposits; and
- new corporate governance requirements applicable generally to all public companies in all industries require, or will require when implemented, new compensation practices, including requiring companies to “claw back” incentive compensation under certain circumstances, to provide shareholders the opportunity to cast a non-binding vote on executive compensation, and to consider the independence of compensation advisers, and new executive compensation disclosure requirements.

New regulations pertaining to debit card fees were enacted by the Federal Reserve in October 2011. The new rules cap debit interchange fees for banks with more than \$10 billion in assets. Although there is no cap for smaller banks, including the Bank, it is still unclear what other market changes may impact debit card fees as the debit cards with higher fees become less competitive, and larger banks take steps to recover income lost due to the caps on their debit card interchange fees.

Although it is impossible for us to predict at this time all the effects the Dodd-Frank Act will have on us and the rest of our industry, it is possible that our non-interest income could decrease, both our interest expense and our non-interest expense could increase, deposit insurance premiums could change, and steps may need to be taken to increase qualifying capital. We expect that our operating and compliance costs will increase and could adversely affect our financial condition and results of operations.

In addition to laws, regulations and actions directed at the operations of banks, proposals to reform the housing finance market consider winding down Fannie Mae and Freddie Mac, which could negatively affect our loan sales.

Adverse changes in the financial markets may adversely impact our results of operations.

The global financial markets have experienced increased volatility in recent years. While we generally invest in securities issued by U.S. government agencies and sponsored entities and U.S. state and local governments with limited credit risk, certain investment securities we hold possess higher credit risk since they represent beneficial interests in structured investments collateralized by residential mortgages, debt obligations and other similar asset-backed assets. Regardless of the level of credit risk, all investment securities are subject to changes in market value due to changing interest rates, implied credit spreads and credit ratings.

Over the last few years, structured investments, like our collateralized debt obligations, have been subject to significant market volatility due to the uncertainty of the credit ratings, deterioration in credit losses occurring within certain types of residential mortgages, changes in prepayments of the underlying collateral and the lack of transparency related to the investment structures and the collateral underlying the structured investment vehicles. These conditions have resulted in our recognizing impairment charges on certain investment securities during 2010 and 2009. Given recent market conditions and changing economic factors, we may be required to recognize additional impairment changes on securities held in our investment portfolio in the future.

We may be compelled to seek additional capital in the future but may not be able to access capital when needed.

Federal banking agencies have adopted extensive changes to their capital requirements, including raising required amounts and eliminating inclusion of certain instruments from the calculation of capital. Should we experience significant loan losses, we may need additional capital. In addition, we may elect to raise additional capital to support our business, to finance acquisitions, if any, or for other purposes. Our ability to raise additional capital, if needed, will depend on our financial performance, conditions in the capital markets, economic conditions and a number of other factors, many of which are outside of our control. There can be no assurance, therefore, that we can raise additional capital at all or on terms acceptable to us. If we cannot raise additional capital when needed or desired, it may have a material adverse effect on our financial condition, results of operations and prospects.

A default by another larger financial institution could adversely affect financial markets generally.

The commercial soundness of many financial institutions may be closely interrelated as a result of relationships between the institutions. As a result, concerns about, or a default or threatened default by, one institution could lead to significant market-wide liquidity and credit problems, losses or defaults by other institutions. This “systemic risk” may adversely affect our business.

Changes in national and local economic and political conditions could adversely affect our earnings, as our borrowers’ ability to repay loans and the value of the collateral securing our loans decline and as loans and deposits decline.

There are inherent risks associated with our lending activities, including credit risk, which is the risk that borrowers may not repay outstanding loans or the value of the collateral securing loans will decrease. Conditions such as inflation, recession, unemployment, changes in interest rates and money supply and other factors beyond our control may adversely affect the ability of our borrowers to repay their loans and the value of collateral securing the loans, which could adversely affect our earnings. Because we have a significant amount of real estate loans, a decline in the value of real estate could have a material adverse effect on us. As of December 31, 2013, 81% of our loan portfolio consisted of commercial, commercial real estate, real estate construction and installment, all of which are generally viewed as having more risk of default than residential real estate loans and all of which, with the exception of installment loans, are typically larger than residential real estate loans. Residential real estate loans held in the portfolio are typically originated using conservative underwriting standards that do not include sub-prime lending. We attempt to manage credit risk through a program of underwriting standards, the review of certain credit decisions and an on-going process of assessment of the quality of the credit already extended. Economic and political changes could also adversely affect our deposits and loan demand, which could adversely affect our earnings and financial condition. Since substantially all of our loans are to individuals and businesses in Ohio, any decline in the economy of this market area could have a materially adverse effect on our credit risk and on our deposit and loan levels.

Changes in interest rates could adversely affect our financial condition and results of operations.

Our results of operations depend substantially on our net interest income, which is the difference between (i) the interest earned on loans, securities and other interest-earning assets and (ii) the interest paid on deposits and borrowings. These rates are highly sensitive to many factors beyond our control, including general economic conditions, inflation, recession, unemployment, money supply and the policies of various governmental and regulatory authorities. If the interest we pay on deposits and other borrowings increases at a faster rate than the interest we receive on loans and other investments, our net interest income and therefore earnings, could be adversely affected. Earnings could also be adversely affected if the interest we receive on loans and other investments falls more quickly than the interest we pay on deposits and borrowings. While we have taken measures intended to manage the risks of operating in a changing interest rate environment, there can be no assurance that these measures will be effective in avoiding undue interest rate risk.

Increases in interest rates also can affect the value of loans and other assets, including our ability to realize gains on the sale of assets. We originate loans for sale and for our portfolio. Increasing interest rates may reduce the origination of loans for sale and consequently the fee income we earn on such sales. Further, increasing interest rates may adversely affect the ability of borrowers to pay the principal or interest on loans and leases, resulting in an increase in non-performing assets and a reduction of income recognized.

Increases in FDIC insurance premiums may have a material adverse effect on our earnings.

During the last few years, there have been higher levels of bank failures, which dramatically increased resolution costs of the FDIC and depleted the deposit insurance fund. In order to maintain a strong funding position and restore reserve ratios of the deposit insurance fund, the FDIC increased assessment rates of insured institutions uniformly by 7 basis points (7 cents for every \$100 of deposits) for 2009 and 2010. Additional changes were also made to require riskier institutions to pay a larger share of premiums by factoring in rate adjustments based on secured liabilities and unsecured debt levels.

The Emergency Economic Stabilization Act of 2008 (the EESA) instituted two temporary programs to further insure customer deposits at FDIC-member banks: deposit accounts became insured up to \$250,000 per customer (up from \$100,000) and noninterest bearing transactional accounts became fully insured (unlimited coverage). Since then, the Dodd-Frank Act made the increase in the standard maximum insurance amount permanent, and the unlimited coverage of non-interest bearing transactions accounts had been extended until December 31, 2012. This unlimited coverage was not extended past that date.

The FDIC also adopted a rule that imposed a special assessment for the second quarter of 2009 and adopted a rule requiring insured institutions to prepay their estimated quarterly risk-based assessments for the fourth quarter of 2009 and for all of 2010, 2011 and 2012. An institution's assessment for 2011 and 2012 was increased by 3 basis points.

Effective April 1, 2011, the assessment base was changed from total domestic deposits to average total assets minus average tangible equity. The new regulations also changed the assessment for larger institutions and the assessment rate schedules.

We are generally unable to control the amount of premiums that we are required to pay for FDIC insurance. If there are additional financial institution failures, we may be required to pay higher FDIC premiums. Increases in FDIC insurance premiums may materially adversely affect our results of operations and our ability to continue to pay dividends on our common shares at the current rate or at all.

Our allowance for loan losses may be insufficient.

We maintain an allowance for loan losses to provide for probable loan losses based on management's quarterly analysis of the loan portfolio. The preparation of consolidated financial statements in conformity with accounting principles generally accepted in the United States (GAAP) requires management to make significant estimates that affect the financial statements. One of our most critical estimates is the level of the allowance for loan losses. Due to the inherent nature of these estimates, we cannot provide absolute assurance that we will not be required to charge earnings for significant unexpected loan losses. For more information on the sensitivity of these estimates, refer to the discussion of our "Critical Accounting Policies" in this report.

We maintain an allowance for loan losses that we believe is a reasonable estimate of known and inherent losses within the loan portfolio. We make various assumptions and judgments about the collectability of our loan portfolio, including the creditworthiness of our borrowers and the value of the real estate and other assets serving as collateral for the repayment of loans. In deciding whether to extend credit or enter into other transactions with customers and counterparties, we may rely on information provided to us by customers and counterparties, including financial statements and other financial information. We may also rely on representations of customers and counterparties as to the accuracy and completeness of that information and, with respect to financial statements, on reports of independent auditors. For example, in deciding whether to extend credit to a business, we may assume that the customer's audited financial statements conform with GAAP and present fairly, in all material respects, the financial condition, results of operations and cash flows of the customer. We may also rely on the audit report covering those financial statements. Our financial condition, results of operations and cash flows could be negatively impacted to the extent that we rely on financial statements that do not comply with GAAP or on financial statements and other financial information that are materially misleading.

Through a periodic review and consideration of the loan portfolio, management determines the amount of the allowance for loan losses by considering general market conditions, credit quality of the loan portfolio, the collateral supporting the loans and performance of customers relative to their financial obligations with us. The amount of future losses is susceptible to changes in economic, operating and other conditions, including changes in interest rates, which may be beyond our control, and these losses may exceed current estimates. We cannot fully predict the amount or timing of losses or whether the loss allowance will be adequate in the future. If our assumptions prove to be incorrect, our allowance for loan losses may not be sufficient to cover losses inherent in our loan portfolio, resulting in additions could have a material adverse impact on our financial condition and results of operations. In addition, federal and state regulators periodically review our allowance for loan losses as part of their examination process and may require management to increase the allowance or recognize further loan charge-offs based on judgments different than those of management. Any increase in the provision for loan losses would decrease our pretax and net income.

If we foreclose on collateral property and own the underlying real estate, we may be subject to the increased costs associated with the ownership of real property, resulting in reduced revenues.

We may have to foreclose on collateral property to protect our investment and may thereafter own and operate such property, in which case we will be exposed to the risks inherent in the ownership of real estate. The amount that we, as a mortgagee, may realize after a default is dependent upon factors outside of our control, including, but not limited to: (i) general or local economic conditions; (ii) neighborhood values; (iii) interest rates; (iv) real estate tax rates; (v) operating expenses of the mortgaged properties; (vi) supply of and demand for rental units or properties; (vii) ability to obtain and maintain adequate occupancy of the properties; (viii) zoning laws; (ix) governmental rules, regulations and fiscal policies; and (x) acts of God. Certain expenditures associated with the ownership of real estate, principally real estate taxes and maintenance costs, may adversely affect the income from the real estate. Therefore, the cost of operating a real property may exceed the rental income earned from such property, and we may have to advance funds in order to protect our investment, or we may be required to dispose of the real property at a loss. The foregoing expenditures and costs could adversely affect our ability to generate revenues, resulting in reduced levels of profitability.

Environmental liability associated with commercial lending could have a material adverse effect on our business, financial condition and results of operations.

In the course of our business, we may acquire, through foreclosure, commercial properties securing loans that are in default. There is a risk that hazardous substances could be discovered on those properties. In this event, we could be required to remove the substances from and remediate the properties at our cost and expense. The cost of removal and environmental remediation could be substantial. We may not have adequate remedies against the owners of the properties or other responsible parties and could find it difficult or impossible to sell the affected properties. These events could have a material adverse effect on our financial condition and results of operation.

The loss of key members of our senior management team could adversely affect our business.

We believe that our success depends largely on the efforts and abilities of our senior management. Their experience and industry contacts significantly benefit us. In addition, our success depends in part upon senior management's ability to implement our business strategy. The competition for qualified personnel in the financial services industry is intense, and the loss of services of any of our senior executive officers or an inability to continue to attract, retain and motivate key personnel could adversely affect our business. We cannot assure you that we will be able to retain our existing key personnel or attract additional qualified personnel.

Loss of key employees may disrupt relationships with certain customers.

Our business is primarily relationship-driven in that many of our key employees have extensive customer relationships. Loss of a key employee with such customer relationships may lead to the loss of business if the customers were to follow that employee to a competitor. While we believe our relationships with our key producers is good, we cannot guarantee that all of our key personnel will remain with our organization. Loss of such key personnel, should they enter into an employment relationship with one of our competitors, could result in the loss of some of our customers.

We operate in an extremely competitive market, and our business will suffer if we are unable to compete effectively.

In our market area, we encounter significant competition from other banks, savings and loan associations, credit unions, mortgage banking firms, securities brokerage firms, asset management firms and insurance companies. The increasingly competitive environment is a result primarily of changes in regulation and the accelerating pace of consolidation among financial service providers. The Company is smaller than many of our competitors. Many of our competitors have substantially greater resources and lending limits than we do and may offer services that we do not or cannot provide.

Our ability to pay cash dividends is limited.

We are dependent primarily upon the earnings of our operating subsidiaries for funds to pay dividends on our common shares. The payment of dividends by us and our subsidiaries is subject to certain regulatory restrictions. As a result, any payment of dividends in the future will be dependent, in large part, on our ability to satisfy these regulatory restrictions and our subsidiaries' earnings, capital requirements, financial condition and other factors. Although our financial earnings and financial condition have allowed us to declare and pay periodic cash dividends to our shareholders, there can be no assurance that our dividend policy or size of dividend distribution will continue in the future.

The preparation of financial statements requires management to make estimates about matters that are inherently uncertain.

Management's accounting policies and methods are fundamental to how we record and report our financial condition and results of operations. Our management must exercise judgment in selecting and applying many of these accounting policies and methods in order to ensure that they comply with generally accepted accounting principles and reflect management's judgment as to the most appropriate manner in which to record and report our financial condition and results of operations. One of the most critical estimates is the level of the allowance of loan losses. Due to the inherent nature of these estimates, we cannot provide absolute assurance that we will not significantly increase the allowance for loan losses or sustain loan losses that are significantly higher than the provided allowance.

Material breaches in security of our systems or those of third-party service providers may have a significant effect on our business.

We collect, process and store sensitive consumer data by utilizing computer systems and telecommunications networks operated by both us and third-party service providers. We have security and backup and recovery systems in place, as well as a business continuity plan, to ensure the computer systems will not be inoperable, to the extent possible. We also have implemented security controls to prevent unauthorized access to the computer systems and requires its third-party service providers to maintain similar controls. However, management cannot be certain that these measures will be successful. A security breach of the computer systems and loss of confidential information, such as customer account numbers and related information, could result in a loss of customers' confidence and, thus, loss of business.

The Bank's necessary dependence upon automated systems to record and process the bank's transaction volumes poses the risk that technical system flaws or employee errors, tampering or manipulation of those systems will result in losses and may be difficult to detect. The company's subsidiary bank may also be subject to disruptions of the operating system arising from events that are beyond the bank's control (for example, computer viruses, cyber attacks preventing customer access or electrical or telecommunications outages). The Bank is further exposed to the risk that the third-party service providers may be unable to fulfill their contractual obligations (or will be subject to the same risk of fraud or operational errors as the Bank). These disruptions may interfere with service to the Bank's customers and result in a financial loss or liability.

Trading in our common shares is very limited, which may adversely affect the time and the price at which you can sell your Company common shares.

Although the common shares of the Company are quoted on the OTC Market, trading in the Company's common shares is not active, and the spread between the bid and the asked price is often wide. As a result, you may not be able to sell your shares on short notice, and the sale of a large number of shares at one time could temporarily depress the market price. The price at which you may be able to sell your common shares may be significantly lower than the price at which you could buy the Company's common shares at that time.

Our organizational documents may have the effect of discouraging a third party from acquiring us.

Our articles of incorporation and code of regulations contain provisions, including a staggered board of directors and a supermajority vote requirement, that make it more difficult for a third party to gain control or acquire us without the consent of the board of directors. These provisions could also discourage proxy contests and may make it more difficult for dissident shareholders to elect representatives as directors and take other corporate actions.

Future expansion may adversely affect our financial condition and results of operations.

We may acquire other financial institutions or parts of institutions in the future and may open new branches. We also may consider and enter into new lines of business or offer new products or services. Expansions of our business involve a number of expenses and risks, including:

- the time and costs associated with identifying and evaluating potential acquisitions;
- the potential inaccuracy of estimates and judgments used to evaluate credit, operations, management and market risk with respect to the target institutions;
- the time and costs of evaluating new markets, hiring local management and opening new offices, and the delay between commencing these activities and the generation of profits from the expansion;
- our ability to finance an acquisition or other expansion and the possible dilution to our existing shareholders;
- the diversion of management's attention to the negotiation of a transaction and the integration of the operations and personnel of the combining businesses;
- entry into unfamiliar markets;
- the introduction of new products and services into our existing business;
- the incurrence and possible impairment of goodwill associated with an acquisition and possible adverse short-term effects on our results of operations; and
- the risk of loss of key employees and customers.

We may incur substantial costs to expand, and we can give no assurance that such expansion will result in the levels of profits we expect. Neither can we assure that integration efforts for any future acquisitions will be successful. We may issue equity securities in connection with acquisitions, which could dilute the economic and voting interests of our existing shareholders.

Changes in accounting standards could materially impact the Company's consolidated financial statements.

The Company's accounting policies and methods are fundamental to how our financial condition and results of operations are recorded and reported. The accounting standard setters, including the Financial Accounting Standards Board, the SEC, and other regulatory bodies, from time to time may change the financial accounting and reporting standards that govern the preparation of the Company's consolidated financial statements. These changes can be hard to predict and can materially impact how the Company records and reports financial condition and results of operations. In some cases, the Company could be required to apply a new or revised standard retroactively, resulting in changes to previously reported financial results, or a cumulative charge to retained earnings. Management may be required to make difficult, subjective, or complex judgments about matters that are uncertain. Materially different amounts could be reported under different conditions or using different assumptions.

The Company undertakes no obligation and disclaims any intention to publish revised information or updates to forward-looking statements contained in the above risk factors or in any other statement made at any time by any director, officer, employee or other representative of the Company unless and until any such revisions or updates are required to be disclosed by applicable securities laws or regulations.

Changes in tax laws could adversely affect our performance.

We are subject to extensive federal, state and local taxes, including income, excise, sales/use, payroll, franchise, withholding and ad valorem taxes. Changes to our taxes could have a material adverse effect on our results of operations. In addition, our customers are subject to a wide variety of federal, state and local taxes. Changes in taxes paid by our customers may adversely affect their ability to purchase homes or consumer products, which could adversely affect their demand for our loans and deposit products. In addition, such negative effects on our customers could result in defaults on the loans we have made and decrease the value of mortgage-backed securities in which we have invested.

The effect of changes to the healthcare laws in the United States may increase the number of employees who choose to participate in our healthcare plans, which may significantly increase our healthcare costs and negatively impact our financial results.

We offer healthcare coverage to our eligible employees with part of the cost subsidized by the Company. With recent changes to the healthcare laws in the United States becoming effective in 2014, more of our employees may choose to participate in our health insurance plans, which could increase our costs for such coverage and material adversely impact our costs of operations.

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.

Full service banking business is conducted at a total of twelve offices, including:

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

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

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

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

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

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 LIMA
9001 Market Street
North Lima, Ohio 44452
330-758-5884

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

The Bank's main and administrative office is located at 194 West Main Street, Cortland, Ohio. A mortgage origination office is located in Canfield, Ohio. The Hubbard, Niles Park Plaza, Canfield and Boardman 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. In 2014, 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 OTC Market under the symbol CLDB. The following brokerage firm is known to be relatively active in trading the Company's common shares:

Boening & Scattergood
9916 Brewster Lane
Powell, OH 43065
Telephone: 866-326-8113

The following table shows the prices at which the common shares of the Company have actually been purchased and sold in market transactions and the dividends declared during the periods indicated. The range of market prices is compiled from data available through Yahoo Finance, Historical Prices. As of March 21, 2014, the Company has approximately 1,473 shareholders of record.

| | Price Per Share | | | Cash Dividends Declared Per Share |
|----------------------|-----------------|---------|----------|--|
| | High | Low | Close | |
| 2013 | | | | |
| Fourth Quarter | \$ 10.75 | \$ 9.40 | \$ 10.25 | \$ 0.03 |
| Third Quarter | 10.48 | 9.10 | 9.45 | 0.03 |
| Second Quarter | 10.85 | 9.95 | 10.00 | 0.03 |
| First Quarter | 11.00 | 9.70 | 10.79 | 0.03 |
| 2012 | | | | |
| Fourth Quarter | \$ 10.49 | \$ 9.60 | \$ 9.70 | \$ 0.03 |
| Third Quarter | 10.25 | 9.40 | 9.65 | — |
| Second Quarter | 10.01 | 7.95 | 10.00 | — |
| First Quarter | 8.25 | 6.60 | 7.95 | — |
| 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 | — |

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

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 2014 is \$4.3 million plus 2014 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
433 S. Carlton Avenue
Wheaton, Illinois 60187
(630) 480-0393

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 2013, 2012 and 2011.

Item 6. Selected Financial Data

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

| | Years Ended December 31, | | | | |
|--|--------------------------|------------|------------|------------|------------|
| | 2013 | 2012 | 2011 | 2010 | 2009 |
| SUMMARY OF OPERATIONS | | | | | |
| Total interest income..... | \$ 20,060 | \$ 21,015 | \$ 21,110 | \$ 21,872 | \$ 23,623 |
| Total interest expense | 3,404 | 4,071 | 4,732 | 6,367 | 9,234 |
| Net interest income (NII)..... | 16,656 | 16,944 | 16,378 | 15,505 | 14,389 |
| Provision for loan losses..... | 650 | 3,020 | 1,196 | 505 | 427 |
| NII after loss provision..... | 16,006 | 13,924 | 15,182 | 15,000 | 13,962 |
| Security (losses) gains including impairment losses | (1,419) | (157) | 680 | (1,694) | (14,070) |
| Mortgage banking gains..... | 1,491 | 1,772 | 162 | 236 | 265 |
| Other income..... | 2,826 | 2,704 | 2,716 | 2,791 | 3,001 |
| Total non-interest income..... | 2,898 | 4,319 | 3,558 | 1,333 | (10,804) |
| Total non-interest expenses..... | 17,032 | 15,488 | 13,475 | 12,441 | 13,648 |
| Income (loss) before (benefit) tax expense..... | 1,872 | 2,755 | 5,265 | 3,892 | (10,490) |
| Federal income tax (benefit) expense | 88 | (158) | 1,193 | 621 | (4,155) |
| Net Income (loss)..... | \$ 1,784 | \$ 2,913 | \$ 4,072 | \$ 3,271 | \$ (6,335) |
| PER COMMON SHARE DATA (1) | | | | | |
| Net income (loss), both basic and diluted..... | \$ 0.39 | \$ 0.64 | \$ 0.90 | \$ 0.72 | \$ (1.40) |
| Cash dividends declared per share..... | 0.12 | 0.03 | — | — | — |
| Book value..... | 10.94 | 10.93 | 10.10 | 9.25 | 8.16 |
| BALANCE SHEET DATA | | | | | |
| Assets..... | \$ 556,918 | \$ 582,240 | \$ 519,830 | \$ 500,273 | \$ 497,299 |
| Investments..... | 160,886 | 184,646 | 185,916 | 188,458 | 171,924 |
| Trading securities..... | 7,247 | — | — | — | — |
| Loans held for sale..... | 656 | 24,756 | 947 | 262 | — |
| Loans..... | 346,833 | 317,282 | 289,096 | 265,179 | 248,248 |
| Allowance for loan losses..... | 3,764 | 3,825 | 3,058 | 2,501 | 2,437 |
| Deposits..... | 448,669 | 476,901 | 422,765 | 391,509 | 387,495 |
| Borrowings..... | 46,404 | 46,051 | 42,273 | 57,901 | 63,366 |
| Subordinated debt..... | 5,155 | 5,155 | 5,155 | 5,155 | 5,155 |
| Shareholders' equity..... | 49,535 | 49,452 | 45,719 | 41,852 | 36,908 |
| AVERAGE BALANCES | | | | | |
| Assets..... | \$ 540,510 | \$ 528,075 | \$ 493,728 | \$ 486,588 | \$ 498,250 |
| Investments..... | 175,712 | 183,514 | 186,872 | 191,546 | 176,524 |
| Trading securities..... | 5,339 | — | — | — | — |
| Loans..... | 306,411 | 287,723 | 260,755 | 237,251 | 238,087 |
| Loans held for sale..... | 12,003 | 13,311 | 325 | 373 | 203 |
| Deposits..... | 435,550 | 424,337 | 395,561 | 378,242 | 383,858 |
| Borrowings..... | 44,127 | 44,054 | 43,734 | 58,317 | 68,307 |
| Subordinated debt..... | 5,155 | 5,155 | 5,155 | 5,155 | 5,155 |
| Shareholders' equity..... | 49,449 | 48,598 | 44,589 | 39,480 | 36,073 |
| ASSET QUALITY RATIOS | | | | | |
| Loan charge-offs..... | \$ (1,022) | \$ (2,415) | \$ (832) | \$ (616) | \$ (620) |
| Recoveries on loans..... | 311 | 162 | 193 | 175 | 160 |
| Net charge-offs..... | \$ (711) | \$ (2,253) | \$ (639) | \$ (441) | \$ (460) |
| Net charge-offs as a percentage of average total loans..... | 0.23% | 0.78% | 0.25% | 0.19% | 0.19% |
| Loans 30+ days delinquent as a percentage of total loans..... | 0.54% | 0.94% | 1.01% | 1.23% | 0.80% |
| Nonperforming loans..... | \$ 6,120 | \$ 5,668 | \$ 4,714 | \$ 3,858 | \$ 2,034 |
| Nonperforming securities..... | 1,203 | 674 | 1,542 | 3,767 | 2,154 |
| Other real estate owned..... | 33 | 145 | 437 | 848 | 687 |
| Total nonperforming assets..... | \$ 7,356 | \$ 6,487 | \$ 6,693 | \$ 8,473 | \$ 4,875 |
| Allowance for loan losses as a percentage of non-performing loans..... | 61.50% | 67.48% | 64.87% | 64.83% | 119.81% |
| Nonperforming assets as a percentage of: | | | | | |
| Total assets..... | 1.32% | 1.11% | 1.29% | 1.69% | 0.98% |
| Equity plus allowance for loan losses..... | 13.80 | 12.16 | 13.72 | 19.10 | 12.39 |
| Tier I capital..... | 13.39 | 12.01 | 12.94 | 18.11 | 10.59 |
| FINANCIAL RATIOS | | | | | |
| Return on average equity..... | 3.61% | 5.99% | 9.13% | 8.29% | (17.56)% |
| Return on average assets..... | 0.33 | 0.55 | 0.82 | 0.67 | (1.27) |
| Effective tax rate..... | 4.70 | (5.74) | 22.66 | 15.96 | (39.61) |
| Average equity-to-average asset ratio..... | 9.15 | 9.20 | 9.03 | 8.11 | 7.24 |
| Tangible equity ratio..... | 10.35 | 9.63 | 10.47 | 9.59 | 9.09 |
| Cash dividend payout ratio..... | 30.77 | 4.69 | — | — | — |
| Net interest margin..... | 3.41 | 3.58 | 3.72 | 3.59 | 3.19 |

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

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)

| | 2013 | | | 2012 | | | 2011 | | |
|---|-----------------------------|-------------------------|---------------|-----------------------------|-------------------------|---------------|-----------------------------|-------------------------|---------------|
| | 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..... | \$ 10,010 | \$ 30 | 0.29% | \$ 10,369 | \$ 31 | 0.29% | \$ 12,738 | \$ 51 | 0.40% |
| Available-for-sale securities (Note 1, 2, 3): | | | | | | | | | |
| U.S. Treasury and other U.S. Government agencies and corporations | 6,551 | 130 | 1.98% | 14,609 | 346 | 2.37% | 27,590 | 808 | 2.93% |
| States of the U.S. and political subdivisions - taxable | 4,690 | 157 | 3.35% | 663 | 21 | 3.17% | — | — | —% |
| States of the U.S. and political subdivisions - nontaxable | 37,356 | 1,878 | 5.03% | 39,697 | 2,118 | 5.34% | 36,534 | 2,118 | 5.80% |
| U.S. Government mortgage-backed pass through certificates..... | 110,186 | 1,928 | 1.75% | 108,881 | 2,414 | 2.22% | 101,347 | 3,141 | 3.10% |
| Other securities | 16,929 | 414 | 2.45% | 19,664 | 532 | 2.70% | 21,401 | 424 | 1.98% |
| Total available-for-sale securities | 175,712 | 4,507 | 2.56% | 183,514 | 5,431 | 2.96% | 186,872 | 6,491 | 3.47% |
| Trading securities (Note 1, 2) | 5,339 | 230 | 4.31% | — | — | —% | — | — | —% |
| Loans (Note 1, 2, 3, 4) | 318,414 | 16,032 | 5.03% | 301,034 | 16,306 | 5.42% | 261,080 | 15,314 | 5.87% |
| Total interest-earning assets ... | 509,475 | \$ 20,799 | 4.08% | 494,917 | \$ 21,768 | 4.40% | 460,690 | \$ 21,856 | 4.74% |
| Noninterest-earning assets: | | | | | | | | | |
| Cash and due from banks..... | 7,476 | | | 7,862 | | | 7,175 | | |
| Premises and equipment | 6,680 | | | 6,524 | | | 6,612 | | |
| Other assets | 16,879 | | | 18,772 | | | 19,251 | | |
| Total assets..... | \$ 540,510 | | | \$ 528,075 | | | \$ 493,728 | | |
| Interest-bearing liabilities: | | | | | | | | | |
| Interest-bearing deposits: | | | | | | | | | |
| Interest-bearing demand deposits | | | | | | | | | |
| | \$ 91,386 | \$ 177 | 0.19% | \$ 83,129 | \$ 151 | 0.18% | \$ 73,809 | \$ 176 | 0.24% |
| Savings..... | 117,808 | 83 | 0.07% | 107,147 | 106 | 0.10% | 94,160 | 141 | 0.15% |
| Time | 140,585 | 1,842 | 1.31% | 156,527 | 2,441 | 1.56% | 161,280 | 2,976 | 1.85% |
| Total interest-bearing deposits..... | 349,779 | 2,102 | 0.60% | 346,803 | 2,698 | 0.78% | 329,249 | 3,293 | 1.00% |
| Borrowings: | | | | | | | | | |
| Securities sold under agreement to repurchase..... | | | | | | | | | |
| | 3,453 | 3 | 0.09% | 4,559 | 5 | 0.11% | 5,236 | 5 | 0.10% |
| Subordinated debt | 5,155 | 90 | 1.75% | 5,155 | 100 | 1.94% | 5,155 | 92 | 1.79% |
| Other borrowings under one year | 10,706 | 135 | 0.66% | 6,575 | 79 | 1.20% | 6,458 | 95 | 1.47% |
| Other borrowings one year and over | 29,968 | 1,074 | 4.88% | 32,920 | 1,189 | 3.61% | 32,040 | 1,247 | 3.89% |
| Total borrowings..... | 49,282 | 1,302 | 2.64% | 49,209 | 1,373 | 2.79% | 48,889 | 1,439 | 2.94% |
| Total interest-bearing liabilities..... | 399,061 | \$ 3,404 | 0.85% | 396,012 | \$ 4,071 | 1.03% | 378,138 | \$ 4,732 | 1.25% |
| Noninterest-bearing liabilities: | | | | | | | | | |
| Demand deposits..... | 85,771 | | | 77,534 | | | 66,312 | | |
| Other liabilities | 6,229 | | | 5,931 | | | 4,689 | | |
| Shareholders' equity | 49,449 | | | 48,598 | | | 44,589 | | |
| Total liabilities and shareholders' equity | \$ 540,510 | | | \$ 528,075 | | | \$ 493,728 | | |
| Net interest income | | \$ 17,395 | | | \$ 17,697 | | | \$ 17,124 | |
| Net interest rate spread (Note 5) | | | 3.23% | | | 3.37% | | | 3.49% |
| Net interest margin (Note 6) | | | 3.41% | | | 3.58% | | | 3.72% |

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 rate of 34%, and have been adjusted to reflect the effect of disallowed interest expenses related to carrying tax-exempt assets. The tax equivalent income adjustment for loans, investments available for sale and trading investments was \$39,000, \$622,000 and \$78,000, respectively, for December 31, 2013; \$46,000, \$707,000 and \$0, respectively, for December 31, 2012; and \$50,000, \$696,000 and \$0, respectively, for December 31, 2011.

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 \$292,000 in 2013, \$336,000 in 2012 and \$295,000 in 2011.

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; political actions, including failure of the United States Congress to raise the federal debt ceiling or the imposition of changes in the federal budget; 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; changes in assumptions underlying the establishment of reserves for possible loan losses, reserves for repurchase of mortgage loans sold and other estimates; changes in operations of CSB Mortgage Company as a result of the activity in the residential real estate market; and 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, if 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 elsewhere 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).

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 elsewhere 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 \$556.9 million at December 31, 2013, 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.

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.

2013 OVERVIEW

Net income in 2013 was impacted by charges for the investment portfolio due to regulatory changes mandated by the Volcker Rule. Other-than-temporary impairment (OTTI) losses in the amount of \$2.0 million were recognized on \$10.5 million of trust preferred securities, a form of collateralized debt obligation. The trust preferred securities were among those considered disallowed under the revised final Volcker Rule, which originated from the Dodd-Frank Act. OTTI losses were \$171,000 in 2012. In 2013, Cortland earned \$1.8 million, or \$0.39 per share, compared to \$2.9 million, or \$0.64 per share in 2012. Excluding the charges for the investment portfolio, which were \$2.0 million pre-tax and \$1.3 million after tax, Cortland would have earned \$3.1 million, or \$0.68 per share, in 2013.

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.

The Company's financial results for 2013 were affected by these notable specific factors:

- Core earnings for the year, which exclude non-recurring items such as impairment loss and certain gain on securities sales, were \$3.5 million compared to \$2.8 million for 2012, an increase of 25.0%, mainly attributed to a decrease in provision for loan losses in 2013 compared to 2012.
- In 2013, earnings per share were \$0.39 and would have been \$0.68 excluding OTTI charges.
- Net interest margin for the full year 2013 was 3.41%, or 17 basis points lower than the 3.58% in 2012. The Company continues to optimally manage its balance sheet in this historically low interest rate environment in preparation for an eventual increase in interest rates.

- Loans increased 9.2% to \$346.8 million from \$317.3 million a year ago.
- The Company and the Bank remained well capitalized, with total risk-based capital to risk-weighted assets of 14.19% and 13.68%, respectively.
- Credit quality continues to improve, reflecting the gradual improvement in the regional economy. Nonaccrual loans declined to \$1.9 million at December 31, 2013, or 0.56% of loans, versus \$3.0 million, or 0.94% of loans, at December 31, 2012. The allowance for loan losses now covers 193% of nonaccrual loans at December 31, 2013, compared to 129% at December 31, 2012. Net loan charge-offs were \$711,000 in the current year, or 0.23% of total average loans, versus a net charge-off rate of 0.78% for the full year 2012. The allowance for loan losses to total loans ratio was 1.09% at December 31, 2013 versus 1.21% a year ago.
- In 2013, the provision for loan losses was \$650,000, with charge-offs of \$711,000, while 2012 was \$3.0 million with charge-offs of \$2.3 million. A \$1.9 million charge-off on one commercial loan caused the increased provision in 2012. Loans considered as potential problem loans decreased from \$2.7 million at December 31, 2012 to \$551,000 at December 31, 2013.
- Reflecting the continued confidence supported by stable revenues from core operations, increasing loan production, and improving capital levels, Cortland paid a cash dividend of \$0.12 per share.

The Company's total shareholders' equity remained steady at \$49.5 million at December 31, 2012 and 2013. The Company continues to maintain capital sufficient to be deemed well capitalized under all regulatory measures. In the current regulatory environment, regulatory oversight bodies expect banks to maintain ratios above the statutory levels as a margin of safety. The calculated ratios are as follows for the year ended December 31, 2013: a Tier 1 leverage ratio of 10.35% (compared to a "well-capitalized" threshold of 5.0%); a Tier 1 risk-based capital ratio of 13.26% (compared to a "well-capitalized" threshold of 6.00%); and a total risk-based capital ratio of 14.19% (compared to a "well-capitalized" threshold of 10.00%). The Company's total risk-based capital is \$17.4 million in excess of the 10% well-capitalized threshold.

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 2012 and 2013 to profit improvement measures, balance sheet restructuring and a reorganization of its management and branch 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.

Total shareholders' equity at December 31, 2013 was \$49.5 million, representing a ratio of equity capital to total assets of 8.89%. In comparison, total shareholders' equity was also \$49.5 million at December 31, 2012, representing a ratio of equity capital to total assets of 8.49%. 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 \$2.9 million at December 31, 2013, compared with net unrealized losses of \$1.7 million at December 31, 2012. 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 decrease in net unrealized losses resulted primarily from the recognition of OTTI in 2013 on trust preferred securities available for sale.

Return on average equity was 3.6% in 2013, compared to 6.0% in 2012, while return on average assets measured 0.3% in 2013 and 0.6% in 2012. Book value per share increased by \$0.01 to \$10.94 at December 31, 2013 from \$10.93 at December 31, 2012. The price of the Company's common shares traded in a range between a low of \$9.10 and a high of \$11.00, closing the year at \$10.25 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 and certain other non-recurring items, were \$3.5 million in 2013 compared to \$2.8 million in 2012 and \$4.0 million in 2011. Core earnings per share were \$0.77 in 2013, \$0.62 in 2012 and \$0.88 in 2011.

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

| | (Amounts in thousands, except per share data) | | |
|---|---|-----------------|-----------------|
| | Years Ended December 31, | | |
| | 2013 | 2012 | 2011 |
| GAAP earnings | \$ 1,784 | \$ 2,913 | \$ 4,072 |
| Impairment losses on investment securities (net of tax) | 1,290 | 113 | 133 |
| Investment gains not in the ordinary course of business (net of tax)* | — | (20) | (227) |
| Expenses relating to reorganization – (net of tax)** | 254 | — | — |
| Expenses relating to curtailment of mortgage banking activities (net of tax) | 165 | — | — |
| Net impact of historic tax credit investment | — | (190) | — |
| Core earnings | <u>\$ 3,493</u> | <u>\$ 2,816</u> | <u>\$ 3,978</u> |
| Core earnings per share | <u>\$ 0.77</u> | <u>\$ 0.62</u> | <u>\$ 0.88</u> |

* The gains in 2012 and 2011 are due to the settlement on General Motors Corporation bonds.

** Retail branch staff realignment and middle management restructure.

Although the provision for loan losses is considered part of core earnings, it is worthy of note that \$1.9 million of the \$3.0 million provision in 2012 relates to a single credit which required a charge off.

RECENT MARKET AND INDUSTRY DEVELOPMENTS

The economic turmoil that began in the middle of 2007 and continued through 2009 has now settled into a slow economic recovery. 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. The Dodd-Frank Act also broadened 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 had 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 all of the final regulations implementing the numerous provisions of the Dodd-Frank Act, a process that is far from complete and may continue for several more 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 \$540.5 million in 2013 compared to \$528.1 million in 2012 and \$493.7 million in 2011.

| | December 31, | | |
|---|---------------|---------------|---------------|
| | 2013 | 2012 | 2011 |
| Sources of Funds: | | | |
| Deposits: | | | |
| Non-interest bearing | 15.9% | 14.7% | 13.4% |
| Interest bearing | 64.7 | 65.7 | 66.7 |
| Long-term debt and other borrowings | 8.2 | 8.3 | 8.9 |
| Subordinated debt | 1.0 | 1.0 | 1.0 |
| Other non-interest bearing liabilities | 1.0 | 1.1 | 1.0 |
| Shareholders' equity | 9.2 | 9.2 | 9.0 |
| Total | <u>100.0%</u> | <u>100.0%</u> | <u>100.0%</u> |
| Uses of Funds: | | | |
| Loans, including loans held for sale | 58.9% | 57.0% | 52.9% |
| Securities | 33.5 | 34.8 | 37.8 |
| Interest-earning deposits and other assets... | 1.9 | 2.0 | 2.6 |
| Bank-owned life insurance | 2.7 | 2.5 | 2.6 |
| Other non-interest earning assets | 3.0 | 3.7 | 4.1 |
| Total | <u>100.0%</u> | <u>100.0%</u> | <u>100.0%</u> |

Deposits continue to be the Company's primary source of funding. During 2013, the relative mix of deposits has remained steady with interest-bearing being the main source. Average non-interest bearing deposits totaled 19.7% of total average deposits in 2013, compared to 18.3% in 2012 and 16.8% in 2011. Additional information regarding deposits can be found in Item 8, Note 5 to the Consolidated Financial Statements and elsewhere 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 \$2.5 million, or 1.3%, to \$181.1 million during 2013 from \$183.5 million in 2012, while average loans increased by \$17.4 million, or 5.8%, to \$318.4 million during 2013 from \$301.0 million in 2012.

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. Non-performing loans include loans in non-accrual status, restructured loans and real estate acquired in satisfaction of debts previously contracted.

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.

Gross income that would have been recorded in 2013 on these nonperforming loans, had they been in compliance with their original terms, was \$466,000. Interest income that actually was included in income on these loans amounted to \$350,000. In addition to nonperforming loans, nonperforming assets include nonperforming investment securities. Gross income that would have been recorded in 2013 on nonperforming investments, had they been in compliance with their original terms, was \$37,000. Interest income that actually was included in income on these investments amounted to \$9,300. 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:

| | (Amounts in thousands) | | | | |
|---|------------------------|-----------------|-----------------|-----------------|-----------------|
| | December 31, | | | | |
| | 2013 | 2012 | 2011 | 2010 | 2009 |
| Non-accrual loans: | | | | | |
| Commercial | \$ 98 | \$ 49 | \$ 70 | \$ 132 | \$ 116 |
| Commercial real estate | 1,279 | 2,336 | 1,470 | 307 | 350 |
| Residential real estate | 481 | 489 | 842 | 1,040 | 718 |
| Consumer - home equity | 72 | 72 | 111 | 47 | — |
| Consumer - other | 16 | 27 | 1,073 | 1,085 | 46 |
| Total non-accrual loans | <u>1,946</u> | <u>2,973</u> | <u>3,566</u> | <u>2,611</u> | <u>1,230</u> |
| Investment securities | 1,203 | 674 | 1,542 | 3,767 | 2,154 |
| Other real estate owned | 33 | 145 | 437 | 848 | 687 |
| Troubled debt restructured loans | 4,174 | 2,695 | 1,148 | 1,247 | 804 |
| Nonperforming assets | <u>\$ 7,356</u> | <u>\$ 6,487</u> | <u>\$ 6,693</u> | <u>\$ 8,473</u> | <u>\$ 4,875</u> |
| Loans past due 30 days or on nonaccrual | <u>\$ 2,176</u> | <u>\$ 3,248</u> | <u>\$ 4,051</u> | <u>\$ 3,649</u> | <u>\$ 1,976</u> |

As of December 31, 2013, there were \$551,000 in loans not included in this table where known information about borrowers' possible credit problems caused management to have some doubts as to the ability of these borrowers to comply with present loan payment terms and which may result in disclosure of such loans in this table.

The following table 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 \$1.2 million in 2010. The total for non-accrual loans in 2013 of \$1.9 million is slightly lower than the average of the five years, which is \$2.5 million. The total of all loans past due more than 30 days or on non-accrual ranged from a low of \$2.0 million in 2009 to a high of \$4.1 million in 2011. Loans charged-off, net of recoveries, was \$711,000 for 2013, compared to \$2.3 million for 2012, \$639,000 for 2011, \$441,000 for 2010 and \$460,000 for 2009. The resulting ratios do not indicate any trends of concern from management's perspective.

Troubled-debt restructured loans are loans that have been modified when economic concessions have been granted to borrowers who have experienced or are expected to experience financial difficulties. In 2013, \$2.8 million in new troubled debt restructurings were added.

As the nation struggled through high unemployment levels from 2008 through 2012, accompanied by high levels of bankruptcy filings and home foreclosures, the Company continued to experience only modest levels of delinquencies and resulting credit concerns. In 2013, the provision for loan losses was \$650,000, as general economic conditions improved and the Company's credit quality remained strong. In 2012 and 2011, the provision for loan losses was \$3.0 million and \$1.2 million, respectively. While the 2011 provision was in response to the substantial loan growth with a commercially-oriented focus, 2012 related to one isolated commercial customer whose financial condition eroded over a short period of time, requiring a charge-off of \$1.9 million. Additional information regarding loans can be found in Item 8, Note 3 to the Consolidated Financial Statements and elsewhere in this Management's Discussion and Analysis.

At December 31, 2013, there was \$1.2 million of the Company's holdings in trust preferred securities considered to be in non-accrual status. Through December 31, 2013, the Company's management was notified that the quarterly interest payments for 2 of its 12 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. In September of 2012, the Company sold 14 of its 29 positions in trust preferred securities, 11 of which were in non-accrual status.

| | December 31, | | | | |
|---|--------------|--------|--------|--------|--------|
| | 2013 | 2012 | 2011 | 2010 | 2009 |
| Non-accrual loans as a percentage of total loans | 0.56% | 0.94% | 1.23% | 0.98% | 0.50% |
| Nonperforming assets as a percentage of total assets | 1.32% | 1.11% | 1.29% | 1.69% | 0.98% |
| Nonperforming assets as a percentage of equity capital plus allowance for loan losses | 13.78% | 12.16% | 13.70% | 19.07% | 12.37% |

RESULTS OF OPERATIONS

Analysis of Net Interest Income - Years Ended December 31, 2013 and 2012

Net interest income, the principal source of the Company's earnings, is the amount by which interest and fees generated by interest-earning assets, primarily loans and investment securities, exceed the interest cost of deposits and borrowed funds. On a fully taxable equivalent basis, net interest income measured \$17.4 million for 2013 and \$17.7 million for 2012. The resulting net interest margin was 3.41% for 2013 and 3.58% for 2012.

The decrease in interest income, on a fully taxable equivalent basis, of \$969,000 is the product of a 32 basis point decrease in interest rates earned offset somewhat by a 2.9% year-over-year increase in average earning assets. The decrease in interest expense of \$667,000 was a product of an 18 basis point decrease in rates paid and a 0.8% increase in average interest-bearing liabilities. The net result was a 1.7% decrease in net interest income on a fully taxable equivalent basis, and a 17 basis point decrease in the Company's net interest margin on a slightly larger asset base with a different mix.

On a fully taxable equivalent basis, income on investment securities available-for-sale decreased by \$924,000, or 17.0%. The average invested balances in these securities decreased by \$7.8 million, or 4.3%, from the levels of a year ago. The decrease in the average balance of investment securities was accompanied by a 40 basis point decrease in the tax equivalent yield of the portfolio. The Company will continue attempting to redeploy liquidity into loans. Any reinvestment into the securities portfolio will serve to decrease the yield due to the current low rate environment. The Company began operating a trading account in the second quarter of 2013. The average balance of trading securities was \$5.3 million with resulting income on a fully taxable equivalent basis of \$230,000 during the year 2013. Additional information regarding investment securities can be found in Item 8, Notes 2 and 11 to the Consolidated Financial Statements and elsewhere in this Management's Discussion and Analysis.

On a fully taxable equivalent basis, income on loans decreased by \$274,000, or 1.7%, for 2013 compared to the same period in 2012. A \$17.4 million increase in the average balance of the loan portfolio, or 5.8%, was accompanied by a 39 basis point decrease in the portfolio's tax equivalent yield. Likewise, new loan volume is at historic low interest rates, while strong competition for good credits also drives rates downward. The commercial loan portfolio housed the majority of the increase in balances. Additional information regarding loans can be found in Item 8, Note 3 to the Consolidated Financial Statements and elsewhere in this Management's Discussion and Analysis.

Other interest income decreased by \$1,000, or 3.2%, from the same period a year ago. The average balance of interest-earning deposits decreased by \$359,000, or 3.5%. The yield did not change from 2012 to 2013. Management intends to remain fully invested, minimizing on-balance sheet liquidity.

As the Company is located in the heart of the Utica Shale geography, material deposit growth was experienced in the latter part of 2012 as a result of customers receiving signing bonuses for the lease of mineral rights. Nearly \$40 million in new deposits has been attributed to these bonuses. In the first half of 2013, nearly half of these funds were withdrawn by customers affecting primarily the time deposit category. Average interest-bearing demand deposits and money market accounts increased by \$8.3 million, or 9.9%, for the year ended December 31, 2013 compared to the same period of 2012, while average savings balances increased by \$10.7 million, or 9.9%. Total interest paid on interest-bearing demand deposits and money market accounts was \$177,000, a \$26,000 increase from last year. The average rate paid on these products increased by 1 basis point, primarily the result of larger deposits in the higher yielding tiers of the money market accounts. Total interest paid on savings accounts was \$83,000, a \$23,000 decrease from 2012. The average rate paid on savings accounts decreased by 3 basis points. The average balance of time deposit products decreased by \$15.9 million, or 10.2%, as the average rate paid decreased by 25 basis points, from 1.56% to 1.31%. Interest expense decreased on time deposits by \$599,000 from the prior year. Customers are opting for more liquid accounts versus time deposits in this low rate environment. As time deposits mature, the balances are reinvested at the lower current rates. After an extended period of declining average rates paid on deposits, the Company is experiencing a flattening on a linked quarter basis. Additional information regarding deposits can be found in Item 8, Note 5 to the Consolidated Financial Statements and elsewhere in this Management's Discussion and Analysis.

Average borrowings and subordinated debt increased by \$73,000 while the average rate paid on borrowings decreased by 15 basis points. Management has paid down long-term borrowings at their respective maturity dates using current liquidity and continues to utilize short-term borrowings to bridge liquidity gaps. 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 elsewhere in this Management's Discussion and Analysis.

Analysis of Net Interest Income — Years Ended December 31, 2012 and 2011

On a fully taxable equivalent basis, net interest income measured \$17.7 million for 2012 and \$17.1 million for 2011, generating a net interest margin of 3.58% for 2012 and 3.72% for 2011.

The decrease in interest income, on a fully taxable equivalent basis, of \$88,000 was the product of a 34 basis point decrease in interest rates earned offset somewhat by a 7.4% year-over-year increase in average earning assets. The decrease in interest expense of \$661,000 was a product of a 22 basis point decrease in rates paid and a 4.7% increase in interest-bearing liabilities. The net result was a 3.3% increase in net interest income on a fully taxable equivalent basis, and a 14 basis point decrease in the Company's net interest margin on a slightly larger asset base with a different mix.

On a fully taxable equivalent basis, income on investment securities decreased by \$1.1 million, or 16.3%. The average invested balances in securities decreased by \$3.4 million, or 1.8%, from 2011. The decrease in the average balance of investment securities was accompanied by a 51 basis point decrease in the tax equivalent yield of the portfolio. The Company continued attempting to redeploy liquidity into loans. Any reinvestment into the securities portfolio served to decrease the yield due to the current low rate environment. Additional information regarding investment securities can be found in Item 8, Notes 2 and 11 to the Consolidated Financial Statements and elsewhere in this Management's Discussion and Analysis.

On a fully taxable equivalent basis, income on loans increased by \$992,000, or 6.5%, for 2012 compared to 2011. A \$40.0 million increase in the average balance of the loan portfolio, or 15.3%, was accompanied by a 45 basis point decrease in the portfolio's tax equivalent yield. Likewise, new loan volume was at historic low interest rates, while strong competition for good credits also drives rates downward. The commercial loan portfolio housed the majority of the increase in balances. Additional information regarding loans can be found in Item 8, Note 3 to the Consolidated Financial Statements and elsewhere in this Management's Discussion and Analysis.

Other interest income decreased by \$20,000, or 39.2%, during 2012 compared to 2011. The average balance of interest-earning deposits decreased by \$2.4 million, or 18.6%. The yield for 2012 decreased by 11 basis points during 2012 compared to 2011.

As the Company is located in the heart of the Utica Shale geography, material deposit growth was experienced as a result of customers receiving signing bonuses for the lease of mineral rights. Nearly \$40 million in new deposits had been attributed to these bonuses. Average interest-bearing demand deposits and money market accounts increased by \$9.3 million, or 12.6%, for 2012 compared to the same period of 2011, while average savings balances increased by \$13.0 million, or 13.8%. Total interest paid on interest-bearing demand deposits and money market account was \$151,000 at 2012, a \$25,000 decrease from 2011. The average rate paid on these products decreased by 6 basis points. Total interest paid on savings accounts was \$106,000 in 2012, a \$35,000 decrease from the prior year. The average rate paid on savings accounts decreased by 5 basis points. The average balance of time deposit products decreased by \$4.8 million, or 2.9%, as the average rate paid decreased by 29 basis points, from 1.85% to 1.56%. Interest expense decreased on time deposits by \$535,000 in 2012 from 2011. Balances were reinvested at lower current rates as time deposits matured. After an extended period of declining average rates paid on deposits, the Company experienced a flattening on a linked quarter basis. The Company expected at least 50% of the shale-related deposits to leave the Bank in 2013 due to the payment of income taxes and reinvestment into other markets. Additional information regarding deposits can be found in Item 8, Note 5 to the Consolidated Financial Statements and elsewhere in this Management's Discussion and Analysis.

Average borrowings and subordinated debt increased by \$320,000 while the average rate paid on borrowings decreased by 15 basis points. 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 elsewhere 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) | | | | | |
|--|------------------------|------------|----------|-----------------------|------------|---------|
| | 2013 Compared to 2012 | | | 2012 Compared to 2011 | | |
| | Volume | Rate | Total | Volume | Rate | Total |
| (Decrease) increase in interest income: | | | | | | |
| Interest-earning deposits and other money markets | \$ (1) | \$ — | \$ (1) | \$ (8) | \$ (12) | \$ (20) |
| Available-for-sale securities: | | | | | | |
| U.S. Government agencies and corporations | (167) | (49) | (216) | (328) | (134) | (462) |
| Obligations of states and political subdivisions | 87 | (191) | (104) | 211 | (190) | 21 |
| Mortgage-backed and related securities | 29 | (515) | (486) | 220 | (947) | (727) |
| Other securities | (70) | (48) | (118) | (36) | 144 | 108 |
| Trading securities | 230 | — | 230 | — | — | — |
| Loans | 911 | (1,185) | (274) | 2,224 | (1,232) | 992 |
| Total interest income change | 1,019 | (1,988) | (969) | 2,283 | (2,371) | (88) |
| Increase (decrease) in interest expense: | | | | | | |
| Interest-bearing demand deposits | 16 | 10 | 26 | 20 | (45) | (25) |
| Savings deposits | 10 | (33) | (23) | 18 | (53) | (35) |
| Time deposits | (233) | (366) | (599) | (86) | (449) | (535) |
| Securities sold under agreements to repurchase .. | (1) | (1) | (2) | (1) | 1 | — |
| Other borrowings under one year | 52 | 4 | 56 | 2 | (18) | (16) |
| Other borrowings one year and over | (106) | (9) | (115) | 33 | (91) | (58) |
| Subordinated debt | — | (10) | (10) | — | 8 | 8 |
| Total interest expense change | (262) | (405) | (667) | (14) | (647) | (661) |
| Increase (decrease) in net interest income on a taxable equivalent basis | \$ 1,281 | \$ (1,583) | \$ (302) | \$ 2,297 | \$ (1,724) | \$ 573 |

PROVISION, NON-INTEREST INCOME, NON-INTEREST EXPENSE AND FEDERAL INCOME TAX

During 2013, 2012 and 2011, the amount charged to operations as a provision for loan loss was adjusted to account for charge-offs against the allowance, as well as an increase in loan balances recorded in the portfolio, expected losses on specific problem loans and several qualitative factors, including factors specific to the local economy and to industries operating in the local market. The Company has allocated a portion of the allowance for a number of specific problem loans through 2013, but has not experienced significant deterioration in any loan type, including the residential real estate portfolios or the commercial loan portfolio, and accordingly has not added any special provision for these loan types. For the year ended December 31, 2013, the provision for loan losses was \$650,000, which was fairly close to net charge-offs of \$711,000, which included charge-offs of \$710,000 to which a specific reserve of \$530,000 was allocated prior to the charge-offs. For the same period last year, the provision was \$3.0 million. The large provision in 2012 was due to a charge-off related to a single borrower to which no related allowance had been previously allocated. In the year ended 2011, the provision was \$1.2 million, far exceeding net charge-offs of \$639,000. Provision expense levels are in recognition of loan growth and a changing composition of the loan portfolio as the Company takes aim at managing its balance sheet with a commercially-oriented focus.

The following table provides a detailed analysis of non-interest income:

| | (Amounts in thousands) | | |
|--|------------------------|----------|----------|
| | December 31, | | |
| | 2013 | 2012 | 2011 |
| Fees for customer services | \$ 1,935 | \$ 2,041 | \$ 2,229 |
| Mortgage banking gains | 1,491 | 1,772 | 162 |
| Other real estate losses - net | (25) | (35) | (113) |
| Earnings on bank-owned life insurance | 477 | 510 | 496 |
| Other non-interest income | 439 | 188 | 104 |
| Other income, excluding investment gains | 4,317 | 4,476 | 2,878 |
| Investment securities gains - net | 535 | 14 | 882 |
| Impairment losses on investment securities | (1,954) | (171) | (202) |
| Total non-interest income | \$ 2,898 | \$ 4,319 | \$ 3,558 |

Total non-interest income, excluding investment gains and impairment losses, decreased by \$159,000, or 3.6%, for 2013 compared to an increase of \$1.6 million, or 55.5%, for 2012. After gains on investment securities and impairment losses, non-interest income decreased by \$1.4 million, or 32.9%, in 2013 compared to an increase of \$761,000, or 21.4%, in 2012.

Fees for customer services decreased by \$106,000, or 5.2% in 2013, compared to a decrease of \$188,000, or 8.4%, in the prior year driven by customer activities.

The wholesale mortgage unit, CSB Mortgage Company, which was formed in 2011 specifically as a result of strategic initiatives aimed at improving overall profitability, saw mortgage banking gains reach \$1.5 million in 2013 versus \$1.8 million in 2012 and \$162,000 in 2011. As indicated in Note 8 to the Consolidated Financial Statements, the Company's mortgage banking unit entered into various interest rate derivative contracts with the purpose of neutralizing the effect of interest rates on mortgage loan commitments. The gains and losses of all these activities are included in mortgage banking gains. Although mortgage banking gains for 2013 are equivalent to year-ago levels, the application volume driving the revenues declined substantially in 2013. The persistent rise in mortgage rates that began in May 2013 have caused the Company's application volume to decline. With the dramatic volume decrease and the prospects for any turnaround considered improbable in the near term, the Company curtailed portions of its mortgage banking activities. Originations from the wholesale channel and all out-of-market retail origination was closed down as of September 13, 2013. In addition to the origination channels, operational staff were also severed in order to right-size the business line with expected volume. These decisions in the aggregate are expected to contribute positively to net income prospectively, conducted primarily through the Bank subsidiary.

Gains on securities called and net gains on the sale of available-for-sale investment securities increased by \$521,000 in 2013 from year ago levels. Consistent with the balance sheet strategy, the Company periodically reviews its investment portfolio to clean up odd-lot securities and to reduce interest rate risk. Recent government programs, such as the Home Affordable Refinance Program (HARP), promote prepayment activities in mortgage backed securities, thus cutting short the intended investment performance. Proactively removing the securities with higher prepayment risk allows the Company to reinvest into securities that produce consistent cash flows. The Company sold 19 of the 22 bank collateralized CDO's in 2012 realizing a nominal net loss of \$164,000. All of these securities exhibited evidence of significant deterioration in issuers' creditworthiness. In 2011, gains of \$344,000 were due to equity securities received relating to the bankruptcy settlement on General Motors Corporation bonds. Gains in 2013, 2012 and 2011 were offset by impairment losses of \$2.0 million, \$171,000 and \$202,000, respectively, on investment securities which had been previously recognized as impaired and/or which required the Company to maintain a higher level of risk weighted assets for regulatory capital ratio purposes. As stated earlier, the \$2.0 million in OTTI losses were recognized on \$10.5 million of trust preferred securities, a form of collateralized debt obligations. The trust preferred securities were among those considered disallowed under the revised final Volcker Rule, which originated from the Dodd-Frank Act. The inability to hold these securities precipitated the loss recognition at December 31, 2013. Additional information regarding investment securities can be found in Item 8, Notes 2 and 11 to the Consolidated Financial Statements and elsewhere in this Management's Discussion and Analysis.

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

| | (Amounts in thousands) | | |
|--|------------------------|------------------|------------------|
| | December 31, | | |
| | 2013 | 2012 | 2011 |
| Salaries and benefits | \$ 9,844 | \$ 8,706 | \$ 7,366 |
| Net occupancy and equipment expense..... | 1,896 | 1,794 | 1,734 |
| State and local taxes | 555 | 497 | 465 |
| FDIC insurance expense | 391 | 297 | 673 |
| Professional fees | 806 | 801 | 761 |
| Loss on partnership..... | — | 444 | — |
| Other non-interest expense | 3,540 | 2,949 | 2,476 |
| Total non-interest expenses..... | <u>\$ 17,032</u> | <u>\$ 15,488</u> | <u>\$ 13,475</u> |

Total non-interest expenses increased by \$1.5 million, or 10.0%, in 2013. This compares to an increase of \$2.0 million, or 14.9%, in 2012.

During 2013, expenditures for salaries and employee benefits increased by \$1.1 million, or 13.1% and in 2012 increased by \$1.3 million, or 18.2%. Much of this increase is due to the additional personnel hired to operate the mortgage banking operation up to its curtailment in September 2013 and to manage the increasing lending volume generated through core bank lending operations. Also, approximately \$242,000 in branch restructuring costs were incurred in 2013. Full-time equivalent employment averaged 164 in 2013 compared to 162 in 2012 and 151 in 2011. The addition of employees throughout the third and fourth quarters of 2011 and in 2012 and 2013 were related to the mortgage banking operation. Management does not expect that the rate of increase in compensation and employee benefits experienced during 2013 will continue in 2014.

Salaries and employee benefits represent 57.8% of all non-interest expenses in 2013, 56.2% in 2012 and 54.7% in 2011. The following table details components of these increases and decreases.

| | December 31, | | | December 31, | | |
|--------------------------------------|------------------------|----------|--------|--------------|-------|-------|
| | 2013 | 2012 | 2011 | 2013 | 2012 | 2011 |
| | Amounts (in thousands) | | | Percentages | | |
| Salaries..... | \$ 954 | \$ 1,066 | \$ 294 | 14.3% | 19.1% | 5.6% |
| Benefits..... | 270 | 286 | 696 | 12.3 | 15.0 | 57.5 |
| | 1,224 | 1,352 | 990 | 13.8 | 18.0 | 15.2 |
| Deferred loan origination fees | (86) | (12) | (13) | 59.3 | 9.0 | 10.8 |
| Total..... | \$ 1,138 | \$ 1,340 | \$ 977 | 13.1% | 18.2% | 15.3% |

Salary expense per employee averaged \$46,000 in 2013, \$41,000 in 2012 and \$37,000 in 2011. Average earning assets per employee measured approximately \$3 million in 2013, 2012 and 2011.

Charges for insurance premiums paid to the FDIC increased by \$94,000 in 2013 compared to a decrease in 2012 of \$376,000. 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 change in the basis used to calculate the assessment contributed in part to the decrease in expense in 2012. The assessment base changed to an asset-based calculation effective for the second quarter of 2011. Concurrently with the effects of the change in assessment base, the Company was also subject to higher insurance premiums in 2011 due to its informal agreement with regulatory agencies. As a result of its fulfillment of the terms of the agreement, FDIC insurance expense declined by 55.9% in 2012. The Company anticipates its FDIC insurance expense will remain consistent in 2014.

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 \$1.2 million at December 31, 2012. The prepaid assessment amounts are included in other assets on the Consolidated Balance Sheets of the Company in 2012. The Bank was assessed quarterly premiums by the FDIC, and such assessments were charged against the prepaid asset until such time as the prepaid asset was fully expensed. In June 2013, the excess balance of \$1.1 million was refunded, at which point the Bank resumed paying premiums to the FDIC.

Included in non-interest expenses for the year ended December 31, 2012 is the one-time investment of \$444,000 in a Historic Tax Credit partnership which generated \$634,000 in tax credits for 2012. The Company recorded no tax credit activity in 2013 but expects modest recognition in 2014 and beyond. All other categories of non-interest expenses increased \$756,000, or 12.5%, in 2013 compared to \$605,000, or 11.1%, in 2012. These expense categories are subject to fluctuation due to non-recurring items. The majority of these increases relate to the expenses incurred by the mortgage banking operation in the form of professional fees, third-party consulting fees and compliance-related costs and \$229,000 of costs to exit the wholesale mortgage banking channel and reducing mortgage operations late in the third quarter of 2013. Also, \$164,000 in costs were incurred in the closing of the Middlefield branch in late 2013.

Income before federal income tax expense amounted to \$1.9 million for 2013 compared to \$2.8 million and \$5.3 million for 2012 and 2011, respectively. The effective tax rate was 4.70% in 2013, (5.74)% in 2012 and 22.66% in 2011, resulting in income tax expense of \$88,000 in 2013 and \$1.2 million in 2011 and an income tax benefit of \$158,000 in 2012. The historic tax credit contributed to the lower effective tax rate in 2012.

| | December 31, | | |
|---|----------------|---------|--------|
| | 2013 | 2012 | 2011 |
| Provision at statutory rate | 34.00% | 34.00% | 34.00% |
| (Deduct) add tax effects of: | | | |
| Earnings on bank-owned life insurance-net | (5.90) | (4.68) | (2.49) |
| Non-taxable interest income | (26.96) | (18.57) | (9.82) |
| Historical tax credit..... | — | (17.53) | — |
| Non-deductible expenses | 3.56 | 1.04 | 0.97 |
| Federal income tax effective rate | 4.70% | (5.74)% | 22.66% |

Net income registered \$1.8 million in 2013, \$2.9 million in 2012 and \$4.1 million in 2011, representing per share amounts of \$0.39 in 2013, \$0.64 in 2012 and \$0.90 in 2011. Cash dividends of \$0.12 per share were paid to shareholders of record in 2013. A cash dividend of \$0.03 per share was paid in 2012. There were no cash dividends in 2011.

The following table shows unaudited financial results by quarter:

| | (Amounts in thousands) | | | | | | | |
|--|-----------------------------|-----------------|-----------------|-----------------|-----------------------------|----------|----------|----------|
| | For the 2013 quarter ended: | | | | For the 2012 quarter ended: | | | |
| | Dec. 31 | Sept. 30 | June 30 | Mar. 31 | Dec. 31 | Sept. 30 | June 30 | Mar. 31 |
| Interest income | \$ 5,129 | \$ 4,948 | \$ 4,938 | \$ 5,045 | \$ 5,347 | \$ 5,136 | \$ 5,227 | \$ 5,305 |
| Interest expense | 792 | 843 | 858 | 911 | 968 | 1,012 | 1,027 | 1,064 |
| Net interest income | 4,337 | 4,105 | 4,080 | 4,134 | 4,379 | 4,124 | 4,200 | 4,241 |
| Loan loss provision | 150 | 150 | 150 | 200 | 2,120 | 300 | 330 | 270 |
| Net security (losses) gains | (3) | 386 | 152 | — | (46) | 25 | 28 | 7 |
| Impairment losses, net | (1,954) | — | — | — | — | — | — | (171) |
| Mortgage banking gains | 56 | 109 | 638 | 688 | 335 | 1,017 | 266 | 154 |
| Other real estate (losses) gains | — | (38) | 13 | — | (50) | 13 | 2 | — |
| Other non-interest income | 794 | 826 | 613 | 618 | 645 | 657 | 732 | 705 |
| Other non-interest expenses | 4,005 | 4,509 | 4,343 | 4,175 | 4,082 | 3,848 | 3,694 | 3,864 |
| (Loss) income before tax | (925) | 729 | 1,003 | 1,065 | (939) | 1,688 | 1,204 | 802 |
| Federal income tax (benefit) expense | (463) | 112 | 204 | 235 | (475) | 422 | 252 | (357) |
| Net (loss) income | \$ (462) | \$ 617 | \$ 799 | \$ 830 | \$ (464) | \$ 1,266 | \$ 952 | \$ 1,159 |
| Net (loss) income per share | \$ (0.11) | \$ 0.14 | \$ 0.18 | \$ 0.18 | \$ (0.11) | \$ 0.28 | \$ 0.21 | \$ 0.26 |
| Net interest income (fully tax-equivalent basis) | \$ 4,540 | \$ 4,299 | \$ 4,262 | \$ 4,294 | \$ 4,556 | \$ 4,321 | \$ 4,394 | \$ 4,426 |
| Net interest rate spread | 3.45% | 3.23% | 3.16% | 3.09% | 3.24% | 3.31% | 3.45% | 3.49% |
| Net interest margin | 3.63% | 3.42% | 3.34% | 3.27% | 3.44% | 3.51% | 3.66% | 3.70% |

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, with 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; and 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 and qualitative factors 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, residential real estate loans, home equity loans and other consumer 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 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 non-interest expenses. At both December 31, 2013 and 2012, 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 management believes the Company uses 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) | | | | |
|---|------------------------|----------------|--------------|--------------|--------------|
| | December 31, | | | | |
| | 2013 | 2012 | 2011 | 2010 | 2009 |
| Balance at beginning of year..... | \$ 3,825 | \$ 3,058 | \$ 2,501 | \$ 2,437 | \$ 2,470 |
| Loan losses: | | | | | |
| Commercial..... | (1) | (1,937) | — | (1) | (5) |
| Commercial real estate..... | (782) | (36) | (211) | (204) | (233) |
| Residential real estate..... | (81) | (231) | (362) | (229) | (87) |
| Consumer - home equity..... | (12) | (59) | (91) | (14) | (97) |
| Consumer - other..... | (146) | (152) | (168) | (168) | (198) |
| Total..... | <u>(1,022)</u> | <u>(2,415)</u> | <u>(832)</u> | <u>(616)</u> | <u>(620)</u> |
| Recoveries on previous loan losses: | | | | | |
| Commercial..... | 167 | 9 | 3 | — | 4 |
| Commercial real estate..... | 11 | 37 | 118 | 58 | 55 |
| Residential real estate..... | 26 | 46 | 6 | 18 | 1 |
| Consumer – home equity..... | 18 | 13 | 6 | 3 | — |
| Consumer – other..... | 89 | 57 | 60 | 96 | 100 |
| Total..... | <u>311</u> | <u>162</u> | <u>193</u> | <u>175</u> | <u>160</u> |
| Net loan losses..... | <u>(711)</u> | <u>(2,253)</u> | <u>(639)</u> | <u>(441)</u> | <u>(460)</u> |
| Provision charged to operations..... | 650 | 3,020 | 1,196 | 505 | 427 |
| Balance at end of year..... | \$ 3,764 | \$ 3,825 | \$ 3,058 | \$ 2,501 | \$ 2,437 |
| Ratio of net loan losses to average total loans outstanding ... | <u>0.23%</u> | <u>0.78%</u> | <u>0.24%</u> | <u>0.19%</u> | <u>0.19%</u> |
| Ratio of loan loss allowance to total loans..... | <u>1.09%</u> | <u>1.21%</u> | <u>1.06%</u> | <u>0.94%</u> | <u>0.98%</u> |

The \$782,000 commercial real estate charge-off in 2013 contains \$710,000 in charge-offs to a single borrower which had \$530,000 in a related specific allowance prior to the charge-off. The \$1.9 million commercial loan charge-off in 2012 related to a single borrower to which no related allowance had been previously allocated.

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:

| | (Amounts in thousands) | | | | |
|------------------------------|------------------------|-----------------|-----------------|-----------------|-----------------|
| | December 31, | | | | |
| | 2013 | 2012 | 2011 | 2010 | 2009 |
| Commercial..... | \$ 593 | \$ 639 | \$ 565 | \$ 249 | \$ 209 |
| Commercial real estate..... | 2,638 | 2,616 | 1,803 | 1,611 | 1,666 |
| Residential real estate..... | 356 | 343 | 470 | 418 | 315 |
| Consumer – home equity..... | 88 | 123 | 128 | 111 | 71 |
| Consumer – other..... | 89 | 104 | 92 | 112 | 176 |
| Total..... | <u>\$ 3,764</u> | <u>\$ 3,825</u> | <u>\$ 3,058</u> | <u>\$ 2,501</u> | <u>\$ 2,437</u> |

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:

| | (Amounts in thousands) | | | | | | | | | |
|-------------------------------|------------------------|------|------------------|------|------------------|------|------------------|------|------------------|------|
| | December 31, | | | | | | | | | |
| | 2013 | | 2012 | | 2011 | | 2010 | | 2009 | |
| | Balance | % | Balance | % | Balance | % | Balance | % | Balance | % |
| Commercial | \$ 73,643 | 21.2 | \$ 62,312 | 19.6 | \$ 60,233 | 20.8 | \$ 42,349 | 16.0 | \$ 38,498 | 15.5 |
| Commercial real estate | 206,744 | 59.6 | 193,417 | 61.1 | 160,319 | 55.5 | 146,389 | 55.2 | 126,507 | 51.0 |
| Residential real estate | 42,288 | 12.2 | 39,091 | 12.3 | 45,780 | 15.8 | 52,262 | 19.7 | 60,904 | 24.5 |
| Consumer – home equity ... | 19,510 | 5.6 | 17,910 | 5.6 | 16,916 | 5.9 | 16,963 | 6.4 | 14,569 | 5.9 |
| Consumer – other..... | 4,648 | 1.4 | 4,552 | 1.4 | 5,848 | 2.0 | 7,216 | 2.7 | 7,770 | 3.1 |
| Total loans..... | <u>\$346,833</u> | | <u>\$317,282</u> | | <u>\$289,096</u> | | <u>\$265,179</u> | | <u>\$248,248</u> | |

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- home equity and consumer-other) as of:

| | (Amounts in thousands) | | | |
|-----------------------------|------------------------|------------------------|------------------|-------------------|
| | December 31, 2013 | | | |
| | 1 Year or Less | Over 1 Year to 5 Years | Over 5 Years | Total |
| Commercial..... | \$ 49,084 | \$ 12,464 | \$ 12,095 | \$ 73,643 |
| Commercial real estate..... | 51,498 | 115,265 | 39,981 | 206,744 |
| Total | <u>\$ 100,582</u> | <u>\$ 127,729</u> | <u>\$ 52,076</u> | <u>\$ 280,387</u> |

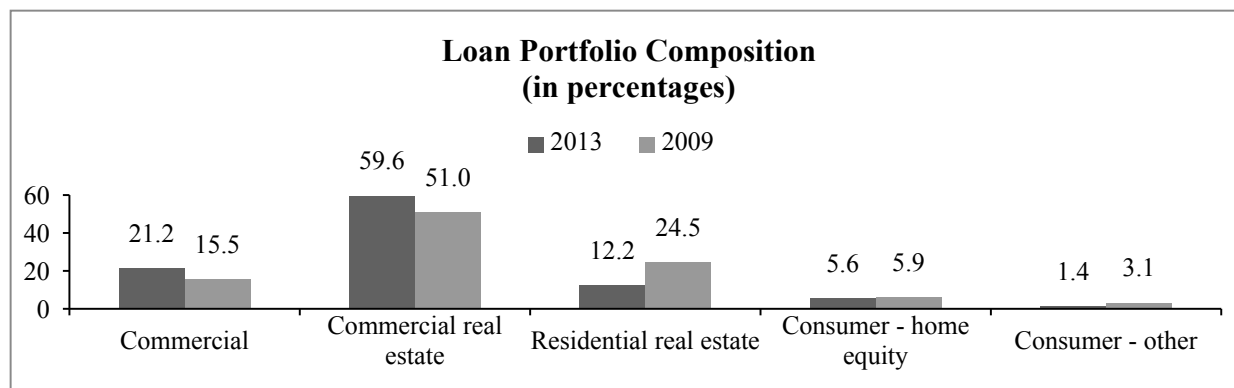
The following schedule sets forth loans based on next re-pricing opportunity for floating and adjustable interest rate products, and by remaining scheduled principal payments for loan products with fixed rates of interest. Residential real estate, consumer - home equity and consumer – other loans have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

| | (Amounts in thousands) | | |
|--|------------------------|-------------------|-------------------|
| | December 31, 2013 | | |
| | 1 Year or Less | Over 1 Year | Total |
| Floating or adjustable rates of interest | \$ 98,127 | \$ 133,462 | \$ 231,589 |
| Fixed rates of interest..... | 2,455 | 46,343 | 48,798 |
| Total..... | <u>\$ 100,582</u> | <u>\$ 179,805</u> | <u>\$ 280,387</u> |

The Company recorded an increase of \$29.6 million in the loan portfolio from the level of \$317.3 million recorded at December 31, 2012. Gross loans as a percentage of earning assets stood at 66.7% as of December 31, 2013 and 59.2% at December 31, 2012. The loan-to-deposit ratio at December 31, 2013 was 77.3% as compared to 66.5% at December 31, 2012. Despite the slow economic recovery in the region, the Bank posted year-over-year growth in total loans of 9.3%. 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 2013 for \$27.6 million, compared to \$20.7 million in 2012. At December 31, 2013 the loan loss allowance of \$3.8 million represented approximately 1.1% of outstanding loans, and at December 31, 2012, the loan loss allowance of \$3.8 million represented approximately 1.2% of outstanding loans.

The portion of the loan portfolio represented by commercial loans (including commercial real estate) remained about the same from 80.6% in 2012 to 80.8% in 2013. Consumer loans (including home equity loans) were approximately 7.0% of the loan portfolio in 2012 and 2013 as the Bank remains challenged in growing these portfolios with consumers deleveraging their household since the economic downturn of 2008-2009. Between 2012 and 2013, the balance of residential real estate loans also remained consistent from 12.3% to 12.2% of the loan portfolio as borrowers continue to look to qualify for the secondary market in order to take advantage of historically low interest rates while management previously elected not to portfolio historically low yields. Although both residential real estate and consumer loans remained level as a percentage of the total portfolio, the Bank reported increases in those portfolios from the prior year of 7.6% and 8.2%, respectively, reversing the three year trend of declining balances. The growth is attributed to retail banking initiatives commenced at the end of the fiscal year 2012.

The following table offers a comparison of loan composition for the time period 2009 to 2013:



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 2013, commercial, commercial real estate and residential real estate loans comprised a combined 93.0% of the portfolio compared to 91.0% at December 31, 2009. The portfolio at December 31, 2013 also included home equity loans at 5.6% and consumer installment loans at 1.4%. These percentages compare to home equity loans at 5.9% and consumer installment loans at 3.1% on December 31, 2009.

The balance of the commercial loan portfolio, which includes commercial mortgages, is \$280.4 million at December 31, 2013, an increase of \$24.7 million from the balance of \$255.7 million recorded at December 31, 2012 and represents a 9.7% growth. Short-term, asset-based commercial loans, including lines of credit, increased during the year. Commercial real estate (CRE) loans reflected the largest component growth from the prior period of \$13.3 million, or 6.9%, which substantially represents investment real estate supported by third-party rents and leases. At December 31, 2013, the total commercial real estate portfolio consisted of 39.2% in owner occupied real estate and 60.8% in non-owner occupied real estate. The increase in CRE loans was a direct result of management taking strategic advantage of competitive market conditions and the Bank’s considerable liquidity position. The CRE portfolio was also enhanced by lending into the Skilled Nursing and Personal Health Care industries. In 2006, the federal banking regulatory agencies published interagency guidance on CRE Concentration Risk Management stating that if total commercial real estate concentration exceeded 300% of a bank’s total capital (or if the CRE portfolio increased by over 50% in the preceding 3 years), the portfolio may represent significant concentration risk and additional monitoring may be required. The Bank’s overall CRE concentration as of December 31, 2013 was \$206.7 million, which is 352% of total unimpaired or risk-based capital. Management believes that its current level of credit review and portfolio monitoring adequately assures that the Bank is mitigating CRE concentration levels. In a strategic effort to diversify, the Bank continues to develop its commercial and industrial portfolio and, as such, the December 31, 2013 balance of \$73.6 million represents 26.3% of the total commercial portfolio, which reflected a 1.9% increase from the period December 31, 2012 to December 31, 2013. The continued focus on owner and non-owner occupied commercial real estate relationships along with commercial and industrial relationships also assisted a year-over-year growth in non-maturing commercial deposits of 9.9% from the period ended December 2012 to December 2013.

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) | | | | | |
|---|------------------------|----------------|-----------|----------------|-----------|----------------|
| | December 31, | | | | | |
| | 2013 | | 2012 | | 2011 | |
| | Balances | % of Portfolio | Balances | % of Portfolio | Balances | % of Portfolio |
| Non-residential building/apartment building | \$ 51,396 | 18.33 | \$ 39,990 | 15.64 | \$ 26,724 | 12.12 |
| Skilled nursing..... | 30,589 | 10.91 | 24,573 | 9.61 | 20,356 | 9.23 |
| Hotels/motels..... | 24,745 | 8.83 | 18,999 | 7.43 | 17,247 | 7.82 |
| Eating establishments..... | 17,583 | 6.27 | 17,391 | 6.80 | 15,805 | 7.17 |
| Nursing and personal care..... | 13,226 | 4.72 | 14,803 | 5.79 | 14,433 | 6.54 |

The most substantial increase in concentrations comes from non-residential building/apartment building, which was significantly enhanced in late 2011, 2012 and 2013. The single largest customer relationship had an aggregate balance at year end 2013 of \$18.1 million compared to \$12.3 million in 2012. This balance represented approximately 4.8% of the total commercial and CRE portfolio in both 2013 and 2012. It is important to note that within this relationship, there is a 60-day note for \$17.0 million in 2013 and \$12.0 million in 2012, which are fully secured by segregated deposit accounts with the Bank.

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 2014.

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; and 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 14 to the Consolidated Financial Statements.

MORTGAGE BANKING

In late 2011, the Company implemented a wholesale mortgage operation serviced through CSB. During 2013 and 2012, management capitalized on the expertise of CSB's newly hired personnel to substantially increase loans sold on the secondary market. In 2013, originations, primarily wholesale, totaled \$249.7 million while sales were \$273.8 million, leaving a year-end loans-held-for-sale balance of \$656,000. In 2012, originations, primarily wholesale, totaled \$244.1 million while sales were \$220.3 million, leaving a year-end loans-held-for-sale balance of \$24.8 million. In 2011, originations, primarily retail, were \$5.4 million; loans sold were \$4.6 million; and loans held for sale were \$947,000. Resulting mortgage banking gains for 2013, 2012 and 2011 were \$1.5 million, \$1.8 million and \$162,000, respectively. In addition to ramping up operations through the association with brokers, the historically low interest rate environment stimulated the refinance volume throughout 2012. Although mortgage banking gains are equivalent to year-ago levels, the application volume driving the revenues has declined substantially over past months. The persistent rise in mortgage rates that began in May 2013 have caused the Company's application volume to decline from \$82.9 million and \$94.2 million for the first and second quarters of 2013 to \$42.7 million in the third quarter of 2013, compared to \$123.9 million for the same quarter of 2012. With the dramatic volume decrease and the prospects for any turnaround considered improbable in the near term, the Company curtailed portions of its mortgage banking activities. Originations from the wholesale channel and all out-of-market retail origination was closed down as of September 13, 2013. In addition to the origination channels, operational staff were also severed in order to right-size the business line with expected volume. These decisions in the aggregate are expected to contribute positively to net income prospectively, conducted primarily through the Bank's subsidiary.

Currently, the Company is not retaining the servicing on loans sold. Although the Company's primary strategy is to sell long-term residential mortgages, loans are occasionally retained in the portfolio when requested by a customer or to enhance account relationships, and tend to be variable rate or shorter term. The mix of portfolio retained to those sold to investors will vary from year to year. The Company has shifted to a more retail based volume versus the wholesale channel.

The Company maintains reserves for mortgage loans sold to agencies and investors in the event that, either through error or disagreement between the parties, the Company is required to indemnify the purchase. The reserves take into consideration risks associated with underwriting, key factors in the mortgage industry, loans with specific reserve requirements, past due loans and potential indemnification by the Company. Reserves are estimated based on consideration of factors in the mortgage industry, such as declining collateral values and rising levels of delinquency, default and foreclosure, coupled with increased incidents of quality reviews at all levels of the mortgage industry seeking justification for pushing back losses to loan originators and wholesalers. As of December 31, 2013 and 2012, the Company had reserves for mortgage loans sold of \$681,400 and \$430,200, respectively. For the twelve months ended December 31, 2013 and 2012, the Company recorded \$251,100 and \$411,500, respectively, in provision expense related to potential repurchase and warranties exposure. For the years ended December 31, 2013 and 2012, the Company did not repurchase any mortgage loans sold.

INVESTMENT SECURITIES

Investment securities are segregated into three separate portfolios: available-for-sale, held-to-maturity and trading. Each portfolio type has its own method of accounting. The Company currently does not maintain a held-to-maturity portfolio.

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.

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.

Trading securities are an investment in obligations of states and political subdivisions and include cash equivalent investments for trading liquidity. Management has purchased these securities principally for the purpose of selling them in the near term. Trading securities are carried at fair value with valuation adjustments included in other non-interest 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 OTTI 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 fair value of available-for-sale securities by type of obligation at:

| | (Amounts in thousands) | | |
|---|------------------------|-------------------|-------------------|
| | December 31, | | |
| | 2013 | 2012 | 2011 |
| U.S. Treasury and U.S. Government agencies and corporations | \$ 9,059 | \$ 8,188 | \$ 20,675 |
| Obligations of states and political subdivisions | 43,535 | 42,316 | 39,019 |
| U.S. Government mortgage-backed securities | 95,107 | 123,481 | 113,283 |
| Private-label mortgage-backed securities | — | — | 381 |
| Trust preferred securities | 10,136 | 7,612 | 9,145 |
| General Motors equity investments | — | — | 364 |
| Regulatory stock | 3,049 | 3,049 | 3,049 |
| Total fair value of available-for-sale securities | <u>\$ 160,886</u> | <u>\$ 184,646</u> | <u>\$ 185,916</u> |

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.

Fair Value

The Company owns 12 trust preferred securities totaling \$14.4 million (par value) issued by banks, thrifts, insurance companies and real estate investment trusts. The market for these securities at December 31, 2013 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, 2013. 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 6.61% to 15.71% 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 \$0.71 per \$1.00 of par value is representative of the fair value of the 12 trust preferred securities.

The Company considered all information available as of December 31, 2013 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. If the conditions of the underlying banks in the trust preferred securities worsen, there may be additional impairment to recognize in 2014 or later. In February 2014, the Company completed the sale of all nine of the disallowed investments along with one other permissible holding. Proceeds of the \$10.2 million were received on an amortized cost of \$10.0 million resulting in a pre-tax gain of approximately \$200,000.

A summary of securities held at December 31, 2013, 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) December 31, 2013 | |
|--|---|-------------------------------|
| | Fair 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 | 1,109 | 1.490 |
| Maturing or repricing after five years but within ten years..... | 7,950 | 2.420 |
| Maturing or repricing after ten years..... | — | — |
| Total U.S. Government agencies and corporations | <u>\$ 9,059</u> | <u>2.310%</u> |
| Obligations of states and political subdivisions: | | |
| Maturing or repricing within one year..... | \$ 1,210 | 4.910% |
| Maturing or repricing after one year but within five years | 1,917 | 3.530 |
| Maturing or repricing after five years but within ten years..... | 6,710 | 5.180 |
| Maturing or repricing after ten years..... | 33,698 | 4.590 |
| Total obligations of states and political subdivisions | <u>\$ 43,535</u> | <u>4.650%</u> |
| U.S. Government mortgage-backed and related securities: | | |
| Maturing or repricing within one year | \$ 1,212 | 1.480% |
| Maturing or repricing after one year but within five years | 22,892 | 1.570 |
| Maturing or repricing after five years but within ten years..... | 3,686 | 2.320 |
| Maturing or repricing after ten years..... | 67,317 | 2.240 |
| Total U.S. Government mortgage-backed and related securities | <u>\$ 95,107</u> | <u>2.070%</u> |
| Other securities (2): | | |
| Maturing or repricing within one year | \$ 10,136 | 2.160% |
| 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..... | 3,049 | — |
| Total other securities..... | <u>\$ 13,185</u> | <u>1.660%</u> |

(1) The weighted-average yield has been computed by dividing the total interest income adjusted for amortization of premium or accretion of discount over the life of the security by the amortized cost of the securities outstanding. The weighted-average yield of tax-exempt obligations of states and political subdivisions has been calculated on a fully taxable equivalent basis. The amount of adjustment to interest, which is based on the statutory tax rate of 34%, was \$622,000.

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

As of December 31, 2013, there were \$3.8 million in callable U.S. Government agency securities and \$6.0 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 \$1.1 million classified as maturing or repricing within one year, \$1.8 million classified as maturing after one year but within five years, \$6.9 million classified as maturing after five years but within ten years and none classified as maturing after 10 years.

As of December 31, 2013, there were \$2.9 million in callable U.S. Government agency securities, \$20.3 million in callable obligations of states and political subdivisions that, given current and expected interest rate environments, have 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 \$300,000 maturing after one year but within five years, \$5.5 million maturing after five years but within ten years and \$17.4 million maturing after 10 years.

As of December 31, 2013, the carrying value of all investment securities totaled \$160.9 million, a decrease of \$23.8 million, or 12.9%, from the prior year. The Bank's management elected to reallocate the majority of the proceeds from called and paid-down securities that were realized during the twelve months ended December 31, 2013. Additionally, by utilizing the available liquidity, the Bank was able to pay off FHLB advances and fund commercial loans. The investment portfolio represents 35.9% of each deposit dollar, down from 38.7% at the prior year end. The allocation between single maturity investment securities and mortgage-backed securities shifted to a 49/51 split versus the 33/67 division of the previous year.

Holdings of U.S. Government-sponsored collateralized mortgage obligations showed a decrease of \$14.1 million, or 45.1%. The decrease was due to \$8.3 million of principal paydowns and \$5.1 million in sales.

Holdings of U.S. Government-sponsored mortgage-backed securities decreased by \$14.3 million, or 15.5%. The decrease was the result of principal paydowns of \$22.5 million and sales of \$21.4 million, offset by \$34.1 million in purchases.

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 2013, and accordingly, the portion of the mortgage-backed portfolio allocated to fixed-rate securities increased slightly from 88.0% to 88.4% in the current year. 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 \$17.1 million and \$31.1 million at December 31, 2013 and 2012, respectively. There were \$5.1 million in collateralized mortgage obligations sold in 2013 and \$4.8 million in collateralized mortgage obligations sold in 2012.

At December 31, 2013, a net unrealized loss of \$2.9 million, net of tax, was included in shareholders' equity as a component of other comprehensive loss, as compared to a net unrealized loss of \$1.7 million, net of tax, as of December 31, 2012. 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 established by a discounted cash flow model, and the losses therein are the primary determinant of the overall loss position.

The Company has \$10.1 million in investments considered to be structured notes as of December 31, 2013, an increase of \$2.5 million, or 32.9% from one year ago. The increase consisted entirely of market valuation of existing securities, as no additional structured notes were purchased. The Company has no investments in 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 a decrease of 5.9% to \$448.7 million at December 31, 2013, as compared to \$476.9 million at December 31, 2012. Much of the decrease is attributed to our customers' ultimate investment of, and payment of taxes on, the shale bonus funds paid to them and deposited during the second half of 2012.

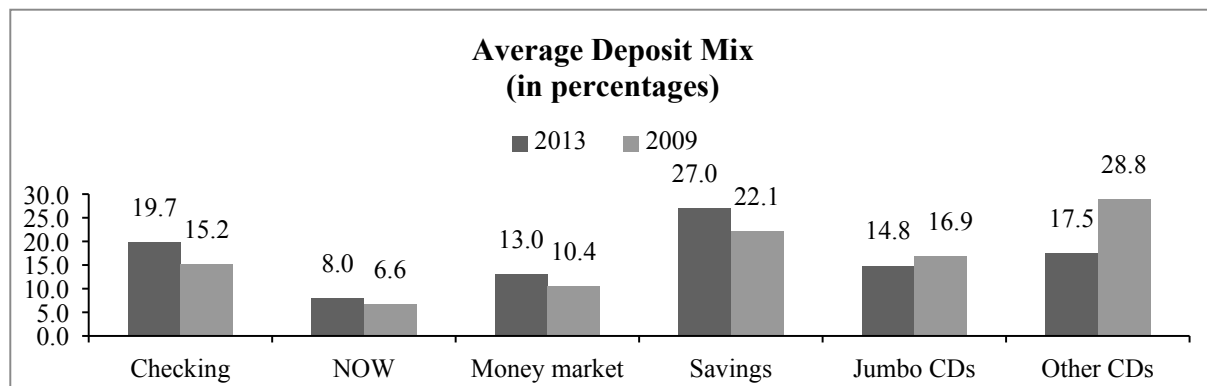
The Company's deposit base consists of demand deposits, savings, money market and time deposit accounts. Average noninterest-bearing deposits increased 10.6% during 2013, while average interest-bearing deposits increased by 0.9%.

During 2013, noninterest-bearing deposits averaged \$85.8 million or 19.7%, of total average deposits, compared to \$77.5 million or 18.3% of total deposits in 2012. Core deposits, defined as deposits less certificates of deposit greater than \$100,000, averaged \$371.2 million for the year ended December 31, 2013, an increase of \$18.2 million from the average level in 2012. During 2012, core deposits had averaged \$353.0 million, an increase of \$27.6 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 represent 85.2% of average total deposits in 2013, compared to 83.2% in 2012. 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 includes an insignificant amount of brokered deposits.

Noninterest-bearing and interest-bearing checking accounts now comprise 27.7% of total deposits compared to 21.8% five years ago. The following graph depicts how the deposit mix has shifted during this five-year time frame.



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

OTHER ASSETS AND OTHER LIABILITIES

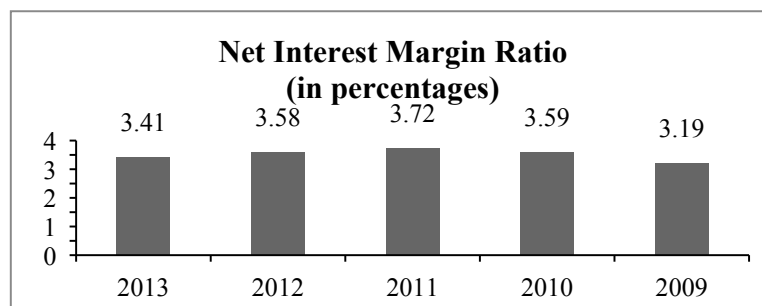
Premises and equipment totaled \$6.7 million at December 31, 2013, an increase of \$100,000 from \$6.6 million at December 31, 2012. Bank-owned life insurance had a cash surrender value of \$15.1 million at December 31, 2013 and \$14.0 million at December 31, 2012. The Company purchased \$714,000 in bank-owned life insurance in 2013 and \$694,000 in 2012 as part of its funding of executive post-retirement benefits. Other assets decreased to \$10.9 million at December 31, 2013 from \$11.2 million at December 31, 2012. Included in other assets in 2012 is a prepaid assessment paid to the FDIC in December of 2009. This prepayment was the estimate, based on projected assessment rates and assessment base, made by the FDIC of premiums due until December 31, 2012. On June 30, 2013, the unused portion of \$1.1 million was returned to the Company. The balance was \$1.2 million at December 31, 2012 and \$1.5 million at December 31, 2011. Other real estate decreased to \$33,000 at December 31, 2013 compared to \$145,000 at December 31, 2012. Net deferred tax assets measured \$5.5 million at December 31, 2013 compared to \$5.0 million at December 31, 2012. Federal income tax receivable of \$1.0 million and \$1.7 million was recorded for the years ended December 31, 2013 and 2012, respectively.

In 2013, a \$1.9 million investment in a partnership fund is included in other assets with an offsetting \$1.8 million in other liabilities, which is the commitment to fund this affordable housing investment. The valuation gain related to the mortgage banking derivatives was \$17,000 at December 31, 2013 and \$531,000 at December 31, 2012.

Other liabilities measured \$7.2 million at December 31, 2013 and \$4.7 million at December 31, 2012. The increase at December 31, 2013 is due to a \$1.9 million commitment to fund the affordable housing partnership fund previously described. Other major components are accrued interest on deposits and borrowings which measured \$290,000 and \$359,000 in 2013 and 2012. Accrued expenses measured \$3.4 million at December 31, 2013 and \$2.7 million at December 31, 2012. Post-retirement benefits is the largest accrued expense item, which measured \$1.9 million at December 31, 2013 and \$1.7 million at December 31, 2012.

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 3.50% ranging between 3.19% and 3.72% as depicted in the following graph.



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 2013, 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 2013 in an attempt to ease strains in the financial market, stimulate spending and help improve the recovery. 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 2013. During the year, management invested the excess funds, 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 4.25%, 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 the Company has 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, properly manage of capital markets funding sources and address unexpected liquidity requirements.

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

Principal repayments on mortgage-backed securities along with investment securities maturing or called amounted to \$39.2 million during 2013, representing 24.4% of the total combined portfolio, compared to \$50.0 million, or 27.1%, of the portfolio a year ago.

In order to address the concern of FDIC insurance of larger depositors, the Bank is a member of the Certificate of Deposit Account Registry Service (CDARS®) program and the Insured Cash Sweep (ICS) program. 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, 2013, the Bank did not have any deposits in the CDARS® program, but had \$3.0 million of deposits in the ICS money market program. For regulatory purposes, CDARS® and ICS are considered a brokered deposit even though reciprocal deposits are matched with funds 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 Federal Home Loan Bank of Cincinnati, which provides its largest source of liquidity. At December 31, 2013, the Bank had approximately \$7.4 million available of collateral-based borrowing capacity at FHLB of Cincinnati, supplementing the \$3.6 million of availability with the Federal Reserve Discount window. Additionally, the FHLB has committed a \$26.7 million cash management line, of which nothing has been disbursed, subject to posting additional collateral. The Bank, by policy, has access to approximately 5% of total deposits in brokered certificates of deposit that could be used as an additional source of liquidity. At December 31, 2013 and 2012, there was \$3.0 million and \$3.2 million, respectively, in outstanding balances 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, 2013. Unpledged securities of \$39.2 million are also available for borrowing under repurchase agreements or as additional collateral for FHLB lines of credit or to sell to generate liquidity.

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 the Bank. 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 available for dividends in 2014 is \$4.3 million plus 2014 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 had cash of \$4.1 million at December 31, 2013 available to meet cash needs. It also held 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 payments on the debentures, to pay dividends to common shareholders and to fund operating expenses.

In May 2012, the Bank closed its North Bloomfield branch in an effort to consolidate it with the Bristol branch approximately five miles away. Any loss of deposits or customers did not have a material effect on liquidity or consolidated deposit totals. In November 2013, the Bank closed its Middlefield branch due to its nominal asset size. In addition, total deposits at the Middlefield branch were less than 1% of total Bank deposits. The Bristol and Mantua branches are less than twenty miles away. Any loss of deposits or customers has not had a material effect on liquidity or consolidated deposit totals.

Cash and cash equivalents decreased from \$27.6 million in 2012 to \$12.4 million in 2013. The following table details the cash flows from operating activities for the years ended 2013, 2012 and 2011.

| | (Amounts in thousands) | | |
|---|------------------------|--------------------|-----------------|
| | December 31, | | |
| | 2013 | 2012 | 2011 |
| Net income | \$ 1,784 | \$ 2,913 | \$ 4,072 |
| Adjustments to reconcile net income to net cash flow (deficit) from operating activities: | | | |
| Depreciation, amortization and accretion | 3,221 | 3,060 | 2,411 |
| Provision for loan losses | 650 | 3,020 | 1,196 |
| Investment securities gains | (535) | (14) | (882) |
| Impairment losses on investment securities | 1,954 | 171 | 202 |
| Other real estate losses | 25 | 35 | 113 |
| Originations of mortgage banking loans held for sale | (249,714) | (244,112) | (5,410) |
| Proceeds from the sale of mortgage banking loans | 275,305 | 222,075 | 4,887 |
| Net mortgage banking income | (1,491) | (1,772) | (162) |
| Increase in trading account | (7,247) | — | — |
| Proceeds from IRS refund | 933 | — | 1,400 |
| Changes in: | | | |
| Deferred tax expense (benefit) | 96 | 973 | (61) |
| Prepaid FDIC assessment | 1,187 | 272 | 647 |
| Bank-owned life insurance | (477) | (510) | (496) |
| Federal income tax receivable | 667 | (1,719) | — |
| Other assets and liabilities | 542 | 697 | 339 |
| Net cash flow (deficit) from operating activities | <u>\$ 26,900</u> | <u>\$ (14,911)</u> | <u>\$ 8,256</u> |

Key variations stem from: 1) Provision for loan losses decreased by \$2.4 million in 2013 from 2012. \$1.9 million of the provision in 2012 related to the charge-off of a single credit. 2) Gains were recognized on the sale, call or maturity of investments of \$535,000 compared to \$14,000 in the same period of 2012 due in part to odd-lot security sales. 3) Impairment losses of \$171,000 were recognized in 2012 with \$1,954,000 being recognized in 2013. The losses in 2013 were due to regulatory changes mandated by the Volcker Rule. 4) In 2013, a refund of \$933,000 was received from the IRS with a resulting decrease in federal income tax receivable. 5) Loans held for sale decreased by \$24.1 million in 2013 compared to an increase of \$23.8 million in 2012 due to the impact of interest rates on activity of mortgage banking and the exit from wholesale operations in September 2013. 6) Included in the \$1.2 million change in the FDIC assessment is a refund of \$1.1 million. 7) A purchase of trading securities was made in 2013 for \$7.0 million. Refer to the Consolidated Statements of Cash Flows in item 8 for a summary of the sources and uses of cash for 2013, 2012 and 2011.

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 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.

| | See Note | (Amounts in thousands) | | | | |
|---|---------------------|------------------------|------------------------|--------------------|--------|-----------|
| | | December 31, 2013 | | | | |
| | | Payments Due in: | | | | |
| | One Year or Less | One to Three Years | Three to Five Years | Over Five Years | Total | |
| Non-interest bearing deposits | | \$ 89,905 | \$ — | \$ — | \$ — | \$ 89,905 |
| Interest bearing deposits(a) | 5 | 226,803 | — | — | — | 226,803 |
| Average rate (b) | | 0.12% | | | | 0.12% |
| Certificates of deposit (a) | 5 | 73,739 | 24,134 | 7,684 | 26,404 | 131,961 |
| Average rate (b) | | 0.50% | 1.35% | 2.43% | 2.75% | 1.22% |
| Federal funds purchased and security repurchase agreements (a) | 6 | 3,804 | — | — | — | 3,804 |
| Average rate (b) | | 0.60% | | | | 0.60% |
| FHLB advances (a) | 6 | 20,600 | 6,000 | 16,000 | — | 42,600 |
| Average rate (b) | | 1.50% | 3.31% | 4.12% | —% | 2.74% |
| Subordinated debt | 7 | — | — | — | 5,155 | 5,155 |
| Average rate (b) | | | | | 1.69% | 1.69% |
| Operating leases | 8 | 185 | 278 | 195 | 44 | 702 |

(a) Excludes present and future accrued interest.

(b) Variable-rate obligations reflect interest rates in effect at December 31, 2013.

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, 2013 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.

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

| | (Amounts in thousands) | | | | |
|--|------------------------|--------------------------|---------------------------|--------------------|-----------|
| | December 31, 2013 | | | | |
| | 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) | \$ 19,091 | \$ 4,927 | \$ 2,687 | \$ 19,339 | \$ 46,044 |
| Residential real estate | — | — | — | 4,227 | 4,227 |
| Revolving home equity | 15,434 | — | — | — | 15,434 |
| Overdraft protection | 9,678 | — | — | — | 9,678 |
| Other | 712 | — | — | — | 712 |
| Standby letters of credit | 607 | 63 | — | — | 670 |
| Mortgage banking derivative commitments: | | | | | |
| Interest rate lock commitments | \$ 1,297 | \$ — | \$ — | \$ — | \$ 1,297 |
| Forward contracts for the future delivery of mortgage loans... | 1,953 | — | — | — | 1,953 |

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.

The FFIEC determines the risk weightings 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. Following these guidelines 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 are lower than otherwise would be. As a result of investment downgrades by the rating agencies, all of the 12 trust preferred securities were rated as “highly speculative grade” debt securities. As a consequence, the Bank is required to maintain higher levels of regulatory risk-based capital for these securities due to the greater perceived risk of default by the underlying bank and insurance company issuers. Specifically, regulatory guidance requires the Bank to apply a higher “risk weighting formula” for these securities to calculate its regulatory capital ratios. The result of that calculation increases the Bank’s risk-weighted assets for these securities to \$45.7 million, well above the \$11.9 million in amortized cost of these securities as of December 31, 2013, thereby significantly diluting the risk-based capital ratios by approximately 1.26% for December 31, 2013 compared to 1.58% for December 31, 2012.

Regardless of the trust preferred securities risk weighting, the Company met all capital adequacy requirements to which it was subject as of December 31, 2013 and December 31, 2012, as supported by the data in the following table. As of those dates, the Company met the capital requirements to be deemed “well capitalized” under regulatory prompt corrective action provisions.

| | Actual Regulatory Capital Ratios as of: | | Regulatory Capital Ratio requirements to be: | |
|---|---|-------------------|--|------------------------|
| | December 31, 2013 | December 31, 2012 | Well Capitalized | Adequately Capitalized |
| Total risk-based capital to risk-weighted assets..... | 14.19% | 14.10% | 10.00% | 8.00% |
| Tier I capital to risk-weighted assets..... | 13.26% | 13.15% | 6.00% | 4.00% |
| Tier I capital to average assets..... | 10.35% | 9.63% | 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, 2013 and December 31, 2012. Management considers these excesses to be adequate with regard to the risks inherent in the balance sheet.

| | (Amounts in thousands) | |
|---|------------------------|-------------------|
| | December 31, | |
| | 2013 | 2012 |
| Tier 1 Capital | \$ 54,927 | \$ 53,996 |
| Tier 2 Capital | 3,847 | 3,909 |
| QUALIFYING CAPITAL | <u>\$ 58,774</u> | <u>\$ 57,905</u> |
| Risk-Adjusted Total Assets (*) | <u>\$ 414,230</u> | <u>\$ 410,773</u> |
| Tier 1 Risk- Based Capital Excess | \$ 30,073 | \$ 29,350 |
| Total Risk- Based Capital Excess | 17,351 | 16,828 |
| Total Leverage Capital Excess | 27,883 | 25,966 |

(*) Includes off-balance sheet exposures

Total assets for leverage capital purposes is calculated as average assets less disallowed deferred tax assets and the net unrealized market value adjustment of investment securities available-for-sale, which averaged \$530.9 million and \$560.6 million for the quarters ended December 31, 2013 and December 31, 2012, 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.

In early September 2013, the regulatory bodies substantially revised the capital requirements for all banks, varying with the size of the institution. The new requirements are to be phased in over four years beginning in 2015. The Company is awaiting further clarification and interpretation of the rules before it can assess the future effect on capital.

Additional information regarding regulatory matters can be found in Item 8, Note 13 to the Consolidated Financial Statements.

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, 2013. 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 (and 100 basis points lower) than the rates in effect at December 31, 2013. Because rates on the short end of the curve are below 3%, it is not practical to review results to the degree of 300 basis points lower. Under both the rising rate scenario and the falling rate scenario, the yield curve is assumed to exhibit a parallel shift.

During 2013, the Federal Reserve kept its target rate for overnight federal funds constant. At December 31, 2013, the difference between the yield on the ten-year Treasury and the three-month Treasury had increased to a positive 297 from the positive 173 basis points that existed at December 31, 2012, indicating that the yield curve had become more steeply upward sloping. At December 31, 2013, 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 \$18.1 million for the year ending December 31, 2014.

| | (Amounts in thousands) | | |
|---|------------------------|-----------|----------|
| | December 31, 2014 | | |
| | Net Interest Income | \$ Change | % Change |
| Change in interest rates: | | | |
| Graduated increase of +300 basis points | \$ 19,198 | \$ 1,109 | 6.1 % |
| Short-term rates unchanged (base case)..... | 18,089 | | |
| Graduated decrease of -100 basis points..... | 17,319 | (770) | (4.3)% |

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 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 included in this Annual Report:

| | |
|--|-------|
| Management's Annual Report on Internal Control Over Financial Reporting | 52 |
| Report of Independent Registered Public Accounting Firm | 53 |
| Consolidated Balance Sheets as of December 31, 2013 and 2012..... | 54 |
| Consolidated Statements of Income for the Years Ended December 31, 2013, 2012 and 2011 | 55 |
| Consolidated Statements of Comprehensive Income for the Years Ended December 31, 2013, 2012 and 2011 | 56 |
| Consolidated Statements of Shareholders' Equity for the Years Ended December 31, 2013, 2012 and 2011 | 57 |
| Consolidated Statements of Cash Flows for the Years Ended December 31, 2013, 2012 and 2011 | 58 |
| Notes to Consolidated Financial Statements | 59-97 |

MANAGEMENT'S ANNUAL REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING

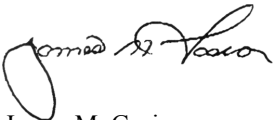
Management of the Company is responsible for establishing and maintaining adequate internal control over financial reporting as defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act. The Company's internal control over financial reporting is designed to provide reasonable assurance regarding 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. 5), 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, 2013. In making this assessment, management used the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) 1992 Internal Control-Integrated Framework. Based on this assessment, management believes that, as of December 31, 2013, the Company's internal control over financial reporting was effective.

This annual report does not include an attestation report of the Company's independent registered public accounting firm regarding internal control over financial reporting. Management's report was not subject to attestation by the Company's independent 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
(Principal Executive Officer)

Cortland, Ohio
March 28, 2014



David J. Lucido
Senior Vice President and Chief Financial Officer
(Principal Financial and Accounting Officer)

Cortland, Ohio
March 28, 2014

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 and subsidiaries as of December 31, 2013 and 2012, and the related consolidated statements of income, comprehensive income, changes in shareholders' equity and cash flows for each of the three years in the period ended December 31, 2013. These financial statements are the responsibility of the Cortland Bancorp'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. Cortland Bancorp 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 Cortland Bancorp'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 Cortland Bancorp and subsidiaries as of December 31, 2013 and 2012, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2013, in conformity with U.S. generally accepted accounting principles.



S.R. Snodgrass, P.C.
Wexford, Pennsylvania
March 28, 2014

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

| | December 31, | |
|---|-------------------|-------------------|
| | 2013 | 2012 |
| ASSETS | | |
| Cash and due from banks..... | \$ 8,271 | \$ 18,538 |
| Interest-earning deposits and other earning assets | 4,125 | 9,039 |
| Total cash and cash equivalents | 12,396 | 27,577 |
| Investment securities available-for-sale (Note 2) | 160,886 | 184,646 |
| Trading securities (Note 2) | 7,247 | — |
| Loans held for sale..... | 656 | 24,756 |
| Total loans (Note 3)..... | 346,833 | 317,282 |
| Less allowance for loan losses (Note 3) | (3,764) | (3,825) |
| Net loans | 343,069 | 313,457 |
| Premises and equipment | 6,676 | 6,565 |
| Bank-owned life insurance | 15,049 | 14,009 |
| Other assets..... | 10,939 | 11,230 |
| Total assets | \$ 556,918 | \$ 582,240 |
| LIABILITIES | | |
| Noninterest-bearing deposits | \$ 89,905 | \$ 91,675 |
| Interest-bearing deposits (Note 5) | 358,764 | 385,226 |
| Total deposits..... | 448,669 | 476,901 |
| Short-term borrowings..... | 3,804 | 4,051 |
| Federal Home Loan Bank advances - short term (Note 6) | 20,600 | 7,500 |
| Federal Home Loan Bank advances - long term (Note 6) | 22,000 | 34,500 |
| Subordinated debt (Note 7)..... | 5,155 | 5,155 |
| Other liabilities | 7,155 | 4,681 |
| Total liabilities | 507,383 | 532,788 |
| SHAREHOLDERS' EQUITY | | |
| Common stock - \$5.00 stated value - authorized 20,000,000 shares; issued 4,728,267 shares in | | |
| 2013 and 2012; outstanding shares, 4,527,849 in 2013 and 4,525,518 in 2012 (Note 1) | 23,641 | 23,641 |
| Additional paid-in capital (Note 1)..... | 20,833 | 20,850 |
| Retained earnings | 11,502 | 10,262 |
| Accumulated other comprehensive loss (Note 1)..... | (2,888) | (1,707) |
| Treasury stock, at cost, 200,418 shares in 2013 and 202,749 shares in 2012 | (3,553) | (3,594) |
| Total shareholders' equity (Note 15) | 49,535 | 49,452 |
| Total liabilities and shareholders' equity | \$ 556,918 | \$ 582,240 |

See accompanying notes to consolidated financial statements

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

| | For the year ended December 31, | | |
|---|---------------------------------|------------------------|------------------------|
| | 2013 | 2012 | 2011 |
| INTEREST INCOME | | | |
| Interest and fees on loans..... | \$ 15,993 | \$ 16,260 | \$ 15,264 |
| Interest and dividends on investment securities: | | | |
| Taxable interest | 2,498 | 3,174 | 4,241 |
| Nontaxable interest | 1,408 | 1,411 | 1,421 |
| Dividends | 131 | 139 | 133 |
| Other interest income..... | 30 | 31 | 51 |
| Total interest income | <u>20,060</u> | <u>21,015</u> | <u>21,110</u> |
| INTEREST EXPENSE | | | |
| Deposits | 2,102 | 2,698 | 3,293 |
| Other short-term borrowings | 3 | 5 | 5 |
| Federal Home Loan Bank advances - short term..... | 135 | 79 | 95 |
| Federal Home Loan Bank advances - long term | 1,074 | 1,189 | 1,247 |
| Subordinated debt | 90 | 100 | 92 |
| Total interest expense | <u>3,404</u> | <u>4,071</u> | <u>4,732</u> |
| Net interest income | <u>16,656</u> | <u>16,944</u> | <u>16,378</u> |
| PROVISION FOR LOAN LOSSES (Note 3) | 650 | 3,020 | 1,196 |
| NET INTEREST INCOME AFTER PROVISION FOR LOAN LOSSES. | <u>16,006</u> | <u>13,924</u> | <u>15,182</u> |
| NON-INTEREST INCOME | | | |
| Fees for customer services | 1,935 | 2,041 | 2,229 |
| Investment securities gains - net..... | 535 | 14 | 882 |
| Impairment losses on investment securities: | | | |
| Total other-than-temporary impairment gains (losses) | 1,641 | (35) | (141) |
| Portion of gains recognized in other comprehensive income (before tax) .. | <u>(3,595)</u> | <u>(136)</u> | <u>(61)</u> |
| Net impairment losses recognized in earnings..... | <u>(1,954)</u> | <u>(171)</u> | <u>(202)</u> |
| Mortgage banking gains..... | 1,491 | 1,772 | 162 |
| Other real estate losses - net | (25) | (35) | (113) |
| Earnings on bank-owned life insurance..... | 477 | 510 | 496 |
| Other non-interest income | 439 | 188 | 104 |
| Total non-interest income | <u>2,898</u> | <u>4,319</u> | <u>3,558</u> |
| NON-INTEREST EXPENSES | | | |
| Salaries and employee benefits..... | 9,844 | 8,706 | 7,366 |
| Net occupancy and equipment expense..... | 1,896 | 1,794 | 1,734 |
| State and local taxes..... | 555 | 497 | 465 |
| FDIC insurance expense | 391 | 297 | 673 |
| Professional fees | 806 | 801 | 761 |
| Loss on partnership..... | — | 444 | — |
| Other operating expenses..... | 3,540 | 2,949 | 2,476 |
| Total non-interest expenses..... | <u>17,032</u> | <u>15,488</u> | <u>13,475</u> |
| INCOME BEFORE FEDERAL INCOME TAX EXPENSE (BENEFIT) | 1,872 | 2,755 | 5,265 |
| Federal income tax expense (benefit) (Note 10)..... | 88 | (158) | 1,193 |
| NET INCOME | <u>\$ 1,784</u> | <u>\$ 2,913</u> | <u>\$ 4,072</u> |
| EARNINGS PER SHARE, BOTH BASIC AND DILUTED (Note 1)..... | \$ 0.39 | \$ 0.64 | \$ 0.90 |
| CASH DIVIDENDS DECLARED PER SHARE | \$ 0.12 | \$ 0.03 | \$ — |

See accompanying notes to consolidated financial statements

CORTLAND BANCORP AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
(Amounts in thousands)

| | For the year ended December 31, | | |
|--|---------------------------------|----------|----------|
| | 2013 | 2012 | 2011 |
| Net income | \$ 1,784 | \$ 2,913 | \$ 4,072 |
| Other comprehensive (loss) income: | | | |
| Securities available for sale: | | | |
| Unrealized holding (gains) losses on available-for-sale securities | (3,166) | 1,292 | 370 |
| Tax effect | 1,076 | (439) | (126) |
| Reclassification adjustment for other-than-temporary impairment losses on debt securities | 1,954 | 171 | 202 |
| Tax effect | (664) | (58) | (69) |
| Reclassification adjustment for net gains realized in net income | (535) | (14) | (882) |
| Tax effect | 182 | 4 | 300 |
| Total securities available for sale | (1,153) | 956 | (205) |
| Change in post-retirement obligations | (28) | — | — |
| Total other comprehensive (loss) income..... | (1,181) | 956 | (205) |
| Total comprehensive income | \$ 603 | \$ 3,869 | \$ 3,867 |

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 Gain (Loss) | Treasury Stock | Total Shareholders' Equity |
|---|------------------|--------------------------------|----------------------|--|-------------------|-------------------------------|
| Balance at December 31, 2010 | \$ 23,641 | \$ 20,850 | \$ 3,413 | \$ (2,458) | \$ (3,594) | \$ 41,852 |
| Net income | — | — | 4,072 | — | — | 4,072 |
| Other comprehensive loss, net of tax | — | — | — | (205) | — | (205) |
| Balance at December 31, 2011 | 23,641 | 20,850 | 7,485 | (2,663) | (3,594) | 45,719 |
| Net income | — | — | 2,913 | — | — | 2,913 |
| Other comprehensive income, net of tax | — | — | — | 956 | — | 956 |
| Cash dividend declared (\$0.03 per share) | — | — | (136) | — | — | (136) |
| Balance at December 31, 2012 | 23,641 | 20,850 | 10,262 | (1,707) | (3,594) | 49,452 |
| Net income | — | — | 1,784 | — | — | 1,784 |
| Other comprehensive loss, net of tax | — | — | — | (1,181) | — | (1,181) |
| Cash dividend declared (\$0.12 per share) | — | — | (544) | — | — | (544) |
| Treasury shares reissued (2,333 shares) | — | (17) | — | — | 41 | 24 |
| Balance at December 31, 2013 | <u>\$ 23,641</u> | <u>\$ 20,833</u> | <u>\$ 11,502</u> | <u>\$ (2,888)</u> | <u>\$ (3,553)</u> | <u>\$ 49,535</u> |

See accompanying notes to consolidated financial statements

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

| | For the year ended December 31, | | |
|--|---------------------------------|------------------|------------------|
| | 2013 | 2012 | 2011 |
| Net cash flow (deficit) from operating activities | | | |
| Net income | \$ 1,784 | \$ 2,913 | \$ 4,072 |
| Adjustments to reconcile net income to net cash flows (deficit) from operating activities: | | | |
| Depreciation, amortization and accretion..... | 3,221 | 3,060 | 2,411 |
| Provision for loan loss..... | 650 | 3,020 | 1,196 |
| Deferred tax expense (benefit)..... | 96 | 973 | (61) |
| Investment securities gains..... | (535) | (14) | (882) |
| Impairment losses on investment securities..... | 1,954 | 171 | 202 |
| Other real estate losses..... | 25 | 35 | 113 |
| Originations of mortgage loans held for sale..... | (249,714) | (244,112) | (5,410) |
| Proceeds from the sale of mortgage loans..... | 275,305 | 222,075 | 4,887 |
| Net mortgage banking income..... | (1,491) | (1,772) | (162) |
| Increase in trading account..... | (7,247) | — | — |
| Earnings on bank-owned life insurance..... | (477) | (510) | (496) |
| Proceeds from IRS refund..... | 933 | — | 1,400 |
| Changes in: | | | |
| Interest receivable..... | 90 | 154 | 205 |
| Interest payable..... | (69) | (81) | (94) |
| Prepaid FDIC assessment..... | 1,187 | 272 | 647 |
| Federal income tax receivable..... | 667 | (1,719) | — |
| Other assets and liabilities..... | 521 | 624 | 228 |
| Net cash flow (deficit) from operating activities..... | <u>26,900</u> | <u>(14,911)</u> | <u>8,256</u> |
| Cash deficit from investing activities | | | |
| Purchases of available-for-sale securities..... | (50,377) | (71,540) | (57,746) |
| Proceeds from sale of securities..... | 29,338 | 24,796 | 14,458 |
| Proceeds from call, maturity and principal payments on securities..... | 39,126 | 46,884 | 44,370 |
| Net increase in loans made to customers..... | (30,496) | (30,509) | (24,636) |
| Proceeds from sale of other real estate..... | 321 | 327 | 378 |
| Proceeds from sale of premise and equipment..... | 14 | — | — |
| Purchases of bank-owned life insurance..... | (714) | (694) | — |
| Purchases of premises and equipment..... | (894) | (730) | (336) |
| Net cash deficit from investing activities..... | <u>(13,682)</u> | <u>(31,466)</u> | <u>(23,512)</u> |
| Cash (deficit) flow from financing activities | | | |
| Net (decrease) increase in deposit accounts..... | (28,232) | 54,136 | 31,256 |
| Repayments of Federal Home Loan Bank advances..... | (2,500) | (1,500) | (23,500) |
| Net proceeds from Federal Home Loan Bank..... | 3,100 | 6,000 | 8,000 |
| Net decrease in short-term borrowings..... | (247) | (722) | (128) |
| Dividends paid..... | (544) | (136) | — |
| Treasury shares reissued..... | 24 | — | — |
| Net cash (deficit) flow from financing activities..... | <u>(28,399)</u> | <u>57,778</u> | <u>15,628</u> |
| Net change in cash and cash equivalents | <u>(15,181)</u> | <u>11,401</u> | <u>372</u> |
| Cash and cash equivalents | | | |
| Beginning of period..... | 27,577 | 16,176 | 15,804 |
| End of period..... | <u>\$ 12,396</u> | <u>\$ 27,577</u> | <u>\$ 16,176</u> |
| Supplemental disclosures: | | | |
| Cash paid during the period for: | | | |
| Income taxes..... | \$ — | \$ 400 | \$ 1,490 |
| Interest..... | \$ 3,473 | \$ 4,152 | \$ 4,826 |
| Transfer of loans to other real estate owned..... | \$ 234 | \$ 70 | \$ 80 |

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, The Cortland Savings and Banking Company (the Bank), CSB Mortgage Company, Inc. 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. 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 Consolidated Balance Sheet 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, but excludes the liquid portion of the securities trading account. 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. Securities classified as trading are those that management has bought principally for the purpose of selling in the near term. The Company currently has no securities classified as held-to-maturity.

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. 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 and is amortized on the level-yield method without anticipating payments, except for U.S. Government mortgage-backed and related securities where twelve months of historical prepayments are taken into consideration. Trading securities are carried at fair value with valuation adjustments included in other non-interest income.

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 available-for-sale 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). Unrealized losses on trading securities are recognized in the Consolidated Statement of Income.

CORTLAND BANCORP AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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, which means that it is probable that all amounts will not be collected according to the contractual terms of the loan agreement.

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. 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.

CORTLAND BANCORP AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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 other liabilities, while the corresponding provision for these losses is recorded as a component of other operating 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.

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 noninterest income, and are not subject to income taxes. The cash surrender 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. Advertising expense was \$240,000 in 2013, \$191,000 in 2012 and \$114,000 in 2011.

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.

CORTLAND BANCORP AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

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, | | |
|---|--------------------------|-----------|-----------|
| | 2013 | 2012 | 2011 |
| Net income (amounts in thousands)..... | \$ 1,784 | \$ 2,913 | \$ 4,072 |
| Weighted average common shares outstanding..... | 4,527,350 | 4,525,524 | 4,525,538 |
| Basic earnings per common share..... | \$ 0.39 | \$ 0.64 | \$ 0.90 |
| Diluted earnings per common share | \$ 0.39 | \$ 0.64 | \$ 0.90 |

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 2012 and 2011 have been reclassified to conform to the 2013 presentation.

Authoritative Accounting Guidance:

In February 2013, the FASB issued ASU 2013-02, *Comprehensive Income (Topic 220): Reporting of Amounts Reclassified Out of Accumulated Other Comprehensive Income*. The amendments in this update require an entity to report the effect of significant reclassifications out of accumulated other comprehensive income on the respective line items in net income if the amount being reclassified is required under U.S. generally accepted accounting principles (GAAP) to be reclassified in its entirety to net income. For other amounts that are not required under U.S. GAAP to be reclassified in their entirety to net income in the same reporting period, an entity is required to cross-reference other disclosures required under U.S. GAAP that provide additional detail about those amounts. For public entities, the amendments are effective prospectively for reporting periods beginning after December 15, 2012. For nonpublic entities, the amendments are effective prospectively for reporting periods beginning after December 15, 2013. Disclosure can be found in Note 12.

In July 2013, the FASB issued ASU 2013-10, *Derivatives and Hedging (Topic 815): Inclusion of the Fed Funds Effective Swap Rate (or Overnight Index Swap Rate) as a Benchmark Interest Rate for Hedge Accounting Purposes*. The amendments in this update permit the Fed Funds Effective Swap Rate (OIS) to be used as a U.S. benchmark interest rate for hedge accounting purposes under Topic 815, in addition to UST and LIBOR. The amendments also remove the restriction on using different benchmark rates for similar hedges. The amendments are effective prospectively for qualifying new or redesignated hedging relationships entered into on or after July 17, 2013. The Company does not expect this ASU to have a material effect on the Company's financial position or results of operations.

CORTLAND BANCORP AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

In July 2013, the FASB issued ASU 2013-11, *Income Taxes (Topic 740): Presentation of an Unrecognized Tax Benefit When a Net Operating Loss Carryforward, a Similar Tax Loss, or a Tax Credit Carryforward Exists*. This update applies to all entities that have unrecognized tax benefits when a net operating loss carryforward, a similar tax loss, or a tax credit carryforward exists at the reporting date. An unrecognized tax benefit, or a portion of an unrecognized tax benefit, should be presented in the financial statements as a reduction to a deferred tax asset for a net operating loss carryforward, a similar tax loss, or a tax credit carryforward, except as follows. To the extent a net operating loss carryforward, a similar tax loss, or a tax credit carryforward is not available at the reporting date under the tax law of the applicable jurisdiction to settle any additional income taxes that would result from the disallowance of a tax position or the tax law of the applicable jurisdiction does not require the entity to use, and the entity does not intend to use, the deferred tax asset for such purpose, the unrecognized tax benefit should be presented in the financial statements as a liability and should not be combined with deferred tax assets. The assessment of whether a deferred tax asset is available is based on the unrecognized tax benefit and deferred tax asset that exist at the reporting date and should be made presuming disallowance of the tax position at the reporting date. The amendments in this update are effective for fiscal years, and interim periods within those years, beginning after December 15, 2013. For nonpublic entities, the amendments are effective for fiscal years, and interim periods within those years, beginning after December 15, 2014. Early adoption is permitted. The amendments should be applied prospectively to all unrecognized tax benefits that exist at the effective date. Retrospective application is permitted. The Company does not expect this ASU to have a material effect on the Company's financial position or results of operations.

In January 2014, FASB issued ASU 2014-01, *Investments – Equity Method and Join Ventures (Topic 323): Accounting for Investments in Qualified Affordable Housing Projects*. The amendments in this update permit reporting entities to make an accounting policy election to account for their investments in qualified affordable housing projects using the proportional amortization method if certain conditions are met. Under the proportional amortization method, an entity amortizes the initial cost of the investment in proportion to the tax credits and other tax benefits received and recognizes the net investment performance in the income statement as a component of income tax expense (benefit). The amendments in this update should be applied retrospectively to all periods presented. A reporting entity that uses the effective yield method to account for its investments in qualified affordable housing projects before the date of adoption may continue to apply the effective yield method for those preexisting investments. The amendments in this update are effective for public business entities for annual periods and interim reporting periods within those annual periods, beginning after December 15, 2014. Early adoption is permitted. This ASU is not expected to have a significant impact on the Company's financial statements.

In January 2014, the FASB issued ASU 2014-04, *Receivables – Troubled Debt Restructurings by Creditors (Subtopic 310-40): Reclassification of Residential Real Estate Collateralized Consumer Mortgage Loans upon Foreclosure*. The amendments in this update clarify that an in substance repossession or foreclosure occurs, and a creditor is considered to have received physical possession of residential real estate property collateralizing a consumer mortgage loan, upon either (1) the creditor obtaining legal title to the residential real estate property upon completion of a foreclosure or (2) the borrower conveying all interest in the residential real estate property to the creditor to satisfy that loan through completion of a deed in lieu of foreclosure or through a similar legal agreement. Additionally, the amendments require interim and annual disclosure of both (1) the amount of foreclosed residential real estate property held by the creditor and (2) the recorded investment in consumer mortgage loans collateralized by residential real estate property that are in the process of foreclosure according to local requirements of the applicable jurisdiction. The amendments in this update are effective for public business entities for annual periods, and interim periods within those annual periods, beginning after December 15, 2014. An entity can elect to adopt the amendments in this update using either a modified retrospective transition method or a prospective transition method. This ASU is not expected to have a significant impact on the Company's financial statements.

CORTLAND BANCORP AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 2 - INVESTMENT SECURITIES

The following is a summary of investment securities:

| | (Amounts in thousands) | | | Fair Value |
|--|------------------------|------------------------------|-------------------------------|-------------------|
| | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | |
| December 31, 2013 | | | | |
| U.S. Treasury securities | \$ 107 | \$ 5 | \$ — | \$ 112 |
| U.S. Government agencies and corporations | 9,259 | — | 312 | 8,947 |
| Obligations of states and political subdivisions | 44,575 | 467 | 1,507 | 43,535 |
| U.S. Government-sponsored mortgage-backed securities | 79,255 | 644 | 1,877 | 78,022 |
| U.S. Government-sponsored collateralized mortgage obligations .. | 17,120 | 105 | 140 | 17,085 |
| Trust preferred securities | 11,854 | — | 1,718 | 10,136 |
| Total debt securities | <u>162,170</u> | <u>1,221</u> | <u>5,554</u> | <u>157,837</u> |
| Federal Home Loan Bank (FHLB) stock | 2,823 | — | — | 2,823 |
| Federal Reserve Bank (FRB) stock | 226 | — | — | 226 |
| Total regulatory stock | <u>3,049</u> | <u>—</u> | <u>—</u> | <u>3,049</u> |
| Total investment securities available-for-sale | <u>\$ 165,219</u> | <u>\$ 1,221</u> | <u>\$ 5,554</u> | <u>\$ 160,886</u> |
| | | | | |
| | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value |
| December 31, 2012 | | | | |
| U.S. Treasury securities | \$ 113 | \$ 10 | \$ — | \$ 123 |
| U.S. Government agencies and corporations | 8,038 | 27 | — | 8,065 |
| Obligations of states and political subdivisions | 40,374 | 1,973 | 31 | 42,316 |
| U.S. Government-sponsored mortgage-backed securities | 90,858 | 2,071 | 590 | 92,339 |
| U.S. Government-sponsored collateralized mortgage obligations .. | 30,917 | 300 | 75 | 31,142 |
| Trust preferred securities | 13,883 | — | 6,271 | 7,612 |
| Total debt securities | <u>184,183</u> | <u>4,381</u> | <u>6,967</u> | <u>181,597</u> |
| Federal Home Loan Bank (FHLB) stock | 2,823 | — | — | 2,823 |
| Federal Reserve Bank (FRB) stock | 226 | — | — | 226 |
| Total regulatory stock | <u>3,049</u> | <u>—</u> | <u>—</u> | <u>3,049</u> |
| Total investment securities available-for-sale | <u>\$ 187,232</u> | <u>\$ 4,381</u> | <u>\$ 6,967</u> | <u>\$ 184,646</u> |

The regulatory stock 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 of Cincinnati and the FRB.

The Bank is required to maintain a minimum investment in stock of the FHLB and FRB. The stock is bought from and sold based upon its 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 and FRB as compared to the capital stock amount and the length of time this situation has persisted, (b) commitments by the FHLB and FRB 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 FRB and (d) the liquidity position of the FHLB and FRB.

Held at December 31, 2013, trading securities of \$7.2 million are an investment in obligations of states and political subdivisions and include cash equivalent investments for trading liquidity. None were held at December 31, 2012. Unrealized gains and losses on trading securities at December 31, 2013 were \$51,800 and \$3,200, respectively. Total net unrealized gains of \$48,600 as of December 31, 2013 are included in the Consolidated Statement of Income.

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The amortized cost and fair value of debt securities at December 31, 2013, by contractual maturity, are shown below. Actual maturities will differ from contractual maturities because issuers may have the right to call or prepay obligations with or without call or prepayment penalties.

| | (Amounts in thousands) | |
|--|------------------------|-------------------|
| | <u>Amortized Cost</u> | <u>Fair Value</u> |
| Due in one year or less | \$ 130 | \$ 133 |
| Due after one year through five years | 3,520 | 3,566 |
| Due after five years through ten years | 14,880 | 14,660 |
| Due after ten years | 47,265 | 44,371 |
| Total | <u>65,795</u> | <u>62,730</u> |
| U.S. Government-sponsored mortgage-backed and related securities | 96,375 | 95,107 |
| Total debt securities | <u>\$ 162,170</u> | <u>\$ 157,837</u> |

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

| | (Amounts in thousands) | | |
|--|------------------------|-----------|-----------|
| | 2013 | 2012 | 2011 |
| Proceeds on securities sold | \$ 29,338 | \$ 24,796 | \$ 14,458 |
| Gross realized gains | 658 | 1,168 | 562 |
| Gross realized losses | 123 | 1,188 | 33 |
| Proceeds on securities called | \$ 7,153 | \$ 2,537 | \$ 1,939 |
| Gross realized gains | — | 8 | 9 |
| Gross realized losses | — | 4 | — |
| Exchange on General Motors securities: | | | |
| Gross realized gains | \$ — | \$ 30 | \$ 344 |

Investment securities with a carrying value of approximately \$108.5 million at December 31, 2013 and \$107.6 million at December 31, 2012 were pledged to secure deposits and for other purposes. The remaining securities provide an adequate level of liquidity.

The following is a summary of the fair value of securities with unrealized losses and an aging of those unrealized losses at December 31, 2013:

| | (Amounts in thousands) | | | | | |
|---|------------------------|--------------------------|-------------------|--------------------------|-------------------|--------------------------|
| | Less than 12 Months | | 12 Months or More | | Total | |
| | <u>Fair Value</u> | <u>Unrealized Losses</u> | <u>Fair Value</u> | <u>Unrealized Losses</u> | <u>Fair Value</u> | <u>Unrealized Losses</u> |
| U.S. Government agencies and corporations | \$ 7,144 | \$ 129 | \$ 1,803 | \$ 183 | \$ 8,947 | \$ 312 |
| Obligations of states and political subdivisions | 19,785 | 1,142 | 1,883 | 365 | 21,668 | 1,507 |
| U.S. Government-sponsored mortgage-backed securities | 34,424 | 1,044 | 29,922 | 833 | 64,346 | 1,877 |
| U.S. Government-sponsored collateralized mortgage obligations | 6,575 | 126 | 2,095 | 14 | 8,670 | 140 |
| Trust preferred securities | — | — | 1,633 | 1,718 | 1,633 | 1,718 |
| Total | <u>\$ 67,928</u> | <u>\$ 2,441</u> | <u>\$ 37,336</u> | <u>\$ 3,113</u> | <u>\$ 105,264</u> | <u>\$ 5,554</u> |

The above table represents 83 investment securities where the fair value is less than the related amortized cost.

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The following is a summary of the fair value of securities with unrealized losses and an aging of those unrealized losses at December 31, 2012:

| | (Amounts in thousands) | | | | | |
|---|------------------------|-------------------|-------------------|-------------------|------------------|-------------------|
| | Less than 12 Months | | 12 Months or More | | Total | |
| | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses |
| Obligations of states and political subdivisions | \$ 4,176 | \$ 31 | \$ — | \$ — | \$ 4,176 | \$ 31 |
| U.S. Government-sponsored mortgage-backed securities | — | — | 47,358 | 590 | 47,358 | 590 |
| U.S. Government-sponsored collateralized mortgage obligations | — | — | 4,825 | 75 | 4,825 | 75 |
| Trust preferred securities | — | — | 7,612 | 6,271 | 7,612 | 6,271 |
| Total | <u>\$ 4,176</u> | <u>\$ 31</u> | <u>\$ 59,795</u> | <u>\$ 6,936</u> | <u>\$ 63,971</u> | <u>\$ 6,967</u> |

The above table represents 46 investment securities where the current value is less than the related amortized cost.

The trust preferred securities with an unrealized loss represent pools of trust preferred debt primarily issued by bank holding companies. The unrealized losses on the Company's investment in U.S. Government-sponsored-mortgage-backed securities, U.S. Government-sponsored collateralized mortgage obligations, obligations of states and political subdivisions and U.S. Government agencies and corporations 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 fair value is attributable to changes in interest rates and relative spreads and not credit quality. Also, except for the securities described below, 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 these investments to be other-than-temporarily impaired at December 31, 2013.

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.

For debt securities in an unrealized loss position, management assesses 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), the Company presents the amount of the OTTI recognized in the Consolidated Statement of Income.

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. The total other-than-temporary impairment is presented in the Consolidated Statement of Income with an offset for the amount of the total other-than-temporary impairment that is recognized in other comprehensive income.

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 discussed in the following table were other-than-temporarily impaired at December 31, 2013, 2012 and 2011.

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The Company records impairment credit losses in earnings (before tax) and non-credit impairment losses in other comprehensive income (loss) (before tax) as indicated in the following table:

| | (Amounts in thousands) | | |
|---|------------------------|--------|--------|
| | December 31, | | |
| | 2013 | 2012 | 2011 |
| Trust preferred securities: | | | |
| Net impairment losses recognized in earnings (before tax) | \$ 1,954 | \$ 171 | \$ 202 |
| Impairment gains recognized in other comprehensive income (before tax) | \$ 3,595 | \$ 136 | \$ 61 |

The following provides a cumulative roll forward of credit losses recognized in earnings for trust preferred securities held for the years ended:

| | (Amounts in thousands) | | |
|---|------------------------|---------------|------------------|
| | December 31, | | |
| | 2013 | 2012 | 2011 |
| Beginning balance | \$ 351 | \$ 10,674 | \$ 10,472 |
| Reduction for debt securities for which other-than-temporary impairment has been previously recognized and there is no related other comprehensive income | — | — | — |
| Credit losses on debt securities for which other-than-temporary impairment has not been previously recognized | 1,954 | — | — |
| Additional credit losses on debt securities for which other-than- temporary impairment was previously recognized | — | 171 | 202 |
| Sale of debt securities | — | (10,494) | — |
| Ending balance | <u>\$ 2,305</u> | <u>\$ 351</u> | <u>\$ 10,674</u> |

In January 2014, the Company determined that its portfolio of insurance trust preferred collateralized debt obligations, commonly known as iTruPS securities, are considered disallowed investments under the final rule implementing Section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, commonly referred to as the Volcker Rule, which was originally released jointly by five regulatory agencies on December 10, 2013, and further clarified with the release of the Interim Final Rule on January 14, 2014. The final rule requires banking entities to divest disallowed securities by July 21, 2015, unless, upon application, the Federal Reserve grants extensions to July 21, 2017.

With the release of the Interim Final Rule on January 14, 2014, the joint agencies granted relief by permitting financial institutions to retain their interests in certain collateralized debt obligations, but limited that provision to those collateralized by issuances prior to May 2010 from bank or thrift holding companies with less than \$15 billion in consolidated assets. The Interim Final Rule did not contain a provision for issuances by insurance companies, which comprise the various iTruPS securities owned by the Company.

The disallowed iTruPS consist of nine positions with an amortized cost of \$10.5 million. Because the Company can no longer hold the securities until their anticipated recovery, an OTTI must be recognized for the entire amount of unrealized loss as of December 31, 2013. The fair value of the iTruPS as determined by the discounted cash flow model used by the Company aggregated to \$8.5 million. The resulting OTTI charge of approximately \$2.0 million is included in the above table in 2013.

In February 2014, the Company completed the sale of all nine of the disallowed investments along with one other permissible holding. Proceeds of the \$10.2 million were received on an amortized cost of \$10.0 million resulting in a pre-tax gain of approximately \$200,000.

During the third quarter of 2012, the Company explored the possible sale of the trust preferred securities collateralized by banks through various brokerage firms. With the lack of an active market for these securities, the brokers sought bids individually for the securities from potential buyers in their client base. Through this process, the Company sold 19 of the 22 bank collateralized positions realizing a nominal net loss of \$164,000. All of these securities exhibited evidence of significant deterioration in issuers' creditworthiness. The three remaining bank collateralized positions, as well as the 9 positions collateralized by insurance companies, have historically not exhibited material other-than-temporary impairment, thus were excluded from sale considerations. Also during the third quarter of 2012, the Company disposed of the two remaining private-label mortgage-backed securities, thereby eliminating all future risk and uncertainty relating to this investment category. A net loss of \$288,000 was realized on the sale of these securities.

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In April 2011, as approved by the U.S. Bankruptcy court, unsecured bondholders of General Motors Corporation (GM) began receiving 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 by \$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 and 2,401 shares of Motors Liquidation Company GUC Trust in several distributions during 2011 and 2012. On November 29, 2012, the Company elected to sell all of its shares of GM common stock, all shares of GM Class A and Class B Warrants and all shares of Motors Liquidation Company GUC Trust. The Company realized a net loss of \$139,000 on this transaction. The Company still holds escrow stubs representing any remaining distributions from the bankruptcy trust.

At December 31, 2013, there was \$1.2 million of investment securities considered to be in non-accrual status. This balance is comprised of 2 of its 12 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 Northeastern Ohio and Western Pennsylvania.

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

| | (Amounts in thousands) | | | |
|-------------------------------|------------------------|------|-------------------|------|
| | December 31, | | | |
| | 2013 | | 2012 | |
| | Balance | % | Balance | % |
| Commercial | \$ 73,643 | 21.2 | \$ 62,312 | 19.6 |
| Commercial real estate | 206,744 | 59.6 | 193,417 | 61.1 |
| Residential real estate | 42,288 | 12.2 | 39,091 | 12.3 |
| Consumer - home equity | 19,510 | 5.6 | 17,910 | 5.6 |
| Consumer - other | 4,648 | 1.4 | 4,552 | 1.4 |
| Total loans | <u>\$ 346,833</u> | | <u>\$ 317,282</u> | |

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

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

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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 | Decreasing |
| Declining trends in financial performance..... | Increasing |
| Structure and lack of performance measures | Increasing |
| Migration between risk categories | Decreasing |

The provision charged to operations can be allocated to a loan segment either as a positive or negative value as a result of any material changes to: net charge-offs or recovery, risk factors or loan balances.

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

| | (Amounts in thousands) | | | | | |
|---------------------------------------|------------------------|---------------------------|----------------------------|------------------------------|---------------------|-----------------|
| | Commercial | Commercial real estate | Residential real estate | Consumer - home equity | Consumer - other | Total |
| December 31, 2013 | | | | | | |
| Balance at beginning of period | \$ 639 | \$ 2,616 | \$ 343 | \$ 123 | \$ 104 | \$ 3,825 |
| Loan charge-offs | (1) | (782) | (81) | (12) | (146) | (1,022) |
| Recoveries | 167 | 11 | 26 | 18 | 89 | 311 |
| Net loan charge-offs | 166 | (771) | (55) | 6 | (57) | (711) |
| Provision charged to operations | (212) | 793 | 68 | (41) | 42 | 650 |
| Balance at end of period | <u>\$ 593</u> | <u>\$ 2,638</u> | <u>\$ 356</u> | <u>\$ 88</u> | <u>\$ 89</u> | <u>\$ 3,764</u> |
| December 31, 2012 | | | | | | |
| Balance at beginning of period | \$ 565 | \$ 1,803 | \$ 470 | \$ 128 | \$ 92 | \$ 3,058 |
| Loan charge-offs | (1,937) | (36) | (231) | (59) | (152) | (2,415) |
| Recoveries | 9 | 37 | 46 | 13 | 57 | 162 |
| Net loan charge-offs | (1,928) | 1 | (185) | (46) | (95) | (2,253) |
| Provision charged to operations | 2,002 | 812 | 58 | 41 | 107 | 3,020 |
| Balance at end of period | <u>\$ 639</u> | <u>\$ 2,616</u> | <u>\$ 343</u> | <u>\$ 123</u> | <u>\$ 104</u> | <u>\$ 3,825</u> |
| December 31, 2011 | | | | | | |
| Balance at beginning of period | \$ 249 | \$ 1,611 | \$ 418 | \$ 111 | \$ 112 | \$ 2,501 |
| Loan charge-offs | — | (211) | (362) | (91) | (168) | (832) |
| Recoveries | 3 | 118 | 6 | 6 | 60 | 193 |
| Net loan charge-offs | 3 | (93) | (356) | (85) | (108) | (639) |
| Provision charged to operations | 313 | 285 | 408 | 102 | 88 | 1,196 |
| Balance at end of period | <u>\$ 565</u> | <u>\$ 1,803</u> | <u>\$ 470</u> | <u>\$ 128</u> | <u>\$ 92</u> | <u>\$ 3,058</u> |

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

CORTLAND BANCORP AND SUBSIDIARIES
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The following tables present a full breakdown by portfolio segment, the changes in the allowance for loan losses and the recorded investment in loans for the periods ended December 31, 2013 and 2012:

| | (Amounts in thousands) | | | | | |
|---|------------------------|---------------------------|----------------------------|------------------------------|---------------------|-------------------|
| December 31, 2013 | Commercial | Commercial real estate | Residential real estate | Consumer - home equity | Consumer - other | Total |
| Allowance for loan losses: | | | | | | |
| Ending allowance balance attributable to loans: | | | | | | |
| Individually evaluated for impairment | \$ 50 | \$ 251 | \$ — | \$ — | \$ — | \$ 301 |
| Collectively evaluated for impairment | 543 | 2,387 | 356 | 88 | 89 | 3,463 |
| Total ending allowance balance | <u>\$ 593</u> | <u>\$ 2,638</u> | <u>\$ 356</u> | <u>\$ 88</u> | <u>\$ 89</u> | <u>\$ 3,764</u> |
| Loan Portfolio: | | | | | | |
| Individually evaluated for impairment | \$ 418 | \$ 5,134 | \$ — | \$ — | \$ — | \$ 5,552 |
| Collectively evaluated for impairment | 73,225 | 201,610 | 42,288 | 19,510 | 4,648 | 341,281 |
| Total ending loans balance | <u>\$ 73,643</u> | <u>\$ 206,744</u> | <u>\$ 42,288</u> | <u>\$ 19,510</u> | <u>\$ 4,648</u> | <u>\$ 346,833</u> |
| | | | | | | |
| December 31, 2012 | Commercial | Commercial real estate | Residential real estate | Consumer - home equity | Consumer - other | Total |
| Allowance for loan losses: | | | | | | |
| Ending allowance balance attributable to loans: | | | | | | |
| Individually evaluated for impairment | \$ 49 | \$ 423 | \$ — | \$ — | \$ — | \$ 472 |
| Collectively evaluated for impairment | 590 | 2,193 | 343 | 123 | 104 | 3,353 |
| Total ending allowance balance | <u>\$ 639</u> | <u>\$ 2,616</u> | <u>\$ 343</u> | <u>\$ 123</u> | <u>\$ 104</u> | <u>\$ 3,825</u> |
| Loan Portfolio: | | | | | | |
| Individually evaluated for impairment | \$ 49 | \$ 5,031 | \$ — | \$ — | \$ — | \$ 5,080 |
| Collectively evaluated for impairment | 62,263 | 188,386 | 39,091 | 17,910 | 4,552 | 312,202 |
| Total ending loans balance | <u>\$ 62,312</u> | <u>\$ 193,417</u> | <u>\$ 39,091</u> | <u>\$ 17,910</u> | <u>\$ 4,552</u> | <u>\$ 317,282</u> |

The following tables represent credit exposures by internally assigned grades for years ended December 31, 2013 and 2012, 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.

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The following is a summary of credit quality indicators by internally assigned grade as of December 31, 2013 and 2012.

| (Amounts in thousands) | | |
|------------------------|------------|---------------------------|
| | Commercial | Commercial real estate |
| December 31, 2013 | | |
| Pass | \$ 72,562 | \$ 192,604 |
| Special Mention..... | 626 | 9,158 |
| Substandard | 455 | 4,982 |
| Doubtful..... | — | — |
| Ending Balance..... | \$ 73,643 | \$ 206,744 |
| | | |
| December 31, 2012 | | |
| Pass | \$ 60,387 | \$ 175,367 |
| Special Mention..... | 1,182 | 11,135 |
| Substandard | 743 | 6,915 |
| Doubtful..... | — | — |
| Ending Balance..... | \$ 62,312 | \$ 193,417 |

The Company evaluates the classification of consumer, home equity and residential loans primarily on a pooled basis. If the Company 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.

The following is a summary of consumer credit exposure as of December 31, 2013 and 2012.

| (Amounts in thousands) | | | |
|------------------------|----------------------------|---------------------------|--------------------|
| | Residential real estate | Consumer - home equity | Consumer- other |
| December 31, 2013 | | | |
| Performing..... | \$ 41,807 | \$ 19,438 | \$ 4,632 |
| Nonperforming..... | 481 | 72 | 16 |
| Total..... | \$ 42,288 | \$ 19,510 | \$ 4,648 |
| | | | |
| December 31, 2012 | | | |
| Performing..... | \$ 38,602 | \$ 17,838 | \$ 4,525 |
| Nonperforming..... | 489 | 72 | 27 |
| Total..... | \$ 39,091 | \$ 17,910 | \$ 4,552 |

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

CORTLAND BANCORP AND SUBSIDIARIES
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Troubled Debt Restructuring

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

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

| (Amounts in thousands) | | | | |
|-------------------------------|------------------------|--|---|------------------------------|
| December 31, 2013 | | | | |
| | Number of contracts | Pre- modification recorded investment | Post- modification recorded investment | Increase in the allowance |
| Commercial..... | 5 | \$ 438 | \$ 438 | \$ 20 |
| Commercial real estate..... | 7 | 2,348 | 2,348 | — |
| Total restructured loans..... | <u>12</u> | <u>\$ 2,786</u> | <u>\$ 2,786</u> | <u>\$ 20</u> |
| Subsequently defaulted..... | <u>—</u> | <u>\$ —</u> | | |
| December 31, 2012 | | | | |
| | Number of contracts | Pre- modification recorded investment | Post- modification recorded investment | Increase in the allowance |
| Commercial real estate..... | 4 | \$ 1,734 | \$ 1,734 | \$ 148 |
| Total restructured loans..... | <u>4</u> | <u>\$ 1,734</u> | <u>\$ 1,734</u> | <u>\$ 148</u> |
| Subsequently defaulted..... | <u>—</u> | <u>\$ —</u> | | |
| December 31, 2011 | | | | |
| | Number of contracts | Pre- modification recorded investment | Post- modification recorded investment | Increase in the allowance |
| Commercial real estate..... | — | \$ — | \$ — | \$ — |
| Total restructured loans..... | <u>—</u> | <u>\$ —</u> | <u>\$ —</u> | <u>\$ —</u> |
| Subsequently defaulted..... | <u>—</u> | <u>\$ —</u> | | |

The seven new commercial real estate loans had either the rate unchanged or blended with no rate impact. All the loans had loan term changes. Five of the commercial real estate loans were to the same customer. Two of the five commercial loans were to the same company. The commercial loans had loan term changes with no rate concessions made. One commercial loan had multiple changes including rate change, shortened maturity and additional collateral and one commercial loan had an extended loan term and interest only for 6 months.

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The following is an aging analysis of the recorded investment of past due loans as of the periods ended December 31, 2013 and 2012:

(Amounts in thousands)

| | 30-59 Days Past Due | 60-89 Days Past Due | 90 Days Or Greater | Total Past Due | Current | Total Loans | Recorded Investment > 90 Days and Accruing |
|-------------------------------|------------------------|------------------------|-----------------------|-------------------|-------------------|-------------------|--|
| December 31, 2013 | | | | | | | |
| Commercial..... | \$ — | \$ — | \$ 30 | \$ 30 | \$ 73,613 | \$ 73,643 | \$ — |
| Commercial real estate..... | — | — | 1,136 | 1,136 | 205,608 | 206,744 | — |
| Residential real estate | — | 201 | 380 | 581 | 41,707 | 42,288 | — |
| Consumer: | | | | | | | |
| Consumer - home equity | — | 7 | 65 | 72 | 19,438 | 19,510 | — |
| Consumer - other..... | 29 | — | 16 | 45 | 4,603 | 4,648 | — |
| Total..... | <u>\$ 29</u> | <u>\$ 208</u> | <u>\$ 1,627</u> | <u>\$ 1,864</u> | <u>\$ 344,969</u> | <u>\$ 346,833</u> | <u>\$ —</u> |
| December 31, 2012 | | | | | | | |
| Commercial..... | \$ — | \$ — | \$ 49 | \$ 49 | \$ 62,263 | \$ 62,312 | \$ — |
| Commercial real estate..... | 32 | — | 2,182 | 2,214 | 191,203 | 193,417 | — |
| Residential real estate | 72 | 158 | 384 | 614 | 38,477 | 39,091 | — |
| Consumer: | | | | | | | |
| Consumer - home equity | — | — | 62 | 62 | 17,848 | 17,910 | — |
| Consumer - other..... | 14 | — | 27 | 41 | 4,511 | 4,552 | — |
| Total..... | <u>\$ 118</u> | <u>\$ 158</u> | <u>\$ 2,704</u> | <u>\$ 2,980</u> | <u>\$ 314,302</u> | <u>\$ 317,282</u> | <u>\$ —</u> |

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

When a loan is determined to be impaired, impairment should be measured based on the present value of expected future cash flows discounted at the loan's effective interest rate. However, as a practical expedient, the Company 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.

CORTLAND BANCORP AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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, 2013 and 2012. Also presented are the average recorded investments in the impaired balances and interest income recognized after impairment for the years ended December 31, 2013, 2012 and 2011.

| | (Amounts in thousands) | | |
|-------------------------------------|--------------------------------|---|------------------------------|
| | <u>Recorded Investment</u> | <u>Unpaid Principal Balance</u> | <u>Related Allowance</u> |
| December 31, 2013 | | | |
| With no related allowance recorded: | | | |
| Commercial..... | \$ 320 | \$ 320 | \$ — |
| Commercial real estate | 3,554 | 3,554 | — |
| With an allowance recorded: | | | |
| Commercial..... | 98 | 98 | 50 |
| Commercial real estate | 1,580 | 1,580 | 251 |
| Total: | | | |
| Commercial..... | <u>\$ 418</u> | <u>\$ 418</u> | <u>\$ 50</u> |
| Commercial real estate | <u>\$ 5,134</u> | <u>\$ 5,134</u> | <u>\$ 251</u> |

| | <u>Recorded Investment</u> | <u>Unpaid Principal Balance</u> | <u>Related Allowance</u> |
|-------------------------------------|--------------------------------|---|------------------------------|
| December 31, 2012 | | | |
| With no related allowance recorded: | | | |
| Commercial real estate | \$ 789 | \$ 789 | \$ — |
| With an allowance recorded: | | | |
| Commercial..... | 49 | 49 | 49 |
| Commercial real estate | 4,242 | 4,242 | 423 |
| Total: | | | |
| Commercial..... | <u>\$ 49</u> | <u>\$ 49</u> | <u>\$ 49</u> |
| Commercial real estate | <u>\$ 5,031</u> | <u>\$ 5,031</u> | <u>\$ 423</u> |

| | (Amounts in thousands) | |
|-------------------------------------|--|---|
| | <u>Average Recorded Investment</u> | <u>Interest Income Recognized</u> |
| December 31, 2013 | | |
| With no related allowance recorded: | | |
| Commercial | \$ 123 | \$ 6 |
| Commercial real estate | 1,638 | 117 |
| With an allowance recorded: | | |
| Commercial | 73 | — |
| Commercial real estate | 3,015 | 95 |
| Total: | | |
| Commercial | <u>\$ 196</u> | <u>\$ 6</u> |
| Commercial real estate | <u>\$ 4,653</u> | <u>\$ 212</u> |

CORTLAND BANCORP AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

| | (Amounts in thousands) | |
|-------------------------------------|-----------------------------------|----------------------------------|
| | Average Recorded Investment | Interest Income Recognized |
| December 31, 2012 | | |
| With no related allowance recorded: | | |
| Commercial | \$ 17 | \$ — |
| Commercial real estate | 1,196 | 3 |
| With an allowance recorded: | | |
| Commercial | 58 | — |
| Commercial real estate | <u>3,177</u> | <u>117</u> |
| Total: | | |
| Commercial | <u>\$ 75</u> | <u>\$ —</u> |
| Commercial real estate | <u>\$ 4,373</u> | <u>\$ 120</u> |
| | Average Recorded Investment | Interest Income Recognized |
| December 31, 2011 | | |
| With no related allowance recorded: | | |
| Commercial..... | \$ 42 | \$ — |
| Commercial real estate | 951 | 66 |
| With an allowance recorded: | | |
| Commercial..... | 83 | — |
| Commercial real estate | <u>1,320</u> | <u>74</u> |
| Total: | | |
| Commercial..... | <u>\$ 125</u> | <u>\$ —</u> |
| Commercial real estate | <u>\$ 2,271</u> | <u>\$ 140</u> |

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

| | (Amounts in thousands) | |
|-------------------------------|------------------------|-----------------|
| | December 31, | |
| | 2013 | 2012 |
| Commercial | <u>\$ 98</u> | \$ 49 |
| Commercial real estate | <u>1,279</u> | 2,336 |
| Residential real estate | <u>481</u> | 489 |
| Consumer: | | |
| Consumer - home equity..... | 72 | 72 |
| Consumer - other | <u>16</u> | <u>27</u> |
| Total | <u>\$ 1,946</u> | <u>\$ 2,973</u> |

Gross income that should have been recorded in income on nonaccrual loans was \$147,000, \$207,000 and \$305,000 for the years ended December 31, 2013, 2012 and 2011, respectively. Actual interest included in income on these nonaccrual loans amounts to \$38,000, \$55,000 and \$191,000 in 2013, 2012 and 2011, respectively.

CORTLAND BANCORP AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 4 - PREMISES AND EQUIPMENT

The following is a summary of premises and equipment:

| | (Amounts in thousands) | |
|------------------------------------|------------------------|-----------------|
| | December 31, | |
| | 2013 | 2012 |
| Land..... | \$ 1,387 | \$ 1,387 |
| Premises..... | 8,372 | 8,128 |
| Equipment..... | 8,652 | 8,074 |
| Leasehold improvements..... | 203 | 265 |
| Total premises and equipment..... | <u>18,614</u> | <u>17,854</u> |
| Less accumulated depreciation..... | <u>11,938</u> | <u>11,289</u> |
| Net book value..... | <u>\$ 6,676</u> | <u>\$ 6,565</u> |

Depreciation expense was \$713,000 in 2013, \$640,000 in 2012 and \$582,000 in 2011.

NOTE 5 - DEPOSITS

The following is a summary of interest-bearing deposits:

| | (Amounts in thousands) | |
|--|------------------------|-------------------|
| | December 31, | |
| | 2013 | 2012 |
| Demand..... | \$ 33,654 | \$ 37,745 |
| Money market..... | 78,783 | 72,404 |
| Savings..... | 114,366 | 122,031 |
| Time: | | |
| In denominations under \$100,000..... | 70,616 | 81,232 |
| In denominations of \$100,000 or more..... | 61,345 | 71,814 |
| Total..... | <u>\$ 358,764</u> | <u>\$ 385,226</u> |

Stated maturities of time deposits were as follows:

| | (Amounts in thousands) | |
|----------------------|------------------------|----------------|
| | December 31, 2013 | |
| 2014..... | \$ | 73,672 |
| 2015..... | | 12,225 |
| 2016..... | | 11,976 |
| 2017..... | | 3,860 |
| 2018..... | | 3,824 |
| 2019 and beyond..... | | 26,404 |
| Total..... | <u>\$</u> | <u>131,961</u> |

CORTLAND BANCORP AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

| | (Amounts in thousands) | | |
|-----------------------------|----------------------------|------------------------|-----------|
| | December 31, 2013 | | |
| | Certificates of Deposit | Other Time Deposits | Total |
| Three months or less | \$ 16,907 | \$ 1,609 | \$ 18,516 |
| Three to six months..... | 11,617 | 106 | 11,723 |
| Six to twelve months..... | 7,534 | 543 | 8,077 |
| One through five years..... | 12,141 | 2,696 | 14,837 |
| Over five years | 5,386 | 2,806 | 8,192 |
| Total | \$ 53,585 | \$ 7,760 | \$ 61,345 |

NOTE 6 - FEDERAL HOME LOAN BANK (FHLB) ADVANCES AND OTHER SHORT-TERM BORROWINGS

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

| | Weighted Average Interest Rate | (Amounts in thousands) | |
|--|--------------------------------------|------------------------|-----------|
| | | December 31, | |
| | | 2013 | 2012 |
| FHLB advances: | | | |
| Fixed-rate payable and convertible fixed-rate FHLB advances, with monthly interest payments: | | | |
| Due in 2013 | | \$ — | \$ 2,500 |
| Due in 2014 | 2.40% | 12,500 | 12,500 |
| Due in 2015 | 2.93% | 4,000 | 4,000 |
| Due in 2016 | 4.07% | 2,000 | 2,000 |
| Due in 2017 | 4.12% | 16,000 | 16,000 |
| Subtotal | 3.36% | 34,500 | 37,000 |
| FHLB Cash Management Advance..... | 0.12% | 8,100 | 5,000 |
| Total FHLB advances..... | 2.74% | 42,600 | 42,000 |
| Other short-term borrowings: | | | |
| Securities sold under repurchase agreements..... | 0.07% | 3,804 | 4,051 |
| Total FHLB advances and other short-term borrowings | 2.52% | \$ 46,404 | \$ 46,051 |

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

| | (Amounts in thousands) | | |
|--|------------------------|----------|----------|
| | 2013 | 2012 | 2011 |
| Average balance during the year..... | \$ 3,453 | \$ 4,559 | \$ 5,598 |
| Average interest rate during the year | 0.09% | 0.11% | 0.09% |
| Maximum month-end balance during the year | \$ 4,022 | \$ 5,550 | \$ 6,566 |
| Weighted average interest rate at year end | 0.07% | 0.13% | 0.07% |

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, 2013 and 2012, securities allocated for this purpose, owned by the Bank and held in safekeeping accounts at independent correspondent banks, amounted to \$7.6 million and \$9.1 million, respectively.

CORTLAND BANCORP AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

At December 31, 2013, 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 \$26.4 million, \$5.0 million in collateralized mortgage obligations and \$24.0 million in mortgage-backed securities. In comparison, in the prior year 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 \$27.0 million, \$9.0 million in collateralized mortgage obligations and \$23.0 million in mortgage-backed securities. Maximum borrowing capacities from FHLB totaled \$50.0 million and \$48.8 million at December 31, 2013 and 2012, respectively.

At December 31, 2013, \$28.5 million of the FHLB fixed rate advances were putable on or after certain specified dates at the option of the FHLB and at December 31, 2012, \$31.0 million of the FHLB fixed rate advances were 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, 2013 and 2012 were 1.69% and 1.76%, 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 par.

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 2019. 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 \$181,000 for 2013, \$147,000 for 2012 and \$162,000 for 2011.

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, 2014..... | \$ 185 |
| December 31, 2015..... | 166 |
| December 31, 2016..... | 112 |
| December 31, 2017..... | 109 |
| December 31, 2018..... | 86 |
| Later years | 44 |
| Total | <u>\$ 702</u> |

At December 31, 2013, the Bank was required to maintain aggregate cash reserves amounting to \$6.0 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 mortgage loans, and consumer loans to customers in Northeastern 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 1.0% of total loans are unsecured at December 31, 2013, compared to 1.2% at December 31, 2012.

CORTLAND BANCORP AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Commitments to fund certain mortgage loans (interest rate locks) to be sold into the secondary market, forward contracts for the future sale of mortgage-backed securities and forward contracts for the future delivery of these mortgage loans are considered derivatives. In calendar 2012 and through the first three quarters of 2013, it was the Company's practice to enter into the forward contracts for the future sale of mortgage-backed securities when interest rate lock commitments are entered into in order to economically hedge the effect of changes in interest rates resulting from its commitments to fund the loans. These mortgage banking derivatives were not formally designated in hedge relationships. The Company simultaneously entered into mandatory delivery commitments of mortgage loans, also considered derivatives.

Effective September 13, 2013, in response to decreased levels of loan originations, the Company ceased entering into mandatory forward contracts for the future delivery of mortgage loans. The Company instead chooses to enter into individual best effort loan sale contracts for the future delivery of residential mortgage loans. These contracts are entered into at the same time that the interest rate lock is entered into with the customer, thereby eliminating the necessity of forward contracts for the future sale of mortgage-backed securities. These contracts are also considered to be derivative instruments and limit the Company's exposure to potential movements in market interest rates. Should levels of loan originations increase to previous levels, the Company may return to entering into forward contracts for the future delivery of mortgage loans.

The Company reports the fair value of the derivative assets and liabilities in other assets and other liabilities; associated income and expense is reported in mortgage banking gains.

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.

The following table is a summary of mortgage banking derivative commitments and the related balance sheet accounts:

| | (Amounts in thousands) | |
|---|------------------------|-----------|
| | December 31, | |
| | 2013 | 2012 |
| Mortgage banking derivative commitments: | | |
| Interest rate lock commitments..... | \$ 1,297 | \$ 65,536 |
| Forward contracts for the future delivery of mortgage loans | 1,953 | 15,731 |
| Forward contracts for the future sale of mortgage-backed securities . | — | 52,000 |
| Corresponding recorded balances : | | |
| Derivative asset..... | \$ 17 | \$ 531 |
| Derivative liability | — | 199 |
| Reserve for loan repurchases | 681 | 430 |

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 of those instruments reflect the extent of involvement the Company has in particular classes of financial instruments.

In the event of nonperformance by the other party, the Company's exposure to credit loss on these financial instruments is represented by the contract or notional amount of the instrument. The Company uses the same credit policies in making commitments and conditional obligations as it does for instruments recorded on the balance sheet. The amount and nature of collateral obtained, if any, is based on management's credit evaluation.

CORTLAND BANCORP AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

The following is a summary of such contractual commitments:

| | (Amounts in thousands) | |
|---------------------------------|------------------------|-----------|
| | December 31, | |
| | 2013 | 2012 |
| Commitments to extend credit: | | |
| Fixed rate | \$ 13,142 | \$ 14,551 |
| Variable rate | 53,275 | 48,184 |
| Standby letters of credit | 670 | 477 |

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 Company 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 Company 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 increase in commitments is in line with the Company's increased focus on commercial and industrial lending, and specifically lines of credit.

The Company also offers limited overdraft protection as a non-contractual courtesy which is available to businesses as well as individually/jointly owned accounts in good standing for personal or household use. The Company reserves the right to discontinue this service without prior notice.

The following table is a summary of overdraft protection for the periods indicated:

| | (Amounts in thousands) | |
|--|------------------------|----------|
| | December 31, | |
| | 2013 | 2012 |
| Overdraft protection available on depositors' accounts | \$ 9,678 | \$ 9,814 |
| Balance of overdrafts included in loans | 190 | 167 |
| Average daily balance of overdrafts | 115 | 112 |
| Average daily balance of overdrafts as a percentage of available | 1.19% | 1.14% |

NOTE 9 – BENEFIT PLANS

The Bank has a contributory defined contribution retirement plan (401(k) plan) which covers substantially all employees. Total expense under the plan was \$296,000 for 2013, \$265,000 for 2012 and \$228,000 for 2011. 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 \$17,500 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, 2013, the accumulated liability for these benefits totaled \$2.4 million, with \$1.9 million accrued for the officers' plan and \$510,000 for the directors' plan.

CORTLAND BANCORP AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

| | (Amounts in thousands) | | |
|-------------------------|--------------------------|----------|----------|
| | Years Ended December 31, | | |
| | 2013 | 2012 | 2011 |
| Beginning balance | \$ 2,218 | \$ 2,049 | \$ 1,897 |
| Benefit expense | 327 | 303 | 282 |
| Benefit payments | (149) | (134) | (130) |
| Ending balance | \$ 2,396 | \$ 2,218 | \$ 2,049 |

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 2014, is expected to be approximately \$335,000. The benefits expected to be paid in the next year are approximately \$163,000.

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, 2013, 2012 and 2011 was \$56,000, \$22,000 and \$22,000, respectively. The accumulated liability at December 31, 2013 is \$614,000. The expense for the year ended December 31, 2014 is expected to be under \$60,000.

NOTE 10 - FEDERAL INCOME TAXES

The composition of income tax expense is as follows:

| | (Amounts in thousands) | | |
|---------------|--------------------------|------------|----------|
| | Years Ended December 31, | | |
| | 2013 | 2012 | 2011 |
| Current..... | \$ (8) | \$ (1,131) | \$ 1,254 |
| Deferred..... | 96 | 973 | (61) |
| Total..... | \$ 88 | \$ (158) | \$ 1,193 |

The ability to realize the benefit of deferred tax assets is dependent upon a number of factors, including the generation of future taxable income, the ability to carry back taxes paid in previous years, the ability to offset capital losses with capital gains, the reversal of deferred tax liabilities, and certain tax planning strategies. A valuation allowance of \$94,000 has been established to offset in its entirety the tax benefits associated with certain impaired securities that management believes may not be realizable.

CORTLAND BANCORP AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

| | (Amounts in thousands) | |
|---|------------------------|----------|
| | December 31, | |
| | 2013 | 2012 |
| Gross deferred tax assets: | | |
| Provision for loan and other real estate losses..... | \$ 1,280 | \$ 1,301 |
| Loan origination cost - net..... | 298 | 268 |
| Impairment loss on securities..... | 784 | 119 |
| Unrealized loss on available-for-sale securities..... | 1,473 | 879 |
| Deferred compensation..... | 814 | 587 |
| NOL carryforward..... | 385 | 1,624 |
| AMT credit carryforward..... | 641 | 387 |
| General business credit carryforward..... | 182 | 483 |
| Other items..... | 727 | 838 |
| Total gross deferred tax assets..... | 6,584 | 6,486 |
| Valuation allowance..... | (94) | (94) |
| Total net deferred tax assets..... | 6,490 | 6,392 |
| Gross deferred tax liabilities: | | |
| Depreciation..... | (433) | (588) |
| Other items..... | (593) | (838) |
| Total net deferred tax liabilities..... | (1,026) | (1,426) |
| Net deferred tax asset..... | \$ 5,464 | \$ 4,966 |

The Company had a deferred tax asset of \$641,000 for credits related to Alternative Minimum Taxes (AMT), a deferred tax asset of \$385,000 relating to a net operating loss (NOL) carryforward, a deferred tax asset of \$182,000 relating to a general business credit carryforward and a deferred tax asset of \$94,000 relating to a capital loss carryforward as of December 31, 2013. In comparison, the Company had a deferred tax asset of \$387,000 for credits related to Alternative Minimum Taxes (AMT), a deferred tax asset of \$1,624,000 relating to a net operating loss (NOL) carryforward, a deferred tax asset of \$483,000 relating to a general business credit carryforward and a deferred tax asset of \$94,000 relating to a capital loss carryforward as of December 31, 2012. The AMT credits have an unlimited carry-forward period. The NOL carryforward and general business credit carryforward both have a 20 year life and expire in 2032. No valuation allowance has been established for these deferred tax assets in view of the Corporation's ability to carry forward taxes paid and credits earned in previous years, to future years, coupled with the anticipated future taxable income as evidenced by the Corporation's earnings potential. The capital loss carryforward has a 5 year life and expires in 2017; it has a 100% valuation allowance of \$94,000 against it.

At December 31, 2013, 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 was recorded at the Bank level in 2012 as explained above and at the Parent Company level relating to impaired losses incurred therein for 2011. Because of the Parent Company's inability to generate taxable income, realization of the deferred tax asset therein was not probable.

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

| | (Amounts in thousands) | | |
|--|--------------------------|----------|----------|
| | Years Ended December 31, | | |
| | 2013 | 2012 | 2011 |
| Statutory tax expense..... | \$ 636 | \$ 937 | \$ 1,790 |
| Tax effect of non-taxable income..... | (504) | (512) | (517) |
| Tax effect of earnings on bank-owned life insurance-net..... | (111) | (129) | (131) |
| Tax effect of historical tax credit..... | — | (483) | — |
| Tax effect of low income housing credit..... | 13 | — | — |
| Tax effect of non-deductible expenses..... | 54 | 29 | 51 |
| Federal income tax expense (benefit)..... | \$ 88 | \$ (158) | \$ 1,193 |

The related income tax expense on investment securities gains amounted to \$182,000 for 2013, \$4,000 for 2012 and \$300,000 for 2011, and is included in the federal income tax expense (benefit).

CORTLAND BANCORP AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

The Company prescribes 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, 2013 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 2009 have been closed for purposes of examination by the Internal Revenue Service and the Ohio Department of Revenue.

NOTE 11 – FAIR VALUE

Measurements

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

- Level 1: Quoted prices are available in active markets for identical assets or liabilities as of the reported date.
- Level 2: Pricing inputs are other than quoted prices in active markets, which are either directly or indirectly observable as of the reported date. The nature of these assets and liabilities include items for which quoted prices are available but which trade less frequently, and items that are fair valued using other financial instruments, the parameters of which can be directly observed.
- Level 3: Assets and liabilities that have little to no pricing observability as of the reported date. These items do not have two-way markets and are measured using management's best estimate of fair value, where inputs into the determination of fair value require significant management judgment or estimation.

CORTLAND BANCORP AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

The following table presents the assets reported on the consolidated balance sheets at their fair value as of December 31, 2013 and December 31, 2012 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.

| Description | December 31, | (Amounts in thousands) | | |
|--|--------------|---|---|---|
| | | Fair Value Measurements at 12/31/13 Using | | |
| | | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
| ASSETS | | | | |
| U.S. Treasury securities | \$ 112 | \$ — | \$ 112 | \$ — |
| U.S. Government agencies and corporations | 8,947 | — | 8,947 | — |
| Obligations of states and political subdivisions | 43,535 | — | 43,535 | — |
| U.S. Government-sponsored mortgage-backed securities | 78,022 | — | 78,022 | — |
| U.S. Government-sponsored collateralized mortgage obligations | 17,085 | — | 17,085 | — |
| Trust preferred securities | 10,136 | — | — | 10,136 |
| Loans held for sale | 656 | 656 | — | — |
| Mortgage banking derivatives | 17 | — | 17 | — |
| LIABILITIES | | | | |
| Mortgage banking derivatives | \$ — | \$ — | \$ — | \$ — |
| ASSETS | | | | |
| U.S. Treasury securities | \$ 123 | \$ — | \$ 123 | \$ — |
| U.S. Government agencies and corporations | 8,065 | — | 8,065 | — |
| Obligations of states and political subdivisions | 42,316 | — | 42,316 | — |
| U.S. Government-sponsored mortgage-backed securities | 92,339 | — | 92,339 | — |
| U.S. Government-sponsored collateralized mortgage obligations | 31,142 | — | 31,142 | — |
| Trust preferred securities | 7,612 | — | — | 7,612 |
| Loans held for sale | 24,756 | — | 24,756 | — |
| Mortgage banking derivatives | 531 | — | 531 | — |
| LIABILITIES | | | | |
| Mortgage banking derivatives | \$ 199 | \$ — | \$ 199 | \$ — |

CORTLAND BANCORP AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

The following tables present the changes in the Level 3 fair value category for the years ended December 31, 2013, 2012 and 2011. 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) | | |
|---|----------------------------|----------------------------|----------------------------|
| | December 31, | | |
| | 2013 | 2012 | 2011 |
| | Trust preferred securities | Trust preferred securities | Trust preferred securities |
| Beginning balance | \$ 7,612 | \$ 9,145 | \$ 12,779 |
| Net realized/unrealized gains/(losses) included in: | | | |
| Noninterest income | (1,954) | (171) | (202) |
| Other comprehensive income | 4,553 | 2,184 | (3,097) |
| Discount accretion (premium amortization) | 8 | 2 | 1 |
| Transfers in and/or out of Level 3 | — | — | — |
| Sales | — | (3,531) | — |
| Purchases, issuances and settlements | (83) | (15) | (335) |
| Ending balance | <u>\$ 10,136</u> | <u>\$ 7,612</u> | <u>\$ 9,145</u> |
| Losses included in net income for the period relating to assets held at December 31 | <u>\$ (1,954)</u> | <u>\$ (90)</u> | <u>\$ (202)</u> |

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

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

Trust Preferred Securities

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

CORTLAND BANCORP AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

The Company holds trust preferred securities 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 into 2013, factors outside the Company's control impacted the fair value of these securities and will likely continue to do so for the foreseeable future. These factors include, but are not limited to, the following: guidance on fair value accounting, issuer credit deterioration, issuer deferral and default rates, potential failure or government seizure of underlying financial institutions or insurance companies, ratings agency actions, or regulatory actions. As a result of changes in these and various other factors during 2009 and into 2013, Moody's Investors Service, Fitch Ratings and Standards and Poor's downgraded multiple trust preferred securities, including securities held by the Company. All 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 2012 have resulted in illiquid and inactive financial markets and severely depressed prices for these securities. As referenced in Note 2, Investment Securities, with the release of the Volcker Rule in December 2013, the Company can no longer support the ability to hold certain trust preferred securities comprised of obligations issued by insurance companies. The inability to hold the investments triggers a \$2.0 million OTTI recognition reflecting the estimated fair value of the securities at December 31, 2013. For the remaining bank-issued trust preferred securities, the Company does not intend to sell the securities and it is more-likely-than-not that the Company will not be required to sell the securities before recovery of its amortized cost basis. There is a risk that subsequent evaluations could result in recognition of OTTI charges in the future. The securities had life-to-date impairment losses as presented below.

The following table details the breakdown of trust preferred securities for the periods indicated:

| | (Dollar amounts in thousands) | |
|---|-------------------------------|-----------------|
| | December 31, | |
| | 2013 | 2012 |
| Total number of trust preferred securities | 12 | 12 |
| Par value..... | \$ 14,366 | \$ 14,449 |
| Number not considered OTTI | 1 | 10 |
| Par value..... | \$ 956 | \$ 11,491 |
| Number considered OTTI..... | 11 | 2 |
| Par value..... | \$ 13,410 | \$ 2,958 |
| Life-to-date impairment recognized in earnings | \$ 2,305 | \$ 351 |
| Life-to-date impairment recognized in other comprehensive income..... | 1,718 | 1,868 |
| Total life-to-date impairment | <u>\$ 4,023</u> | <u>\$ 2,219</u> |

The following table details the 11 debt securities with other-than-temporary impairment, their credit ratings at December 31, 2013 and the related losses recognized in earnings:

| | Moody's/Fitch Rating | Amount of OTTI related to credit loss at January 1, 2013 | (Amounts in thousands) | | | | Amount of OTTI related to credit loss at December 31, 2013 |
|--------------------|----------------------|--|---------------------------------|--------------------------------|-------------------------------------|------------------------------------|--|
| | | | Additions in QTD March 31, 2013 | Additions in QTD June 30, 2013 | Additions in QTD September 30, 2013 | Additions in QTD December 31, 2013 | |
| PreTSL XXIII Class | | | | | | | |
| C-FP..... | Ca/C | \$ 211 | \$ — | \$ — | \$ — | \$ — | \$ 211 |
| I-PreTSL I | NR/CCC | — | — | — | — | 216 | 216 |
| I-PreTSL I | NR/CCC | — | — | — | — | 230 | 230 |
| I-PreTSL I | NR/CCC | — | — | — | — | 230 | 230 |
| I-PreTSL II | NR/B | — | — | — | — | 291 | 291 |
| I-PreTSL III..... | Ba3/CCC | — | — | — | — | 130 | 130 |
| I-PreTSL III..... | NR/CCC | — | — | — | — | 380 | 380 |
| I-PreTSL IV..... | Ba2/B | — | — | — | — | 140 | 140 |
| I-PreTSL IV..... | Ba2/B | — | — | — | — | 140 | 140 |
| I-PreTSL IV..... | Caa1/CCC | — | — | — | — | 197 | 197 |
| Trapeza IX..... | Ca/CC | 140 | — | — | — | — | 140 |
| Total..... | | <u>\$ 351</u> | <u>\$ —</u> | <u>\$ —</u> | <u>\$ —</u> | <u>\$ 1,954</u> | <u>\$ 2,305</u> |

CORTLAND BANCORP AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

The following table details the 2 debt securities with other-than-temporary impairment, their credit ratings at December 31, 2012 and the related losses recognized in earnings:

(Amounts in thousands)

| | Moody's/Fitch Rating | Amount of OTTI related to credit loss at January 1, 2012 | Additions in QTD March 31, 2012 | Additions in QTD June 30, 2012 | Additions in QTD September 30, 2012 | Additions in QTD December 31, 2012 | Amount of OTTI related to credit loss at December 31, 2012 |
|--------------------|----------------------|--|---------------------------------|--------------------------------|-------------------------------------|------------------------------------|--|
| PreTSL XXIII Class | | | | | | | |
| C-FP..... | C/C | \$ 211 | \$ — | \$ — | \$ — | \$ — | \$ 211 |
| Trapeza IX..... | Ca/CC | 50 | 90 | — | — | — | 140 |
| Total..... | | <u>\$ 261</u> | <u>\$ 90</u> | <u>\$ —</u> | <u>\$ —</u> | <u>\$ —</u> | <u>\$ 351</u> |

The following table provides additional information related to the Company's trust preferred securities as of December 31, 2013 used to evaluate other-than-temporary impairments:

(Amounts in thousands)

| Deal | Class | Amortized Cost | 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 XXIII..... | C-2 | \$ 956 | \$ 392 | \$ (564) | Ca/C | 93 | 24.20% | —% |
| PreTSL XXIII..... | C-FP | 1,535 | 811 | (724) | Ca/C | 93 | 24.20 | — |
| I-PreTSL I..... | B-1 | 770 | 770 | — | NR/CCC | 14 | 17.30 | 7.78 |
| I-PreTSL I..... | B-2 | 770 | 770 | — | NR/CCC | 14 | 17.30 | 7.78 |
| I-PreTSL I..... | B-3 | 770 | 770 | — | NR/CCC | 14 | 17.30 | 7.78 |
| I-PreTSL II..... | B-3 | 2,700 | 2,700 | — | NR/B | 21 | 8.00 | 18.03 |
| I-PreTSL III..... | B-2 | 870 | 870 | — | Ba3/CCC | 20 | 14.10 | 14.74 |
| I-PreTSL III..... | C | 620 | 620 | — | NR/CCC | 20 | 14.10 | 4.70 |
| I-PreTSL IV..... | B-1 | 860 | 860 | — | Ba2/B | 30 | — | 17.67 |
| I-PreTSL IV..... | B-2 | 860 | 860 | — | Ba2/B | 30 | — | 17.67 |
| I-PreTSL IV..... | C | 283 | 283 | — | Caa1/CCC | 30 | — | 11.16 |
| Trapeza IX..... | B-1 | 860 | 430 | (430) | Ca/CC | 32 | 20.90 | — |
| Total..... | | <u>\$ 11,854</u> | <u>\$ 10,136</u> | <u>\$ (1,718)</u> | | | | |

The following table provides additional information related to the Company's trust preferred securities as of December 31, 2012 used to evaluate other-than-temporary impairments:

(Amounts in thousands)

| Deal | Class | Amortized Cost | 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 XXIII..... | C-2 | \$ 1,011 | \$ 203 | \$ (808) | C/C | 88 | 26.28% | —% |
| PreTSL XXIII..... | C-FP | 1,556 | 325 | (1,231) | C/C | 88 | 26.28 | — |
| I-PreTSL I..... | B-1 | 986 | 368 | (618) | NR/CCC | 15 | 7.96 | 13.60 |
| I-PreTSL I..... | B-2 | 1,000 | 757 | (243) | NR/CCC | 15 | 7.96 | 13.60 |
| I-PreTSL I..... | B-3 | 1,000 | 758 | (242) | NR/CCC | 15 | 7.96 | 13.60 |
| I-PreTSL II..... | B-3 | 2,990 | 1,810 | (1,180) | NR/B | 23 | 7.20 | 11.00 |
| I-PreTSL III..... | B-2 | 1,000 | 765 | (235) | Ba3/CCC | 23 | 6.37 | 15.60 |
| I-PreTSL III..... | C | 1,000 | 822 | (178) | NR/CCC | 23 | 6.37 | — |
| I-PreTSL IV..... | B-1 | 1,000 | 614 | (386) | Ba2/CCC | 23 | 14.16 | 5.60 |
| I-PreTSL IV..... | B-2 | 1,000 | 822 | (178) | Ba2/CCC | 23 | 14.16 | 5.60 |
| I-PreTSL IV..... | C | 480 | 146 | (334) | Caa1/CC | 23 | 14.16 | 1.20 |
| Trapeza IX..... | B-1 | 860 | 222 | (638) | Ca/CC | 34 | 19.91 | — |
| Total..... | | <u>\$ 13,883</u> | <u>\$ 7,612</u> | <u>\$ (6,271)</u> | | | | |

CORTLAND BANCORP AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

The market for these securities at December 31, 2013 and December 31, 2012 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, 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, 2013;
- An income valuation approach technique (present value technique) that maximizes the use of relevant observable inputs and minimizes the use of unobservable inputs will be equally or more representative of fair value than the market approach valuation technique used at measurement dates prior to 2008; and
- The trust preferred securities will be classified within Level 3 of the fair value hierarchy because the Company determined that significant judgments are required to determine fair value at the measurement date.

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

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

The effective discount rates on an overall basis generally range from 6.61% to 15.71% 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.

CORTLAND BANCORP AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

The following table presents the assets measured on a nonrecurring basis on the consolidated balance sheets at their fair value as of December 31, 2013 and December 31, 2012, 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, 2013 | | | | |
| | Level 1 | Level 2 | Level 3 | Total |
| Assets measured on a nonrecurring basis: | | | | |
| Impaired loans: | | | | |
| Recorded investment..... | \$ — | \$ — | \$ 5,552 | \$ 5,552 |
| Reserve..... | — | — | (301) | (301) |
| Net balance | \$ — | \$ — | \$ 5,251 | \$ 5,251 |
| Other real estate owned: | | | | |
| Recorded investment..... | \$ — | \$ — | \$ 33 | \$ 33 |
| December 31, 2012 | | | | |
| | Level 1 | Level 2 | Level 3 | Total |
| Assets measured on a nonrecurring basis: | | | | |
| Impaired loans: | | | | |
| Recorded investment..... | \$ — | \$ — | \$ 5,080 | \$ 5,080 |
| Reserve | — | — | (472) | (472) |
| Net balance | \$ — | \$ — | \$ 4,608 | \$ 4,608 |
| Other real estate owned: | | | | |
| Recorded investment..... | \$ — | \$ — | \$ 145 | \$ 145 |

Financial Instruments

The Company discloses 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 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 what the secondary markets are currently offering for loans with similar characteristics.

Loans, net of allowance for loan losses – 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.

Bank-owned life insurance – The fair value is based upon the cash surrender value of the underlying policies and matches the book value.

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

CORTLAND BANCORP AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Mortgage banking derivatives – The Company enters into derivative financial instruments in the form of interest rate locks with potential mortgage loan borrowers. 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. Commitments to deliver mortgage loans are valued at the commitment price from the investor. Interest rate lock commitments are valued at best execution prices at December 31, 2013 and 2012. Fair value adjustments relating to these mortgage banking derivatives are recorded in current year earnings as a component of mortgage banking gains.

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 puttable on or after certain specified dates at the option of the FHLB are priced using the FHLB of Cincinnati's model.

Short-term borrowings – 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, 2013 and December 31, 2012 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.

CORTLAND BANCORP AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

(Amounts in thousands)
December 31, 2013

| | Carrying Amount | Level 1 | Level 2 | Level 3 | Estimated Fair Value |
|---|--------------------|------------|---------|---------|-------------------------|
| ASSETS: | | | | | |
| Cash and cash equivalents | \$ 12,396 | \$ 12,396 | \$ — | \$ — | \$ 12,396 |
| Investment securities available-for-sale | 160,886 | — | 150,750 | 10,136 | 160,886 |
| Trading securities | 7,247 | — | 7,247 | — | 7,247 |
| Loans held for sale | 656 | 656 | — | — | 656 |
| Loans, net of allowance for loan losses | 343,069 | — | — | 349,190 | 349,190 |
| Bank-owned life insurance | 15,049 | 15,049 | — | — | 15,049 |
| Accrued interest receivable | 1,675 | 1,675 | — | — | 1,675 |
| Mortgage banking derivatives | 17 | — | 17 | — | 17 |
| LIABILITIES: | | | | | |
| Demand, savings and money market deposits | \$ 316,708 | \$ 316,708 | \$ — | \$ — | \$ 316,708 |
| Time deposits | 131,961 | — | 135,712 | — | 135,712 |
| FHLB advances | 42,600 | — | — | 44,746 | 44,746 |
| Short-term borrowings | 3,804 | 3,804 | — | — | 3,804 |
| Subordinated debt | 5,155 | — | — | 4,694 | 4,694 |
| Accrued interest payable | 290 | 290 | — | — | 290 |

December 31, 2012

| | Carrying Amount | Level 1 | Level 2 | Level 3 | Estimated Fair Value |
|---|--------------------|------------|---------|---------|-------------------------|
| ASSETS: | | | | | |
| Cash and cash equivalents | \$ 27,577 | \$ 27,577 | \$ — | \$ — | \$ 27,577 |
| Investment securities available-for-sale | 184,646 | — | 177,034 | 7,612 | 184,646 |
| Loans held for sale | 24,756 | — | 24,756 | — | 24,756 |
| Loans, net of allowance for loan losses | 313,457 | — | — | 320,012 | 320,012 |
| Bank-owned life insurance | 14,009 | 14,009 | — | — | 14,009 |
| Accrued interest receivable | 1,765 | 1,765 | — | — | 1,765 |
| Mortgage banking derivatives | 531 | — | 531 | — | 531 |
| LIABILITIES: | | | | | |
| Demand, savings and money market deposits | \$ 323,855 | \$ 323,855 | \$ — | \$ — | \$ 323,855 |
| Time deposits | 153,046 | — | 157,406 | — | 157,406 |
| FHLB advances | 42,000 | — | — | 45,113 | 45,113 |
| Short-term borrowings | 4,051 | 4,051 | — | — | 4,051 |
| Subordinated debt | 5,155 | — | — | 4,227 | 4,227 |
| Accrued interest payable | 359 | 359 | — | — | 359 |
| Mortgage banking derivatives | 199 | — | 199 | — | 199 |

CORTLAND BANCORP AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

The following table presents quantitative information about the Level 3 significant unobservable inputs for assets and liabilities measured at fair value on a recurring and nonrecurring basis at December 31, 2013.

| | (Amounts in thousands) Fair value at December 31, 2013 | Valuation Technique | Significant Unobservable Input | Description of Inputs |
|---------------------------------|---|----------------------------------|-----------------------------------|---|
| Trust preferred securities..... | \$ 10,136 | Discounted Cash Flow | Projected Prepayments | 1) Trust preferred securities issued by banks subject to Dodd-Frank's phase-out of trust preferred securities from Tier 1 Capital. 2) Trust preferred securities issued by healthy, well capitalized banks that have fixed rate coupons greater than 8% or floating rate spreads greater than 300 bps. 3) 5% every 5 years for all banks beginning in 2018. 4) Zero for collateral issued by REITs or insurance companies. |
| | | | Projected Defaults | 1) All deferring issuers that do not meet the criteria for curing, as described below, are projected to default immediately. 2) Banks with high, near team default risk are identified using a CAMELS model, and projected to default immediately. Healthy banks are projected to default at a rate of 2% annually for 2 years, and .36% annually thereafter. 3) Insurance and REIT defaults are projected according to the historical default rates exhibited by companies with the same credit ratings. Historical default rates are doubled in each of the first two years of the projection to account for current economic conditions. Unrated issuers are assumed to have CCC- ratings. |
| | | | Projected Cures | 1) Deferring issuers that have definitive agreements to either be acquired or recapitalized. |
| | | | Projected Recoveries | 1) Zero for insurance companies, REITs and insolvent banks, and 10% for projected bank deferrals. |
| | | | Discount Rates | 1) Ranging from ~6.61% to ~15.71%, depending on each bond's seniority and remaining subordination after projected losses. |
| Impaired loans..... | 5,251 | Appraisal of Collateral (1) | Appraisal Adjustments (2) | Weighted average (21)% |
| | | | Liquidation Expenses (2) | Weighted average (6)% |
| Other real estate owned..... | 33 | Appraisal of Collateral (1), (3) | Appraisal Adjustments (2) | 0% |

- (1) Fair value is generally determined through independent appraisals of the underlying collateral, which generally include various Level 3 inputs which are not identifiable.
- (2) Appraisals may be adjusted by management for qualitative factors such as economic conditions and estimated liquidation expenses. The range and weighted average of liquidation expenses are presented as a percent of the appraisal. The adjustment of appraised value is measured as the effect on fair value as a percentage of unpaid principal.
- (3) Includes qualitative adjustments by management and estimated liquidation expenses.

CORTLAND BANCORP AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

The following table presents quantitative information about the Level 3 significant unobservable inputs for assets and liabilities measured at fair value on a recurring and nonrecurring basis at December 31, 2012.

| | (Amounts in thousands) Fair value at December 31, 2012 | Valuation Technique | Significant Unobservable Input | Description of Inputs |
|---------------------------------|---|----------------------------------|-----------------------------------|---|
| Trust preferred securities..... | \$ 7,612 | Discounted Cash Flow | Projected Prepayments | 1) Trust preferred securities issued by banks subject to Dodd-Frank's phase-out of trust preferred securities from Tier 1 Capital. 2) Trust preferred securities issued by healthy, well capitalized banks that have fixed rate coupons greater than 8% or floating rate spreads greater than 300 bps. 3) 5% every 5 years for all banks beginning in 2018. 4) Zero for collateral issued by REITs or insurance companies. |
| | | | Projected Defaults | 1) All deferring issuers that do not meet the criteria for curing, as described below, are projected to default immediately. 2) Banks with high, near team default risk are identified using a CAMELS model, and projected to default immediately. Healthy banks are projected to default at a rate of 2% annually for 2 years, and .36% annually thereafter. 3) Insurance and REIT defaults are projected according to the historical default rates exhibited by companies with the same credit ratings. Historical default rates are doubled in each of the first two years of the projection to account for current economic conditions. Unrated issuers are assumed to have CCC- ratings. |
| | | | Projected Cures | 1) Deferring issuers that have definitive agreements to either be acquired or recapitalized. |
| | | | Projected Recoveries | 1) Zero for insurance companies, REITs and insolvent banks, and 10% for projected bank deferrals. |
| | | | Discount Rates | 1) Ranging from ~5.69% to ~21.76%, depending on each bond's seniority and remaining subordination after projected losses. |
| Impaired loans..... | 3,503 | Appraisal of Collateral (1) | Appraisal Adjustments (2) | Weighted average (22)% |
| | | | Liquidation Expenses (2) | Weighted average (8)% |
| | 1,105 | Discounted Cash Flow | Discount Rate | 5.75% (only one loan) |
| Other real estate owned..... | 145 | Appraisal of Collateral (1), (3) | Sales Agreements | 0% to (39)% |

- (1) Fair value is generally determined through independent appraisals of the underlying collateral, which generally include various Level 3 inputs which are not identifiable.
- (2) Appraisals may be adjusted by management for qualitative factors such as economic conditions and estimated liquidation expenses. The range and weighted average of liquidation expenses are presented as a percent of the appraisal. The adjustment of appraised value is measured as the effect on fair value as a percentage of unpaid principal.
- (3) Includes qualitative adjustments by management and estimated liquidation expenses.

CORTLAND BANCORP AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 12 - ACCUMULATED OTHER COMPREHENSIVE INCOME

The following table presents the changes in accumulated other comprehensive loss by component net of tax for the years ended December 31, 2013 and 2012.

| | (Amounts in thousands) | |
|---|--|---|
| | Unrealized gains on available-for-sale securities(a) | Change in pension and postretirement obligations |
| Balance as of December 31, 2011 | \$ (2,663) | \$ — |
| Other comprehensive loss before reclassification | 853 | — |
| Amount reclassified from accumulated other comprehensive income | 103 | — |
| Total other comprehensive income | <u>956</u> | <u>—</u> |
| Balance as of December 31, 2012 | (1,707) | — |
| Other comprehensive loss before reclassification | (2,090) | (28) |
| Amount reclassified from accumulated other comprehensive income | 937 | — |
| Total other comprehensive income | <u>(1,153)</u> | <u>(28)</u> |
| Balance as of December 31, 2013 | <u>\$ (2,860)</u> | <u>\$ (28)</u> |

(a) All amounts are net of tax. Amounts in parentheses indicate debits.

The following table presents significant amounts reclassified out of each component of accumulated other comprehensive income for the years ended December 31, 2013 and 2012.

| | (Amounts in thousands) | |
|---|---|--|
| | December 31, 2013 | |
| | Amount reclassified from accumulated other comprehensive income | Affected line item in the statement where net income is presented |
| Details about other comprehensive income: | | |
| Unrealized gains on available-for-sale securities | \$ 1,954 | Net impairment losses recognized in earnings |
| | (535) | Investment securities gains, net |
| | (482) | Federal income tax expense (benefit) |
| | <u>\$ 937</u> | Net of tax |
| | | |
| | December 31, 2012 | |
| | Amount reclassified from accumulated other comprehensive income | Affected line item in the statement where net income is presented |
| Details about other comprehensive income: | | |
| Unrealized gains on available-for-sale securities | \$ 171 | Net impairment losses recognized in earnings |
| | (14) | Investment securities gains, net |
| | (54) | Federal income tax expense (benefit) |
| | <u>\$ 103</u> | Net of tax |

CORTLAND BANCORP AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 13 - REGULATORY MATTERS

The Company and the Bank are 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 requirements for the Company to remain a financial holding company, 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 requirements for the Company to remain a financial holding company, the Company is categorized as well-capitalized, which requires minimum capital ratios of 10% for total risk-based capital to risk-weighted assets and 6% for Tier I risk-based capital to risk-weighted assets. Management believes that as of December 31, 2013, the Company meets all capital adequacy requirements to which it is subject.

| | (Amounts in thousands) | | | |
|------------------------------------|------------------------|--------|-----------|--------|
| | December 31, | | | |
| | 2013 | | 2012 | |
| | Amount | Ratio | Amount | Ratio |
| Total Risk-Based Capital | \$ 58,774 | | \$ 57,905 | |
| Ratio to Risk-Weighted Assets..... | | 14.19% | | 14.10% |
| Tier I Risk-Based Capital..... | \$ 54,927 | | \$ 53,996 | |
| Ratio to Risk-Weighted Assets..... | | 13.26% | | 13.15% |
| Ratio to Average Assets | | 10.35% | | 9.63% |

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 14 - RELATED PARTY TRANSACTIONS

Certain directors, executive officers and companies with whom they are affiliated were loan customers during 2013. The following is an analysis of such loans:

| | (Amounts in thousands) | |
|--|------------------------|----------------|
| Total related-party loans at December 31, 2012 | \$ | 3,362 |
| New related-party loans | | 1,717 |
| Repayments or other..... | | <u>(2,206)</u> |
| Total related-party loans at December 31, 2013..... | \$ | <u>2,873</u> |

Deposits from executive officers, directors, and their affiliates at December 31, 2013 and 2012 were \$2.4 million and \$4.2 million, respectively.

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

CORTLAND BANCORP AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 15 - 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)

| | <u>December 31,</u> | |
|---|---------------------|------------------|
| | <u>2013</u> | <u>2012</u> |
| ASSETS | | |
| Cash..... | \$ 204 | \$ 244 |
| Investment in bank subsidiary..... | 45,813 | 45,583 |
| Investment in non-bank subsidiary..... | 15 | 15 |
| Subordinated note from subsidiary bank..... | 6,000 | 6,000 |
| Other assets..... | 3,478 | 3,520 |
| Total assets | \$ 55,510 | \$ 55,362 |
| LIABILITIES | | |
| Other liabilities..... | \$ 820 | \$ 755 |
| Subordinated debt (Note 7)..... | 5,155 | 5,155 |
| Total liabilities | 5,975 | 5,910 |
| SHAREHOLDERS' EQUITY | | |
| Common stock..... | 23,641 | 23,641 |
| Additional paid-in capital..... | 20,833 | 20,850 |
| Retained earnings..... | 11,502 | 10,262 |
| Accumulated other comprehensive loss..... | (2,888) | (1,707) |
| Treasury stock..... | (3,553) | (3,594) |
| Total shareholders' equity | 49,535 | 49,452 |
| Total liabilities & shareholders' equity | \$ 55,510 | \$ 55,362 |

STATEMENTS OF INCOME

(Amounts in thousands)

| | <u>Years ended December 31,</u> | | |
|---|---------------------------------|-----------------|-----------------|
| | <u>2013</u> | <u>2012</u> | <u>2011</u> |
| Dividends from bank subsidiary..... | \$ 544 | \$ 136 | \$ — |
| Interest and dividend income..... | 96 | 107 | 98 |
| Investment securities (losses) gains..... | — | (16) | 51 |
| Other income..... | 99 | 113 | 114 |
| Interest on subordinated debt..... | (90) | (100) | (92) |
| Other expenses..... | (380) | (340) | (362) |
| Income (loss) before income tax and equity in undistributed earnings of subsidiaries | 269 | (100) | (191) |
| Income tax benefit..... | 104 | 125 | 85 |
| Equity in undistributed earnings of subsidiaries..... | 1,411 | 2,888 | 4,178 |
| Net income | \$ 1,784 | \$ 2,913 | \$ 4,072 |
| Comprehensive income | \$ 603 | \$ 3,869 | \$ 3,867 |

CORTLAND BANCORP AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

STATEMENTS OF CASH FLOWS
(Amounts in thousands)

| | Years ended December 31, | | |
|---|--------------------------|----------|----------|
| | 2013 | 2012 | 2011 |
| Cash flows (deficit) from operating activities | | | |
| Net income | \$ 1,784 | \$ 2,913 | \$ 4,072 |
| Adjustments to reconcile net income to net cash flow (deficit) from operating activities: | | | |
| Equity in undistributed net income of subsidiaries | (1,411) | (2,888) | (4,178) |
| Deferred tax benefit..... | (6) | (14) | (14) |
| Investment securities losses (gains) | — | 16 | (51) |
| Change in other assets and liabilities | 113 | (180) | 28 |
| Net cash flows (deficit) from operating activities | 480 | (153) | (143) |
| Cash flows from investing activities | | | |
| Proceeds from sales of securities | — | 77 | — |
| Net cash flows from investing activities..... | — | 77 | — |
| Cash deficit from financing activities | | | |
| Dividends paid..... | (544) | (136) | — |
| Treasury shares reissued..... | 24 | — | — |
| Net cash deficit from financing activities | (520) | (136) | — |
| Net change in cash..... | (40) | (212) | (143) |
| Cash | | | |
| Beginning of year | 244 | 456 | 599 |
| End of year | \$ 204 | \$ 244 | \$ 456 |

NOTE 16 - 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 2014 is \$4.3 million plus 2014 profits retained up to the date of the dividend declaration.

NOTE 17 – LITIGATION

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

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) under 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 were effective.

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 2013 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 – Not applicable.

PART III

Item 10. 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 18, 2014 in connection with the Annual Meeting of Shareholders to be held May 27, 2014 (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 28, 2014 are as follows:

| <u>Name</u> | <u>Age</u> | <u>Position Held</u> |
|------------------------|------------|--|
| James M. Gasior..... | 54 | President, Chief Executive Officer and Director |
| Timothy Carney..... | 48 | Executive Vice President, Chief Operations Officer, Secretary and Director |
| David J. Lucido | 56 | Senior Vice President and Chief Financial Officer |
| Stanley P. Feret | 53 | 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 director of the Company and the Bank since November of 2005 and is also a director of CSB Mortgage Company, Inc. He is a Certified Public Accountant, a member of the American Institute of CPA's and the Ohio Society of CPA's. Previously, Mr. Gasior served as Senior Vice President, Chief Financial Officer and Secretary of the Company and the Bank 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 the Company and the Bank on November 2, 2009. Mr. Carney was appointed to the Board of Directors on November 2, 2009 to serve the unexpired term of Lawrence Fantauzzi. He is also the President of CSB Mortgage Company, Inc. 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 Officer of the Bank since May 1999.

Mr. Lucido was appointed Senior Vice President and Chief Financial Officer of the Company and the Bank on January 18, 2010. Mr. Lucido is also the Treasurer of CSB Mortgage Company, Inc. Previously, he 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 11. 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 “Director Compensation in 2013.”

Item 12. 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 of Directors and Executive Officers.”

The Company has no compensation plan under which equity securities of the Company are authorized for issuance.

Item 13. 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 14. 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 | 52 |
| Report of Independent Registered Public Accounting Firm | 53 |
| Consolidated Balance Sheets as of December 31, 2013 and 2012 | 54 |
| Consolidated Statements of Income for the Years Ended December 31, 2013, 2012 and 2011 | 55 |
| Consolidated Statements of Comprehensive Income for the Years Ended December 31, 2013, 2012 and 2011 | 56 |
| Consolidated Statements of Shareholders’ Equity for the Years Ended December 31, 2013, 2012 and 2011 | 57 |
| Consolidated Statements of Cash Flows for the Years Ended December 31, 2013, 2012 and 2011 | 58 |
| Notes to Consolidated Financial Statements | 59-97 |

(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 28, 2014

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.

| | | |
|---|--|-------------------------------|
| <u>/s/ Timothy K. Woofter</u> Timothy K. Woofter | Director and Chairman of the Board | <u>March 28, 2014</u> Date |
| <u>/s/ James M. Gasior</u> James M. Gasior | President, Chief Executive Officer and Director (Principal Executive Officer) | <u>March 28, 2014</u> Date |
| <u>/s/ Timothy Carney</u> Timothy Carney | Director | <u>March 28, 2014</u> Date |
| <u>/s/ David C. Cole</u> David C. Cole | Director | <u>March 28, 2014</u> Date |
| <u>/s/ George E. Gessner</u> George E. Gessner | Director | <u>March 28, 2014</u> Date |
| <u>/s/ James E. Hoffman, III</u> James E. Hoffman, III | Director | <u>March 28, 2014</u> Date |
| <u>/s/ Neil J. Kaback</u> Neil J. Kaback | Director | <u>March 28, 2014</u> Date |
| <u>/s/ Joseph E. Koch</u> Joseph E. Koch | Director | <u>March 28, 2014</u> Date |
| <u>/s/ Joseph P. Langhenry</u> Joseph P. Langhenry | Director | <u>March 28, 2014</u> Date |
| <u>/s/ Richard B. Thompson</u> Richard B. Thompson | Director | <u>March 28, 2014</u> Date |
| <u>/s/ Anthony R. Vross</u> Anthony R. Vross | Director | <u>March 28, 2014</u> Date |
| <u>/s/ David J. Lucido</u> David J. Lucido | Chief Financial Officer (Principal Financial and Accounting Officer) | <u>March 28, 2014</u> Date |

CORTLAND BANCORP

BOARD OF DIRECTORS

TIMOTHY K. WOOFER
Chairman

TIMOTHY CARNEY

DAVID C. COLE

JAMES M. GASIOR

GEORGE E. GESSNER

JAMES E. HOFFMAN, III

NEIL J. KABACK

JOSEPH E. KOCH

JOSEPH P. LANGHENRY

ANTHONY R. VROSS

RICHARD B. THOMPSON

DIRECTOR EMERITUS

K. RAY MAHAN

OFFICERS

JAMES M. GASIOR
President and
Chief Executive Officer

TIMOTHY CARNEY
Executive Vice President,
Chief Operating Officer and
Corporate 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

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

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

JAMES M. GASIOR
President and Chief Executive Officer

GEORGE E. GESSNER
Attorney, Gessner and Platt

JAMES E. HOFFMAN, III
Attorney, Hoffman and Walker

NEIL J. KABACK
Partner, Cohen & Company

JOSEPH E. KOCH
President, Joe Koch Construction

JOSEPH P. LANGHENRY
Executive, Watteredge, Inc.

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

ANTHONY R. VROSS
Executive, Simon Roofing

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

DIRECTOR EMERITUS

K. RAY MAHAN

OFFICERS

JAMES M. GASIOR
President and Chief Executive Officer

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

KAREN BOSLEY
Assistant Vice President
Community Banking Manager/Business Banking Officer

NICHOLAS P. BERARDINO
Vice President
Commercial Banking Officer

HEATHER J. BOWSER
Assistant Vice President
Collection Officer

DANIELLE CANTRELL
Vice President
Retail Banking Manager

MICHELLE CERMAK
Vice President
Retail Mortgage Banking Officer

MELANIE CHRISTIE
Assistant Vice President
Compliance Officer

JONI EVERSON
Vice President
Retail Mortgage Banking Officer

DEBORAH L. EAZOR
Vice President
Operations Manager

DAVID J. LUCIDO
Senior Vice President and Chief Financial Officer

STANLEY P. FERET
Senior Vice President and Chief Lending Officer

STANLEY MAGIELSKI
Vice President
Commercial Banking Officer

KAREN MILLER
Assistant Secretary
Branch Training Coordinator

LANCE A. MORRISON
Vice President
General Counsel/Director of Human Resources

ROBERT MEEK
Assistant Vice President
Treasury Management/Sales Representative

KEITH MROZEK
Vice President
Special Assets

ROCCO PAGE
Vice President
Retail Mortgage Banking Officer

RICHARD M. PAVLOCK
Vice President
Retail Mortgage Banking Officer

MICHELLE REILLY
Vice President, Assistant Treasurer
Mortgage Banking/ Funds Management

JOAN M. FRANGIAMORE
Vice President
Controller

RITA FUSCOE
Assistant Vice President
Community Banking Manager/Business Banking Officer

JOHN HEWITT
Assistant Vice President
Credit Manager

JANET K. HOUSER
Assistant Vice President
Electronic Banking Specialist

JAMES HUGHES
Assistant Vice President
Community Banking Manager/Business Banking Officer

SHANE HRUBY
Vice President
Retail Mortgage Banking Officer

BRYAN IGNAZIO
Assistant Vice President
Community Banking Manager/Business Banking Officer

DAVID KOVACS
Assistant Vice President
Commercial Banking Officer

MICHELE LEE
Assistant Vice President
Community Banking Manager/Business Banking Officer

ANGELO LOCASTRO
Assistant Vice President
Community Banking Manager/Business Banking Officer

DARLENE MACK
Assistant Vice President
Human Resources Manager

JUDY RUSSELL
Vice President
Loan Servicing Manager

BARBARA R. SANDROCK
Vice President
Information Systems Manager

JEROME L. SMITH
Vice President
Commercial Banking Officer

CARRIE STACKHOUSE
Assistant Vice President
Commercial Banking Officer

RUSSELL E. TAYLOR
Assistant Vice President
Director of Security

SHIRLEY A. WADE
Assistant Vice President
Executive Secretary

JAMES E. WELLINGTON
Vice President
Retail Mortgage Banking Officer

MINDY WIESENSEE
Assistant Vice President
Community Banking Manager/Business Banking Officer

NICOLE WHITSEL
Assistant Vice President
Risk Manager/Compliance

JOHN D. YURCHISON
Vice President
Commercial Banking Officer

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