COMMUNITY BANK SYSTEM INC
Form 10-K
March 15, 2007

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

**FORM 10-K**

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

For the fiscal year ended December 31, 2006

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

For the transition period from _________ to __________
Commission file number 001-13695

**COMMUNITY BANK SYSTEM, INC.**
(Exact name of registrant as specified in its charter)

| | |
|---|---|
| Delaware | 16-1213679 |
| (State or other jurisdiction of incorporation or organization) | (I.R.S. Employer Identification No.) |
| 5790 Widewaters Parkway, DeWitt, New York | 13214-1883 |
| (Address of principal executive offices) | (Zip Code) |

(315) 445-2282

Registrant s telephone number, including area code

**Securities registered pursuant of Section 12(b) of the Act:**

| Title of each class | Name of each exchange on which registered |
|---|---|
| Common Stock, Par Value $1.00 | New York Stock Exchange |

**Securities registered pursuant to Section 12(g) of the Act: None**

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes o No x.

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes o No x.

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

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K (§229.405 of this chapter) is not contained herein, and will not be contained, to the best of the registrant s knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment of this Form 10-K. o

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer o Accelerated filer x Non-accelerated filer o

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

State the aggregate market value of the voting and non-voting common equity held by non-affiliates computed by reference to the price at which the common equity was last sold, or the average bid and ask price of such common equity, as of the last business day of the registrant s most recently completed second fiscal quarter $ 579,986,030.

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

30,157,455 shares of Common Stock, $1.00 par value, were outstanding on February 28, 2007.

DOCUMENTS INCORPORATED BY REFERENCE.

Portions of Definitive Proxy Statement for Annual Meeting of Shareholders to be held on May 15, 2007 (the Proxy Statement ) is incorporated by reference in Part III of this Annual Report on Form 10-K.

Exhibit Index is located on page 75 of 86

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## Part I

This Annual Report on Form 10-K contains certain forward-looking statements with respect to the financial condition, results of operations and business of Community Bank System, Inc. These forward-looking statements involve certain risks and uncertainties. Factors that may cause actual results to differ materially from those contemplated by such forward-looking statements are set forth herein under the caption Forward-Looking Statements. The share and per-share information in this document has been adjusted to give effect to a two-for-one stock split of the Company s common stock effected as of April 12, 2004.

### ***Item 1. Business***

Community Bank System, Inc. ( the Company ) was incorporated on April 15, 1983, under the Delaware General Corporation Law. Its principal office is located at 5790 Widewaters Parkway, DeWitt, New York 13214. The Company maintains a website at communitybankna.com and firstlibertybank.com. Annual reports on Form 10-K, quarterly reports on Form 10-Q and current reports on Form 8-K, and amendments to those reports, are available on the Company s web-site free of charge as soon as reasonably practicable after such reports or amendments are electronically filed with or furnished to the Securities and Exchange Commission. The information on the website is not part of this filing. Copies of all documents filed with the SEC can also be obtained by visiting the SEC s Public Reference Room at 100 F Street, NE, Washington, DC 20549, by calling the SEC at 1-800-SEC-0330 or by accessing the SEC s website at http://www.sec.gov.

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.

Community Bank System, Inc. is a single bank holding company which wholly-owns five subsidiaries: Community Bank, N.A. ( the Bank ), Benefit Plans Administrative Services, Inc. ( BPAS ), CFSI Closeout Corp. ( CFSICC ), First of Jermyn Realty Co. ( FJRC ) and Town & Country Agency LLC ( T&C ). BPAS owns two subsidiaries, Benefit Plans Administrative Services LLC ( BPA ) and Harbridge Consulting Group LLC. BPAS provides administration, consulting and actuarial services to sponsors of employee benefit plans. CFSICC, FJRC and T&C are inactive companies. The Company also wholly-owns four unconsolidated subsidiary business trusts formed for the purpose of issuing mandatorily redeemable preferred securities which are considered Tier I capital under regulatory capital adequacy guidelines.

The Bank operates 128 customer facilities throughout twenty-three counties of Upstate New York and five counties of Northeastern Pennsylvania offering a range of commercial and retail banking services. The Bank owns the following subsidiaries: Community Investment Services, Inc. ( CISI ), CBNA Treasury Management Corporation ( TMC ), CBNA Preferred Funding Corporation ( PFC ), Nottingham Advisors, Inc. ( Nottingham ), First Liberty Service Corp. ( FLSC ) and Brilie Corporation ( Brilie ). CISI provides broker-dealer and investment advisory services. TMC provides the cash management, investment, and treasury services to the Bank. PFC primarily is an investor in residential real estate loans. Nottingham provides asset management services to individuals, corporate pension and profit sharing plans, and foundations. FLSC provides banking-related services to the Pennsylvania branches of the Bank. Brilie was acquired as part of the Elmira acquisition and invests in a partnership that develops land for resale as residential housing.

*Acquisition History (2002-2007)*

Hand Benefits & Trust, Inc.

On February 22, 2007, the Company announced an agreement pursuant to which BPAS will acquire Hand Benefits & Trust, Inc. ( HBT ) in an all cash transaction. HBT is a Houston, Texas based provider of employee benefit plan administration and trust services. The acquisition is expected to close during the second quarter of 2007, pending customary regulatory approval.

TLNB Financial Corporation

On January 9, 2007, the Company announced an agreement to acquire TLNB Financial Corporation, parent company of Tupper Lake National Bank ( TLNB ), in an all-cash transaction valued at approximately $17.6 million. Based in Tupper Lake, N.Y., TLNB operates five branches in the northeastern New York State cities of Tupper Lake, Plattsburgh and Saranac Lake, as well as an insurance subsidiary, TLNB Insurance Agency, Inc. On a consolidated basis, TLNB has approximately $100 million in assets and $87 million of deposits. The acquisition is expected to close during the second quarter of 2007, pending both customary regulatory and TLNB shareholder approval.

ONB Corporation

On December 1, 2006, the Company acquired ONB Corporation ( ONB ), the parent company of Ontario National Bank, a federally-chartered national bank, in an all-cash transaction valued at approximately $15.7 million. ONB operated four branches in the villages of Clifton Springs, Phelps, and Palmyra, New York.

ES&L Bancorp, Inc.

On August 11, 2006, the Company acquired ES&L Bancorp, Inc. ( Elmira ), the parent company of Elmira Savings and Loan, F.A., a federally-chartered thrift, in an all-cash transaction valued at approximately $40 million. Elmira operated two branches in the cities of Elmira and Ithaca, New York.

Dansville Branch Acquisition

On December 3, 2004, the Company completed the purchase of a branch office in Dansville, N.Y. ( Dansville ) from HSBC Bank USA, N.A with deposits of $32.6 million and loans of $5.6 million.

First Heritage Bank

On May 14, 2004, the Company acquired First Heritage Bank ( First Heritage ), a closely held bank headquartered in Wilkes-Barre, PA with three branches in Luzerne County, Pennsylvania. First Heritage s three branches operate as part of First Liberty Bank & Trust, a division of Community Bank, N.A. Consideration included 2,592,213 shares of common stock with a fair value of $52 million, employee stock options with a fair value of $3.0 million, and $7.0 million of cash (including capitalized acquisition costs of $1.0 million).

Grange National Banc Corp.

On November 24, 2003, the Company acquired Grange National Banc Corp. ( Grange ), a $280 million-asset bank holding company based in Tunkhannock, Pa. Grange s 12 branches operate as part of First Liberty Bank & Trust, a division of Community Bank, N.A. The Company issued approximately 2,294,000 shares of its common stock to certain of the former shareholders with a fair value of $55 million. The remaining shareholders received $21.25 per share in cash or approximately $20.9 million. In addition, Grange stock options representing $5.4 million of fair value were exchanged for options to purchase shares in the Company.

Peoples Bankcorp Inc.

On September 5, 2003, the Company acquired Peoples Bankcorp, Inc. ( Peoples ), a $29-million-asset savings and loan holding company based in Ogdensburg, New York. Peoples single branch is being operated as a branch of the Bank s network of branches in Northern New York.

Harbridge Consulting Group

On July 31, 2003, the Company acquired PricewaterhouseCoopers Upstate New York Global Human Resource Solutions consulting group. This practice has been renamed Harbridge Consulting Group ( Harbridge ) and is a leading provider of retirement and employee benefits actuarial consulting services throughout Upstate New York, and is complementary to BPA, the Company s employee benefits plan administration subsidiary.

*Services*

The Bank is a community bank committed to the philosophy of serving the financial needs of customers in local communities. The Bank s branches are generally located in smaller towns and cities within its geographic market areas of Upstate New York and Northeastern Pennsylvania. The Company believes that the local character of business, knowledge of the customer and customer needs, and comprehensive retail and business products, together with responsive decision-making at the branch and regional level, enable the Bank to compete effectively. The Bank is a member of the Federal Reserve System and the Federal Home Loan Bank of New York ( FHLB ), and its deposits are insured by the Federal Deposit Insurance Corporation ( FDIC ) up to applicable limits.

*Competition*

The banking and financial services industry is highly competitive in the New York and Pennsylvania markets. The Company competes actively for loans, deposits and customers with other national and state banks, thrift institutions, credit unions, retail brokerage firms, mortgage bankers, finance companies, insurance companies, and other regulated and unregulated providers of financial services. In order to compete with other financial service providers, the Company stresses the community nature of its operations and the development of profitable customer relationships across all lines of business.

The table below summarizes the Bank s deposits and market share by the twenty-eight counties of New York and Pennsylvania in which it has customer facilities. Market share is based on deposits of all commercial banks, credit unions, savings and loan associations, and savings banks.

| | | | | | Number of | | | |
|---|---|---|---|---|---|---|---|---|
| | **County** | **State** | **Deposits as of 6/30/2006 (000 s omitted)[1]** | **Market Share** | **Facilities** | **ATM s** | **Towns/ Cities** | **Towns Where Company Has 1st or 2nd Market Position** |
| 1. | Allegany*** | NY | $ 191,843 | 49.3% | 8 | 8 | 8 | 7 |
| 2. | Lewis | NY | 84,783 | 37.9% | 4 | 2 | 3 | 3 |
| 3. | Seneca | NY | 131,192 | 34.3% | 4 | 3 | 4 | 4 |
| 4. | Yates | NY | 74,061 | 30.3% | 3 | 2 | 2 | 2 |
| 5. | Cattaraugus | NY | 285,068 | 28.1% | 10 | 7 | 8 | 8 |
| 6. | St. Lawrence | NY | 367,381 | 26.7% | 14 | 7 | 11 | 11 |
| 7. | Wyoming | PA | 88,657 | 23.3% | 4 | 1 | 4 | 3 |
| 8. | Franklin | NY | 81,698 | 16.1% | 5 | 3 | 4 | 3 |
| 9. | Chautauqua | NY | 198,004 | 13.1% | 12 | 11 | 10 | 6 |
| 10. | Livingston | NY | 83,625 | 13.0% | 3 | 3 | 3 | 3 |
| 11. | Schuyler | NY | 18,150 | 12.5% | 1 | 1 | 1 | 0 |
| 12. | Steuben | NY | 181,135 | 11.8% | 9 | 6 | 8 | 6 |
| 13. | Jefferson | NY | 144,006 | 11.7% | 5 | 5 | 4 | 2 |
| 14. | Ontario* | NY | 164,057 | 11.2% | 7 | 11 | 5 | 3 |
| 15. | Chemung** | NY | 140,765 | 10.7% | 2 | 2 | 2 | 0 |
| 16. | Lackawanna | PA | 448,212 | 9.9% | 12 | 12 | 8 | 4 |
| 17. | Tioga | NY | 32,336 | 8.1% | 2 | 2 | 2 | 1 |
| 18. | Wayne* | NY | 57,128 | 6.2% | 2 | 5 | 2 | 1 |
| 19. | Herkimer | NY | 35,330 | 6.0% | 1 | 1 | 1 | 1 |
| 20. | Luzerne | PA | 253,360 | 4.4% | 7 | 8 | 6 | 2 |
| 21. | Susquehanna | PA | 22,271 | 4.1% | 2 | 0 | 2 | 2 |
| 22. | Oswego | NY | 42,509 | 3.9% | 2 | 2 | 2 | 2 |
| 23. | Cayuga | NY | 29,179 | 3.5% | 2 | 1 | 2 | 1 |
| 24. | Bradford | PA | 21,708 | 2.5% | 2 | 2 | 2 | 1 |
| | Subtotal | | 3,176,458 | 10.9% | 123 | 105 | 104 | 76 |
| 25. | Oneida | NY | 57,346 | 1.2% | 2 | 1 | 1 | 1 |
| 26. | Tompkins** | NY | 17,320 | 1.0% | 1 | 0 | 1 | 0 |
| 27. | Erie | NY | 29,188 | 0.1% | 1 | 1 | 1 | 1 |
| 28. | Onondaga | NY | 11,492 | 0.1% | 1 | 2 | 1 | 0 |
| | Total | | $3,291,804 | 3.7% | 128 | 109 | 108 | 78 |

(1) Deposit market share data as of June 30, 2006, the most recent information available, calculated by Sheshunoff Information Services, Inc.

* - Includes balances of Ontario National Bank which was acquired in December 2006.

** - Includes balances of Elmira Savings and Loan which was acquired in August 2006.

*** - Adjusted for the consolidation of the Friendship, NY branch into the Cuba, NY branch in October 2006.

*Employees*

As of December 31, 2006 the Company employed 1,352 full-time equivalent employees. The Company offers a variety of employment benefits and considers its relationship with its employees to be good.

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*Supervision and Regulation*

Bank holding companies and national banks are regulated by state and federal law. The following is a summary of certain laws and regulations that govern the Company and the Bank. To the extent that the following information describes statutory or regulatory provisions, it is qualified in its entirety by reference to the actual statutes and regulations thereunder.

Federal Bank Holding Company Regulation

The Company is registered under, and is subject to, the Bank Holding Company Act of 1956, as amended. This Act limits the type of companies that Community Bank System, Inc. may acquire or organize and the activities in which it or they may engage. In general, the Company and the Bank are prohibited from engaging in or acquiring direct or indirect control of any corporation engaged in non-banking activities unless such activities are so closely related to banking as to be a proper incident thereto. In addition, the Company must obtain the prior approval of the Board of Governors of the Federal Reserve System (the FRB ) to acquire control of any bank; to acquire, with certain exceptions, more than five percent of the outstanding voting stock of any other corporation; or, to merge or consolidate with another bank holding company. As a result of such laws and regulation, the Company is restricted as to the types of business activities it may conduct and the Bank is subject to limitations on, among others, the types of loans and the amounts of loans it may make to any one borrower. The Financial Modernization Act of 1999 created, among other things, a new entity, the financial holding company . Such entities may engage in a broader range of activities that are financial in nature , including insurance underwriting, securities underwriting and merchant banking. Bank holding companies which are well capitalized and well managed under regulatory standards may convert to financial holding companies relatively easily through a notice filing with the FRB, which acts as the umbrella regulator for such entities. The Company may seek to become a financial holding company in the future.

Federal Reserve System

The Company is required by the Board of Governors of the Federal Reserve System to maintain cash reserves against its deposits. After exhausting other sources of funds, the Company may seek borrowings from the Federal Reserve for such purposes. Bank holding companies registered with the FRB are, among other things, restricted from making direct investments in real estate. Both the Company and the Bank are subject to extensive supervision and regulation, which focus on, among other things, the protection of depositors funds.

The Federal Reserve System also regulates the national supply of bank credit in order to influence general economic conditions. These policies have a significant influence on overall growth and distribution of loans, investments and deposits, and affect the interest rates charged on loans or paid for deposits.

Fluctuations in interest rates, which may result from government fiscal policies and the monetary policies of the Federal Reserve System, have a strong impact on the income derived from loans and securities, and interest paid on deposits. While the Company and the Bank strive to anticipate changes and adjust their strategies for such changes, the level of earnings can be materially affected by economic circumstances beyond their control.

The Company and the Bank are subject to minimum capital requirements established, respectively, by the FRB, the OCC (as defined below) and the FDIC. For information on these capital requirements and the Company s and the Bank s capital ratios see Management s Discussion and Analysis of Financial Condition and Results of Operations - Capital and Note P to the Financial Statements.

Office of Comptroller of the Currency

The Bank is supervised and regularly examined by the Office of the Comptroller of the Currency (the OCC ). The various laws and regulations administered by the OCC affect corporate practices such as payment of dividends, incurring debt, and acquisition of financial institutions and other companies. It also affects business practices, such as payment of interest on deposits, the charging of interest on loans, types of business conducted and location of offices. There are no regulatory orders or outstanding issues resulting from regulatory examinations of the Bank.

Sarbanes-Oxley Act of 2002

The Sarbanes Oxley Act of 2002 (the Sarbanes-Oxley Act ) implemented a broad range of corporate governance, accounting and reporting reforms for companies that have securities registered under the Securities Exchange Act of 1934. In particular, the Sarbanes-Oxley Act established, among other things: (i) new requirements for audit and other key committees involving independence, expertise levels, and specified responsibilities; (ii) additional responsibilities regarding the oversight of financial statements by the Chief Executive Officer and Chief Financial Officer of the reporting company; (iii) the creation of an independent accounting oversight board for the accounting industry; (iv) new standards for auditors and the regulation of audits, including independence provisions which restrict non-audit services that accountants may provide to their audit clients; (v) increased disclosure and reporting obligations for the reporting company and its directors and executive officers including accelerated reporting of company stock transactions; (vi) a prohibition of personal loans to directors and officers, except certain loans made by insured financial institutions on nonpreferential terms and in compliance with other bank regulator requirements; and (vii) a range of new and increased civil and criminal penalties for fraud and other violation of the securities laws.

***Item 1A. Risk Factors***

Investment in Community Bank System, Inc. common stock involves risk. The market price of the Company s common stock may fluctuate significantly in response to a number of factors including, but not limited to:

- Changes in securities analysts expectations of financial performance
- Volatility of stock market prices and volumes
- Incorrect information or speculation
- Changes in industry valuations
- Interest rate changes
- Variations in operating results from general expectations
- Actions taken against the Company by various regulatory agencies
- Changes in authoritative accounting guidance by Financial Accounting Standards Board or other regulatory agencies
- Changes in general domestic economic conditions such as inflation rates, tax rates, unemployment rates, labor and healthcare cost trend rates, recessions, and changing government policies, laws and regulations

The Company s main markets are located in the states of New York and Pennsylvania. A prolonged economic downturn in these markets could negatively impact the Company.

The Company s income and cash flow depends to a great extent on the difference between the interest earned on loans and investment securities, and the interest paid on deposits and borrowings. Interest rates are beyond the Company s control, and they fluctuate in response to general economic conditions and the policies of various governmental and regulatory agencies, in particular, the Federal Reserve Board. Changes in monetary policy, including changes in interest rates, will influence the origination of loans, the purchase of investments, the generation of deposits and the rates received on loans and investment securities and paid on deposits.

The Company and its subsidiaries are subject to extensive state and federal regulation, supervision and legislation that govern nearly every aspect of its operations. Changes to these laws could affect the Company s ability to deliver or expand its services and diminish the value of its business.

The business strategy of the Company includes growth through acquisition. Any future acquisitions will be accompanied by the risks commonly encountered in acquisitions. These risks include among other things; the difficulty of integrating the operations and personnel of acquired banks and branches, the potential disruption of our ongoing business, the inability of our management to maximize our financial and strategic position, and the inability to maintain uniform standards, controls, procedures and policies and the impairment of relationships with employees and customers as a result of changes in management.

The Company relies on communication, information, operating and financial control systems from third-party service providers. Any failure or interruption or breach in security of these systems could result in failures or interruptions in our customer relationship management, general ledger, deposit, servicing and/or loan origination systems.

Readers are cautioned that it is not possible to predict or identify all of the risks, uncertainties and other factors that may affect future results and that the above list should not be considered to be a complete list.

***<u>Item 1B. Unresolved Staff Comments</u>***

None

***Item 2. Properties***

The Company s primary headquarters is located at 5790 Widewaters Parkway, Dewitt, New York, which is leased. In addition, the Company has 138 properties, 93 are owned and 45 are located in long-term leased premises. Real property and related banking facilities owned by the Company at December 31, 2006 had a net book value of $48.9 million and none of the properties was subject to any material encumbrances. For the year ended December 31, 2006, rental fees of $2.7 million were paid on facilities leased by the Company for its operations. The Company believes that its facilities are suitable and adequate for the Company s current operations.

***Item 3. 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 4. Submission of Matters to a Vote of Security Holders***

There were no matters submitted to a vote of the shareholders during the quarter ended December 31, 2006.

***Item 4A. Executive Officers of the Registrant***

The executive officers of the Company and the Bank who are elected by the Board of Directors are as follows:

| Name | Age | Position |
|---|---|---|
| Mark E. Tryniski | 46 | Director, President and Chief Executive Officer of the Company and the Bank. Mr. Tryniski assumed his current position in August 2006. He served as Executive Vice President and Chief Operating Officer from March 2004 to July 2006 and as the Treasurer and Chief Financial Officer from June 2003 to March 2004. He previously served as a partner in the Syracuse office of PricewaterhouseCoopers LLP, with eighteen years of experience working with SEC registrants in banking and other industries. |
| Scott A. Kingsley | 42 | Treasurer of the Company, and Executive Vice President and Chief Financial Officer of the Bank. Mr. Kingsley joined the Company in August 2004 in his current position. He served as Vice President and Chief Financial Officer of Carlisle Engineered Products, Inc., a subsidiary of the Carlisle Companies, Inc., from 1997 until joining the Company. |
| Brian D. Donahue | 50 | Executive Vice President and Chief Banking Officer. Mr. Donahue assumed his current position in August 2004. He served as the Bank s Chief Credit Officer from February 2000 to July 2004 and as the Senior Lending Officer for the Southern Region of the Bank from 1992 until June 2004. |
| Timothy J. Baker | 55 | Senior Vice President and Director of Special Projects. Mr. Baker assumed his current position in August 2004. He was previously the Senior Operations Officer of the Bank responsible for bank operations, special projects and technology innovation from 1995 to 2004. |
| Bernadette R. Barber | 45 | Senior Vice President and Chief Human Resources Officer. Ms. Barber joined the Company in February 2005 in her current position. She served as Vice President of Human Resources and Administration for The Penn Traffic Company from 1997 until joining the Company. |
| J. David Clark | 52 | Senior Vice President and Chief Credit Officer. Mr. Clark assumed his current position in October 2004. He was previously the Commercial Market Manager in the Bank s Corning, New York market since April 1993. |
| Stephen G. Hardy | 52 | Senior Vice President and Chief Credit Administrator. Mr. Hardy assumed his current position in December 2006. He served as the Bank s Senior Vice President and Credit Risk Manager from January 2004 to November 2006 and as a Senior Regional Loan Officer from May 2001 to |

| | | |
|---|---|---|
| | | December 2003. He joined the former First Liberty Bank Corp. in August 1999 as Senior Vice President of Operations and was named its Senior Loan Officer in January 2001. |
| Richard M. Heidrick | 48 | Senior Vice President and Retail Banking Administrator. Mr. Heidrick assumed his current position in July 2006. He previously served as Vice President of Loan Administration from 1998 until July 2006 and held several management positions within the lending, collections and facilities areas of the bank prior to that. He joined Community Bank in May 1986 from Cattaraugus County Bank. |

| Name | Age | Position |
|---|---|---|
| Claire F. LaGarry | 57 | Senior Vice President, Retail Banking Manager. Ms. LaGarry assumed her current position in February 2007. She previously served as Retail Banking Manager from 1992 until her current appointment. She has 38 years of experience in various management positions at the Company at many different levels. |
| Joseph J. Lemchak | 45 | Senior Vice President and Chief Investment Officer. Mr. Lemchak joined the Company in 1990 and since May 1991 he has served in the dual capacity of Chief Investment Officer and Asset/Liability Manager for the Bank. |
| Robert P. Matley | 55 | Executive Vice President and Senior Lending Officer, PA Banking. Mr. Matley joined the Company in 2004. He was previously employed by First Heritage Bank, having joined that organization in 1994 as Executive Vice President and Senior Lending Officer. He was promoted to President and Chief Operating Officer in 2003 and served in that capacity until the merger with the Company in 2004. |
| Thomas A. McCullough | 60 | President, Pennsylvania Banking. Mr. McCullough joined the Company in November 2003 in his current position. He was previously the President and Chief Executive Officer of Grange National Banc Corp. from 1989 until its merger with the Company. |
| W. Valen McDaniel | 60 | Senior Vice President and Chief Risk Officer. Mr. McDaniel assumed his current position in January 2004. He served as the Company s corporate auditor and risk manager since joining the Company in June 1991. He is responsible for the insurance portfolio, audit function, compliance, loan review, and security of the bank and all subsidiaries. |
| Nicholas S. Russell | 39 | Senior Vice President and Senior Commercial Lending Officer for the Northern Region. Mr. Russell assumed his current position in October 2006. Previously he served as Vice President and Commercial Team Leader from November 2004 until his present appointment and as Vice President and Commercial Lender in the northern New York market from January 2001 until November 2004. Prior to joining Community Bank Mr. Russell served as Vice President at Key Bank, N.A. in the middle market corporate banking group. |
| Harold M. Wentworth | 42 | Senior Vice President and Director of Sales and Marketing. Mr. Wentworth assumed his current position in January 2005. He was previously a manager in the Bank s treasury department and was responsible for asset liability management and product development. |
| J. Michael Wilson | 36 | Senior Vice President and Chief Technology Officer. Mr. Wilson joined the Company in June 2002 as Vice President of Information Technology and assumed his current position in October 2004. He previously held the position of Director of Technology Services for Unizan Bank in Ohio. |

## Part II

### ***Item 5. Market for the Registrant s Common Stock, Related Shareholder Matters and Issuer Purchases of Equity Securities***

The Company s common stock has been trading on the New York Stock Exchange under the symbol CBU since December 31, 1997. Prior to that, the common stock traded over-the-counter on the NASDAQ National Market under the symbol CBSI beginning on September 16, 1986. There were 30,020,159 shares of common stock outstanding on December 31, 2006, held by approximately 3,609 registered shareholders of record. The following table sets forth the high and low prices for the common stock, and the cash dividends declared with respect thereto, for the periods indicated. The prices do not include retail mark-ups, mark-downs or commissions.

| Year / Qtr | High Price | Low Price | Quarterly Dividend |
|---|---|---|---|
| 2006 | | | |
| 4th | $ 25.11 | $ 21.79 | $ 0.20 |
| 3rd | $ 22.84 | $ 19.45 | $ 0.20 |

| | | | |
|---|---|---|---|
| 2nd | $ 22.38 | $ 18.75 | $ 0.19 |
| 1st | $ 24.31 | $ 20.64 | $ 0.19 |
| 2005 | | | |
| 4th | $ 24.68 | $ 21.60 | $ 0.19 |
| 3rd | $ 26.12 | $ 21.63 | $ 0.19 |
| 2nd | $ 24.87 | $ 21.40 | $ 0.18 |
| 1st | $ 28.30 | $ 22.41 | $ 0.18 |

The Company has historically paid regular quarterly cash dividends on its common stock, and declared a cash dividend of $0.20 per share for the first quarter of 2007. The Board of Directors of the Company presently intends to continue the payment of regular quarterly cash dividends on the common stock, as well as to make payment of regularly scheduled dividends on the trust preferred stock when due, subject to the Company s need for those funds. However, because substantially all of the funds available for the payment of dividends by the Company are derived from the Bank, future dividends will depend upon the earnings of the Bank, its financial condition, its need for funds and applicable governmental policies and regulations.

The following graph compares cumulative total shareholders returns on the Company s common stock over the last five fiscal years to the S&P Small Cap Commercial Banks Index, the NASDAQ Bank Index, the S&P 600 Small Cap Index (of which the Company became a member in 2004), and the Russell 2000 Index (of which the Company became a member in 2003). Total return values were calculated as of December 31 of each indicated year assuming a $100 investment on December 31, 2001 and reinvestment of dividends. The following table provides information as of December 31, 2006 with respect to shares of common stock that may be issued under the Company s existing equity compensation plans:

**CBU Long-term Total Return Performance Vs. Indices**

| | 12/31/2001 | 12/31/2002 | 12/31/2003 | 12/31/2004 | 12/31/2005 | 12/31/2006 |
|---|---|---|---|---|---|---|
| Community Bank System, Inc. | 100.00 | 124.10 | 199.97 | 237.19 | 195.38 | 206.56 |
| S &P 600 Small Cap Index | 100.00 | 85.37 | 118.47 | 145.32 | 156.51 | 180.16 |
| NASDAQ Bank Index | 100.00 | 106.93 | 142.25 | 161.66 | 158.54 | 180.42 |
| S&P Small Cap Commercial Bank Index | 100.00 | 107.07 | 143.49 | 174.09 | 158.54 | 170.46 |
| Russell 2000 Index | 100.00 | 79.54 | 117.14 | 138.72 | 145.12 | 171.86 |

The following table provides information as of December 31, 2006 with respect to shares of common stock that may be issued under the Company s existing equity compensation plans.

| Plan Category | Number of Securities to be Issued upon Exercise of Outstanding Options, Warrants and Rights (1) | Weighted Average Exercise Price on Outstanding Options, Warrants and Rights | Number of Securities Remaining Available for Future Issuance |
|---|---|---|---|
| Equity compensation plans approved by security holders: | | | |
| 1994 Long Term Incentive Plan | 1,616,586 | $ 16.78 | 0 |
| 2004 Long Term Incentive Plan | 967,820 | $ 23.99 | 3,019,256 |
| Total | 2,584,406 | $ 19.48 | 3,019,256 |

(1) The number of securities includes unvested restricted stock issued of 9,443.

The following table shows treasury stock purchases during the fourth quarter 2006.

| | 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 |
|---|---|---|---|---|
| October 1-31, 2006 (1) | 0 | $ 0.00 | 853,161 | 646,839 |
| November 1-30,2006 (1) | 0 | 0.00 | 853,161 | 646,839 |
| December 1-31, 2006 (1) | 0 | 0.00 | 853,161 | 1,546,839 |
| Total | 0 | 0.00 | 853,161 | 1,546,839 |

(1) All shares were repurchased through the Company s publicly announced share repurchase program. 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. Also, on December 20, 2006 the Company announced an additional two-year authorization to repurchase up to 900,000 of its outstanding shares in open market or privately negotiated transactions. These repurchases will be for general corporate purposes, including those related to stock plan activities.

***Item 6. Selected Financial Data***

The following table sets forth selected consolidated historical financial data of the Company as of and for each of the years in the five-year period ended December 31, 2006. The historical information set forth under the captions Income Statement Data and Balance Sheet Data is derived from the audited financial statements while the information under the captions Capital and Related Ratios , Selected Performance Ratios and Asset Quality Ratios for all periods is unaudited. All financial information in this table should be read in conjunction with the information contained in Management s Discussion and Analysis of Financial Condition and Results of Operations and with the Consolidated Financial Statements and the related notes thereto included elsewhere in this Annual Report on Form 10-K.

**SELECTED CONSOLIDATED FINANCIAL INFORMATION**

| | Years Ended December 31, | | | | |
|---|---|---|---|---|---|
| **(In thousands except per share data and ratios)** | **2006** | **2005** | **2004** | **2003** | **2002** |
| **Income Statement Data:** | | | | | |
| Loan interest income | $ 167,113 | $ 147,608 | $ 137,077 | $ 125,256 | $ 130,859 |
| Investment interest income | 64,788 | 71,836 | 75,770 | 65,915 | 74,310 |
| Interest expense | 97,092 | 75,572 | 61,752 | 59,301 | 77,242 |
| Net interest income | 134,809 | 143,872 | 151,095 | 131,870 | 127,927 |
| Provision for loan losses | 6,585 | 8,534 | 8,750 | 11,195 | 12,222 |
| Other noninterest income | 51,679 | 48,401 | 44,321 | 37,887 | 30,312 |
| Gain (loss) on investment securities & early retirement of long-term borrowings | (2,403) | 12,195 | 72 | (2,698) | 1,673 |
| Special charges/acquisition expenses | 647 | 2,943 | 1,704 | 498 | 700 |
| Other noninterest expenses | 126,556 | 124,446 | 118,195 | 102,213 | 94,586 |
| Income before income taxes | 50,297 | 68,545 | 66,839 | 53,153 | 52,404 |
| Net income | 38,377 | 50,805 | 50,196 | 40,380 | 38,517 |
| Diluted earnings per share (1) | 1.26 | 1.65 | 1.64 | 1.49 | 1.46 |
| Diluted earnings per share cash (1)(3) | 1.47 | 1.84 | 1.81 | 1.64 | 1.63 |
| **Balance Sheet Data:** | | | | | |
| Investment securities | 1,229,271 | 1,303,117 | 1,584,633 | 1,329,645 | 1,286,583 |
| Loans, net of unearned discount | 2,701,558 | 2,411,769 | 2,358,420 | 2,128,446 | 1,806,826 |
| Allowance for loan losses | (36,313) | (32,581) | (31,778) | (29,095) | (26,331) |
| Intangible assets | 246,136 | 224,878 | 232,500 | 196,111 | 134,828 |
| Total assets | 4,497,797 | 4,152,529 | 4,393,295 | 3,854,984 | 3,436,837 |
| Deposits | 3,168,299 | 2,983,507 | 2,927,524 | 2,723,950 | 2,503,607 |
| Borrowings | 805,495 | 653,090 | 920,511 | 667,786 | 543,575 |
| Shareholders equity | 461,528 | 457,595 | 474,628 | 404,828 | 325,038 |
| **Capital and Related Ratios:** | | | | | |
| Cash dividend declared per share (1) | $ 0.78 | $ 0.74 | $ 0.68 | $ 0.61 | $ 0.56 |
| Book value per share (1) | 15.37 | 15.28 | 15.49 | 14.29 | 12.52 |
| Tangible book value per share (1) | 7.17 | 7.77 | 7.90 | 7.37 | 7.33 |
| Market capitalization (in millions) | 690 | 676 | 866 | 694 | 407 |
| Tier 1 leverage ratio | 8.81% | 7.57% | 6.94% | 7.26% | 7.05% |
| Total risk-based capital to risk-adjusted assets | 15.47% | 13.64% | 13.18% | 13.01% | 13.32% |
| Tangible equity to tangible assets | 5.07% | 5.93% | 5.82% | 5.70% | 5.76% |
| Dividend payout ratio | 60.7% | 43.9% | 40.9% | 40.2% | 37.7% |
| Period end common shares outstanding (1) | 30,020 | 29,957 | 30,642 | 28,330 | 25,957 |
| Diluted weighted average shares outstanding (1) | 30,392 | 30,838 | 30,670 | 27,035 | 26,334 |
| **Selected Performance Ratios:** | | | | | |
| Return on assets | 0.90% | 1.19% | 1.20% | 1.16% | 1.14% |
| Return on equity | 8.36% | 10.89% | 11.39% | 11.78% | 13.07% |
| Net interest margin | 3.91% | 4.17% | 4.45% | 4.68% | 4.62% |
| Noninterest income/operating income (FTE) | 24.8% | 27.7% | 21.1% | 19.6% | 18.6% |
| Efficiency ratio(2) | 59.9% | 56.8% | 52.8% | 53.4% | 52.1% |
| **Asset Quality Ratios:** | | | | | |
| Allowance for loan loss/loans outstanding | 1.34% | 1.35% | 1.35% | 1.37% | 1.46% |
| Nonperforming loans/loans outstanding | 0.47% | 0.55% | 0.55% | 0.62% | 0.65% |
| Allowance for loan loss/nonperforming loans | 288% | 245% | 245% | 219% | 225% |
| Net charge-offs/average loans | 0.24% | 0.33% | 0.37% | 0.54% | 0.56% |
| Loan loss provision/net charge-offs | 108% | 110% | 104% | 109% | 125% |

(1) All share and share-based amounts reflect the two-for-one stock split effected as a 100% stock dividend on April 12, 2004.

(2) Efficiency ratio excludes intangible amortization, gain (loss) on investment securities & debt extinguishments and special charges/acquisition expenses.

(3) Cash earnings are reconciled to GAAP net income in Table 1 on page 15.

***Item 7. Management s Discussion and Analysis of Financial Condition and Results of Operations***

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 ) for the past two years, although in some circumstances a period longer than two years is covered in order to comply with Securities and Exchange Commission disclosure requirements or to more fully explain long-term trends. The following discussion and analysis should be read in conjunction with the Selected Consolidated Financial Information on page 12 and the Company s Consolidated Financial Statements and related notes that appear on pages 41 through 70. All references in the discussion to the financial condition and results of operations are to the consolidated position and results of the Company and its subsidiaries taken as a whole.

Unless otherwise noted, all earnings per share ( EPS ) figures disclosed in the MD&A refer to diluted EPS; interest income, net interest income and net interest margin are presented on a fully tax-equivalent ( FTE ) basis. The term this year and equivalent terms refer to results in calendar year 2006, last year and equivalent terms refer to calendar year 2005, and all references to income statement results correspond to full-year activity unless otherwise noted. All share and share-based amounts reflect the two-for-one stock split effected as a 100% stock dividend on April 12, 2004.

This Management s Discussion and Analysis of Financial Condition and Results of Operations contains certain forward-looking statements with respect to the financial condition, results of operations and business of Community Bank System, Inc. These forward-looking statements involve certain risks and uncertainties. Factors that may cause actual results to differ materially from those contemplated by such forward-looking statements are set herein under the caption Forward-Looking Statements on page 37.

**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 the critical accounting estimates include:

Allowance for loan losses The allowance for loan losses reflects management s best estimate of probable loan losses in the Company s loan portfolio. Determination of the allowance for loan losses is inherently subjective. It requires significant estimates including the amounts and timing of expected future cash flows on impaired loans and the amount of estimated losses on pools of homogeneous loans which is based on historical loss experience and consideration of current economic trends, all of which may be susceptible to significant change.

Actuarial assumptions associated with pension, post-retirement and other employee benefit plans These assumptions include discount rate, rate of future compensation increases and expected return on plan assets. Specific discussion of the assumptions used by management is discussed in Note K on pages 61 through 64.

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 judgments 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 them to select 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 , starting on page 46.

**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 profitable loan and deposit volume using both organic and acquisition strategies, (iii) increase the non-interest income component of total revenues through development of banking-related fee income, growth in existing financial services business units, and the acquisition of additional financial services and banking businesses, and (iv) utilize technology to deliver customer-responsive products and services and to reduce operating costs.

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

The Company s reported net income for the year was below the record earnings of 2005 as a result of increased cost of funds, lower investment income, lower gains on sales of securities, an additional $1.8 million of stock option expense and a one-time $2.4 million charge related to the early redemption of fixed rate, trust-preferred obligations. This was partially offset by higher noninterest income, excluding securities gains and debt extinguishments costs, improved asset quality, organic and acquired loan and deposit growth and proactive operating expense management. The higher cost of funds resulted in margin compression throughout the year. Noninterest income, excluding gain/loss on investment securities and debt extinguishments, increased 6.8% over 2005 as a result of strong growth from banking sources and the Company s employee benefits administration and consulting businesses. Capital levels remained strong with the Tier 1 leverage ratio improving from 2005.

Asset quality remained strong in 2006, with a reduction in the loan charge-off ratios, delinquency and nonperforming loan ratios versus 2005. The Company experienced year-over-year loan growth in all portfolios: consumer installment, consumer mortgage and business lending, due to both the Elmira and ONB acquisitions and organic loan growth. The investment portfolio decreased from the prior year, as the Company has used the proceeds from the sale of certain securities in 2005 and cash flows from the maturing securities over the last two years to pay off variable and short-term borrowings. Average deposits increased as compared to 2005 from both organic growth and the Elmira and ONB acquisitions. In December 2006, the Company completed its sale of $75 million of trust preferred securities, the proceeds of which will be used for general corporate purposes including the early call of $30 million of fixed-rate trust preferred securities in January 2007.

**Net Income and Profitability**

Net income for 2006 was $38.4 million, or $1.26 per share, down $12.4 million, or 24%, from 2005 s record earnings of $50.8 million, or $1.65 per share. In 2005, the Company made significant progress on its objective of shortening the average life of its investment portfolio, generating a $0.29 per share after-tax gain through the sale of securities that had optimized their total return and interest-rate sensitivity characteristics. The 2006 earnings included incremental stock option expense of $1.8 million, or $0.05 per share, a one-time, $2.4 million, or $0.06 per share, charge related to the early redemption of fixed rate, trust-preferred obligations, as well as $0.6 million, or $0.02 per share, of acquisition expenses and special charges. The 2005 results were also impacted by a $2.9 million, or $0.07 per share, nonrecurring charge related to the early retirement of certain executives.

In addition to the earnings results presented above in accordance with GAAP, the Company provides cash earnings per share which excludes the after-tax effect of the amortization of intangible assets, the market value adjustments on net assets acquired in mergers, and the noncash portion of debt extinguishments costs. Management believes that this information helps investors understand the effect of acquisition activity and certain noncash transactions in reported results. Cash earnings per share for 2006 were $1.47, down 20% from $1.84 for the year ended December 31, 2005.

Net income and earnings per share for 2005 were $50.8 million and $1.65, up 1.2% and 0.6%, respectively, from 2004 results. The growth rate of EPS was below that of net income due to higher weighted average diluted shares outstanding, driven by the 2.6 million shares of common stock issued in conjunction with the acquisition of First Heritage in May 2004 and the exercise of options under the employee stock plan. As noted above, the 2005 earnings were impacted by a $0.29 per share gain on the sale of securities and a $0.07 per share nonrecurring charge related to the early retirement of certain executives. Earnings in 2004 included $1.7 million of nonrecurring acquisition related expenses.

**Table 1: Reconciliation of GAAP Net Income To Cash Net Income**

| | Years Ended December 31, | | | | |
|---|---|---|---|---|---|
| **(000 s omitted)** | **2006** | **2005** | **2004** | **2003** | **2002** |
| Net income | $ 38,377 | $ 50,805 | $ 50,196 | $ 40,380 | $ 38,517 |
| After-tax adjustments: | | | | | |
| Net amortization of market value adjustments on net assets acquired in mergers | 813 | 655 | (126) | 72 | 0 |
| Amortization of intangible assets | 4,598 | 5,281 | 5,568 | 3,869 | 4,375 |
| Noncash portion of debt extinguishments charge | 794 | 0 | 0 | 0 | 0 |
| Net income cash | $ 44,582 | $ 56,741 | $ 55,638 | $ 44,321 | $ 42,892 |

**Table 2: Condensed Income Statements**

| | Years Ended December 31, | | |
|---|---|---|---|
| **(000 s omitted, except per share data)** | **2006** | **2005** | **2004** |
| Net interest income | $ 134,809 | $ 143,872 | $ 151,095 |
| Loan loss provision | 6,585 | 8,534 | 8,750 |
| Noninterest income | 49,276 | 60,596 | 44,393 |
| Operating expenses | 127,203 | 127,389 | 119,899 |
| Income before taxes | 50,297 | 68,545 | 66,839 |
| Income taxes | 11,920 | 17,740 | 16,643 |
| Net income | $ 38,377 | $ 50,805 | $ 50,196 |
| Diluted earnings per share | $ 1.26 | $ 1.65 | $ 1.64 |
| Diluted earnings per share-cash(1) | $ 1.47 | $ 1.84 | $ 1.81 |

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

The primary factors explaining 2006 performance are discussed in detail in the remaining sections of this document and are summarized as follows:

As shown in Table 2 above, net interest income decreased $9.1 million, or 6.3%, due to a 26 basis point decrease in the net interest margin, partially offset by a $25 million increase in average earning assets. Average loans grew $139 million or 5.9%, primarily due to strong consumer installment growth as well as the addition of Elmira in August 2006 and ONB in December 2006. Average investments decreased $142 million, or 10.1%, in 2006 primarily as a result of the sales made throughout 2005 and the non-reinvestment of maturing cash flows in both years. Short-term cash equivalents increased $99.2 million as compared to the end of 2005 in expectation of certain debt reduction transactions in early 2007. The growth in earning assets was funded by $88 million, or 3.0%, higher average deposits, primarily due to the acquisitions of Elmira and ONB. Cash flows from the investment portfolios were used to pay down external borrowings throughout 2005 and early 2006, resulting in $89 million lower average borrowings in 2006 as compared to 2005.

The loan loss provision of $6.6 million decreased $1.9 million, or 23%, from the prior year level. Net charge-offs of $6.1 million decreased by $1.7 million from 2005, reducing the net charge-off ratio (net charge-offs / total average loans) to 0.24% for the year. Asset quality in 2006 remained favorable as evidenced by improvement in key metrics such as nonperforming loans as a percentage of total loans, nonperforming assets as a percentage of loans and other real estate owned and delinquent loans (30+ days through nonaccruing) as a percentage of total loans. Additional information on trends and policy related to asset quality is provided in the asset quality section on pages 28 through 31.

Noninterest income for 2006 of $49.3 million decreased by $11.3 million, or 19%, from 2005 s level, primarily due to a $12.2 million gain on the sale of investment securities in 2005 and a $2.4 million loss from the early redemption of trust preferred securities in 2006. Fees from banking services were up $1.2 million or 3.9%, primarily due to several revenue enhancement initiatives implemented over the last two years, as well as the acquisitions in 2006. Financial services revenue was $2.1 million, or 11.4% higher mostly as a result of strong growth at the Company s benefit plan administration and consulting business. Gain (loss) from investment security sales and debt extinguishments decreased $14.6 million as the Company took advantage of market conditions in 2005 to sell certain securities in order to shorten the average length of the portfolio and maximize their expected total return. No security sales were conducted in 2006. Additionally, 2006 included a one-time $2.4 million charge related to the early redemption of $30 million of fixed-rate trust preferred obligations which will help to reduce the Company s average long-term borrowing costs in future periods.

Total operating expenses decreased $0.2 million or 0.1% in 2006 to $127.2 million. Excluding special charges/acquisition expenses in both years, 2006 operating expenses rose $2.1 million, or 1.7%. A majority of the increase was due to increased personnel expenses associated with the adoption of SFAS No. 123(R), *Share-Based Payments* ( SFAS 123(R) ), higher business development costs associated with a more robust marketing strategy and increased expenses due to the acquisitions in 2006, partially offset by reductions in the amortization of core deposit intangibles associated with prior acquisitions.

The Company s combined effective federal and state income tax rate decreased 2.2 percentage points in 2006 to 23.7%, primarily as a result of a lower proportion of income being generated from fully taxable sources (loans and investments).

**Selected Profitability and Other Measures**

Return on average assets, return on average equity, dividend payout and equity to asset ratios for the years indicated are as follows:

**Table 3: Selected Ratios**

| | 2006 | 2005 | 2004 |
|---|---|---|---|
| Return on average assets | 0.90% | 1.19% | 1.20% |
| Return on average equity | 8.36% | 10.89% | 11.39% |
| Dividend payout ratio | 60.7% | 43.9% | 40.9% |
| Average equity to average assets | 10.80% | 10.93% | 10.50% |

As displayed in Table 3 above, the return on average assets decreased in 2006 as compared to 2005 and 2004. This was a result of lower net income primarily due to lower gains on sale of investment securities and lower net interest income. Reported return on equity in 2006 was down from 2005 s level. This was mainly a result of net income decreasing 25% in 2006, while equity capital decreased only slightly, primarily due to treasury stock purchases made throughout the second half of 2005 and the first half of 2006. Return on equity in 2005 was down slightly from 2004 s level. This was mainly a result of equity capital increasing at a faster pace than net income due to the impact of shares issued in the First Heritage acquisition and the enhancement of the Company s capital position through the retention of net profits. The slight decrease in the average equity to average assets ratio in 2006 as compared to 2005 is reflective of the decline in the average equity as discussed above, with a smaller decrease in average assets over the same period.

The dividend payout ratio for 2006 was above 2005 s level due to the decrease in net income and the 5.3% increase in the quarterly dividend in the third quarter of 2006. The dividend payout ratio also increased in 2005 as compared to 2004, primarily due to the 5.6% increase in the quarterly dividend in the third quarter of 2005 and a greater number of shares outstanding.

**Net Interest Income**

Net interest income is the amount that interest and fees on earning assets (loans and investments) exceeds 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 disclosed in Table 4, net interest income (with nontaxable income converted to a fully tax-equivalent basis) totaled $149.5 million in 2006, down $8.7 million, or 5.5%, from the prior year. An $18.3 million increase in average interest-bearing liabilities and a 26 basis point decrease in the net interest margin more than offset a $24.7 million increase in average earning-assets. As reflected in Table 5, the volume changes mentioned above increased net interest income by $1.0 million, while the lower net interest margin had a $9.7 million negative impact.

The net interest margin declined 26 basis points from 4.17% in 2005 to 3.91% in 2006. This decline was primarily attributable to the four rate hikes (25 basis points each) by the Federal Reserve to the overnight federal funds rates since last

December having a greater impact on funding costs (up 58 basis points) than earning-asset yields (up 29 basis points). The rising short-term market rates resulted in steady increases to rates throughout the year on interest-bearing deposits (up 67 basis points) and total external borrowings (up 98 basis points). The yield on loans increased 43 basis points, with the majority of the increases occurring in the second and third quarters, reflective of the timing of the Federal Reserve s rate increases. The yield on investments increased slightly from 6.03% in 2005 to 6.04% in 2006 as the sold, maturing and called securities have yields similar to those of the overall portfolio.

The net interest margin also declined in 2005 to 4.17% compared to 4.45% for 2004. This trend was mostly attributable to the eight rate hikes (25 basis point each) by the Federal Reserve during 2005 to the overnight federal funds rates. The rising short-term market rates resulted in steady increases to rates throughout the year on interest-bearing deposits (up 30 basis points) and total external borrowings (up 101 basis points). Loan yields in 2005 moved from 6.16% in the first quarter to 6.42% in the fourth quarter, reflective of the repricing on the variable rate portion of the Company s loan portfolio during the year. The yield on investments declined during the year from 6.18% for 2004 to 6.03% for 2005, as a result of the sale of higher yielding securities.

As shown in Table 4, total interest income increased by $12.8 million, or 5.5%, in 2006. Table 5 reveals that higher average earning assets contributed a positive $1.5 million variance and higher yields contributed $11.3 million. Average loans grew a total of $139.3 million in 2006, as a result of $78.9 million from the acquisitions of Elmira in August 2006 and ONB in December 2006 as well as $60.4 million of organic growth in all portfolios. Interest and fees on loans increased $19.6 million or 13.2%. The increase was attributable to higher average loan balances (positive $9.0 million) as well as a 43-basis point increase in loan yields (positive $10.6 million) due to the increase in short-term rates. Average loans grew $110 million in 2005, the majority as a result of the addition of $204 million of loans through the acquisition of First Heritage in May 2004 and $5.6 million from the November 2004 acquisition of the Dansville branch as well as organic growth in the consumer installment and consumer mortgage portfolios. Interest and fees on loans increased $10.6 million, or 7.7%, in 2005 as compared to 2004. The increase was attributable to higher average loan balances (positive $6.8 million), as well as a 17-basis point increase in loan yields (positive $3.8 million) due to the rising rate environment.

In 2005, the Company decided to sell certain securities and not fully reinvest cash flows from maturing securities in the then flat (now inverted) yield environment, to take advantage of market conditions to shorten the average life of the portfolio, improve its interest-rate sensitivity profile in a rising-rate environment, and maximize the expected total return. In 2006, the portfolio continued to decline due to the contractual maturing and early calling of securities. The cash flows have been used to pay down short-term borrowings and the excess funds invested in short-term cash equivalents, as long-term investments are not attractive given the current market conditions. As a result, average investments for 2006 decreased $142.3 million versus 2005, partially offset by an increase in cash equivalents of $27.6 million. The expected life-to-maturity of the investment portfolio was reduced from 5.9 years at December 31, 2004 to 5.3 years at December 31, 2005 and 4.7 at December 31, 2006. Refer to the Investments section of the MD&A on pages 34 through 36 for further information.

Investment interest income in 2006 of $78.9 million was $6.8 million, or 7.9%, lower than the prior year as a result of a smaller portfolio (negative $6.8 million impact). Investment interest income in 2005 of $85.7 million was $4.2 million, or 4.7%, lower than the prior year as a result of a smaller portfolio (negative $2.1 million impact) as well as a decrease in the average investment yield from 6.16% to 6.03% (negative $2.1 million impact). The decrease in the yield was principally driven by the sale and maturity of higher-yielding securities. The performance of the investment portfolio in 2006 and 2005 remained strong despite the interest rate environment.

The average earning asset yield grew 29 basis points to 6.45% in 2006 because of the previously mentioned increase in loan yields and the stable investment yields. In 2004 investment yields were nine basis points above those produced by loans. During 2005, changes in market interest rates combined with the strategic investment portfolio actions previously discussed resulted in the yield on the loan portfolio being higher than the investment portfolio by 21 basis points. This gap widened in 2006 as the yield on the loan portfolio expanded and investment portfolio yield stabilized resulting in loan yields being 63 basis points higher than the yield on the investment portfolio.

Total average funding (deposits and borrowings) in 2006 remained consistent with 2005 s level. Deposits increased $88.5 million, $52.6 million attributable to the acquisitions of Elmira and ONB and $35.9 million to organic deposit growth. Interest bearing deposits increased $106.9 million as a result of acquisitions, the successful launch of new interest bearing checking account products and customers shifting funds from demand deposits to time and other higher rate deposit products as rates have risen. Average external borrowings declined $88.6 million in 2006 as compared to the prior year as cash flows from the maturing securities were used to reduce short-term borrowings. In 2005 total average funding increased by $40.0 million, with $103.0 million of the increase coming from deposits, mostly attributable to the acquisitions of First Heritage, Dansville and organic growth. External borrowings declined $63.0 million in 2005 as compared to the prior year, as cash flows from the securities sales were used to reduce short-term borrowings.

The cost of funding increased throughout 2006 reflective of the four 25 basis point increases to short-term rates by the Federal Reserve since December of 2005. Interest rates on deposit accounts were raised throughout the year, with increases in all product offerings. The primary drivers of the increase in deposit cost of funds were customers transferring funds from non and lower rate interest accounts to higher yielding time deposit accounts, as well as transferring noninterest bearing accounts to new interest-bearing checking products. This is demonstrated by the percentage of average deposits that were in time deposit accounts and checking accounts increasing from 40.8% and 10.4%, respectively, in 2005 to 44.0% and 11.3%, respectively, in 2006, while demand deposits and savings accounts decreased from 19.7% and 17.2% in 2005 to 18.5% and 15.2% in 2006. The flattening and inverted yield curve also resulted in decreasing the interest rate differential between short and long-term debt.

Total interest expense increased by $21.5 million to $97.1 million in 2006. As shown in Table 5, higher interest rates on deposits and external borrowings resulted in $21.1 million of this increase, while the higher deposit and borrowings balances accounted for just $0.4 million of the increase in interest expense. Interest expense as a percentage of earning assets increased by 55 basis points to 2.54%. The rate on interest-bearing deposits increased 67 basis points to 2.46%, due largely to increases in money market and time deposit rates throughout 2006 and the previously discussed shifting of funds to higher rate deposit products. The rate on external borrowings increased 98 basis points to 5.29% because of the aforementioned increase in short-term market rates. Total interest expense increased by $13.8 million to $75.6 million in 2005 as compared to 2004. Higher interest rates accounted for the vast majority of the increase. The rate on interest-bearing deposits increased 30 basis points to 1.79% and the rate on external borrowings increased 101 basis points to 4.31% in 2005.

The following table sets forth information related to average interest-earning assets and interest-bearing liabilities and their associated yields and rates for the years ended December 31, 2006, 2005 and 2004. Interest income and yields are on a fully tax-equivalent basis using marginal income tax rates of 38.4% in 2006, 38.6% in 2005, and 38.7% in 2004. Average balances are computed by totaling 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 4: Average Balance Sheet**

| (000 s omitted except yields and rates) | Year Ended December 31, 2006 | | | Year Ended December 31, 2005 | | | Year Ended December 31, 2004 | | |
|---|---|---|---|---|---|---|---|---|---|
| | Average Balance | Interest | Avg. Yield/Rate Paid | Average Balance | Interest | Avg. Yield/Rate Paid | Average Balance | Interest | Avg. Yield/Rate Paid |
| Interest-earning assets: | | | | | | | | | |
| Time deposits in other banks | $ 36,458 | $ 1,824 | 5.00% | $ 8,867 | $ 281 | 3.17% | $ 6,233 | $ 75 | 1.19% |
| Taxable investment securities (1) | 754,618 | 41,702 | 5.53% | 881,696 | 49,739 | 5.64% | 940,792 | 54,205 | 5.76% |
| Nontaxable investment securities (1) | 515,459 | 35,418 | 6.87% | 530,639 | 35,704 | 6.73% | 512,666 | 35,626 | 6.95% |
| Loans (net of unearned discount) | 2,514,173 | 167,676 | 6.67% | 2,374,832 | 148,075 | 6.24% | 2,264,791 | 137,450 | 6.07% |
| Total interest-earning assets | 3,820,708 | 246,620 | 6.45% | 3,796,034 | 233,799 | 6.16% | 3,724,482 | 227,356 | 6.10% |
| Noninterest-earning assets | 431,940 | | | 470,966 | | | 471,743 | | |
| Total assets | $ 4,252,648 | | | $ 4,267,000 | | | $ 4,196,225 | | |
| Interest-bearing liabilities: | | | | | | | | | |
| Interest checking, savings and money market deposits | $ 1,149,236 | 11,792 | 1.03% | $ 1,175,818 | 8,959 | 0.76% | $ 1,130,914 | 6,368 | 0.56% |
| Time deposits | 1,348,167 | 49,752 | 3.69% | 1,214,719 | 33,793 | 2.78% | 1,188,625 | 28,219 | 2.37% |
| Short-term borrowings | 144,043 | 5,513 | 3.83% | 366,775 | 11,249 | 3.07% | 442,287 | 7,242 | 1.64% |
| Long-term borrowings | 528,355 | 30,035 | 5.68% | 394,195 | 21,571 | 5.47% | 381,716 | 19,923 | 5.22% |
| Total interest-bearing liabilities | 3,169,801 | 97,092 | 3.06% | 3,151,507 | 75,572 | 2.40% | 3,143,542 | 61,752 | 1.96% |
| Noninterest-bearing liabilities: | | | | | | | | | |
| Demand deposits | 567,500 | | | 585,913 | | | 553,867 | | |
| Other liabilities | 56,149 | | | 63,004 | | | 58,189 | | |
| Shareholders equity | 459,198 | | | 466,576 | | | 440,627 | | |
| Total liabilities and shareholders equity | $ 4,252,648 | | | $ 4,267,000 | | | $ 4,196,225 | | |
| Net interest earnings | | $ 149,528 | | | $ 158,227 | | | $ 165,604 | |
| Net interest spread | | | 3.39% | | | 3.76% | | | 4.14% |
| Net interest margin on interest-earning assets | | | 3.91% | | | 4.17% | | | 4.45% |
| Fully tax-equivalent adjustment | | $ 14,719 | | | $ 14,355 | | | $ 14,508 | |

(1) Averages for investment securities are based on historical cost 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, the change in net interest income (fully tax-equivalent basis) may be analyzed by segregating the volume and rate components of the changes in interest income and interest expense for each underlying category.

**Table 5: Rate/Volume**

| | 2006 Compared to 2005 | | | 2005 Compared to 2004 | | |
|---|---|---|---|---|---|---|
| | Increase (Decrease) Due to Change in (1) | | | Increase (Decrease) Due to Change in (1) | | |
| **(000 s omitted)** | **Volume** | **Rate** | **Net Change** | **Volume** | **Rate** | **Net Change** |
| Interest earned on: | | | | | | |
| Time deposits in other banks | $ 1,300 | $ 243 | $ 1,543 | $ 42 | $ 164 | $ 206 |
| Taxable investment securities | (7,041) | (996) | (8,037) | (3,351) | (1,115) | (4,466) |
| Nontaxable investment securities | (1,034) | 748 | (286) | 1,229 | (1,151) | 78 |
| Loans (net of unearned discount) | 8,965 | 10,636 | 19,601 | 6,795 | 3,830 | 10,625 |
| Total interest-earning assets (2) | 1,529 | 11,292 | 12,821 | 4,394 | 2,049 | 6,443 |
| Interest paid on: | | | | | | |
| Interest checking, savings and money market deposits | (207) | 3,040 | 2,833 | 262 | 2,329 | 2,591 |
| Time deposits | 4,017 | 11,942 | 15,959 | 632 | 4,942 | 5,574 |
| Short-term borrowings | (8,033) | 2,297 | (5,736) | (1,413) | 5,420 | 4,007 |
| Long-term borrowings | 7,598 | 866 | 8,464 | 664 | 984 | 1,648 |
| Total interest-bearing liabilities (2) | 441 | 21,079 | 21,520 | 157 | 13,663 | 13,820 |
| Net interest earnings (2) | 1,022 | (9,721) | (8,699) | 3,135 | (10,512) | (7,377) |

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

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

## Noninterest Income

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

**Table 6: Noninterest Income**

| | Years Ended December 31, | | |
|---|---|---|---|
| **(000 s omitted except ratios)** | **2006** | **2005** | **2004** |
| Deposit service charges and fees | $ 22,183 | $ 21,961 | $ 20,342 |
| Benefit plan administration, consulting and actuarial fees | 13,205 | 11,193 | 9,158 |
| Trust, investment and asset management fees | 7,396 | 7,307 | 7,583 |
| Commissions and other | 4,713 | 4,630 | 4,157 |
| Electronic banking | 3,443 | 2,788 | 2,556 |
| Mortgage banking | 739 | 522 | 525 |
| Subtotal | 51,679 | 48,401 | 44,321 |
| Gain (loss) on investment securities & debt extinguishments | (2,403) | 12,195 | 72 |
| Total noninterest income | $ 49,276 | $ 60,596 | $ 44,393 |
| Noninterest income/operating income (FTE) | 24.8% | 27.7% | 21.1% |

As displayed in Table 6, noninterest income, excluding security gains and debt extinguishments costs, increased by 6.8% to $51.7 million largely as a result of growth in recurring bank fees and benefit plan administration, consulting and actuarial fees. The gain (loss) on the sale of investment securities and debt extinguishments decreased $14.6 million as 2006 included a one-time $2.4 million charge related to the early redemption of fixed rate, trust-preferred obligations. Additionally, 2006 did not include $12.2 million of gains on the sale of investment securities. Refer to the Investments section of the MD&A on pages 34 through 36 for further information. Total noninterest income, excluding security gains and debt extinguishments costs, of $48.4 million for 2005 increased by 9.2% over 2004, largely as a result of higher utilization of bank services, and growth at BPA-Harbridge.

Noninterest income as a percent of operating income (FTE basis) was 24.8% in 2006, down 2.9 percentage points from the prior year. Excluding the gain (loss) on investment securities & debt extinguishments, noninterest income as a percent of operating income (FTE basis) was 25.7% in 2006, a 2.2 percentage point increase from 23.5% for 2005. This increase was primarily driven by the aforementioned strong growth in recurring bank fees and benefit plan administration, consulting and actuarial fees and declining net interest income. This ratio is considered an important measure for determining the progress the Company is making on one of its primary long-term strategies, expansion of noninterest income in order to diversify its revenue sources and reduce reliance on net interest margins that may be strongly impacted by general interest rate and other market conditions.

The largest portion of the Company s recurring noninterest income is the wide variety of fees earned from general banking services, which reached $31.1 million in 2006, up 3.9% from the prior year. A large portion of the income growth was attributable to electronic banking fees, up $0.7 million, or 24%, over 2005 s level, due in large part to a concerted effort to increase the penetration and utilization of debit cards as well as the introduction of a business debit card program. Overdraft fees were also up $0.7 million, or 4.1%, over 2005 s level, driven by several revenue enhancement initiatives put into place during 2005 and core deposit account growth. Mortgage banking fees increased $0.2 million, or 42%, primarily due to the addition of a $300 million serviced loan portfolio in conjunction with the Elmira acquisition in August 2006.Fees from general banking services were $29.9 million in 2005, up $2.3 million, or 8.4%, from 2004 primarily driven by growth in overdraft fees and commissions, a majority of which was derived from having a full year of results from the First Heritage and Dansville acquisitions.

As disclosed in Table 6, noninterest income from financial services (including revenues from benefit plan consulting and administration and wealth management services) rose $2.1 million, or 11.4%, in 2006 to $20.6 million. Financial services revenue now comprises 40% of total noninterest income, excluding net gains (losses) on the sale of investment securities and debt extinguishments. Strong performance at

BPA-Harbridge generated revenue growth of $2.0 million, or 18%, for the 2006 year, achieved primarily through new product offerings and expanded market coverage. BPA-Harbridge offers their clients daily valuation, actuarial and employee benefit consulting services on a national basis from offices in Upstate New York and Pittsburgh. BPA-Harbridge revenue of $11.2 million in 2005 was $2.0 million higher than prior year results, driven by enhanced service offerings to both new and existing clients, a portion of which relates to new actuarial determinations required by certain state and federal healthcare programs.

Personal trust generated revenue growth of $210,000, or 10.5%, in 2006, achieved primarily through the generation of estate settlement fees. CISI generated revenue growth of $117,000, or 3.1%, in 2006 primarily through the addition of new financial consultants. Revenue at Nottingham declined $238,000, or 16%, during 2006 as it transitioned to a new management team, a new name and the broadening of its product offerings. In 2005 personal trust had positive revenue growth of $154,000 or, 8.3%, achieved through new client relationships and the investment of additional assets by established clients. CISI and Nottingham were negatively impacted in 2005 by the challenging retail investment market conditions. Revenues in 2005 were down $323,000, or 17.6%, and $106,000, or 2.7%, at Nottingham and CISI, respectively, as compared to 2004.

Assets under management and administration at the Company s financial services businesses rose considerably over the last two years reaching $3.2 billion at the end of 2006, compared to $2.5 billion at year-end 2005 and $2.2 billion at year-end 2004. Market-driven gains in equity-based assets were augmented by attraction of new client assets. BPA in particular was very successful at growing its asset base, as demonstrated by a $549 million, or 40%, increase in its assets under administration during 2006.

Excluding debt extinguishments costs, the total financial services group contributed $4.6 million (excluding allocation of indirect corporate expense), or 8.7%, of the Company s pre-tax income in 2006, reflecting nearly a 21% operating margin. In 2005, financial services contribution, excluding nonrecurring retirement charges was $2.9 million, or 4.1%, of total pre-tax income, with a margin of 15%. The higher earnings in 2006 were the result of increased revenues at BPA-Harbridge and personal trust combined with expense reduction activities. The increase in percentage contribution was primarily due to growth in the financial services businesses in 2006, combined with the decline in banking net interest income.

In the fourth quarter of 2006, the Company incurred a $2.4 million charge related to the early redemption of its $30 million, 9.75% fixed-rate trust preferred obligations, which included a premium call provision at 4.54%. There were no gains or losses on security transactions in 2006 as compared to gains of $12.2 million in 2005 and $72,000 in 2004, as the Company took advantage of market conditions in 2005 to sell certain securities in order to shorten the average length of the portfolio and maximize their expected total return. Securities sold included $173.2 million of U.S. Treasury and Agency securities, $46.1 million of AAA-rated obligations of state and political subdivisions, and $24.4 million of investment grade corporate bonds. The corresponding gains recognized on these sales were $7.0 million, $2.2 million and $3.0 million, respectively.

The security and debt gains and losses taken over the last three years are illustrative of the Company s active management of its investment portfolio and external borrowings to achieve a desirable total return through the combination of net interest income, transaction gains/losses and changes in market value across financial market cycles, as well as achieving an appropriate interest-rate sensitivity profile in changing rate environments.

**Operating Expenses**

As shown in Table 7, operating expenses declined $0.2 million, or 0.1%, in 2006 to $127.2 million. Excluding special charges/acquisition expenses, operating expenses were up $2.1 million, or 1.7%, in 2006, primarily attributable to the effect of adopting SFAS 123(R), increased business development and marketing expenses, and operating expenses related to the acquisitions of Elmira and ONB, partially offset by lower amortization of intangible assets. Operating expenses for 2006 as a percent of average assets were 2.99%, consistent with 2005 and 13 basis points above the 2.86% in 2004. The increase in this ratio for 2005 was principally due to the reduction in the size of the investment portfolio, the special charge related to certain early retirement actions as well as more robust business development and marketing programs.

The efficiency ratio, a performance measurement tool widely used by banks, is defined by the Company as operating expenses (excluding special charges/acquisition expenses and intangible amortization) divided by operating income (fully tax-equivalent net interest income plus noninterest income, excluding net securities and debt gains and losses). Lower ratios are often correlated to higher efficiency. In 2006 the efficiency ratio increased 3.1 percentage points to 59.9% due to a 2.7% increase in operating expenses and a 5.5% decline in net interest income having a greater impact than a 6.8% increase in noninterest income (excluding net securities gains and debt extinguishments costs). The efficiency ratio for 2005 was 4.0 percentage points higher than the 52.8% ratio for 2004 due to similar reasons, with 5.9% higher operating expenses and 1.6% lower net operating income.

**Table 7: Operating Expenses**

| | Years Ended December 31, | | |
|---|---|---|---|
| **(000 s omitted)** | **2006** | **2005** | **2004** |
| Salaries and employee benefits | $ 65,497 | $ 65,059 | $ 61,146 |
| Stock option expense | 1,848 | 0 | 0 |
| Occupancy and equipment | 17,884 | 17,756 | 16,745 |
| Data processing and communications | 13,178 | 13,565 | 13,972 |
| Amortization of intangible assets | 6,027 | 7,125 | 7,414 |
| Legal and professional fees | 4,351 | 4,540 | 4,566 |
| Office supplies and postage | 4,035 | 3,804 | 3,722 |
| Business development and marketing | 4,007 | 2,771 | 2,003 |
| Foreclosed property | 858 | 1,312 | 994 |
| Special charges/acquisition expenses | 647 | 2,943 | 1,704 |
| Other | 8,871 | 8,514 | 7,633 |
| Total operating expenses | $ 127,203 | $ 127,389 | $ 119,899 |
| Operating expenses/average assets | 2.99% | 2.99% | 2.86% |
| Efficiency ratio | 59.9% | 56.8% | 52.8% |

Salaries and benefits increased $0.4 million or 0.6% in 2006 as a result of $0.5 million related to the acquisitions of Elmira in August and ONB in December and $0.6 million related to higher retirement plan expense, partially offset by higher deferred loan origination costs. Stock option expense of $1.8 million relates to the adoption of SFAS 123(R), which required the recognition of expense based on the fair value of the options on the grant date. Higher personnel expenses accounted for 52% of 2005 s increase in operating costs, primarily the result of the First Heritage and Dansville acquisitions in 2004. The remainder of the increase in personnel expense reflects higher benefit costs and merit increases. Total full-time equivalent staff at the end of 2006 was 1,352 compared to 1,299 at December 31, 2005 and 1,301 at the end of 2004.

Medical expenses declined 2.6% in 2006 as a result of proactive claims management, lower utilization, and a change in plan administrators. Medical expenses were up in 2005 due to a general rise in the cost of medical care, administration and insurance, as well as a greater number of insured employees. In 2006 qualified and nonqualified pension expense decreased $1.0 million due to the special charge taken in 2005 related to certain early retirement actions. Qualified and nonqualified pension expenses increased in 2005 principally due to the special charge related to certain early retirement actions and a lower discount rate. The three assumptions that have the largest impact on the calculation of annual pension expense are the aforementioned discount rate, the rate applied to future compensation increases and the expected rate of return on plan assets. See Note K to the financial statements for further information concerning the pension plan.

Total non-personnel operating expense decreased $2.1 million or 1.7% in 2006. Excluding special charges/acquisition expense, nonpersonnel expenses were consistent with 2005 s level. As displayed in Table 7, this was largely caused by higher business development and marketing (up $1.2 million), other expenses (up $0.4 million), office and supplies (up $0.2 million), and occupancy and equipment expense (up $0.1 million), partially offset by decreases in amortization of intangible assts (down $1.1 million), foreclosed property (down $0.5 million) and data processing and communication expense (down $0.4 million). Business and marketing costs were up mostly due to the initiation of a bankwide deposit generation program. A majority of the remaining increase in nonpersonnel operating costs is attributable to $0.3 million of expenses added as a result of the Elmira and ONB acquisitions in the second half of 2006. The amortization of intangibles decreased as certain core deposit and customer relationship intangibles arising from prior acquisitions became fully amortized.

The Company successfully managed all aspects of its operating expense structure for 2006, resulting in operating expenses excluding special charges/acquisitions, the effect of adopting SFAS 123(R), and costs associated with the acquisitions decreasing slightly as compared to the year earlier period. During 2006, the Company consolidated three of its branch offices into nearby sister branches. This realignment will reduce market overlap and further strengthen its branch network, and reflects management s focus on achieving long-term performance improvements through proactive strategic decision making.

Total nonpersonnel expenses increased $3.9 million, or 6.4%, in 2005 from 2004. Excluding acquisition-related expenses, nonpersonnel expenses were up $2.3 million, or 4.1%, from 2004 s level. This increase was largely caused by higher occupancy and equipment expense (up $1.0 million), business development and marketing (up $0.8 million), foreclosed property (up $0.3 million), and other expenses (up $0.9 million), partially offset by decreases in data processing and communication expense (down $0.4 million) and amortization of intangible assets (down $0.3 million). The increase in occupancy and equipment in 2005 was mainly due to incremental costs from recently acquired facilities, expenses arising from renovations and repairs, the effect of higher rates and severe weather on maintenance and utilities expenses, and the general increase in property taxes in many of the municipalities in which we operate. Business development and marketing costs were up due to a more robust marketing strategy in 2005. The majority of the increase in other expenses relates to higher overdraft charge-offs as a result of higher transaction volume and certain fixed asset write-downs. Data processing and communications costs have decreased due to certain contract renegotiations, the assimilation of the 2004 acquisitions, and other vendor management programs.

Special charges/acquisition expenses totaled $0.6 million in 2006, down $2.3 million from $2.9 million in 2005. The 2006 special charge relates to early retirement of certain long-service employees and acquisition expenses of $0.3 million. The 2005 special charge relates to the early retirement of certain long-service executives and includes severance and certain benefit plan enhancements. Acquisition expenses totaled $1.7 million in 2004 comprised of severance and employee benefits of $1.0 million and legal, consulting and system conversion costs of $0.7 million.

**Income Taxes**

The Company estimates its tax expense based on the amount it expects to owe the respective tax authorities, plus the impact of deferred tax items. Taxes are discussed in more detail in Note I of the Consolidated Financial Statements beginning on page 59. Accrued taxes represent the net estimated amount due or to be received from taxing authorities. In estimating accrued taxes, management assesses the relative merits and risks of the appropriate tax treatment of transactions taking into account statutory, judicial and regulatory guidance in the context of the Company s tax position. If the final resolution of taxes payable differs from its estimates due to regulatory determination or legislative or judicial actions, adjustments to tax expense may be required.

The effective tax rate for 2006 decreased by 2.2 percentage points to 23.7%. The lower effective tax rate for 2006 was principally a result of a higher proportion of income being generated from tax-exempt securities and loans. The effective tax rate for 2005 increased by 1.0 percentage point to 25.9%. This increase was due to a larger proportion of income from fully taxable sources, primarily the gains from the sale of investment securities versus the prior year period.

**Capital**

Shareholders equity ended 2006 at $461.5 million, up $3.9 million, or 0.9%, from one year earlier. This increase reflects net income of $38.4 million and $7.5 million from the issuance of shares through employee stock plans. These increases were partially offset by common stock dividends declared of $23.3 million, treasury share purchases of $5.5 million and a $13.1 million decrease in other comprehensive loss. The other comprehensive loss is comprised of a $9.9 million charge for the adoption of SFAS 158, *Employers Accounting for Defined Benefit Pension and Other Postretirement Plans an Amendment of FASB Statements No. 87, 88, 106, and 132(R)* ( SFAS 158 ), a $3.6 million decline in the market value adjustment ( MVA , represents the after-tax, unrealized change in value of available-for-sale securities in the Company s investment portfolio), partially offset by a $0.5 million increase in the fair value of interest rate swaps. The adoption of SFAS 158 required that the funded status of all defined benefit pension and postretirement plans be recorded as an asset or liability on the Company s consolidated statement of condition with a corresponding offset, net of taxes recorded in accumulated other comprehensive income within shareholders equity. Excluding accumulated other comprehensive income in both 2006 and 2005, capital rose by $17.1 million, or 3.8%. Shares outstanding increased by 63,000 during the year, comprised of 322,000 added through employee stock plans, offset by the purchase of 259,000 treasury shares.

The Company s ratio of Tier 1 capital to assets (or tier 1 leverage ratio), the basic measure for which regulators have established a 5% minimum for an institution to be considered well-capitalized, increased 124 basis points at year-end 2006 to 8.81%. This was due primarily to the capital-building contribution from the issuance of trust-preferred securities in December 2006, partially offset by the increase in average assets due primarily to the Elmira and ONB acquisitions. The tangible equity/tangible assets ratio was 5.07% at the end of 2006 versus 5.93% one year earlier. The decline was due to a 7.4% decrease in tangible equity as a result of increased levels of intangible assets from the acquisitions and the implementation of SFAS 158 as well as an 8.2% increase in tangible assets due to organic and acquired growth. The Company manages organic and acquired growth in a manner that enables it to continue to build upon its strong capital base, and maintain the Company s ability to take advantage of future strategic growth opportunities.

Cash dividends declared on common stock in 2006 of $23.3 million represented an increase of 4.6% over the prior year. This growth was mostly a result of dividends per share of $0.78 for 2006 increasing from $0.74 in 2005, a result of quarterly dividends per share being raised from $0.19 to $0.20 (+5.3%) in the third quarter of 2006 and from $0.18 to $0.19 (+5.6%) in the third quarter of 2005. Additionally the increase in dollar amount of dividends declared rose because of a slight increase in the number of shares outstanding during the year, primarily a result of the issuance of shares through employee stock plans, partially offset by treasury stock purchases in 2006. The dividend payout ratio for this year was 60.7% compared to 43.9% in 2005, and 40.9% in 2004. The significant change in 2006 is a result of the aforementioned increase in dividends declared combined with a 24% decrease in net income.

**Liquidity**

Liquidity risk is measured by the Company s ability to raise cash when needed at a reasonable cost and minimize any loss. The Company must be capable of meeting all obligations to its customers at any time and, therefore, the active management of its liquidity position is critical. Given the uncertain nature of our customers demands as well as the Company s desire to take advantage of earnings enhancement opportunities, the Company must have available adequate sources of on and off-balance sheet funds that can be acquired in time of need. Accordingly, in addition to the liquidity provided by balance sheet cash flows, liquidity must be supplemented with additional sources such as credit lines from correspondent banks, the Federal Home Loan Bank, and Federal Reserve Bank. Other funding alternatives may also be appropriate from time to time, including wholesale and retail repurchase agreements, large certificates of deposit, and brokered CD relationships.

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 as a percentage of total assets); and second, a projection of subsequent cash availability over an additional 60 days. As of December 31, 2006, this ratio was 13.5% and 13.3% for the respective time periods, excluding the Company s capacity to borrow additional funds from the Federal Home Loan Bank and other sources, as compared to the Bank policy that requires a minimum of 7.5%. There is currently $122 million in additional Federal Home Loan Bank borrowing capacity based on the Company s year-end collateral levels. Additionally, the Company has $11 million in unused capacity at the Federal Reserve Bank and $100 million in unused capacity from unsecured lines of credit with other correspondent banks.

In addition to the 30 and 90-day basic surplus/deficit model, longer-term liquidity over a minimum of five years is measured and a liquidity analysis projecting sources and uses of funds is prepared. To measure longer-term liquidity, a baseline projection of loan and deposit growth for five years is made to reflect how liquidity levels could change over time. This five-year measure reflects ample liquidity for loan growth over the next five years.

Though remote, the possibility of a funding crisis exists at all financial institutions and, therefore, must be planned for. Management has addressed this issue by formulating a Liquidity Contingency Plan, which has been reviewed and approved by both the Board of Directors and the Company s Asset/Liability Management Committee. The plan addresses those actions the Company would take in response to both a short-term and long-term funding crisis.

A short-term funding crisis would most likely result from a shock to the financial system, either internal or external, which disrupts orderly short-term funding operations. Such a crisis should be temporary in nature and would not involve a change in credit ratings. A long-term funding crisis would most likely be the result of drastic credit deterioration at the Company. Management believes that both circumstances have been fully addressed through detailed action plans and the establishment of trigger points for monitoring such events.

**Intangible Assets**

Intangible assets at the end of 2006 of $246.1 million increased $21.3 million from the prior year-end due to $27.3 million of additional intangible assets arising from the acquisitions of Elmira and ONB, offset by $6.0 million of amortization during the year.

Intangible assets consist of goodwill, core deposit value and customer relationships arising from acquisitions. Goodwill represents the excess cost of an acquisition over the fair value of the net assets acquired. Goodwill at December 31, 2006 amounted to $220 million, comprised of $209 million related to banking acquisitions and $11 million arising from the acquisition of financial services businesses. Goodwill is subjected to periodic impairment analysis to determine whether the carrying value of the acquired net assets exceeds their fair value, which would necessitate a write-down of the goodwill. The Company completed its goodwill impairment analyses during 2006 and 2005 and no adjustments were necessary. The impairment analysis was 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 them to select 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. Management believes that there is a low probability of future impairment with regard to the goodwill associated with whole-bank and branch acquisitions. The performance of Nottingham weakened subsequent to its acquisition in 2000 as a result of adverse market conditions, however, its performance stabilized in 2004 as market conditions improved. As a result of margin compression and minimal growth, operating revenues declined in 2005 and 2006. Additionally, certain organizational and structural changes were made late in 2005 and 2006 that will decrease operating expenses without a reduction in service capacity. Additionally, in the third quarter Nottingham completed its re-branding efforts that included changing its name from Elias Asset Management to Nottingham, to underscore the enhanced product and service offerings it has recently developed. The Company expects these changes will result in improved operating performance for Nottingham in the future. However, additional declines in Nottingham s operating results may cause future impairment to its recorded goodwill of $7.3 million.

Core deposit intangibles represent the premium the Company has paid for deposits acquired in excess of the cost that would have been incurred had the funds been purchased in the capital markets. Core deposit intangibles are amortized on either an accelerated or straight-line basis over periods ranging from seven to twenty years. The recognition of a customer relationship intangible arose due to the acquisition of Harbridge. This asset was determined based on a methodology that calculates the present value of the projected future revenue derived from the acquired customer base. This asset is being amortized over eleven years on an accelerated basis.

**Loans**

The Company s loans outstanding, by type, as of December 31 are as follows:

**Table 8: Loans Outstanding**

| (000 s omitted) | 2006 | 2005 | 2004 | 2003 | 2002 |
|---|---|---|---|---|---|
| Consumer mortgage | $ 912,505 | $ 815,463 | $ 801,069 | $ 739,318 | $ 510,040 |
| Business lending | 960,034 | 819,605 | 831,244 | 689,436 | 629,874 |
| Consumer installment | 829,033 | 776,729 | 726,155 | 699,774 | 667,028 |
| Gross loans | 2,701,572 | 2,411,797 | 2,358,468 | 2,128,528 | 1,806,942 |
| Less: unearned discount | 14 | 28 | 48 | 82 | 116 |
| Net loans | 2,701,558 | 2,411,769 | 2,358,420 | 2,128,446 | 1,806,826 |
| Allowance for loans | 36,313 | 32,581 | 31,778 | 29,095 | 26,331 |
| Loans, net of allowance for loan losses | $ 2,665,245 | $ 2,379,188 | $ 2,326,642 | $ 2,099,351 | $ 1,780,495 |

As disclosed in Table 8 above, gross loans outstanding reached a record level of $2.7 billion as of year-end 2006, up $289.8 million or 12.0% compared to twelve months earlier. The acquisition of Elmira and ONB accounted for $242.5 million of the growth. Excluding the impact of these acquisitions, total loans rose $47.3 million or 2.0%. All of the organic loan growth was produced in the consumer mortgage and installment lines of business, with small declines experienced in business lending.

The compounded annual growth rate ( CAGR ) for the Company s total loan portfolio between 2002 and 2006 was 10.6% comprised of approximately 3.4% organic growth, with the remainder coming from whole bank and branch acquisitions. The greatest overall expansion occurred in the consumer mortgage segment, which grew at a 16% CAGR (including the impact of acquisitions) over that time frame. The consumer mortgage growth was primarily driven by record mortgage refinancing volumes over the last five years, as well as the acquisition of consumer-oriented banks and branches in that time period. As a consequence, the consumer mortgages segment accounted for 34% of the total loan portfolio at year-end 2006 versus 28% at the end of 2002. Consumer installment loans, largely borrowings originated in automobile, marine and recreational vehicle dealerships experienced a compounded annual growth rate of 10.8% over the last 5 years. Business lending grew at a compounded annual growth rate of 9.7% from 2002 to 2006.

The weighting of retail lending in the Company s loan portfolio enables it to be highly diversified. Approximately 64% of loans outstanding at the end of 2006 were made to consumers borrowing on an installment, line of credit or residential mortgage loan basis. The commercial portfolio is also broadly diversified by industry type as demonstrated by the following distributions at year-end 2006: real estate development (23%), healthcare (9%), general services (9%), motor vehicle and parts dealers (6%), construction (5%), agriculture (6%), restaurant & lodging (5%), retail trade (7%), manufacturing (6%) and wholesale trade (5%). A variety of other industries with less than a 3% share of the total portfolio comprise the remaining 19%. Since August 2006, the mix of loans has become more weighted towards business lending due to the high proportion of commercial loans in Elmira s portfolio.

The consumer mortgage segment of the Company s loan portfolio is comprised of fixed (91%) and adjustable rate (9%) residential lending. Consumer mortgages increased $97.0 million or 11.9% in 2006. Excluding the impact of the Elmira and ONB acquisitions, this segment was up $17.0 million or 2.1% in 2006. During the last several years, record levels of refinancing activity were driven by mortgage rates that were at or near 40-year lows. Consumer mortgage growth has slowed in 2006 and 2005 compared to the prior years, as the pace of refinancing slowed after an extended period of elevated demand in the low-rate environment. Growth in the consumer mortgage portfolio would have been 15.8% if the sale of $31.4 million of longer-term, fixed-rate mortgages in the secondary market had not been conducted. These mortgages were sold in the secondary market to improve the Company s interest rate risk position.

The combined total of general-purpose business lending, dealer floor plans and mortgages on commercial property is characterized as the Company s business lending activity. The business-lending portfolio increased $140.4 million or 17.1% in 2006. Excluding the impact of the Elmira and ONB acquisitions, this segment declined $3.1 million or less than 1%. Growth in commercial mortgage and business line of credit activity during the year has more than offset a planned and managed decline in automotive dealer floor plans outstanding. The Company continues to face competitive conditions in most of its markets and it maintains its commitment to generating growth in its business portfolio in a manner that adheres to its twin goals of maintaining strong asset quality and producing profitable margins.

Consumer installment loans, both those originated directly (such as personal loans and home equity loans and lines of credit), and indirectly (originated predominantly in automobile, marine and recreational vehicle dealerships), rose $52.3 million or 6.7% from one year ago. Excluding the impact of the Elmira and ONB acquisitions, this segment increased $33.4 million or 4.3%. Continued moderate interest rates by historical standards, aggressive dealer and manufacturer incentives on new vehicles, and enhanced business development efforts have helped drive strong growth in this segment over the last three years.

The following table shows the maturities and type of interest rates for business and construction loans as of December 31, 2006:

**Table 9: Maturity Distribution of Business and Construction Loans [(1)]**

| (000 s omitted) | Maturing in One Year or Less | Maturing After One but Within Five Years | Maturing After Five Years |
|---|---|---|---|
| Commercial, financial and agricultural | $ 315,502 | $ 441,711 | $ 178,943 |
| Real estate - construction | 23,946 | 0 | 0 |
| Total | $ 339,448 | $ 441,711 | $ 178,943 |
| Fixed or predetermined interest rates | $ 132,899 | $ 262,812 | $ 46,125 |
| Floating or adjustable interest rates | 206,549 | 178,899 | 132,818 |
| Total | $ 339,448 | $ 441,711 | $ 178,943 |

(1) Scheduled repayments are reported in the maturity category in which the payment is due.

**Asset Quality**

The following table presents information concerning nonperforming assets:

**Table 10: Nonperforming Assets**

| (000 s omitted) | 2006 | 2005 | 2004 | 2003 | 2002 |
|---|---|---|---|---|---|
| Nonaccrual loans | $ 10,107 | $ 10,857 | $ 11,798 | $ 11,940 | $ 9,754 |
| Accruing loans 90+ days delinquent | 1,207 | 1,075 | 1,158 | 1,307 | 1,890 |
| Restructured loans | 1,275 | 1,375 | 0 | 28 | 43 |
| Total nonperforming loans | 12,589 | 13,307 | 12,956 | 13,275 | 11,687 |
| Other real estate | 1,838 | 1,048 | 1,645 | 1,077 | 704 |
| Total nonperforming assets | $ 14,427 | $ 14,355 | $ 14,601 | $ 14,352 | $ 12,391 |
| Allowance for loan losses to total loans | 1.34% | 1.35% | 1.35% | 1.37% | 1.46% |
| Allowance for loan losses to nonperforming loans | 288% | 245% | 245% | 219% | 225% |
| Nonperforming loans to total loans | 0.47% | 0.55% | 0.55% | 0.62% | 0.65% |
| Nonperforming assets to total loans and other real estate | 0.53% | 0.59% | 0.62% | 0.67% | 0.69% |

The Company places a loan on nonaccrual status when the loan becomes ninety days past due or sooner, if management concludes collection of interest is doubtful, except when, in the opinion of management, it is well-collateralized and in the process of collection. As shown in Table 10 above, nonperforming loans, defined as nonaccruing loans plus accruing loans 90 days or more past due, ended 2006 at $12.6 million, down approximately $0.7 million or 5.4% from one year earlier. The ratio of nonperforming loans to total loans decreased eight basis points from the prior year to 0.47%. The ratio of nonperforming assets (which includes troubled debt restructuring and other real estate owned, or OREO , in addition to nonperforming loans) to total loans plus OREO decreased to 0.53% at year-end 2006, down six basis points from one-year earlier. The improvement was driven by improvements in the economy, enhanced collection and recovery efforts, and the charge-off and disposition of certain problematic loans in prior years. Had nonaccrual loans for the year ended December 31, 2006 been current in accordance with their original terms, additional interest income of approximately $1.0 million would have been recorded. At year-end 2006, the Company was managing 23 OREO properties with a value of $1.8 million as compared to 15 OREO properties at a value of $1.0 million a year earlier.

Total delinquencies, defined as loans 30 days or more past due or in nonaccrual status, finished the current year at 1.33% of total loans outstanding versus 1.46% at the end of 2005. As of year-end 2006, total delinquency ratios for commercial loans, consumer loans, and real estate mortgages were 1.62%, 1.33%, and 1.03%, respectively. These measures were 1.80%, 1.57% and 1.02%, respectively, as of December 31, 2005. Delinquency levels, particularly in the 30 to 89 days category, tend to be somewhat volatile due to their measurement at a point in time, and therefore management believes that it is useful to look at this ratio over a longer period. The total average quarter-end delinquency ratio for 2006 was 1.24% versus 1.40% in 2005.

The changes in the allowance for loan losses for the last five years is as follows:

**Table 11: Allowance for Loan Loss Activity**

| | Years Ended December 31, | | | | |
|---|---|---|---|---|---|
| **(000 s omitted except for ratios)** | **2006** | **2005** | **2004** | **2003** | **2002** |
| Allowance for loan losses at beginning of period | $ 32,581 | $ 31,778 | $ 29,095 | $ 26,331 | $ 23,901 |
| *Charge-offs:* | | | | | |
| Business lending | 3,787 | 2,639 | 3,621 | 5,521 | 5,071 |
| Consumer mortgage | 344 | 522 | 535 | 239 | 221 |
| Consumer installment | 5,902 | 8,071 | 7,624 | 7,351 | 6,723 |
| Total charge-offs | 10,033 | 11,232 | 11,780 | 13,111 | 12,015 |
| *Recoveries:* | | | | | |
| Business lending | 930 | 730 | 871 | 417 | 281 |
| Consumer mortgage | 107 | 142 | 48 | 78 | 119 |
| Consumer installment | 2,925 | 2,629 | 2,437 | 2,353 | 1,823 |
| Total recoveries | 3,962 | 3,501 | 3,356 | 2,848 | 2,223 |
| Net charge-offs | 6,071 | 7,731 | 8,424 | 10,263 | 9,792 |
| Provision for loan losses | 6,585 | 8,534 | 8,750 | 11,195 | 12,222 |
| Allowance on acquired loans (1) | 3,218 | 0 | 2,357 | 1,832 | 0 |
| Allowance for loan losses at end of period | $ 36,313 | $ 32,581 | $ 31,778 | $ 29,095 | $ 26,331 |
| Amount of loans outstanding at end of period | $ 2,701,558 | $ 2,411,769 | $ 2,358,420 | $ 2,128,446 | $ 1,806,826 |
| Daily average amount of loans (net of unearned discount) | 2,514,173 | 2,374,832 | 2,264,791 | 1,885,541 | 1,759,500 |
| Net charge-offs to average loans outstanding | 0.24% | 0.33% | 0.37% | 0.54% | 0.56% |

(1) This reserve addition is attributable to loans acquired from Elmira and ONB in 2006, First Heritage Bank in 2004, and Peoples Bankcorp Inc. and Grange National Banc Corp in 2003.

As displayed in Table 11 above, total net charge-offs in 2006 were $6.1 million, down $1.7 million from the prior year, principally due to significantly improved results in the consumer installment lending portfolio, offset by increased net charge-offs in the business lending portfolio. Net charge-offs in 2005 were $0.7 million below 2004 s level, benefiting from improved results in the business-lending portfolio. A prolonged period of economic weakness in our markets from late 2000 through early 2003 impacted the net charge-off levels in both 2002 and 2003, with the greatest impact being realized in the business loan segment.

Due to the significant increases in average loan balances over time due to acquisition and organic growth, management believes that net charge-offs as a percent of average loans ( net charge-off ratio ) offers a more meaningful representation of asset quality trends. The net charge-off ratio for 2006 was down nine basis points from last year to 0.24%. This year s ratio benefited from improved gross charge-off and recovery performance. Gross charge-offs as a percentage of average loans dropped seven basis points to 0.40% in 2006. Enhanced recovery efforts were evidenced by recoveries of $4.0 million, representing 37% of average gross charge-offs for the latest two years, compared to 30% in 2005.

Business loan net charge-offs increased in 2006, totaling $2.9 million or 0.33% of average business loans outstanding versus $1.9 million or 0.23% in 2005. The primary reason for the increased net charge-off ratio for business loans were three commercial relationships in the auto industry. Consumer installment loan net charge-offs decreased to $3.0 million this year from $5.4 million in 2005, and the 2006 net charge-off ratio decreased 35 basis points to 0.37% due to improved collection efforts and underwriting processes. Consumer mortgage net charge-offs declined $0.1 million to $0.2 million in 2006, and the net charge-off ratio declined two basis points to 0.03%.

All the primary asset quality metrics deteriorated in 2002 and these conditions continued into 2003. This was principally due to the weakened economic conditions in the Company s markets, and was manifested most strongly in the business loan portfolio. Based on almost all measurements, the asset quality profile of the Company began to improve in 2003 in conjunction with gradually improving economic conditions and strengthened credit administration and loan review resources. Significant changes and enhancements were made to lending and credit administration functions in 2003 and have continued through 2006. These improvements contributed significantly to the positive credit management performance in over the last three years.

Management continually evaluates the credit quality of the Company s loan portfolio and conducts a formal review of the allowance for loan loss adequacy on a quarterly basis. The two primary components of the loan review process that are used to determine proper allowance levels are specific and general loan loss allocations.

Measurement of specific loan loss allocations is typically based on expected future cash flows, collateral values and other factors that may impact the borrower s ability to pay. Impaired loans greater than $0.5 million are evaluated for specific loan loss allocations, as defined in SFAS No. 114, *Accounting by Creditors for Impairment of a Loan*, as amended. Consumer mortgages and consumer installment loans are considered smaller balance homogeneous loans and are evaluated collectively. The Company considers a loan to be impaired when, based on current information and events, it is probable that the Company will be unable to collect all amounts according to the contractual terms of the loan agreement or the loan is delinquent 90 days or more.

The second component of the allowance establishment process, general loan loss allocations, is composed of two calculations that are computed on the four main loan segments: commercial, consumer direct, consumer indirect and residential real estate. The first calculation determines an allowance level based on the latest three years of historical net charge-off data for each loan category (commercial loans exclude balances with specific loan loss allocations). The second calculation is qualitative and takes into consideration five major factors affecting the level of loan loss risk: portfolio risk migration patterns (internal credit quality trends); the growth of the segments of the loan portfolio; economic and business environment trends in the Company s markets (includes review of bankruptcy, unemployment, population, consumer spending and regulatory trends); industry, geographical and product concentrations in the portfolio; and the perceived effectiveness of managerial resources and lending practices and policies. These two allowance calculations are added together to determine the general loan loss allocation. The allowance levels computed from the specific and general loan loss allocation methods are combined to derive the necessary allowance for loan loss to be reflected on the Consolidated Statement of Condition.

The loan loss provision is calculated by subtracting the previous period allowance for loan loss, net of the interim period net charge-offs, from the current required allowance level. This provision is then recorded as an expense in the income statement for that period.

Members of senior management and the loan committee of the Board of Directors review the adequacy of the allowance for loan loss quarterly. Management is committed to continually improving the credit assessment and risk management capabilities of the Company and has dedicated the resources necessary to ensure advancement in this critical area of operations.

The allowance for loan loss was increased to $36.3 million at year-end 2006 from $32.6 million at the end of 2005. The $3.7 million increase was primarily due to the $242 million additional loans from the Elmira and ONB acquisitions as well as $47 million of organic loan growth, while the Company s asset quality profile remained favorable. The ratio of the allowance for loan loss to total loans decreased one basis point to 1.34% for year-end 2006 as compared to 1.35% for year end 2005 and 2004 primarily due to acquired loans. Management believes the year-end 2006 allowance for loan losses to be adequate in light of the probable losses inherent in the Company s loan portfolio.

The loan loss provision of $6.6 million in 2006 decreased by $1.9 million or 23% as a result of management s assessment of the probable losses in the loan portfolio, and the reduced level of charge-offs in 2006, as discussed above. The loan loss provision as a percentage of average loans decreased from 0.36% in 2005 to 0.26% this year in most part due to the improving asset quality trends. The loan loss provision covered net charge-offs by 108% this year versus 110% in 2005, reflective of the reduced level of charge-offs this year.

The following table sets forth the allocation of the allowance for loan losses by loan category as of the dates indicated, as well as the percentage of loans in each category to total loans. This allocation is based on management s assessment, as of a given point in time, of the risk characteristics of each of the component parts of the total loan portfolio and is subject to changes when the risk factors of each component part change. The allocation is not indicative of either the specific amounts of the loan categories in which future charge-offs may be taken, nor should it be taken as an indicator of future loss trends. The allocation of the allowance to each category does not restrict the use of the allowance to absorb losses in any category.

**Table 12: Allowance for Loan Losses by Loan Type**

| (000 s omitted except for ratios) | 2006 Allowance | 2006 Loan Mix | 2005 Allowance | 2005 Loan Mix | 2004 Allowance | 2004 Loan Mix | 2003 Allowance | 2003 Loan Mix | 2002 Allowance | 2002 Loan Mix |
|---|---|---|---|---|---|---|---|---|---|---|
| Consumer mortgage | $ 3,519 | 33.8% | $ 2,991 | 33.8% | $ 1,810 | 34.0% | $ 1,724 | 34.7% | $ 479 | 28.2% |
| Business lending | 17,700 | 35.5% | 15,917 | 34.0% | 16,439 | 35.2% | 15,549 | 32.4% | 16,765 | 34.9% |
| Consumer installment | 10,258 | 30.7% | 12,005 | 32.2% | 11,487 | 30.8% | 11,112 | 32.9% | 8,978 | 36.9% |
| Unallocated | 4,836 | | 1,668 | | 2,042 | | 710 | | 109 | |
| Total | $ 36,313 | 100.0% | $ 32,581 | 100.0% | $ 31,778 | 100.0% | $ 29,095 | 100.0% | $ 26,331 | 100.0% |

As demonstrated in Table 12 above and discussed previously, business lending by its nature carries a higher credit risk than consumer mortgage or consumer direct and indirect, and as a result a disproportionate amount of the allowance for loan losses is deemed necessary for this portfolio. For 2006 the proportion of the allowance for loan losses allocated to consumer direct and indirect declined 8.6 percentage points, as a result of the favorable net charge-off performance over the last year.

The unallocated allowance increased from $1.7 million in 2005 to $4.8 million in 2006. As in prior years, the unallocated allowance is maintained for inherent losses in the portfolio not reflected in the historical loss ratios, model imprecision and for the acquired loan portfolios, including Elmira and ONB, which historically have included loans underwritten with less conservative underwriting standards.

**Funding Sources**

The Company utilizes a variety of funding sources to support the earning asset base as well as to achieve targeted growth objectives. Overall funding is comprised of three primary sources that possess a variety of maturity, stability, and price characteristics: deposits of individuals, partnerships and corporations (IPC deposits); collateralized municipal deposits (public funds); and external borrowings.

The average daily amount of deposits and the average rate paid on each of the following deposit categories are summarized below for the years indicated:

**Table 13: Average Deposits**

| (000 s omitted, except rates) | 2006 Average Balance | 2006 Average Rate Paid | 2005 Average Balance | 2005 Average Rate Paid | 2004 Average Balance | 2004 Average Rate Paid |
|---|---|---|---|---|---|---|
| Noninterest-bearing demand deposits | $ 567,500 | 0.00% | $ 585,913 | 0.00% | $ 553,867 | 0.00% |
| Interest-bearing demand deposits | 346,618 | 0.44% | 309,617 | 0.25% | 300,377 | 0.24% |
| Regular savings deposits | 465,058 | 0.76% | 511,907 | 0.67% | 524,425 | 0.66% |
| Money market deposits | 337,560 | 2.00% | 354,294 | 1.34% | 306,112 | 0.72% |
| Time deposits | 1,348,167 | 3.69% | 1,214,719 | 2.78% | 1,188,625 | 2.37% |
| Total deposits | $ 3,064,903 | 2.01% | $ 2,976,450 | 1.44% | $ 2,873,406 | 1.20% |

As displayed in Table 13 above, total average deposits for 2006 equaled $3.06 billion, up $88.5 million or 3.0% from the prior year. Excluding the average deposits acquired from Elmira and ONB in 2006, average deposits increased $35.8 million or 1.2%. Average deposits in 2005 were up $103 million or 3.6% from 2004. This increase was principally the result of deposits obtained through the First Heritage and Dansville acquisitions in the second and fourth quarter of 2004, respectively.

The Company s funding composition continues to benefit from a high level of IPC deposits, which reached an all-time high in 2006 with an average balance of $2.83 billion, an increase of $56.0 million or 2.0% over the comparable 2005 period. This was largely due to the $52 million in IPC deposits added in conjunction with the acquisitions of Elmira and ONB in August and December, respectively. IPC deposits are frequently considered to be a bank s most attractive source of funding because they are generally stable, do not need to be collateralized, have a relatively low cost, and provide a strong customer base for which a variety of loan, deposit and other financial service-related products can be sold.

Full-year average deposits of local municipalities rose $32.5 million or 16% during 2006, with the Elmira and ONB acquisitions accounting for $0.5 million of the increase. The Company is required to collateralize all local government deposits with marketable securities from its investment portfolio. Because of this stipulation, management considers this source of funding to be similar to external borrowings. As such, the Company generally prices the time deposit portion of this funding source consistent with alternative external borrowing rates.

The mix of average deposits in 2006 changed slightly in comparison to 2005. The weightings of interest checking and time deposits increased from their 2005 levels, while noninterest bearing demand deposit, savings, and money market weightings decreased. This change in deposit mix reflects new product introductions, proactive marketing and increasing yields on time deposit accounts throughout the year. The average balance for time deposit accounts increased from 40.8% of the total deposits in 2005 to 44.0% of total deposits this year. This shift in mix, combined with increased interest rates on all deposit products caused the cost of interest bearing deposits to rise 2.46% in 2006, as compared to 1.79% in 2005 and 1.49% in 2004.

The remaining maturities of time deposits in amounts of $100,000 or more outstanding as of December 31 are as follows:

**Table 14: Time Deposit > $100,000 Maturities**

| **(000 s omitted)** | **2006** | **2005** |
|---|---|---|
| Less than three months | $ 92,930 | $ 104,029 |
| Three months to six months | 40,358 | 36,538 |
| Six months to one year | 77,581 | 70,482 |
| Over one year | 54,915 | 37,190 |
| Total | $ 265,784 | $ 248,239 |

External borrowings are defined as funding sources available on a national market basis, generally requiring some form of collateralization. Borrowing sources for the Company include the Federal Home Loan Bank of New York and Federal Reserve Bank of New York, as well as access to the repurchase market through established relationships with primary market security dealers. The Company also had approximately $158 million in fixed and floating-rate subordinated debt outstanding at the end of 2006 that is held by unconsolidated subsidiary trusts. In December 2006 the Company completed a sale of $75 million of trust preferred securities. The securities mature on December 15, 2036 at an annual rate equal to the three month LIBOR rate plus 1.65%. The net proceeds of the offering will be used by the Company for general corporate purposes including the early call of $30 million of fixed-rate trust preferred securities in early 2007. At the time of the offering, the Company also entered into an interest rate swap agreement to convert the variable rate trust preferred securities into a fixed rate obligation for a term of five years at a fixed rate of 6.43%.

External borrowings averaged $672 million or 18% of total funding sources for all of 2006 as compared to $761 million or 20% of total funding sources for 2005. As shown in Table 15 on page 33, at year-end 2006, $186 million or 23% of external borrowings had remaining terms of one year or less, down considerably from $649 million or 71% at the end of 2004. This change in external funding mix is the result of not fully reinvesting the cash flows from the sales and maturities of investments in the current flat yield curve environment, and instead using the funds to pay down short-term borrowings.

As displayed in Table 4 on page 19, the overall mix of funding has shifted in 2006. The percentage of funding derived from deposits increased to 82% in 2006 from 80% in 2005 and 78% in 2004. FHLB borrowings decreased during 2005 and early 2006 as cash flows from the maturity of investments were used to reduce short-term borrowings. Additionally, the Company took advantage of the low interest rates in 2006 and converted $150 million of FHLB short term borrowings to long term instruments with two or three year convertible features. At December 31, 2006, borrowings are up $152.4 million from December 31, 2005, primarily due to the $75 million of new trust preferred securities as well as approximately $50 million of long term borrowings acquired in the Elmira and ONB transactions.

The following table summarizes the outstanding balance of short-term borrowings of the Company as of December 31:

**Table 15: Short-term Borrowings**

| (000 s omitted, except rates) | 2006 | 2005 | 2004 |
|---|---|---|---|
| Federal funds purchased | $ 0 | $ 36,300 | $ 13,200 |
| Term borrowings at banks | | | |
| 90 days or less | 20,300 | 55,000 | 465,000 |
| Over 90 days | 135,000 | 100,000 | 171,000 |
| Commercial loans sold with recourse | 143 | 190 | 74 |
| Subordinated debt held by unconsolidated subsidiary trusts | 30,928 | 0 | 0 |
| Balance at end of period | $ 186,371 | $ 191,490 | $ 649,274 |
| Daily average during the year | $ 144,043 | $ 366,775 | $ 442,287 |
| Maximum month-end balance | $ 192,000 | $ 552,500 | $ 649,274 |
| Weighted average rate during the year | 3.83% | 3.07% | 1.64% |
| Weighted average year-end rate | 4.90% | 3.67% | 2.51% |

The following table shows the maturities of various contractual obligations as of December 31, 2006:

**Table 16: Maturities of Contractual Obligations**

| (000 s omitted) | Maturing Within One Year or Less | Maturing After One Year but Within Three Years | Maturing After Three Years but Within Five Years | Maturing After Five Years | Total |
|---|---|---|---|---|---|
| Federal Home Loan Bank advances | $ 155,300 | $ 24,756 | $ 180,803 | $ 286,127 | $ 646,986 |
| Subordinated debt held by unconsolidated subsidiary trusts | 30,928 | 0 | 0 | 127,086 | 158,014 |
| Commercial loans sold with recourse | 143 | 0 | 11 | 341 | 495 |
| Purchase obligations, primarily premises and equipment | 2,430 | 0 | 0 | 0 | 2,430 |
| Operating leases | 2,291 | 2,916 | 2,229 | 3,466 | 10,902 |
| Total | $ 191,092 | $ 27,672 | $ 183,043 | $ 417,020 | $ 818,827 |

**Financial Instruments with Off-Balance Sheet Risk**

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 fair value of these commitments is immaterial for disclosure in accordance with FASB Interpretation No. 45, *Guarantor s Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others* .

The contract amount of these off-balance sheet financial instruments as of December 31 is as follows:

**Table 17: Off-Balance Sheet Financial Instruments**

| (000 s omitted) | 2006 | 2005 |
|---|---|---|
| Commitments to extend credit | $ 443,367 | $ 434,640 |
| Standby letters of credit | 10,082 | 25,638 |
| Total | $ 453,449 | $ 460,278 |

**Investments**

The objective of the Company s investment portfolio is to hold low-risk, high-quality earning assets that provide favorable returns and provide another effective tool to actively manage its asset/liability position to maximize future net interest income opportunities. This must be accomplished within the following constraints: (a) implementing certain interest rate risk management strategies which achieve a relatively stable level of net interest income; (b) providing both the regulatory and operational liquidity necessary to conduct day-to-day business activities; (c) considering investment risk-weights as determined by the regulatory risk-based capital guidelines; and (d) generating a favorable return without undue compromise of the other requirements.

The Company executed a number of sales strategies during 2005, with a focus on maximizing the total return performance of the portfolio. During 2005 sales of U.S. Treasury and Agency securities, AAA rated obligations of state and political subdivisions, and investment grade corporate bonds were $173.2 million, $46.1 million and $24.4 million, respectively. The corresponding pre-tax gains on investment securities recognized on these sales were $7.0 million, $2.2 million and $3.0 million, respectively. All proceeds from these sales were used to repay short-term borrowings from the Federal Home Loan Bank of New York. During 2006, the investment portfolio has continued to decline due to the contractual runoff of securities. Cash flows from the maturing securities have been used to pay down short-term borrowings and the excess has been invested in short-term interest bearing cash equivalents, as the long-term investments alternatives are not attractive in the current flat yield curve environment.

As displayed in Table 18 below, the book value of the Company s investment portfolio decreased $67.9 million or 5.3% during the year to $1.221 billion. Investment maturities and limited new investment opportunities in the current flat yield curve environment were the primary reasons for this decline in balance. As of December 31, 2006 the expected life-to-maturity of the portfolio was 4.7 years versus 5.3 years as of December 31, 2005. Average investment balances (book value basis) for 2006 decreased $142.3 million or 10.1% versus the prior year. Investment interest income in 2006 was $7.0 million or 9.8% lower than the prior year as a result of the lower average balances in the portfolio, partially offset by a one basis point increase in the average investment yield from 6.03% to 6.04%.

The investment portfolio has limited credit risk due to the composition continuing to heavily favor U.S. Agency debentures, U.S. Agency mortgage-backed pass-throughs, U.S. Agency CMOs and municipal bonds insured by third parties. As of year-end 2006, these four AAA-rated (highest possible rating) security types accounted for 95% of the portfolio s total book value. These four security types comprised 96% of total investments as of December 31, 2005.

Eighty-eight percent of the investment portfolio was classified as available-for-sale at year-end 2006 versus 89% at the end of 2005. The net pre-tax market value gain over book value for the available-for-sale portfolio as of December 31, 2006 was $7.8 million, down $5.9 million from one year earlier. This decline reflects the maturing of securities, as well as increasing market interest rates during the intervening period.

The following table sets forth the amortized cost and market value for the Company s investment securities portfolio:

**Table 18: Investment Securities**

| | 2006 | | 2005 | | 2004 | |
|---|---|---|---|---|---|---|
| **(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 | $ 127,200 | $ 124,020 | $ 127,345 | $ 124,326 | $ 127,490 | $ 125,906 |
| Obligations of state and political subdivisions | 7,242 | 7,257 | 5,709 | 5,735 | 6,576 | 6,694 |
| Other securities | 11,417 | 11,417 | 9,451 | 9,451 | 3,578 | 3,578 |
| Total held-to-maturity portfolio | 145,859 | 142,694 | 142,505 | 139,512 | 137,644 | 136,178 |
| *Available-for-Sale Portfolio:* | | | | | | |
| U.S. treasury and agency securities | 372,706 | 370,787 | 420,062 | 420,808 | 630,058 | 650,767 |
| Obligations of state and political subdivisions | 502,677 | 514,647 | 519,661 | 532,708 | 545,992 | 573,845 |
| Corporate debt securities | 35,603 | 35,080 | 35,744 | 35,559 | 40,443 | 43,898 |
| Collateralized mortgage obligations | 43,768 | 43,107 | 78,710 | 78,468 | 70,986 | 72,444 |
| Mortgage-backed securities | 76,266 | 75,181 | 53,019 | 53,363 | 50,347 | 52,664 |
| Subtotal | 1,031,020 | 1,038,802 | 1,107,196 | 1,120,906 | 1,337,826 | 1,393,618 |
| Equity securities [(1)] | 34,028 | 34,028 | 29,841 | 29,841 | 43,515 | 43,515 |
| Federal Reserve Bank common stock | 10,582 | 10,582 | 9,865 | 9,865 | 9,856 | 9,856 |
| Total available-for-sale portfolio | 1,075,630 | 1,083,412 | 1,146,902 | 1,160,612 | 1,391,197 | 1,446,989 |
| Net unrealized gain on available-for-sale portfolio | 7,782 | 0 | 13,710 | 0 | 55,792 | 0 |
| Total | $ 1,229,271 | $ 1,226,106 | $ 1,303,117 | $ 1,300,124 | $ 1,584,633 | $ 1,583,167 |

(1) Includes $32,717, $28,791 and $42,480 of FHLB common stock at December 31, 2006, 2005, and 2004, respectively.

The following table sets forth as of December 31, 2006, the maturities of investment securities and the weighted-average yields of such securities, which have been calculated on the cost basis, weighted for scheduled maturity of each security, and adjusted to a fully tax-equivalent basis:

**Table 19: Maturities of Investment Securities**

| (000 s omitted, except rates) | Maturing Within One Year or Less | Maturing After One Year but Within Five Years | Maturing After Five Years but Within Ten Years | Maturing After Ten Years | Total Amortized Cost/Book Value |
|---|---|---|---|---|---|
| *Held-to-Maturity Portfolio:* | | | | | |
| U.S. treasury and agency securities | $ 0 | $ 0 | $ 112,200 | $ 15,000 | $ 127,200 |
| Obligations of state and political subdivisions | 5,465 | 1,747 | 30 | 0 | 7,242 |
| Other securities | 0 | 0 | 96 | 11,321 | 11,417 |
| Total held-to-maturity portfolio | $ 5,465 | $ 1,747 | $ 112,326 | $ 26,321 | $ 145,859 |
| Weighted Average Yield (1) | 4.39% | 5.14% | 5.01% | 5.19% | 5.02% |
| *Available-for-Sale Portfolio:* | | | | | |
| U.S. treasury and agency securities | $ 11,107 | $ 103,508 | $ 186,046 | $ 72,045 | $ 372,706 |
| Obligations of state and political subdivisions | 3,915 | 116,140 | 235,244 | 147,378 | 502,677 |
| Corporate debt securities | 0 | 17,476 | 18,127 | 0 | 35,603 |
| Collateralized mortgage obligations (2) | 0 | 920 | 17,783 | 25,065 | 43,768 |
| Mortgage-backed securities (2) | 203 | 629 | 7,187 | 68,247 | 76,266 |
| Total available-for-sale portfolio | $ 15,225 | $ 238,673 | $ 464,387 | $ 312,735 | $ 1,031,020 |
| Weighted Average Yield (1) | 5.11% | 4.62% | 4.87% | 5.45% | 4.99% |

(1) Weighted average yields are an arithmetic computation of accrued income divided by average balance; they may differ from the yield to maturity, which considers the time value of money.

(2) Mortgage-backed securities and collateralized mortgage obligations are listed based on the contractual maturity. Actual maturities will differ from contractual maturities because borrowers may have the right to call or prepay certain obligations with or without penalties.

**Impact of Inflation and Changing Prices**

The Company s financial statements have been prepared in terms of historical dollars, without considering changes in the relative purchasing power of money over time due to inflation. Unlike most industrial companies, virtually all of the assets and liabilities of a financial institution are monetary in nature. As a result, interest rates have a more significant impact on a financial institution s performance than the effect of general levels of inflation. Interest rates do not necessarily move in the same direction or in the same magnitude as the prices of goods and services. Notwithstanding this, inflation can directly affect the value of loan collateral, in particular real estate.

**New Accounting Pronouncements**

See *New Accounting Pronouncements* Section of Note A of the notes to the consolidated financial statements on page 51 for additional accounting pronouncements.

**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 exclusive. 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 will make additional updates or corrections with respect thereto or with respect to other forward-looking statements.

***Item 7A. Quantitative and Qualitative Disclosures about Market Risk***

*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. Although more than a third of the securities portfolio at year-end 2006 was invested in municipal bonds, 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 also believes that it has an insignificant amount of credit risk in its investment portfolio because essentially all of the fixed-income securities in the portfolio are AAA-rated (highest possible rating). The Company does not have any material foreign currency exchange rate risk exposure. 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. The committee 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.

*Asset/Liability Management*

The primary objective of the Company s asset/liability management process is to maximize earnings and return on capital within acceptable levels of risk. 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 that enable it to identify and quantify sources of interest rate risk in varying rate environments. The primary tools used by the Company in managing interest rate risk are the income simulation model and economic value of equity modeling.

*Interest Rate Risk*

Interest rate risk ( IRR ) can result from the timing differences in the maturity/repricing of an institution s assets, liabilities, and off-balance sheet contracts; the effect of embedded options, such as loan prepayments, interest rate caps/floors, and deposit withdrawals; and differences in the behavior of lending and funding rates, sometimes referred to as basis risk; an example of basis risk would occur if floating rate assets and liabilities, with otherwise identical repricing characteristics, were based on market indexes that were imperfectly correlated.

Given the potential types and differing related characteristics of IRR, it is important that the Company maintain an appropriate process and set of measurement tools that enable it to identify and quantify its primary sources of IRR. The Company also recognizes that effective management of IRR includes an understanding of when potential adverse changes in interest rates will flow through the income statement. Accordingly, the Company will manage its position so that it monitors its exposure to net interest income over both a one year planning horizon and a longer-term strategic horizon.

It is the Company s objective to manage its exposure to interest rate risk, bearing in mind that it will always be in the business of taking on rate risk and that rate risk immunization is not possible. Also, it is recognized that as exposure to interest rate risk is reduced, so too may net interest margin be reduced.

*Income Simulation*

Income simulation is tested on a wide variety of balance sheet and treasury yield curve scenarios. The simulation projects changes in net interest income caused by the effect of changes in interest rates. The model requires management to make assumptions about how the balance sheet is likely to evolve through time in different interest rate environments. Loan and deposit growth rate assumptions are derived from management s outlook, as are the assumptions used for new loan yields and deposit rates. Loan prepayment speeds are based on a combination of current industry averages and internal historical prepayments. Balance sheet and yield curve assumptions are analyzed and reviewed by the ALCO Committee regularly.

The following table reflects the Company s one-year net interest income sensitivity, using December 31, 2006 asset and liability levels as a starting point.

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 the treasury curve shifts 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, generally reflecting 10%-65% of the movement of 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**

| Changes in Interest Rates | Calculated increase (decrease) in Projected Net Interest Income at December 31 — 2006 | 2005 |
| --- | --- | --- |
| +200 basis points | $ (668,000) | $ 330,000 |
| -100 basis points | ($ 1,155,000) | ($ 535,000) |

In the 2006 model, both the rising and falling rate environments reflect a reduction in net interest income ( NII ) from a flat rate environment. Initially, the rising rate environment reflects a decrease in NII from a flat rate environment largely due to short-term capital market borrowings repricing as rates rise. Over a longer time period the growth in NII improves significantly in a rising rate environment as lower yielding assets mature and are replaced at higher rates. In a falling rate environment, NII decreases as a result of assets repricing faster than liabilities.

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.

Management uses a value of equity model to supplement the modeling technique described above. Those supplemental analyses are based on discounted cash flows associated with on and off-balance sheet financial instruments. Such analyses are modeled to reflect changes in interest rates and shifts in the maturity curve of interest rates and provide management with a long-term interest rate risk metric.

***Item 8. Financial Statements and Supplementary Data***

The following consolidated financial statements and independent auditor s reports of Community Bank System, Inc. are contained on pages 41 through 70 of this item.



Quarterly Selected Data (Unaudited) for 2006 and 2005 are contained on page 73.

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

| | December 31, | |
|---|---|---|
| | **2006** | **2005** |
| Assets: | | |
| Cash and cash equivalents | $ 232,032 | $ 114,605 |
| Available-for-sale investment securities | 1,083,412 | 1,160,612 |
| Held-to-maturity investment securities | 145,859 | 142,505 |
| Total investment securities (fair value of $1,226,107 and $1,300,124, respectively) | 1,229,271 | 1,303,117 |
| Loans | 2,701,558 | 2,411,769 |
| Allowance for loan losses | (36,313) | (32,581) |
| Net loans | 2,665,245 | 2,379,188 |
| Core deposit intangibles, net | 24,665 | 28,147 |
| Goodwill | 220,290 | 195,195 |
| Other intangibles, net | 1,181 | 1,536 |
| Intangible assets, net | 246,136 | 224,878 |