COMMUNITY BANK SYSTEM INC
Form 10-Q
August 07, 2008

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 June 30, 2008

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 XNo

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer or a smaller reporting company. See definitions of “large accelerated filer”, “accelerated filer”, and “smaller reporting company” in Rule 12b-2 of the Exchange Act.

Large accelerated filer	Accelerated filer	X	Non-accelerated filer	Smaller reporting company	.

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

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

29,934,709 shares of Common Stock, $1.00 par value, were outstanding on July 31, 2008.

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Part I. Financial Information
Item 1. Financial Statements

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

	(Unaudited) June 30, 2008	December 31, 2007
Cash and cash equivalents	$123,233	$130,823
Available-for-sale investment securities, at fair value	1,120,625	1,254,622
Held-to-maturity investment securities	138,167	137,250
Total investment securities (fair value of $1,258,673 and $1,392,281, respectively)	1,258,792	1,391,872
Loans	2,922,243	2,821,055
Allowance for loan losses	(37,128)	(36,427)
Net loans	2,885,115	2,784,628
Core deposit intangibles, net	16,926	19,765
Goodwill	234,686	234,449
Other intangibles, net	2,140	2,002
Intangible assets, net	253,752	256,216
Premises and equipment, net	69,556	69,685
Accrued interest receivable	23,654	25,531
Other assets	43,681	38,747
Total assets	$4,657,783	$4,697,502
Liabilities:		
Noninterest-bearing deposits	$584,752	$584,921
Interest-bearing deposits	2,662,596	2,643,543
Total deposits	3,247,348	3,228,464
Borrowings	772,646	801,604
Subordinated debt held by unconsolidated subsidiary trusts	101,963	127,724
Accrued interest and other liabilities	52,178	60,926
Total liabilities	4,174,135	4,218,718
Commitment and contingencies (See Note H)		
Shareholders' equity:		
Preferred stock $1.00 par value, 500,000 shares authorized, 0 shares issued	-	-
Common stock, $1.00 par value, 50,000,000 shares authorized;	33,300	33,000
33,299,520 and 32,999,544 shares issued in 2008 and 2007, respectively		
Additional paid-in capital	213,970	208,429

Retained earnings	319,927	310,281
Accumulated other comprehensive (loss) income	(9,921)	702
Treasury stock, at cost (3,364,811 and 3,364,811 shares, respectively)	(73,628)	(73,628)
Total shareholders' equity	483,648	478,784
Total liabilities and shareholders' equity	$4,657,783	$4,697,502

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,	
	2008	2007	2008	2007
Interest income:				
Interest and fees on loans	$45,691	$46,090	$92,206	$91,025
Interest and dividends on taxable investments	9,635	11,839	20,349	22,942
Interest and dividends on nontaxable investments	5,744	5,327	11,666	10,847
Total interest income	61,070	63,256	124,221	124,814
Interest expense:				
Interest on deposits	16,039	20,092	33,733	38,212
Interest on borrowings	7,882	7,388	15,923	14,893
Interest on subordinated debt held by unconsolidated subsidiary trusts	1,709	2,438	3,527	5,004
Total interest expense	25,630	29,918	53,183	58,109
Net interest income	35,440	33,338	71,038	66,705
Less: provision for loan losses	1,570	414	2,350	614
Net interest income after provision for loan losses	33,870	32,924	68,688	66,091
Noninterest income:				
Deposit service fees	8,910	7,825	17,171	14,802
Other banking services	539	425	1,134	1,095
Benefit plan administration, consulting and actuarial fees	5,933	4,767	12,245	8,739
Wealth management services	2,324	2,009	4,487	3,869
(Loss)/gain on sales of investment securities	(57)	(8)	230	(8)
Total noninterest income	17,649	15,018	35,267	28,497
Operating expenses:				
Salaries and employee benefits	19,772	18,386	40,158	36,672
Occupancy and equipment	5,189	4,559	10,762	9,225
Data processing and communications	4,100	3,808	8,085	7,373
Amortization of intangible assets	1,645	1,581	3,176	3,096
Legal and professional fees	902	1,054	2,200	2,241
Office supplies and postage	1,237	1,008	2,515	2,054
Business development and marketing	1,507	1,538	2,829	2,488
Other	2,603	2,198	5,604	4,902
Total operating expenses	36,955	34,132	75,329	68,051
Income before income taxes	14,564	13,810	28,626	26,537
Income taxes	3,277	3,451	6,441	6,522
Net income	$11,287	$10,359	$22,185	$20,015
Basic earnings per share	$0.38	$0.34	$0.74	$0.66
Diluted earnings per share	$0.37	$0.34	$0.74	$0.66
Dividends declared per share	$0.21	$0.20	$0.42	$0.40

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, 2008
(In Thousands, Except Share Data)

	Common Stock Shares Outstanding	Amount Issued	Additional Paid-in Capital	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Treasury Stock	Total
Balance at December 31, 2007	29,634,733	$33,000	$208,429	$310,281	$702	($73,628)	$478,784
Net income				22,185			22,185
Other comprehensive loss, net of tax					(10,623)		(10,623)
Dividends declared:							
Common, $0.42 per share				(12,539)			(12,539)
Common stock issued under Stock plan, including tax benefits of $410	299,976	300	4,431				4,731
Stock options earned			1,110				1,110
Balance at June 30, 2008	29,934,709	$33,300	$213,970	$319,927	($9,921)	($73,628)	$483,648

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,	
	2008	2007	2008	2007
Change in pension liability	$200	$0	$55	($50)
Change in unrealized loss on derivative instruments used in cash flow hedging relationship	2,832	1,414	73	991
Unrealized gain (loss) on securities:				
Unrealized holding loss arising during period	(21,281)	(13,476)	(17,001)	(12,063)
Reclassification adjustment for (gains) losses included in net income	57	8	(230)	8
Other comprehensive loss, before tax	(18,192)	(12,054)	(17,103)	(11,114)
Income tax benefit related to other comprehensive loss	6,873	4,438	6,480	4,201
Other comprehensive loss, net of tax:	(11,319)	(7,616)	(10,623)	(6,913)
Net income	11,287	10,359	22,185	20,015
Comprehensive (loss) income	($32)	$2,743	$11,562	$13,102

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, 2008	2007
Operating activities:		
Net income	$22,185	$20,015
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation	4,698	4,601
Amortization of intangible assets	3,176	3,096
Net accretion of premiums and discounts on securities and loans	(406)	(2,176)
Amortization of unearned compensation and discount on subordinated debt	283	199
Provision for loan losses	2,350	614
(Gain) loss on investment securities and debt extinguishments	(230)	8
Loss (Gain) on sale of loans and other assets	26	(64)
Proceeds from the sale of loans held for sale	1,120	5,276
Origination of loans held for sale	(1,115)	(5,238)
Excess tax benefits from share-based payment arrangements	(379)	(129)
Change in other operating assets and liabilities	(4,489)	(5,789)
Net cash provided by operating activities	27,219	20,413
Investing activities:		
Proceeds from sales of available-for-sale investment securities	31,344	5,478
Proceeds from maturities of held-to-maturity investment securities	2,859	11,153
Proceeds from maturities of available-for-sale investment securities	219,644	269,235
Purchases of held-to-maturity investment securities	(3,849)	(1,790)
Purchases of available-for-sale investment securities	(133,515)	(258,056)
Net increase in loans outstanding	(102,835)	(11,043)
Cash paid for acquisition (net of cash acquired of $0 and $9,181)	(479)	(11,613)
Expenditure for intangibles	(322)	0
Capital expenditures	(5,266)	(4,849)
Net cash provided by (used in) investing activities	7,581	(1,485)
Financing activities:		
Net change in non-interest checking, interest checking and savings accounts	80,824	22,549
Net change in time deposits	(61,940)	89,727
Net change in short-term borrowings	(38,556)	(73,720)
Change in long-term borrowings (net of payments of $402 and $866)	9,598	(915)
Payment on subordinated debt held by unconsolidated subsidiary trusts	(25,773)	(30,929)
Issuance of common stock	5,570	2,685
Purchase of treasury stock	0	(6,059)
Cash dividends paid	(12,492)	(12,017)
Tax benefits from share-based payment arrangements	379	129
Net cash used in financing activities	(42,390)	(8,550)
Change in cash and cash equivalents	(7,590)	10,378
Cash and cash equivalents at beginning of period	130,823	232,032
Cash and cash equivalents at end of period	$123,233	$242,410
Supplemental disclosures of cash flow information:		
Cash paid for interest	$53,799	$57,666
Cash paid for income taxes	6,316	3,575
Supplemental disclosures of noncash financing and investing activities:		

Dividends declared and unpaid	6,286	5,976
Gross change in unrealized gain on available-for-sale investment securities	(17,231)	(12,055)

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, 2008

NOTE A: BASIS OF PRESENTATION

The interim financial data as of June 30, 2008 and for the three and six months ended June 30, 2008 and 2007 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

Alliance Benefit Group MidAtantic
On July 7, 2008, Benefit Plans Administrative Services, Inc. (BPAS), a wholly owned subsidiary of the Company, completed its acquisition of the Philadelphia division of Alliance Benefit Group MidAtlantic (ABG) from BenefitStreet, Inc. ABG provides retirement plan consulting, daily valuation administration, actuarial and ancillary support services.

Citizens Branch Acquisition
On June 25, 2008, the Company announced an agreement to acquire 18 branch-banking centers in northern New York State from Citizens Financial Group, Inc. (Citizens) in an all cash transaction. Under the terms of the agreement, the company will acquire approximately $135 million in loans and $630 million in deposits at a blended deposit premium of 12%. The acquisition is expected to close during the fourth quarter of 2008, pending customary regulatory approvals. In support of the transaction, the Company expects to issue approximately $30 million of equity capital prior to its completion.

Hand Benefits & Trust, Inc.
On May 18, 2007, 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 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 $17.8 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.

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, 2008, the Company has repurchased, pursuant to the program, 1,464,811 shares at an aggregate cost of $31.5 million and an average price per share of $21.51. 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

SFAS No. 141(R)
In December 2007, the FASB issued SFAS No. 141(R), Business Combinations. This statement provides new accounting guidance and disclosure requirements for business combinations. The Company will be required to apply SFAS No. 141(R) to all business combinations completed on or after January 1, 2009. The Company is currently assessing the effect of SFAS No. 141(R) on its financial statements.

SFAS No. 160
In December 2007, the FASB issued SFAS No. 160, Noncontrolling Interests in Consolidated Financial Statements – an amendment of ARB No. 51. This statement provides new accounting guidance and disclosure and presentation requirements for noncontrolling interests in a subsidiary. SFAS No. 160 is effective for fiscal years beginning on or after December 15, 2008. The Company is currently assessing the effect of SFAS No. 160 on its financial statements.

SFAS No. 161
In March 2008, the FASB issued SFAS No. 161, Disclosures About Derivative Instruments and Hedging Activities – an amendment of FASB Statement No. 133. This statement expands quarterly disclosure requirements in SFAS No. 133 about an entity's derivative instruments and hedging activities. SFAS No. 161 is effective for fiscal years beginning on or after November 15, 2008. The Company is currently assessing the effect of SFAS No. 161 on its financial statements.

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 restricted stock and 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 (those where the 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 1.1 million anti-dilutive stock options outstanding at June 30, 2008 compared to approximately 1.7 million weighted-average anti-dilutive stock options outstanding at June 30, 2007 that were not included in the computation below. The following is a reconciliation of basic to diluted earnings per share for the three and six months ended June 30, 2008 and 2007.

(000's omitted, except per share data)	Income	Shares	Per Share Amount
Three Months Ended June 30, 2008			
Basic EPS	$11,287	29,885	$ 0.38
Stock options and restricted stock		395	
Diluted EPS	$11,287	30,280	$ 0.37
Three Months Ended June 30, 2007			
Basic EPS	$10,359	30,087	$ 0.34
Stock options and restricted stock		309	
Diluted EPS	$10,359	30,396	$ 0.34
Six Months Ended June 30, 2008			
Basic EPS	$22,185	29,802	$ 0.74
Stock options and restricted stock		352	
Diluted EPS	$22,185	30,154	$ 0.74
Six Months Ended June 30, 2007			
Basic EPS	$20,015	30,139	$ 0.66
Stock options and restricted stock		332	
Diluted EPS	$20,015	30,471	$ 0.66

NOTE E: INTANGIBLE ASSETS

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

	As of June 30, 2008			As of December 31, 2007		
(000's omitted)	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount

Amortizing intangible assets:						
Core deposit intangibles	$66,368	$(49,442)	$16,926	$66,368	($46,603)	$19,765
Other intangibles	4,290	(2,150)	2,140	3,923	(1,921)	2,002
Total amortizing intangibles	70,658	(51,592)	19,066	70,291	(48,524)	21,767
Non-amortizing intangible assets:						
Goodwill	234,686	0	234,686	234,449	0	234,449
Total intangible assets, net	$305,344	$(51,592)	$253,752	$304,740	($48,524)	$256,216

No goodwill impairment adjustments were recognized in 2008 or 2007. The estimated aggregate amortization expense for each of the succeeding fiscal years ended December 31 is as follows:

(000's omitted)	Amount
July-Dec 2008	$3,086
2009	5,607
2010	3,624
2011	1,481
2012	1,221
Thereafter	4,047
Total	$19,066

NOTE F: MANDATORILY REDEEMABLE PREFERRED SECURITIES

The Company sponsors two business trusts, Community Statutory Trust III and Community Capital Trust IV (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
III	7/31/2001	$24.5 million	3 month LIBOR plus 3.58% (6.48%)	7/31/2031	5 year beginning 2006	106.00% declining to par in 2011
IV	12/8/2006	$75 million	3 month LIBOR plus 1.65% (4.43%)	12/15/2036	5 year beginning 2012	Par

The Company also entered into an interest rate swap agreement on December 8, 2006 to convert Trust IV's variable rate trust preferred securities into a fixed rate security for a term of five years at a fixed rate of 6.43%. Additional interest expense of $377,000 was recognized for the interest rate swap agreement for the six months ended June 30, 2008.

NOTE G: BENEFIT PLANS

The Company provides defined benefit pension benefits and post-retirement health and life insurance benefits to eligible employees. The Company also provides supplemental pension retirement benefits for several current and former key employees. No contributions in 2008 are required for regulatory purposes. 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:

Pension Benefits		Post-retirement Benefits	
Three Months Ended	Six months Ended	Three Months	Six months

					Ended		Ended	
	June 30,		June 30,		June 30,		June 30,	
(000's omitted)	2008	2007	2008	2007	2008	2007	2008	2007
Service cost	$780	$763	$1,559	$1,526	$175	$148	$350	$296
Interest cost	819	678	1,638	1,357	150	131	300	261
Expected return on plan assets	(1,118)	(1,007)	(2,235)	(2,014)	0	0	0	0
Net amortization and deferral	165	248	330	494	25	29	50	59
Amortization of prior service cost	(27)	(23)	(55)	(46)	28	28	55	55
Amortization of transition obligation	0	0	0	0	10	10	20	21
Net periodic benefit cost	$619	$659	$1,237	$1,317	$388	$346	$775	$692

During the third quarter, the Company expects to make a contribution to its defined benefit pension plan of $9.6 million. No additional contributions in 2008 are required for regulatory purposes.

NOTE H: COMMITMENTS, CONTINGENT LIABILITIES AND RESTRICTIONS

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

The contract amount of commitment and contingencies are as follows:

(000's omitted)	June 30, 2008	December 31, 2007
Commitments to extend credit	$503,230	$482,517
Standby letters of credit	11,527	10,121
Total	$514,757	$492,638

NOTE I: FAIR VALUE

Effective January 1, 2008, the Company adopted SFAS No. 157, Fair Value Measurements (SFAS 157) and SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities (SFAS 159). SFAS 159 allows entities an irrevocable option to measure certain 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. The implementation of this standard did not have a material impact on the Company's consolidated financial position or results of operations.

SFAS 157 establishes a common definition for fair value to be applied to generally accepted accounting principals requiring the use of fair value, establishes a framework for measuring fair value and expands disclosure about such fair value instruments. It defines fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date (exit price). It also classifies the inputs used to measure fair value into the following hierarchy:

- Level 1 – Quoted prices in active markets for identical assets or liabilities.
- Level 2 – Quoted prices in active markets for similar assets or liabilities, or quoted prices for identical or similar assets or liabilities in markets that are not active, or inputs other than quoted prices that are observable for the asset or liability.
- Level 3 – Significant valuation assumptions not readily observable in a market.

A financial instrument's categorization within the valuation hierarchy is based upon the lowest level of input that is significant to the fair value measurement. The following tables set forth the Company's financial assets and liabilities that were accounted for at fair value on a recurring basis as of June 30, 2008:

(000's omitted)	Level 2	Level 3

	Level 1			Total Fair Value
Available-for-sale investment securities	$1,049	$1,007,250	$63,144	$1,071,443
Derivative assets/(liabilities), net	-	(2,171)	-	(2,171)
Total	$1,049	$1,005,079	$63,144	$1,069,272

The valuation techniques used to measure fair value for the items in the table above are as follows:

- Available for sale investment securities – The fair value of available for sale investment securities is based upon quoted prices, if available. If quoted prices are not available, fair values are measured using quoted market prices for similar securities or model-based valuation techniques. Level 1 securities include U.S. Treasury securities that are traded by dealers or brokers in active over-the-counter markets. Level 2 securities include mortgage-backed securities issued by government sponsored entities, municipal securities and corporate debt securities. Securities classified as Level 3 include asset-backed securities in less liquid markets. The value of these instruments is determined using pricing models or similar techniques as well as significant judgment or estimation.
- Derivative assets and liabilities – The fair value of derivative instruments traded in over-the-counter markets where quoted market prices are not readily available, are measured using models for which the significant assumptions such as yield curves and option volatilities are market observable.

The changes in Level 3 assets measured at fair value on a recurring basis are summarized in the following table:

(000's omitted)	AFS investments
Balance at April 1, 2008	$69,584
Total gains (losses) included in earnings (a)	18
Total gains (losses) included in other comprehensive income	(6,353)
Purchases	34
Sales/calls	(139)
Transfers	0
Balance at June 30, 2008	$63,144

(000's omitted)	AFS investments
Balance at January 1, 2008	$73,442
Total gains (losses) included in earnings (a)	24
Total gains (losses) included in other comprehensive income	(10,149)
Purchases	34
Sales/calls	(207)
Transfers	0
Balance at June 30, 2008	$63,144

(a) Included in gain (loss) on sales of investment securities and relate to securities still held at June 30, 2008.

Loans are generally not recorded at fair value on a recurring basis. Periodically, the Company records nonrecurring adjustments to the carrying value of loans based on fair value measurements for partial charge-offs of the uncollectible portions of those loans. Nonrecurring adjustments also include certain impairment amounts for collateral-dependent loans calculated in accordance with SFAS No. 114, “Accounting by Creditors for Impairment of a Loan,” when establishing the allowance for credit losses. Such amounts are generally based on the fair value of the underlying collateral supporting the loan and, as a result, the carrying value of the loan less the calculated valuation amount does not necessarily represent the fair value of the loan. Real estate collateral is typically valued using independent appraisals or other indications of value based on recent comparable sales of similar properties or assumptions generally observable in the marketplace and the related nonrecurring fair value measurement adjustments have generally been classified as Level 2. Estimates of fair value used for other collateral supporting commercial loans generally are based on assumptions not observable in the marketplace and therefore such valuations have been classified as Level 3. Loans subject to nonrecurring fair value measurement had a gross carrying amount of $1,994,000, with an associated valuation allowance of $567,000 for a fair value of $1,427,000 at June 30, 2008. These loans were classified as a Level 3 valuation.

NOTE J: SEGMENT INFORMATION

Statement of Financial Accounting Standards No. 131 (SFAS 131), Disclosures about Segments of an Enterprise and Related Information has established standards for public companies relating to the reporting of financial and descriptive information about their operating segments in financial statements. Operating segments are components of an enterprise, which are evaluated regularly by the chief operating decision maker in deciding how to allocate resources and assess performance. The Company’s chief operating decision maker is the President and Chief Executive Officer of the Company.

The Company has identified "Banking" as its reportable operating business segment. The Banking segment provides full-service banking to consumers, businesses and governmental units in northern, central and western New York as well as Northeastern Pennsylvania.

Immaterial operating segments of the Company's operations, which do not have similar characteristics to the banking segment and do not meet the quantitative thresholds requiring disclosure, are included in the "Other" category. Revenues derived from these segments includes administration, consulting and actuarial services provided to sponsors of employee benefit plans, broker-dealer and investment advisory services, asset management services to individuals, corporate pension and profit sharing plans, trust services and insurance commissions from various insurance related products and services. The accounting policies used in the disclosure of business segments are the same as those described in the summary of significant accounting policies (See Note A, Summary of Significant Accounting Policies of the most recent Form 10-K for the year ended December 31, 2007).

Information about reportable segments and reconciliation of the information to the consolidated financial statements follows:

	For the Three Months Ended					
	June 30, 2008			June 30, 2007		
(000's omitted)	Banking	Other	Consolidated Total	Banking	Other	Consolidated Total
Net interest income	$35,393	$47	$35,440	$33,208	$130	$33,338
Provision for loan losses	1,570	0	1,570	414	0	414
Noninterest income excluding loss on investment securities and debt extinguishments	8,927	8,779	17,706	7,696	7,330	15,026
Loss on investment securities	(57)	0	(57)	(8)	0	(8)
Amortization of intangible assets	1,535	110	1,645	1,496	85	1,581
Other operating expenses	28,586	6,724	35,310	27,173	5,378	32,551
Income before income taxes	$12,572	$1,992	$14,564	$11,813	$1,997	$13,810

	For the Six Months Ended					
	June 30, 2008			June 30, 2007		
	Banking	Other	Consolidated Total	Banking	Other	Consolidated Total
Net interest income	$70,908	$130	$71,038	$66,448	$257	$66,705
Provision for loan losses	2,350	0	2,350	614	0	614
Noninterest income excluding loss on investment securities and debt extinguishments	17,393	17,644	35,037	14,864	13,641	28,505
Gain/(Loss) on investment securities	230	0	230	(8)	0	(8)
Amortization of intangible assets	2,956	220	3,176	2,941	155	3,096
Other operating expenses	58,456	13,697	72,153	54,643	10,312	64,955
Income before income taxes	$24,769	$3,857	$ 28,626	$23,106	$3,431	$26,537
Assets	$4,621,743	$36,040	$4,657,783	$4,548,958	$34,191	$4,583,149
Goodwill	$221,322	$13,364	$234,686	$220,770	$12,449	$233,219

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, 2008 and 2007, although in some circumstances the first quarter of 2008 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 14. 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 2008, "second quarter" refers to the quarter ended June 30, 2008, 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 29.

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, among other things, 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, 2007) filed with the Securities and Exchange Commission on March 13, 2008.

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 July 7, 2008, Benefit Plans Administrative Services, Inc. (BPAS) completed its acquisition of the Philadelphia division of Alliance Benefit Group MidAtlantic (ABG) from BenefitStreet, Inc. ABG provides retirement plan consulting, daily valuation administration, actuarial and ancillary support services. This transaction, which is expected to add approximately $5.0 million in annual revenues, adds valuable capacity to support BPAS's growing customer base of more than 300 actuarial engagements, administration of over 200,000 defined contribution and flexible spending participant accounts and of nearly $4.0 billion in retirement plan assets.

On June 25, 2008, the Company announced an agreement to acquire 18 branch-banking centers in northern New York State from Citizens Financial Group, Inc. (Citizens) in an all cash transaction. Under the terms of the agreement, the company will acquire approximately $135 million in loans and $630 million in deposits at a blended deposit premium of 12%. This acquisition is expected to close during the fourth quarter of 2008, pending customary regulatory approvals. In support of the transaction, the Company expects to issue approximately $30 million of equity capital prior to its completion. Excluding one-time expenses, the transaction is expected to be immediately accretive to earnings per share, inclusive of the impact of the additional equity issuance.

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 $17.8 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, the Company's subsidiary, 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.

Second quarter and June year-to-date 2008 earnings per share were $0.37 and $0.74, respectively, an increase of $0.03 and $0.08 as compared to the respective prior year periods. The increase was driven by solid organic loan growth, continued expansion of non-interest income sources, improved net interest margin and favorable asset quality results. These were partially offset by a higher provision for loan loss and increased 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 $0.42 versus $0.39 for the prior year's second quarter and $0.83 versus $0.75 for the prior year-to-date period.

Asset quality in the second quarter of 2008 remained favorable in the first half of the year and was relatively consistent with the same period last year. Net charge-offs and nonperforming loan and total delinquent loan ratios increased, but remained well below average historical quarterly levels. The Company experienced solid year-over-year organic loan growth in all portfolios: consumer installment, consumer mortgage and business lending. The investment portfolio increased as compared to the second quarter of 2007 and decreased as compared to December 31, 2007. Average deposits increased in the second quarter of 2008 as compared to the first quarter of 2008 and declined from the second quarter of 2007. These changes supported the Company's objective of lowering its overall funding costs by reducing higher cost time deposits, and focusing on expanding core account relationships. External borrowings decreased from the end of December 2007 due to the redemption of $25 million of variable-rate trust preferred securities in the beginning of the first quarter of 2008 and lower funding needs due to the reduction of the investment portfolio and cash equivalent balances. Additionally, in December 2007, the Company refinanced $150 million of its fixed rate Federal Home Loan Bank (FHLB) advances, replacing them with lower cost instruments with similar remaining duration. These restructuring strategies had a positive impact on the Company's net interest margin in the first half of 2008.

Net Income and Profitability

As shown in Table 1, earnings per share for the second quarter and June YTD of $0.37 and $0.74, respectively, were $0.03 and $0.08 higher than the EPS generated in the same periods of last year. Net income for the quarter of $11.3 million was up 9.0% over the second quarter of 2007 and net income of $22.2 million for the first six months of 2008 increased 10.8% from the amount earned in the first half of 2007. As compared to the first quarter of 2008, net income increased $0.4 million or 3.6% and earnings per share increased $0.01 or 2.8%.

Second quarter net interest income of $35.4 million was up $2.1 million or 6.3% from the comparable prior year period, and net interest income for the first six months of 2008 increased $4.3 million or 6.5% over the first half of 2007. The current quarter's provision for loan losses increased $1.2 million as compared to the second quarter of 2007 and increased $1.7 million for the first six months of 2008 as compared to the same period of 2007, reflective of organic loan growth in the quarter. Second quarter noninterest income, excluding securities gains and losses, was $17.7 million, up $2.7 million or 18% from the second quarter of 2007, while YTD noninterest income of $35.0 million increased $6.5 million or 23% from the prior year level. Operating expenses of $37.0 million for the quarter and $68.1 million for the first six months of 2008 were up $2.8 million or 8.3% and $7.3 million or 10.7% respectively, from the comparable prior year periods. A significant portion of the increase was attributable to the acquisitions of TLNB and HBT during the second quarter of 2007.

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 impact of acquisition activity on reported results. Cash earnings per share for the second quarter and the first six months of 2008 were $0.42 and $0.83, respectively, up 7.7% and 10.7% from the $0.39 and $0.75 earned in the comparable periods of 2007.

As reflected in Table 1, the primary reasons for improved earnings over the prior year were higher noninterest income and net interest income, partially offset by higher operating expenses and loan loss provision. Net interest income for the second quarter and year-to-date period increased as compared to the comparable periods of 2007 as a result of higher net interest margins as well as acquired and organic loan growth. Excluding security gains and losses, noninterest income increased due to a strong performance by the Company's employee benefits consulting and plan administration business, as a result of significant organic growth and the acquisition of HBT, as well as higher banking service fees, including account fees and debit card related revenues. An increase in total loans and higher net charge-offs were the primary reasons for the increase in the loan loss provision. Operating expenses increased for the quarter and year-to-date periods, primarily due to costs associated with the two acquisitions in the last year, as well as higher business development and volume-based processing costs, increased facility-based utilities and maintenance costs, and higher personnel expenses. As compared to the first quarter of 2008, operating expenses decreased $1.4 million or 3.7%, reflective of seasonally lower occupancy, professional and personnel-related costs.

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

Table 1: Summary Income Statements

	Three Months Ended June 30,		Six Months Ended June 30,	
(000's omitted, except per share data)	2008	2007	2008	2007
Net interest income	$35,440	$33,338	$71,038	$66,705
Provision for loan losses	1,570	414	2,350	614

Noninterest income excluding security losses	17,706	15,026	35,037	28,505
(Loss) gain on sales of investment securities	(57)	(8)	230	(8)
Operating expenses	36,955	34,132	75,329	68,051
Income before taxes	14,564	13,810	28,626	26,537
Income taxes	3,277	3,451	6,441	6,522
Net income	$11,287	$10,359	$22,185	$20,015
Diluted earnings per share	$0.37	$0.34	$0.74	$0.66

Table 2: Reconciliation of GAAP Net Income to Cash Net Income (Non-GAAP measure)

	Three Months Ended June 30,		Six Months Ended June 30,	
(000's omitted)	2008	2007	2008	2007
Net income	$11,287	$10,359	$22,185	$20,015
After-tax cash adjustments:				
Amortization of market value adjustments on net assets acquired in mergers	149	175	305	354
Amortization of intangible assets	1,274	1,185	2,461	2,335
Net income – cash	$12,710	$11,719	$24,951	$22,704
Diluted earnings per share – cash	$0.42	$0.39	$0.83	$0.75

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 the second quarter of 2008 was $39.2 million, a $2.1 million increase from the same period last year. A $90.4 million increase in interest-earning assets and a 14 basis point increase in the net interest margin versus the prior year offset a $73.7 million increase in average interest-bearing liabilities. As reflected in Table 4, the rate decreases from interest bearing liabilities and the volume increases in interest earning assets had a $6.4 million favorable impact on net interest income, while the decrease in rate on interest bearing assets and higher interest bearing liability balances had a $4.3 million unfavorable impact on net interest income. June 2008 YTD net interest income of $78.7 million increased $4.4 million or 6.0% from the year earlier period. A $116.8 million increase in interest bearing assets and a 10 basis point increase in the net interest margin more than offset a $110.3 million increase in interest bearing liabilities. The increase in interest earning assets and the lower rate on interest bearing liabilities had a $10.5 million favorable impact that was partially offset by a $6.1 million unfavorable impact from the decrease in rate on interest bearing assets and the increase in interest bearing liability balances.

Higher second quarter and June YTD average loan balances were attributable to $119.3 million of quarterly average organic loan growth since the second quarter of 2007, driven by growth in all portfolios: consumer installment, consumer mortgage and business lending. The remaining contribution to the increase in the average second quarter loan balance was the $38.0 million of loan growth due to the TLNB acquisition. Average investments and cash equivalents for the second quarter and YTD periods were $66.9 million and $30.6 million lower than the respective periods of 2007, primarily due to cash flows from maturing investments being used to fund loan growth. In comparison to the prior year, total average deposits declined $45.9 million or 1.4% and $2.7 million or 0.1% for the quarter and YTD periods, respectively. Consistent with the Company's objectives, core deposit products increased $97 million or 5.5% since the second quarter of 2007, while time deposits were allowed to decline $142 million during the same timeframe. Quarterly average deposits from the TLNB acquisition were $68 million, an increase of $41.9 million from the second quarter of 2007. Quarterly and YTD average borrowings increased $125.4 million and

$117.9 million as compared to the second quarter and first six months of 2007, respectively, primarily due to the all-cash acquisitions of TLNB and HBT, partially offset by the redemption of $25 million of fixed rate trust preferred securities in the first quarter of 2008.

The net interest margin of 3.78% for the second quarter and 3.79% for the year to date period increased 14 basis points and 10 basis points, respectively, versus the same periods in the prior year. The improvement was primarily attributable to a 48 basis point and a 33 basis point decrease in the cost of funds for the quarter and year-to-date periods, respectively, as compared to the prior year periods. The decrease in the cost of funds is due to a 54 basis point and 34 basis point decrease in the rate paid on interest bearing deposits for the second quarter and YTD periods, respectively, and the restructuring of $175 million of external borrowings that were replaced with lower cost instruments in late 2007 and early 2008. Partially offsetting these improvements was a 33 basis point and 23 basis point decline in earning assets yields for the quarter and YTD periods, respectively, as compared to the comparable periods of 2007. The change in earning-asset yields was driven by a 41 basis point and 29 basis point decrease in loan yields for the quarter and YTD periods, respectively, and a 21 basis point and 12 basis point decline in the investment yields for the quarter and YTD periods, respectively, mostly as a result of variable and adjustable-rate assets repricing downward due to the decline in short-term fed funds and other indexed rates.

The second quarter cost of funds decreased 48 basis points versus the prior year's quarter due to an 86 basis point decrease in the average interest rate paid on external borrowings and a 54 basis point decrease on interest-bearing deposits rates. The decrease in the external borrowing rate is due to the restructuring of $150 million of FHLB advances in December 2007 and the redemption of $25 million of variable rate, trust-preferred securities in January 2008. Additionally, the long-term rate was impacted by the approximately 250 basis point decrease in the three 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. Interest rates on selected categories of deposit accounts were lowered throughout the second half of 2007 and the first half of 2008 in response to market conditions. Additionally, the proportion of customer deposits in higher cost time deposits has declined 3.6 percentage points over the last twelve months, while the percentage of deposits in lower cost checking and savings accounts increased.

Tables 3a and 3b below set forth information related to average interest-earning assets and interest-bearing liabilities and their associated yields and rates for the periods indicated. Interest income and yields are on a fully tax-equivalent basis using marginal income tax rates of 38.49% in 2008 and 38.75% in 2007. 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, 2008			Three Months Ended June 30, 2007		
	Average Balance	Interest	Avg. Yield/Rate Paid	Average Balance	Interest	Avg. Yield/Rate Paid
Interest-earning assets:						
Cash equivalents	$29,138	$140	1.93%	$87,554	$1,148	5.26%
Taxable investment securities (1)	750,820	9,775	5.24%	797,807	11,214	5.64%
Nontaxable investment securities (1)	524,454	9,063	6.95%	485,922	8,355	6.90%
Loans (net of unearned discount)	2,869,338	45,837	6.43%	2,712,021	46,262	6.84%
Total interest-earning assets	4,173,750	64,815	6.25%	4,083,304	66,979	6.58%
Noninterest-earning assets	466,196			453,044		
Total assets	$4,639,946			$4,536,348		
Interest-bearing liabilities:						
Interest checking, savings and money market deposits	$1,304,146	2,519	0.78%	$1,213,419	3,435	1.14%
Time deposits	1,362,278	13,520	3.99%	1,504,716	16,657	4.44%
Short-term borrowings	420,392	4,258	4.07%	154,799	1,622	4.20%
Long-term borrowings	449,474	5,333	4.77%	589,686	8,204	5.58%
Total interest-bearing liabilities	3,536,290	25,630	2.92%	3,462,620	29,918	3.47%
Noninterest-bearing liabilities:						
Demand deposits	563,045			557,195		
Other liabilities	51,167			50,881		
Shareholders' equity	489,444			465,652		
Total liabilities and shareholders' equity	$4,639,946			$4,536,348		
Net interest earnings		$39,185			$37,061	
Net interest spread			3.33%			3.11%
Net interest margin on interest-earnings assets			3.78%			3.64%

Fully tax-equivalent adjustment	$3,745	$3,723

(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's omitted except yields and rates)	Six Months Ended June 30, 2008			Six Months Ended June 30, 2007		
	Average Balance	Interest	Avg. Yield/Rate Paid	Average Balance	Interest	Avg. Yield/Rate Paid
Interest-earning assets:						
Cash equivalents	$36,933	$458	2.49%	$95,012	$2,478	5.26%
Taxable investment securities (1)	757,527	20,492	5.44%	769,712	21,493	5.63%
Nontaxable investment securities (1)	532,724	18,396	6.94%	493,058	16,994	6.95%
Loans (net of unearned discount)	2,845,719	92,509	6.54%	2,698,369	91,367	6.83%
Total interest-earning assets	4,172,903	131,855	6.35%	4,056,151	132,332	6.58%
Noninterest-earning assets	468,079			446,830		
Total assets	$4,640,982			$4,502,981		
Interest-bearing liabilities:						
Interest checking, savings and money market deposits	$1,282,540	5,234	0.82%	$1,205,843	6,775	1.13%
Time deposits	1,380,464	28,499	4.15%	1,464,725	31,437	4.33%
Short-term borrowings	423,254	8,678	4.12%	157,108	3,259	4.18%
Long-term borrowings	453,326	10,772	4.78%	601,589	16,638	5.58%
Total interest-bearing liabilities	3,539,584	53,183	3.02%	3,429,265	58,109	3.42%
Noninterest-bearing liabilities:						
Demand deposits	559,486			554,655		
Other liabilities	55,815			53,920		
Shareholders' equity	486,097			465,141		
Total liabilities and shareholders' equity	$4,640,982			$4,502,981		
Net interest earnings		$78,672			$74,223	
Net interest spread			3.33%			3.16%
Net interest margin on interest-earnings assets			3.79%			3.69%
Fully tax-equivalent adjustment		$7,634			$7,518	

(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.

As discussed above and disclosed in Table 4 below, the quarterly change in net interest income (on a 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 2008 versus 2nd Quarter 2007 Increase (Decrease) Due to Change in (1)			Six Months Ended June 30, 2008 versus June 30, 2007 Increase (Decrease) Due to Change in (1)		
(000's omitted)	Volume	Rate	Net Change	Volume	Rate	Net Change
Interest earned on:						
Cash equivalents	($517)	($491)	($1,008)	($1,088)	($932)	($2,020)
Taxable investment securities	(639)	(800)	(1,439)	(336)	(665)	(1,001)
Nontaxable investment securities	666	42	708	1,370	32	1,402
Loans (net of unearned discount)	2,601	(3,026)	(425)	4,874	(3,732)	1,142
Total interest-earning assets (2)	1,461	(3,625)	(2,164)	3,752	(4,229)	(477)
Interest paid on:						
Interest checking, savings and money market deposits	241	(1,157)	(916)	409	(1,950)	(1,541)
Time deposits	(1,499)	(1,638)	(3,137)	(1,767)	(1,171)	(2,938)
Short-term borrowings	2,692	(56)	2,636	5,457	(38)	5,419
Long-term borrowings	(1,773)	(1,098)	(2,871)	(3,733)	(2,133)	(5,866)
Total interest-bearing liabilities (2)	625	(4,913)	(4,288)	1,822	(6,748)	(4,926)
Net interest earnings (2)	$832	$1,292	$2,124	$2,168	$2,281	$4,449

(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 such 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: 1) general banking services related to loans, deposits and other core customer activities typically provided through the branch network and electronic banking channels; 2) employee benefit plan administration, actuarial and consulting services (performed by BPA-Harbridge and HBT); and 3) wealth management services, comprised of trust services (performed by the trust unit within CBNA), investment and insurance products (performed by Community Investment Services, Inc. or CISI and CBNA Insurance Agency, Inc.) and asset management (performed by Nottingham Advisors or Nottingham). Additionally, the Company has periodic transactions, most often net gains (losses) from the sale of investment securities and prepayment of debt instruments.

Table 5: Noninterest Income

	Three Months Ended June 30,		Six months Ended June 30,	
(000's omitted)	2008	2007	2008	2007
Deposit service fees	$8,910	$7,825	$17,171	$14,802
Benefit plan administration, consulting and actuarial fees	5,933	4,767	12,245	8,739
Wealth management services	2,324	2,009	4,487	3,869
Other banking services	367	256	740	669
Mortgage banking	172	169	394	426
Subtotal	17,706	15,026	35,037	28,505
(Loss)/gain on sales of investment securities	(57)	(8)	230	(8)
Total noninterest income	$17,649	$15,018	$35,267	$28,497
Noninterest income/total income (FTE)	31.1%	28.9%	30.8%	27.7%

As displayed in Table 5, noninterest income (excluding securities gains and losses) was $17.7 million in the second quarter and $35.0 million for the first half of 2008. This represents an increase of $2.7 million or 18% for the quarter, and $6.5 million or 23% for the YTD period in comparison to one year earlier. A significant portion of the growth was attributable to higher benefit plan administration, consulting and actuarial fees, primarily due to the acquisition of HBT in mid May 2007. The remainder of the increase was due to organic growth generated from new clients along with enhanced product offerings to both new and existing customers. Second quarter and YTD wealth management services revenue increased $0.3 million or 16% and $0.6 million or 16%, respectively, a majority of which was attributable to acquired insurance agency revenues.

General recurring banking fees of $9.4 million and $18.3 million for the second quarter and first six months of 2008 were up $1.2 million or 14.5% and $2.4 million or 15.1%, respectively, as compared to the prior year periods. The increase was driven by organic core deposit account growth, higher electronic-banking revenues, including card-related activity, and incremental income generated from acquired branches.

The ratio of noninterest income to total income (FTE basis) was 31.1% for the quarter and 30.8% for the year-to-date period versus 28.9% and 27.7% for the comparable periods in 2007. This improvement is a function of increased noninterest banking and financial services income (excluding net security gains), combined with proportionally smaller increases in net interest income.

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 expense utilization effectiveness used in the banking industry.

Table 6: Operating Expenses

	Three Months Ended June 30,		Six months Ended June 30,	
(000's omitted)	2008	2007	2008	2007
Salaries and employee benefits	$19,772	$18,386	$40,158	$36,672
Occupancy and equipment	5,189	4,559	10,762	9,225
Data processing and communications	4,100	3,808	8,085	7,373
Amortization of intangible assets	1,645	1,581	3,176	3,096
Legal and professional fees	902	1,054	2,200	2,241
Office supplies and postage	1,237	1,008	2,515	2,054
Business development and marketing	1,507	1,538	2,829	2,488
Other	2,603	2,198	5,604	4,902
Total operating expenses	$36,955	$34,132	$75,329	$68,051
Operating expenses/average assets	3.20%	3.02%	3.26%	3.05%
Efficiency ratio	62.1%	62.2%	63.4%	63.0%

As shown in Table 6, second quarter 2008 operating expenses were $37.0 million, up $2.8 million or 8.3% from the prior year level. Year-to-date operating expenses of $75.3 million rose $7.3 million or 10.7% compared to the same period in 2007. A significant portion of the increase was attributable to incremental operating expenses related to the TLNB and HBT acquisitions. Additionally, the increase in operating expenses can be attributed to annual merit and other personnel related costs ($0.7 million for the quarter, $1.6 million for YTD), higher facility-based utility and maintenance costs ($0.5 million for the quarter, $1.1 million YTD), higher volume-based data processing and communication costs ($0.2 million for the quarter, $0.4 million YTD), and an increased level of business development and marketing expenses ($0.4 million for the YTD period). A portion of the increase in data processing and communications costs, as well as the increase in business development and marketing expenses, reflects the Company’s continued investment in strategic technology and business development initiatives to grow and enhance its service offerings.

The Company’s efficiency ratio (recurring operating expenses excluding intangible amortization and acquisition expenses divided by the sum of net interest income (FTE) and recurring noninterest income) was 62.1% for the second quarter, slightly below the comparable quarter of 2007. 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 slightly faster rate of 9.2%. The efficiency ratio of 63.4% for the first half of 2008 was up 0.4 percentage points from a year earlier due to core operating expenses increasing 11.5% while recurring operating income increased at a slower rate of 10.8%. In both periods, the efficiency ratios were adversely affected by the growing proportion of financial services activities, which, due to the differing nature of their business carry high efficiency ratios. Operating expenses as a percentage of average assets increased 18 basis points and 21 basis points for the quarter and year to date periods, respectively, as operating expenses increased 8.3% and 10.7%, respectively, while average assets increased 2.3% and 3.1%, respectively, during the same time periods. This ratio was impacted by the comparatively higher growth rates of the financial services businesses, which are less asset-intensive and have higher efficiency ratio attributes.

Income Taxes

The second quarter effective income tax rate was 22.5%, compared to the 25.0% effective tax rate in the second quarter of 2007. The year to date effective tax rate was 22.5% as compared to the 24.6% for the first half of 2007. The lower effective tax rate for 2008 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 $1.26 billion at the end of the second quarter, a decrease of $133.1 million from December 31, 2007 and an increase of $39.4 million from June 30, 2007. The book value (excluding unrealized gains and losses) of investments decreased $115.8 million from December 31, 2007 and increased $35.2 million from June 30, 2007. The short-term agency securities purchased during the third quarter of 2007 matured during the fourth quarter of 2007 and the first quarter of 2008. Cash flows from these securities provided an opportunity to invest in municipal and certain mortgage-backed securities that improved the Company's interest rate sensitivity position. The overall mix of securities within the portfolio over the last year has changed, with an increase in the proportion of obligations of state and political subdivisions and mortgage-backed securities, the addition of asset-backed securities and a decrease in U.S. Treasury and Agency, collateralized mortgage obligations and corporate securities. The change in the carrying value of investments is impacted by the amount of net unrealized gains and losses in the available for sale portfolio at a point in time. At June 30, 2008, the portfolio had a $0.1 million net unrealized loss, a decrease of $17.2 million from the unrealized gain at December 31, 2007 and an improvement of $4.2 million from the unrealized loss at June 30, 2007. 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.

Included in the available for sale portfolio are asset-backed securities with a current par value of $74.8 million and unrealized losses of $12.8 million at June 30, 2008. The underlying collateral of these assets are principally trust-preferred securities of community banks. The Company has the intent and ability to hold these securities to recovery and does not consider these investments to be other-than temporarily impaired as of June 30, 2008. Other than temporary impairment assessments are based on an evaluation of both current and future market and credit conditions as of June 30, 2008. Subsequent changes in market or credit conditions could change those evaluations.

Table 7: Investments

	June 30, 2008		December 31, 2007		June 30, 2007	
(000's omitted)	Amortized Cost/Book Value	Fair Value	Amortized Cost/Book Value	Fair Value	Amortized Cost/Book Value	Fair Value
Held-to-Maturity Portfolio:						
U.S. Treasury and Agency securities	$126,983	$126,800	$127,055	$127,382	$127,127	$122,376
Obligations of state and political subdivisions	7,978	8,042	6,207	6,289	5,296	5,301
Other securities	3,206	3,206	3,988	3,988	4,000	4,000
Total held-to-maturity portfolio	138,167	138,048	137,250	137,659	136,423	131,677
Available-for-Sale Portfolio:						
U.S. Treasury and Agency securities	245,971	250,800	432,832	438,526	414,868	410,397
Obligations of state and political subdivisions	515,893	523,835	532,431	543,963	479,600	482,719
Corporate securities	35,613	35,349	40,457	40,270	40,527	39,533
Collateralized mortgage obligations	29,978	30,243	34,451	34,512	38,483	37,934
Asset-backed securities	72,920	61,981	73,089	72,300	0	0
Mortgage-backed securities	169,923	168,040	72,655	73,525	72,076	70,698
Subtotal	1,070,298	1,070,248	1,185,915	1,203,096	1,045,554	1,041,281
Equity securities	50,377	50,377	51,526	51,526	41,656	41,656
Total available-for-sale portfolio	1,120,675	1,120,625	1,237,441	1,254,622	1,087,210	1,082,937
Net unrealized (loss) gain on available-for-sale portfolio	(50)	0	17,181	0	(4,273)	0

Total	$1,258,792	$1,258,673	$1,391,872	$1,392,281	$1,219,360	$1,214,614

Loans

As shown in Table 8, loans ended the second quarter at $2.92 billion, up $101.2 million or 3.6% from year-end 2007 and up $155.1 million or 5.6% versus one year earlier. On an organic basis, average loans were up $119.3 million versus one year earlier, with solid growth in all portfolios; consumer mortgage, consumer installment and business lending. All three portfolios also grew during the second quarter, with increases of $12.7 million in the business lending portfolio, $27.3 million in the consumer mortgage portfolio, and $44.5 million in the consumer installment portfolio.

Table 8: Loans

(000's omitted)	June 30, 2008		December 31, 2007		June 30, 2007	
Business lending	$1,011,137	34.6%	$984,780	34.9%	$988,886	35.7%
Consumer mortgage	1,015,114	34.7%	977,553	34.7%	948,430	34.3%
Consumer installment	895,992	30.7%	858,722	30.4%	829,860	30.0%
Total loans	$2,922,243	100.0%	$2,821,055	100.0%	$2,767,176	100.0%

Business lending increased $26.4 million in the first six months of 2008 and increased $22.3 million versus one year ago. 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. The Company has continued to invest in additional personnel, technology and business development resources to further strengthen its capabilities in this key business segment.

Consumer mortgages increased $66.7 million year-over-year and $37.6 million in the first six months of 2008. Consumer mortgage growth has been strong over the last few quarters despite softening demand in the overall market. The consumer real estate portfolio does not include exposure to subprime, Alt-A, or other higher-risk mortgage products. The Company's solid performance during a tumultuous period in the overall industry is a testament to the stable, low-risk profile of its portfolio, and its ability to successfully meet customer needs at a time when some national mortgage lenders are restricting their lending activities in many markets.

Consumer installment loans, including borrowings originated in automobile, marine and recreational vehicle dealerships, as well as branch originated home equity and installment loans, increased $37.3 million in the first six months of 2008 and increased $66.1 million on a year-over-year basis. Declines in manufacturer production and industry sale projections indicate continued weakness in the new vehicle market which has created demand in late model used and program car inventories, segments in which the Company is an active participant. Aggressive business development efforts have created opportunities to strategically expand the Company's share of the market, helping drive productive growth in this portfolio.

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, 2008 and 2007 and December 31, 2007.

Table 9: Nonperforming Assets

(000's omitted)	June 30, 2008	December 31, 2007	June 30, 2007
Nonaccrual loans	$10,016	$7,140	$8,003
Accruing loans 90+ days delinquent	370	622	778
Restructured loans	1,064	1,126	1,189
Total nonperforming loans	11,450	8,888	9,970
Other real estate owned (OREO)	637	1,007	1,411
Total nonperforming assets	$12,087	$9,895	$11,381
Allowance for loan losses to total loans	1.27%	1.29%	1.33%

Allowance for loan losses to nonperforming loans	324%	410%	368%
Nonperforming loans to total loans	0.39%	0.32%	0.36%
Nonperforming assets to total loans and other real estate	0.41%	0.35%	0.41%
Delinquent loans (30 days past due to nonaccruing) to total loans	1.13%	1.10%	0.95%
Net charge-offs to average loans outstanding (quarterly)	0.12%	0.13%	0.05%
Loan loss provision to net charge-offs (quarterly)	180%	98%	114%

As displayed in Table 9, nonperforming assets at June 30, 2008 were $12.1 million, an increase of $0.7 million versus one year earlier and a $2.2 million increase as compared to the level at the end of 2007. Nonperforming loan ratios increased slightly during the second quarter of 2008, but remain at or near historically low levels, reflective of disciplined credit management and relatively stable economic conditions in our markets over the past few years. Other real estate owned (OREO) decreased $0.4 million and $0.8 million from year-end 2007 and one-year ago, respectively, a result of the Company managing 14 OREO properties at June 30, 2008 as compared to 20 OREO properties at June 30, 2007. No single property has a carrying value in excess of $200,000.

Nonperforming loans were 0.39% of total loans outstanding at the end of the second quarter, seven basis points higher than the level at December 31, 2007 and three basis points higher than the 0.36% at June 30, 2007. The allowance for loan losses to nonperforming loans ratio, a general measure of coverage adequacy, was 324% at the end of the second quarter compared to 410% at year-end 2007 and 368% at June 30, 2007, reflective of a favorable and stable overall asset quality profile, combined with slightly higher nonaccrual loan levels.

Delinquent loans (30 days through nonaccruing) as a percent of total loans was 1.13% at the end of the second quarter, slightly higher than the 1.10% at year-end 2007 and the 0.95% at June 30, 2007. The commercial loan delinquency ratio at the end of the second quarter increased in comparison to December 31, 2007 and June 30, 2007. The delinquency rate for real estate loans decreased as compared to the December 31, 2007 and increased as compared to June 30, 2007. The consumer installment loan delinquency rate decreased as compared to both December 31, 2007 and June 30, 2007. The delinquency levels at the end of the current quarter remain favorable and are only slightly above the Company’s average of 1.11% over the previous eight quarters.

Table 10: Allowance for Loan Losses Activity

	Three Months Ended June 30,		Six Months Ended June 30,	
(000's omitted)	2008	2007	2008	2007
Allowance for loan losses at beginning of period	$36,428	$35,891	$36,427	$36,313
Charge-offs:				
Business lending	406	295	684	535
Consumer mortgage	62	45	114	280
Consumer installment	1,305	1,251	2,653	2,412
Total charge-offs	1,773	1,591	3,451	3,227
Recoveries:				
Business lending	168	389	341	646
Consumer mortgage	9	20	55	21
Consumer installment	726	820	1,405	1,576
Total recoveries	903	1,229	1,801	2,243
Net charge-offs	870	362	1,650	984
Provision for loans losses	1,570	414	2,350	614
Allowance for acquired loans	0	747	0	747
Allowance for loan losses at end of period	$37,128	$36,690	$37,128	$36,690
Net charge-offs to average loans outstanding:				
Business lending	0.10%	-0.04%	0.07%	-0.02%
Consumer mortgage	0.02%	0.01%	0.01%	0.06%
Consumer installment	0.27%	0.21%	0.29%	0.21%
Total loans	0.12%	0.05%	0.12%	0.07%

As displayed in Table 10, net charge-offs during the second quarter were $0.9 million, $0.5 million higher than the equivalent 2007 period. All portfolios, consumer installment, business lending, and consumer mortgage experienced small increases in the level of charge-offs as compared to the historical low levels experienced in the second quarter of 2007. The net charge-off ratio (net charge-offs as a percentage of average loans outstanding) for the second quarter was 0.12%, seven basis points higher than the comparable quarter of 2007 and two basis points below the average charge-off ratio for the previous eight quarters. Net charge-offs and the corresponding net charge-off ratios continue to be below the average net charge-off levels of the past several years.

All portfolios experienced slightly higher net charge off ratios for the second quarter of 2008 as compared to the second quarter of 2007. For the six months ended June 30, 2008 the net charge off ratio improved five basis points for the consumer mortgage portfolio, while the business lending and consumer installment charge off ratios were higher by nine and eight basis points, respectively. The average net charge-off ratio for each of the portfolios is lower in the current quarter than their average net charge-off ratios for the previous eight quarters.

A loan loss allowance of $37.1 million was determined as of June 30, 2008, necessitating a $1.6 million loan loss provision for the quarter, compared to $0.4 million one year earlier, driven by the growth in the loan portfolio during the second quarter. The allowance for loan losses rose $0.4 million or 1.2% over the last 12 months, less than the 5.6% growth in the loan portfolio over the same period. Contributing to the changes were the favorable charge-off, nonperforming and delinquency trends experienced over the last twelve months. This contributed to the ratio of allowance for loan loss to loans outstanding declining to 1.27% at the end of the second quarter, six basis points below its level at June 30, 2007 and two basis points lower than the level at December 31, 2007. The decrease was also slightly impacted by the increased proportion of low-risk consumer mortgage and home equity loans in the overall loan portfolio, as a result of both organic and acquired growth.

Deposits

As shown in Table 11, average deposits of $3.2 billion in the second quarter were down $45.9 million or 1.4% compared to the second quarter of 2007 and decreased $12.7 million or 0.4% versus the fourth quarter of last year. Excluding the impact of the TLNB acquisition, average deposits decreased $87.7 million or 2.7% as compared to the second quarter of 2007. Consistent with the Company's focus on expanding core account relationships and reducing higher cost time deposits, core product relationships grew $96.6 million or 5.5% as compared to the second quarter of 2007 while time deposits were allowed to decline $142.4 million or 9.5%. Interest checking account balances are above the prior year levels primarily as a result of the continued success of new product initiatives that commenced in the second quarter of 2006. This shift in mix, combined with the Company's ability to reduce rates due to market conditions, resulted in the quarterly cost of interest-bearing deposits declining from 3.0% in the second quarter of 2007 to 2.4% in the most recent quarter.

Average second quarter non-public fund deposits were down $18.9 million or 0.6% compared to the year earlier period and decreased $22.6 million or 0.7% versus the fourth quarter of 2007. Excluding time deposits, non-public deposits for the second quarter were up $98.3 million or 6.1% as compared to the second quarter of 2007. Average public funds have increased $9.9 million or 5.1% from the fourth quarter of 2007 and decreased $26.9 million or 11.6% from the second quarter of 2007. The Company continues to focus heavily on growing its core deposits through enhanced marketing and training programs and new product offerings introduced during the past two years. The success of these efforts is demonstrated by the solid organic core deposit growth generated over the past year, with second quarter average balances increasing $68.4 million or 3.9% versus one year earlier.

Table 11: Quarterly Average Deposits

(000's omitted)	June 30, 2008	December 31, 2007	June 30, 2007
Demand deposits	$563,045	$574,266	$557,195
Interest checking deposits	485,113	464,996	430,038
Savings deposits	458,556	451,148	459,514
Money market deposits	360,477	329,566	323,867
Time deposits	1,362,278	1,422,159	1,504,716
Total deposits	$3,229,469	$3,242,135	$3,275,330
Non-public fund deposits	$3,023,407	$3,046,018	$3,042,325
Public fund deposits	206,062	196,117	233,005
Total deposits	$3,229,469	$3,242,135	$3,275,330

Borrowings

Borrowings of $874.6 million at the end of the second quarter, decreased $54.7 million from December 31, 2007 and were up $170.4 million versus the end of the second quarter of 2007. Borrowings were up from one year ago primarily due to the need to supplement the funding of strong loan growth and selected investment purchases. The decline in borrowings during the first six months of 2008 was mostly attributable to a planned reduction of short-term investments and substantial core deposit balance growth. In December 2007, the Company refinanced $150 million of its fixed rate FHLB advances, replacing them with lower cost instruments with similar remaining duration and conducted an early redemption of $25 million of its variable rate, trust-preferred securities in January 2008. These restructuring strategies helped reduce the Company's interest expense on external borrowings and consequently improved its net interest margin in the first six months of 2008.

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, 2008, the Company had repurchased 1,464,811 shares at an aggregate cost of $31.5 million under this program.

Total shareholders' equity of $483.6 million at the end of the second quarter increased $4.9 million from the balance at December 31, 2007. This change consisted of net income of $22.2 million, $4.7 million from shares issued under the employee stock plan, and $1.1 million from employee stock options earned, partially offset by dividends declared of $12.5 million and a $10.6 million decrease in other comprehensive income. The other comprehensive loss is comprised of a $10.7 million decrease in the after-tax market value adjustment on the available-for-sale investment portfolio, partially offset by a $45,000 increase in the after-tax market value adjustment on the interest rate swap and a $33,000 adjustment to the funded status of the Company's retirement plans. Over the past 12 months total shareholders' equity increased by $24.0 million, as net income, 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 the funded status of the Company's defined benefit pension and other postretirement plans.

The Company's Tier I leverage ratio, a primary measure of regulatory capital for which 5% is the requirement to be "well-capitalized," was 7.75% at the end of the second quarter, down five basis points from year-end 2007 and 12 basis points lower than its level one year ago. The decrease in the Tier I leverage ratio compared to December 31, 2007 is primarily the result of the early call of $25 million of variable-rate trust preferred securities in the first quarter. The decrease in the Tier I ratio, as compared to the prior year second quarter, is the result of a 0.8% increase in Tier I capital (includes shareholders equity and trust preferred securities and excludes intangibles and the market value adjustment), combined with a larger 2.3% increase in average assets excluding intangibles and the market value adjustment. The primary drivers of the year-over-year changes were treasury share purchases, the redemption of trust-preferred securities and two acquisitions that increased both asset and intangible levels. The tangible equity-to-assets ratio of 5.22% increased 21 basis points versus December 31, 2007 and increased 56 basis points versus June 30, 2007, due to shareholders equity excluding intangible assets growing at a faster pace than assets excluding intangibles.

The dividend payout ratio (dividends declared divided by net income) for the first six months of 2008 was 56.5%, down from 60.0% for the first six months of 2007. The ratio decreased because net income increased 10.8% while dividends declared increased at a lesser 4.5%. The expansion of dividends declared was caused by the dividend per share being raised 5.0% in August 2007, from $0.20 to $0.21, and a slight increase in the number of shares outstanding. On a cash earnings basis, the dividend payout ratio was 50.3% for the first six months of 2008 as compared to 52.9% for the first six months of 2007.

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, 2008, this ratio was 10.8% for 30 days and 10.8% for 90 days, excluding the Company's capacity to borrow additional funds from the FHLB.

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 Disclosures 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 a minimal amount of credit risk in its investment portfolio because the majority 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, 2008 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,

	2008
+ 200 basis points	(0.7%)
- 100 basis points	(3.4%)

The modeled net interest income (NII) reflects a decrease in a rising and falling rate environment from a flat rate scenario. The decrease in a rising rate environment is largely a result of the repricing of liabilities to higher rates, while assets reprice to higher rates at a slower pace. The decrease in a falling rate environment is largely a result of lower rates on assets offset by lower liability rates and the rate decrease of total investments. In the long term the growth in NII improves in a rising rate environment as lower yielding assets mature and are replaced at higher rates.

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

Item 4. Controls and Procedures

The Company maintains disclosure controls and procedures, 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, 2008.

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 2007 Form 10-K for the fiscal year ended December 31, 2007 (filed with the SEC on March 13, 2008).

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 2008.

	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 2008	0	$0	1,464,811	935,189
May 2008	0	0	1,464,811	935,189
June 2008	0	0	1,464,811	935,189
Total	0	$0		

Item 3. Defaults Upon Senior Securities

Not applicable.

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

At the 2008 Annual Meeting of Shareholders of the Company held on May 21, 2008, the shareholders elected three directors to serve for three-year terms expiring in 2011, ratified the appoint of PricewaterhouseCoopers LLP as independent auditors for the year ending December 31, 2008, and voted on a shareholder proposal regarding the annual election of all Directors. Directors whose terms in office continued after the Annual Meeting were David C. Patterson, Sally A. Steele, Mark E. Tryniski, Nicholas A. DiCerbo, James A. Gabriel and Charles E. Parente.

The vote on each issue was as follows:

	For	Against	Abstain
Election of Directors:			
Brian R. Ace	17,025,974	*	8,782,286
Paul M. Cantwell, Jr.	18,548,578	*	7,259,682
William M. Dempsey	23,777,894	*	2,030,366
Ratification of the appointment of PricewaterhouseCoopers LLP as Independent Auditors	25,090,395	625,760	92,107
Shareholder proposal regarding annual election of all Directors	11,863,989	9,370,981	575,097 **

* Proxies provide that shareholders may either cast a vote for, or abstain from voting for, directors

** In addition, there were 3,998,184 broker nonvotes on this matter.

Item 5. Other Information

Not applicable.

Item 6. Exhibits

Exhibit No.	Description
31.1	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.
31.2	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.
32.1	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.
32.2	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

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 7,2008	/s/ Mark E. Tryniski Mark E. Tryniski, President and Chief Executive Officer
Date: August 7, 2008	/s/ Scott Kingsley Scott Kingsley, Treasurer and Chief Financial Officer