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COMMUNITY BANK SYSTEM INC

Form 10-Q

November 04, 2005

United States  
SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549

FORM 10-Q

QUARTERLY REPORT

Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934

For the quarterly period ended September 30, 2005  
Commission file number 001-13695

=====  
[LOGO]  
COMMUNITY BANK SYSTEM, INC.  
(Exact name of registrant as specified in its charter)  
=====

New York Stock Exchange  
(Name of Each Exchange on Which Registered)

Delaware  
(State or other jurisdiction of incorporation)

16-1213679  
(I.R.S. Employer  
Identification No.)

5790 Widewaters Parkway, DeWitt, New York  
(Address of principal executive offices)

13214-1883  
(Zip Code)

(315) 445-2282  
(Registrant's telephone number, including area code)

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

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act).  
☒ Yes ☐ No

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

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

Common Stock, \$1.00 par value -29,942,199 shares outstanding as of  
October 28, 2005

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## Part 1. Financial Information

### Item 1. Financial Statements

COMMUNITY BANK SYSTEM, INC.  
CONSOLIDATED STATEMENTS OF CONDITION (Unaudited)  
(In Thousands, Except Share Data)

|                                          | September 30,<br>2005 |
|------------------------------------------|-----------------------|
| Cash and cash equivalents                | \$ 154,672            |
| Available-for-sale investment securities | 1,176,463             |

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|                                                                                                                                         |              |
|-----------------------------------------------------------------------------------------------------------------------------------------|--------------|
| Held-to-maturity investment securities                                                                                                  | 141,973      |
| <hr/>                                                                                                                                   |              |
| Total investment securities (fair value of \$1,316,224 and \$1,582,873, respectively)                                                   | 1,318,436    |
| Loans                                                                                                                                   | 2,411,893    |
| Allowance for loan losses                                                                                                               | 32,460       |
| <hr/>                                                                                                                                   |              |
| Net loans                                                                                                                               | 2,379,433    |
| Core deposit intangibles, net                                                                                                           | 29,642       |
| Goodwill                                                                                                                                | 195,195      |
| Other intangibles, net                                                                                                                  | 1,645        |
| <hr/>                                                                                                                                   |              |
| Intangible assets, net                                                                                                                  | 226,482      |
| Premises and equipment, net                                                                                                             | 65,299       |
| Accrued interest receivable                                                                                                             | 25,262       |
| Other assets                                                                                                                            | 43,080       |
| <hr/>                                                                                                                                   |              |
| Total assets                                                                                                                            | \$ 4,212,664 |
| <hr/>                                                                                                                                   |              |
| Liabilities:                                                                                                                            |              |
| Non-interest bearing deposits                                                                                                           | \$ 590,951   |
| Interest bearing deposits                                                                                                               | 2,394,968    |
| <hr/>                                                                                                                                   |              |
| Total deposits                                                                                                                          | 2,985,919    |
| Federal funds purchased                                                                                                                 | 60,800       |
| Borrowings                                                                                                                              | 565,351      |
| Subordinated debt held by unconsolidated subsidiary trusts                                                                              | 80,488       |
| Accrued interest and other liabilities                                                                                                  | 59,656       |
| <hr/>                                                                                                                                   |              |
| Total liabilities                                                                                                                       | 3,752,214    |
| <hr/>                                                                                                                                   |              |
| Commitment and contingencies (See Note H)                                                                                               |              |
| Shareholders' equity:                                                                                                                   |              |
| Preferred stock \$1.00 par value, 500,000 shares authorized, 0 shares issued                                                            |              |
| Common stock, \$1.00 par value, 50,000,000 shares authorized;<br>32,324,222 and 32,041,591 shares issued in 2005 and 2004, respectively | 32,324       |
| Additional paid-in capital                                                                                                              | 194,232      |
| Retained earnings                                                                                                                       | 274,177      |
| Accumulated other comprehensive income                                                                                                  | 14,487       |
| Treasury stock, at cost (2,421,611 and 1,400,000 shares, respectively)                                                                  | (54,416)     |
| Employee stock plan - unearned                                                                                                          | (354)        |
| <hr/>                                                                                                                                   |              |
| Total shareholders' equity                                                                                                              | 460,450      |
| <hr/>                                                                                                                                   |              |
| Total liabilities and shareholders' equity                                                                                              | \$ 4,212,664 |
| <hr/>                                                                                                                                   |              |

The accompanying notes are an integral part of the consolidated financial statements.

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CONSOLIDATED STATEMENTS OF INCOME (Unaudited)  
(In Thousands, Except Per-Share Data)

|                                                                        | Three Months Ended<br>September 30, |           |
|------------------------------------------------------------------------|-------------------------------------|-----------|
|                                                                        | 2005                                | 2004      |
| Interest income:                                                       |                                     |           |
| Interest and fees on loans                                             | \$ 37,133                           | \$ 35,267 |
| Interest and dividends on taxable investments                          | 11,213                              | 13,895    |
| Interest and dividends on non-taxable investments                      | 5,724                               | 6,061     |
| Total interest income                                                  | 54,070                              | 55,223    |
| Interest expense:                                                      |                                     |           |
| Interest on deposits                                                   | 11,140                              | 8,622     |
| Interest on borrowings                                                 | 6,271                               | 6,084     |
| Interest on subordinated debt held by unconsolidated subsidiary trusts | 1,715                               | 1,460     |
| Total interest expense                                                 | 19,126                              | 16,166    |
| Net interest income                                                    | 34,944                              | 39,057    |
| Less: provision for loan losses                                        | 2,275                               | 2,300     |
| Net interest income after provision for loan losses                    | 32,669                              | 36,757    |
| Non-interest income:                                                   |                                     |           |
| Deposit service fees                                                   | 7,237                               | 6,755     |
| Other banking services                                                 | 1,411                               | 1,136     |
| Trust, investment and asset management fees                            | 1,823                               | 1,974     |
| Benefit plan administration, consulting and actuarial fees             | 2,767                               | 2,299     |
| Gain on sales of investment securities                                 | 5,305                               | 0         |
| Total non-interest income                                              | 18,543                              | 12,164    |
| Operating expenses:                                                    |                                     |           |
| Salaries and employee benefits                                         | 16,458                              | 15,638    |
| Occupancy                                                              | 2,739                               | 2,570     |
| Equipment and furniture                                                | 2,304                               | 2,143     |
| Amortization of intangible assets                                      | 1,553                               | 2,003     |
| Legal and professional fees                                            | 993                                 | 1,003     |
| Data processing                                                        | 1,841                               | 1,973     |
| Office supplies                                                        | 641                                 | 613       |
| Acquisition expenses                                                   | 1                                   | 53        |
| Other                                                                  | 4,197                               | 3,930     |
| Total operating expenses                                               | 30,727                              | 29,926    |
| Income before income taxes                                             | 20,485                              | 18,995    |
| Income taxes                                                           | 5,621                               | 4,761     |
| Net income                                                             | \$ 14,864                           | \$ 14,234 |

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|                              |    |      |    |      |
|------------------------------|----|------|----|------|
| Basic earnings per share     | \$ | 0.49 | \$ | 0.47 |
| Diluted earnings per share   | \$ | 0.48 | \$ | 0.45 |
| Dividends declared per share | \$ | 0.19 | \$ | 0.18 |

The accompanying notes are an integral part of the consolidated financial statements.

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## COMMUNITY BANK SYSTEM, INC. CONSOLIDATED STATEMENT OF CHANGES IN SHAREHOLDERS' EQUITY (Unaudited) Nine Months Ended September 30, 2005 (In Thousands, Except Share Data)

|                                                                                   | Common Stock          |                  | Additional<br>Paid-In<br>Capital | Retained<br>Earnings | Accumulated<br>Other<br>Comprehensive<br>Income |
|-----------------------------------------------------------------------------------|-----------------------|------------------|----------------------------------|----------------------|-------------------------------------------------|
|                                                                                   | Shares<br>Outstanding | Amount<br>Issued |                                  |                      |                                                 |
| Balance at December 31, 2004                                                      | 30,641,591            | \$32,042         | \$190,769                        | \$248,295            | \$34,200                                        |
| Net income                                                                        |                       |                  |                                  | 42,479               |                                                 |
| Other comprehensive loss, net of tax                                              |                       |                  |                                  |                      | (19,713)                                        |
| Dividends declared:                                                               |                       |                  |                                  |                      |                                                 |
| Common, \$0.55 per share                                                          |                       |                  |                                  | (16,597)             |                                                 |
| Common stock issued under employee stock<br>plan, including tax benefits of \$951 | 282,631               | 282              | 3,463                            |                      |                                                 |
| Treasury stock purchased                                                          | (1,021,611)           |                  |                                  |                      |                                                 |
| Balance at September 30, 2005                                                     | 29,902,611            | \$32,324         | \$194,232                        | \$274,177            | \$14,487                                        |

The accompanying notes are an integral part of the consolidated financial statements.

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## COMMUNITY BANK SYSTEM, INC. CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (Unaudited) (In Thousands)

| Three Months Ended<br>September 30, |      |
|-------------------------------------|------|
| 2005                                | 2004 |

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|                                                                           |            |        |
|---------------------------------------------------------------------------|------------|--------|
| Other comprehensive (loss) income, before tax:                            |            |        |
| Unrealized (losses) gains on securities:                                  |            |        |
| Unrealized holding (losses) gains arising during period                   | (\$16,842) | \$ 35, |
| Reclassification adjustment for gains included in net income              | (5,305)    |        |
| Other comprehensive (loss) income, before tax                             | (22,147)   | 35,    |
| Income tax benefit (expense) related to other comprehensive (loss) income | 8,546      | (13,   |
| Other comprehensive (loss) income, net of tax                             | (13,601)   | 21,    |
| Net income                                                                | 14,864     | 14,    |
| Comprehensive income                                                      | \$ 1,263   | \$ 35, |

The accompanying notes are an integral part of the consolidated financial statements.

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## COMMUNITY BANK SYSTEM, INC. CONSOLIDATED STATEMENTS OF CASH FLOWS (Unaudited) (In Thousands)

|                                                                                  | Nine<br>Ended Sep |
|----------------------------------------------------------------------------------|-------------------|
|                                                                                  | 2005              |
| Operating activities:                                                            |                   |
| Net income                                                                       | \$ 42,479         |
| Adjustments to reconcile net income to net cash provided by operating activities |                   |
| Depreciation                                                                     | 6,412             |
| Amortization of intangible assets                                                | 5,521             |
| Net amortization of premiums and discounts on securities and loans               | 772               |
| Amortization of unearned compensation and discount on subordinated debt          | 230               |
| Provision for loan losses                                                        | 6,284             |
| Gain on sales of investment securities                                           | (12,195)          |
| (Gain) loss on loans and other assets                                            | (40)              |
| Change in other operating assets and liabilities                                 | 3,783             |
| Net cash provided by operating activities                                        | 53,246            |
| Investing activities:                                                            |                   |
| Proceeds from sales of available-for-sale investment securities                  | 310,336           |
| Proceeds from maturities of held-to-maturity investment securities               | 3,855             |
| Proceeds from maturities of available-for-sale investment securities             | 98,097            |
| Purchases of held-to-maturity investment securities                              | (8,294)           |
| Purchases of available-for-sale investment securities                            | (158,888)         |
| Net increase in loans outstanding                                                | (58,269)          |
| Cash received from acquisition (net of cash paid of \$7,023)                     | 0                 |
| Capital expenditures                                                             | (8,166)           |
| Net cash provided (used) by investing activities                                 | 178,671           |

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### Financing activities:

|                                                                            |           |
|----------------------------------------------------------------------------|-----------|
| Net change in demand deposits, checking, savings and money market deposits | 12,245    |
| Net change in time deposits                                                | 44,696    |
| Net change in federal funds purchased                                      | 47,600    |
| Net change in short-term borrowings                                        | (362,000) |
| Proceeds from long-term borrowings (net of payments of \$227 and \$112)    | 99,773    |
| Issuance of common stock                                                   | 2,738     |
| Purchase of treasury stock                                                 | (24,217)  |
| Cash dividends paid                                                        | (16,425)  |
| Other financing activities                                                 | 0         |

---

|                                                  |           |
|--------------------------------------------------|-----------|
| Net cash (used) provided by financing activities | (195,590) |
|--------------------------------------------------|-----------|

---

|                                                |         |
|------------------------------------------------|---------|
| Change in cash and cash equivalents            | 36,327  |
| Cash and cash equivalents at beginning of year | 118,345 |

---

|                                            |            |
|--------------------------------------------|------------|
| Cash and cash equivalents at end of period | \$ 154,672 |
|--------------------------------------------|------------|

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### Supplemental disclosures of cash flow information:

|                            |           |
|----------------------------|-----------|
| Cash paid for interest     | \$ 54,054 |
| Cash paid for income taxes | \$ 10,446 |

### Supplemental disclosures of non-cash financing and investing activities:

|                                                                              |            |
|------------------------------------------------------------------------------|------------|
| Dividends declared and unpaid                                                | \$ 5,687   |
| Gross change in unrealized gains on available-for-sale investment securities | (\$32,205) |
| Acquisitions:                                                                |            |
| Fair value of assets acquired, excluding acquired cash and intangibles       | \$ 0       |
| Fair value of liabilities assumed                                            | \$ 0       |
| Common stock and options issued                                              | \$ 0       |

The accompanying notes are an integral part of the consolidated financial statements.

### COMMUNITY BANK SYSTEM, INC.

### NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)

September 30, 2005

#### NOTE A: BASIS OF PRESENTATION

The interim financial data as of September 30, 2005 and for the three and nine months ended September 30, 2005 and September 30, 2004 is unaudited; however, in the opinion of the Company, the interim data includes all adjustments, consisting only of normal recurring adjustments, necessary for a fair statement of the results for the interim periods. The results of operations for the interim periods are not necessarily indicative of the results that may be expected for the full year or any other interim period.

#### NOTE B: OTHER MATTERS

On April 20, 2005, the Company announced a twenty-month authorization to repurchase up to 1,500,000 of its outstanding shares. Through September 30, 2005, the Company has repurchased against this authorization 521,611 shares at an aggregate cost of \$12.3 million and an average price per share of \$23.58. The repurchased shares will be used for general corporate purposes, including those related to stock plan activities.

#### NOTE C: ACCOUNTING POLICIES

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### Critical Accounting Policies

#### Allowance for Loan Losses

Management continually evaluates the credit quality of the Company's loan portfolio, and performs a formal review of the adequacy of the allowance for loan losses on a quarterly basis. The allowance reflects management's best estimate of probable losses inherent in the loan portfolio. Determination of the allowance is subjective in nature and requires significant estimates. The Company's allowance methodology consists of two broad components, general and specific loan loss allocations.

The general loan loss allocation is composed of two calculations that are computed on four main loan segments: commercial, consumer direct, consumer indirect and residential real estate. The first calculation determines an allowance level based on the latest three years of historical net charge-off data for each loan category (commercial loans exclude balances with specific loan loss allocations). The second calculation is qualitative and takes into consideration five major factors affecting the level of loan loss risk: portfolio risk migration patterns (internal credit quality trends); the growth of the segments of the loan portfolio; economic and business environment trends in the Company's markets (includes review of bankruptcy, unemployment, population, consumer spending and regulatory trends); industry, geographical and product concentrations in the portfolio; and the perceived effectiveness of managerial resources and lending practices and policies. These two calculations are added together to determine the general loan loss allocation. The specific loan loss allocation relates to individual commercial loans that are both greater than \$0.5 million and in a non-accruing status with respect to interest. Specific losses are based on discounted estimated cash flows, including any cash flows resulting from the conversion of collateral.

Loan losses are charged off against the allowance, while recoveries of amounts previously charged off are credited to the allowance. A provision for loan loss is charged to operations based on management's periodic evaluation of factors previously mentioned.

#### Income Taxes

Provisions for income taxes are based on taxes currently payable or refundable, and deferred taxes which are based on temporary differences between the tax basis of assets and liabilities and their reported amounts in the financial statements. Deferred tax assets and liabilities are reported in the financial statements at currently enacted income tax rates applicable to the period in which the deferred tax assets and liabilities are expected to be realized or settled.

#### Intangible Assets

Intangible assets include core deposit intangibles, customer relationship intangibles and goodwill arising from acquisitions. Core deposit intangibles and customer relationship intangibles are amortized on either an accelerated or straight-line basis over periods ranging from 7 to 20 years. Goodwill is evaluated at least annually for impairment. The carrying value of goodwill and other intangible assets is based upon discounted cash flow modeling techniques that require management to make estimates regarding the amount and timing of expected future cash flows. It also requires use of a discount rate that reflects the current return requirements of the market in relation to present risk-free interest rates, required equity market premiums, and company-specific

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risk indicators.

### Retirement Benefits

The Company provides defined benefit pension benefits and post-retirement health and life insurance benefits to eligible employees. The Company also provides deferred compensation and supplemental executive retirement plans for selected current and former employees and officers. Expense under these plans is charged to current operations and consists of several components of net periodic benefit cost based on various actuarial assumptions regarding future experience under the plans, including discount rate, rate of future compensation increases and expected return on plan assets.

### Stock-Based Compensation

The Company accounts for stock-based awards issued to directors, officers and key employees using the intrinsic value method. This method requires that compensation expense be recognized to the extent that the fair value of the underlying stock exceeds the exercise price of the stock award at the grant date. The Company generally does not recognize compensation expense related to stock awards because the stock awards generally have fixed terms and exercise prices that are equal to or greater than the fair value of the Company's common stock at the grant date.

SFAS 123, "Accounting for Stock-Based Compensation," requires companies that use the "intrinsic value method" to account for stock compensation plans to provide pro forma disclosures of the net income and earnings per share effect of stock options using the "fair value method." Under this method, the fair value of the option on the date of grant is recognized ratably as compensation expense over the vesting period of the option.

Management estimated the fair value of options granted using the Black-Scholes option-pricing model. This model was originally developed to estimate the fair value of exchange-traded equity options, which (unlike employee stock options) have no vesting period or transferability restrictions. As a result, the Black-Scholes model is not necessarily a precise indicator of the value of an option, but it is commonly used for this purpose. The Black-Scholes model requires several assumptions, which management developed based on historical trends and current market observations. These assumptions include:

|                                           | 2005   | 2004           |
|-------------------------------------------|--------|----------------|
| Weighted-average expected life (in years) | 7.76   | 7.78           |
| Future dividend yield                     | 3.00%  | 3.00%          |
| Share price volatility                    | 26.78% | 25.47 - 26.88% |
| Weighted average risk-free interest rate  | 4.17%  | 4.02 - 4.45%   |

If these assumptions are not accurate, the estimated fair value used to derive the information presented in the following table also will be inaccurate. Moreover, the model assumes that the estimated fair value of an option is amortized over the option's vesting period and would be included in salaries and employee benefits on the income statement.

The pro forma impact of applying the fair value method of accounting for the periods shown below may not be indicative of the pro forma impact in future periods.

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|                                                                                       | Three Months Ended<br>September 30, |          | Nine Months Ended<br>September 30, |          |
|---------------------------------------------------------------------------------------|-------------------------------------|----------|------------------------------------|----------|
| (000's omitted except per share amounts)                                              | 2005                                | 2004     | 2005                               | 2004     |
| Net income, as reported                                                               | \$14,864                            | \$14,234 | \$42,479                           | \$38,114 |
| Plus: stock-based compensation expense determined under intrinsic method, net of tax  | 41                                  | 63       | 116                                | 116      |
| Less: stock-based compensation expense determined under fair value method, net of tax | (332)                               | (269)    | (1,224)                            | (1,224)  |
| Pro forma net income                                                                  | \$14,573                            | \$14,028 | \$41,371                           | \$37,006 |

## Earnings per share:

### As reported:

|         |         |         |         |         |
|---------|---------|---------|---------|---------|
| Basic   | \$ 0.49 | \$ 0.47 | \$ 1.40 | \$ 1.37 |
| Diluted | \$ 0.48 | \$ 0.45 | \$ 1.37 | \$ 1.34 |

### Pro forma:

|         |         |         |         |         |
|---------|---------|---------|---------|---------|
| Basic   | \$ 0.48 | \$ 0.46 | \$ 1.36 | \$ 1.34 |
| Diluted | \$ 0.47 | \$ 0.44 | \$ 1.34 | \$ 1.31 |

As of September 30, 2005 there were 2,512,000 stock options outstanding.

## New Accounting Pronouncements

In December 2004, the Financial Accounting Standards Board revised SFAS No. 123, "Accounting for Stock-Based Compensation." SFAS 123R establishes accounting requirements for share-based compensation to employees and carries forward prior guidance on accounting for awards to non-employees. SFAS 123R requires an entity to recognize compensation expense based on an estimate of the number of awards expected to actually vest, exclusive of awards expected to be forfeited. In April 2005, the Securities and Exchange Commission approved a new rule which delays the effective date of SFAS 123R. The provisions of this statement will become effective January 1, 2006 for all equity awards granted or vested after the effective date. Management does not expect the impact of the adoption of this pronouncement to be materially different from the pro forma impacts disclosed under SFAS No. 123.

## NOTE D: EARNINGS PER SHARE

Basic earnings per share are computed based on the weighted-average common shares outstanding for the period. Diluted earnings per share are based on the weighted-average shares outstanding adjusted for the dilutive effect of the assumed exercise of stock options during the year. The dilutive effect of options is calculated using the treasury stock method of accounting. The treasury stock method determines the number of common shares that would be outstanding if all the dilutive options (average market price is greater than the exercise price) were exercised and the proceeds were used to repurchase common shares in the open market at the average market price for the applicable time period. There were 831,101 anti-dilutive stock options outstanding for the three months and nine months ended September 30, 2005 compared to 429,114 and 433,622 anti-dilutive stock options outstanding for the three and nine months ended September 30, 2004. The following is a reconciliation of basic to diluted

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earnings per share for the three and nine months ended September 30, 2005 and 2004.

| (000's omitted, except per share data) | Income   | Shares | Per Share Amount |
|----------------------------------------|----------|--------|------------------|
| -----                                  |          |        |                  |
| Three Months Ended September 30, 2005  |          |        |                  |
| Basic EPS                              | \$14,864 | 30,178 | \$ 0.49          |
| Stock options                          |          | 534    |                  |
| -----                                  |          |        |                  |
| Diluted EPS                            | \$14,864 | 30,712 | \$ 0.48          |
| =====                                  |          |        |                  |
| Three Months Ended September 30, 2004  |          |        |                  |
| Basic EPS                              | \$14,234 | 30,580 | \$ 0.47          |
| Stock options                          |          | 965    |                  |
| -----                                  |          |        |                  |
| Diluted EPS                            | \$14,234 | 31,545 | \$ 0.45          |
| =====                                  |          |        |                  |
| Nine Months Ended September 30, 2005   |          |        |                  |
| Basic EPS                              | \$42,479 | 30,385 | \$ 1.40          |
| Stock options                          |          | 562    |                  |
| -----                                  |          |        |                  |
| Diluted EPS                            | \$42,479 | 30,947 | \$ 1.37          |
| =====                                  |          |        |                  |
| Nine Months Ended September 30, 2004   |          |        |                  |
| Basic EPS                              | \$37,530 | 29,664 | \$ 1.27          |
| Stock options                          |          | 933    |                  |
| -----                                  |          |        |                  |
| Diluted EPS                            | \$37,530 | 30,597 | \$ 1.23          |
| =====                                  |          |        |                  |

## NOTE E: INTANGIBLE ASSETS

The gross carrying amount and accumulated amortization for each type of intangible asset are as follows:

| (000's omitted)                   | As of September 30, 2005 |                          |                     | As of De              |                          |
|-----------------------------------|--------------------------|--------------------------|---------------------|-----------------------|--------------------------|
|                                   | Gross Carrying Amount    | Accumulated Amortization | Net Carrying Amount | Gross Carrying Amount | Accumulated Amortization |
| -----                             |                          |                          |                     |                       |                          |
| Amortizing intangible assets:     |                          |                          |                     |                       |                          |
| Core deposit intangibles          | \$ 63,162                | (\$33,520)               | \$ 29,642           | \$ 63,691             | (                        |
| Other intangibles                 | 2,750                    | (1,105)                  | 1,645               | 2,750                 |                          |
| -----                             |                          |                          |                     |                       |                          |
| Total amortizing intangibles      | 65,912                   | (34,625)                 | 31,287              | 66,441                |                          |
| Non-amortizing intangible assets: |                          |                          |                     |                       |                          |
| Goodwill                          | 195,195                  | 0                        | 195,195             | 195,163               |                          |
| -----                             |                          |                          |                     |                       |                          |
| Total intangible assets, net      | \$261,107                | (\$34,625)               | \$226,482           | \$261,604             | (                        |
| =====                             |                          |                          |                     |                       |                          |

The changes in the gross carrying amount of core deposit and goodwill relate to the 2004 branch acquisition in Dansville, NY. No goodwill impairment adjustments

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were recognized in 2005 or 2004.

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The estimated aggregate amortization expense for each of the succeeding fiscal years ended December 31 is as follows:

| (000's omitted) | Amount   |
|-----------------|----------|
| Oct-Dec 2005    | \$ 1,604 |
| 2006            | 5,944    |
| 2007            | 5,569    |
| 2008            | 5,262    |
| 2009            | 4,777    |
| Thereafter      | 8,131    |
| Total           | \$31,287 |

## NOTE F: MANDATORILY REDEEMABLE PREFERRED SECURITIES

The Company sponsors three business trusts, Community Capital Trust I, Community Capital Trust II, and Community Statutory Trust III, of which 100% of the common stock is owned by the Company. The trusts were formed for the purpose of issuing company-obligated mandatorily redeemable preferred securities to third-party investors and investing the proceeds from the sale of such preferred securities solely in junior subordinated debt securities of the Company. The debentures held by each trust are the sole assets of that trust. Distributions on the preferred securities issued by each trust are payable semi-annually or quarterly at a rate per annum equal to the interest rate being earned by the trust on the debentures held by that trust. The preferred securities are subject to mandatory redemption, in whole or in part, upon repayment of the debentures. The Company has entered into agreements which, taken collectively, fully and unconditionally guarantee the preferred securities subject to the terms of each of the guarantees. The terms of the preferred securities of each trust are as follows:

|     | Issuance<br>Date | Amount         | Interest Rate                   | Maturity<br>Date | Call Provision         |
|-----|------------------|----------------|---------------------------------|------------------|------------------------|
| I   | 2/3/1997         | \$30 million   | 9.75%                           | 2/03/2027        | 10 year beginning 2007 |
| II  | 7/16/2001        | \$25 million   | 6 month LIBOR plus 3.75%(7.67%) | 7/16/2031        | 5 year beginning 2006  |
| III | 7/31/2001        | \$24.5 million | 3 month LIBOR plus 3.58%(7.27%) | 7/31/2031        | 5 year beginning 2006  |

## NOTE G: BENEFIT PLANS

The Company provides defined benefit pension benefits and post-retirement health and life insurance benefits to eligible employees. The Company also provides supplemental pension retirement benefits for several current and former key employees. The Company accrues for the estimated cost of these benefits through charges to expense during the years that employees earn these benefits. The net periodic benefit cost for the three and nine months ended September 30 is as follows:

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|                                       | Pension Benefits                    |        |                                    |          |                   |
|---------------------------------------|-------------------------------------|--------|------------------------------------|----------|-------------------|
|                                       | Three Months Ended<br>September 30, |        | Nine Months Ended<br>September 30, |          | Three Mo<br>Septe |
| (000's omitted)                       | 2005                                | 2004   | 2005                               | 2004     | 2005              |
| Service cost                          | \$ 641                              | \$ 568 | \$ 1,922                           | \$ 1,703 | \$ 110            |
| Interest cost                         | 651                                 | 631    | 1,953                              | 1,892    | 104               |
| Expected return on plan assets        | (877)                               | (790)  | (2,631)                            | (2,371)  | 0                 |
| Net amortization and deferral         | 318                                 | 262    | 953                                | 788      | 19                |
| Amortization of prior service cost    | 29                                  | 73     | 89                                 | 219      | 28                |
| Amortization of transition obligation | 0                                   | 0      | 0                                  | 0        | 10                |
| Net periodic benefit cost             | \$ 762                              | \$ 744 | \$ 2,286                           | \$ 2,231 | \$ 271            |

During the third quarter 2005 the Company contributed \$6.8 million to the pension plan. The Company does not anticipate making any further contributions in the fourth quarter.

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## NOTE H: COMMITMENTS, CONTINGENT LIABILITIES AND RESTRICTIONS

The Company 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 consist primarily of commitments to extend credit and standby letters of credit. Commitments to extend credit are agreements to lend to customers, generally having fixed expiration dates or other termination clauses that may require payment of a fee. These commitments consist principally of unused commercial and consumer credit lines. Standby letters of credit generally are contingent upon the failure of the customer to perform according to the terms of an underlying contract with a third party. The credit risks associated with commitments to extend credit and standby letters of credit are essentially the same as that involved with extending loans to customers and are subject to normal credit policies. Collateral may be obtained based on management's assessment of the customer's creditworthiness.

The contract amount of commitment and contingencies are as follows:

| (000's omitted)              | September 30,<br>2005 | December 31,<br>2004 |
|------------------------------|-----------------------|----------------------|
| Commitments to extend credit | \$441,874             | \$429,751            |
| Standby letters of credit    | 24,826                | 22,948               |
| Total                        | \$466,700             | \$452,699            |

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## Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

### Introduction

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This Management's Discussion and Analysis of Financial Condition and Results of Operations ("MD&A") primarily reviews the financial condition and results of operations of Community Bank System, Inc. ("the Company" or "CBSI") as of and for the three and nine months ended September 30, 2005 and 2004, although in some circumstances the second quarter of 2005 is also discussed in order to more fully explain recent trends. The following discussion and analysis should be read in conjunction with the Company's Consolidated Financial Statements and related notes that appear on pages 3 through 13. All references in the discussion to the financial condition and results of operations are to those of the Company and its subsidiaries taken as a whole.

Unless otherwise noted, the term "this year" refers to results in calendar year 2005, "third quarter" refers to the quarter ended September 30, 2005, "year to date" or ("YTD") refers to the nine months ended September 30, 2005, earnings per share ("EPS") figures refer to diluted EPS, and net interest income and net interest margin are presented on a fully tax-equivalent ("FTE") basis. All share and share-based amounts reflect the two-for-one stock split effected as a 100% stock dividend on April 12, 2004.

This MD&A contains certain forward-looking statements with respect to the financial condition, results of operations and business of the Company. These forward-looking statements involve certain risks and uncertainties. Factors that may cause actual results to differ materially from those proposed by such forward-looking statements are set herein under the caption, "Forward-Looking Statements," on page 28.

### Critical Accounting Policies

As a result of the complex and dynamic nature of the Company's business, management must exercise judgement in selecting and applying the most appropriate accounting policies for its various areas of operations. The policy decision process not only ensures compliance with the latest generally accepted accounting principles, but also reflects on management's discretion with regard to choosing the most suitable methodology for reporting the Company's financial performance. It is management's opinion that the accounting estimates covering certain aspects of the business have more significance than others due to the relative importance of those areas to overall performance, or the level of subjectivity in the selection process. These estimates affect the reported amounts of assets and liabilities and disclosures of revenues and expenses during the reporting period. Changes in the circumstances considered when determining management's estimates and assumptions could result in changes to those estimates. Actual results could differ from those estimates. Management believes that critical accounting estimates include:

- o Allowance for loan losses - The allowance for loan losses reflects management's best estimate of probable losses inherent in the loan portfolio. Determination of the allowance is subjective in nature and requires significant estimates including the amounts and timing of expected future cash flows on impaired loans and the amount of estimated losses on pools of homogeneous loans which is based on historical loss experience and consideration of current economic trends, all of which may be susceptible to significant change.
- o Actuarial assumptions associated with pension, post-retirement and other employee benefit plans - These assumptions include discount rate, rate of future compensation increases and expected return on plan assets.
- o Provision for income taxes - The Company is subject to examinations from various taxing authorities. Such examinations may result in challenges to the tax return treatment applied by the Company to specific transactions. Management believes that the assumptions and judgements used to record tax

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related assets or liabilities have been appropriate. Should tax laws change or the taxing authorities determine that management's assumptions were inappropriate, an adjustment may be required which could have a material effect on the Company's results of operations.

- o Carrying value of goodwill and other intangible assets - The carrying value of goodwill and other intangible assets is based upon discounted cash flow modeling techniques that require management to make estimates regarding the amount and timing of expected future cash flows. It also requires use of a discount rate that reflects the current return requirements of the market in relation to present risk-free interest rates, required equity market premiums, and company-specific risk indicators.

A summary of the accounting policies used by management is disclosed in Note A, "Summary of Significant Accounting Policies" on pages 43-48 of the most recent Form 10-KA (fiscal year ended December 31, 2004).

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### Executive Summary

The Company's business philosophy is to operate as a community bank with local decision-making, principally in non-metropolitan markets, providing a broad array of banking and financial services to retail, commercial and municipal customers.

The Company's core operating objectives are: (i) grow the branch network, primarily through a disciplined acquisition strategy, and certain selective de novo expansions, (ii) build high-quality, profitable loan portfolios using both organic and acquisition strategies, (iii) increase the non-interest income component of total revenues through development of banking-related fee income, growth in existing financial services business units, and the acquisition of additional financial services and banking businesses, and (iv) utilize technology to deliver customer-responsive products and services and to reduce operating costs.

Significant factors management reviews to evaluate achievement of the Company's operating objectives and its operating results and financial condition include, but are not limited to: net income and earnings per share, return on assets and equity, net interest margins, non-interest income, operating expenses, asset quality, loan and deposit growth, capital management, performance of individual banking and financial services business units, liquidity and interest rate sensitivity, enhancements to customer products and services, technology enhancements, market share, peer comparisons, and the performance of acquisition and integration activities.

Third quarter and September year-to-date ("YTD") earnings per share were \$0.03 and \$0.14, above their respective prior year periods, driven by organic loan growth, higher non-interest income including security gains, improved asset quality and lower acquisition expenses. These were partially offset by higher recurring operating expenses, a higher cost of funds, and a higher effective tax rate. In the quarter, the Company continued to make progress on its objective of shortening the average life of its investment portfolio, generating an \$0.11 per share after-tax gain through the sale of securities that had optimized their total return and interest-rate sensitivity characteristics. Cash earnings per share (which excludes the after-tax effect of the amortization of intangibles assets) were \$0.52 versus \$0.49 for the prior year's third quarter.

Asset quality remained strong in the third quarter of 2005 in comparison to the

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same period last year, with reductions in non-performing loans and consistent net charge-off and delinquent loan ratios. The Company experienced year-over-year loan growth in consumer mortgage and consumer installment lending on an organic basis. The business lending portfolio declined primarily due to significant declines in automotive dealer floor plans, a result of the robust manufacturer incentive programs in effect during the quarter and the seasonal transition to a new model-year. The investment portfolio decreased \$248 million and \$234 million as compared to the third quarter of 2004 and December 31, 2004, respectively. At September 30, 2005 total deposits increased \$67 million from September 30, 2004's level and \$57 million since December 31, 2004, and borrowings, principally short-term and variable rate instruments, decreased \$265 million and \$214 million during the same time periods.

The Company completed the following two acquisitions in 2004: (1) First Heritage Bank, a \$275 million-asset three branch commercial bank based in Wilkes-Barre, PA acquired in May, and (2) a bank branch in Dansville, NY, from HSBC Bank USA, N.A., acquired in December with deposits of \$32.6 million.

### Net Income and Profitability

As shown in Table 2, earnings per share for the third quarter and September YTD of \$0.48 and \$1.37, respectively, was \$0.03 and \$0.14 higher than the EPS generated in the same periods of last year. Net income for the quarter of \$14.9 million was up 4.4% over the third quarter of 2004 and net income of \$42.5 million for the first nine months of 2005 increased 13.2% from the amount earned in the first nine months of 2004. Net interest income for the third quarter of \$34.9 million was down \$4.1 million or 10.5% from the comparable prior year period, while net interest income for the first nine months of 2005 of \$108.7 million was down \$3.8 million versus the first nine months of 2004. Third quarter non-interest income, including securities gains, was \$18.5 million, up \$6.4 million (52%) from the third quarter 2004. Year-to-date non-interest income of \$48.1 million rose 43% from the prior year level. Operating expenses of \$30.7 million for the quarter and \$93.0 million for the first nine months of 2005 were up 2.7% and 3.9%, respectively, from the comparable prior year periods.

In addition to the earnings results presented above in accordance with generally accepted accounting principles ("GAAP"), the Company provides cash earnings per share, which excludes the after-tax effect of the amortization of intangible assets. Management believes that this information helps investors better understand the effect of acquisition activity in reported results. Cash earnings per share for the third quarter and the first nine months of 2005 were \$0.52 and \$1.48, respectively, up 6.1% from the \$0.49 earned in the third quarter of 2004 and 11.3% higher than the \$1.33 generated in the first nine months of 2004.

As reflected in Table 2, the primary reasons for improved earnings for both periods were higher non-interest income including securities gains and a lower loan loss provision, offset by lower net interest income and higher operating expenses. The decrease in net interest income for the quarter was due to higher cost of funds and lower average investment balances, partially offset by organic

loan growth. For the nine month period, the increase in the cost of funds more than offset the increase in average earning assets, derived primarily from the acquisitions of First Heritage and the Dansville branch and organic consumer mortgage and consumer installment loan growth. The improvement in asset quality metrics and change in the composition of the loan portfolio were the primary reasons for the decrease in loan loss provision, despite an increase in total loans. The increase in non-interest income, excluding security gains, was mostly attributable to a strong performance by the employee benefits consulting and

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plan administration business and additional banking service fees. These revenue improvements were partially offset by a growth in operating expenses resulting mostly from the acquisitions made in 2004, as well as higher compensation and benefit expenses.

A reconciliation of GAAP-based earnings results to cash-based earnings results and a condensed income statement are as follows:

Table 1: Reconciliation of GAAP Net Income to Cash Net Income

|                                   | Three Months Ended<br>September 30, |           | Nine Months Ended<br>September 30, |           |
|-----------------------------------|-------------------------------------|-----------|------------------------------------|-----------|
|                                   | 2005                                | 2004      | 2005                               | 2004      |
| (000's omitted)                   |                                     |           |                                    |           |
| Net income                        | \$ 14,864                           | \$ 14,234 | \$ 42,479                          | \$ 37,530 |
| After-tax cash adjustments:       |                                     |           |                                    |           |
| Amortization of intangible assets | 954                                 | 1,228     | 3,391                              | 3,311     |
| Net income - cash                 | \$ 15,818                           | \$ 15,462 | \$ 45,870                          | \$ 40,841 |

Table 2: Summary Income Statements

|                                              | Three Months Ended<br>September 30, |           | Nine Months Ended<br>September 30, |           |
|----------------------------------------------|-------------------------------------|-----------|------------------------------------|-----------|
|                                              | 2005                                | 2004      | 2005                               | 2004      |
| (000's omitted, except per share data)       |                                     |           |                                    |           |
| Net interest income                          | \$ 34,944                           | \$ 39,057 | \$108,702                          | \$112,468 |
| Provision for loan losses                    | 2,275                               | 2,300     | 6,284                              | 6,650     |
| Non-interest income including security gains | 18,543                              | 12,164    | 48,108                             | 33,613    |
| Operating expenses                           | 30,727                              | 29,926    | 92,958                             | 89,457    |
| Income before taxes                          | 20,485                              | 18,995    | 57,568                             | 49,974    |
| Income taxes                                 | 5,621                               | 4,761     | 15,089                             | 12,444    |
| Net income                                   | \$ 14,864                           | \$ 14,234 | \$ 42,479                          | \$ 37,530 |
| Diluted earnings per share                   | \$ 0.48                             | \$ 0.45   | \$ 1.37                            | \$ 1.23   |
| Diluted earnings per share-cash (1)          | \$ 0.52                             | \$ 0.49   | \$ 1.48                            | \$ 1.33   |

(1) Cash earnings exclude the after-tax effect of the amortization of intangible assets.

### Net Interest Income

Net interest income is the amount by which interest and fees on earning assets (loans and investments) exceed the cost of funds, primarily interest paid to the Company's depositors and interest on external borrowings. Net interest margin is the difference between the gross yield on earning assets and the cost of interest-bearing funds as a percentage of earning assets.

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As shown in Table 3, net interest income (with non-taxable income converted to a fully tax-equivalent basis) for the third quarter 2005 was \$38.5 million, down \$4.4 million or 10.2% from the same period last year. A \$153 million decrease in interest earning assets and a 29-basis point decrease in the net interest margin more than offset a \$222 million decrease in average interest-earning liabilities. As reflected in Table 4, the volume and net interest margin changes mentioned above adversely impacted net interest income by \$1.6 million and \$2.7 million, respectively, for the third quarter 2005 as compared to the third quarter of 2004. September 2005 YTD net interest income of \$119.5 million was down \$3.7 million or 3.0% from the year-earlier period. An \$82 million increase in average interest-bearing liabilities and a 31 basis point decline in the net interest margin had a greater negative effect than the benefits from a \$157 million increase in average interest-earning assets. As reflected in Table 4, a lower net interest margin had a negative \$8.8 million impact on net interest income, partially offset by interest-bearing asset and liability volume changes that resulted in \$5.2 million more net interest income.

Higher third quarter average loan balances were attributable to \$33 million of organic loan growth since the third quarter of 2004, driven principally by growth of consumer installment and consumer mortgage loans. The year-to-date average loan growth was

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attributable to \$212 million of loans acquired in the First Heritage and Dansville transactions as well as the organic loan growth discussed above. Average investments for the third quarter were \$188 million less than the third quarter of 2004 due principally to the sales made throughout 2005. Average YTD investments are consistent with the same period last year at \$1.4 billion. Total average deposits were up 1.7% for the quarter as compared to the previous year principally due to organic deposit growth. Year-to-date average deposits were up 4.3% compared to the previous year-to-date period due to both organic growth and the deposits added in the First Heritage and Dansville acquisitions. Cash flows from the investment sales were used to pay down external borrowings throughout 2005, resulting in average quarterly borrowings being \$241 million lower in the third quarter of 2005 as compared to the third quarter of 2004. Average borrowings for the year to date period increased \$4.2 million in comparison to the year earlier period.

The net interest margin of 4.06% for the third quarter and 4.19% for the YTD period dropped 29 and 31 basis points, respectively, versus the same periods in the prior year. These declines were primarily attributable to increases in the cost of funds (quarter up 40 basis points, YTD up 32 basis points), due principally to the effect of the eight rate hikes (25 basis points each) by the Federal Reserve since last September, while earning assets yields changed minimally (quarter increased seven basis points, YTD no change). The changes in earning-asset yields were driven by declines in investment yields of 15 basis points for the quarter and 19 basis points for the YTD period, while loan yields increased 22 basis points for the quarter and 11 basis points for the year-to-date period. The decrease in investment yields was the result of the sale and maturity of certain investments, a portion of whose proceeds were used to lower borrowings versus reinvestment in the current flat yield curve environment.

The third quarter cost of funds increased 40 basis points due to a 41 basis point increase in deposit costs and a 131 basis point increase in the average interest rate paid on external borrowings. The increase in the YTD costs of funds was driven by a 22 basis point increase in deposit costs and borrowing rates that were up 95 basis points, as short-term interest rates had an impact on interest-bearing deposits and short-term borrowings.

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Tables 3 and 3A below set forth information related to average interest-earning assets and interest-bearing liabilities and their associated yields and rates for the periods indicated. Interest income and yields are on a fully tax-equivalent basis using marginal income tax rates of 38.6% in 2005 and 38.7% in 2004. Average balances are computed by summing the daily ending balances in a period and dividing by the number of days in that period. Loan yields and amounts earned include loan fees. Average loan balances include non-accrual loans.

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Table 3: Quarterly Average Balance Sheet

| (000's omitted except yields and rates)              |                    | Three Months Ended<br>September 30, 2005 |                            |
|------------------------------------------------------|--------------------|------------------------------------------|----------------------------|
|                                                      | Average<br>Balance | Interest                                 | Avg.<br>Yield/Rate<br>Paid |
| <b>Interest-earning assets:</b>                      |                    |                                          |                            |
| Time deposits in other banks                         | \$ 951             | \$ 4                                     | 1.67%                      |
| Taxable investment securities (2)                    | 840,872            | 11,581                                   | 5.46%                      |
| Non-taxable investment securities (2)                | 523,301            | 8,753                                    | 6.64%                      |
| Loans (net of unearned discount) (1)                 | 2,397,472          | 37,265                                   | 6.17%                      |
| Total interest-earning assets                        | 3,762,596          | 57,603                                   | 6.07%                      |
| Non-interest earning assets                          | 468,195            |                                          |                            |
| Total assets                                         | \$4,230,791        |                                          |                            |
| <b>Interest-bearing liabilities:</b>                 |                    |                                          |                            |
| Interest checking, savings and money market deposits | \$1,163,628        | 2,352                                    | 0.80%                      |
| Time deposits                                        | 1,218,291          | 8,788                                    | 2.86%                      |
| Short-term borrowings                                | 338,405            | 2,523                                    | 2.96%                      |
| Long-term borrowings                                 | 371,877            | 5,463                                    | 5.83%                      |
| Total interest-bearing liabilities                   | 3,092,201          | 19,126                                   | 2.45%                      |
| <b>Non-interest bearing liabilities:</b>             |                    |                                          |                            |
| Demand deposits                                      | 607,621            |                                          |                            |
| Other liabilities                                    | 62,410             |                                          |                            |
| Shareholders' equity                                 | 468,559            |                                          |                            |
| Total liabilities and shareholders' equity           | \$4,230,791        |                                          |                            |
| Net interest earnings                                |                    | \$ 38,477                                |                            |
| Net interest spread                                  |                    |                                          | 3.62%                      |
| Net interest margin on interest-earnings assets      |                    |                                          | 4.06%                      |
| Fully tax-equivalent adjustment                      |                    | \$ 3,533                                 |                            |

(1) The impact of interest not recognized on non-accrual loans was immaterial.

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- (2) Averages for investment securities are based on historical cost basis and the yields do not give effect to changes in fair value that is reflected as a component of shareholders' equity and deferred taxes.

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Table 3a: Year to Date Average Balance Sheet

| (000's omitted except yields and rates)              |                    | Nine Months Ended<br>September 30, 2005 |                            |
|------------------------------------------------------|--------------------|-----------------------------------------|----------------------------|
|                                                      | Average<br>Balance | Interest                                | Avg.<br>Yield/Rate<br>Paid |
| <b>Interest-earning assets:</b>                      |                    |                                         |                            |
| Time deposits in other banks                         | \$ 889             | \$ 18                                   | 2.71%                      |
| Taxable investment securities (2)                    | 918,230            | 38,781                                  | 5.65%                      |
| Non-taxable investment securities (2)                | 533,520            | 26,988                                  | 6.76%                      |
| Loans (net of unearned discount) (1)                 | 2,364,359          | 109,132                                 | 6.17%                      |
| Total interest-earning assets                        | 3,816,998          | 174,919                                 | 6.13%                      |
| Non-interest earning assets                          | 488,344            |                                         |                            |
| Total assets                                         | \$4,305,342        |                                         |                            |
| <b>Interest-bearing liabilities:</b>                 |                    |                                         |                            |
| Interest checking, savings and money market deposits | \$1,175,152        | 6,493                                   | 0.74%                      |
| Time deposits                                        | 1,206,555          | 24,110                                  | 2.67%                      |
| Short-term borrowings                                | 412,141            | 9,301                                   | 3.02%                      |
| Long-term borrowings                                 | 383,113            | 15,470                                  | 5.40%                      |
| Total interest-bearing liabilities                   | 3,176,961          | 55,374                                  | 2.33%                      |
| <b>Non-interest bearing liabilities:</b>             |                    |                                         |                            |
| Demand deposits                                      | 595,722            |                                         |                            |
| Other liabilities                                    | 63,174             |                                         |                            |
| Shareholders' equity                                 | 469,485            |                                         |                            |
| Total liabilities and shareholders' equity           | \$4,305,342        |                                         |                            |
| Net interest earnings                                |                    | \$119,545                               |                            |
| Net interest spread                                  |                    |                                         | 3.80%                      |
| Net interest margin on interest-earnings assets      |                    |                                         | 4.19%                      |
| Fully tax-equivalent adjustment                      |                    | \$ 10,843                               |                            |

- (1) The impact of interest not recognized on non-accrual loans was immaterial.
- (2) Averages for investment securities are based on historical cost basis and the yields do not give effect to changes in fair value that is reflected as a component of shareholders' equity and deferred taxes.

As discussed above and disclosed in Table 4 below, the quarterly and year-to-date change in net interest income (fully tax-equivalent basis) may be analyzed by segregating the volume and rate components of the changes in interest income and interest expense for each underlying category.

Table 4: Rate/Volume

|                                                      | 3rd Quarter 2005 versus 3rd<br>Quarter 2004 |           |               |
|------------------------------------------------------|---------------------------------------------|-----------|---------------|
|                                                      | Increase (Decrease) Due to<br>Change in (1) |           |               |
| (000's omitted)                                      | Volume                                      | Rate      | Net<br>Change |
| Interest earned on:                                  |                                             |           |               |
| Time deposits in other banks                         | \$0                                         | \$3       | \$3           |
| Taxable investment securities                        | (2,284)                                     | (394)     | (2,678)       |
| Non-taxable investment securities                    | (391)                                       | (257)     | (648)         |
| Loans (net of unearned discount)                     | 527                                         | 1,383     | 1,910         |
| Total interest-earning assets (2)                    | (\$2,336)                                   | \$923     | (\$1,413)     |
| Interest paid on:                                    |                                             |           |               |
| Interest checking, savings and money market deposits | (\$8)                                       | \$733     | \$725         |
| Time deposits                                        | 147                                         | 1,646     | 1,793         |
| Short-term borrowings                                | (901)                                       | 1,274     | 373           |
| Long-term borrowings                                 | (901)                                       | 970       | 69            |
| Total interest-bearing liabilities (2)               | (\$1,142)                                   | \$4,102   | \$2,960       |
| Net interest earnings (2)                            | (\$1,637)                                   | (\$2,736) | (\$4,373)     |

- (1) The change in interest due to both rate and volume has been allocated in proportion to the relationship of the absolute dollar amounts of change in each.
- (2) Changes due to volume and rate are computed from the respective changes in average balances and rates and are not a summation of the changes of the components.

#### Non-interest Income

The Company's sources of non-interest income are as follows: general banking services related to loans, deposits and other core customer activities typically provided through the branch network; retirement plan administration and employee benefit, actuarial and consulting services (BPA-Harbridge), trust services, investment and insurance products (Community Investment Services, Inc. or CISI) and investment management (Elias Asset Management or EAM); and periodic transactions, most often net gains (losses) from the sale of investment

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securities and prepayment of term debt.

Table 5: Non-interest Income

|                                                            | Three Months Ended<br>September 30, |          | Nine<br>Se |
|------------------------------------------------------------|-------------------------------------|----------|------------|
| (000's omitted)                                            | 2005                                | 2004     | 2005       |
| Deposit service charges and fees                           | \$ 5,742                            | \$ 5,363 | \$16,03    |
| Benefit plan administration, consulting and actuarial fees | 2,767                               | 2,299    | 8,25       |
| Trust, investment and asset management fees                | 1,823                               | 1,974    | 5,46       |
| Commissions and other                                      | 1,881                               | 1,579    | 3,69       |
| Electronic banking                                         | 736                                 | 758      | 2,06       |
| Mortgage banking                                           | 289                                 | 191      | 39         |
| Sub-total                                                  | 13,238                              | 12,164   | 35,91      |
| Gain on sales of investment securities                     | 5,305                               | 0        | 12,19      |
| Total non-interest income                                  | \$18,543                            | \$12,164 | \$48,10    |
| Non-interest income/total income (FTE)                     | 32.5%                               | 22.1%    | 28.        |

As displayed in Table 5, non-interest income (excluding securities gains) was \$13.2 million in the third quarter and \$35.9 million for the first nine months of 2005. This represented increases of \$1.1 million (8.8%) for the quarter and \$2.4 million (7.3%) for the YTD period in comparison to one year earlier. A majority of the growth in both time intervals was attributable to the \$0.8 million and \$1.4 million increases in recurring bank fees for the quarter and year-to-date periods, respectively. Benefit plan administration, consulting and actuarial fees were up 20.4% for the current quarter and 19.6% for the first nine months of 2005 versus year-earlier levels. Gain on the sale of investment securities increased \$5.3 million and \$12.2 million for the quarter and year-to-date periods, respectively, as the Company took advantage of market conditions to sell certain securities in order to shorten the average length of the portfolio and maximize their expected total return. As a result, the expected life-to-maturity of the portfolio was reduced from 6.3 years at September 30, 2004 to 4.8 years at the end of the current quarter.

Electronic banking, deposit service charges and overdraft fees contributed \$0.4 million and \$1.0 million to the year-over-year increase in the quarter and YTD periods, respectively. This was due in large part to the incremental transaction volume generated from the accounts added through the First Heritage and Dansville acquisitions, as well as several revenue enhancement initiatives implemented this year. In 2004, losses on the sale of fixed assets were incurred, contributing \$0.2 million and \$0.3 million to the quarterly and year-to-date increase in non-interest income.

A strong performance at BPA-Harbridge generated revenue growth of \$0.5 million (20%) for the quarter and \$1.4 million (20%) for the first nine months of 2005, achieved primarily through enhanced service offerings to both new and existing clients, a portion of which relates to new actuarial determinations required by certain state and federal healthcare programs. Third quarter and September YTD revenue for trust services was up 21% and 11% versus the prior year, respectively, also achieved through new client relationships and the investment of additional assets by established clients. In comparison to the third quarter and year-to-date periods in the prior year, EAM and CISI revenues were down due

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to softer demand for their investment products.

The ratio of non-interest income to total income (FTE basis) was 32.5% for the quarter and 28.7% for the year-to-date period as compared to 22.1% and 21.4% for the comparable periods in 2004. Excluding net security gains, the ratio of non-interest income to total income (FTE basis) was 25.6% and 23.1% for the third quarter and YTD periods of 2005, respectively, as compared to 22.1% and 21.4% for the comparable periods in 2004.

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### Operating Expenses

Table 6 below sets forth the quarterly and year-to-date results of the major operating expense categories for the current and prior year, as well as efficiency ratios (defined below), a standard measure of overhead utilization used in the banking industry.

Table 6: Operating Expenses

|                                   | Three Months Ended<br>September 30, |                 | Nine Months Ended<br>September 30, |                 |
|-----------------------------------|-------------------------------------|-----------------|------------------------------------|-----------------|
| (000's omitted)                   | 2005                                | 2004            | 2005                               | 2004            |
| Salaries and employee benefits    | \$16,458                            | \$15,638        | \$48,836                           | \$46,197        |
| Occupancy                         | 2,739                               | 2,570           | 8,456                              | 7,700           |
| Equipment and furniture           | 2,304                               | 2,143           | 6,608                              | 6,445           |
| Legal and professional fees       | 993                                 | 1,003           | 3,306                              | 2,970           |
| Data processing                   | 1,841                               | 1,973           | 5,375                              | 5,777           |
| Amortization of intangible assets | 1,553                               | 2,003           | 5,521                              | 5,401           |
| Office supplies                   | 641                                 | 613             | 1,765                              | 1,711           |
| Foreclosed property               | 157                                 | 178             | 922                                | 621             |
| Acquisition expenses              | 1                                   | 53              | 48                                 | 1,434           |
| Other                             | 4,040                               | 3,752           | 12,121                             | 11,201          |
| <b>Total operating expenses</b>   | <b>\$30,727</b>                     | <b>\$29,926</b> | <b>\$92,958</b>                    | <b>\$89,457</b> |
| Operating expenses/average assets | 2.88%                               | 2.71%           | 2.89%                              | 2.89%           |
| Efficiency ratio                  | 56.4%                               | 50.7%           | 56.2%                              | 52.7%           |

As shown in Table 6, third quarter 2005 operating expenses were \$30.7 million, up \$0.8 million or 2.7% from the prior year level, and year-to-date operating expenses of \$93.0 million rose \$3.5 million or 3.9% compared to 2004. Recurring operating expenses (excluding acquisition expenses) were up 2.9% and 5.6% for the third quarter and the first nine months of 2005 versus the equivalent prior year periods, respectively. The increases for both periods were primarily attributable to increases in salaries and benefits at rates slightly above the consumer price index and higher equipment and occupancy costs related to rising utility costs and the opening of two new branches. Additionally, for the year to date period higher costs associated with business development due to a more robust marketing strategy and the disposal of several foreclosed properties were incurred during 2005 as compared to 2004. Offsetting these increases for the quarter, amortization of intangibles decreased \$0.45 million due to the completion of amortization of core deposit intangibles from a late 1990's

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acquisition. For the year-to-date period acquisition related expenses decreased \$1.4 million and data processing expenses remain below 2004's levels. The year-to-date increases in recurring operating expenses were also partially attributable to the acquisitions of First Heritage and Dansville in the second and fourth quarters of 2004, respectively, which affected virtually all expense categories.

The Company's efficiency ratio (recurring operating expense excluding intangible amortization divided by the sum of net interest income (FTE) and recurring non-interest income) was 56.4% for the third quarter, 5.7 percentage points above the comparable quarter of 2004. This resulted from operating expenses (as described above) increasing 4.7% primarily due to acquisitions and higher personnel costs, while recurring operating income decreased 6.0% mostly due to a lower net interest margin, partially offset by an 8.8% increase in non-interest income excluding security gains. The efficiency ratio of 56.2% for the first nine months of 2005 was up 3.5 basis points from a year earlier due to core operating expenses increasing 5.8%, while recurring operating income decreased 0.8% due to a lower net interest margin, partially offset by a 7.3% increase in non-interest income excluding security gains.

### Income Taxes

The third quarter effective income tax rate was 27.4%, a 2.3 percentage point increase from the 25.1% rate used in the third quarter of 2004. The YTD effective tax rate was 26.2%, compared to 24.9% for the first nine months of 2004. The increased effective tax rate for 2005 was principally a result of a lower proportion of income being generated from tax-exempt securities and loans.

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### Investments

As reflected in Table 7 below, the carrying value of investments (including unrealized gains on available-for-sale securities) was \$1.32 billion at the end of the third quarter, a decrease of \$266 million and \$287 million from December 31, 2004 and September 30, 2004, respectively. The book value (excluding unrealized gains) of investments was down \$234 million from year-end 2004 and down \$248 million versus September 30, 2004. The decrease in the portfolio was the result of the decision to sell certain securities and not fully reinvest cash flows from maturing securities to take advantage of market conditions to shorten the average life of the portfolio and maximize the expected total return. As a result, the expected life-to-maturity of the portfolio was reduced from 6.3 years at September 30, 2004 to 4.8 years at the end of the current quarter. The overall mix of securities within the portfolio remained relatively consistent, with a small increase in the proportion of obligations of state and political subdivision and a corresponding decrease in the proportion of U.S. treasury and agency securities. The change in the carrying value of investments is impacted by the amount of net unrealized gains in the portfolio at a point in time. Net unrealized gains decreased by \$32.2 million and \$38.4 million since December 31, 2004 and September 30, 2004, respectively. This fluctuation is indicative of the interest rate movements during the respective time periods and the reduction in the size of the portfolio.

Table 7: Investments

| September 30, 2005 | December 31, 2004 |
|--------------------|-------------------|
| -----              | -----             |
| Amortized          | Amortized         |

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| (000's omitted)                                     | Cost/Book<br>Value | Fair<br>Value | Cost/Book<br>Value |      |
|-----------------------------------------------------|--------------------|---------------|--------------------|------|
| -----                                               |                    |               |                    |      |
| Held-to-Maturity Portfolio:                         |                    |               |                    |      |
| U.S. treasury and agency securities                 | \$ 127,381         | \$ 125,114    | \$ 127,490         | \$   |
| Obligations of state and political subdivisions     | 5,131              | 5,186         | 6,576              |      |
| Other securities                                    | 9,461              | 9,461         | 3,578              |      |
| -----                                               |                    |               |                    |      |
| Total held-to-maturity portfolio                    | 141,973            | 139,761       | 137,644            |      |
| -----                                               |                    |               |                    |      |
| Available-for-Sale Portfolio:                       |                    |               |                    |      |
| U.S. treasury and agency securities                 | 420,315            | 423,923       | 630,058            |      |
| Obligations of state and political subdivisions     | 523,257            | 542,131       | 545,698            |      |
| Corporate securities                                | 35,779             | 35,881        | 40,443             |      |
| Collateralized mortgage obligations                 | 76,053             | 76,029        | 70,986             |      |
| Mortgage-backed securities                          | 55,629             | 56,656        | 50,347             |      |
| -----                                               |                    |               |                    |      |
| Sub-total                                           | 1,111,033          | 1,134,620     | 1,337,532          | 1,   |
| Equity securities                                   | 41,843             | 41,843        | 53,371             |      |
| -----                                               |                    |               |                    |      |
| Total available-for-sale portfolio                  | 1,152,876          | 1,176,463     | 1,390,903          | 1,   |
| Net unrealized gain on available-for-sale portfolio | 23,587             | 0             | 55,792             |      |
| -----                                               |                    |               |                    |      |
| Total                                               | \$1,318,436        | \$1,316,224   | \$1,584,339        | \$1, |
| =====                                               |                    |               |                    |      |

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## Loans

As shown in Table 8, loans ended the third quarter at \$2.4 billion, up \$53 million (2.3%) year-to-date and up \$38 million (1.6%) versus one year earlier. All of the loan growth for both periods was produced in the consumer mortgage and consumer installment portfolios. Consistent with prior years, the Company experienced softness within our lending portfolio in the first quarter, due principally to seasonal (weather-related) trends and demands. In the second and third quarters, loans increased \$33.0 million and \$44.5 million, respectively, with year-to-date increases in the consumer installment portfolio (\$56.3 million) and consumer mortgage portfolio (\$12.2 million), partially offset by a decrease in the business lending portfolio (\$15.1 million).

Table 8: Loans

| (000's omitted)      | September 30, 2005 |       | December 31, 2004 |       | September 30, 2004 |       |
|----------------------|--------------------|-------|-------------------|-------|--------------------|-------|
| -----                |                    |       |                   |       |                    |       |
| Consumer mortgage    | \$ 813,611         | 33.7% | \$ 801,412        | 34.0% | \$ 793,120         | 33.4% |
| Business lending     | 816,145            | 33.8% | 831,244           | 35.2% | 847,844            | 35.7% |
| Consumer installment | 782,137            | 32.4% | 725,837           | 30.8% | 732,787            | 30.9% |
| -----                |                    |       |                   |       |                    |       |
| Total loans          | \$2,411,893        | 100%  | \$2,358,493       | 100%  | \$2,373,751        | 100%  |
| -----                |                    |       |                   |       |                    |       |

Total consumer mortgages increased \$10.5 million in the third quarter of 2005

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and \$20.5 million over the last twelve months. During the last several years, record levels of refinancing activity were driven by mortgage rates that were at or near 40-year lows. Consumer mortgages growth slowed in 2005 compared to the past two years, as the pace of refinancings slowed after an extended period of elevated demand in the low-rate environment. The growth for the quarter, and nine and twelve month time frames was derived principally from activity in the New York markets.

Business lending decreased \$7.9 million in the third quarter of 2005 and decreased \$31.7 million versus one year ago. The declines were concentrated in the Pennsylvania market, while the New York markets experienced growth of \$6.7 million in the third quarter of 2005 and \$5.6 million since December 2004 despite the previously mentioned declines in dealer floor plan loans. The Pennsylvania market continues to be impacted by very competitive conditions.

Consumer installment loans, largely borrowings originated in automobile, marine and recreational vehicle dealerships as well as branch originated home equity and installment loans, rose \$30.4 million (4.0%) in the third quarter of 2005 and \$49.4 million (6.7%) on a year-over-year basis. Continued moderate interest rates (by historical standards), aggressive dealer and manufacturer incentives on new vehicles, and enhanced business development efforts have helped drive strong growth in this segment over the last two years. Consumer installment loans increased in both the New York and Pennsylvania markets during the quarter, nine-month and year over year time frames.

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### Asset Quality

Table 9 below exhibits the major components of non-performing loans and assets and key asset quality metrics for the periods ending September 30, 2005 and 2004 and December 31, 2004.

Table 9: Non-performing Assets

| (000's omitted)                                               | September 30,<br>2005 | December 31,<br>2004 | Sept  |
|---------------------------------------------------------------|-----------------------|----------------------|-------|
| -----                                                         | -----                 | -----                | ----- |
| Non-accrual loans                                             | \$12,896              | \$11,798             | \$    |
| Accruing loans 90+ days delinquent                            | 672                   | 1,158                |       |
| Restructured loans                                            | 0                     | 0                    |       |
| -----                                                         | -----                 | -----                | ----- |
| Total non-performing loans                                    | 13,568                | 12,956               |       |
| Other real estate                                             | 882                   | 1,645                |       |
| -----                                                         | -----                 | -----                | ----- |
| Total non-performing assets                                   | \$14,450              | \$14,601             | \$    |
| =====                                                         | =====                 | =====                | ===== |
| Allowance for loan losses to total loans                      | 1.35%                 | 1.35%                |       |
| Allowance for loan losses to non-performing loans             | 239%                  | 245%                 |       |
| Non-performing loans to total loans                           | 0.56%                 | 0.55%                |       |
| Non-performing assets to total loans and other real estate    | 0.60%                 | 0.62%                |       |
| Delinquent loans (30 days old to non-accruing) to total loans | 1.46%                 | 1.45%                |       |
| Net charge-offs to average loans outstanding (quarterly)      | 0.30%                 | 0.49%                |       |
| Loan loss provision to net charge-offs (quarterly)            | 125%                  | 72%                  |       |

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As displayed in Table 9, non-performing loans at September 30, 2005 were \$13.6 million, an increase of \$0.6 million versus year-end 2004 and a \$2.6 million decrease as compared to the level at the end of the third quarter 2004. During the second quarter of 2005, \$2.7 million of non-performing consumer mortgages were sold. Offsetting this decrease was the movement of one large floor plan relationship into non-performing status. Total non-performing assets including other real estate decreased \$0.2 million from year-end 2004 and decreased \$2.4 million from one-year ago, the decrease being the result of disposing of several properties that had been classified as other real estate.

Non-performing loans were 0.56% of total loans outstanding at the end of the third quarter, slightly above the 0.55% at year-end 2004 and substantially below the 0.68% at September 30, 2004. The allowance for loan losses to non-performing loans ratio, a general measure of coverage adequacy, was 239% at the end of the third quarter compared to 245% at year-end 2004 and 202% at September 30, 2004.

Delinquent loans (30 days through non-accruing) as a percent of total loans was 1.46% at the end of the third quarter, slightly above the 1.45% at year-end 2004 and below the 1.47% delinquency ratio at September 30, 2004. Real estate and installment loan delinquency ratios at the end of the third quarter improved in comparison to both of the earlier periods. Commercial loan delinquency ratios increased slightly from both the third and fourth quarters of 2004. The current delinquency level at the end of the quarter was six basis points below the Company's average of 1.52% over the previous eight quarters.

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Table 10: Allowance for Loan Losses Activity

|                                                  | Three Months Ended<br>September 30, |          | Nine Months Ended<br>September 30, |          |
|--------------------------------------------------|-------------------------------------|----------|------------------------------------|----------|
| (000's omitted)                                  | 2005                                | 2004     | 2005                               | 2004     |
| Allowance for loan losses at beginning of period | \$32,011                            | \$32,040 | \$31,778                           | \$29,095 |
| Charge-offs:                                     |                                     |          |                                    |          |
| Business lending                                 | 577                                 | 504      | 2,138                              | 2,236    |
| Consumer mortgage                                | 87                                  | 95       | 489                                | 225      |
| Consumer installment                             | 2,130                               | 1,84     | 5,727                              | 5,492    |
| Total charge-offs                                | 2,794                               | 2,442    | 8,354                              | 7,953    |
| Recoveries:                                      |                                     |          |                                    |          |
| Business lending                                 | 231                                 | 90       | 602                                | 669      |
| Consumer mortgage                                | 3                                   | 12       | 137                                | 35       |
| Consumer installment                             | 734                                 | 60       | 2,013                              | 1,756    |
| Total recoveries                                 | 968                                 | 71       | 2,752                              | 2,460    |
| Net charge-offs                                  | 1,826                               | 1,731    | 5,602                              | 5,493    |
| Provision for loan losses                        | 2,275                               | 2,300    | 6,284                              | 6,650    |
| Allowance on acquired loans                      | 0                                   | 0        | 0                                  | 2,357    |
| Allowance for loan losses at end of period       | \$32,460                            | \$32,60  | \$32,460                           | \$32,609 |
| Net charge-offs to average loans outstanding:    |                                     |          |                                    |          |
| Business lending                                 | 0.17%                               | 0.19%    | 0.25%                              | 0.27%    |

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|                      |       |       |       |       |
|----------------------|-------|-------|-------|-------|
| Consumer mortgage    | 0.04% | 0.04% | 0.06% | 0.03% |
| Consumer installment | 0.72% | 0.68% | 0.67% | 0.71% |
| Total loans          | 0.30% | 0.29% | 0.32% | 0.33% |

As displayed in Table 10, net charge-offs during the third quarter were \$1.8 million, \$0.1 million higher than the equivalent 2004 period. The consumer mortgage and consumer installment portfolios experienced increased levels of charge-offs, while business lending charge-offs decreased. The net charge-off ratio (net charge-offs as a percentage of average loans outstanding) for the third quarter was 0.30%, one basis point higher than the comparable quarter of 2004, and ten basis points lower than average charge off ratio for the previous eight quarters. On a year-to-date basis, net charge-offs increased \$0.1 million versus the prior year period, while average loans were up \$37 million, resulting in a one basis point decline in the YTD net charge-off ratio to 0.32%

The business lending net charge-off ratio decreased two basis points to 0.17% for the third quarter and 0.25% for the first nine months from the comparable periods in the prior year. The consumer mortgage net charge-off ratio for the third quarter of 2005 was consistent with the third quarter of 2004. The consumer mortgage net charge-off ratio for the year-to-date period increased three basis points from the same period in 2004 mostly as a result of the previously mentioned sale of non-performing mortgages. The net charge-off ratio for consumer installments was 0.72% and 0.67% for the third quarter and first nine months of 2005, respectively; consistent with, or lower than the average for the last eight quarters of 0.72%.

A required loan loss allowance of \$32.5 million was determined as of September 30, 2005, necessitating a \$2.3 million loan loss provision for the quarter, consistent with one year earlier. The third quarter 2005 loan loss provision was \$0.4 million higher than net charge-offs mainly due to the growth in the loan portfolio. The allowance for loan losses decreased slightly over the last 12 months, while the loan portfolio grew 1.6%. Consequently, the ratio of allowance for loan loss to loans outstanding decreased from 1.37% to 1.35%, which was consistent with the level at December 31, 2004.

### Deposits

As shown in Table 11, average deposits of \$2.990 billion in the third quarter were up \$51 million compared to fourth quarter 2004 and increased \$49 million versus the same quarter of last year. Deposits totaling \$33 million were added as a result of the acquisition of the Dansville branch in December 2004.

In 2004 and continuing into 2005, the deposit mix shifted towards demand deposits and more liquid interest-bearing deposits (money market accounts). This shift in deposit mix may have reflected customers' rising rate expectations and consequently their unwillingness to be locked into rates and products for extended periods of time. New product introductions, proactive marketing and increased yields on money market accounts throughout the year resulted in the average balances for money market accounts increasing from 10.6% of the total deposits to 11.8% of total deposits. Recently, as interest rates have risen, time deposits have

attracted more funds evidenced by their 2.4% increase in the current quarter versus fourth quarter 2004. This shift in mix, combined with increasing interest rates on money market and time deposit accounts increased the quarterly cost of interest bearing deposits from 1.49% in the last quarter of, 2004 to 1.86% in the most recent quarter, and compared to 1.45% for the quarter ended September

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30, 2004.

Excluding the impact of acquisitions, average third quarter IPC (individuals and businesses) deposits increased \$20.8 million or 0.8% versus the quarter ended December 31, 2004, but were down \$2.3 million or 0.1% compared to the year earlier period. Average public funds, excluding acquisitions, have increased \$6.0 million or 3.3% and \$18.3 million or 10.9% over the same periods. The increase in core deposits is the result of ongoing enhanced marketing efforts and new product offerings introduced throughout 2005.

Table 11: Quarterly Average Deposits

| (000's omitted)            | September 30,<br>2005 | December 31,<br>2004 | September 30,<br>2004 |
|----------------------------|-----------------------|----------------------|-----------------------|
| Demand deposits            | \$ 607,621            | \$ 584,223           | \$ 577,949            |
| Interest checking deposits | 308,297               | 309,817              | 302,757               |
| Savings deposits           | 501,989               | 542,954              | 555,015               |
| Money market deposits      | 353,342               | 312,317              | 311,560               |
| Time deposits              | 1,218,291             | 1,189,729            | 1,193,700             |
| Total deposits             | \$2,989,540           | \$2,939,040          | \$2,940,981           |
| IPC deposits               | \$2,802,743           | \$2,759,269          | \$2,773,933           |
| Public fund deposits       | 186,797               | 179,771              | 167,048               |
| Total deposits             | \$2,989,540           | \$2,939,040          | \$2,940,981           |

## Borrowings

At the end of the third quarter, borrowings of \$707 million were down \$214 million from December 31, 2004 and down \$265 million from the third quarter 2004 level. The reduction in borrowings over the last nine months was principally the result of the decision to not fully reinvest the cash flows from the sales and maturities of investments in the current flat yield curve environment.

## Shareholders' Equity

On April 20, 2005, the Company announced that its Board of Directors had authorized a stock repurchase program to acquire up to 1,500,000 of its shares, or approximately 5%, of its outstanding common stock. The shares may be repurchased from time to time, in open market or privately negotiated transactions over the course of the subsequent 20 months. All reacquired shares will become treasury shares and will be used for general corporate purposes. Through September 30, 2005, the Company has repurchased 521,611 shares at an aggregate cost of \$12.3 million.

Total shareholders' equity of \$460 million at the end of the third quarter was a decrease of \$14.2 million from the balance at December 31, 2004. This change consisted of a decrease in the after-tax market value adjustment on the available-for-sale investment portfolio of \$19.7 million, dividends declared of \$16.6 million and treasury stock purchases of \$24.2 million, partially offset by net income of \$42.5 million and \$3.9 million from shares issued under the employee stock plan. Over the past 12 months total shareholders' equity decreased by \$6.8 million, as dividends declared, treasury stock purchases, and a lower market value adjustment more than offset net income and increases from shares issued under the employee stock plan.

The Company's Tier I leverage ratio, a primary measure of regulatory capital for which 5% is the requirement to be "well-capitalized," was 7.34% at the end of

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the third quarter, up 39 basis points from year-end 2004 and 61 basis points higher than its level one year ago. These increases were primarily the result of average assets excluding intangibles and market value adjustments decreasing more than the decrease in shareholders equity excluding intangibles and market value adjustments, mostly due to the reduction of the investment portfolio. The tangible equity-to-assets ratio of 5.86% increased 4 basis points versus year-end 2004 and 18 basis points versus September 30, 2004, for similar reasons.

The dividend payout ratio (dividends declared divided by net income) for the first nine months of 2005 was 39.1%, down 0.9 percentage points from one year ago. The ratio declined because dividends declared increased 10.5%, a lower percentage increase

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than the 13.2% growth in net income. The expansion of dividends declared was caused by the dividend per share being raised 5.6% in August 2005, from \$0.18 to \$0.19, offset by a 2.1% decrease in the number of shares outstanding.

### Liquidity

Management of the Company's liquidity is critical due to the potential for unexpected fluctuations in deposits and loans. Adequate sources of both on and off-balance sheet funding are in place to effectively respond to such unexpected fluctuations.

The Company's primary approach to measuring liquidity is known as the Basic Surplus/Deficit model. It is used to calculate liquidity over two time periods: first, the amount of cash that could be made available within 30 days (calculated as liquid assets less short-term liabilities); and second, a projection of subsequent cash availability over an additional 60 days. The minimum policy level of liquidity under the Basic Surplus/Deficit approach is 7.5% of total assets for both the 30 and 90-day time horizons. As of September 30, 2005, this ratio was 14.9% for 30 days and 14.7% for 90 days excluding the Company's capacity to borrow additional funds from the Federal Home Loan Bank.

To measure longer-term liquidity, a baseline projection of loan and deposit growth for five years is made to reflect how current liquidity levels could change over time. This five-year measure reflects adequate liquidity to fund loan and other asset growth over the next five years.

### New Accounting Pronouncements

See New Accounting Pronouncement section of Note C to the consolidated financial statements.

### Forward-Looking Statements

This document contains comments or information that constitute forward-looking statements (within the meaning of the Private Securities Litigation Reform Act of 1995), which involve significant risks and uncertainties. Actual results may differ materially from the results discussed in the forward-looking statements. Moreover, the Company's plans, objectives and intentions are subject to change based on various factors (some of which are beyond the Company's control). Factors that could cause actual results to differ from those discussed in the forward-looking statements include: (1) risks related to credit quality, interest rate sensitivity and liquidity; (2) the strength of the U.S. economy in general and the strength of the local economies where the Company conducts its business; (3) the effect of, and changes in, monetary and fiscal policies and

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laws, including interest rate policies of the Board of Governors of the Federal Reserve System; (4) inflation, interest rate, market and monetary fluctuations; (5) the timely development of new products and services and customer perception of the overall value thereof (including features, pricing and quality) compared to competing products and services; (6) changes in consumer spending, borrowing and savings habits; (7) technological changes; (8) any acquisitions or mergers that might be considered or consummated by the Company and the costs and factors associated therewith; (9) the ability to maintain and increase market share and control expenses; (10) the effect of changes in laws and regulations (including laws and regulations concerning taxes, banking, securities and insurance) and accounting principles generally accepted in the United States; (11) changes in the Company's organization, compensation and benefit plans and in the availability of, and compensation levels for, employees in its geographic markets; (12) the costs and effects of litigation and of any adverse outcome in such litigation; (13) other risk factors outlined in the Company's filings with the Securities and Exchange Commission from time to time; and (14) the success of the Company at managing the risks of the foregoing.

The foregoing list of important factors is not all-inclusive. Such forward-looking statements speak only as of the date on which they are made and the Company does not undertake any obligation to update any forward-looking statement, whether written or oral, to reflect events or circumstances after the date on which such statement is made. If the Company does update or correct one or more forward-looking statements, investors and others should not conclude that the Company would make additional updates or corrections with respect thereto or with respect to other forward-looking statements.

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### Item 3. Quantitative and Qualitative Disclosure about Market Risk

Market risk is the risk of loss in a financial instrument arising from adverse changes in market rates, prices or credit risk. Credit risk associated with the Company's loan portfolio has been previously discussed in the asset quality section of Management's Discussion and Analysis of Financial Condition and Results of Operations. Management believes that the tax risk of the Company's municipal investments associated with potential future changes in statutory, judicial and regulatory actions is minimal. The Company has an insignificant amount of credit risk in its investment portfolio because essentially all of the fixed-income securities in the portfolio are AAA-rated (highest possible rating). Therefore, almost all the market risk in the investment portfolio is related to interest rates.

The ongoing monitoring and management of both interest rate risk and liquidity, in the short and long term time horizons is an important component of the Company's asset/liability management process, which is governed by limits established in the policies reviewed and approved annually by the Board of Directors. The Board of Directors delegates responsibility for carrying out the policies to the Asset/Liability Committee (ALCO) which meets each month and is made up of the Company's senior management as well as regional and line-of-business managers who oversee specific earning asset classes and various funding sources. As the Company does not believe it is possible to reliably predict future interest rate movements, it has maintained an appropriate process and set of measurement tools, which enable it to identify and quantify sources of interest rate risk in varying rate environments. The primary tool used by the Company in managing interest rate risk is income simulation.

While a wide variety of strategic balance sheet and treasury yield curve scenarios are tested on an ongoing basis, the following reflects the Company's one-year net interest income sensitivity based on:

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- o Asset and liability levels using September 30, 2005 as a starting point.
- o There are assumed to be conservative levels of balance sheet growth--low to mid single digit growth in loans and deposits, while using the cashflows from investment contractual maturities and prepayments to repay short-term capital market borrowings.
- o The prime rate and federal funds rates are assumed to move up 200 basis points and down 100 basis points over a 12-month period while moving the long end of the treasury curve to spreads over federal funds that are more consistent with historical norms. Deposit rates are assumed to move in a manner that reflects the historical relationship between deposit rate movement and changes in the federal funds rate.
- o Cash flows are based on contractual maturity, optionality and amortization schedules along with applicable prepayments derived from internal historical data and external sources.

### Net Interest Income Sensitivity Model

| Change in interest<br>rates | Calculated annualized<br>increase (decrease) in<br>projected net interest income<br>at September 30, 2005 |
|-----------------------------|-----------------------------------------------------------------------------------------------------------|
| -----                       | -----                                                                                                     |
| + 200 basis points          | (1.0%)                                                                                                    |
| - 100 basis points          | (0.8%)                                                                                                    |

The modeled net interest income in a falling rate environment is initially more favorable than if rates were to rise due to a faster initial reaction from core deposit pricing and short-term capital market borrowing rates. Over a longer time period, however, the growth in net interest income improves in a rising rate environment as a result of lower yielding earning assets running off and being replaced at increased rates.

The analysis does not represent a Company forecast and should not be relied upon as being indicative of expected operating results. These hypothetical estimates are based upon numerous assumptions: the nature and timing of interest rate levels (including yield curve shape), prepayments on loans and securities, deposit decay rates, pricing decisions on loans and deposits, reinvestment/replacement of asset and liability cash flows, and other factors. While the assumptions are developed based upon current economic and local market conditions, the Company cannot make any assurances as to the predictive nature of these assumptions, including how customer preferences or competitor influences might change. Furthermore, the sensitivity analysis does not reflect actions that ALCO might take in responding to or anticipating changes in interest rates.

#### Item 4. Controls and Procedures

The Company maintains disclosure controls and procedures designed to ensure that it is able to collect the information it is required to disclose in the reports that are filed with the Securities and Exchange Commission, or SEC, and to process, summarize and disclose this information within the time periods specified in the rules of the SEC. Based on managements evaluation of the Company's disclosure controls and procedures, with the participation of the Chief Executive and the Chief Financial Officer, it has concluded that, as of

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the end of the period covered by this Quarterly Report on Form 10-Q, these disclosure controls and procedures were effective to ensure that the Company is able to record, process, summarize and report the information it is required to disclose in the reports the Company files with the SEC within the required time periods.

There have been no significant changes in the Company's internal controls over financial reporting in connection with the evaluation referenced in the paragraph above that occurred during the Company's last fiscal quarter that has materially affected or is reasonably likely to materially affect the Company's internal control over financial reporting.

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

### Part II. Other Information

#### Item 1. Legal Proceedings.

The Company and its subsidiaries are subject in the normal course of business to various pending and threatened legal proceedings in which claims for monetary damages are asserted. Management, after consultation with legal counsel, does not anticipate that the aggregate liability, if any, arising out of litigation pending against the Company or its subsidiaries will have a material effect on the Company's consolidated financial position or results of operations.

#### Item 2. Unregistered Sales of Equity Securities and Use of Proceeds.

On April 20, 2005, the Company announced a twenty-month authorization to repurchase up to 1,500,000 of its outstanding shares in open market or privately negotiated transactions. These repurchases will be for general corporate purposes, including those related to stock plan activities. The following table shows treasury stock purchases during the third quarter 2005.

|                | Number of<br>Shares<br>Purchased | Average Price<br>Paid<br>Per share | Total Number of Shares<br>Purchased as part of Publicly<br>Announced Plans or Programs | Number of Shares<br>Yet to be purchased<br>Under the Plans or Programs |
|----------------|----------------------------------|------------------------------------|----------------------------------------------------------------------------------------|------------------------------------------------------------------------|
| July 2005      | 0                                | \$ 0.00                            | 0                                                                                      | 1,358,000                                                              |
| August 2005    | 322,850                          | 23.55                              | 322,850                                                                                | 1,035,150                                                              |
| September 2005 | 56,860                           | 23.17                              | 379,710                                                                                | 978,440                                                                |
| Total          | 379,710                          | \$23.49                            | 379,710                                                                                | 978,440                                                                |

#### Item 3. Defaults Upon Senior Securities.

Not applicable.

#### Item 4. Submission of Matters to a Vote of Securities Holders.

There were no matters submitted to a vote of the shareholders during the quarter ending September 30, 2005.

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### Item 5. Other Information.

Not applicable

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### Item 6. Exhibits and Reports on Form 8-K

| Exhibit No.<br>----- | Description<br>-----                                                                                                                                                                                                                                       |
|----------------------|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| 31.1                 | Certification of Sanford A. Belden, President and Chief Executive Officer of the Registrant, pursuant to Rule 13a-15(e) or Rule 15d-15(e) under the Securities Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002. |
| 31.2                 | Certification of Scott A. Kingsley, Treasurer and Chief Financial Officer of the Registrant, pursuant to Rule 13a-15(e) or Rule 15d-15(e) under the Securities Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002. |
| 32.1                 | Certification of Sanford A. Belden, President and Chief Executive Officer of the Registrant, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.                                                     |
| 32.2                 | Certification of Scott A. Kingsley, Treasurer and Chief Financial Officer of the Registrant, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002                                                      |

#### Reports on Form 8-K:

- o Form 8-K related to quarterly earnings press release was filed on October 21, 2005.

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### 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.

Community Bank System, Inc.

Date: November 4, 2005

/s/ Sanford A. Belden  
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Sanford A. Belden, President, Chief  
Executive Officer and Director

Date: November 4, 2005

/s/ Scott A. Kingsley  
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Scott A. Kingsley, Treasurer and Chief  
Financial Officer

