

COMMUNITY BANK SYSTEM INC
Form 10-Q
August 08, 2007

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 June 30, 2007

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

For the transition period from _____ to _____

Commission File Number 001-13695

COMMUNITY BANK SYSTEM, INC.

(Exact name of registrant as specified in its charter)

Delaware

16-1213679

(State or other jurisdiction of incorporation or organization)

(I.R.S. Employer Identification No.)

5790 Widewaters Parkway, DeWitt, New York

13214-1883

(Address of principal executive offices)

(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 a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of "accelerated filer and large accelerated filer" in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer

Accelerated filer

Non-accelerated filer

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 issuer's classes of common stock, as of the latest practicable date.

Edgar Filing: COMMUNITY BANK SYSTEM INC - Form 10-Q

29,804,190 shares of Common Stock, \$1.00 par value, were outstanding on July 31, 2007.

TABLE OF CONTENTS

| | <u>Page</u> |
|--|-------------|
| Part I. Financial Information | |
| Item 1. Financial Statements (Unaudited) | |
| <u>Consolidated Statements of Condition</u> <u>June 30, 2007 and December 31, 2006</u> | 3 |
| <u>Consolidated Statements of Income</u> <u>Three and six months ended June 30, 2007 and 2006</u> | 4 |
| <u>Consolidated Statement of Changes in Shareholders' Equity</u> <u>Six months ended June 30, 2007</u> | 5 |
| <u>Consolidated Statements of Comprehensive Income</u> <u>Three and six months ended June 30, 2007 and 2006</u> | 6 |
| <u>Consolidated Statements of Cash Flows</u> <u>Six months ended June 30, 2007 and 2006</u> | 7 |
| <u>Notes to the Consolidated Financial Statements</u> <u>June 30, 2007</u> | 8 |
| Item 2. <u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u> | 13 |
| Item 3. <u>Quantitative and Qualitative Disclosure about Market Risk</u> | 28 |
| Item 4. <u>Controls and Procedures</u> | 29 |
| Part II. Other Information | |
| Item 1. <u>Legal Proceedings</u> | 29 |
| Item 1A. <u>Risk Factors</u> | 29 |
| Item 2. <u>Unregistered Sales of Equity Securities and Use of Proceeds</u> | 29 |
| Item 3. <u>Defaults Upon Senior Securities</u> | 29 |
| Item 4. <u>Submission of Matters to a Vote of Securities Holders</u> | 29 |
| Item 5. <u>Other Information</u> | 29 |
| Item 6. <u>Exhibits</u> | 30 |

Part I. Financial Information**Item 1. Financial Statements**
COMMUNITY BANK SYSTEM, INC.
CONSOLIDATED STATEMENTS OF CONDITION
(In Thousands, Except Share Data)

| | (Unaudited) June 30, 2007 | December 31, 2006 |
|--|---------------------------------|----------------------|
| Cash and cash equivalents | \$ 242,410 | \$ 232,032 |
| Available-for-sale investment securities, at fair value | 1,082,937 | 1,083,412 |
| Held-to-maturity investment securities (fair value of \$131,677 and \$142,694, respectively) | 136,423 | 145,859 |
| Total investment securities | 1,219,360 | 1,229,271 |
| Loans | 2,767,176 | 2,701,558 |
| Allowance for loan losses | (36,690) | (36,313) |
| Net loans | 2,730,486 | 2,665,245 |
| Core deposit intangibles, net | 23,124 | 24,665 |
| Goodwill | 233,219 | 220,290 |
| Other intangibles, net | 1,767 | 1,181 |
| Intangible assets, net | 258,110 | 246,136 |
| Premises and equipment, net | 69,639 | 66,199 |
| Accrued interest receivable | 24,859 | 26,797 |
| Other assets | 38,285 | 32,117 |
| Total assets | \$ 4,583,149 | \$ 4,497,797 |
| Liabilities: | | |
| Noninterest bearing deposits | \$ 588,132 | \$ 578,951 |
| Interest bearing deposits | 2,776,445 | 2,589,348 |
| Total deposits | 3,364,577 | 3,168,299 |
| Borrowings | 577,134 | 647,481 |
| Subordinated debt held by unconsolidated subsidiary trusts | 127,111 | 158,014 |
| Accrued interest and other liabilities | 54,703 | 62,475 |
| Total liabilities | 4,123,525 | 4,036,269 |
| Commitment and contingencies (See Note I) | | |
| Shareholders' equity: | | |
| Preferred stock \$1.00 par value, 500,000 shares authorized, 0 shares issued | 32,920 | 32,773 |

Edgar Filing: COMMUNITY BANK SYSTEM INC - Form 10-Q

(Unaudited)
June 30,
2007 **December 31,**
2006

| | | |
|---|---------------------|---------------------|
| Common stock, \$1.00 par value, 50,000,000 shares authorized; 32,920,155 and 32,773,320 shares issued in 2007 and 2006, respectively | | |
| Additional paid-in capital | 206,106 | 203,197 |
| Retained earnings | 299,883 | 291,871 |
| Accumulated other comprehensive income | (11,610) | (4,697) |
| Treasury stock, at cost (3,046,961 and 2,753,161 shares, respectively) | (67,675) | (61,616) |
| <hr/> | | |
| Total shareholders equity | 459,624 | 461,528 |
| <hr/> | | |
| Total liabilities and shareholders equity | \$ 4,583,149 | \$ 4,497,797 |

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

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

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|--|--------------------------------|---------------|------------------------------|----------------|
| | 2007 | 2006 | 2007 | 2006 |
| Interest income: | | | | |
| Interest and fees on loans | \$ 46,090 | \$ 39,760 | \$ 91,025 | \$ 78,088 |
| Interest and dividends on taxable investments | 11,839 | 10,839 | 22,942 | 21,374 |
| Interest and dividends on nontaxable investments | 5,327 | 5,883 | 10,847 | 11,678 |
| Total interest income | 63,256 | 56,482 | 124,814 | 111,140 |
| Interest expense: | | | | |
| Interest on deposits | 20,092 | 14,620 | 38,212 | 27,641 |
| Interest on short-term borrowings | 1,622 | 1,150 | 3,259 | 2,608 |
| Interest on subordinated debt held by unconsolidated subsidiary trusts | 2,438 | 1,872 | 5,004 | 3,687 |
| Interest on long-term borrowings | 5,766 | 5,231 | 11,634 | 9,910 |
| Total interest expense | 29,918 | 22,873 | 58,109 | 43,846 |
| Net interest income | 33,338 | 33,609 | 66,705 | 67,294 |
| Less: provision for loan losses | 414 | 1,725 | 614 | 3,875 |
| Net interest income after provision for loan losses | 32,924 | 31,884 | 66,091 | 63,419 |
| Noninterest income: | | | | |
| Deposit service fees | 7,825 | 7,063 | 14,802 | 13,672 |
| Other banking services | 425 | 361 | 1,095 | 837 |
| Benefit plan administration, consulting and actuarial fees | 4,767 | 3,155 | 8,739 | 6,536 |
| Trust, investment and asset management fees | 2,009 | 1,766 | 3,869 | 3,816 |
| Loss on sales of investment securities | (8) | | (8) | |
| Total noninterest income | 15,018 | 12,345 | 28,497 | 24,861 |
| Operating expenses: | | | | |
| Salaries and employee benefits | 18,386 | 16,425 | 36,672 | 33,207 |
| Occupancy and equipment | 4,559 | 4,448 | 9,225 | 9,207 |
| Data processing and communications | 3,808 | 3,252 | 7,373 | 6,483 |
| Amortization of intangible assets | 1,581 | 1,489 | 3,096 | 2,982 |
| Legal and professional fees | 1,054 | 1,108 | 2,241 | 2,391 |
| Office supplies and postage | 1,008 | 1,083 | 2,054 | 2,059 |
| Business development and marketing | 1,538 | 1,164 | 2,488 | 1,894 |
| Other | 2,198 | 2,239 | 4,902 | 4,420 |
| Total operating expenses | 34,132 | 31,208 | 68,051 | 62,643 |

Edgar Filing: COMMUNITY BANK SYSTEM INC - Form 10-Q

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|-------------------------------------|--------------------------------|-----------------|------------------------------|------------------|
| Income before income taxes | 13,810 | 13,021 | 26,537 | 25,637 |
| Income taxes | 3,451 | 3,137 | 6,522 | 6,291 |
| Net income | \$ 10,359 | \$ 9,884 | \$ 20,015 | \$ 19,346 |
| Basic earnings per share | \$ 0.34 | \$ 0.33 | \$ 0.66 | \$ 0.65 |
| Diluted earnings per share | \$ 0.34 | \$ 0.33 | \$ 0.66 | \$ 0.64 |
| Dividends declared per share | \$ 0.20 | \$ 0.19 | \$ 0.40 | \$ 0.38 |

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

COMMUNITY BANK SYSTEM, INC.
CONSOLIDATED STATEMENT OF CHANGES IN SHAREHOLDERS EQUITY (Unaudited)
Six Months Ended June 30, 2007
(In Thousands, Except Share Data)

| | Common Stock | | Additional Paid-In Capital | Retained Earnings | Accumulated Other Comprehensive Income | Treasury Stock | Total |
|---|-----------------------|------------------|----------------------------------|----------------------|---|-------------------|------------|
| | Shares Outstanding | Amount Issued | | | | | |
| Balance at December 31, 2006 | 30,020,159 | \$ 32,773 | \$ 203,197 | \$ 291,871 | (\$ 4,697) | (\$ 61,616) | \$ 461,528 |
| Net income | | | | 20,015 | | | 20,015 |
| Other comprehensive loss, net of tax | | | | | (6,913) | | (6,913) |
| Dividends declared: | | | | | | | |
| Common, \$0.40 per share | | | | (12,003) | | | (12,003) |
| Common stock issued under Stock plan, including tax benefits of \$250 | 146,835 | 147 | 1,700 | | | | 1,902 |
| Stock options earned | | | 1,209 | | | | 1,154 |
| Treasury stock purchased | (293,800) | | | | | (6,059) | (6,059) |
| Balance at June 30, 2007 | 29,873,194 | \$ 32,920 | \$ 206,106 | \$ 299,883 | (\$ 11,610) | (\$ 67,675) | \$ 459,624 |

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

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

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|--------------------------------|----------|------------------------------|----------|
| | 2007 | 2006 | 2007 | 2006 |
| Other comprehensive loss, before tax: | | | | |
| Change in pension liability | \$ 0 | \$ 0 | (\$ 50) | (\$ 118) |
| Change in unrealized gain on derivative instruments used in cash flow hedging relationship | 1,414 | 0 | 991 | 0 |
| Unrealized gain (loss) on securities: | | | | |
| Unrealized holding loss arising during period | (13,476) | (11,572) | (12,063) | (19,495) |
| Reclassification adjustment for losses included in net income | 8 | 0 | 8 | 0 |
| Other comprehensive loss, before tax: | (12,054) | (11,572) | (11,114) | (19,613) |
| Income tax benefit related to other comprehensive loss | 4,438 | 4,439 | 4,201 | 7,555 |
| Other comprehensive loss, net of tax: | (7,616) | (7,133) | (6,913) | (12,058) |
| Net income | 10,359 | 9,884 | 20,015 | 19,346 |
| Comprehensive income | \$ 2,743 | \$ 2,751 | \$ 13,102 | \$ 7,288 |

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

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

| | Six Months Ended June 30, | |
|---|------------------------------|-----------------|
| | 2007 | 2006 |
| Operating activities: | | |
| Net income | \$ 20,015 | \$ 19,346 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Depreciation | 4,601 | 4,348 |
| Amortization of intangible assets | 3,096 | 2,982 |
| Net (accretion) amortization of premiums and discounts on securities and loans | (2,176) | 440 |
| Amortization of unearned compensation and discount on subordinated debt | 199 | 64 |
| Provision for loan losses | 614 | 3,875 |
| Loss on investment securities and debt extinguishments | 8 | 0 |
| (Gain) loss on sale of loans and other assets | (64) | 3 |
| Proceeds from the sale of loans held for sale | 5,276 | 9,372 |
| Origination of loans held for sale | (5,238) | (9,375) |
| Excess tax benefits from share-based payment arrangements | (129) | (198) |
| Change in other operating assets and liabilities | (5,789) | 6,718 |
| Net cash provided by operating activities | 20,413 | 37,575 |
| Investing activities: | | |
| Proceeds from sales of available-for-sale investment securities | 5,478 | 28,409 |
| Proceeds from maturities of held-to-maturity investment securities | 11,153 | 3,299 |
| Proceeds from maturities of available-for-sale investment securities | 269,235 | 56,987 |
| Purchases of held-to-maturity investment securities | (1,790) | (3,682) |
| Purchases of available-for-sale investment securities | (258,056) | (55,042) |
| Net increase in loans outstanding | (11,043) | (36,044) |
| Cash paid for acquisition, net of cash acquired of \$9,181 | (11,613) | 0 |
| Capital expenditures | (4,849) | (3,000) |
| Net cash used in investing activities | (1,485) | (9,073) |
| Financing activities: | | |
| Net change in demand deposits, NOW accounts and savings accounts | 22,549 | (22,724) |
| Net change in time deposits | 89,727 | 78,255 |
| Net change in federal funds purchased | 0 | (29,500) |
| Net change in short-term borrowings | (73,720) | (140,000) |
| Change in long-term borrowings (net of payments of \$866 and \$91) | (915) | 109,909 |
| Payment on subordinated debt held by unconsolidated subsidiary trusts | (30,929) | 0 |
| Issuance of common stock | 2,685 | 2,121 |
| Purchase of treasury stock | (6,059) | (5,534) |
| Cash dividends paid | (12,017) | (11,379) |
| Tax benefits from share-based payment arrangements | 129 | 198 |
| Net cash provided by financing activities | (8,550) | (18,654) |
| Change in cash and cash equivalents | 10,378 | 9,848 |
| Cash and cash equivalents at beginning of period | 232,032 | 114,605 |

| | Six Months Ended June 30, | |
|--|------------------------------|------------|
| Cash and cash equivalents at end of period | \$ 242,410 | \$ 124,453 |
| Supplemental disclosures of cash flow information: | | |
| Cash paid for interest | \$ 57,666 | \$ 41,457 |
| Cash paid for income taxes | 3,575 | 2,082 |
| Supplemental disclosures of noncash financing and investing activities: | | |
| Dividends declared and unpaid | 5,976 | 5,670 |
| Gross change in unrealized loss on available-for-sale investment securities | (12,055) | (19,495) |

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

COMMUNITY BANK SYSTEM, INC.**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)****June 30, 2007****NOTE A: BASIS OF PRESENTATION**

The interim financial data as of June 30, 2007 and for the three and six months ended June 30, 2007 and 2006 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: ACQUISITION AND OTHER MATTERS*Hand Benefits & Trust, Inc.*

On May 18, 2007, Benefit Plans Administrative Services, Inc. (BPAS), a wholly owned subsidiary of the Company, completed its acquisition of Hand Benefits & Trust, Inc. (HBT) in an all cash transaction. HBT is a Houston, Texas based provider of employee benefit plan administration and trust services. The results of HBT's operations have been included in the consolidated financial statements since that date.

TLNB Financial Corporation

On June 1, 2007, the Company completed its acquisition of TLNB Financial Corporation, parent company of Tupper Lake National Bank (TLNB), in an all-cash transaction valued at approximately \$17.6 million. Based in Tupper Lake, NY, TLNB operated five branches in the northeastern New York State cities of Tupper Lake, Plattsburgh and Saranac Lake, as well as an insurance subsidiary, TLNB Insurance Agency, Inc. The results of TLNB's operations have been included in the consolidated financial statements since that date.

The estimated purchase price allocation of the assets acquired and liabilities assumed in the purchase of HBT and TLNB, including capitalized acquisition costs, is as follows:

(000 s omitted)

| | |
|---|------------------|
| Cash and due from banks | \$ 9,181 |
| Available-for-sale investment securities | 25,995 |
| Loans net of allowance for loan losses of \$747 | 54,805 |
| Premises and equipment, net | 3,166 |
| Other assets | 3,689 |
| Goodwill | 12,777 |
| Core deposit & customer list intangibles | 2,141 |
| Total assets acquired | 111,754 |
| Deposits | 84,002 |
| Borrowings | 4,288 |
| Other liabilities | 2,671 |
| Total liabilities assumed | 90,961 |
| Net assets acquired | \$ 20,793 |

Acquisitions in 2006

Edgar Filing: COMMUNITY BANK SYSTEM INC - Form 10-Q

The Company completed two acquisitions in 2006: (1) in August, the Company acquired ES&L Bancorp (Elmira), the parent company of Elmira Savings and Loan, FA, a federally chartered thrift based in Elmira, NY with two branches and approximately \$210 million in assets; and (2) in December, the Company acquired ONB Corporation (ONB), the parent company of Ontario National Bank, a federally chartered national bank based in Clifton Springs, NY with four branches and approximately \$95 million in assets.

Stock Repurchase Program

On April 20, 2005, the Company announced a twenty-month authorization to repurchase up to 1,500,000 of its outstanding shares. On December 20, 2006, the Company extended the program through December 31, 2008 and announced an additional two-year authorization to repurchase up to 900,000 of its shares in open market or privately negotiated transactions. Through June 30, 2007, the Company has repurchased pursuant to the program 1,146,961 shares at an aggregate cost of \$25.6 million and an average price per share of \$22.29. The repurchased shares will be used for general corporate purposes, including those related to stock plan activities.

NOTE C: ACCOUNTING POLICIES

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 categories: 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 categories 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 nonaccruing 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 the 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 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.

New Accounting Pronouncements

In February 2007, the Financial Accounting Standards Board (FASB) issued SFAS No. 159 *The Fair Value Option for Financial Assets and Financial Liabilities* (SFAS No. 159). SFAS No. 159 permits entities to choose to measure many financial assets and financial liabilities at fair value. Unrealized gains and losses on items for which the fair value option has been elected are reported in earnings. SFAS No. 159 is effective for fiscal years beginning after November 15, 2007. The Company is

Edgar Filing: COMMUNITY BANK SYSTEM INC - Form 10-Q

currently assessing the impact of SFAS No. 159 on its consolidated statements of condition and income.

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements* (SFAS 157). SFAS 157 does not address what to measure at fair value; instead, it addresses how to measure fair value. SFAS 157 applies (with limited exceptions) to existing standards that require assets or liabilities to be measured at fair value. SFAS 157 establishes a fair value hierarchy, giving the highest priority to quoted prices in active markets and the lowest priority to unobservable data and requires new disclosures for assets and liabilities measured at fair value based on their level in the hierarchy. SFAS 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007. The Company is currently evaluating the impact of adopting SFAS 157.

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 approximately 1,666,000 anti-dilutive stock options outstanding at June 30, 2007 compared to approximately 1,383,000 weighted-average anti-dilutive stock options outstanding at June 30, 2006. The following is a reconciliation of basic to diluted earnings per share for the three and six months ended June 30, 2007 and 2006.

| (000 s omitted, except per share data) | Income | Shares | Per Share Amount |
|---|-----------|--------|---------------------|
| <i>Three Months Ended June 30, 2007</i> | | | |
| Basic EPS | \$ 10,359 | 30,087 | \$ 0.34 |
| Stock options | | 309 | |
| Diluted EPS | \$ 10,359 | 30,396 | \$ 0.34 |
| <i>Three Months Ended June 30, 2006</i> | | | |
| Basic EPS | \$ 9,884 | 29,946 | \$ 0.33 |
| Stock options | | 362 | |
| Diluted EPS | \$ 9,884 | 30,308 | \$ 0.33 |
| <i>Six Months Ended June 30, 2007</i> | | | |
| Basic EPS | \$ 20,015 | 30,139 | \$ 0.66 |
| Stock options | | 332 | |
| Diluted EPS | \$ 20,015 | 30,471 | \$ 0.66 |
| <i>Six Months Ended June 30, 2006</i> | | | |
| Basic EPS | \$ 19,346 | 29,984 | \$ 0.65 |
| Stock options | | 409 | |
| Diluted EPS | \$ 19,346 | 30,393 | \$ 0.64 |

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 June 30, 2007 | | | As of December 31, 2006 | | |
|--------------------------------------|-----------------------------|-----------------------------|---------------------------|-----------------------------|-----------------------------|---------------------------|
| | Gross Carrying Amount | Accumulated Amortization | Net Carrying Amount | Gross Carrying Amount | Accumulated Amortization | Net Carrying Amount |
| <i>Amortizing intangible assets:</i> | | | | | | |
| Core deposit intangibles | \$ 66,748 | (\$43,624) | \$ 23,124 | \$ 65,351 | (\$40,686) | \$ 24,665 |
| Other intangibles | 3,383 | (1,616) | 1,767 | 2,750 | (1,569) | 1,181 |

Edgar Filing: COMMUNITY BANK SYSTEM INC - Form 10-Q

| | As of June 30, 2007 | | | As of December 31, 2006 | | |
|--|---------------------|------------|------------|-------------------------|------------|------------|
| Total amortizing intangibles | 70,131 | (45,240) | 24,891 | 68,101 | (42,255) | 29,846 |
| <i>Non-amortizing intangible assets:</i> | | | | | | |
| Goodwill | 233,219 | 0 | 233,219 | 220,290 | 0 | 220,290 |
| Total intangible assets, net | \$ 303,350 | (\$45,240) | \$ 258,110 | \$ 288,391 | (\$42,255) | \$ 246,136 |

No goodwill impairment adjustments were recognized in 2007 or 2006.

Edgar Filing: COMMUNITY BANK SYSTEM INC - Form 10-Q

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

| (000 s omitted) | Amount |
|-----------------|------------------|
| Jul-Dec 2007 | \$ 3,203 |
| 2008 | 6,073 |
| 2009 | 5,480 |
| 2010 | 3,558 |
| 2011 | 1,459 |
| Thereafter | 5,118 |
| Total | \$ 24,891 |

NOTE F: MANDATORILY REDEEMABLE PREFERRED SECURITIES

The Company sponsors three business trusts, Community Capital Trust II, Community Statutory Trust III and Community Capital Trust IV, 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 and are recorded as interest expense in the consolidated financial statements. 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 Date | Par Amount | Interest Rate | Maturity Date | Call Provision | Call Price |
|-----|------------------|-----------------|--|------------------|-----------------------|---------------------------------------|
| II | 7/16/2001 | \$ 25 million | 6 month LIBOR plus 3.75% (9.15%) | 7/16/2031 | 5 year beginning 2006 | 107.6875% declining to par in 2011 |
| III | 7/31/2001 | \$ 24.5 million | 3 month LIBOR plus 3.58% (8.94%) | 7/31/2031 | 5 year beginning 2006 | 107.5000% declining to par in 2011 |
| IV | 12/8/2006 | \$ 75 million | 3 month LIBOR plus 1.65% (7.01%) | 12/15/2036 | 5 year beginning 2012 | Par |

The Company also entered into an interest rate swap agreement to convert the variable rate trust preferred IV security into a fixed rate security for a term of five years at a fixed rate of 6.43%. A net gain of \$217,000 was recognized for the interest rate swap agreement for the six months ended June 30, 2007 and was used to offset the interest expense for the trust preferred securities.

NOTE G: INCOME TAXES

The Company adopted the provisions of FASB Interpretation No. 48 *Accounting for Uncertainty in Income Taxes* (FIN 48) an interpretation of FASB Statement No. 109 (SFAS 109) on January 1, 2007. As a result of the implementation of FIN 48, the Company recognized no material adjustment in the liability for uncertain tax positions. As of the adoption date of January 1, 2007, the liability, net of applicable deferred tax assets, for unrecognized income tax benefits was \$12.2 million, of which \$11.1 million, if recognized, would favorably affect the Company's effective tax rate. As of June 30, 2007, the liability, net of applicable deferred tax assets, for unrecognized income tax benefits was \$13.0 million. During the first six months of 2007, there were additions of \$0.8 million for tax positions related to the current year all of which was provided through the effective tax rate.

Edgar Filing: COMMUNITY BANK SYSTEM INC - Form 10-Q

The Company recognizes interest and penalties related to uncertain tax positions in income tax expense. As of January 1, 2007, the Company had approximately \$2.9 million of accrued interest related to uncertain tax positions.

The tax years 2003 - 2006 remain open to examination by the Federal taxing authority. The tax years 1997 - 2006 remain open to examination by New York State. The Company does not anticipate that total unrecognized tax benefits will significantly change due to the settlement of audits and the expiration of statute of limitations prior to June 30, 2008.

NOTE H: 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 six months ended June 30 is as follows:

| (000 s omitted) | Pension Benefits | | | | Post-retirement Benefits | | | |
|---------------------------------------|--------------------------------|--------|------------------------------|----------|--------------------------------|--------|------------------------------|--------|
| | Three Months Ended June 30, | | Six Months Ended June 30, | | Three Months Ended June 30, | | Six Months Ended June 30, | |
| | 2007 | 2006 | 2007 | 2006 | 2007 | 2006 | 2007 | 2006 |
| Service cost | \$ 763 | \$ 748 | \$ 1,526 | \$ 1,496 | \$ 148 | \$ 127 | \$ 296 | \$ 261 |
| Interest cost | 678 | 634 | 1,357 | 1,267 | 131 | 116 | 261 | 237 |
| Expected return on plan assets | (1,007) | (827) | (2,014) | (1,654) | 0 | 0 | 0 | 0 |
| Net amortization and deferral | 248 | 315 | 494 | 631 | 29 | 26 | 59 | 54 |
| Amortization of prior service cost | (23) | (42) | (46) | (84) | 28 | 26 | 55 | 55 |
| Amortization of transition obligation | \$ 0 | 0 | 0 | 0 | 10 | 11 | 21 | 20 |
| Net periodic benefit cost | \$ 659 | \$ 828 | \$ 1,317 | \$ 1,656 | \$ 346 | \$ 306 | \$ 692 | \$ 627 |

During the second quarter, the Company made a contribution to its defined benefit pension plan of \$9.2 million. No additional contributions in 2007 are required for regulatory purposes.

NOTE I: 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) | June 30, 2007 | December 31, 2006 |
|------------------------------|------------------|----------------------|
| Commitments to extend credit | \$ 487,945 | \$ 443,367 |
| Standby letters of credit | 11,427 | 10,082 |
| Total | \$ 499,372 | \$ 453,449 |

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

Introduction

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 six months ended June 30, 2007 and 2006, although in some circumstances the first quarter of 2007 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 12. 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 2007, "second quarter" refers to the quarter ended June 30, 2007, 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.

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 27.

Critical Accounting Policies

As a result of the complex and dynamic nature of the Company's business, management must exercise judgment 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. Actual results could differ from those estimates. Management believes that critical accounting estimates include:

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 inherently subjective. It 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.

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.

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 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.

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 46-51 of the most recent Form 10-K (fiscal year ended December 31, 2006) filed with the Securities and Exchange Commission on March 15, 2007.

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 and deposit portfolios using both organic and acquisition strategies, (iii) increase the noninterest 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, noninterest income, operating expenses, asset quality, loan and deposit growth, capital management, performance of individual banking and financial services 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.

On June 1, 2007, the Company completed its acquisition of TLNB Financial Corporation, parent company of Tupper Lake National Bank (TLNB), in an all-cash transaction valued at approximately \$17.6 million. Based in Tupper Lake, NY, TLNB operated five branches in the northeastern New York State cities of Tupper Lake, Plattsburgh and Saranac Lake, as well as an insurance subsidiary, TLNB Insurance Agency, Inc. On a consolidated basis, TLNB had approximately \$100 million in assets and \$87 million of deposits.

On May 18, 2007, Benefit Plans Administrative Services, Inc. (BPAS) completed its acquisition of Hand Benefits & Trust, Inc. (HBT) in an all cash transaction. HBT is a Houston, Texas based provider of employee benefit plan administration and trust services.

The Company completed two acquisitions in 2006: (1) in August, the Company acquired ES&L Bancorp (Elmira), the parent company of Elmira Savings and Loan, FA, a federally chartered thrift based in Elmira, NY with two branches and approximately \$210 million in assets; and (2) in December, the Company acquired ONB Corporation (ONB), the parent company of Ontario National Bank, a federally chartered national bank based in Clifton Springs, NY with four branches and \$95 million in assets.

Second quarter and June year-to-date (YTD) earnings per share were \$0.34 and \$0.66, respectively, an increase of \$0.01 and \$0.02 as compared to the respective prior year periods. The increase was driven by increased income on loans and investments, a 22% increase in noninterest income and favorable asset quality results. These were partially offset by higher cost of funds and higher operating expenses. Cash earnings per share (which excludes the after-tax effect of the amortization of intangibles assets and acquisition-related market value adjustments) were \$0.39 versus \$0.37 for the prior year's second quarter and \$0.36 for the first quarter of 2007.

Asset quality continued to improve in the second quarter of 2007 in comparison to the first quarter of 2007 and the same period last year, with reductions in the net charge-off, nonperforming loan and total delinquent loan ratios. The Company experienced year-over-year loan growth in all portfolios: consumer installment, consumer mortgage and business lending, due to organic growth and the acquisition of TLNB, Elmira and ONB. The size of the investment portfolio increased from both the prior year-end and the second quarter of 2006, principally due to higher short-term invested cash equivalents, which were up \$98.8 million from June 30, 2006. Average deposits increased in the second quarter of 2007 as compared to both the first quarter of 2007 and the second quarter of 2006, due to organic growth and the TLNB, Elmira and ONB acquisitions. External borrowings were down from the end of December 2006 and included the early redemption of \$30 million of fixed-rate trust preferred securities early in the first quarter of 2007.

Net Income and Profitability

As shown in Table 2, earnings per share for the second quarter and June YTD of \$0.34 and \$0.66, respectively, were \$0.01 and \$0.02 higher than the EPS generated in the same periods of last year. Net income for the quarter of \$10.4 million was up 4.8% over the second quarter of 2006 and net income of \$20.0 million for the first six months of 2007 increased 3.5% from the amount earned in the first six months of 2006. As compared to the first quarter of 2007, net income increased \$0.7 million or

Edgar Filing: COMMUNITY BANK SYSTEM INC - Form 10-Q

7.3%, and earnings per share increased \$0.02 or 6.3%.

Second quarter net interest income of \$33.3 million was down \$0.3 million or 0.8% from the comparable prior year period, while net interest income for the first six months of 2007 decreased \$0.6 million or 0.9% over the first half of 2006. The provision for loan losses decreased \$1.3 million as compared to the second quarter of 2006 and decreased \$3.3 million for the first six months of 2007 as compared to 2006 as a result of favorable and improved asset quality attributes. Second quarter noninterest income, excluding securities losses, was \$15.0 million, up \$2.7 million or 22% from the second quarter of 2006, while YTD noninterest income of \$28.5 million increased \$3.6 million or 15% from the prior year level. Operating expenses of \$34.1 million for the quarter and \$68.1 million for the first six months of 2007 were up \$2.9 million or 9.4% and \$5.4 million or 8.6%, respectively, from the comparable prior year

Edgar Filing: COMMUNITY BANK SYSTEM INC - Form 10-Q

periods, a significant portion due to the acquisition of TLNB and HBT during the second quarter of 2007 and Elmira and ONB in the second and fourth quarters of 2006.

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 and acquisition-related market value adjustments. Management believes that this information helps investors better understand the effect of acquisition activity in reported results. Cash earnings per share for the second quarter and the first six months of 2007 were \$0.39 and \$0.75, respectively, up 5.4% and 4.2% from the \$0.37 and \$0.72 earned in the comparable periods of 2006.

As reflected in Table 2, the primary reasons for higher earnings in both periods were a lower loan loss provision and higher noninterest income, partially offset by higher operating expenses and slightly lower net interest income. The decreases in net interest income for the quarter and year to date period were due to a higher cost of funds, partially offset by both acquired and organic loan growth and higher loan yields. Excluding security losses, noninterest income increased due to a strong performance by the Company's employee benefits consulting and plan administration business, partially due to the acquisition of HBT and higher banking service fees, including higher debit card related revenues. Improved net charge-off and nonperforming loan ratios were the primary reasons for the decrease in loan loss provision, despite an increase in total loans outstanding. Operating expenses increased for the quarter and year to date periods primarily due to costs associated with the four acquisitions in the last year, as well as employee merit increases, higher medical costs, business development and marketing expenditures, and data processing and communication costs.

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 (Non-GAAP measure)

| (000 \$ omitted) | Three Months Ended June 30, | | Six Months Ended June 30, | |
|--|--------------------------------|-----------|------------------------------|-----------|
| | 2007 | 2006 | 2007 | 2006 |
| Net income | \$ 10,359 | \$ 9,884 | \$ 20,015 | \$ 19,346 |
| After-tax cash adjustments: | | | | |
| Amortization of market value adjustments | | | | |
| On net assets acquired in mergers | 175 | 207 | 354 | 412 |
| Amortization of intangible assets | 1,185 | 1,130 | 2,335 | 2,250 |
| Net income - cash | \$ 11,719 | \$ 11,221 | \$ 22,704 | \$ 22,008 |
| Diluted earnings per share - cash | \$ 0.39 | \$ 0.37 | \$ 0.75 | \$ 0.72 |

Table 2: Summary Income Statements

| (000 \$ omitted, except per share data) | Three Months Ended March 31, | | Six Months Ended March 31, | |
|---|---------------------------------|-----------|-------------------------------|-----------|
| | 2007 | 2006 | 2007 | 2006 |
| Net interest income | \$ 33,338 | \$ 33,609 | \$ 66,705 | \$ 67,294 |
| Provision for loan losses | 414 | 1,725 | 614 | 3,875 |
| Noninterest income excluding security gains | 15,026 | 12,345 | 28,505 | 24,861 |
| Loss on sales of investment securities | (8) | 0 | (8) | 0 |
| Operating expenses | 34,132 | 31,208 | 68,051 | 62,643 |
| Income before taxes | 13,810 | 13,021 | 26,537 | 25,637 |
| Income taxes | 3,451 | 3,137 | 6,522 | 6,291 |

Edgar Filing: COMMUNITY BANK SYSTEM INC - Form 10-Q

| | Three Months Ended March 31, | | Six Months Ended March 31, | |
|----------------------------|---------------------------------|----------|-------------------------------|-----------|
| Net income | \$ 10,359 | \$ 9,884 | \$ 20,015 | \$ 19,346 |
| Diluted earnings per share | \$ 0.34 | \$ 0.33 | \$ 0.66 | \$ 0.64 |

Net Interest Income

Net interest income is the amount by which interest and fees on earning assets (loans, investments and cash) 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.

As shown in Table 3, net interest income (with nontaxable income converted to a fully tax-equivalent basis) for second quarter 2007 was \$37.1 million, down slightly from the same period last year. A \$366 million increase in interest-bearing liabilities and a 36 basis point decrease in the net interest margin offset a \$335 million increase in average interest-earning assets. As reflected in Table 4, the volume and rate increases from interest bearing assets had a \$6.7 million favorable impact on net interest income, while the volume and rate increases from interest bearing liabilities had a slightly larger \$7.0 million negative impact on net interest income. June 2007 YTD net interest income of \$74.2 million was down \$0.3 million or 0.4% from the year earlier period. A \$359 million increase in interest-bearing liabilities and a 34 basis point decrease in the net interest margin more than offset a \$327 million increase in interest bearing assets. The volume and rate increases from interest bearing assets contributed a positive \$14.0 million variance on net interest income, while the volume and rate increases from interest bearing liabilities had a larger \$14.3 million negative impact on net interest income.

Higher second quarter and June YTD average loan balances were attributable to \$37.4 million of quarterly average organic loan growth since the second quarter of 2006, driven by growth in all portfolios, consumer installment, consumer mortgage and business lending, as well as a \$248.9 million increase in second quarter 2007 average loans from the TLNB, Elmira and ONB acquisitions. Average investments for the second quarter and YTD periods were \$49.2 million and \$41.8 million higher than the respective periods of 2006, primarily due to an increase in invested short-term cash equivalents. In comparison to the prior year, total average deposits were up \$248.9 million or 8.2% and \$212.3 million or 7.0% for the quarter and YTD periods, respectively, as a result of organic growth and three banking acquisitions during the past year. Quarterly and YTD average deposits from acquired TLNB, Elmira and ONB branches were \$207.3 million and \$195.5 million, respectively. Quarterly and YTD average borrowings increased \$108.2 million and \$124.1 million as compared to the second quarter and first six months of 2006 primarily due to the all-cash acquisitions of TLNB, Elmira and ONB, as well as the issuance of \$75 million of trust preferred securities in the fourth quarter of 2006, partially offset by the early redemption of \$30 million of fixed rate trust preferred securities in the first quarter of 2007.

The net interest margin of 3.64% for the second quarter and 3.69% for the year to date period dropped 36 basis points and 34 basis points, respectively, versus the same periods in the prior year. These declines were primarily attributable to an increase in the cost of funds (quarter up 49 basis points, YTD up 52 basis points), due to the effect of the two rate hikes (25 basis points each) by the Federal Reserve since March 2006, continued customer migration to time deposit products as well as completed acquisitions, while earning assets yields increased at a slower rate (quarter up 13 basis points, YTD up 18 basis points). The change in the earning-asset yield was driven by an increase in loan yields of 24 basis points for the quarter and 29 basis points for the YTD period, while investment yields declined 11 basis points for the quarter and five basis points for the YTD period. Results included the impact of the TLNB, Elmira and ONB acquisitions, which had lower net interest margin attributes than the Company's historical averages.

The second quarter cost of funds increased 49 basis points versus the prior year quarter due to a 58 basis point increase in interest bearing deposit costs and a nine basis point increase in the average interest rate paid on external borrowings. The increase in the YTD cost of funds was driven by a 60 basis point increase in deposit costs and borrowing rates that were up 14 basis points. Interest rates on selected categories of deposit accounts were raised throughout 2006 in response to market conditions. Additionally, customers continued to move funds from low rate and noninterest-earning accounts to higher yielding checking and time deposit accounts. The increase in the borrowing rates is mostly attributable to the rate increases by the Federal Reserve. Additionally, the long-term rate was impacted by the 60 basis point increase in the six month LIBOR (London Interbank Offered Rates) over the last twelve months, from which the interest rate on \$25 million of the mandatorily redeemable preferred securities is based. These developments were partially offset by the benefit the Company received by retiring \$30 million of trust preferred securities early in 2007 and replacing it with a new issuance that carried an interest rate approximately 300 basis points lower.

Edgar Filing: COMMUNITY BANK SYSTEM INC - Form 10-Q

Table 3 below sets 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 38.8% in 2007 and 38.4% in 2006. Average balances are computed by accumulating 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 nonaccrual loans and loans held for sale.

Table 3a: Quarterly Average Balance Sheet

| (000 s omitted except yields and rates) | Three Months Ended June 30, 2007 | | | Three Months Ended June 30, 2006 | | |
|---|-------------------------------------|------------------|----------------------------|-------------------------------------|------------------|----------------------------|
| | Average Balance | Interest | Avg. Yield/Rate Paid | Average Balance | Interest | Avg. Yield/Rate Paid |
| Interest-earning assets: | | | | | | |
| Time deposits in other banks | \$ 87,356 | \$ 1,148 | 5.27% | \$ 32,922 | \$ 403 | 4.91% |
| Taxable investment securities ⁽¹⁾ | 797,807 | 11,214 | 5.64% | 770,614 | 10,843 | 5.64% |
| Nontaxable investment securities ⁽¹⁾ | 485,922 | 8,355 | 6.90% | 518,309 | 9,093 | 7.04% |
| Loans (net of unearned discount) | 2,712,021 | 46,262 | 6.84% | 2,425,763 | 39,890 | 6.60% |
| | <u>4,083,106</u> | <u>66,979</u> | 6.58% | <u>3,747,608</u> | <u>60,229</u> | 6.45% |
| Noninterest-earning assets | <u>453,242</u> | | | <u>419,795</u> | | |
| Total assets | <u>\$ 4,536,348</u> | | | <u>\$ 4,167,403</u> | | |
| Interest-bearing liabilities: | | | | | | |
| Interest checking, savings and money market deposits | \$ 1,213,419 | \$ 3,435 | 1.14% | \$ 1,130,655 | \$ 2,775 | 0.98% |
| Time deposits | 1,504,716 | 16,657 | 4.44% | 1,330,126 | 11,845 | 3.57% |
| Short-term borrowings | 154,799 | 1,622 | 4.20% | 127,208 | 1,150 | 3.63% |
| Long-term borrowings | 589,686 | 8,204 | 5.58% | 509,102 | 7,103 | 5.60% |
| | <u>3,462,620</u> | <u>29,918</u> | 3.47% | <u>3,097,091</u> | <u>22,873</u> | 2.96% |
| Noninterest-bearing liabilities: | | | | | | |
| Demand deposits | 557,195 | | | 565,651 | | |
| Other liabilities | 50,881 | | | 52,253 | | |
| Shareholders' equity | 465,652 | | | 452,408 | | |
| | <u>4,536,348</u> | | | <u>4,167,403</u> | | |
| Net interest earnings | | <u>\$ 37,061</u> | | | <u>\$ 37,356</u> | |
| Net interest spread | | | 3.11% | | | 3.49% |
| Net interest margin on interest-earnings assets | | | 3.64% | | | 4.00% |
| Fully tax-equivalent adjustment | | <u>\$ 3,723</u> | | | <u>\$ 3,747</u> | |

⁽¹⁾ 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.

Table 3b: Year-to-Date Average Balance Sheet

| (000 \$ omitted except yields and rates) | Six Months Ended June 30, 2007 | | | Six Months Ended June 30, 2006 | | |
|---|-----------------------------------|------------------|----------------------------|-----------------------------------|------------------|----------------------------|
| | Average Balance | Interest | Avg. Yield/Rate Paid | Average Balance | Interest | Avg. Yield/Rate Paid |
| Interest-earning assets: | | | | | | |
| Time deposits in other banks | \$ 94,913 | \$ 2,478 | 5.26% | \$ 20,166 | \$ 479 | 4.79% |
| Taxable investment securities ⁽¹⁾ | 769,712 | 21,493 | 5.63% | 775,477 | 21,685 | 5.64% |
| Nontaxable investment securities ⁽¹⁾ | 493,058 | 16,994 | 6.95% | 520,200 | 17,867 | 6.93% |
| Loans (net of unearned discount) | 2,698,369 | 91,367 | 6.83% | 2,413,414 | 78,322 | 6.54% |
| Total interest-earning assets | 4,056,052 | 132,332 | 6.58% | 3,729,257 | 118,353 | 6.40% |
| Noninterest-earning assets | 446,929 | | | 426,704 | | |
| Total assets | \$ 4,502,981 | | | \$ 4,155,961 | | |
| Interest-bearing liabilities: | | | | | | |
| Interest checking, savings and money market deposits | \$ 1,205,843 | \$ 6,775 | 1.13% | \$ 1,128,696 | \$ 5,289 | 0.94% |
| Time deposits | 1,464,725 | 31,437 | 4.33% | 1,307,007 | 22,352 | 3.45% |
| Short-term borrowings | 157,108 | 3,259 | 4.18% | 145,473 | 2,608 | 3.62% |
| Long-term borrowings | 601,589 | 16,638 | 5.58% | 489,104 | 13,597 | 5.61% |
| Total interest-bearing liabilities | 3,429,265 | 58,109 | 3.42% | 3,070,280 | 43,846 | 2.88% |
| Noninterest-bearing liabilities: | | | | | | |
| Demand deposits | 554,655 | | | 577,240 | | |
| Other liabilities | 53,920 | | | 53,171 | | |
| Shareholders' equity | 465,141 | | | 455,270 | | |
| Total liabilities and shareholders' equity | \$ 4,502,981 | | | \$ 4,155,961 | | |
| Net interest earnings | | \$ 74,223 | | | \$ 74,507 | |
| Net interest spread | | | 3.16% | | | 3.52% |
| Net interest margin on interest-earnings assets | | | 3.69% | | | 4.03% |
| Fully tax-equivalent adjustment | | \$ 7,518 | | | \$ 7,213 | |

⁽¹⁾ 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.

Edgar Filing: COMMUNITY BANK SYSTEM INC - Form 10-Q

As discussed above and disclosed in Table 4 below, the quarterly 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

| | 2nd Quarter 2007 versus 2nd Quarter 2006 | | | Six Months Ended June 30, 2007 versus June 30, 2006 | | |
|---|---|---------|------------|--|---------|------------|
| | Increase (Decrease) Due to Change in ⁽¹⁾ | | | Increase (Decrease) Due to Change in ⁽¹⁾ | | |
| | Volume | Rate | Net Change | Volume | Rate | Net Change |
| (000 s omitted) | | | | | | |
| Interest earned on: | | | | | | |
| Time deposits in other banks | \$ 713 | \$ 32 | \$ 745 | \$ 1,946 | \$ 53 | \$ 1,999 |
| Taxable investment securities | 384 | (13) | 371 | (160) | (32) | (192) |
| Nontaxable investment securities | (560) | (178) | (738) | (936) | 63 | (873) |
| Loans (net of unearned discount) | 4,841 | 1,531 | 6,372 | 9,541 | 3,504 | 13,045 |
| Total interest-earning assets ⁽²⁾ | 5,484 | 1,266 | 6,750 | 10,592 | 3,387 | 13,979 |
| Interest paid on: | | | | | | |
| Interest checking, savings and money market deposits | 213 | 447 | 660 | 380 | 1,106 | 1,486 |
| Time deposits | 1,687 | 3,125 | 4,812 | 2,918 | 6,167 | 9,085 |
| Short-term borrowings | 273 | 199 | 472 | 220 | 431 | 651 |
| Long-term borrowings | 1,121 | (20) | 1,101 | 3,111 | (70) | 3,041 |
| Total interest-bearing liabilities ⁽²⁾ | 2,888 | 4,157 | 7,045 | 5,496 | 8,767 | 14,263 |
| Net interest earnings ⁽²⁾ | 3,195 | (3,490) | (295) | 6,249 | (6,533) | (284) |

⁽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 component.

⁽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.

Noninterest Income

The Company's sources of noninterest income are of three primary types: general banking services related to loans, deposits and other core customer activities typically provided through the branch network and electronic banking channels; employee benefit plan administration, actuarial and consulting services (BPA-Harbridge and HBT), trust services, investment and insurance products (Community Investment Services, Inc. or CISI and CBNA Insurance Agency, Inc.) and asset management (Nottingham Advisors or Nottingham); and periodic transactions, most often net gains (losses) from the sale of investment securities and prepayment of debt instruments.

Table 5: Noninterest Income

| (000 \$ omitted) | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|--------------------------------|-----------|------------------------------|-----------|
| | 2007 | 2006 | 2007 | 2006 |
| Deposit service charges and fees | \$ 7,825 | \$ 7,063 | \$ 14,802 | \$ 13,672 |
| Benefit plan administration, consulting And actuarial fees | 4,767 | 3,155 | 8,739 | 6,536 |
| Trust, investment and asset management fees | 2,009 | 1,766 | 3,869 | 3,816 |
| Other banking services | 256 | 303 | 669 | 593 |
| Mortgage banking | 169 | 58 | 426 | 244 |
| Subtotal | 15,026 | 12,345 | 28,505 | 24,861 |
| Loss on sales of investment securities | (8) | 0 | (8) | 0 |
| Total noninterest income | \$ 15,018 | \$ 12,345 | \$ 28,497 | \$ 24,861 |
| Noninterest income/total income (FTE) | 28.9% | 24.8% | 27.7% | 25.0% |

As displayed in Table 5, noninterest income (excluding securities gains) was \$15.0 million in the first quarter and \$28.5 million for the first half of 2007. This represents an increase of \$2.7 million or 22% for the quarter, and \$3.6 million or 15% for the YTD period in comparison to one year earlier. A significant portion of the growth in both time intervals was attributable to growth in benefit plan administration, consulting and actuarial fees, a majority of which was organic. The acquisition of HBT in mid May 2007 generated \$0.8 million of revenue growth. General recurring banking fees of \$8.3 million for the second quarter and \$15.9 million for the first six months of 2007 were up \$0.8 million or 11.1% and \$1.4 million or 9.6%, respectively, as compared to the prior year periods, driven by organic core deposit account growth, higher electronic banking related revenues and incremental income generated from the TLNB, Elmira and ONB branches acquired.

Strong performance at BPA-Harbridge, combined with the acquisition of HBT, generated revenue growth of \$1.6 million (51%) for the quarter and \$2.2 million (34%) for the first six months. The organic growth was achieved primarily through enhanced service offerings to both new and existing clients. Second quarter trust, investment, asset management, and insurance-related revenues increased \$0.2 million as compared to the prior year and increased slightly for the year to date period.

The ratio of noninterest income to total income (FTE basis) was 28.8% for the quarter and 27.7% for the year-to-date period versus 24.8% and 25.0% for the comparable periods in 2006. This improvement is a function of increased noninterest banking and financial services income (excluding net security losses), combined with lower net interest income attributable to the decline in the net interest margin.

Operating Expenses

Table 6 below sets forth the quarterly 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

| (000 s omitted) | Three Months Ended June 30, | | Six Months Ended June 30, | |
|------------------------------------|--------------------------------|------------------|------------------------------|------------------|
| | 2007 | 2006 | 2007 | 2006 |
| Salaries and employee benefits | \$ 18,386 | \$ 16,425 | \$ 36,672 | \$ 33,207 |
| Occupancy and equipment | 4,559 | 4,448 | 9,225 | 9,207 |
| Data processing and communications | 3,748 | 3,252 | 7,373 | 6,483 |
| Amortization of intangible assets | 1,581 | 1,489 | 3,096 | 2,982 |
| Legal and professional fees | 1,054 | 1,108 | 2,241 | 2,391 |
| Office supplies and postage | 1,008 | 1,083 | 2,054 | 2,059 |
| Business development and marketing | 1,598 | 1,164 | 2,488 | 1,894 |
| Other | 2,198 | 2,239 | 4,902 | 4,420 |
| Total operating expenses | \$ 34,132 | \$ 31,208 | \$ 68,051 | \$ 62,643 |
| Operating expenses/average assets | 3.02% | 3.00% | 3.05% | 3.04% |
| Efficiency ratio | 62.2% | 59.8% | 63.0% | 60.0% |

As shown in Table 6, second quarter 2007 operating expenses were \$34.1 million, up \$2.9 million or 9.4% from the prior year level. Year-to-date operating expenses of \$68.1 million rose \$5.4 million or 8.6% compared to 2006. The increase was primarily attributable to incremental operating expenses related to the TLNB, HBT, Elmira and ONB acquisitions (\$1.6 million for the quarter, \$2.5 million YTD), annual merit increases (approximately \$0.5 million for the quarter, \$1.0 million YTD), higher data processing and communication costs (\$0.3 million for the quarter, \$0.6 million YTD), higher mortgage servicing rights amortization (\$0.2 million for the quarter, \$0.4 million YTD) and an increased level of business development and marketing expense (\$0.4 million for the quarter, \$0.5 million YTD). These costs were partially offset by lower occupancy and equipment costs (\$0.2 million for the quarter, \$0.4 million YTD) and lower legal and professional fees (\$0.1 million for the quarter, \$0.2 million YTD). Included in total operating expenses of \$34.1 million and \$68.1 million for the second quarter and first six months of 2007, are non-recurring transaction related acquisition expenses of \$0.2 million and \$0.3 million, respectively.

The Company's efficiency ratio (recurring operating expense excluding intangible amortization and acquisition expenses divided by the sum of net interest income (FTE) and recurring noninterest income) was 62.2% for the second quarter, 2.4 percentage points above the comparable quarter of 2006. This resulted from operating expenses (as described above) increasing 9.0% primarily due to the acquisitions in the last year, while recurring operating income increased at a slower rate of 4.8% due to a slight decrease in net interest income quarter over quarter, offset by a \$2.7 million increase in noninterest income excluding security gains. The efficiency ratio of 63.0% for the first half of 2007 was up 3.0 percentage points from a year earlier due to core operating expenses increasing 8.4% while recurring operating income increased at a slower rate of 3.4%. Operating expenses as a percentage of average assets increased two and one basis points for the quarter and year to date periods, respectively, as operating expenses increased 9.4% and 8.6%, while average assets increased 8.9% and 8.3% during the same time periods.

Income Taxes

The second quarter effective income tax rate was 25.0%, compared to the 24.1% effective tax rate in the second quarter of 2006. The year-to-date effective tax rate was 24.6% as compared to 24.5% for the first half of 2006. The higher effective tax rate for 2007 was principally a result of a lower proportion of income being generated from tax-exempt securities and loans.

Investments

As reflected in Table 7 below, the carrying value of investments (including unrealized gains on available-for-sale securities) was \$1.22 billion at the end of the second quarter, a decrease of \$9.9 million and \$33.8 million from December 31, 2006 and June 30, 2006, respectively. The book value (excluding unrealized gains) of investments increased \$2.1 million from December 31, 2006 and decreased \$35.4 million versus June 30, 2006. During 2006, the investment portfolio was allowed to run off in the flat yield curve environment. Cash flows were used to support loan growth and repay borrowings until more advantageous investment opportunities became available. During the first half of 2007, cash flows were reinvested in short-term agency securities and other cash equivalents, as well as, used to repay short-term borrowings. The overall mix of securities within the portfolio over the last year has remained relatively consistent, with a small increase in the proportion of U.S. Treasury and Agency securities and a corresponding decrease in obligations of state and political subdivisions and mortgage-backed securities. The change in the carrying value of investments is impacted by the amount of net unrealized gains in the available for sale portfolio at a point in time. At June 30, 2007, the portfolio had a \$4.3 million net unrealized loss, a decrease of \$12.1 million from the unrealized gain at December 31, 2006 and an improvement of \$1.5 million from the unrealized loss at June 30, 2006. This fluctuation is indicative of the interest rate movements during the respective time periods and the changes in the size and composition of the portfolio.

Table 7: Investments

| (000 s omitted) | June 30, 2007 | | December 31, 2006 | | June 30, 2006 | |
|---|---------------------------------|---------------------|---------------------------------|---------------------|---------------------------------|---------------------|
| | Amortized Cost/Book Value | Fair Value | Amortized Cost/Book Value | Fair Value | Amortized Cost/Book Value | Fair Value |
| <i>Held-to-Maturity Portfolio:</i> | | | | | | |
| U.S. Treasury and Agency securities | \$ 127,127 | \$ 122,376 | \$ 127,200 | \$ 124,020 | \$ 127,273 | \$ 120,040 |
| Obligations of state and political subdivisions | 5,296 | 5,301 | 7,242 | 7,257 | 6,052 | 6,053 |
| Other securities | 4,000 | 4,000 | 11,417 | 11,417 | 9,474 | 9,474 |
| Total held-to-maturity portfolio | 136,423 | 131,677 | 145,859 | 142,694 | 142,799 | 140,767 |
| <i>Available-for-Sale Portfolio:</i> | | | | | | |
| U.S. Treasury and Agency securities | 414,868 | 410,397 | 372,706 | 370,787 | 399,555 | 390,970 |
| Obligations of state and political subdivisions | 479,600 | 482,719 | 502,677 | 514,647 | 510,831 | 517,673 |
| Corporate securities | 40,527 | 39,533 | 35,603 | 35,080 | 35,674 | 34,193 |
| Collateralized mortgage obligations | 38,483 | 37,934 | 43,768 | 43,107 | 57,934 | 56,827 |
| Mortgage-backed securities | 72,076 | 70,698 | 76,266 | 75,181 | 75,086 | 73,632 |
| Subtotal | 1,045,554 | 1,041,281 | 1,031,020 | 1,038,802 | 1,079,080 | 1,073,295 |
| Equity securities | 41,656 | 41,656 | 44,610 | 44,610 | 37,108 | 37,108 |
| Total available-for-sale portfolio | 1,087,210 | 1,082,937 | 1,075,630 | 1,083,412 | 1,116,188 | 1,110,403 |
| Net unrealized (loss) gain on available-for-sale portfolio | (4,273) | 0 | 7,782 | 0 | (5,785) | 0 |
| Total | \$ 1,219,360 | \$ 1,215,266 | \$ 1,229,271 | \$ 1,226,106 | \$ 1,253,202 | \$ 1,246,170 |

Loans

As shown in Table 8, loans ended the second quarter at \$2.77 billion, up \$65.6 million (2.4%) from year-end 2006 and up \$322.9 million (13.2%) versus one year earlier. The TLNB, Elmira and ONB acquisitions added approximately \$285.1 million of loans to the loan portfolio as of June 30, 2007. Excluding the impact of the TLNB, Elmira and ONB acquisitions, loans

Edgar Filing: COMMUNITY BANK SYSTEM INC - Form 10-Q

increased \$37.8 million or 1.6% from the second quarter of 2006 with organic growth in all three categories. During the second quarter, excluding the impact of the acquired branches, loans increased \$36.6 million with increases in the consumer installment portfolio (\$16.0 million), the business lending portfolio (\$8.8 million) and the consumer mortgage portfolio (\$11.8 million).

Table 8: Loans

| (000 s omitted) | June 30, 2007 | | December 31, 2006 | | June 30, 2006 | |
|----------------------|---------------------|---------------|---------------------|---------------|---------------------|---------------|
| Business lending | \$ 988,886 | 35.7% | \$ 960,034 | 35.5% | \$ 827,021 | 33.8% |
| Consumer mortgage | 948,430 | 34.3% | 912,505 | 33.8% | 822,235 | 33.7% |
| Consumer installment | 829,860 | 30.0% | 829,019 | 30.7% | 795,010 | 32.5% |
| Total loans | \$ 2,767,176 | 100.0% | \$ 2,701,558 | 100.0% | \$ 2,444,266 | 100.0% |

Edgar Filing: COMMUNITY BANK SYSTEM INC - Form 10-Q

Business lending increased \$28.9 million in the first six months of 2007 and increased \$161.9 million versus one year ago. Excluding the impact of the TLNB, Elmira and ONB acquisitions, business lending was up \$13.6 million over the last six months and \$3.0 million over the last year. Growth in commercial mortgage and business line of credit activity during the last year has more than offset a planned and managed decline in automotive dealer floor plan outstandings. The Company continues to face competitive conditions in most of its markets and it maintains its commitment to generating growth in its business portfolio in a manner that adheres to its twin goals of maintaining strong asset quality and producing profitable margins.

Consumer mortgages increased \$126.2 million, year-over-year, and \$35.9 million in the first six months of 2007, despite the sale of a portion of longer-term fixed-rate new mortgage originations in the secondary market. Excluding the impact of the TLNB, Elmira and ONB acquisitions, consumer mortgages increased \$12.9 million and \$23.1 million for the past six and twelve month periods, respectively. Consumer mortgage growth has remained steady over the last few quarters despite interest rates rising above prior year levels. The consumer real estate portfolio does not include exposure to subprime, Alt-A, or other higher-risk mortgage products.

Consumer installment loans, including borrowings originated in automobile, marine and recreational vehicle dealerships, as well as branch originated home equity and installment loans, increased \$0.8 million in the first six months of 2007 and increased \$34.9 million on a year-over-year basis. Excluding the impact of the TLNB, Elmira and ONB acquisitions, consumer installment lending increased \$16.0 million for the second quarter of 2007 and increased \$11.7 million for the year-over-year period. Continued moderate interest rates (by historical standards), aggressive dealer and manufacturer incentives on new vehicles, and enhanced business development efforts have helped drive profitable growth in this segment in all the Company's markets over the last year.

Asset Quality

Table 9 below exhibits the major components of nonperforming loans and assets and key asset quality metrics for the periods ending June 30, 2007 and 2006 and December 31, 2006.

Table 9: Nonperforming Assets

| (000 \$ omitted) | June 30, 2007 | December 31, 2006 | June 30, 2006 |
|--|------------------|----------------------|------------------|
| Nonaccrual loans | \$ 8,003 | \$ 10,107 | \$ 9,002 |
| Accruing loans 90+ days delinquent | 778 | 1,207 | 765 |
| Restructured loans | 1,189 | 1,275 | 1,325 |
| Total nonperforming loans | 9,970 | 12,589 | 11,092 |
| Other real estate (OREO) | 1,411 | 1,838 | 1,353 |
| Total nonperforming assets | \$ 11,381 | \$ 14,427 | \$ 12,445 |
| Allowance for loan losses to total loans | 1.33% | 1.34% | 1.35% |
| Allowance for loan losses to nonperforming loans | 368% | 288% | 297% |
| Nonperforming loans to total loans | 0.36% | 0.47% | 0.45% |
| Nonperforming assets to total loans and other real estate | 0.41% | 0.53% | 0.51% |
| Delinquent loans (30 days old to nonaccruing) to total loans | 0.95% | 1.33% | 1.15% |
| Net charge-offs to average loans outstanding (quarterly) | 0.05% | 0.21% | 0.26% |
| Loan loss provision to net charge-offs (quarterly) | 114% | 101% | 112% |

As displayed in Table 9, nonperforming assets at June 30, 2007 were \$11.4 million, a decrease of \$1.1 million versus one year earlier and a \$3.0 million decrease as compared to the level at the end of 2006. Nonperforming loans ratios remain at the lowest level in over three years, reflective of disciplined credit management and a steady improvement in economic conditions over the past few years. Other real estate increased \$0.1 million from one-year ago and decreased \$0.4 million from year-end 2006, a result of the Company managing 20 properties at June 30, 2007 as compared to 22 OREO properties at June 30, 2006. No single property has a carrying value in excess of \$300,000.

Edgar Filing: COMMUNITY BANK SYSTEM INC - Form 10-Q

Nonperforming loans were 0.36% of total loans outstanding at the end of the second quarter, significantly below the 0.47% and 0.45% at December 31, 2006 and June 30, 2006, respectively. The allowance for loan losses to nonperforming loans ratio, a general measure of coverage adequacy, was 368% at the end of the second quarter compared to 288% at year-end 2006 and 297% at June 30, 2006, reflective of the low level of nonperforming loans.

Edgar Filing: COMMUNITY BANK SYSTEM INC - Form 10-Q

Delinquent loans (30 days through nonaccruing) as a percent of total loans was 0.95% at the end of the second quarter, substantially below the 1.33% at year-end 2006 and 1.15% at June 30, 2006. Commercial, real estate and installment loan delinquency ratios at the end of the second quarter improved in comparison to both of the earlier periods. The delinquency level at the end of the current quarter was 33 basis points below the Company's average of 1.28% over the previous eight quarters.

Table 10: Allowance for Loan Losses Activity

| (000 s omitted) | Three Months Ended June 30, | | Six Months Ended June 30, | |
|--|--------------------------------|--------------|------------------------------|--------------|
| | 2007 | 2006 | 2007 | 2006 |
| Allowance for loan losses at beginning of period | \$ 35,891 | \$ 32,720 | \$ 36,313 | \$ 32,581 |
| <i>Charge-offs:</i> | | | | |
| Business lending | 295 | 1,201 | 535 | 2,556 |
| Consumer mortgage | 45 | 67 | 280 | 102 |
| Consumer installment | 1,251 | 1,237 | 2,412 | 2,862 |
| Total charge-offs | 1,591 | 2,505 | 3,227 | 5,520 |
| <i>Recoveries:</i> | | | | |
| Business lending | 389 | 125 | 646 | 239 |
| Consumer mortgage | 20 | 19 | 21 | 77 |
| Consumer installment | 820 | 816 | 1,576 | 1,648 |
| Total recoveries | 1,229 | 960 | 2,243 | 1,964 |
| Net charge-offs | 362 | 1,545 | 984 | 3,556 |
| Provision for loans losses | 414 | 1,725 | 614 | 3,875 |
| Allowance for acquired loans | 747 | 0 | 747 | 0 |
| Allowance for loan losses at end of period | \$ 36,690 | \$ 32,900 | \$ 36,690 | \$ 32,900 |
| <i>Net charge-offs to average loans outstanding:</i> | | | | |
| Business lending | -0.04% | 0.52% | -0.02% | 0.57% |
| Consumer mortgage | 0.01% | 0.02% | 0.06% | 0.01% |
| Consumer installment | 0.21% | 0.22% | 0.21% | 0.31% |
| Total loans | 0.05% | 0.26% | 0.07% | 0.30% |

As displayed in Table 10, net charge-offs during the second quarter were \$0.4 million, \$1.2 million lower than the equivalent 2006 period. The consumer mortgage and consumer installment portfolios experienced declines in the level of charge-offs, while the business lending portfolio experienced a net recovery position in the second quarter of 2007. The three and six months ended June 30, 2006 included charge-offs of \$0.8 million and \$1.7 million related to three dealer floor plan relationships. The net charge-off ratio (net charge-offs as a percentage of average loans outstanding) for the second quarter was 0.05%, 21 basis points lower than both the comparable quarter of 2006 and the average charge-off ratio for the previous eight quarters. Net charge-offs and the corresponding net charge-off ratios are at their lowest level in several years.

The business lending portfolio experienced a net recovery for the quarter, while the consumer installment and consumer mortgage net charge-off ratios each decreased one basis point in the second quarter versus the prior year to 0.21% and 0.01%, respectively. For the year-to-date period, the business lending portfolio was in a net recovery position, the consumer installment net charge-off ratio improved 10 basis points compared to one year earlier, while the consumer mortgage charge-off ratio was higher by five basis points, but still at a favorable level.

A loan loss allowance of \$36.7 million was determined as of June 30, 2007, necessitating a \$0.4 million loan loss provision for the quarter, compared to \$1.7 million one year earlier. The second quarter 2007 loan loss provision was \$0.4 million slightly

Edgar Filing: COMMUNITY BANK SYSTEM INC - Form 10-Q

above quarterly net charge-offs. The allowance for loan losses rose \$3.8 million or 11.5% over the last 12 months, slightly less than the 13.2% growth in the loan portfolio. Contributing to the changes was the acquired TLNB, Elmira and ONB loans and reserves, with a combined coverage ratio of 1.27%. This contributed to the ratio of allowance for loan loss to loans outstanding decreasing two basis points to 1.33% for the second quarter, as compared to the levels at June 30, 2006 and declining one basis point from the level at December 31, 2006. The decrease is also attributable to the favorable charge-off, nonperforming and delinquency trends experienced over the last twelve months.

Deposits

As shown in Table 11, average deposits of \$3.3 billion in the second quarter were up \$140.9 million compared to fourth quarter 2006 and increased \$248.9 million versus the same quarter of last year. Excluding the impact of the TLNB, Elmira and ONB acquisitions, average deposits increased \$74.2 million as compared to the fourth quarter of 2006 and increased \$41.6 million as compared to the second quarter of the prior year. The mix of average deposits changed slightly since the second quarter of 2006. The weightings of time deposits and interest checking deposits increased from their second quarter levels, while demand, savings and money market deposit weightings decreased. As interest rates continue to rise, time deposits have continued to attract more funds, as evidenced by their 7.0% and 2.3% increases, excluding the impact of the TLNB, Elmira and ONB acquisitions, as compared to the fourth and second quarters of 2006, respectively. Interest checking account balances are above the prior year levels primarily as a result of new product initiatives that commenced in the second quarter of 2006. This shift in mix, combined with higher interest rates on money market and time deposit accounts increased the quarterly cost of interest-bearing deposits from 2.38% in the second quarter of 2006 to 2.96% in the most recent quarter.

Average second quarter non-public fund deposits increased \$113.0 million or 3.9% versus the fourth quarter of 2006, and were up \$267.5 million or 9.6% compared to the year earlier period. Average public funds have increased \$27.9 million or 13.6% from the fourth quarter of 2006 and decreased \$18.6 million or 7.4% from the second quarter of 2006. The Company continues to focus heavily on growing its core deposits through enhanced marketing efforts and new product offerings introduced throughout 2006 and the first half of 2007.

Table 11: Quarterly Average Deposits

| (000 s omitted) | June 30, 2007 | December 31, 2006 | June 30, 2006 |
|----------------------------|---------------------|----------------------|---------------------|
| Demand deposits | \$ 557,195 | \$ 558,439 | \$ 565,651 |
| Interest checking deposits | 430,038 | 389,336 | 331,553 |
| Savings deposits | 459,514 | 458,320 | 462,111 |
| Money market deposits | 323,867 | 330,150 | 336,991 |
| Time deposits | 1,504,716 | 1,398,235 | 1,330,126 |
| Total deposits | \$ 3,275,330 | \$ 3,134,480 | \$ 3,026,432 |
| Non-public fund deposits | \$ 3,042,325 | \$ 2,929,343 | \$ 2,774,828 |
| Public fund deposits | 233,005 | 205,137 | 251,604 |
| Total deposits | \$ 3,275,330 | \$ 3,134,480 | \$ 3,026,432 |

Borrowings

At the end of the second quarter, borrowings of \$704 million were down \$101.3 million from December 31, 2006 and were up \$110.7 million versus the end of the second quarter of 2006 as a result of funding all-cash acquisitions and increasing the amount of trust preferred securities. The reduction in borrowings during the first half of 2007 included the result of the early redemption of \$30 million of fixed-rate trust preferred securities.

The Company is currently in the process of reviewing early extinguishment of its two \$25 million, variable-rate trust preferred obligations, which include premium call provisions slightly over 6%. The company estimates the impact of the one-time charge associated with this potential action to be between \$0.08 and \$0.10 per share, but is expected to have a positive impact on future net interest margins. The Company expects to conclude its evaluation prior to year-end.

Shareholders Equity

On April 20, 2005, the Company announced a twenty-month authorization to repurchase up to 1.5 million of its outstanding shares in open market or privately negotiated transactions. On December 20, 2006, the Company extended the program through December 31, 2008 and announced an additional two-year authorization to repurchase up to 900,000 of its outstanding shares in open market or privately negotiated transactions. All reacquired shares will become treasury shares and will be used for general corporate purposes, including those related to employee and director stock plan activities. Through June 30, 2007, the Company had repurchased 1,146,961 shares at an aggregate cost of \$25.6 million under this program.

Total shareholders equity of \$460 million at the end of the second quarter decreased \$1.9 million from the balance at December 31, 2006. This change consisted of dividends declared of \$12.0 million, a \$6.9 million decline in the after-tax market value adjustment on the available-for-sale investment portfolio and treasury stock purchases of \$6.1 million, partially offset by net income of \$20.0 million, \$1.9 million from shares issued under the employee stock plan and \$1.2 million from employee stock options earned. Over the past 12 months total shareholders equity increased by \$8.0 million, as net income and positive contributions from shares issued under the employee stock plan more than offset dividends declared, treasury stock purchases, a lower market value adjustment and the impact of the adoption of SFAS 158, *Employers Accounting for Defined Benefit Pension and Other Postretirement Plans an Amendment of FASB Statements No. 87, 88, 106, and 132(R)* (SFAS 158).

The Company's Tier I leverage ratio, a primary measure of regulatory capital for which 5% is the requirement to be well-capitalized, was 7.90% at the end of the second quarter, down 91 basis points from year-end 2006 and 17 basis points higher than its level one year ago. The decrease in the Tier I leverage ratio compared to December 31, 2006 is primarily the result of the early call of the \$30 million of fixed-rate trust preferred securities in the first quarter and assets from the ONB acquisition being included in the average assets for a full quarter versus only one month at December 31, 2006. The increase in Tier I, as compared to the prior year second quarter, is the result of a 10.5% increase in shareholders equity, excluding intangibles and market value adjustment, combined with a smaller 8.2% increase in average assets excluding intangibles and market value adjustment and the \$51.4 million net increase in trust preferred securities. The tangible equity-to-assets ratio of 4.66% decreased 41 basis points versus December 31, 2006 and was down 120 basis points versus June 30, 2006, mostly due to the acquisitions of HBT, TLNB, Elmira and ONB, treasury share purchases, and the adoption of SFAS 158.

The dividend payout ratio (dividends declared divided by net income) for the first half of 2007 was 60.0%, up from 58.7% for the first half of 2006. The ratio increased because dividends declared increased 5.7%, while net income including securities gains increased a lesser 3.5%. The expansion of dividends declared was caused by the dividend per share being raised 5.3% in August 2006, from \$0.19 to \$0.20, and a slight increase in the number of shares outstanding. On a cash earnings basis, the dividend payout ratio was 52.9% for the first half of 2007 as compared to 51.6% for the first half of 2006.

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 June 30, 2007, this ratio was 12.8% for 30 days and 12.7% 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.

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 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.

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 projected net interest income sensitivity over the subsequent twelve months based on:

Asset and liability levels using June 30, 2007 as a starting point.

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.

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.

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 rates | Calculated annualized increase (decrease) in projected net interest income at June 30, 2007 |
|--------------------------|--|
| + 200 basis points | 0.6% |
| - 100 basis points | (0.3%) |

The modeled net interest income does not significantly change as interest rates increase/decrease over a 12-month period. The Bank remains fairly neutral in each of the above rate environments. Over a longer time period, however, the Bank is asset sensitive as 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 having a greater impact than increases in funding costs.

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, as defined in Rule 13a-15(e) under the Securities Exchange Act of 1934, designed to: (i) record, process, summarize, and report within the time periods specified in the Securities and Exchange Commission's (SEC) rules and forms, and (ii) accumulate and communicate to management, including the principal executive and principal financial officers, as appropriate, to allow timely decisions regarding disclosure. Based on management's evaluation of the Company's disclosure controls and procedures, with the participation of the Chief Executive Officer and the Chief Financial Officer, it has concluded that, as of the end of the period covered by this Quarterly Report on Form 10-Q, these disclosure controls and procedures were effective as of June 30, 2007.

There have been no 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.

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 1A. Risk Factors

There has not been any material change in the risk factors disclosure from that contained in the Company's 2006 Form 10-K for the fiscal year ended December 31, 2006.

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. On December 20, 2006, the Company extended the program through December 31, 2008 and announced an additional two-year authorization to repurchase up to 900,000 of its 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 second quarter of 2007.

| | Number of Shares Purchased | Average Price Paid Per share | Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs | Maximum Number of Shares That May Yet Be Purchased Under the Plans or Programs |
|------------|-----------------------------------|-------------------------------------|---|---|
| April 2007 | 5,900 | \$ 20.83 | 920,361 | 1,479,639 |
| May 2007 | 140,800 | 20.99 | 1,061,161 | 1,338,839 |
| June 2007 | 85,800 | 20.15 | 1,146,961 | 1,253,039 |
| Total | 232,500 | 20.67 | | |

Item 3. Defaults Upon Senior Securities

Not applicable.

Item 4. Submission of Matters to a Vote of Security Holders

There were no matters submitted to a vote of the shareholders during the quarter ending June 30, 2007.

Item 5. Other Information

Not applicable.

Item 6. Exhibits

| <u>Exhibit No.</u> | <u>Description</u> |
|--------------------|--|
| 31.1 | <u>Certification of Mark E. Tryniski, 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.</u> |
| 31.2 | <u>Certification of Scott 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.</u> |
| 32.1 | <u>Certification of Mark E. Tryniski, 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.</u> |
| 32.2 | <u>Certification of Scott 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.</u> |

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: August 8, 2007

/s/ Mark E. Tryniski

Mark E. Tryniski, President, Chief
Executive Officer and Director

Date: August 8, 2007

/s/ Scott Kingsley

Scott Kingsley, Treasurer and Chief
Financial Officer