

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

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

FORM 10-Q

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

For the quarterly period ended March 31, 2007

o 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 x No o

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 shell company (as defined in Rule 12b-2 of the Exchange Act). Yes o No x

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

30,090,792 shares of Common Stock, \$1.00 par value, were outstanding on April 30, 2007.

TABLE OF CONTENTS

| | <u>Page</u> |
|--|-------------|
| <u>Part I.</u> | |
| <u>Financial Information</u> | |
| <u>Item 1.</u> | |
| <u>Financial Statements (Unaudited)</u> | |
| <u>Consolidated Statements of Condition</u> <u>March 31, 2007 and December 31, 2006</u> | 3 |
| <u>Consolidated Statements of Income</u> <u>Three months ended March 31, 2007 and 2006</u> | 4 |
| <u>Consolidated Statement of Changes in Shareholders' Equity</u> <u>Three months ended March 31, 2007</u> | 5 |
| <u>Consolidated Statements of Comprehensive Income</u> <u>Three months ended March 31, 2007 and 2006</u> | 6 |
| <u>Consolidated Statements of Cash Flows</u> <u>Three months ended March 31, 2007 and 2006</u> | 7 |
| <u>Notes to the Consolidated Financial Statements</u> <u>March 31, 2007</u> | 8 |
| <u>Item 2.</u> | |
| <u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u> | 13 |
| <u>Item 3.</u> | |
| <u>Quantitative and Qualitative Disclosure about Market Risk</u> | 25 |
| <u>Item 4.</u> | |
| <u>Controls and Procedures</u> | 26 |
| <u>Part II.</u> | |
| <u>Other Information</u> | |
| <u>Item 1.</u> | |
| <u>Legal Proceedings</u> | 26 |
| <u>Item 1A.</u> | |
| <u>Risk Factors</u> | 26 |
| <u>Item 2.</u> | |
| <u>Unregistered Sales of Equity Securities and Use of Proceeds</u> | 26 |
| <u>Item 3.</u> | |
| <u>Defaults Upon Senior Securities</u> | 26 |
| <u>Item 4.</u> | |
| <u>Submission of Matters to a Vote of Securities Holders</u> | 26 |
| <u>Item 5.</u> | |
| <u>Other Information</u> | 26 |
| <u>Item 6.</u> | |
| <u>Exhibits</u> | 27 |

Part 1. Financial Information
Item 1. Financial Statements

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

| | (Unaudited) March 31, 2007 | December 31, 2006 |
|--|----------------------------------|----------------------|
| Cash and cash equivalents | \$ 224,917 | \$ 232,032 |
| Available-for-sale investment securities, at fair value | 1,179,041 | 1,083,412 |
| Held-to-maturity investment securities (fair value of \$135,915 and \$142,695, respectively) | 138,513 | 145,859 |
| Total investment securities | 1,317,554 | 1,229,271 |
| Loans | 2,682,234 | 2,701,558 |
| Allowance for loan losses | (35,891) | (36,313) |
| Net loans | 2,646,343 | 2,665,245 |
| Core deposit intangibles, net | 23,219 | 24,665 |
| Goodwill | 220,268 | 220,290 |
| Other intangibles, net | 1,111 | 1,181 |
| Intangible assets, net | 244,598 | 246,136 |
| Premises and equipment, net | 66,211 | 66,199 |
| Accrued interest receivable | 25,727 | 26,797 |
| Other assets | 33,538 | 32,117 |
| Total assets | \$ 4,558,888 | \$ 4,497,797 |
| Liabilities: | | |
| Noninterest bearing deposits | \$ 592,954 | \$ 578,951 |
| Interest bearing deposits | 2,685,514 | 2,589,348 |
| Total deposits | 3,278,468 | 3,168,299 |
| Borrowings | 626,765 | 647,481 |
| Subordinated debt held by unconsolidated subsidiary trusts | 127,099 | 158,014 |
| Accrued interest and other liabilities | 59,659 | 62,475 |
| Total liabilities | 4,091,991 | 4,036,269 |

Commitment and contingencies (See Note I)

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

| | | | |
|--|-----------|------------------|---------------------|
| Shareholders' equity: | | | |
| Preferred stock \$1.00 par value, 500,000 shares authorized, 0 shares issued | | | |
| Common stock, \$1.00 par value, 50,000,000 shares authorized; 32,910,233 and | | | |
| 32,773,320 shares issued in 2007 and 2006, respectively | | 32,910 | 32,773 |
| Additional paid-in capital | | 205,349 | 203,197 |
| Retained earnings | | 295,500 | 291,871 |
| Accumulated other comprehensive income | | (3,994) | (4,697) |
| Treasury stock, at cost (2,814,461 and 2,753,161 shares, respectively) | | (62,868) | (61,616) |
| <hr/> | | | |
| Total shareholders' equity | | 466,897 | 461,528 |
| <hr/> | | | |
| Total liabilities and shareholders' equity | \$ | 4,558,888 | \$ 4,497,797 |
| <hr/> | | | |

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 March 31, | |
|--|---------------------------------|-----------|
| | 2007 | 2006 |
| Interest income: | | |
| Interest and fees on loans | \$ 44,935 | \$ 38,328 |
| Interest and dividends on taxable investments | 11,103 | 10,535 |
| Interest and dividends on nontaxable investments | 5,520 | 5,795 |
| Total interest income | 61,558 | 54,658 |
| Interest expense: | | |
| Interest on deposits | 18,120 | 13,021 |
| Interest on short-term borrowings | 1,637 | 1,458 |
| Interest on subordinated debt held by unconsolidated subsidiary trusts | 2,566 | 1,815 |
| Interest on long-term borrowings | 5,868 | 4,679 |
| Total interest expense | 28,191 | 20,973 |
| Net interest income | 33,367 | 33,685 |
| Less: provision for loan losses | 200 | 2,150 |
| Net interest income after provision for loan losses | 33,167 | 31,535 |
| Noninterest income: | | |
| Deposit service fees | 6,977 | 6,609 |
| Other banking services | 670 | 476 |
| Benefit plan administration, consulting and actuarial fees | 3,972 | 3,381 |
| Trust, investment and asset management fees | 1,860 | 2,050 |
| Total noninterest income | 13,479 | 12,516 |
| Operating expenses: | | |
| Salaries and employee benefits | 18,286 | 16,782 |
| Occupancy and equipment | 4,666 | 4,759 |
| Data processing and communications | 3,625 | 3,231 |
| Amortization of intangible assets | 1,515 | 1,493 |
| Legal and professional fees | 1,187 | 1,283 |
| Office supplies and postage | 1,046 | 976 |
| Business development and marketing | 890 | 730 |
| Other | 2,704 | 2,181 |
| Total operating expenses | 33,919 | 31,435 |
| Income before income taxes | 12,727 | 12,616 |

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

| | | | | |
|-------------------------------------|----|-------|----|-------|
| Income taxes | | 3,071 | | 3,154 |
| <hr/> | | | | |
| Net income | \$ | 9,656 | \$ | 9,462 |
| <hr/> | | | | |
| Basic earnings per share | \$ | 0.32 | \$ | 0.32 |
| Diluted earnings per share | \$ | 0.32 | \$ | 0.31 |
| Dividends declared per share | \$ | 0.20 | \$ | 0.19 |

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

COMMUNITY BANK SYSTEM, INC.
CONSOLIDATED STATEMENT OF CHANGES IN SHAREHOLDERS' EQUITY (Unaudited)
Three Months Ended March 31, 2007
(In Thousands, Except Share Data)

| | Common Stock | | | | | | |
|---|-----------------------|------------------|----------------------------------|----------------------|---|-------------------|------------|
| | Shares Outstanding | Amount Issued | Additional Paid-In Capital | Retained Earnings | Accumulated Other Comprehensive Income | Treasury Stock | Total |
| Balance at December 31, 2006 | 30,020,159 | \$ 32,773 | \$ 203,197 | \$ 291,871 | (\$ 4,697) | (\$ 61,616) | \$ 461,528 |
| Net income | | | | 9,656 | | | 9,656 |
| Other comprehensive loss, net of tax | | | | | 703 | | 703 |
| Dividends declared: | | | | | | | |
| Common, \$0.20 per share | | | | (6,027) | | | (6,027) |
| Common stock issued under stock plan, including tax benefits of \$220 | 136,913 | 137 | 1,530 | | | | 1,667 |
| Stock options earned | | | 622 | | | | 622 |
| Treasury stock purchased | (61,300) | | | | | (1,252) | (1,252) |
| Balance at March 31, 2007 | 30,095,772 | \$ 32,910 | \$ 205,349 | \$ 295,500 | (\$ 3,994) | (\$ 62,868) | \$ 466,897 |

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 March 31, | |
|--|---------------------------------|----------|
| | 2007 | 2006 |
| Other comprehensive loss, before tax: | | |
| Change in pension liability | (\$ 50) | (\$ 118) |
| Change in unrealized gains and losses on derivative instruments used in cash flow hedging relationship | (423) | 0 |
| Unrealized gain (loss) on securities: | | |
| Unrealized holding gain (loss) arising during period | 1,413 | (7,923) |
| Other comprehensive gain (loss), before tax: | 940 | (8,041) |
| Income tax (expense) benefit related to other comprehensive gain (loss) | (237) | 3,116 |
| Other comprehensive gain (loss), net of tax: | 703 | (4,925) |
| Net income | 9,656 | 9,462 |
| Comprehensive income | \$ 10,359 | \$ 4,537 |

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

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

| | Three Months Ended March 31, | |
|---|---|-------------------|
| | 2007 | 2006 |
| Operating activities: | | |
| Net income | \$ 9,656 | \$ 9,462 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Depreciation | 2,267 | 2,190 |
| Amortization of intangible assets | 1,515 | 1,493 |
| Net amortization of premiums and discounts on securities and loans | (405) | 215 |
| Amortization of unearned compensation and discount on subordinated debt | 100 | 36 |
| Provision for loan losses | 200 | 2,150 |
| Gain on sale of loans and other assets | (34) | (23) |
| Proceeds from the sale of loans held for sale | 3,889 | 4,314 |
| Origination of loans held for sale | (3,863) | (4,291) |
| Excess tax benefits from share-based payment arrangements | (106) | (169) |
| Change in other operating assets and liabilities | (3,691) | (1,482) |
| Net cash provided by operating activities | 9,528 | 13,895 |
| Investing activities: | | |
| Proceeds from sales of available-for-sale investment securities | 3,023 | 14,342 |
| Proceeds from maturities of held-to-maturity investment securities | 8,095 | 709 |
| Proceeds from maturities of available-for-sale investment securities | 56,610 | 14,512 |
| Purchases of held-to-maturity investment securities | (785) | (2,482) |
| Purchases of available-for-sale investment securities | (153,413) | (39,148) |
| Net decrease in loans outstanding | 18,704 | 1,542 |
| Capital expenditures | (2,271) | (1,867) |
| Net cash used in investing activities | (70,037) | (12,392) |
| Financing activities: | | |
| Net change in demand deposits, NOW accounts and savings accounts | 42,636 | 23,072 |
| Net change in time deposits | 67,533 | 56,443 |
| Net change in federal funds purchased | 0 | (36,300) |
| Net change in short-term borrowings | (20,394) | (40,000) |
| Change in long-term borrowings (net of payments of \$322 and \$47) | (322) | 9,953 |
| Payment on subordinated debt held by unconsolidated subsidiary trusts | (30,928) | 0 |
| Issuance of common stock | 2,004 | 1,566 |
| Purchase of treasury stock | (1,252) | (3,521) |
| Cash dividends paid | (5,989) | (5,695) |
| Tax benefits from share-based payment arrangements | 106 | 169 |
| Net cash provided by financing activities | 53,394 | 5,687 |
| Change in cash and cash equivalents | (7,115) | 7,190 |
| Cash and cash equivalents at beginning of period | 232,032 | 114,605 |
| Cash and cash equivalents at end of period | \$ 224,917 | \$ 121,795 |

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

Supplemental disclosures of cash flow information:

| | | | | |
|----------------------------|----|--------|----|--------|
| Cash paid for interest | \$ | 29,475 | \$ | 21,144 |
| Cash paid for income taxes | | 0 | | 39 |

Supplemental disclosures of noncash financing and investing activities:

| | | | | |
|---|--|-------|--|---------|
| Dividends declared and unpaid | | 6,027 | | 5,683 |
| Gross change in unrealized gain on available-for-sale investment securities | | 1,413 | | (7,923) |

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

COMMUNITY BANK SYSTEM, INC.
NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)
March 31, 2007

NOTE A: BASIS OF PRESENTATION

The interim financial data as of March 31, 2007 and for the three months ended March 31, 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

Acquisitions in 2006

The Company completed the two following 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.

Hand Benefits & Trust, Inc.

On February 22, 2007, the Company announced an agreement pursuant to which its subsidiary, Benefit Plans Administrative Services, Inc. (BPAS) will acquire 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 acquisition is expected to close during the second quarter of 2007, pending customary regulatory approval.

TLNB Financial Corporation

On January 9, 2007, the Company announced an agreement to acquire 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 operates 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 has approximately \$100 million in assets and \$87 million of deposits. The acquisition is expected to close during the second quarter of 2007, pending both customary regulatory and TLNB shareholder approval.

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 March 31, 2007, the Company has repurchased pursuant to the program 914,461 shares at an aggregate cost of \$20.8 million and an average price per share of \$22.70. 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 segments: commercial, consumer direct, consumer indirect and residential real estate. The first calculation determines an allowance level based on the latest three years of historical net

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

charge-off data for each loan category (commercial loans exclude balances with specific loan loss allocations). The second calculation is qualitative and takes into consideration five major factors affecting the level of loan loss risk: portfolio risk migration patterns (internal credit quality trends); the growth of the segments of the loan portfolio; economic and business environment trends in the Company's markets (includes review of bankruptcy, unemployment, population, consumer spending and regulatory trends); industry, geographical and product concentrations in the portfolio; and the perceived effectiveness of managerial resources and lending practices and policies. These two calculations are added together to determine the general loan loss allocation. The specific loan loss allocation relates to individual commercial loans that are both greater than \$0.5 million and in a 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 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 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 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 1,676,000 anti-dilutive stock options outstanding at March 31, 2007 compared to approximately 1,388,800 weighted-average anti-dilutive stock options outstanding at March 31, 2006. The following is a reconciliation of basic to diluted earnings per share for the three months ended March 31, 2007 and 2006.

| (000 s omitted, except per share data) | Income | Shares | Per Share Amount |
|--|----------|--------|------------------|
| <i>Three Months Ended March 31, 2007</i> | | | |
| Basic EPS | \$ 9,656 | 30,192 | \$ 0.32 |
| Stock options | | 355 | |
| Diluted EPS | \$ 9,656 | 30,547 | \$ 0.32 |
| <i>Three Months Ended March 31, 2006</i> | | | |
| Basic EPS | \$ 9,462 | 30,023 | \$ 0.32 |
| Stock options | | 456 | |
| Diluted EPS | \$ 9,462 | 30,479 | \$ 0.31 |

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 March 31, 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 | \$ 65,347 | (\$ 42,128) | \$ 23,219 | \$ 65,351 | (\$ 40,686) | \$ 24,665 |
| Other intangibles | 2,642 | (1,531) | 1,111 | 2,750 | (1,569) | 1,181 |
| Total amortizing intangibles | 67,989 | (43,659) | 24,330 | 68,101 | (42,255) | 29,846 |
| <i>Non-amortizing intangible assets:</i> | | | | | | |
| Goodwill | 220,268 | 0 | 220,268 | 220,290 | 0 | 220,290 |
| Total intangible assets, net | \$ 288,257 | (\$ 43,659) | \$ 244,598 | \$ 288,391 | (\$ 42,255) | \$ 246,136 |

No goodwill impairment adjustments were recognized in 2007 or 2006.

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

(000 s omitted) Amount

| | | |
|--------------|----|--------|
| Apr-Dec 2007 | \$ | 4,530 |
| 2008 | | 5,677 |
| 2009 | | 5,132 |
| 2010 | | 3,258 |
| 2011 | | 1,208 |
| Thereafter | | 4,525 |
| <hr/> | | |
| Total | \$ | 24,330 |
| <hr/> | | |

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. 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% (7.00%) | 12/15/2036 | 5 year beginning 2012 | Par |

NOTE G: INCOME TAXES

The Company adopted the provisions of Financial Standards Accounting Board 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.

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 March 31, 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 months ended March 31 is as follows:

| | Pension Benefits | | Post-retirement Benefits | |
|---------------------------------------|------------------|--------|--------------------------|--------|
| | 2007 | 2006 | 2007 | 2006 |
| (000 \$ omitted) | | | | |
| Service cost | \$ 763 | \$ 748 | \$ 148 | \$ 134 |
| Interest cost | 678 | 660 | 131 | 121 |
| Expected return on plan assets | (1,024) | (827) | 0 | 0 |
| Net amortization and deferral | 247 | 315 | 29 | 29 |
| Amortization of prior service cost | (23) | (43) | 28 | 27 |
| Amortization of transition obligation | 0 | 0 | 10 | 10 |
| Net periodic benefit cost | \$ 641 | \$ 853 | \$ 346 | \$ 321 |

The Company is not required for regulatory purposes to make a contribution to its defined benefit pension plan.

NOTE 1: 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 \$ omitted) | March 31, 2007 | December 31, 2006 |
|------------------------------|-------------------|----------------------|
| Commitments to extend credit | \$ 444,079 | \$ 443,367 |
| Standby letters of credit | 9,947 | 10,082 |
| Total | \$ 454,026 | \$ 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 months ended March 31, 2007 and 2006, although in some circumstances the fourth quarter of 2006 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, "first quarter" refers to the quarter ended March 31, 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 24.

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).

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.

The Company completed the two following 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.

Net income for the first quarter of 2007 was \$9.7 million, an increase of \$0.2 million as compared to the first quarter of 2006, driven by favorable asset quality results, increased income on loans and investments and an 7.7% increase in noninterest income. 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 \$0.36 versus \$0.35 for the prior year's first quarter.

Asset quality continued to improve in the first quarter of 2007 in comparison to the fourth quarter of 2006 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 both the Elmira and ONB acquisitions and organic loan growth. The size of the investment portfolio increased from both the prior year-end and the first quarter of 2006, principally from short-term invested cash equivalents. Average deposits increased in the first quarter of 2007 as compared to the first quarter of 2006, due to both organic growth and the 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 quarter.

On February 22, 2007, the Company announced an agreement pursuant to which Benefit Plans Administrative Services, Inc. (BPAS) will acquire 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 acquisition is expected to close during the second quarter of 2007, pending customary regulatory approval.

On January 9, 2007, the Company announced an agreement to acquire 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 operates 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 has approximately \$100 million in assets and \$87 million of deposits. The acquisition is expected to close during the second quarter of 2007, pending both customary regulatory and TLNB shareholder approval.

Net Income and Profitability

As shown in Table 2, net income for the quarter of \$9.7 million was 2.1% higher than the first quarter of 2006. Earnings per share for the first quarter of \$0.32 was \$0.01 higher than the EPS generated in the same period of last year. As compared to the fourth quarter of 2006, net income increased \$1.5 million or 18%, and earnings per share increased \$0.05 or 19%.

First quarter net interest income of \$33.4 million was down \$0.3 million or 0.9% from the comparable prior year period. The provision for loan losses decreased \$2.0 million as compared to the first quarter of 2006 and decreased \$1.2 million from the fourth quarter of 2006 as a result of strong asset quality attributes. First quarter noninterest income, excluding securities gains, was \$13.5 million, up \$1.0 million or 7.7% from the first quarter of 2006. Operating expenses of \$33.9 million for the quarter were up \$2.5 million or 7.9% from the comparable prior year period, a significant portion due to the acquisition of Elmira and ONB during the second and fourth quarters of 2006.

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

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 first quarter of 2007 was \$0.36, up 2.9% from the \$0.35 earned in the first quarter of 2006.

As reflected in Table 2, the primary reasons for higher earnings for the quarter were a lower loan loss provision and higher noninterest income, partially offset by higher operating expenses and slightly lower net interest income. The decrease in net interest income for the quarter was due to a higher cost of funds, partially offset by both acquired and organic loan growth and higher loan yields. Excluding security gains, noninterest income increased due to a strong performance by the Company's employee benefits consulting and plan administration business and higher banking service fees. 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 primarily due to costs associated with the Elmira and ONB acquisitions, 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

| (000 \$ omitted) | Three Months Ended March 31, | |
|--|---------------------------------|-----------|
| | 2007 | 2006 |
| Net income | \$ 9,656 | \$ 9,462 |
| After-tax cash adjustments: | | |
| Amortization of premium on net assets acquired in merger | 179 | 205 |
| Amortization of intangible assets | 1,150 | 1,120 |
| Net income - cash | \$ 10,985 | \$ 10,787 |

Table 2: Summary Income Statements

| (000 \$ omitted, except per share data) | Three Months Ended March 31, | |
|--|---------------------------------|-----------|
| | 2007 | 2006 |
| Net interest income | \$ 33,367 | \$ 33,685 |
| Provision for loan losses | 200 | 2,150 |
| Noninterest income excluding security gains | 13,479 | 12,516 |
| Operating expenses | 33,919 | 31,435 |
| Income before taxes | 12,727 | 12,616 |
| Income taxes | 3,071 | 3,154 |
| Net income | \$ 9,656 | \$ 9,462 |
| Diluted earnings per share | \$ 0.32 | \$ 0.31 |
| Diluted earnings per share - cash ⁽¹⁾ | \$ 0.36 | \$ 0.35 |

⁽¹⁾ Cash earnings are reconciled to GAAP net income in Table 1.

Net Interest Income

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

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 the first quarter 2007 was \$37.2 million, consistent with the same period last year. A \$352 million increase in interest-bearing liabilities and a 32 basis point decrease in the net interest margin offset a \$318 million increase in average interest-earning assets. As reflected in Table 4, the volume and rate increases from interest bearing assets had a \$7.2 million favorable impact on net interest income, while the volume and rate increases from interest bearing liabilities had a similar \$7.2 million negative impact to net interest income.

Higher first quarter average loan balances were attributable to \$43.7 million of quarterly average organic loan growth since the first quarter of 2006, driven by growth in the consumer installment and consumer mortgage portfolios with a slight decrease in the business lending portfolio, as well as a \$239.9 million increase in first quarter 2007 average loans from the Elmira and ONB acquisitions. Average investments for the first quarter were \$34.4 million higher than the respective period of 2006, primarily due to an increase in short-term cash equivalents. In comparison to the prior year, total average deposits were up \$175.3 million or 5.8% for the quarter as a result of growth in IPC balances. Average deposits acquired in the Elmira and ONB acquisitions were \$183.6 million. Quarterly average borrowings increased \$140.2 million as compared to the first quarter of 2006 primarily due to the acquisitions of Elmira and ONB as well as the issuance of \$75 million of trust preferred securities in the fourth quarter of 2006.

The net interest margin of 3.74% for the first quarter dropped 32 basis points versus the same period in the prior year. This decline was primarily attributable to an increase in the cost of funds (up 56 basis points), due principally to the effect of the three rate hikes (25 basis points each) by the Federal Reserve since March 2006, while earning assets yields increased at a slower rate (up 23 basis points). The change in the earning-asset yield was driven by an increase in loan yields of 32 basis points for the quarter, while investment yields increased one basis point for the quarter. Results included the impact of the Elmira and ONB acquisitions, which had lower net interest margin attributes than the Company's historical averages.

The first quarter cost of funds increased 56 basis points versus the prior year quarter due to a 61 basis point increase in interest bearing deposit costs and a 19 basis point increase in the average interest rate paid on external borrowings. Interest rates on selected categories of deposit accounts were raised throughout 2006 in response to market conditions and the Federal Reserve rate increases. Additionally, customers continued to transfer 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 more than 65 basis point increase in three and six month LIBOR (London Interbank Offered Rates) over the last twelve months, from which the interest rate on \$50 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 three percentage points lower.

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 summing the daily ending balances in a period and dividing by the number of days in that period. Loan yields and amounts earned include loan fees. Average loan balances include nonaccrual loans and loans held for sale.

Table 3: Quarterly Average Balance Sheet

| (000 \$ omitted except yields and rates) | Three Months Ended March 31, 2007 | | | Three Months Ended March 31, 2006 | | |
|--|--------------------------------------|-----------|----------------------------|--------------------------------------|-----------|----------------------------|
| | Average Balance | Interest | Avg. Yield/Rate Paid | Average Balance | Interest | Avg. Yield/Rate Paid |
| Interest-earning assets: | | | | | | |
| Time deposits in other banks | \$ 102,553 | \$ 1,329 | 5.26% | \$ 7,269 | \$ 76 | 4.23% |
| Taxable investment securities ⁽¹⁾ | 741,304 | 10,280 | 5.62% | 780,395 | 10,842 | 5.63% |
| Nontaxable investment securities ⁽¹⁾ | 500,273 | 8,639 | 7.00% | 522,112 | 8,773 | 6.82% |
| Loans (net of unearned discount) | 2,684,566 | 45,106 | 6.81% | 2,400,926 | 38,431 | 6.49% |
| Total interest-earning assets | 4,028,696 | 65,354 | 6.58% | 3,710,702 | 58,122 | 6.35% |
| Noninterest-earning assets | 440,548 | | | 433,689 | | |
| Total assets | \$ 4,469,244 | | | \$ 4,144,391 | | |
| Interest-bearing liabilities: | | | | | | |
| Interest checking, savings and money market deposits | \$ 1,198,183 | 3,340 | 1.13% | \$ 1,126,716 | 2,513 | 0.90% |
| Time deposits | 1,424,289 | 14,780 | 4.21% | 1,283,632 | 10,508 | 3.32% |
| Short-term borrowings | 159,444 | 1,637 | 4.16% | 163,940 | 1,458 | 3.61% |
| Long-term borrowings | 613,624 | 8,434 | 5.57% | 468,884 | 6,494 | 5.62% |
| Total interest-bearing liabilities | 3,395,540 | 28,191 | 3.37% | 3,043,172 | 20,973 | 2.80% |
| Noninterest-bearing liabilities: | | | | | | |
| Demand deposits | 552,087 | | | 588,957 | | |
| Other liabilities | 56,994 | | | 54,099 | | |
| Shareholders' equity | 464,623 | | | 458,163 | | |
| Total liabilities and shareholders' equity | \$ 4,469,244 | | | \$ 4,144,391 | | |
| Net interest earnings | | \$ 37,163 | | | \$ 37,149 | |
| Net interest spread | | | 3.21% | | | 3.55% |
| Net interest margin on interest-earnings assets | | | 3.74% | | | 4.06% |
| Fully tax-equivalent adjustment | | \$ 3,796 | | | \$ 3,464 | |

⁽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

| (000 \$ omitted) | 1st Quarter 2007 versus 1st Quarter 2006 | | |
|--|---|---------|------------|
| | Increase (Decrease) Due to Change in ⁽¹⁾ | | |
| | Volume | Rate | Net Change |
| Interest earned on: | | | |
| Time deposits in other banks | \$ 1,231 | \$ 22 | \$ 1,253 |
| Taxable investment securities | (543) | (19) | (562) |
| Nontaxable investment securities | (372) | 238 | (134) |
| Loans (net of unearned discount) | 4,700 | 1,975 | 6,675 |
| Total interest-earning assets ⁽²⁾ | 5,107 | 2,125 | 7,232 |
| Interest paid on: | | | |
| Interest checking, savings and money market deposits | 167 | 660 | 827 |
| Time deposits | 1,240 | 3,032 | 4,272 |
| Short-term borrowings | (41) | 220 | 179 |
| Long-term borrowings | 1,989 | (49) | 1,940 |
| Total interest-bearing liabilities ⁽²⁾ | 2,608 | 4,610 | 7,218 |
| Net interest earnings ⁽²⁾ | 3,054 | (3,040) | 14 |

⁽¹⁾ The change in interest due to both rate and volume has been allocated in proportion to the relationship of the absolute dollar amounts of change in each.

⁽²⁾ Changes due to volume and rate are computed from the respective changes in average balances and rates and are not a summation of the changes of the components.

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), trust services, investment and insurance products (Community Investment Services, Inc. or CISI) 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 | |
|--|--------------------|----------|
| | March 31, 2007 | 2006 |
| Deposit service charges and fees | \$ 6,977 | \$ 6,609 |
| Benefit plan administration, consulting and actuarial fees | 3,972 | 3,381 |
| Trust, investment and asset management fees | 1,860 | 2,050 |
| Other banking services | 413 | 290 |
| Mortgage banking | 257 | 186 |
| Subtotal | 13,479 | 12,516 |
| Gain on sales of investment securities | 0 | 0 |

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

| | | |
|--------------------------|-----------|-----------|
| Total noninterest income | \$ 13,479 | \$ 12,516 |
|--------------------------|-----------|-----------|

| | | |
|---------------------------------------|-------|-------|
| Noninterest income/total income (FTE) | 26.6% | 25.2% |
|---------------------------------------|-------|-------|

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

As displayed in Table 5, noninterest income (excluding securities gains) was \$13.5 million in the first quarter, an increase of \$1.0 million or 7.7% from one year earlier. General recurring banking fees of \$7.4 million were up \$0.5 million or 7.1% compared to the first quarter of 2006, driven by organic core deposit account growth, higher electronic banking related revenues and incremental income generated from the Elmira and ONB branches acquired. Strong performance at BPA-Harbridge generated revenue growth of \$0.6 million (17%) for the quarter, achieved primarily through enhanced service offerings to both new and existing clients. Trust, investment and asset management fees have decreased \$0.2 million as compared to the first quarter of 2006. Excluding certain estate fees generated in the first quarter of 2006, trust services, CISI and Nottingham revenues were essentially flat.

The ratio of noninterest income to total income (FTE basis) was 26.6% for the quarter as compared to 25.2% for the comparable period in 2006. This improvement is a function of increased noninterest banking and financial services income (excluding net security gains), 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 \$ omitted) | Three Months Ended March 31, | |
|------------------------------------|---------------------------------|------------------|
| | 2007 | 2006 |
| Salaries and employee benefits | \$ 18,286 | \$ 16,782 |
| Occupancy and equipment | 4,666 | 4,759 |
| Data processing and communications | 3,625 | 3,231 |
| Amortization of intangible assets | 1,515 | 1,493 |
| Legal and professional fees | 1,187 | 1,283 |
| Office supplies and postage | 1,046 | 976 |
| Business development and marketing | 890 | 730 |
| Other | 2,704 | 2,181 |
| Total operating expenses | \$ 33,919 | \$ 31,435 |
| Operating expenses/average assets | 3.08% | 3.08% |
| Efficiency ratio | 63.8% | 60.3% |

As shown in Table 6, first quarter 2007 operating expenses were \$33.9 million, up \$2.5 million or 7.9% from the prior year level. The increase was primarily attributable to incremental operating expenses related to the Elmira and ONB acquisitions (\$0.9 million), annual merit increases (approximately \$0.5 million), higher health and welfare plan costs (\$0.4 million), higher data processing and communication costs (\$0.3 million), higher mortgage servicing rights amortization (\$0.2 million) and an increased level of business development and marketing expense (\$0.1 million). These costs were partially offset by lower occupancy and equipment costs (\$0.2 million) and lower legal and professional fees (\$0.1 million).

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 63.8% for the first quarter, 3.5 percentage points above the comparable quarter of 2006. This resulted from operating expenses (as described above) increasing 7.9% primarily due to the acquisitions of Elmira and ONB, while recurring operating income increased at a slower rate of 2.0% due to flat net interest income quarter over quarter, offset by a \$1.0 million increase in noninterest income excluding security gains. Operating expenses as a percentage of average assets remained level at 3.08%, as operating expenses increased 7.9% while average assets increased 7.8% during the same time period.

Income Taxes

The first quarter effective income tax rate was 24.1%, compared to the 25.0% effective tax rate in the first quarter of 2006. The lower effective tax rate for 2007 was principally a result of a higher 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 \$1.32 billion at the end of the first quarter, an increase of \$88.3 million and \$10.5 million from December 31, 2006 and March 31, 2006, respectively. The book value (excluding unrealized gains) of investments increased \$86.9 million from year-end 2006 and \$7.1 million versus March 31, 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 quarter of 2007, cash flows were reinvested in short-term agency securities. 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 March 31, 2006, the portfolio had a \$9.2 million net unrealized gain, an increase of \$1.4 million and \$3.4 million from the unrealized gain at December 31, 2006 and March 31, 2007, respectively. This fluctuation is indicative of the interest rate movements during the respective time periods and the changes in the size of the portfolio.

Table 7: Investments

| (000 s omitted) | March 31, 2007 | | December 31, 2006 | | March 31, 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 | \$ 127,164 | \$ 124,538 | \$ 127,200 | \$ 124,020 | \$ 127,309 | \$ 122,011 |
| Obligations of state and political subdivisions | 7,345 | 7,373 | 7,242 | 7,257 | 7,445 | 7,419 |
| Other securities | 4,004 | 4,004 | 11,417 | 11,417 | 9,488 | 9,488 |
| Total held-to-maturity portfolio | 138,513 | 135,915 | 145,859 | 142,694 | 144,242 | 138,918 |
| <i>Available-for-Sale Portfolio:</i> | | | | | | |
| U.S. Treasury and Agency securities | 484,354 | 483,805 | 372,706 | 370,787 | 419,808 | 415,366 |
| Obligations of state and political subdivisions | 491,172 | 502,447 | 502,677 | 514,647 | 518,680 | 531,316 |
| Corporate securities | 35,568 | 35,209 | 35,603 | 35,080 | 35,709 | 34,728 |
| Collateralized mortgage obligations | 41,005 | 40,592 | 43,768 | 43,107 | 67,858 | 66,944 |
| Mortgage-backed securities | 74,067 | 73,308 | 76,266 | 75,181 | 78,212 | 77,700 |
| Subtotal | 1,126,166 | 1,135,361 | 1,031,020 | 1,038,802 | 1,120,267 | 1,126,054 |
| Equity securities | 43,680 | 43,680 | 44,610 | 44,610 | 36,745 | 36,745 |
| Total available-for-sale portfolio | 1,169,846 | 1,179,041 | 1,075,630 | 1,083,412 | 1,157,012 | 1,162,799 |
| Net unrealized gain on available-for-sale portfolio | 9,195 | 0 | 7,782 | 0 | 5,787 | 0 |
| Total | \$ 1,317,554 | \$ 1,314,956 | \$ 1,229,271 | \$ 1,226,106 | \$ 1,307,041 | \$ 1,301,717 |

Loans

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

As shown in Table 8, loans ended the first quarter at \$2.68 billion, down \$19.3 million (0.7%) from year-end 2006 and up \$274.0 (11.4%) versus one year earlier. The Elmira and ONB acquisitions added approximately \$237 million of loans to the loan portfolio as of March 31, 2007. Excluding the impact of the Elmira and ONB acquisitions, loans increased \$37.3 million or 1.5% from the first quarter of 2006 with organic growth in all three categories. During the first quarter, excluding the impact of the acquired branches, loans decreased \$13.6 million with decreases in the consumer installment portfolio (\$19.4 million) more than offsetting the increases in business lending portfolio (\$4.7 million) and the consumer mortgage portfolio (\$1.1 million).

Table 8: Loans

| (000 \$ omitted) | March 31, 2007 | | December 31, 2006 | | March 31, 2006 | |
|----------------------|----------------|--------|-------------------|--------|----------------|--------|
| Business lending | \$ 957,853 | 35.7% | \$ 960,034 | 35.5% | \$ 820,722 | 34.1% |
| Consumer mortgage | 914,909 | 34.1% | 912,505 | 33.8% | 814,885 | 33.8% |
| Consumer installment | 809,472 | 30.2% | 829,019 | 30.7% | 772,614 | 32.1% |
| Total loans | \$ 2,682,234 | 100.0% | \$ 2,701,558 | 100.0% | \$ 2,408,221 | 100.0% |

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

Business lending decreased \$2.2 million in the first quarter of 2007 and increased \$137.1 million versus one year ago. Excluding the impact of the Elmira and ONB acquisitions, business lending was up \$4.7 million over the last quarter and \$0.5 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 \$100.0 million, year over year, and \$2.4 million in the first quarter 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 Elmira and ONB acquisitions, consumer mortgages increased \$1.1 million and \$18.7 million for the past three and twelve month periods, respectively. Consumer mortgage growth has remained steady over the last few quarters despite interest rates rising above prior year levels.

Consumer installment loans, including borrowings originated in automobile, marine and recreational vehicle dealerships, as well as branch originated home equity and installment loans, declined \$19.5 million in the first three months of 2007 and increased \$36.9 million on a year-over-year basis. Excluding the impact of the Elmira and ONB acquisitions, consumer installment lending decreased \$19.4 million for the first three months of 2007 and increased \$18.1 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. Consistent with prior years, the first quarter experienced seasonal slowness in consumer lending.

Asset Quality

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

Table 9: Nonperforming Assets

| (000's omitted) | March 31, 2007 | December 31, 2006 | March 31, 2006 |
|--|-------------------|----------------------|-------------------|
| Nonaccrual loans | \$ 9,451 | \$ 10,107 | \$ 12,351 |
| Accruing loans 90+ days delinquent | 1,914 | 1,207 | 1,213 |
| Restructured loans | 1,246 | 1,275 | 1,350 |
| Total nonperforming loans | 12,611 | 12,589 | 14,914 |
| Other real estate (OREO) | 1,916 | 1,838 | 1,613 |
| Total nonperforming assets | \$ 14,527 | \$ 14,427 | \$ 16,527 |
| Allowance for loan losses to total loans | 1.34% | 1.34% | 1.36% |
| Allowance for loan losses to nonperforming loans | 285% | 288% | 219% |
| Nonperforming loans to total loans | 0.47% | 0.47% | 0.62% |
| Nonperforming assets to total loans and other real estate | 0.54% | 0.53% | 0.69% |
| Delinquent loans (30 days old to nonaccruing) to total loans | 1.02% | 1.33% | 1.26% |
| Net charge-offs to average loans outstanding (quarterly) | 0.09% | 0.21% | 0.34% |
| Loan loss provision to net charge-offs (quarterly) | 32% | 101% | 107% |

As displayed in Table 9, nonperforming assets at March 31, 2007 were \$14.5 million, a decrease of \$2.0 million versus one year earlier and a \$0.1 million increase 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 \$0.3 million from one-year ago and increased \$0.1 million from year-end 2006, a result of the Company managing 22 properties at March 31, 2007 as compared to 20 OREO properties at March 31, 2006. No single property has a carrying value in excess of \$300,000.

Nonperforming loans were 0.47% of total loans outstanding at the end of the first quarter, significantly below the 0.62% at March 31, 2006, and consistent with the end of the fourth quarter of 2006. The allowance for loan losses to nonperforming loans ratio, a general measure of coverage adequacy, was 285% at the end of the first quarter compared to 288% at year-end 2006 and 219% at March 31, 2006, reflective of the low level

of nonperforming loans.

Delinquent loans (30 days through nonaccruing) as a percent of total loans was 1.02% at the end of the first quarter, substantially below the 1.33% at year-end 2006 and 1.26% at March 31, 2006. Commercial, real estate and installment loan delinquency ratios at the end of the first quarter improved in comparison to both of the earlier periods. The delinquency level at the end of the current quarter was 30 basis points below the Company's average of 1.32% over the previous eight quarters.

Table 10: Allowance for Loan Losses Activity

| (000 s omitted) | Three Months Ended March 31, | |
|--|---------------------------------|-----------|
| | 2007 | 2006 |
| Allowance for loan losses at beginning of period | \$ 36,313 | \$ 32,581 |
| <i>Charge-offs:</i> | | |
| Business lending | 240 | 1,355 |
| Consumer mortgage | 235 | 35 |
| Consumer installment | 1,161 | 1,625 |
| Total charge-offs | 1,636 | 3,015 |
| <i>Recoveries:</i> | | |
| Business lending | 257 | 114 |
| Consumer mortgage | 1 | 58 |
| Consumer installment | 756 | 832 |
| Total recoveries | 1,014 | 1,004 |
| Net charge-offs | 622 | 2,011 |
| Provision for loans losses | 200 | 2,150 |
| Allowance for loan losses at end of period | \$ 35,891 | \$ 32,720 |
| Net charge-offs to average loans outstanding: | | |
| Business lending | -0.01% | 0.62% |
| Consumer mortgage | 0.10% | -0.01% |
| Consumer installment | 0.20% | 0.42% |
| Total loans | 0.09% | 0.34% |

As displayed in Table 10, net charge-offs during the first quarter were \$0.6 million, \$1.4 million lower than the equivalent 2006 period. The installment and business lending portfolios experienced significant declines in the level of charge-offs, while the consumer mortgage portfolio charge-off ratio increased from a net recovery position in the previous year. The net charge-off ratio (net charge-offs as a percentage of average loans outstanding) for the first quarter was 0.09%, 25 basis points lower than the comparable quarter of 2006, and 19 basis points lower than 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 years. In comparison to the fourth quarter of 2006, total net charge offs declined \$0.8 million and the net charge-off ratio improved by 12 basis points.

The business lending portfolio experienced a net recovery for the quarter, while consumer installment net charge-off ratio decreased by 20 basis points to 0.20% and the consumer mortgage portfolio charge-off ratio increased two basis points to 0.10% versus the linked quarter. For the year-to-date period, the business lending and consumer installment net charge-off ratios improved 63 basis points and 22 basis points, respectively, while the consumer mortgage charge-off ratios was unfavorable by 11 basis points.

A loan loss allowance of \$35.9 million was determined as of March 31, 2007, necessitating a \$0.2 million loan loss provision for the quarter, compared to \$2.2 million one year earlier. The first quarter 2007 loan loss provision was \$0.4 million lower than net charge-offs, as a result of improving asset quality ratios and a reduction in the size of the loan portfolio. The allowance for loan losses rose \$3.2 million or 9.7% over the last 12 months, slightly less than the 11.4% growth in the loan portfolio. Contributing to the changes was the acquired Elmira and ONB loans and reserves, with a combined coverage ratio of 1.25%. Consequently, the ratio of allowance for loan loss to loans outstanding decreased two basis points to 1.34% for the first quarter, as compared to the levels at March 31, 2006 and remained consistent with 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 \$3.2 billion in the first quarter were up \$40.1 million compared to fourth quarter 2006 and increased \$175.3 million versus the same quarter of last year. Excluding the impact of the Elmira and ONB acquisitions, average deposits decreased \$2.9 million as compared to the fourth quarter of 2006 and decreased \$8.4 million as compared to the first quarter of the prior year. The mix of average deposits changed slightly since the first quarter of 2006. The weightings of time deposits and interest checking deposits increased from their first 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 5.4% and 2.4% increases, excluding the impact of the Elmira and ONB acquisitions, as compared to the fourth and first 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 increasing interest rates on money market and time deposit accounts increased the quarterly cost of interest-bearing deposits from 2.19% in the first quarter of 2006 to 2.80% in the most recent quarter.

Average first quarter non-public fund deposits increased \$19.9 million or 0.7% versus the fourth quarter of 2006, and were up \$190.5 million or 6.9% compared to the year earlier period. Average public funds have increased \$20.2 million or 9.9% from the fourth quarter of 2006 and decreased \$15.3 million or 6.4% from the first 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 quarter of 2007.

Table 11: Quarterly Average Deposits

| (000 s omitted) | March 31, 2007 | December 31, 2006 | March 31, 2006 |
|----------------------------|---------------------|----------------------|---------------------|
| Demand deposits | \$ 552,087 | \$ 558,439 | \$ 588,957 |
| Interest checking deposits | 408,573 | 389,336 | 299,637 |
| Savings deposits | 457,177 | 458,320 | 475,970 |
| Money market deposits | 332,433 | 330,150 | 351,109 |
| Time deposits | 1,424,289 | 1,398,235 | 1,283,632 |
| Total deposits | \$ 3,174,559 | \$ 3,134,480 | \$ 2,999,305 |
| Non-public fund deposits | \$ 2,949,201 | \$ 2,929,343 | \$ 2,758,662 |
| Public fund deposits | 225,358 | 205,137 | 240,643 |
| Total deposits | \$ 3,174,559 | \$ 3,134,480 | \$ 2,999,305 |

Borrowings

At the end of the first quarter, borrowings of \$754 million were down \$51.6 million from December 31, 2006 and were up \$167.1 million versus the end of the first quarter of 2006 related to acquisitions and additional trust preferred securities. The reduction in borrowings during the first quarter of 2007 was principally the result of the early redemption of \$30 million of fixed-rate trust preferred securities and the decline in the loan portfolio.

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 March 31, 2007, the Company had repurchased 914,461 shares at an aggregate cost of \$20.8 million.

Total shareholders' equity of \$467 million at the end of the first quarter increased \$5.4 million from the balance at December 31, 2006. This change consisted of net income of \$9.6 million, \$1.7 million from shares issued under the employee stock plan, \$0.6 million from employee stock options earned, and \$0.7 million from the after-tax market value adjustment on the available-for-sale investment portfolio, partially offset by dividends declared of \$6.0 million and treasury stock purchases of \$1.3 million. Over the past 12 months total shareholders' equity increased by \$11.5 million, as net income and positive contributions from shares issued under the employee stock plan and a higher market value adjustment more than offset dividends declared, treasury stock purchases, and a charge for 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 8.29% at the end of the first quarter, down 52 basis points from year-end 2006 and 61 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 and assets from the ONB acquisition being included in the average assets for a full quarter versus only one month of the linked quarter. The increase in Tier I, as compared to the prior year first quarter, is the result of a 16.4% increase in shareholders' equity, excluding intangibles and market value adjustment, combined with a smaller 7.9% 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 5.15% increased eight basis points versus December 31, 2006 as a result of net income generation and relatively flat assets, and decreased 74 basis points versus March 31,

2006 mostly due to the acquisition of 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 three months of 2007 was 62.4%, up from 60.1% for the first quarter of 2006. The ratio increased because dividends declared increased 6.1%, while net income including securities gains increased a lesser 2.1%. 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 54.9% for the first quarter of 2007 as compared to 52.7% for the first quarter 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 March 31, 2007, this ratio was 12.6% for 30 days and 12.4% 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 March 31, 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 March 31, 2007 |
|---------------------------------|---|
| + 200 basis points | 0.4% |
| - 100 basis points | (0.9%) |

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 ensure that it is able to collect the information it is required to disclose in the reports that are filed with the Securities and Exchange Commission (SEC), and to process, summarize and disclose this information within the time periods specified in the rules of the SEC. 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 March 31, 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 first 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 |
|---------------|----------------------------------|------------------------------------|--|--|
| January 2007 | | \$ | 853,161 | 1,546,839 |
| February 2007 | | | 853,161 | 1,546,839 |
| March 2007 | 61,300 | (20.42) | 914,461 | 1,485,539 |
| Total | 61,300 | \$ (20.42) | 914,461 | 1,485,539 |

Item 3. Defaults Upon Senior Securities

Not applicable.

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

There were no matters submitted to a vote of the shareholders during the quarter ending March 31, 2007.

Item 5. Other Information

Not applicable

Item 6. Exhibits

| <u>Exhibit No.</u> | <u>Description</u> |
|--------------------|--|
| <u>10.1</u> | <u>Supplemental Retirement Plan Agreement, by and between Community Bank System Inc. and Mark E. Tryniski.</u> |
| <u>31.1</u> | <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> |
| <u>31.2</u> | <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> |
| <u>32.1</u> | <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> |
| <u>32.2</u> | <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: May 8, 2007

/s/ Mark E. Tryniski

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

Date: May 8, 2007

/s/ Scott Kingsley

Scott Kingsley, Treasurer and Chief
Financial Officer