CORTLAND BANCORP INC
Form 10-Q
November 13, 2012

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D. C. 20549

FORM 10-Q

(Mark One)

x **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the quarterly period ended September 30, 2012

or

¨ **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the transition from to

Commission file number: 0-13814

Cortland Bancorp

(Exact name of registrant as specified in its charter)

Ohio	**34-1451118**
(State or other jurisdiction of	**(I.R.S. Employer**
Incorporation or organization)	**Identification No.)**
194 West Main Street, Cortland, Ohio	**44410**
(Address of principal executive offices)	**(Zip code)**

330- 637-8040

(Registrant s telephone number, including area code)

N/A

(Former name, former address and former fiscal year, if changed since last report)

Indicate by check mark whether the registrant: (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes x No ¨

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, 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 x No ¨

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 definition of accelerated filer and large accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act.

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

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

APPLICABLE ONLY TO CORPORATE ISSUERS:

Indicate the number of shares outstanding of each of the issuer s classes of common stock, as of the latest practicable date.

TITLE OF CLASS	SHARES OUTSTANDING
Common Stock, No Par Value	4,525,520 Shares November 6, 2012

PART I - FINANCIAL INFORMATION

CORTLAND BANCORP AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS (UNAUDITED)

(Amounts in thousands, except share data)

	September 30, 2012	December 31, 2011
ASSETS		
Cash and due from banks	**$ 11,622**	$ 10,055
Interest-earning deposits and other earning assets	**29,207**	6,121
Total cash and cash equivalents	**40,829**	16,176
Investment securities available-for-sale (Note 3)	**175,024**	185,916
Loans held for sale	**15,999**	947
Total loans (Note 4)	**293,194**	289,096
Less allowance for loan losses (Note 4)	**(3,617)**	(3,058)
Net loans	**289,577**	286,038
Premises and equipment	**6,524**	6,474
Bank-owned life insurance	**13,920**	12,937
Other assets	**12,635**	11,342
Total assets	**$ 554,508**	$ 519,830
LIABILITIES		
Noninterest-bearing deposits	**$ 82,304**	$ 70,726
Interest-bearing deposits	**356,553**	352,039
Total deposits	**438,857**	422,765
Short-term borrowings	**4,737**	4,773
Federal Home Loan Bank advances - short term	**2,500**	6,500
Federal Home Loan Bank advances - long term	**34,500**	31,000
Subordinated debt (Note 7)	**5,155**	5,155
Other liabilities	**18,199**	3,918
Total liabilities	**503,948**	474,111
SHAREHOLDERS EQUITY		
Common stock - $5.00 stated value - authorized 20,000,000 shares; issued 4,728,267 shares in 2012 and 2011; outstanding shares, 4,525,520 in 2012 and 4,525,530 in 2011	**23,641**	23,641
Additional paid-in capital	**20,850**	20,850
Retained earnings	**10,862**	7,485
Accumulated other comprehensive loss	**(1,199)**	(2,663)
Treasury stock, at cost, 202,747 shares in 2012 and 202,737 shares in 2011	**(3,594)**	(3,594)
Total shareholders equity	**50,560**	45,719
Total liabilities and shareholders equity	**$ 554,508**	$ 519,830

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

CORTLAND BANCORP AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF INCOME (UNAUDITED)

(Amounts in thousands, except share data)

	THREE MONTHS ENDED SEPTEMBER 30,		NINE MONTHS ENDED SEPTEMBER 30,	
	2012	2011	2012	2011
INTEREST INCOME				
Interest and fees on loans	**$ 4,097**	$ 3,837	**$ 11,990**	$ 11,449
Interest and dividends on investment securities:				
Taxable interest	**634**	1,070	**2,467**	3,262
Nontaxable interest	**372**	330	**1,097**	1,079
Dividends	**29**	28	**98**	98
Other interest income	**4**	10	**16**	45
Total interest income .	**5,136**	5,275	**15,668**	15,933
INTEREST EXPENSE				
Deposits	**661**	814	**2,064**	2,519
Other short-term borrowings	**2**	1	**4**	4
Federal Home Loan Bank advances - short term	**23**	5	**61**	79
Federal Home Loan Bank advances - long term	**301**	315	**898**	944
Subordinated debt	**25**	23	**76**	68
Total interest expense	**1,012**	1,158	**3,103**	3,614
Net interest income	**4,124**	4,117	**12,565**	12,319
PROVISION FOR LOAN LOSSES	**300**	324	**900**	872
NET INTEREST INCOME AFTER PROVISION FOR LOAN LOSSES	**3,824**	3,793	**11,665**	11,447
NON-INTEREST INCOME				
Fees for customer services	**509**	583	**1,547**	1,645
Investment securities gains - net	**25**	92	**60**	873
Impairment losses on investment securities:				
Total other-than-temporary impairment losses			**(35)**	(141)
Portion of gains recognized in other comprehensive income (before tax)			**(136)**	(61)
Net impairment losses recognized in earnings			**(171)**	(202)
Mortgage banking gains	**1,017**	25	**1,437**	61
Other real estate gains (losses) - net	**13**	28	**15**	(71)
Earnings on bank-owned life insurance	**128**	124	**381**	374
Other non-interest income	**20**	18	**166**	63
Total non-interest income	**1,712**	870	**3,435**	2,743
NON-INTEREST EXPENSES				
Salaries and employee benefits	**2,208**	1,835	**6,288**	5,429
Net occupancy and equipment expense	**477**	420	**1,350**	1,299
State and local taxes	**125**	116	**376**	349
FDIC insurance expense	**76**	148	**217**	521
Professional fees	**183**	158	**585**	520
Loss on partnership			**444**	
Other operating expenses	**779**	614	**2,146**	1,849

Total non-interest expenses		**3,848**		3,291		**11,406**		9,967
INCOME BEFORE FEDERAL INCOME TAX EXPENSE		**1,688**		1,372		**3,694**		4,223
Federal income tax expense		**422**		318		**317**		979
NET INCOME	**$**	**1,266**	$	1,054	**$**	**3,377**	$	3,244
EARNINGS PER SHARE, BOTH BASIC AND DILUTED (Note 6)	**$**	**0.28**	$	0.24	**$**	**0.75**	$	0.72
CASH DIVIDENDS DECLARED PER SHARE	**$**		$		**$**		$	

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

CORTLAND BANCORP AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (UNAUDITED)

(Amounts in thousands)

	THREE MONTHS ENDED SEPTEMBER 30,		NINE MONTHS ENDED SEPTEMBER 30,	
	2012	2011	2012	2011
Net income	**$ 1,266**	$ 1,054	**$ 3,377**	$ 3,244
Other comprehensive income:				
Securities available for sale:				
Unrealized holding gains (losses) on available-for-sale securities	**1,779**	(2,182)	**2,108**	(583)
Tax effect	**(605)**	742	**(717)**	198
Reclassification adjustment for other-than-temporary impairment losses on debt securities			**171**	202
Tax effect			**(58)**	(69)
Reclassification adjustment for net gains realized in net income	**(25)**	(92)	**(60)**	(873)
Tax effect	**8**	31	**20**	297
Total other comprehensive income (loss)	**1,157**	(1,501)	**1,464**	(828)
Total comprehensive income (loss)	**$ 2,423**	$ (447)	**$ 4,841**	$ 2,416

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

CORTLAND BANCORP AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CHANGES OF SHAREHOLDERS EQUITY (UNAUDITED)

(Amounts in thousands)

	Common Stock	Additional Paid-in Capital	Retained Earnings	Accumulated Other Comprehensive Loss	Treasury Stock	Total Shareholders Equity
NINE MONTHS ENDED SEPTEMBER 30, 2011						
Balance at December 31, 2010	$ 23,641	$ 20,850	$ 3,413	$ (2,458)	$ (3,594)	$ 41,852
Comprehensive income:						
Net income			3,244			3,244
Other comprehensive loss, net of tax				(828)		(828)
Balance at September 30, 2011	$ 23,641	$ 20,850	$ 6,657	$ (3,286)	$ (3,594)	$ 44,268
NINE MONTHS ENDED SEPTEMBER 30, 2012						
Balance at December 31, 2011	**$ 23,641**	**$ 20,850**	**$ 7,485**	**$ (2,663)**	**$ (3,594)**	**$ 45,719**
Comprehensive income:						
Net income			**3,377**			**3,377**
Other comprehensive income, net of tax				**1,464**		**1,464**
Balance at September 30, 2012	**$ 23,641**	**$ 20,850**	**$ 10,862**	**$ (1,199)**	**$ (3,594)**	**$ 50,560**

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

CORTLAND BANCORP AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS (UNAUDITED)

(Amounts in thousands)

	FOR THE NINE MONTHS ENDED SEPTEMBER 30, 2012	2011
Net cash (deficit) flow from operating activities	**$ (9,405)**	$ 6,591
Cash flow (deficit) from investing activities		
Purchases of available-for-sale securities	**(31,521)**	(50,744)
Proceeds from sales of securities	**19,277**	14,458
Proceeds from call, maturity and principal payments on securities	**36,191**	34,174
Net (increase) decrease in loans made to customers	**(4,509)**	1,269
Proceeds from disposition of other real estate	**280**	378
Purchases of bank-owned life insurance	**(694)**	
Purchases of premises and equipment	**(522)**	(258)
Net cash flow (deficit) from investing activities	**18,502**	(723)
Cash flow (deficit) from financing activities		
Net increase in deposit accounts	**16,092**	10,612
Repayments of Federal Home Loan Bank advances	**(6,500)**	(20,500)
Proceeds from Federal Home Loan Bank	**6,000**	4,000
Net (decrease) increase in short-term borrowings	**(36)**	1,048
Net cash flow (deficit) from financing activities	**15,556**	(4,840)
Net change in cash and cash equivalents	**24,653**	1,028
Cash and cash equivalents		
Beginning of period	**16,176**	15,804
End of period	**$ 40,829**	$ 16,832
Supplemental disclosures:		
Cash paid during the period for:		
Income taxes	**$ 400**	$ 1,190
Interest	**$ 3,164**	$ 3,703
Transfer of loans to other real estate owned	**$ 70**	$ 80

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

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

1.) Basis of Presentation:

The accompanying unaudited consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States (U.S. GAAP) for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by U.S. GAAP for complete financial statements. In the opinion of management, all adjustments (consisting of normal recurring items) considered necessary for a fair presentation have been included. Operating results for the three and nine months ended September 30, 2012 are not necessarily indicative of the results that may be expected for the year ending December 31, 2012. These interim unaudited consolidated financial statements should be read in conjunction with our annual audited financial statements as of December 31, 2011, included in our Form 10-K for the year ended December 31, 2011, filed with the United States Securities and Exchange Commission. The accompanying consolidated balance sheet at December 31, 2011, has been derived from the audited consolidated balance sheet but does not include all of the information and footnotes required by U.S. GAAP for complete financial statements.

2.) Reclassifications:

Certain items contained in the 2011 financial statements have been reclassified to conform to the presentation for 2012. Such reclassifications had no effect on the net results of operations.

3.) Investment Securities Available-for-Sale:

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 or trading.

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

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 is permanent, but indicates that the prospect for a near-term recovery of value is not necessarily favorable and that there is a lack of evidence to support a realizable value equal to or greater than the carrying value of the investment. Unrealized losses on investments have not been recognized into income. However, once a decline in value is determined to be other-than-temporary, the credit related other-than-temporary impairment (OTTI) is recognized in earnings while the non-credit related OTTI on securities not expected to be sold is recognized in other comprehensive loss.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

The following is a summary of investment securities:

	(Amounts in thousands)			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
September 30, 2012				
Investment securities available-for-sale				
U.S. Treasury securities	**$ 115**	**$ 11**	**$**	**$ 126**
U.S. Government agencies and corporations	**9,079**	**50**		**9,129**
Obligations of states and political subdivisions	**38,589**	**2,054**	**8**	**40,635**
U.S. Government-sponsored mortgage-backed securities	**72,919**	**2,563**	**94**	**75,388**
U.S. Government-sponsored collateralized mortgage obligations	**38,547**	**479**	**75**	**38,951**
Trust preferred securities	**13,882**		**6,586**	**7,296**
Total debt securities	**173,131**	**5,157**	**6,763**	**171,525**
Regulatory stock	**3,049**			**3,049**
General Motors equity investments	**661**	**10**	**221**	**450**
Total available-for-sale	**$ 176,841**	**$ 5,167**	**$ 6,984**	**$ 175,024**
December 31, 2011				
Investment securities available-for-sale				
U.S. Treasury securities	$ 119	$ 14	$	$ 133
U.S. Government agencies and corporations	20,280	262		20,542
Obligations of states and political subdivisions	37,419	1,602	2	39,019
U.S. Government-sponsored mortgage-backed securities	71,078	3,102	91	74,089
U.S. Government-sponsored collateralized mortgage obligations	39,131	318	255	39,194
Private-label mortgage-backed securities	127	3		130
Private-label collateralized mortgage obligations	518		267	251
Trust preferred securities	17,600	4	8,459	9,145
Total debt securities	186,272	5,305	9,074	182,503
Regulatory stock	3,049			3,049
General Motors equity investments	631		267	364
Total available-for-sale	$ 189,952	$ 5,305	$ 9,341	$ 185,916

At September 30, 2012 and December 31, 2011, regulatory stock consisted of $2.8 million in Federal Home Loan Bank of Cincinnati (FHLB) stock and $226,000 in Federal Reserve Bank (FED) stock. Each investment is carried at cost, and the Company is required to hold such investments as a condition of membership in order to transact business with the FHLB and the FED.

While the Federal Home Loan Banks have been negatively impacted by the current economic conditions, the FHLB has reported profits for 2011 and year-to-date 2012, remains in compliance with regulatory capital and liquidity requirements, continues to pay dividends on stock and makes redemptions at par value. With consideration given to these factors, management concluded that the stock was not impaired at September 30, 2012 or December 31, 2011.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

The amortized cost and fair value of debt securities at September 30, 2012, by contractual maturity, are shown below. Actual maturities will differ from contractual maturities because issuers may have the right to call or prepay obligations with or without call or prepayment penalties.

	(Amounts in thousands)	
	Amortized Cost	Fair Value
Investment securities available-for-sale		
Due in one year or less	**$ 1,466**	**$ 1,478**
Due after one year through five years	**5,160**	**5,309**
Due after five years through ten years	**9,634**	**9,872**
Due after ten years	**45,405**	**40,527**
Total investment securities available-for-sale	**61,665**	**57,186**
U.S. Government-sponsored mortgage-backed and related securities	**111,466**	**114,339**
Total investment securities	**$ 173,131**	**$ 171,525**

The table below sets forth the proceeds and gains or losses realized on securities sold or called for the periods presented:

	(Amounts in thousands)			
	THREE MONTHS ENDED September 30,		NINE MONTHS ENDED September 30,	
	2012	2011	2012	2011
Proceeds on securities sold	**$ 19,568**	$ 1,949	**$ 19,568**	$ 14,458
Gross realized gains	**1,040**	71	**1,040**	562
Gross realized losses	**1,013**		**1,013**	33
Proceeds on securities called	**120**	859	**2,526**	1,839
Gross realized gains		6	**7**	10
Gross realized losses	**2**		**4**	
Exchange on General Motors transaction:				
Gross realized gains		15	**30**	334

Available-for-sale securities, carried at fair value, totaled $175.0 million at September 30, 2012 and $185.9 million at December 31, 2011. These securities represent 100.00% of all investment securities at both September 30, 2012 and December 31, 2011. In management s opinion, these levels provide an adequate level of liquidity.

Investment securities with a carrying value of approximately $106.0 million and $106.4 were pledged to secure deposits and for other purposes at September 30, 2012 and December 31, 2011.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

The following is a summary of the fair value of securities with unrealized losses and an aging of those unrealized losses at September 30, 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
U.S. Government-sponsored mortgage-backed and related securities	**$ 11,203**	**$ 84**	**$ 1,516**	**$ 10**	**$ 12,719**	**$ 94**
U.S. Government-sponsored collateralized mortgage obligations	**8,220**	**31**	**2,935**	**44**	**11,155**	**75**
Obligations of states and political subdivisions	**905**	**8**			**905**	**8**
Trust preferred securities			**7,296**	**6,586**	**7,296**	**6,586**
General Motors equity investments	**8**	**2**	**401**	**219**	**409**	**221**
Total	**$ 20,336**	**$ 125**	**$ 12,148**	**$ 6,859**	**$ 32,484**	**$ 6,984**

The above table comprises 38 investment securities where the fair value is less than the related amortized cost.

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

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

The above table comprises 45 investment securities where the fair 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 and insurance companies. The unrealized loss on these securities at September 30, 2012 was $6.6 million, compared to an $8.5 million loss at December 31, 2011.

The unrealized losses on the Company s investment in obligations of states and political subdivisions, U.S. Government-sponsored mortgage-backed securities, U.S. Government-sponsored collateralized mortgage obligations and private-label collateralized mortgage obligations (CMO) were caused by changes in market rates and related spreads, as well as reflecting current distressed conditions in the credit markets and the market s on-going reassessment of appropriate liquidity and risk premiums. It is expected that the securities would not be settled at less than the amortized cost of the Company s investment because the decline in fair value is attributable to changes in interest rates and relative spreads and not credit quality. Also, the Company does not intend to sell those investments and it is not more-likely-than-not that the Company will be required to sell the investments before recovery of its amortized cost basis less any current period credit loss. The Company does not consider those investments to be other-than-temporarily impaired at September 30, 2012.

<u>Securities Deemed to be Other-Than-Temporarily Impaired</u>

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, FASB ASC topic 320, *Investments Debt and Equity Securities* requires an entity to assess whether (a) it has the intent to sell the debt security or (b) it is more-likely-than-not that it will be required to sell the debt security before its anticipated recovery. If either of these conditions is met, an OTTI on the security must be recognized.

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

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

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 income statement 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 9, 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 September 30, 2012 and 2011. The Company recorded no impairment credit losses in earnings on available-for-sale securities for the quarters ended September 30, 2012 and 2011, respectively. The non-credit portion of impairment recognized for the nine months ended September 30, 2012 and 2011, respectively, was recorded in other comprehensive income.

	(Amounts in thousands)			
	THREE MONTHS ENDED September 30,		NINE MONTHS ENDED September 30,	
	2012	2011	2012	2011
Trust preferred securities	**$**	$	**$ 171**	$ 202
Total	**$**	$	**$ 171**	$ 202

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

	(Amounts in thousands)			
	THREE MONTHS ENDED September 30,		NINE MONTHS ENDED September 30,	
	2012	2011	2012	2011
Beginning balance	**$ 10,845**	$ 10,674	**$ 10,674**	$ 10,472
Additional credit losses on debt securities for which other-than-temporary impairment was previously recognized			**171**	202
Sale of debt securities	**(10,494)**		**(10,494)**	
Ending balance	**$ 351**	$ 10,674	**$ 351**	$ 10,674

During the quarter, 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 was able to sell 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. The Company continues to have both the intent and ability to hold these securities to maturity. Also during the quarter, 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.

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. The market value of the equity securities received exceeded the written down basis, generating a recognizable gain of $15,000 for the three months ended September 30, 2011. Year-to-date gains of $30,000 were recognized for the period ended September 30, 2012 and $334,000 for the period ended September 30, 2011. The Company holds escrow stubs representing any remaining distributions from the bankruptcy trust. The fair value of the

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

equity securities at September 30, 2012 was $450,000 reflecting an unrealized loss of $211,000. In reviewing GM s recent share price history, targets prices of analysts, GM s achievement of the number one automaker in terms of sales and the Company s ability to hold the securities for a period of time to allow for potential recovery, the securities are not considered other-than-temporarily impaired.

At September 30, 2012, there was $832,000 of investment securities considered to be in non-accrual status. This balance is comprised of 3 of the 12 investments in trust preferred securities. The quarterly interest payments have been placed in payment in kind status, which results in a temporary delay in the payment of interest. 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.

4.) Loans and Allowance for Loan Losses:

The Company, through its subsidiary 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)			
	September 30, 2012		December 31, 2011	
	Balance	%	Balance	%
Commercial real estate	**$ 184,490**	**63.0**	$ 160,319	55.5
Commercial	**45,544**	**15.5**	60,233	20.8
Residential real estate	**41,187**	**14.0**	45,780	15.8
Consumer - other	**4,263**	**1.5**	5,848	2.0
Consumer - home equity	**17,710**	**6.0**	16,916	5.9
Total loans	**$ 293,194**		$ 289,096	

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

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

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

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

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

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

NINE MONTHS ENDED (Amounts in thousands)

September 30, 2012	Commercial	Commercial real estate	Consumer - other	Consumer - home equity	Residential real estate	Total
Balance at beginning of period	**$ 565**	**$ 1,803**	**$ 92**	**$ 128**	**$ 470**	**$ 3,058**
Loan charge-offs	**(17)**	**(36)**	**(110)**	**(58)**	**(231)**	**(452)**
Recoveries	**7**	**17**	**40**	**8**	**39**	**111**
Net loan charge-offs	**(10)**	**(19)**	**(70)**	**(50)**	**(192)**	**(341)**
Provision charged to operations	**132**	**577**	**77**	**42**	**72**	**900**
Balance at end of period	**$ 687**	**$ 2,361**	**$ 99**	**$ 120**	**$ 350**	**$ 3,617**

September 30, 2011	Commercial	Commercial real estate	Consumer - other	Consumer - home equity	Residential real estate	Total
Balance at beginning of period	$ 249	$ 1,611	$ 112	$ 111	$ 418	$ 2,501
Loan charge-offs		(200)	(125)	(91)	(75)	(491)
Recoveries	2	119	46	4	5	176
Net loan charge-offs	2	(81)	(79)	(87)	(70)	(315)
Provision charged to operations	286	336	68	106	76	872
Balance at end of period	$ 537	$ 1,866	$ 101	$ 130	$ 424	$ 3,058

THREE MONTHS ENDED (Amounts in thousands)

September 30, 2012	Commercial	Commercial real estate	Consumer - other	Consumer - home equity	Residential real estate	Total
Balance at beginning of period	**$ 600**	**$ 2,100**	**$ 90**	**$ 152**	**$ 396**	**$ 3,338**
Loan charge-offs		**(20)**	**(38)**		**(12)**	**(70)**
Recoveries	**2**	**1**	**11**	**3**	**32**	**49**
Net loan charge-offs	**2**	**(19)**	**(27)**	**3**	**20**	**(21)**
Provision charged to operations	**85**	**280**	**36**	**(35)**	**(66)**	**300**
Balance at end of period	**$ 687**	**$ 2,361**	**$ 99**	**$ 120**	**$ 350**	**$ 3,617**

September 30, 2011	Commercial	Commercial real estate	Consumer - other	Consumer - home equity	Residential real estate	Total
Balance at beginning of period	$ 518	$ 1,739	$ 106	$ 101	$ 389	$ 2,853
Loan charge-offs			(29)	(91)	(24)	(144)
Recoveries	1	7	13	2	2	25

Net loan charge-offs	1	7	(16)	(89)	(22)	(119)
Provision charged to operations	18	120	11	118	57	324
Balance at end of period	$ 537	$ 1,866	$ 101	$ 130	$ 424	$ 3,058

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The total allowance of $3.6 million reflects management s estimate of loan losses inherent in the loan portfolio at the consolidated balance sheet date. The following tables present a full breakdown by portfolio segment of the allowance for loan losses and the recorded investment in loans for the periods ended September 30, 2012 and December 31, 2011.

(Amounts in thousands)

September 30, 2012	Commercial	Commercial real estate	Consumer - other	Consumer - home equity	Residential real estate	Total
Allowance for loan losses:						
Ending allowance balance attributable to loans:						
Individually evaluated for impairment	**$ 53**	**$ 423**	**$**	**$**	**$**	**$ 476**
Collectively evaluated for impairment	**634**	**1,938**	**99**	**120**	**350**	**3,141**
Total ending allowance balance	**$ 687**	**$ 2,361**	**$ 99**	**$ 120**	**$ 350**	**$ 3,617**
Loan Portfolio:						
Individually evaluated for impairment	**$ 53**	**$ 5,694**	**$**	**$**	**$**	**$ 5,747**
Collectively evaluated for impairment	**45,491**	**178,796**	**4,263**	**17,710**	**41,187**	**287,447**
Total ending loans balance	**$ 45,544**	**$ 184,490**	**$ 4,263**	**$ 17,710**	**$ 41,187**	**$ 293,194**

December 31, 2011	Commercial	Commercial real estate	Consumer - other	Consumer - home equity	Residential real estate	Total
Allowance for loan losses:						
Ending allowance balance attributable to loans:						
Individually evaluated for impairment	$ 69	$ 55	$	$	$	$ 124
Collectively evaluated for impairment	496	1,748	92	128	470	2,934
Total ending allowance balance	$ 565	$ 1,803	$ 92	$ 128	$ 470	$ 3,058
Loan Portfolio:						
Individually evaluated for impairment	$ 69	$ 2,618	$	$	$	$ 2,687
Collectively evaluated for impairment	60,164	157,701	5,848	16,916	45,780	286,409
Total ending loans balance	$ 60,233	$ 160,319	$ 5,848	$ 16,916	$ 45,780	$ 289,096

The following tables represent credit exposures by internally assigned grades for September 30, 2012 and December 31, 2011. 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 September 30, 2012 and December 31, 2011:

	(Amounts in thousands)		
September 30, 2012	Commercial	Commercial real estate	Total
Pass	**$ 43,521**	**$ 166,156**	**$ 209,677**
Special Mention	**1,056**	**8,935**	**9,991**
Substandard	**967**	**9,399**	**10,366**
Doubtful/Loss			
Ending Balance	**$ 45,544**	**$ 184,490**	**$ 230,034**

December 31, 2011	Commercial	Commercial real estate	Total
Pass	$ 57,545	$ 142,781	$ 200,326
Special Mention	503	8,269	8,772
Substandard	2,185	9,269	11,454
Doubtful/Loss			
Ending Balance	$ 60,233	$ 160,319	$ 220,552

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 September 30, 2012 and December 31, 2011.

	(Amounts in thousands)		
	Consumer- other	Consumer - home equity	Residential real estate
September 30, 2012			
Performing	**$ 4,207**	**$ 17,637**	**$ 40,586**
Nonperforming	**56**	**73**	**601**
Total	**$ 4,263**	**$ 17,710**	**$ 41,187**

	Consumer- other	Consumer - home equity	Residential real estate
December 31, 2011			
Performing	$ 4,775	$ 16,805	$ 44,938
Nonperforming	1,073	111	842
Total	$ 5,848	$ 16,916	$ 45,780

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.

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 nine months.

There were $2.9 million in TDRs at September 30, 2012 and $1.2 million at December 31, 2011 and September 30, 2011. The total interest recognized on these loans was $117,000, $69,000 and $52,000 for the periods ending September 30, 2012, December 31, 2011 and September 30, 2011, respectively. Had the loans not been restructured, interest would have increased pretax income by $4,000 at both December 31, 2011 and September 30, 2011 and at September 30, 2012 there was no impact on pretax income.

The following presents by class, information related to loans modified in a TDR during the periods ended (1):

	(Amounts in thousands)					
	Three Months Ended September 30, 2012			Nine Months Ended September 30, 2012		
Troubled Debt Restructurings (amounts in thousands)	Number of Contracts	Recorded Investment (as of period end)	Increase in the Allowance (as of period end)	Number of Contracts	Recorded Investment (as of period end)	Increase in the Allowance (as of period end)
Commercial Real Estate	**1**	**$ 159**	**$**	**4**	**$ 1,736**	**$ 148**
Total	**1**	**$ 159**	**$**	**4**	**$ 1,736**	**$ 148**

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

There were no loans modified in a TDR from July 1, 2011 through June 30, 2012 that subsequently defaulted (i.e., 60 days or more past due following a modification) during the three months ended September 30, 2012.

There were no loans modified in a TDR from January 1, 2011 through December 31, 2011 that subsequently defaulted (i.e., 60 days or more past due following a modification) during the nine months ended September 30, 2012.

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The following is an aging analysis of the recorded investment of past due loans as of September 30, 2012 and December 31, 2011.

(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
September 30, 2012							
Commercial real estate	**$ 568**	**$**	**$ 2,821**	**$ 3,389**	**$ 181,101**	**$ 184,490**	**$**
Commercial			**53**	**53**	**45,491**	**45,544**	
Residential real estate	**292**		**406**	**698**	**40,489**	**41,187**	
Consumer:							
Consumer - home equity		**28**	**62**	**90**	**17,620**	**17,710**	
Consumer - other	**20**		**56**	**76**	**4,187**	**4,263**	
Total	**$ 880**	**$ 28**	**$ 3,398**	**$ 4,306**	**$ 288,888**	**$ 293,194**	**$**

	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, 2011							
Commercial real estate	$ 50	$	$ 515	$ 565	$ 159,754	$ 160,319	$
Commercial	1		69	70	60,163	60,233	
Residential real estate	296	112	667	1,075	44,705	45,780	
Consumer:							
Consumer - home equity		3	90	93	16,823	16,916	
Consumer - other	54	33	1,039	1,126	4,722	5,848	
Total	$ 401	$ 148	$ 2,380	$ 2,929	$ 286,167	$ 289,096	$

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.

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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 September 30, 2012 and December 31, 2011. Also presented are the average recorded investments in the impaired balances and interest income recognized after impairment for the three and nine months ended September 30, 2012 and September 30, 2011.

	(Amounts in thousands)		
	Recorded Investment	Unpaid Principal Balance	Related Allowance
September 30, 2012			
With no related allowance recorded:			
Commercial real estate	**$ 1,435**	**$ 1,435**	**$**
With an allowance recorded:			
Commercial real estate	**$ 4,259**	**$ 4,259**	**$ 423**
Commercial	**53**	**53**	**53**
Total:			
Commercial real estate	**$ 5,694**	**$ 5,694**	**$ 423**
Commercial	**53**	**53**	**53**

	Recorded Investment	Unpaid Principal Balance	Related Allowance
December 31, 2011			
With no related allowance recorded:			
Commercial real estate	$ 1,218	$ 1,218	$
With an allowance recorded:			
Commercial real estate	$ 1,400	$ 1,400	$ 55
Commercial	69	69	69
Total:			
Commercial real estate	$ 2,618	$ 2,618	$ 55
Commercial	69	69	69

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	(Amounts in thousands)			
	THREE MONTHS ENDED		NINE MONTHS ENDED	
	Average Recorded Investment	Interest Income Recognized	Average Recorded Investment	Interest Income Recognized
September 30, 2012				
With no related allowance recorded:				
Commercial real estate	**$ 1,512**	**$**	**$ 1,171**	**$**
Commercial			**23**	
With an allowance recorded:				
Commercial real estate	**$ 4,272**	**$ 29**	**$ 2,819**	**$ 73**
Commercial	**54**		**60**	
Total:				
Commercial real estate	**$ 5,784**	**$ 29**	**$ 3,990**	**$ 73**
Commercial	**54**		**83**	

	THREE MONTHS ENDED		NINE MONTHS ENDED	
	Average Recorded Investment	Interest Income Recognized	Average Recorded Investment	Interest Income Recognized
September 30, 2011				
With no related allowance recorded:				
Commercial real estate	$ 887	$ 31	$ 858	$ 37
Commercial	168		56	
With an allowance recorded:				
Commercial real estate	$ 1,412	$ 39	$ 1,293	$ 57
Commercial	76		88	
Total:				
Commercial real estate	$ 2,299	$ 70	$ 2,151	$ 94
Commercial	244		144	

The following is a summary of classes of loans on non-accrual status as of September 30, 2012 and December 31, 2011:

	(Amounts in thousands)	
	September 30, 2012	December 31, 2011
Commercial real estate	**$ 2,980**	$ 1,470
Commercial	**53**	70
Residential real estate	**601**	842
Consumer:		
Consumer - home equity	**73**	111
Consumer - other	**56**	1,073
Total	**$ 3,763**	$ 3,566

As of September 30, 2012 and December 31, 2011, there were $4.7 million and $8.9 million, respectively, in loans that were neither classified as non-accrual nor considered impaired, but which can be considered potential problem loans.

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5.) Legal Proceedings:

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

6.) Earnings Per Share and Capital Transactions:

The following table sets forth the computation of basic earnings per common share and diluted earnings per common share. Basic earnings per share is computed by dividing net income by the weighted average number of shares outstanding during the applicable period.

	THREE MONTHS ENDED September 30,		NINE MONTHS ENDED September 30,	
	2012	2011	2012	2011
Net income (amounts in thousands)	**$ 1,266**	$ 1,054	**$ 3,377**	$ 3,244
Weighted average common shares outstanding	**4,525,523**	4,525,537	**4,525,526**	4,525,539
Basic earnings per share	**$ 0.28**	$ 0.24	**$ 0.75**	$ 0.72
Diluted earnings per share	**$ 0.28**	$ 0.24	**$ 0.75**	$ 0.72

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 Bancorp 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 September 30, 2012 and December 31, 2011 were 1.84% and 2.00%, 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.

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

8.) Commitments:

Commitments to fund certain mortgage loans (interest rate locks) to be sold into the secondary market, forward contracts for the future purchase of mortgage-backed securities and forward contracts for the future delivery of these mortgage loans are considered derivatives. It is the Company s practice to enter into the forward contracts for the future purchase 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 are not formally designated in hedge relationships. The Company reports 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.

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

	(Amounts in thousands) September 30, 2012	December 31, 2011
Mortgage banking derivative commitments:		
Interest rate lock commitments	**$ 70,139**	$ 12,300
Forward contracts for the future delivery of mortgage loans	**13,078**	
Forward contracts for the future purchase of mortgage-backed securities	**45,000**	
Corresponding recorded balances :		
Derivative asset	**$ 1,696**	$ 66
Derivative liability	**1,059**	
Reserve for loan repurchases	**247**	19

The Bank is a party to financial instruments with off-balance sheet risk in the normal course of business to meet the financing needs of its customers. These financial instruments include commitments to extend credit, standby letters of credit and financial guarantees. Such instruments involve, to varying degrees, elements of credit risk in excess of the amount recognized on the consolidated balance sheets. The contract or notional amounts or those instruments reflect the extent of involvement the Company has in particular classes of financial instruments.

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

The following is a summary of such contractual commitments:

	(Amounts in thousands) September 30, 2012	December 31, 2011
Commitments to extend credit:		
Fixed rate	**$ 8,099**	$ 7,725
Variable rate	**48,850**	52,026
Standby letters of credit	**652**	714

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 available amount of overdraft protection on depositors accounts totaled $9.9 million at September 30, 2012 and $10.1 million at December 31, 2011. The total average daily balance of overdrafts used at

September 30, 2012 was $112,000 and $120,000 at December 31, 2011, or less than 2% of the total aggregate overdraft protection available to depositors. The balance at September 30, 2012 of all deposit overdrafts included in total loans was $109,000 and $115,000 at December 31, 2011.

9.) Fair Value of Assets and Liabilities:

Measurements

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

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

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

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

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

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The following table presents the assets reported on the consolidated balance sheets at their fair value as of September 30, 2012 and December 31, 2011 by level within the fair value hierarchy. Financial assets and liabilities are classified in their entirety based on the lowest level of input that is significant to the fair value measurement.

		(Amounts in thousands) Fair Value Measurements at 9/30/12 Using		
Description	September 30, 2012	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	**$ 126**	**$**	**$ 126**	**$**
U.S. Government agencies and corporations	**9,129**		**9,129**	
Obligations of states and political subdivisions	**40,635**		**40,635**	
U.S. Government-sponsored mortgage-backed and CMO securities	**114,339**		**114,339**	
Trust preferred securities	**7,296**			**7,296**
General Motors equity investments	**450**	**450**		
Loans held for sale	**15,999**		**15,999**	
Mortgage banking derivatives	**1,696**		**1,696**	
LIABILITIES				
Mortgage banking derivatives	**$ 1,059**	**$**	**$ 1,059**	**$**

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

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

The following tables present the changes in the Level 3 fair value category for the three and nine months ended September 30, 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)	
	Trust preferred securities Three Months Ended September 30, 2012	Trust preferred securities Nine Months Ended September 30, 2012
Beginning balance	**$ 9,421**	**$ 9,145**
Net realized/unrealized gains/(losses) included in:		
Noninterest income		**(171)**
Other comprehensive income	**1,406**	**1,869**
Transfers in and/or out of Level 3		
Sales	**(3,531)**	**(3,531)**
Purchases, issuances and settlements		**(16)**
Ending balance, September 30, 2012	**$ 7,296**	**$ 7,296**
Losses included in net income for the period relating to assets held at September 30, 2012	**$**	**$ (90)**

	(Amounts in thousands)	
	Trust preferred securities Three Months Ended September 30, 2011	Trust preferred securities Nine Months Ended September 30, 2011
Beginning balance	$ 11,722	$ 12,779
Net realized/unrealized gains/(losses) included in:		
Noninterest income		(202)
Other comprehensive income	(2,790)	(3,639)
Transfers in and/or out of Level 3		
Purchases, issuances and settlements	(4)	(10)
Ending balance, September 30, 2011	$ 8,928	$ 8,928
Losses included in net income for the period relating to assets held at September 30, 2011	$	$ (202)

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.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

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.

The Company holds 12 trust preferred securities totaling $14.4 million (par value) that are backed by pooled trust preferred debt issued by banks, thrifts, insurance companies and real estate investment trusts. These securities were all rated investment grade at inception. Beginning during the second half of 2008 and through the third quarter of 2012, factors outside the Company s control impacted the fair value of these securities and will likely continue to do so for the foreseeable future. These factors include, but are not limited to, the following: guidance on fair value accounting, issuer credit deterioration, issuer deferral and default rates, potential failure or government seizure of underlying financial institutions or insurance companies, ratings agency actions, or regulatory actions. As a result of changes in these and various other factors during 2009 through the third quarter of 2012, Moody s Investors Service, Fitch Ratings and Standards and Poor s downgraded multiple trust preferred securities, including securities held by the Company. All 12 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 the third quarter of 2012 have resulted in illiquid and inactive financial markets and severely depressed prices for these securities. The Company analyzed the cash flow characteristics of the 12 securities. For 10 of these securities, the Company does not consider the investment in these assets to be OTTI at September 30, 2012. 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 was no adverse change in the cash flows. Although the Company does not consider the investment in these assets to be OTTI at September 30, 2012, there is a risk that subsequent evaluations could result in recognition of OTTI charges in the future. The remaining 2 securities had life-to-date impairment losses of $2.1 million, of which $351,000 was recorded as expense, and $1.7 million was recorded in other comprehensive loss. The securities subjected to FASB ASC Topic 320 accounted for the entire $6.6 million of gross unrealized losses in the trust preferred securities category at September 30, 2012.

The following table details the 2 debt securities with other-than-temporary impairment, their credit ratings at September 30, 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	Amount of OTTI related to credit loss at September 30, 2012
PreTSL XXIII Class C-FP	C/C	$ **211**	$	$	$	$ **211**
Trapeza IX B-1	Ca/CC	**50**	**90**			**140**
Total		$ **261**	$ **90**	$	$	$ **351**

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

The following table details the 18 debt securities with other-than-temporary impairment, their credit ratings at September 30, 2011 and the related losses recognized in earnings:

(Amounts in thousands)

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

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

The following table provides additional information related to the Company s trust preferred securities as of September 30, 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	$ 156	$ (855)	C/C	93	25.49%	%
PreTSL XXIII	C-FP	1,554	531	(1,023)	C/C	93	25.49	
I-PreTSL I	B-1	986	600	(386)	NR/CCC	14	25.78	4.22
I-PreTSL I	B-2	1,000	600	(400)	NR/CCC	14	25.78	4.22
I-PreTSL I	B-3	1,000	600	(400)	NR/CCC	14	25.78	4.22
I-PreTSL II	B-3	2,991	2,245	(746)	NR/B	23	12.60	13.19
I-PreTSL III	B-2	1,000	602	(398)	Ba3/CCC	22	18.02	9.18
I-PreTSL III	C	1,000	372	(628)	NR/CCC	22	18.02	0.56
I-PreTSL IV	B-1	1,000	643	(357)	Ba2/CCC	24	13.87	7.44
I-PreTSL IV	B-2	1,000	643	(357)	Ba2/CCC	24	13.87	7.44
I-PreTSL IV	C	480	144	(336)	Caa1/CC	24	13.87	1.88
Trapeza IX	B-1	860	160	(700)	Ca/CC	34	19.91	
Total		$ 13,882	$ 7,296	$ (6,586)				

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

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

(Amounts in thousands)

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

The market for these securities at September 30, 2012 and December 31, 2011 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 September 30, 2012;

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.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

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 10.04% to 23.27% and are highly dependent upon the credit quality of the collateral, the relative position of the tranche in the capital structure of the trust preferred security and the prepayment assumptions.

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

The following table presents the assets measured on a nonrecurring basis on the consolidated balance sheets at their fair value as of September 30, 2012 and December 31, 2011, 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) September 30, 2012			
	Level 1	Level 2	Level 3	Total
Assets measured on a nonrecurring basis:				
Impaired loans	**$**	**$**	**$ 5,271**	**$ 5,271**
Other real estate owned			**242**	**242**

	December 31, 2011			
	Level 1	Level 2	Level 3	Total
Assets measured on a nonrecurring basis:				
Impaired loans	$	$	$ 2,563	$ 2,563
Other real estate owned			437	437

Impaired loans: A loan is considered to be impaired when, based on current information and events, it is probable that the Company will be unable to collect all amounts due (both interest and principal) according to the contractual terms of the loan agreement. Impaired loans are measured, as a practical expedient, at the loan s observable market price or the fair market value of the collateral if the loan is collateral dependent. At September 30, 2012, the recorded investment in impaired loans was $5,747,000 with a related reserve of $476,000 resulting in a net balance of $5,271,000. At December 31, 2011, the recorded investment in impaired loans was $2,687,000 with a related reserve of $124,000 resulting in a net balance of $2,563,000.

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

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

relating to holding and maintaining the property, are charged to expense. At September 30, 2012, the recorded investment in OREO was $365,000 with a valuation allowance of $123,000 resulting in a net balance of $242,000. At December 31 2011, the recorded investment in OREO was $560,000 with a valuation allowance of $123,000 resulting in a net balance of $437,000.

Financial Instruments

The FASB ASC Topic 825, *Financial Instruments*, requires disclosure of fair value information about financial instruments,

whether or not recognized in the Consolidated Balance Sheets, for which it is practicable to estimate the value. In cases where quoted market prices are not available, fair values are based on estimates using present value or other estimation techniques. Those techniques are significantly affected by the assumptions used, including the discount rate and estimates of future cash flows.

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

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

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

Loans 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. Loans held for sale are carried, in aggregate, at the lower of cost or fair value.

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

Mortgage banking derivatives   The Company enters into derivative financial instruments in the form of interest rate locks with potential mortgage loan borrowers, and likewise enters into contracts for the future delivery of residential mortgage loans into the secondary markets. These derivative instruments are recognized as either assets or liabilities at fair value on a recurring basis in the consolidated balance sheets as indicated in the ensuing table. 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 September 30, 2012. Forward contracts to purchase mortgage-backed securities are valued at trading levels as of September 30, 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 putable 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.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

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 September 30, 2012 and December 31, 2011 is not material.

In addition, other assets and liabilities of the Company that are not defined as financial instruments are not included in the

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

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

	(Amounts in thousands) September 30, 2012				
	Carrying Amount	Level 1	Level 2	Level 3	Estimated Fair Value
ASSETS:					
Cash and cash equivalents	**$ 40,829**	**$ 40,829**	**$**	**$**	**$ 40,829**
Investment securities available-for-sale	**175,024**	**450**	**167,278**	**7,296**	**175,024**
Loans held for sale	**15,999**		**15,999**		**15,999**
Loans, net of allowance for loan losses	**289,577**			**297,187**	**297,187**
Accrued interest receivable	**2,007**	**2,007**			**2,007**
Mortgage banking derivatives	**1,696**		**1,696**		**1,696**
LIABILITIES:					
Demand, savings and money market deposits	**$ 280,536**	**$ 280,536**	**$**	**$**	**$ 280,536**
Time deposits	**158,321**		**162,610**		**162,610**
FHLB advances	**37,000**			**40,366**	**40,366**
Short-term borrowings	**4,737**	**4,737**			**4,737**
Subordinated debt	**5,155**			**4,325**	**4,325**
Accrued interest payable	**381**	**381**			**381**
Mortgage banking derivatives	**1,059**		**1,059**		**1,059**

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

	(Amounts in thousands) December 31, 2011	
	Carrying Amount	Estimated Fair Value
ASSETS:		
Cash and cash equivalents	$ 16,176	$ 16,176
Investment securities available-for-sale	185,916	185,916
Loans held for sale	947	947
Loans, net of allowance for loan losses	286,038	291,681
Accrued interest receivable	1,919	1,919
Mortgage banking derivatives	66	66
LIABILITIES:		
Demand, savings and money market deposits	$ 265,171	$ 265,171
Time deposits	157,594	160,978
FHLB advances	37,500	41,113
Short-term borrowings	4,773	4,773
Subordinated debt	5,155	3,508
Accrued interest payable	441	441

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

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 September 30, 2012.

	(Amounts in thousands) Fair value at September 30, 2012	Valuation Technique	Significant Unobservable Input	Description of Inputs
Trust preferred securities	$ 7,296	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 0.36% 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 ~10.04% to ~23.27%, depending on each bond s seniority and remaining subordination after projected losses.
Impaired loans	4,139	Appraisal of Collateral (1)	Appraisal Adjustments (2)	0% to (27)%
			Liquidation Expenses (2)	0% to (13)%
	1,132	Discounted Cash Flow	Discount Rate	5.75% (only one loan)
Other real estate owned	242	Appraisal of Collateral (1), (3)	Appraisal Adjustments (2)	0% to (36)%
			Sales Agreements	0% to (38)%

(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.

CONSOLIDATED AVERAGE BALANCE SHEETS, YIELDS AND RATES (UNAUDITED)

(Fully taxable equivalent basis in thousands of dollars)

	SEPTEMBER 30, 2012			YEAR-TO-DATE AS OF DECEMBER 31, 2011			SEPTEMBER 30, 2011		
	Average Balance	Interest	Average Rate	Average Balance	Interest	Average Rate	Average Balance	Interest	Average Rate
ASSETS									
Interest earning deposits and other assets	**$ 7,322**	**$ 16**	**0.29%**	$ 12,738	$ 51	0.40%	$ 14,856	$ 45	0.39%
Investment securities (1) (2)	**182,576**	**4,203**	**3.07%**	186,872	6,491	3.47%	184,877	4,967	3.59%
Loans (1) (2) (3)	**293,935**	**12,025**	**5.45%**	261,080	15,314	5.87%	259,344	11,486	5.93%
Total interest-earning assets	**483,833**	**$ 16,244**	**4.48%**	460,690	$ 21,856	4.74%	459,077	$ 16,498	4.81%
Cash and due from banks	**7,725**			7,175			7,040		
Bank premises and equipment	**6,511**			6,612			6,637		
Other assets	**18,773**			19,251			20,155		
Total non-interest-earning assets	**33,009**			33,038			33,832		
Total assets	**$ 516,842**			$ 493,728			$ 492,909		
LIABILITIES AND SHAREHOLDERS EQUITY									
Interest-bearing demand deposits	**$ 80,696**	**$ 105**	**0.17%**	$ 73,809	$ 176	0.20%	$ 72,796	$ 137	0.25%
Savings	**102,932**	**78**	**0.10%**	94,160	141	0.12%	93,155	112	0.16%
Time	**156,915**	**1,881**	**1.60%**	161,280	2,976	1.75%	161,791	2,270	1.88%
Total interest-bearing deposits	**340,543**	**2,064**	**0.81%**	329,249	3,293	0.92%	327,742	2,519	1.03%
Other borrowings	**44,730**	**963**	**2.88%**	43,734	1,347	3.26%	45,307	1,027	3.03%
Subordinated debt	**5,155**	**76**	**1.94%**	5,155	92	1.86%	5,155	68	1.76%
Total interest-bearing liabilities	**390,428**	**$ 3,103**	**1.06%**	378,138	$ 4,732	1.25%	378,204	$ 3,614	1.28%
Demand deposits	**73,943**			66,312			65,217		
Other liabilities	**4,428**			4,689			4,986		
Shareholders equity	**48,043**			44,589			44,502		
Total liabilities and Shareholders equity	**$ 516,842**			$ 493,728			$ 492,909		
Net interest income		**$ 13,141**			$ 17,124			$ 12,884	
Net interest rate spread (4)			**3.42%**			3.49%			3.53%
Net interest margin (5)			**3.62%**			3.72%			3.76%
Ratio of interest-earning assets to interest-bearing liabilities			**1.24**			1.22			1.21

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

(2) Tax exempt interest is shown on a tax equivalent basis for proper comparison using a statutory federal income tax of 34%. The tax equivalent income adjustment for loans and investments is $35,000 and $541,000 for September 30, 2012, $50,000 and $696,000 for

December 31, 2011 and $37,000 and $528,000 for September 30, 2011.

(3) Includes applicable loan origination and commitment fees, net of deferred origination cost amortization.

(4) Interest rate spread represents the difference between the yield on earning assets and the ratio paid on interest-bearing liabilities.

(5) Interest margin is calculated by dividing net interest income by total interest-earning assets.

CONSOLIDATED AVERAGE BALANCE SHEETS, YIELDS AND RATES (UNAUDITED)

(Fully taxable equivalent basis in thousands of dollars)
QUARTER-TO-DATE AS OF

	SEPTEMBER 30, 2012			JUNE 30, 2012			SEPTEMBER 30, 2011		
	Average Balance	Interest	Average Rate	Average Balance	Interest	Average Rate	Average Balance	Interest	Average Rate
ASSETS									
Interest earning deposits and other assets	**$ 9,729**	**$ 4**	**0.21%**	$ 7,364	$ 7	0.34%	$ 12,403	$ 10	0.32%
Investment securities (1) (2)	**175,539**	**1,219**	**2.80%**	185,034	1,479	3.20%	188,967	1,590	3.39%
Loans (2) (3)	**306,987**	**4,108**	**5.33%**	287,960	3,937	5.36%	261,306	3,851	5.87%
Total interest-earning assets	**492,255**	**$ 5,331**	**4.33%**	480,358	$ 5,423	4.45%	462,676	$ 5,451	4.71%
Cash and due from banks	**7,901**			7,539			7,321		
Bank premises and equipment	**6,557**			6,493			6,572		
Other assets	**20,031**			19,089			19,196		
Total non-interest-earning assets	**34,489**			33,121			33,089		
Total assets	**$ 526,744**			$ 513,479			$ 495,765		
LIABILITIES AND SHAREHOLDERS EQUITY									
Interest-bearing demand deposits	**$ 81,167**	**$ 39**	**0.19%**	$ 78,554	$ 32	0.16%	$ 72,882	$ 41	0.23%
Savings	**105,579**	**27**	**0.10%**	103,130	25	0.09%	94,664	33	0.14%
Time	**155,713**	**595**	**1.52%**	157,483	626	1.59%	163,819	740	1.79%
Total interest-bearing deposits	**342,459**	**661**	**0.77%**	339,167	683	0.81%	331,365	814	0.98%
Other borrowings	**47,771**	**326**	**2.71%**	42,760	319	2.99%	38,401	321	3.31%
Subordinated debt	**5,155**	**25**	**1.91%**	5,155	25	1.92%	5,155	23	1.74%
Total interest-bearing liabilities	**395,385**	**$ 1,012**	**1.02%**	387,082	$ 1,027	1.07%	374,921	$ 1,158	1.23%
Demand deposits	**77,023**			73,787			68,080		
Other liabilities	**5,247**			4,350			7,066		
Shareholders equity	**49,089**			48,260			45,698		
Total liabilities and Shareholders equity	**$ 526,744**			$ 513,479			$ 495,765		
Net interest income		**$ 4,319**			$ 4,396			$ 4,293	
Net interest rate spread (4)			**3.31%**			3.38%			3.48%
Net interest margin (5)			**3.51%**			3.59%			3.72%
Ratio of interest-earning assets to interest-bearing liabilities			**1.25**			1.24			1.23

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

(2) Tax exempt interest is shown on a tax equivalent basis for proper comparison using a statutory federal income tax of 34%. The tax equivalent income adjustment for loans and investments is $11,000 and $184,000 for September 30, 2012, $11,000 and $185,000 for June 30, 2012 and $14,000 and $162,000 for September 30, 2011.

(3) Includes applicable loan origination and commitment fees, net of deferred origination cost amortization.

(4) Interest rate spread represents the difference between the yield on earning assets and the ratio paid on interest-bearing liabilities.

(5) Interest margin is calculated by dividing net interest income by total interest-earning assets.

SELECTED FINANCIAL DATA FOR THE QUARTER ENDED

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

Unaudited	September 30, 2012	June 30, 2012	March 31, 2012	December 31, 2011	September 30, 2011
SUMMARY OF OPERATIONS					
Total interest income	**$ 5,136**	$ 5,227	$ 5,305	$ 5,177	$ 5,275
Total interest expense	**(1,012)**	(1,027)	(1,064)	(1,118)	(1,158)
NET INTEREST INCOME (NII)	**4,124**	4,200	4,241	4,059	4,117
Provision for loan losses	**(300)**	(330)	(270)	(324)	(324)
NII after loss provision	**3,824**	3,870	3,971	3,735	3,793
Security gains (losses) including impairment losses	**25**	28	(164)	9	92
Mortgage banking gains	**1,017**	266	154	42	25
Total non-interest income (excluding security and loan gains)	**670**	734	705	764	753
Total non-interest expense	**(3,848)**	(3,694)	(3,864)	(3,508)	(3,291)
Income before tax	**1,688**	1,204	802	1,042	1,372
Net income	**$ 1,266**	$ 952	$ 1,159	$ 828	$ 1,054
PER COMMON SHARE DATA (1)					
Net income, both basic and diluted	**$ 0.28**	$ 0.21	$ 0.26	$ 0.18	$ 0.24
Book value	**11.17**	10.64	10.53	10.10	9.78
BALANCE SHEET DATA					
Assets	**$ 554,508**	$ 522,699	$ 508,446	$ 519,830	$ 497,757
Investments	**175,024**	177,228	182,686	185,916	188,712
Loans	**293,194**	284,257	277,357	289,096	263,514
Loans held for sale	**15,999**	14,882	6,804	947	216
Deposits	**438,857**	414,304	409,055	422,765	402,121
Borrowings	**41,737**	50,559	42,180	42,273	42,449
Subordinated Debt	**5,155**	5,155	5,155	5,155	5,155
Shareholders equity	**50,560**	48,137	47,633	45,719	44,268
AVERAGE BALANCES					
Assets	**$ 526,744**	$ 513,479	$ 510,604	$ 496,192	$ 495,765
Investments	**175,539**	185,034	187,235	192,792	188,967
Loans	**289,792**	287,960	281,594	265,427	259,172
Loans held for sale	**17,195**	9,356	5,121	805	172
Deposits	**419,482**	412,954	410,969	403,291	399,445
Borrowings	**47,771**	42,760	43,625	39,064	38,401
Subordinated Debt	**5,155**	5,155	5,155	5,155	5,155
Shareholders equity	**49,089**	48,260	46,767	44,851	45,698
ASSET QUALITY RATIOS					
Loan charge-offs	**$ (70)**	$ (168)	$ (214)	$ (341)	$ (144)
Recoveries on loans	**49**	37	25	17	25
Net charge-offs	**$ (21)**	$ (131)	$ (189)	$ (324)	$ (119)
Net charge-offs as a percentage of average total loans	**0.03%**	0.19%	0.27%	0.49%	0.18%
Loans 30 days or more beyond their contractual due date as a percent of total loans	**1.56**	2.18	1.13	1.40	2.18
Nonperforming loans	**$ 6,477**	$ 7,667	$ 3,721	$ 4,714	$ 4,501

Nonperforming securities	**832**	1,376	1,523	1,542	1,626
Other real estate owned	**242**	316	359	437	479
Total nonperforming assets	**$ 7,551**	$ 9,359	$ 5,603	$ 6,693	$ 6,606
Nonperforming assets as a percentage of:					
Total assets	**1.36%**	1.79%	1.10%	1.29%	1.33%
Equity plus allowance for loan losses	**13.92**	18.15	11.02	13.70	13.93
Tier I capital	**13.70**	17.54	10.64	12.94	13.08
FINANCIAL RATIOS					
Return on average equity	**10.32%**	7.89%	9.91%	7.38%	9.23%
Return on average assets	**0.96**	0.74	0.91	0.67	0.85
Efficiency ratio	**66.22**	71.04	75.76	72.11	67.23
Effective tax rate	**25.00**	20.93	(44.51)	20.54	23.18
Net interest margin	**3.51**	3.59	3.67	3.64	3.72

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

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

Financial Review

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

Note Regarding Forward-looking Statements

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

Economic circumstances, the Company s operations and actual results could differ significantly from those discussed in any forward-looking statements. Some of the factors that could cause or contribute to such differences are changes in the economy and interest rates either nationally or in the Company s market area, including the impact of the impairment of securities; changes in customer preferences and consumer behavior; increased competitive pressures or changes in either the nature or composition of competitors; changes in the legal and regulatory environment; changes in factors influencing liquidity, such as expectations regarding the rate of inflation or deflation, currency exchange rates, and other factors influencing market volatility; and unforeseen risks associated with other global economic, political and financial factors.

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

Analysis of Assets and Liabilities for the First Nine Months

Earning assets are comprised of investment securities, loans and deposits at financial institutions, including the Federal Reserve Bank. Earning assets were $513.4 million at September 30, 2012, an increase of 11.1% from the September 30, 2011 balance of $462.0 million, and an increase of 6.5% from the December 31, 2011 balance of $482.1 million. The increase from December 31 was the net result of the following: an increase in deposits at the Federal Reserve of $23.3 million, a decrease in investment securities of $10.9 million, $19.5 million of 60-day loans redeemed prior to September 30, 2012, an increase of $24.2 million in commercial real estate loans and a $15.1 million increase in loans held for sale as a result of CSB Mortgage Company increased activity. Total cash and cash equivalents increased by $24.7 million from year-end and increased by $24.0 million from the balance at September 30, 2011. $13.0 million of the increase was used to settle securities in October 2012 that were purchased in September 2012.

At September 30, 2012, the investment securities portfolio was $175.0 million compared to $188.7 million at September 30, 2011, a decrease of $13.7 million, or 7.3%. Investment securities decreased $10.9 million compared to December 31, 2011, a decrease of 5.9%. Investment securities represented 34.1% of earning assets at September 30, 2012, compared to 40.9% at September 30, 2011 and 38.6% at December 31, 2011. The decrease is partially due to the sale of $3.5 million in trust preferred securities. As the Company manages its balance sheet for loan growth, asset mix, liquidity and for current interest rates and interest rate forecasts, the investment portfolio is a primary source of liquidity. The investment portfolio represented 39.9% of each deposit dollar, down from 46.9% a year ago and down from 44.0% of year-end levels.

The investment securities available-for-sale portfolio had net unrealized losses of $1.8 million at September 30, 2012, a decrease of $3.2 million compared to net unrealized losses of $5.0 million at September 30, 2011, and a decrease of $2.2 million compared to net unrealized losses of $4.0 million at December 31, 2011. Contributing to the volatility in net unrealized losses over the past twelve months are changes in interest rates and an inactive market for certain securities as discussed in Note 9 to the financial statements. A partial sale of these securities has lessened unrealized losses.

ITEM 2. MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL

CONDITION AND RESULTS OF OPERATIONS

The Company s investment portfolio contains trust preferred securities, which have resulted in valuation charges against income of $13.7 million in 2009, $2.7 million in 2010, $202,000 in 2011 and $171,000 in the nine months of 2012. The Company continues to value these securities consistent with valuation techniques prescribed under accounting standards. The market for these securities and similar securities, which had been relatively active through 2003, became illiquid during the financial crisis of 2008 and is still currently not active. Since 2008, the Company has modeled and analyzed the cash flow characteristics and has concluded that a major portion of these devalued securities were not recoverable. In 2012, a portion of these securities were sold. The charge for this other than temporary impairment for the first nine months of 2012 was $171,000 versus $202,000 in the nine months of 2011.

Loans held for sale increased to $16.0 million at September 30, 2012 compared to $947,000 at December 31, 2011 and $215,000 at September 30, 2011. The increase is in line with expected results from the newly formed wholesale banking unit, which originated over $135.0 million of mortgage loans through September 2012.

Total loans at September 30, 2012 were $293.2 million as compared to $263.5 million a year ago, an 11.3% increase, and $289.1 million at December 31, 2011, a 1.4% increase. Total assets of $554.5 million at September 30, 2012 reflect an increase of 11.4% from year ago asset totals of $497.8 million and an increase of 6.7% from December 31, 2011 asset totals of $519.8 million with loans providing the core growth. Cumulative loan growth since September 2010 exceeds 26.0%, while cumulative asset growth during the same period reflects a 15.6% increase. The Company continues its objective of shifting its asset mix into in-market commercial loans with the intent of improving net interest margin.

Loans net of the allowance for losses increased by $29.1 million during the twelve month period from September 30, 2011 to September 30, 2012, and increased by $3.5 million from December 31, 2011. Gross loans as a percentage of earning assets stood at 57.1% as of September 30, 2012, 57.0% at September 30, 2011 and 60.0% as of December 31, 2011. The loan to deposit ratio was 66.8% at September 30, 2012, 65.5% at September 30, 2011 and 68.4% at December 31, 2011. The increase in loans at year-end was due in part to 60-day term commercial loans for a total of $19.5 million that closed in December 2011 and were fully secured by segregated deposit accounts with the Bank. The loans matured in the first quarter of 2012. Additionally, commercial real estate loans increased by $24.2 million.

At September 30, 2012, the loan loss allowance of $3.6 million represented approximately 1.23% of outstanding loans, and at September 30, 2011 the loan loss allowance of $3.1 million represented approximately 1.16% of outstanding loans. The loan loss allowance at December 31, 2011 of $3.1 million represented approximately 1.06% of outstanding loans, or 1.15% excluding the 60-day term loans.

During the first nine months, loan charge-offs were $452,000 in 2012 compared to $491,000 for the same period in 2011, while the recovery of previously charged-off loans amounted to $111,000 in 2012 and $176,000 in 2011. The net charge-offs represent 0.16% of average loans for both periods. Charge-offs of specific problem loans, as well as for smaller balance homogeneous loans, are recorded periodically during the year. The number of loan accounts and the amount of charge-off associated with account balances vary from period to period as loans are deemed uncollectible by management.

Loans accounted for on a non-accrual basis increased slightly from $3.6 million at December 31, 2011 and $3.3 million at September 30, 2011 to $3.8 million at the recent quarter ended September 30, 2012. Non-accrual loans at September 30, 2012 represent a relatively insignificant 1.3% of the loan portfolio compared to 1.2% at December 31, 2011 and 1.3% at September 30, 2011. The allowance for loan losses covers 96.0% of nonaccrual loans at September 30, 2012.

Bank-owned life insurance had a cash surrender value of $13.9 million at September 30, 2012, $12.9 million at December 31, 2011 and $12.8 million at September 30, 2011. The Company purchased $694,000 in bank-owned life insurance in 2012 as part of its funding of executive post retirement benefits. Other assets increased slightly to $12.6 million at September 30, 2012 from $11.3 million at December 31, 2011 and from $12.2 million at September 30, 2011. Included in other assets is a prepaid assessment paid to the FDIC in December of 2009. This prepayment is the estimate, based on projected assessment rates and assessment base, made by the FDIC of premiums due until December 31, 2012. On a quarterly basis, this prepayment is reduced through a charge to expense until the prepayment is depleted. The balance is $1.3 million at September 30, 2012, $1.5 million at December 31, 2011 and $1.6 million at September 30, 2011. Other real estate decreased to $242,000 at September 30, 2012 compared to $437,000 at December 31, 2011 and $479,000 at September 30, 2011. Also included in other assets is deferred taxes of $2.8 million, $6.4 million and $7.0 million for the periods ended September 30, 2012, December 31, 2011 and September 30, 2011, respectively, and Federal income tax receivable of $3.3 million, $335,000 and $44,000 for the periods ended September 30, 2012, December 31, 2011 and September 30, 2011, respectively. $3.5 million of deferred taxes were

ITEM 2. MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL

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reclassified to a Federal income tax receivable due to the sale of trust preferred securities with impairment previously recorded. Noninterest-bearing deposits measured $82.3 million at September 30, 2012 up from $70.7 million at December 31, 2011 and $68.8 million at September 30, 2011. Interest-bearing deposits increased $4.6 million to $356.6 million at September 30, 2012 from $352.0 million at December 31, 2011 and increased $23.3 million from $333.3 million at September 30, 2011. The increase in interest bearing deposits from year end is net of segregated deposit accounts with the Bank which fully collateralized $19.5 million in 60-day term commercial loans that closed in December 2011. The loans matured and the deposits withdrew the first quarter of 2012.

Federal Home Loan Bank advances and short term borrowings stayed consistent at $41.7 million at September 30, 2012 from $42.3 million at December 31, 2011 and from $42.4 million at September 30, 2011. Future maturities of long term notes are expected to be paid off. Management continues to use short-term borrowings to bridge its cash flow needs.

Other liabilities measured $18.2 million at September 30, 2012 compared to $3.9 at December 31, 2011 and $3.8 million at September 30, 2011. The increase is due to $13.0 million in securities purchases traded in September 2012, but settled in October 2012.

The Company s total shareholders equity increased from $45.7 million on December 31, 2011 and $44.3 million at September 30, 2011 to $50.6 million at September 30, 2012, an increase of $4.9 million and $6.3 million, respectively. The Company s capital continues to meet the requirements for the Company to be deemed well capitalized under all regulatory measures. The Company s total risk-based capital is $18.6 million in excess of the 10% threshold for the Company to be well-capitalized.

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

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

In April 2009, the FFIEC issued additional instructions for reporting of direct credit substitutions that have been downgraded below investment grade. Included in the definition of a direct credit substitute are mezzanine and subordinated tranches of trust preferred securities and non-agency collateralized mortgage obligations. Adopting these instructions 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 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 $57.5 million, well above the $13.9 million in amortized cost of these securities as of September 30, 2012, thereby significantly diluting the risk-based capital ratios by approximately 1.7% for September 30, 2012 and 2.2% for December 31, 2011.

Regardless of the trust preferred securities risk weighting, the Company met all capital adequacy requirements to which it was subject as of September 30, 2012 and December 31, 2011, 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.

ITEM 2. MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL

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	Actual Regulatory Capital Ratios as of:		Regulatory Capital Ratio Requirements:	
	September 30, 2012	December 31, 2011	Well Capitalized	Adequately Capitalized
Tier I capital to risk-weighted assets	**13.72%**	13.37%	6.00%	4.00%
Total risk-based capital to risk-weighted assets	**14.64%**	14.18%	10.00%	8.00%
Tier I capital to average assets	**10.66%**	10.47%	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. The Company s capital ratios remain above 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 September 30, 2012 and December 31, 2011. Management considers these excesses to be adequate with regard to the risks inherent in the balance sheet.

	(Amounts in thousands)	
	September 30, 2012	December 31, 2011
Tier 1 Capital	**$ 55,104**	$ 51,739
Tier 2 Capital	**3,700**	3,142
QUALIFYING CAPITAL	**$ 58,804**	$ 54,881
Risk-Adjusted Total Assets (*)	**$ 401,599**	$ 387,091
Tier 1 Risk- Based Capital Excess	**$ 31,008**	$ 28,514
Total Risk- Based Capital Excess	**18,644**	16,172
Total Leverage Capital Excess	**29,249**	27,028

(*) Includes off-balance sheet exposures

Average 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 $517.1 million for the nine months ended September 30, 2012 and $494.2 million for the year ended December 31, 2011.

Accounting guidelines require that investments designated as available-for-sale are marked-to-market with corresponding entries to the deferred taxes 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.

Executive Summary Income and Expenses

Net income of $1.3 million, or $0.28 per share, was recorded for the third quarter of 2012 compared to $1.1 million, or $0.24 per share, for the third quarter of 2011. Net income for the nine months ended September 30, 2012 was $3.4 million versus $3.2 million for the same period in 2011.

Respective to the quarterly operating results, highlights of operations are as follows:

Spurred by the commercial loan growth, net interest income increased by $7,000 in 2012 versus 2011 as the Company continues to optimally manage its balance sheet in this historically low interest rate environment.

ITEM 2. MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL

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The Company continues to excel in managing risks in the loan portfolio as asset quality measures are among the best for banks with similar asset totals. Net loan charge-offs were 0.03% of average loans in 2012 and 0.18% for 2011. The allowance for loan loss (ALLL) to total loans ratio was 1.23% at September 30, 2012 versus 1.16% a year ago.

Mortgage banking gains reached $1.0 million in the quarter versus $25,000 in the same quarter of 2011. These gains, which are reported as non-interest income, are exceeding expectations from the wholesale mortgage unit which was formed late last year specifically as a result of strategic initiatives aimed at improving overall profitability. The wholesale mortgage unit, CSB Mortgage Company partners with mortgage brokers in contiguous states to originate mortgage loans. The loans are sold to investors in the secondary market generating a profit margin.

The improvement in earnings is highlighted by a 19.8% year over year growth rate in the commercial loan portfolio and a composite loan portfolio growth rate of 11.3%.

Net interest income, which provides the core earnings base for the Company, has remained stable with the prior year at $4.1 million in the third quarter of 2012 and 2011. The Company has benefited in this low interest rate environment from increasing balances in the loan portfolio yielding 5.33% during the quarter in lieu of allocating funds into the investment portfolio earning 2.80%. Also, as liabilities continue to mature and reprice at lower rates, the net interest income is expected to improve. Even with deposit rates creeping lower to reflect market trends, the Company has been able to both retain and grow deposits and has recorded a 9.1% increase in balances over the past year.

The Company, to date, has not experienced notable deterioration in credit quality despite less than favorable economic conditions over the past several years. Nonaccrual loans of $3.8 million at September 30, 2012, or 1.28% of loans, were relatively stable from $3.6 million at December 31, 2011. The Company s allowance for loan losses covers 96.0% of nonaccrual loans at September 30, 2012.

Non-interest income for the quarter increased by $842,000 from a year ago. This is driven by mortgage banking gains in 2012 of $1.0 million versus gains in 2011 of $25,000. Non-interest expenses increased 16.9% from the same quarter a year ago, reflecting the additional personnel and other expenses to operate the mortgage banking operation. The Company incurred over $250,000 in non-interest expenses in 2011 and to date in 2012 representing costs associated with the start-up of the mortgage banking unit including the employment expenses of managerial personnel, administrative staff and seasoned mortgage loan originators. As the mortgage unit operations continue to transition from a start-up unit to a growing business unit, CSB Mortgage Company has already made a positive contribution to the first nine months of 2012 on just over $135 million of originations.

For the current quarter, the provision for loan losses was $300,000, substantially exceeding the net charge-offs for the quarter of $21,000. For the same quarter last year, the provision was $324,000, also exceeding net charge-offs for the quarter of $119,000. 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.

Certain Non-GAAP Measures

Certain financial information has been determined by methods other than Generally Accepted Accounting Principles (GAAP). Specifically, certain financial measures are based on core earnings rather than net income. Core earnings exclude income, expense, gains and losses that either are not reflective of ongoing operations or that are not expected to reoccur with any regularity or reoccur with a high degree of uncertainty and volatility. Such information may be useful to both investors and management, and can aid them in understanding the Company s current performance trends and financial condition. Core earnings are a supplemental tool for analysis and not a substitute for GAAP net income. Reconciliation from GAAP net income to the non-GAAP measure of core earnings is shown as part of management s discussion and analysis of financial results of operations.

Core earnings (earnings before other-than-temporary-impairment charge and certain other non-recurring items) increased for the nine months ended September 30, 2012 as compared to the comparable 2011 period. Core earnings for the first nine months of 2012 were $3.3 million, or $0.72 per share, compared to $3.2 million, or $0.70 per share for the first nine months of 2011. Core earnings for the quarter ended September 30, 2012 were $1.3 million, or $0.28 per share, compared to $1.0 million, or $0.23 per share.

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The following is reconciliation between core earnings and earnings under GAAP.

(Amounts in thousands, except per share amounts)

	THREE MONTHS ENDED September 30, 2012	THREE MONTHS ENDED September 30, 2011	NINE MONTHS ENDED September 30, 2012	NINE MONTHS ENDED September 30, 2011
GAAP earnings	**$ 1,266**	$ 1,054	**$ 3,377**	$ 3,244
Impairment losses on investment securities (net of tax)			**113**	134
Investment gains not in the ordinary course of business (net of tax)*		(9)	**(20)**	(220)
Net impact of historic tax credit investment			**(190)**	
Core earnings	**$ 1,266**	$ 1,045	**$ 3,280**	$ 3,158
Core earnings per share	**$ 0.28**	$ 0.23	**$ 0.72**	$ 0.70

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

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Analysis of Net Interest Income Nine months ended September 30, 2012 and 2011

	(Amounts in thousands)					
	September 30, 2012			September 30, 2011		
	Average Balance	Interest	Average Rate	Average Balance	Interest	Average Rate
INTEREST-EARNING ASSETS						
Interest-earning deposits and other earning assets	**$ 7,322**	**$ 16**	**0.29%**	$ 14,856	$ 45	0.39%
Investment securities(1)(2)	**182,576**	**4,203**	**3.07%**	184,877	4,967	3.59%
Loans(1)(2)(3)	**293,935**	**12,025**	**5.45%**	259,344	11,486	5.93%
Total interest-earning assets	**$ 483,833**	**$ 16,244**	**4.48%**	$ 459,077	$ 16,498	4.81%
INTEREST-BEARING LIABILITIES						
Interest-bearing demand and money market deposits	**$ 80,696**	**$ 105**	**0.17%**	$ 72,796	$ 137	0.25%
Savings	**102,932**	**78**	**0.10%**	93,155	112	0.16%
Time	**156,915**	**1,881**	**1.60%**	161,791	2,270	1.88%
Total interest-bearing deposits	**340,543**	**2,064**	**0.81%**	327,742	2,519	1.03%
Other borrowings	**44,730**	**963**	**2.88%**	45,307	1,027	3.03%
Subordinated debt	**5,155**	**76**	**1.94%**	5,155	68	1.76%
Total interest-bearing liabilities	**$ 390,428**	**$ 3,103**	**1.06%**	$ 378,204	$ 3,614	1.28%
Net interest income		**$ 13,141**			$ 12,884	
Net interest rate spread(4)			**3.42%**			3.53%
Net interest margin(5)			**3.62%**			3.76%

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

(2) The amounts are presented on a fully taxable equivalent basis using the statutory tax rate of 34%, and have been adjusted to reflect the effect of disallowed interest expense related to carrying tax-exempt assets. The tax equivalent income adjustment for loans and investments is $35,000 and $541,000 for 2012 and $37,000 and $528,000 for 2011, respectively.

(3) Includes applicable loan origination and commitment fees, net of deferred origination cost amortization.

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

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

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 $13.1 million at September 30, 2012 and $12.9 million at September 30, 2011. During the recent reporting period the net interest margin registered 3.62% at September 30, 2012 and 3.76% at September 30, 2011.

The decrease in interest income, on a fully taxable equivalent basis, of $254,000 is the product of a 33 basis point decrease in interest rates earned offset somewhat by a 5.4% year-over-year increase in average earning assets. The decrease in interest expense of $511,000 was a product of a 22 basis point decrease in rates paid and a 3.2% increase in interest-bearing liabilities. The net result was a 2.0% 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 $764,000, or 15.4%. The average invested balances in securities decreased by $2.3 million, or 1.2%, from the levels of a year ago. The decrease in the average balance of investment securities was accompanied by a 52 basis point decrease in the tax equivalent yield of the portfolio. The Company expects to continue redeployment of liquidity into loans. Any reinvestment into the securities portfolio will serve to decrease the yield due to the current low rate environment.

On a fully taxable equivalent basis, income on loans increased by $539,000, or 4.7%, for the first nine months of 2012 compared to the same period in 2011. A $34.6 million increase in the average balance of the loan portfolio, or 13.3%, was accompanied by a 48 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.

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Other interest income decreased by $29,000, or 64.4%, from the same period a year ago. The average balance of interest earning deposits decreased by $7.5 million, or 50.7%. The yield decreased by 10 basis points during the first nine months of 2012 compared to 2011. Management intends to remain fully invested, minimizing on-balance sheet liquidity.

Average interest-bearing demand deposits and money market accounts increased by $7.9 million, or 10.9%, for the nine months ended September 30, 2012 compared to the same period of 2011, while average savings balances increased by $9.8 million, or 10.5%. Total interest paid on interest-bearing demand deposits and money market account was $105,000, a $32,000 decrease from last year. The average rate paid on these products decreased by 8 basis points. Total interest paid on savings accounts was $78,000, a $34,000 decrease from last year. The average rate paid on savings accounts decreased by 6 basis points. The average balance of time deposit products decreased by $4.9 million, or 3.0%, as the average rate paid decreased by 28 basis points, from 1.88% to 1.60%. Interest expense decreased on time deposits by $389,000 from the prior year. 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.

Average borrowings and subordinated debt decreased by $577,000 while the average rate paid on borrowings increased by 12 basis points. Management plans to pay down long term borrowings at their respective maturity dates in the future using current liquidity.

<u>Impairment Analysis of Investment Securities</u>

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 the 12 securities at September 30, 2012 is not fully active and markets for similar securities are also not completely 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 September 30, 2012. 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 fair value discount rates on an overall basis generally range from 10.04% to 23.27% 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 $0.50 per $1.00 of par value is representative of the fair value of the 12 trust preferred securities, with individual securities therein ranging from $0.15 to $0.75.

The Company considered all information available as of September 30, 2012 to estimate the impairment and resulting fair value of the trust preferred securities. These securities are supported by a number of banks and insurance companies located throughout the country. The FDIC has recently indicated that there are many financial institutions still considered troubled banks even after the numerous failures in 2010 and 2011. The Company recognized no credit related impairment in the third

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quarter and $171,000 in the first quarter of 2012 versus no credit related impairment in the third quarter of 2011 and $202,000 in the first quarter of 2011. If the conditions of the underlying banks in the trust preferred securities worsen, there may be additional impairment to recognize in 2012 or later.

During the current quarter, the Bank reduced its holdings in bank-collateralized trust preferred securities by soliciting bids from various brokerage firms. The issues sold were those which could be exited at or near recorded values as a group; 19 securities were sold for a net realized loss of $164,000. The remaining trust preferred securities, two collateralized by banks and nine by insurance companies, were excluded from sales efforts since they have exhibited little to no OTTI to date.

Analysis of Other Income, Other Expense and Federal Income Tax for the First Nine Months

During the first nine months of both 2011 and 2012, the amount charged to operations as a provision for loan loss was increased 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 the first nine months of 2012, 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. The provision for loan loss was $900,000 and $872,000 for the nine months ended September 30, 2012 and September 30, 2011, respectively.

Total non-interest income, excluding investment gains and impairment losses, increased by $1.5 million. After impairment losses and gains on investment securities, non-interest income increased by $692,000 from the same period a year ago. The increase is due mainly to mortgage banking gains of $1.4 million, compared to $61,000 in 2011. The Company strategically began a wholesale mortgage unit in late 2011 utilizing the secondary market as an outlet.

As indicated in Note 8 to the Consolidated Financial Statements, the Company s mortgage banking unit enters 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.

Fees for other customer services decreased by $98,000, or 6.0%, driven by customer activities. Loss on the sale of other real estate owned (OREO) was $71,000 at September 30, 2011, compared to a gain of $15,000 at September 30, 2012, resulting in an increase to income of $86,000. Other sources of non-recurring non-interest income increased by $110,000 from the same period a year ago. This latter income category is subject to fluctuation due to the non-recurring nature of the items.

Gains on securities called and net gains on the sale of available-for-sale investment securities decreased by $813,000 from year ago levels. Gains were offset by impairment losses attributable to trust preferred securities primarily issued by bank holding companies. Losses of $171,000 were recognized in 2012 as compared to $202,000 in 2011. Settlement on General Motors Corporation bonds accounted for $334,000 of the gains in the first nine months of 2011 and $30,000 of the gains in the first nine months of 2012.

Total non-interest expenses in the first nine months were $11.4 million in 2012 compared to $10.0 million in 2011, an increase of $1.4 million, or 14.4%. Full time equivalent employment averaged 159 during the first nine months of 2012 and 150 in 2011. Salaries and benefits increased by $859,000, or 15.8%, from the similar period a year ago. This increase is due mainly to costs associated with the wholesale mortgage unit which was formed late in 2011.

Charges for insurance premiums paid to the FDIC decreased by $304,000. 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 58.3% in 2012. The Company anticipates its FDIC insurance expense will remain consistent for the remaining quarters in 2012.

In late March 2012, the Company invested in a partnership for the purpose of acquiring tax credits, the investment in the partnership increased other non-interest expense by $444,000 as a result of partnership losses and impairment recognition. At the same time it generated a $483,000 tax credit in addition to the $151,000 tax benefit on the partnership loss. The net effect is a $190,000 increase to net income.

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All other expense categories increased by 11.0%, or $440,000 in the aggregate. These expense categories are subject to fluctuation due to non-recurring items. Much of the increase is due to start-up costs associated with the wholesale mortgage unit formed late in 2011.

The effective tax rate for the first nine months was 8.6% in 2012 and 23.2% in 2011, resulting in income tax expense of $317,000 and $979,000, respectively. As discussed above, a $634,000 tax benefit was generated from a historic tax credit structure.

The provision for income taxes differs from the amount of income tax determined applying the applicable U.S. statutory federal income tax rate (34%) to pre-tax income as a result of the following differences:

	(Amounts in thousands)			
	September 30, 2012		September 30, 2011	
	Balance	%	Balance	%
Provision at statutory rate	**$ 1,256**	**34.0**	$ 1,436	34.0
Add (Deduct):				
Tax effect of earnings on bank-owned life insurance-net	**(98)**	**(2.6)**	(99)	(2.3)
Tax effect of historic tax credit	**(483)**	**(13.1)**		
Tax effect of other non-taxable income	**(397)**	**(10.7)**	(393)	(9.3)
Tax effect of non-deductible expense	**39**	**1.0**	35	0.8
Federal income taxes	**$ 317**	**8.6**	$ 979	23.2

The majority of non-taxable income consists of interest on obligations of states and political subdivisions.

Net income registered $3.4 million for the nine months ended September 30, 2012 and $3.2 million for the similar period of 2011, representing per share amounts of $0.75 in 2012 and $0.72 in 2011.

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Analysis of Net Interest Income Third quarter ended September 30, 2012 and 2011

(Amounts in thousands)

	September 30, 2012			September 30, 2011		
	Average Balance	Interest	Average Rate	Average Balance	Interest	Average Rate
INTEREST-EARNING ASSETS						
Interest-earning deposits and other earning assets	**$ 9,729**	**$ 4**	**0.21%**	$ 12,403	$ 10	0.32%
Investment securities(1)(2)	**175,539**	**1,219**	**2.80%**	188,967	1,590	3.39%
Loans(1)(2)(3)	**306,987**	**4,108**	**5.33%**	261,306	3,851	5.87%
Total interest-earning assets	**$ 492,255**	**$ 5,331**	**4.33%**	$ 462,676	$ 5,451	4.71%
INTEREST-BEARING LIABILITIES						
Interest-bearing demand and money market deposits	**$ 81,167**	**$ 39**	**0.19%**	$ 72,882	$ 41	0.23%
Savings	**105,579**	**27**	**0.10%**	94,664	33	0.14%
Time	**155,713**	**595**	**1.52%**	163,819	740	1.79%
Total interest-bearing deposits	**342,459**	**661**	**0.77%**	331,365	814	0.98%
Other borrowings	**47,771**	**326**	**2.71%**	38,401	321	3.31%
Subordinated debt	**5,155**	**25**	**1.91%**	5,155	23	1.74%
Total interest-bearing liabilities	**$ 395,385**	**$ 1,012**	**1.02%**	$ 374,921	$ 1,158	1.23%
Net interest income		**$ 4,319**			$ 4,293	
Net interest rate spread(4)			**3.31%**			3.48%
Net interest margin(5)			**3.51%**			3.72%

(1) Includes both taxable and tax exempt securities and loans.
(2) The amounts are presented on a fully taxable equivalent basis using the statutory tax rate of 34%, and have been adjusted to reflect the effect of disallowed interest expense related to carrying tax-exempt assets. The tax equivalent income adjustment for loans and investments is $11,000 and $184,000 for 2012 and $14,000 and $162,000 for 2011, respectively.
(3) Includes applicable loan origination and commitment fees, net of deferred origination cost amortization.
(4) Net interest rate spread represents the difference between the yield on earning assets and the rate paid on interest-bearing liabilities.
(5) Net interest margin is calculated by dividing the net interest income by total interest-earning assets.

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 $4.3 million at September 30, 2012 and 2011, respectively. During the recent reporting period the net interest margin registered 3.51% at September 30, 2012 and 3.72% at September 30, 2011.

The decrease in interest income, on a fully taxable equivalent basis, of $120,000 is the product of a 38 basis point decrease in interest rates earned offset somewhat by a 6.4% year-over-year increase in average earning assets. The decrease in interest expense of $146,000 was a product of a 21 basis point decrease in rates paid and a 5.5% increase in interest-bearing liabilities. The net result was a 0.6% increase in net interest income on a fully taxable equivalent basis, and a 21 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 $371,000, or 23.3%. The average invested balances in securities decreased by $13.4 million, or 7.1%, from the levels of a year ago. The decrease in the average balance of investment securities was accompanied by a 59 basis point decrease in the tax equivalent yield of the portfolio. The Company expects to continue redeployment of liquidity into loans. Any reinvestment into the securities portfolio will serve to decrease the yield due to the current low rate environment.

On a fully taxable equivalent basis, income on loans increased by $257,000, or 6.7%, for the third quarter of 2012 compared to the same period in 2011. A $45.7 million increase in the average balance of the loan portfolio, or 17.5%, was accompanied by a 54 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.

Other interest income decreased by $6,000, or 60.0%, from the same period a year ago. The average balance of interest earning deposits decreased by $2.7 million, or 21.6%. The yield decreased by 11 basis points during the third quarter of 2012 compared to 2011. Management intends to remain fully invested, minimizing on-balance sheet liquidity.

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Average interest-bearing demand deposits and money market accounts increased by $8.3 million, or 11.4%, while average savings balances increased by $10.9 million, or 11.5%. Total interest paid on interest-bearing demand deposits and money market account was $39,000, a $2,000 decrease from last year. The average rate paid on these products decreased by 4 basis points. Total interest paid on savings accounts was $27,000, a $6,000 decrease from last year. The average rate paid on savings accounts decreased by 4 basis points. The average balance of time deposit products decreased by $8.1 million, or 4.9%, as the average rate paid decreased by 27 basis points, from 1.79% to 1.52%. Interest expense decreased on time deposits by $145,000 from the prior year. 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.

Average borrowings and subordinated debt increased by $9.4 million while the average rate paid on borrowings increased by 50 basis points. Management plans to pay down long term borrowings at their respective maturity dates in the future using current liquidity.

Analysis of Other Income, Other Expense and Federal Income Tax for the Third Quarter

Loan charge-offs during the quarter were $70,000 in 2012 compared to $144,000 in 2011, while the recovery of previously charged-off loans amounted to $49,000 during the quarter of 2012 compared to $25,000 in the same period of 2011. The Company s provision for loan losses during the quarter of 2012 was $300,000 and $324,000 in the same quarter of 2011. Charge-offs of specific problem loans, as well as for smaller balance homogeneous loans, are recorded periodically during the year. The number of loan accounts and the amount of charge-offs associated with account balances vary from period to period as loans are deemed uncollectible by management. The balance of the allowance for loan loss and provisions to the loan loss allowance are based on an assessment of both the risk of loss and the amount of loss on loans within the loan portfolio.

Total non-interest income, excluding investment gains and impairment losses, increased by $909,000 from the quarter ended September 2011 compared to the same quarter of 2012. After impairment losses and gains on investment securities, non-interest income increased by $842,000 from the same period a year ago. The increase is due to mortgage banking gains of $1.0 million compared to $25,000 in 2011, the strategic initiative for which was noted prior in this discussion. Fees for other customer services decreased by $74,000. Other sources of non-recurring non-interest income decreased by $9,000 from the same period a year ago. This latter income category is subject to fluctuation due to the non-recurring nature of the items. Gains on securities called and net gains on the sale of available for sale investment securities decreased by $67,000 from year ago levels.

Total non-interest expenses in the third quarter were $3.8 million in 2012 compared to $3.3 million in 2011, an increase of $557,000, or 16.9%. Salaries and benefits increased in the third quarter of 2012 by $373,000, or 20.3%, from the similar period a year ago. This increase is due mainly to costs associated with the wholesale mortgage unit which was formed late in 2011. Charges for insurance premiums paid to the FDIC decreased by $72,000 from the third quarter of 2011. All other expense categories increased by 19.6%, or $256,000 in the aggregate. These expense categories are subject to fluctuation due to non-recurring items. The majority of the increase is due to increased costs associated with the wholesale mortgage unit.

Income before tax during the third quarter amounted to $1.7 million in 2012 compared to $1.4 million in 2011. The effective tax rate for the third quarter was 25.0% in 2012 and 23.2% in 2011, resulting in income tax expense of $422,000 and $318,000, respectively. Third quarter net income was $1.3 million in 2012 compared $1.1 million in 2011. Income per share for the third quarter was $0.28 in 2012 and $0.24 in 2011.

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

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ability to fund balance sheet growth and meet deposit and debt obligations in a timely and cost-effective manner. Management monitors liquidity through a regular review of asset and liability maturities, funding sources, and loan and deposit forecasts. The Company maintains strategic and contingency liquidity plans to ensure sufficient available funding to satisfy requirements for balance sheet growth, proper management of capital markets funding sources and addressing unexpected liquidity requirements.

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

Concerns over deposit fluctuations with respect to the overall banking industry were addressed by the FDIC in September and October 2008. The FDIC temporarily increased the individual account deposit insurance from $100,000 per account to $250,000 per account through December 31, 2009, which has subsequently been made permanent. The FDIC also implemented the Transaction Account Guarantee Program (TAGP), which provides for full FDIC coverage for transaction accounts, regardless of dollar amounts. The Company elected to opt-in to this program, thus, customers received full coverage for transaction accounts under the program. The TAGP expired December 31, 2010. It was replaced by a final rule to implement the section of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) that provides temporary unlimited coverage for non-interest bearing transaction accounts at all FDIC-insured depository institutions. The separate coverage for non-interest bearing transaction accounts became effective on December 31, 2010 and terminates on December 31, 2012. This provision is similar to the TAGP, except it does not include low-interest Negotiable Order of Withdrawal (NOW) accounts. The Dodd-Frank provision also differs significantly from the TAGP in that it applies to all FDIC-insured depository institutions with qualifying deposits. Concerns regarding the overall banking industry or the Company could have an adverse effect on future deposit levels.

In order to address the concern of FDIC insurance of larger depositors, the Bank became a member of the Certificate of Deposit Account Registry Service (CDARS®) program in 2009 and the Insured Cash Sweep (ICS) program in 2011. Through CDARS®, the Bank s customers can increase their FDIC insurance by up to $50.0 million through reciprocal certificate of deposit accounts and likewise through ICS, they can accomplish the same through money market savings accounts. This is accomplished by the Bank entering into reciprocal depository relationships with other member banks. The individual customer s large deposit is broken into amounts below $250,000 and placed with other banks that are members of the network. The reciprocal member bank issues certificates of deposit or money market savings accounts in amounts that ensure that the entire deposit is eligible for FDIC insurance. At September 30, 2012, the Bank did not have any deposits in either program. For regulatory purposes, CDARS® and ICS are considered a brokered deposit even though reciprocal deposits can be 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 September 30, 2012, the Bank had approximately $5.7 million available of collateral-based borrowing capacity at FHLB of Cincinnati, supplementing the $0.6 million of availability with the Federal Reserve Discount window. Additionally, the FHLB has committed a $25.8 million cash management line, of which nothing has been dispersed, subject to posting additional collateral. The Bank has access to approximately 10% of total deposits in brokered certificates of deposit that could be used as an additional source of liquidity. At September 30, 2012, there was a $3.2 million outstanding balance in brokered certificates of deposit. The Company was also granted a total of $8.5 million in unsecured, discretionary Federal Funds lines of credit with no funds drawn upon as of September 30, 2012. Unpledged securities of $58.2 million are also available for borrowing under repurchase agreements or as additional collateral for FHLB lines of credit.

CSB obtains its funding through the Bank. The Bank occasionally utilizes short term borrowings under its FHLB cash management line to fund the needs of CSB. Upon establishing an inventory of loans held for sale, such loans may be used as additional collateral for FHLB borrowings.

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

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capitalized after the dividend payment. Such amount as of September 30, 2012 is $11.0 million. The Company has cash of $273,000 at September 30, 2012 available to meet cash needs. It also holds a $6.0 million note receivable, the cash flow from which approximates the debt service on the Junior Subordinated Debentures. Cash is generally used by the Company to pay quarterly interest payments on the debentures, pay dividends to common shareholders and to fund operating expenses.

In May 2012, the Bank closed its North Bloomfield branch to consolidate it with the Bristol branch approximately five miles away. To date, losses of deposits or customers did not have a material effect on liquidity or consolidated deposit totals.

Cash and cash equivalents increased from $16.8 million in September 2011 to $40.8 million in September 2012.

The following table details the cash flows from operating activities for the nine months ended:

	(Amounts in thousands) September 30, 2012	2011
Net income	**$ 3,377**	$ 3,244
Adjustments to reconcile net income to net cash flows (deficit) from operating activities:		
Depreciation, amortization and accretion	**2,241**	1,706
Provision for loan loss	**900**	872
Investment securities gains	**(60)**	(873)
Impairment losses	**171**	202
Other real estate (gains) losses	**(15)**	71
Originations of mortgage banking loans held for sale	**(140,868)**	(2,840)
Proceeds from the sale of mortgage banking loans	**127,253**	2,948
Net mortgage banking income	**(1,437)**	(61)
Proceeds from IRS tax refund		1,400
Changes in:		
Deferred tax	**2,869**	(357)
Prepaid FDIC assessment	**200**	500
Bank-owned life insurance	**(289)**	(351)
Federal income tax receivable	**(3,287)**	
Other assets and liabilities	**(460)**	130
Net cash (deficit) flows from operating activities	**$ (9,405)**	$ 6,591

Key variations stem from: 1) Amortization on investments measured $1.8 million at September 30, 2012 compared to $1.3 million at September 30, 2011, reflecting more securities purchased at a premium in this low rate environment. 2) Gains were recognized on the sale, call or maturity of investments of $873,000 in 2011 compared to $60,000 in the same period of 2012 and 3) Loans held for sale increased by $15.1 million due to increased activity of the mortgage banking company. Refer to the Consolidated Statements of Cash Flows for a summary of the sources and uses of cash for 2012 and 2011.

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 accounting principles generally accepted in the United States of America. 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 our 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.

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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: specific valuation allowances based on probable losses on specific loans; valuation allowances based on historical loan loss experience for similar loans with similar characteristics and trends; and 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 based on current information and events; it is probable the Company will not collect all amounts due according to the original contractual terms of the loan agreement. The level of the general allowance is established to provide coverage for management s estimate of the credit risk in the loan portfolio by various loan segments not covered by the specific allowance. Additional information regarding allowance for credit losses can be found in the Notes to the Consolidated Financial Statements (NOTE 4) and further more in Management s Discussion and Analysis.

Investment Securities and Impairment

The classification and accounting for investment securities is discussed in detail in Note 3 of 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 our 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 our investment securities are generally determined by reference to quoted market prices and reliable independent sources. At each reporting date, the Company assesses whether there is an other-than-temporary impairment to the Company s investment securities. Such impairment must be recognized in current earnings rather than in other comprehensive income (loss).

The Company reviews investment debt securities on an ongoing basis for the presence of other-than-temporary impairment (OTTI) with formal reviews performed quarterly. OTTI losses on individual investment securities were recognized during 2012 and 2011 in accordance with FASB ASC topic 320, *Investments Debt and Equity Securities*. The purpose of this ASC

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is to provide greater clarity to investors about the credit and noncredit component of an OTTI event and to communicate more effectively when an OTTI event has occurred. This ASC amends the OTTI guidance in GAAP for debt securities, improves the presentation and disclosure of OTTI on investment securities and changes the calculation of the OTTI recognized in earnings in the financial statements. This ASC does not amend existing recognition and measurement guidance related to OTTI of equity securities.

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

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

In these instances, the impairment is separated into the amount of the total impairment related to the credit loss and the amount of the total impairment related to all other factors. The amount of the total other-than-temporary impairment 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.

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. 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 the Company s 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. The Company conducts periodic assessments of deferred tax assets to determine if it is more-likely-than-not that they will be realized. In making these assessments, the Company considers 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.

Authoritative Accounting Guidance

In May 2011, the FASB issued ASU 2011-04, *Fair Value Measurement (Topic 820): Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs.* The amendments in this Update result in common fair value measurement and disclosure requirements in U.S. GAAP and IFRSs. Consequently, the amendments change the wording used to describe many of the requirements in U.S. GAAP for measuring fair value and for disclosing information about fair value measurements. The amendments in this Update are to be applied prospectively. For public entities, the amendments are effective during interim and annual periods beginning after December 15, 2011. For nonpublic entities, the amendments are effective for annual periods beginning after December 15, 2011. Early application by public entities is not permitted. The Company has provided the necessary disclosure in Note 9.

In June 2011, the FASB issued ASU 2011-05, *Comprehensive Income (Topic 220): Presentation of Comprehensive Income*. The amendments in this Update improve the comparability, clarity, consistency, and transparency of financial reporting and

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increase the prominence of items reported in other comprehensive income. To increase the prominence of items reported in other comprehensive income and to facilitate convergence of U.S. GAAP and IFRS, the option to present components of other comprehensive income as part of the statement of changes in stockholders equity was eliminated. The amendments require that all non-owner changes in stockholders equity be presented either in a single continuous statement of comprehensive income or in two separate consecutive statements. In the two-statement approach, the first statement should present total net income and its components followed consecutively by a second statement that should present total other comprehensive income, the components of other comprehensive income, and the total of comprehensive income. All entities that report items of comprehensive income, in any period presented, will be affected by the changes in this Update. For public entities, the amendments are effective for fiscal years, and interim periods within those years, beginning after December 15, 2011. For nonpublic entities, the amendments are effective for fiscal years ending after December 15, 2012, and interim and annual periods thereafter. The amendments in this Update should be applied retrospectively, and early adoption is permitted. The Company has provided the necessary disclosure in the Consolidated Statements of Comprehensive Income.

In December 2011, the FASB issued ASU 2011-12, *Comprehensive Income (Topic 220): Deferral of the Effective Date for Amendments to the Presentation of Reclassifications of Items Out of Accumulated Other Comprehensive Income in Accounting Standards Update No. 2011-05*. In order to defer only those changes in Update 2011-05 that relate to the presentation of reclassification adjustments, the paragraphs in this Update supersede certain pending paragraphs in Update 2011-05. Entities should continue to report reclassifications out of accumulated other comprehensive income consistent with the presentation requirements in effect before Update 2011-05. All other requirements in Update 2011-05 are not affected by this Update, including the requirement to report comprehensive income either in a single continuous financial statement or in two separate but consecutive financial statements. Public entities should apply these requirements for fiscal years, and interim periods within those years, beginning after December 15, 2011. Nonpublic entities should begin applying these requirements for fiscal years ending after December 15, 2012, and interim and annual periods thereafter. The Company has provided the necessary disclosure in the Consolidated Statements of Comprehensive Income.

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 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

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

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

The simulation model allows management to test and evaluate alternative responses to a changing interest rate environment. Typically when confronted with a heightened risk of rising interest rates, the Company will evaluate strategies that shorten investment and loan re-pricing intervals and maturities, emphasize the acquisition of floating rate over fixed rate assets, and lengthen the maturities of liability funding sources. When the risk of falling rates is perceived, management will 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 September 30, 2012 and December 31, 2011. For purposes of this analysis, short-term interest rates as measured by the federal funds rate and the prime lending rate are assumed to increase (decrease) gradually over the next twelve months reaching a level 300 basis points higher (lower) than the rates in effect at September 30, 2012. Under both the rising rate scenario and the falling rate scenario, the yield curve is assumed to exhibit a parallel shift.

During the previous twelve months, the Federal Reserve kept its target rate for overnight federal funds constant. At September 30, 2012, the difference between the yield on the ten-year Treasury and the three-month Treasury had decreased to a positive 155 from the positive 187 basis points that existed at December 31, 2011, indicating that the yield curve had become less steeply upward sloping. At September 30, 2012, 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.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

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 $16.0 million for the twelve month period ending September 30, 2013.

	(Amounts in thousands)					
	Net Interest Income		$ Change		% Change	
	September 30, 2013	December 31, 2012	September 30, 2013	December 31, 2012	September 30, 2013	December 31, 2012
Change in Interest Rates:						
Graduated increase of +300 basis points	$ 17,760	$ 17,380	$ 1,803	$ 1,659	11.3%	10.6%
Short-term rates unchanged (base case)	15,957	15,721				
Graduated decrease of -300 basis points	13,451	13,316	(2,506)	(2,405)	(15.7)%	(15.3)%

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

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

ITEM 4. CONTROLS AND PROCEDURES

Evaluation of Disclosure Controls and Procedures. With the supervision and participation of management, including the Company s principal executive officer and chief financial officer, the effectiveness of disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) of the Securities Exchange Act of 1934 (the Exchange Act)) has been evaluated as of the end of the period covered by this report. Based upon that evaluation, the Company s principal executive officer and chief financial officer has concluded that such disclosure controls and procedures are, to the best of their knowledge, effective as of the end of the period covered by this report to ensure that material information relating to the Company and its consolidated subsidiaries is made known to them, particularly during the period for which our periodic reports, including this report, are being prepared.

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

PART II - OTHER INFORMATION

Item 1. Legal Proceedings

See Note (5) of the financial statements.

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.

Beginning in the latter half of 2007, negative developments in the capital markets 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.

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.

Further, legislation has been proposed that would reduce the amount that our customers are required to pay under existing loan contracts or limit our ability to foreclose on collateral. There can be no assurance that future legislation will not significantly impact our ability to collect on our current loans or foreclose on collateral.

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. Because the Dodd-Frank Act requires various federal agencies to adopt a broad range of regulations with significant discretion, many of the details of the law 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 changes to occur pursuant to the Dodd-Frank Act that can be expected to have an effect on our business are the following:

- the Dodd-Frank Act creates a Consumer Financial Protection Bureau with broad powers to adopt and enforce consumer protection regulations;

PART II - OTHER INFORMATION

- new capital regulations for bank holding companies will be adopted, which may 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 will have 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 will require 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.

In addition, the FDIC has issued guidance prescribing the order in which Banks may process customer debit items and imposing limits on the overdraft fees banks may charge. Currently, these limits only apply to banks governed by the FDIC but may eventually impact all banks. These limitations could negatively impact the Company s earnings.

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.

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

The global financial markets have experienced increased volatility and an overall loss of investor confidence 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.

PART II - OTHER INFORMATION

We may not be able to access capital when needed.

We are required by regulatory authorities to maintain specified levels 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 affect on us. As of September 30, 2012, 80% of our loan portfolio consisted of commercial and industrial, commercial real estate, real estate construction, installment and agricultural loans, 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 does 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.

PART II - OTHER INFORMATION

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 has been extended until December 31, 2012.

On May 22, 2009, the FDIC adopted a rule that imposed a special assessment for the second quarter of 2009 of 5 basis points on each insured depository institution s assets minus its Tier 1 capital as of June 30, 2009, which was collected on September 30, 2009.

On November 12, 2009, the FDIC 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. The prepaid assessments for these periods were collected on December 30, 2009, along with the regular quarterly risk-based deposit insurance assessment for the third quarter of 2009. For the fourth quarter of 2009 and for all of 2010, the prepaid assessment rate was based on each institution s total base assessment rate in effect on September 30, 2009, modified to assume that the assessment rate in effect for the institution on September 30, 2009, was in effect for the entire third quarter of 2009. On September 29, 2009, the FDIC increased annual assessment rates uniformly by 3 basis points beginning in 2011. As a result, an institution s total base assessment rate for purposes estimating an institution s assessment for 2011 and 2012 was increased by 3 basis points. Each institution s prepaid assessment base was calculated using its third quarter 2009 assessment base, adjusted quarterly for an estimated five percent annual growth rate in the assessment base through the end of 2012. The three-year prepayment was $3 million for us, of which $1.7 million has been expensed through September 30, 2012.

On February 7, 2011, the FDIC issued final regulations, effective April 1, 2011, as required by the Dodd-Frank Act to change the deposit insurance assessment base from total domestic deposits to average total assets minus average tangible equity, as well as changing the assessment for larger institutions and the assessment rate schedules. These changes have reduced the Bank s FDIC premiums due to a lower assessment rate.

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.

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PART II - OTHER INFORMATION

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 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.

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.

PART II - OTHER INFORMATION

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.

PART II - OTHER INFORMATION

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.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds - Not applicable

Company s Common Stock - There were no repurchases of shares of the Company s common stock during the three months ended September 30, 2012.

Item 3. Defaults upon Senior Securities - Not applicable

Item 4. Mine Safety Disclosures - Not applicable

Item 5. Other Information - Not applicable

CORTLAND BANCORP AND SUBSIDIARIES

INDEX TO EXHIBITS

The following exhibits are filed or incorporated by reference as part of this report:

Exhibit		Incorporated by Reference			
No.	**Exhibit Description**	**Form**	**Exhibit**	**Filing Date**	**Filed Herewith**
3.1	Restated Amended Articles of Cortland Bancorp reflecting amendment dated June 25, 1999. Note: filed for purposes of SEC reporting compliance only. This restated document has not been filed with the State of Ohio.	10-K(1)	3.1	03/16/06	
3.2	Code of Regulations, as amended:				
	For the Bancorp	10-K(1)	3.2	03/16/06	
	For Cortland Savings and Banking	10-K	3.2	03/15/07	
4.1	The rights of holders of equity securities are defined in portions of the Articles of Incorporation and Code of Regulations as referenced in Exhibits 3.1 and 3.2	10-K(1)	4.1	03/16/06	
4.2	Agreement to furnish instruments and agreements defining rights of holders of long-term debt	10-Q	4.2	11/13/12	X
*10.1	Group Term Carve Out Plan dated February 23, 2001, by The Cortland Savings and Banking Company with each executive officer other than Rodger W. Platt and with selected other officers, as amended by the August 2002 letter amendment	10-K(1)	10.1	03/16/06	
*10.2	Group Term Carve Out Plan Amended Split Dollar Policy Endorsement entered into by The Cortland Savings and Banking Company on December 15, 2003 with Stephen A. Telego, Sr.	10-K(1)	10.2	03/16/06	
*10.3	Amended Director Retirement Agreement between Cortland Bancorp and Jerry A. Carleton, dated as of December 18, 2007	10-K	10.3	03/17/08	
*10.4	Amended Director Retirement Agreement between Cortland Bancorp and David C. Cole, dated as of December 18, 2007	10-K	10.4	03/17/08	
*10.5	Amended Director Retirement Agreement between Cortland Bancorp and George E. Gessner, dated as of December 18, 2007	10-K	10.5	03/17/08	
*10.6	Amended Director Retirement Agreement between Cortland Bancorp and William A. Hagood, dated as of October 12, 2003	10-K(1)	10.6	03/16/06	
*10.7	Amended Director Retirement Agreement between Cortland Bancorp and James E. Hoffman III, dated as of December 18, 2007	10-K	10.7	03/17/08	
*10.8	Amended Director Retirement Agreement between Cortland Bancorp and Neil J. Kaback, dated as of December 18, 2007	10-K	10.8	03/17/08	
*10.9	Director Retirement Agreement between Cortland Bancorp and K. Ray Mahan, dated as of March 1, 2001	10-K(1)	10.9	03/16/06	
*10.10	Amended Director Retirement Agreement between Cortland Bancorp and Richard B. Thompson, dated as of December 18, 2007	10-K	10.10	03/17/08	
*10.11	Amended Director Retirement Agreement between Cortland Bancorp and Timothy K. Woofter, dated as of December 18, 2007	10-K	10.11	03/17/08	
*10.12	Form of Split Dollar Agreement entered into by Cortland Bancorp and each of Directors David C. Cole, George E. Gessner, William A. Hagood, James E. Hoffman III, K. Ray Mahan, and Timothy K. Woofter as of February 23, 2001, as of March 1, 2004, with Director Neil J. Kaback, and as of October 1, 2001, with Director Richard B. Thompson;	10-K(1)	10.12	03/16/06	

as amended on December 26, 2006, for Directors Cole, Gessner, Hoffman, Mahan, Thompson, and Woofter;	10-K	10.12	03/15/07
Amended Split Dollar Agreement and Endorsement entered into by Cortland Bancorp as of December 18, 2007, with Director Jerry A. Carleton	10-K	10.12	03/17/08

CORTLAND BANCORP AND SUBSIDIARIES

INDEX TO EXHIBITS (continued)

Exhibit No.	Exhibit Description	Incorporated by Reference Form	Exhibit	Filing Date	Filed Herewith
*10.13	Director s Retirement Agreement between Cortland Bancorp and Director Joseph E. Koch, dated as of April 19, 2011	8-K	10.13	04/22/11	
*10.14	Split Dollar Agreement and Endorsement between Cortland Bancorp and Director Joseph E. Koch, dated as of April 19, 2011	8-K	10.14	04/22/11	
*10.15	Form of Indemnification Agreement entered into by Cortland Bancorp with each of its directors	10-K(1)	10.15	03/16/06	
*10.16	Endorsement Split Dollar Agreement between The Cortland Savings and Banking Company and David J. Lucido, dated as of March 27, 2012	10-K	10.16	03/29/12	
*10.17	Fifth Amended Salary Continuation Agreement between The Cortland Savings and Banking Company and Timothy Carney, dated as of March 27, 2012	10-K	10.17	03/29/12	
*10.18	Third Amended Salary Continuation Agreement between The Cortland Savings and Banking Company and Lawrence A. Fantauzzi, dated as of December 3, 2008	8-K	10.18	12/12/08	
*10.19	Fifth Amended Salary Continuation Agreement between The Cortland Savings and Banking Company and James M. Gasior, dated as of March 27, 2012	10-K	10.19	03/29/12	
*10.20	Second Amended Salary Continuation Agreement between The Cortland Savings and Banking Company and Marlene Lenio, dated as of December 3, 2008	8-K	10.20	12/12/08	
*10.20.1	Amendment of the December 3, 2008 Second Amended Salary Continuation Agreement between The Cortland Savings and Banking Company and Marlene J. Lenio	10-Q	10.20.1	05/17/10	
*10.21	Amended Salary Continuation Agreement between The Cortland Savings and Banking Company and Craig Phythyon, dated as of December 3, 2008	8-K	10.21	12/12/08	
*10.21.1	Amendment of the December 3, 2008 Second Amended Salary Continuation Agreement between The Cortland Savings and Banking Company and Craig M. Phythyon	10-Q	10.21.1	05/17/10	
*10.22	Third Amended Salary Continuation Agreement between The Cortland Savings and Banking Company and Stephen A. Telego, Sr., dated as of December 3, 2008	8-K	10.22	12/12/08	
*10.22.1	Amendment of the December 3, 2008 Third Amended Salary Continuation Agreement between The Cortland Savings and Banking Company and Stephen A. Telego, Sr.	10-Q	10.22.1	05/17/10	
*10.23	Salary Continuation Agreement between The Cortland Savings and Banking Company and David J. Lucido dated as of June 1, 2010	8-K	10.23	06/02/10	
*10.24	Fourth Amended Split Dollar Agreement and Endorsement between The Cortland Savings and Banking Company and Timothy Carney, dated as of April 19, 2011	8-K	10.24	04/22/11	
*10.25	Salary Continuation Agreement between The Cortland Savings and Banking Company and Stanley P. Feret dated as of June1, 2010	8-K	10.25	06/02/10	
*10.26	Fourth Amended Split Dollar Agreement and Endorsement between The Cortland Savings and Banking Company and James M. Gasior, dated as of April 19, 2011	8-K	10.26	04/22/11	

CORTLAND BANCORP AND SUBSIDIARIES

INDEX TO EXHIBITS (continued)

Exhibit No.	Exhibit Description	Incorporated by Reference Form	Exhibit	Filing Date	Filed Herewith
*10.27	Second Amended Split Dollar Agreement between The Cortland Savings and Banking Company and Marlene Lenio, dated as of December 3, 2008	8-K	10.27	12/12/08	
*10.27.1	Termination of Split Dollar Agreement and Endorsement between The Cortland Savings and Banking Company and Marlene Lenio	10-Q	10.27.1	05/17/10	
*10.28.1	Termination of the Split Dollar Agreement and Endorsement between The Cortland Savings and Banking Company and Craig Phythyon	10-Q	10.28.1	05/17/10	
*10.29	Third Amended Split Dollar Agreement and Endorsement between The Cortland Savings and Banking Company and Stephen A. Telego, Sr., dated as of December 3, 2008	8-K	10.29	12/12/08	
*10.29.1	Termination of the Split Dollar Agreement and Endorsement between The Cortland Savings and Banking Company and Stephen A. Telego, Sr.	10-Q	10.29.1	05/17/10	
10.30	Reserved				
*10.31.1	Severance Agreement between Cortland Bancorp and Tim Carney, dated as of September 28, 2012	8-K	10.31.1	10/03/12	
*10.31.2	Severance Agreement between Cortland Bancorp and James Gasior, dated as of September 28, 2012	8-K	10.31.2	10/03/12	
*10.31.3	Severance Agreement between Cortland Bancorp and David J. Lucido, dated as of September 28, 2012	8-K	10.31.3	10/03/12	
*10.31.4	Severance Agreement between Cortland Bancorp and David J. Lucido, dated as of June 1, 2010	8-K	10.31.4	10/03/12	
*10.32	Severance Agreement entered into by Cortland Bancorp and The Cortland Savings and Banking Company in December 3, 2008, with each of Marlene J. Lenio, Craig M. Phythyon and Barbara R. Sandrock	8-K	10.32	12/12/08	
*10.32.1	Termination of Severance Agreement entered into by each of Mses. Marlene J. Lenio and Barbara R. Sandrock and Messrs. Craig M. Phythyon and Stephen A. Telego, Sr.	10-Q	10.32.1	05/17/10	
*10.33	Agreement and General Release with Lawrence A. Fantauzzi	8-K	10.1	10/22/09	
*10.34	Severance Agreement between Cortland Bancorp and Stanley P. Feret, dated as of September 28, 2012	8-K	10.34	10/03/12	
11	Statement of re-computation of per share earnings	See Note 6 of Financial Statements			
31.1	Certification of the Chief Executive Officer under Rule 13a-14(a)				ü
31.2	Certification of Chief Financial Officer under Rule 13a-14(a)				ü
32	Section 1350 Certification of Chief Executive Officer and Chief Financial Officer required under section 906 of the Sarbanes-Oxley Act of 2002				ü

101	The following materials from Cortland Bancorp s Quarterly Report on Form 10-Q for the quarter ended September 30, 2012, formatted in Extensible Business Reporting Language (XBRL): (a) Consolidated Balance Sheets; (b) Consolidated Statements of Income; (c) Consolidated Statements of Comprehensive Income; (d) Consolidated Statements of Changes in Shareholders Equity; (e) Consolidated Statements of Cash Flows; and (f) the Notes to Consolidated Financial Statements tagged as blocks of text and in detail (included with this filing)**

(1) Film number 06691632

* Management contract or compensatory plan or arrangement

** Pursuant to Rule 406T of Regulation S-T, these interactive data files are deemed not filed or part of a registration statement or prospectus for purposes of Sections 11 or 12 of the Securities Act of 1933 or Section 18 of the Securities Exchange Act of 1934, as amended, and otherwise are not subject to liability under those sections.

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

CORTLAND BANCORP

(Registrant)

/s/ James M. Gasior James M. Gasior	Date: November 13, 2012
President and	
Chief Executive Officer	
(Principal Executive Officer)	
/s/ David J. Lucido David J. Lucido	Date: November 13, 2012
Senior Vice President and	
Chief Financial Officer	
(Principal Financial Officer)	