FINANCIAL INSTITUTIONS INC
Form 10-Q
November 06, 2007

Table of Contents

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
FORM 10-Q

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

FOR THE QUARTERLY PERIOD ENDED September 30, 2007

Commission File Number 0-26481

(Exact Name of Registrant as specified in its charter)

NEW YORK	16-0816610
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification Number)
220 Liberty Street Warsaw, NY	14569
(Address of Principal Executive Offices)	(Zip Code)

Registrant s Telephone Number Including Area Code:
(585) 786-1100

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 twelve months (or for such shorter period that the Registrant was required to file reports) and (2) has been subject to such requirements for at least the past 90 days.

YES þ NO o

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

Large Accelerated filer o Accelerated filer þ Non-accelerated filer o

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

YES o NO þ

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

CLASS	OUTSTANDING AT OCTOBER 31, 2007
Common Stock, $0.01 par value	11,065,747 shares

FINANCIAL INSTITUTIONS, INC.
FORM 10-Q
INDEX

PART I FINANCIAL INFORMATION

Item 1. Financial Statements (Unaudited)

Consolidated Statements of Financial Condition (Unaudited) as of September 30, 2007 and December 31, 2006 3

Consolidated Statements of Income (Unaudited) for the Three and Nine Months Ended September 30, 2007 and 2006 4

Consolidated Statement of Changes in Shareholders Equity and Comprehensive Income (Unaudited) for the Nine Months Ended September 30, 2007 5

Consolidated Statements of Cash Flows (Unaudited) for the Nine Months Ended September 30, 2007 and 2006 6

Notes to Unaudited Consolidated Financial Statements 7

Item 2. Management s Discussion and Analysis of Financial Condition and Results of Operations 12

Item 3. Quantitative and Qualitative Disclosures About Market Risk 28

Item 4. Controls and Procedures 28

PART II OTHER INFORMATION

Item 1. Legal Proceedings 29

Item 1A. Risk Factors 29

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds 29

Item 6. Exhibits 30

SIGNATURES

EXHIBITS
EX-31.1
EX-31.2
EX-32.1
EX-32.2

Table of Contents

Item 1. Financial Statements (Unaudited)

FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF FINANCIAL CONDITION
(Unaudited)

(Dollars in thousands, except per share amounts)	September 30, 2007	December 31, 2006
Assets		
Cash and due from banks	$ 55,736	$ 47,166
Federal funds sold and interest-bearing deposits in other banks	2,685	62,606
Securities available for sale, at fair value	742,716	735,148
Securities held to maturity, at amortized cost (fair value of $56,615 at September 30, 2007 and $40,421 at December 31, 2006)	56,885	40,388
Loans held for sale	107	992
Loans	949,671	926,482
Less: Allowance for loan losses	15,611	17,048
Loans, net	934,060	909,434
Premises and equipment, net	34,690	34,562
Goodwill	37,369	37,369
Other assets	38,737	39,887
Total assets	$ 1,902,985	$ 1,907,552
Liabilities And Shareholders Equity		
Liabilities:		
Deposits:		
Noninterest-bearing demand	$ 284,252	$ 273,783
Interest-bearing demand, savings and money market	692,990	674,224
Certificates of deposit	639,020	669,688
Total deposits	1,616,262	1,617,695
Short-term borrowings	33,374	32,310
Long-term borrowings	29,145	38,187
Junior subordinated debentures issued to unconsolidated subsidiary trust (Junior subordinated debentures)	16,702	16,702
Other liabilities	19,178	20,270
Total liabilities	1,714,661	1,725,164

Shareholders equity:		
3% cumulative preferred stock, $100 par value, authorized 10,000 shares, issued and outstanding 1,586 shares at September 30, 2007 and December 31, 2006	159	159
8.48% cumulative preferred stock, $100 par value, authorized 200,000 shares, issued and outstanding 174,223 shares at September 30, 2007 and 174,639 shares at December 31, 2006	17,422	17,464
Common stock, $0.01 par value, authorized 50,000,000 shares, issued 11,348,122 shares at September 30, 2007 and December 31, 2006	113	113
Additional paid-in capital	24,626	24,222
Retained earnings	156,451	148,947
Accumulated other comprehensive loss	(5,186)	(8,404)
Treasury stock, at cost 266,497 shares at September 30, 2007 and 5,351 shares at December 31, 2006	(5,261)	(113)
Total shareholders equity	188,324	182,388
Total liabilities and shareholders equity	$ 1,902,985	$ 1,907,552

See Accompanying Notes to Unaudited Consolidated Financial Statements.

Table of Contents

FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF INCOME
(Unaudited)

(Dollars in thousands, except per share amounts)	Three Months Ended September 30, 2007	2006	Nine Months Ended September 30, 2007	2006
Interest income:				
Interest and fees on loans	$ 17,571	$ 17,291	$ 51,130	$ 50,944
Interest and dividends on securities	8,814	8,001	26,192	24,597
Other interest income	168	531	1,494	1,307
Total interest income	26,553	25,823	78,816	76,848
Interest expense:				
Deposits	10,428	9,491	32,528	26,833
Short-term borrowings	360	166	682	404
Long-term borrowings	472	1,052	1,441	3,142
Junior subordinated debentures	432	432	1,296	1,296
Total interest expense	11,692	11,141	35,947	31,675
Net interest income	14,861	14,682	42,869	45,173
Credit for loan losses	(82)	(491)	(235)	(1,842)
Net interest income after credit for loan losses	14,943	15,173	43,104	47,015
Noninterest income:				
Service charges on deposits	2,778	3,054	8,114	8,559
ATM and debit card income	735	558	2,079	1,645
Broker-dealer fees and commissions	323	375	1,053	1,182
Trust fees		116		377
Loan servicing income	259	208	707	668
Income from corporate owned life insurance	1,090	14	1,139	466
Net gain on sale of securities	67		118	
Net gain on sale of loans held for sale	313	503	589	916
Net gain (loss) on sale and disposal of other assets	59	(56)	147	65
Net gain on sale of trust relationships		1,365	13	1,365
Other	710	842	1,719	1,873
Total noninterest income	6,334	6,979	15,678	17,116
Noninterest expense:				
Salaries and employee benefits	8,574	8,510	24,935	25,294

Occupancy and equipment	2,422	2,293	7,321	7,083
Supplies and postage	443	442	1,283	1,452
Amortization of other intangible assets	77	108	230	323
Computer and data processing	547	469	1,593	1,312
Professional fees and services	476	698	1,548	2,247
Other	2,070	2,073	5,976	6,738
Total noninterest expense	14,609	14,593	42,886	44,449
Income before income taxes	6,668	7,559	15,896	19,682
Income taxes	1,414	2,314	3,585	5,324
Net income	$ 5,254	$ 5,245	$ 12,311	$ 14,358
Earnings per common share (Note 3):				
Basic	$ 0.44	$ 0.43	$ 1.00	$ 1.17
Diluted	$ 0.44	$ 0.43	$ 1.00	$ 1.17

See Accompanying Notes to Unaudited Consolidated Financial Statements.

Table of Contents

FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENT OF CHANGES IN
SHAREHOLDERS EQUITY AND COMPREHENSIVE INCOME
(Unaudited)

(Dollars in thousands, except per share amounts)	3% Preferred Stock	8.48% Preferred Stock	Common Stock	Additional Paid-in Capital	Retained Earnings	Accumulated Other Comprehensive Loss	Treasury Stock	Total Shareholders Equity
Balance December 31, 2006	$ 159	$ 17,464	$ 113	$ 24,222	$ 148,947	$ (8,404)	$ (113)	$ 182,388
Purchase 295,439 shares of common stock							(5,846)	(5,846)
Issue 11,874 shares of common stock - exercised stock options, net of taxes				(35)			247	212
Purchase of 416 shares of 8.48% preferred stock		(42)						(42)
Issue 5,319 shares of common stock - directors plan				(2)			107	105
Issue 17,100 shares of common stock - restricted stock awards				(344)			344	
Amortization of unvested stock options				667				667
Amortization of unvested restricted stock awards				118				118
Comprehensive income:								
Net income					12,311			12,311
Net unrealized gain on securities available for sale, net of taxes						3,147		3,147
Reclassification adjustment for net gain included in net income, net of taxes						72		72

Defined benefit pension plan, net of taxes						12		12
Postretirement benefit plan, net of taxes						(13)		(13)
Other comprehensive income								3,218
Total comprehensive income								15,529
Cash dividends declared:								
3% Preferred - $2.25 per share					(4)			(4)
8.48% Preferred - $6.36 per share					(1,109)			(1,109)
Common - $0.33 per share					(3,694)			(3,694)
Balance September 30, 2007	$ 159	$ 17,422	$ 113	$ 24,626	$ 156,451	$ (5,186)	$ (5,261)	$ 188,324

See Accompanying Notes to Unaudited Consolidated Financial Statements.

Table of Contents

FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS
(Unaudited)

(Dollars in thousands)	Nine Months Ended September 30, 2007	2006
Cash flows from operating activities:		
Net income	$ 12,311	$ 14,358
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	2,958	3,131
Net (accretion) amortization of premiums and discounts on securities	(150)	507
Credit for loan loses	(235)	(1,842)
Amortization of unvested stock options	667	701
Amortization of unvested restricted stock awards	118	18
Deferred income tax expense (benefit)	655	(583)
Proceeds from sale of loans held for sale	35,999	59,145
Originations of loans held for sale	(34,525)	(58,357)
Net gain on sale of securities	(118)	
Net gain on sale of loans held for sale	(589)	(916)
Net gain on sale and disposal of other assets	(147)	(65)
Net gain on sale of trust relationships	(13)	(1,365)
(Increase) decrease in other assets	(721)	8,155
(Decrease) increase in other liabilities	(4,145)	631
Net cash provided by operating activities	12,065	23,518
Cash flows from investing activities:		
Purchase of securities:		
Available for sale	(255,497)	(35,126)
Held to maturity	(40,206)	(25,498)
Proceeds from maturity, call and principal pay-down of securities:		
Available for sale	222,096	86,096
Held to maturity	26,463	26,160
Proceeds from the sale of securities available for sale	31,400	
Net loan (increase) decrease	(26,317)	48,522
Net proceeds from sale of commercial-related loans held for sale		659
Proceeds from sales of other assets	997	1,379
Proceeds from sale of trust relationships	13	1,365
Purchase of premises and equipment	(2,884)	(878)
Net cash (used in) provided by investing activities	(43,935)	102,679
Cash flows from financing activities:		
Net decrease in deposits	(1,434)	(77,642)
Net increase (decrease) in short-term borrowings	1,063	(1,557)
Repayment of long-term borrowings	(9,042)	(2,050)
Purchase of preferred and common stock	(5,888)	(233)
Issuance of common stock - directors plan	105	112

Stock options exercised	212	184
Excess tax benefit from stock options exercised		15
Dividends paid	(4,497)	(3,833)
Net cash used in financing activities	(19,481)	(85,004)
Net (decrease) increase in cash and cash equivalents	(51,351)	41,193
Cash and cash equivalents at the beginning of the period	109,772	91,940
Cash and cash equivalents at the end of the period	$ 58,421	$ 133,133
Supplemental disclosure of cash flow information:		
Cash paid during period for:		
Interest	$ 38,491	$ 31,217
Income taxes paid	3,091	2,493
Income taxes received		(6,300)
Noncash investing and financing activities:		
Real estate and other assets acquired in settlement of loans	$ 1,930	$ 2,080
Net increase in security purchases pending settlement	2,755	
Net decrease (increase) in unrealized loss on available for sale securities, net of taxes	3,219	(966)

See Accompanying Notes to Unaudited Consolidated Financial Statements.

Table of Contents

FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES
NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

(1) Basis of Presentation

Financial Institutions, Inc. (FII), a bank holding company organized under the laws of New York State, and its subsidiaries (collectively the Company) provide deposit, lending and other financial services to individuals and businesses in Central and Western New York State. The Company is subject to regulation by certain federal and state agencies.

FII s primary subsidiary is, the New York State-chartered, Five Star Bank (100% owned) (FSB or the Bank). In addition, FII formerly qualified as a financial holding company under the Gramm-Leach-Bliley Act, which allowed the expansion of business operations to include a broker-dealer subsidiary, namely, Five Star Investment Services, Inc. (100% owned) (FSIS). During 2003, FII terminated its financial holding company status and now operates as a bank holding company. The future acquisition or expansion of non-financial activities may require prior Federal Reserve Bank (FRB) approval and will be limited to those that are permissible for bank holding companies.

In February 2001, the Company formed FISI Statutory Trust I (100% owned) (FISI or the Trust) and capitalized the entity with a $502,000 investment in the Trust s common securities. The Trust was formed to facilitate the private placement of $16.2 million in capital securities (trust preferred securities). Effective December 31, 2003, the provisions of Financial Accounting Standards Board (FASB) Interpretation No. 46, Consolidation of Variable Interest Entities, resulted in the deconsolidation of the Trust. The deconsolidation resulted in the derecognition of the $16.2 million in trust preferred securities and the recognition of $16.7 million in junior subordinated debentures and a $502,000 investment in the Trust recorded in other assets in the Company s consolidated statements of financial condition.

In management s opinion, the interim consolidated financial statements reflect all adjustments necessary for a fair presentation. The results of operations for the interim periods are not necessarily indicative of the results of operations to be expected for the full year ended December 31, 2007. The interim consolidated financial statements should be read in conjunction with the Company s 2006 Annual Report on Form 10-K. The consolidated financial information included herein combines the results of operations, assets, liabilities and shareholders equity of FII and its subsidiaries. All significant inter-company transactions and balances have been eliminated in consolidation. Certain amounts in the prior periods consolidated financial statements are reclassified when necessary to conform to the current period s presentation.

The interim consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America and prevailing practices in the banking industry. In preparing the financial statements, management is required to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities, and the reported revenues and expenses for the period. Actual results could differ from those estimates. A material estimate that is particularly susceptible to near-term change is the allowance for loan losses.

For purposes of the consolidated statements of cash flows, cash and due from banks, federal funds sold and interest-bearing deposits in other banks are considered cash and cash equivalents.

(2) Recent Accounting Pronouncements

In February 2006, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) No. 155, Accounting for Certain Hybrid Financial Instruments. SFAS No. 155 amends SFAS No. 133 and SFAS No. 140, and improves the financial reporting of certain hybrid financial instruments by requiring more consistent accounting that eliminates exemptions and provides a means to simplify the accounting for these instruments. Specifically, SFAS No. 155 allows financial instruments that have embedded derivatives to be accounted for as a whole (eliminating the need to bifurcate the derivative from its host) if the holder elects to account for the whole instrument on a fair value basis. SFAS No. 155 is effective for all financial instruments acquired or issued in fiscal years beginning after September 15, 2006. The Company adopted this statement effective January 1, 2007 and adoption did not have an effect on its consolidated financial position, consolidated results of operations, or liquidity.

In March 2006, the FASB issued SFAS No. 156, Accounting for Servicing of Financial Assets, an amendment of SFAS No. 140, which requires that all separately recognized servicing assets and servicing liabilities be initially

measured at fair value, if practicable and permits the entities to elect either fair value measurement with changes in fair value reflected in earnings or the amortization and impairment requirements of SFAS No. 140 for subsequent

Table of Contents

measurement. SFAS No. 156 is effective for fiscal years beginning after September 15, 2006. The Company adopted this statement effective January 1, 2007 and elected to continue using the amortization and impairment requirements of SFAS No. 140 for subsequent measurement of servicing assets, therefore adoption did not have an effect on its consolidated financial position, consolidated results of operations, or liquidity.

In June 2006, the FASB issued FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes an interpretation of FASB Statement No. 109 (FIN 48). FIN 48 prescribes a recognition threshold and measurement attribute for financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return, and also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure, and transition. FIN 48 is effective for fiscal years beginning after December 15, 2006. The Company adopted this statement effective January 1, 2007 and the required disclosures are included in Note 9. The adoption of FIN 48 did not have a material effect on the Company s consolidated financial position, consolidated results of operations, or liquidity.

In September 2006, the FASB issued SFAS No. 157, Fair Value Measurements. SFAS No. 157 defines fair value, establishes a framework for measuring fair value under generally accepted accounting principles, and expands disclosures about fair value measurements. SFAS No. 157 emphasizes that fair value is a market-based measurement, not an entity-specific measurement, and states that a fair value measurement should be determined based on assumptions that market participants would use in pricing the asset or liability. The Company is required to adopt SFAS No. 157 for its fiscal year beginning after November 15, 2007. The Company plans to adopt this statement on January 1, 2008 and is currently assessing the impact that the adoption will have on its consolidated financial position, consolidated results of operations, or liquidity.

In September 2006, the FASB issued SFAS No. 158, Employers Accounting for Defined Benefit Pension and Other Postretirement Plans an amendment of FASB Statements No. 87, 88, 106, and 132(R). SFAS No. 158 requires companies to recognize the over-funded or under-funded status of a defined benefit postretirement plan (other than a multi-employer plan) as an asset or liability in its balance sheet and to recognize changes in that funded status in the year in which the changes occur through comprehensive income. The Company adopted this provision of SFAS No. 158 for the year ended December 31, 2006 and the required disclosures were included in Note 13 of the annual report on Form 10-K as filed on March 13, 2007. SFAS No. 158 also requires companies to measure the funded status of a plan as of the date of the company s fiscal year-end, with limited exceptions. The Company is required and plans to adopt this provision for the fiscal year ending December 31, 2008 and does not expect adoption to have a material effect on its consolidated financial position, consolidated results of operations, or liquidity.

In September 2006, the Emerging Issues Task Force (EITF) reached a final consensus on Issue No. 06-04, Accounting for Deferred Compensation and Postretirement Benefit Aspects of Endorsement Split Dollar Life Insurance Arrangements (EITF 06-04). In accordance with EITF 06-04, an agreement by an employer to share a portion of the proceeds of a life insurance policy with an employee during the postretirement period is a postretirement benefit arrangement required to be accounted for in accordance with SFAS No. 106 or Accounting Principles Board Opinion (APB) No. 12, Omnibus Opinion 1967. Furthermore, the purchase of a split dollar life insurance policy does not constitute a settlement under SFAS No. 106 and, therefore, a liability for the postretirement obligation must be recognized under SFAS No. 106 if the benefit is offered under an arrangement that constitutes a plan or under APB No. 12 if it is not part of a plan. The provisions of EITF 06-04 are to be applied through either a cumulative-effect adjustment to retained earnings as of the beginning of the year of adoption or retrospective application. The Company is required to adopt this statement in its fiscal year beginning after December 15, 2007, with early adoption permitted. The Company plans to adopt this statement on January 1, 2008 and is currently assessing the impact that the adoption will have on its consolidated financial position, consolidated results of operations, or liquidity.

In September 2006, the EITF reached a final consensus on Issue No. 06-05, Accounting for Purchases of Life Insurance Determining the Amount That Could Be Realized in Accordance with FASB Technical Bulletin No. 85-4, Accounting for Purchases of Life Insurance (EITF 06-05). EITF 06-05 provides clarifying guidance on determining the amount that could be realized from a life insurance contract The provisions of EITF 06-05 are to be applied through either a cumulative-effect adjustment to retained earnings as of the beginning of the year of adoption or retrospective application. EITF 06-05 is effective for fiscal years beginning after December 15, 2006. The Company

adopted this statement effective January 1, 2007 and adoption did not have an effect on its consolidated financial position, consolidated results of operations, or liquidity.

Table of Contents

In February 2007, the FASB issued SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities, including an amendment of FASB Statement No. 115. SFAS No. 159 allows entities to irrevocably elect fair value as the initial and subsequent measurement attribute for certain financial assets and financial liabilities that are not otherwise required to be measured at fair value, with changes in fair value recognized in earnings as they occur. SFAS No. 159 also requires entities to report those financial assets and financial liabilities measured at fair value in a manner that separates those reported fair values from the carrying amounts of similar assets and liabilities measured using another measurement attribute on the face of the statement of financial condition. Lastly, SFAS No. 159 establishes presentation and disclosure requirements designed to improve comparability between entities that elect different measurement attributes for similar assets and liabilities. The Company is required to adopt SFAS No. 159 for its fiscal year beginning after November 15, 2007, with early adoption permitted if an entity also early adopts the provisions of SFAS No. 157. The Company plans to adopt this statement on January 1, 2008 and is currently assessing the impact the adoption will have on its consolidated financial position, consolidated results of operations, or liquidity.

(3) Earnings Per Common Share

Basic earnings per common share, after giving effect to preferred stock dividends, has been computed using weighted average common shares outstanding. Diluted earnings per share reflect the effects, if any, of incremental common shares issuable upon exercise of dilutive stock options.

Earnings per common share have been computed based on the following:

	Three Months Ended September 30,		Nine Months Ended September 30,	
(Dollars and shares in thousands, except per share amounts)	2007	2006	2007	2006
Net income	$ 5,254	$ 5,245	$ 12,311	$ 14,358
Less: Preferred stock dividends	371	371	1,113	1,115
Net income available to common shareholders	$ 4,883	$ 4,874	$ 11,198	$ 13,243
Weighted average number of common shares outstanding used to calculate basic earnings per common share	11,091	11,327	11,198	11,326
Add: Effect of common stock equivalents	23	45	33	31
Weighted average number of common shares used to calculate diluted earnings per common share	$ 11,114	$ 11,372	$ 11,231	$ 11,357
Earnings per common share:				
Basic	$ 0.44	$ 0.43	$ 1.00	$ 1.17
Diluted	$ 0.44	$ 0.43	$ 1.00	$ 1.17

There were approximately 410,000 and 326,000 weighted average common stock equivalents from outstanding stock options for the three and nine months ended September 30, 2007, respectively, that were not considered in the calculation of diluted earnings per share since their effect would have been anti-dilutive. There were approximately 258,000 and 277,000 weighted average stock options for the three and nine months ended September 30, 2006, respectively, that were not considered in the calculation of diluted earnings per share since their effect would have been anti-dilutive.

(4) Stock Compensation Plans

The Company has a Management Stock Incentive Plan and a Director s Stock Incentive Plan (the Plans). Under the Plans, the Company may grant stock options to purchase shares of common stock, shares of restricted stock or stock appreciation rights to its directors and key employees. Grants under the Plans may be made up to 10% of the number of shares of common stock issued, including treasury shares. The exercise price of each option equals the market price of the Company s stock on the date of the grant. The maximum term of each option is ten years and the vesting period generally ranges between three and five years.

During the nine months ended September 30, 2007, 90,700 stock options (weighted average fair value of $7.09 per share) and 17,100 restricted stock awards (weighted average fair value of $19.41 per share) were granted under the Plans. During the nine months ended September 30, 2006, 97,797 stock options (weighted average fair value of $8.14 per share) and 13,200 restricted stock awards (weighted average fair value of $19.75 per share) were granted under the Plans.

Table of Contents

Effective January 1, 2006, the Company adopted SFAS No. 123(R), Share-Based Payments , requiring the Company to recognize expense related to the fair value of the stock-based compensation awards. The following table presents the expense associated with the amortization of unvested stock compensation included in the consolidated statements of income for the periods indicated.

	Three Months Ended September 30,		Nine Months Ended September 30,	
(Dollars and shares in thousands, except per share amounts)	2007	2006	2007	2006
Stock options:				
Management Stock Incentive Plan (1)	$ 286	$ 230	$ 457	$ 428
Director Stock Incentive Plan (2)	10	29	210	273
Total amortization of unvested stock options	296	259	667	701
Restricted stock awards:				
Management Stock Incentive Plan (1)	68	18	118	18
Total amortization of unvested restricted stock awards	68	18	118	18
Total amortization of unvested stock compensation	$ 364	$ 277	$ 785	$ 719

(1) Included in salaries and employee benefits in the consolidated statements of income.

(2) Included in other noninterest expense in the consolidated statements of income.

(5) Loans

Loans outstanding, including net unearned income and net deferred fees and costs of $5.5 million and $4.5 million at September 30, 2007 and December 31, 2006, respectively, are summarized as follows:

(Dollars in thousands)	September 30, 2007	December 31, 2006
Commercial	$ 123,226	$ 105,806
Commercial real estate	241,981	243,966
Agricultural	53,877	56,808
Residential real estate	167,771	163,243

Consumer indirect	128,016	106,391
Consumer direct and home equity	234,800	250,268
Total loans	949,671	926,482
Allowance for loan losses	(15,611)	(17,048)
Loans, net	$ 934,060	$ 909,434

The Company s significant concentrations of credit risk in the loan portfolio relate to a geographic concentration in the communities that the Company serves.

(6) Retirement and Postretirement Benefit Plans

The Company adopted SFAS No. 158 effective December 31, 2006, which required the over-funded or under-funded status of its defined benefit pension and postretirement benefit plans to be recognized as an asset or liability in the consolidated statements of financial condition. Future changes in the funded status of the defined benefit and postretirement plans will be recognized in the year in which the changes occur, net of taxes, through comprehensive income or loss.

Defined Benefit Pension Plan

The Company participates in The New York State Bankers Retirement System, which is a defined benefit pension plan covering substantially all employees. The benefits are based on years of service and the employee s highest average compensation during five consecutive years of employment.

The defined benefit pension plan was closed to new participants effective December 31, 2006. Only employees hired on or before December 31, 2006 and who meet participation requirements on or before January 1, 2008 shall be eligible to receive benefits.

Table of Contents

Net periodic pension cost consists of the following components:

(Dollars in thousands)	Three Months Ended September 30, 2007	2006	Nine Months Ended September 30, 2007	2006
Service cost	$ 374	$ 431	$ 1,123	$ 1,294
Interest cost on projected benefit obligation	369	335	1,105	1,006
Expected return on plan assets	(476)	(467)	(1,430)	(1,400)
Amortization of net transition asset		(6)		(20)
Amortization of unrecognized loss	7	56	23	167
Amortization of unrecognized prior service cost	3	4	9	11
Net periodic pension cost	$ 277	$ 353	$ 830	$ 1,058

The Company s funding policy is to contribute, at a minimum, an actuarially determined amount that will satisfy the minimum funding requirements determined under the appropriate sections of Internal Revenue Code. The minimum required contribution is zero for the year ended December 31, 2007; however, the Company is considering making a discretionary contribution to the defined benefit pension plan during the fourth quarter of 2007.

Postretirement Benefit Plan

Prior to December 31, 2001, an entity acquired by the Company provided health and dental care benefits to certain retired employees who met specified age and service requirements through a postretirement health and dental care plan in which both the acquired entity and the retiree shared the cost. The plan was amended in 2001 to curtail eligible benefit payments to only retired employees and active participants who were fully vested under the plan.

(7) Commitments and Contingencies

In the normal course of business there are outstanding commitments to extend credit not reflected in the accompanying consolidated financial statements. These commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. The Company uses the same credit policy to make such commitments as it uses for on-balance-sheet items. Unused lines of credit and loan commitments totaling $273.0 million and $258.6 million were contractually available at September 30, 2007 and December 31, 2006, respectively, and are not reflected in the consolidated statements of financial condition. Since commitments to extend credit and unused lines of credit may expire without being fully drawn upon, the amount does not necessarily represent future cash commitments.

The Company guarantees the obligations or performance of customers by issuing stand-by letters of credit to third parties. The risk involved in issuing stand-by letters of credit is essentially the same as the credit risk involved in extending loan facilities to customers, and they are subject to the same credit origination, portfolio maintenance and management procedures in effect to monitor other credit and off-balance-sheet products. Typically, these instruments have terms of five years or less and expire unused; therefore, the amount does not necessarily represent future cash requirements. Stand-by letters of credit totaled $6.1 million and $5.8 million at September 30, 2007 and December 31, 2006, respectively. As of September 30, 2007, the fair value of the stand-by letters of credit was not material to the Company s consolidated financial statements.

From time to time, the Company is a party to or otherwise involved in legal proceedings arising in the normal course of business. Management does not believe that there is any pending or threatened proceeding against the Company, which, if determined adversely, would have a material adverse effect on the Company s business, results of operations or financial condition.

(8) Supervision and Regulation

The supervision and regulation of financial and bank holding companies and their subsidiaries is intended primarily for the protection of depositors, the deposit insurance funds regulated by the FDIC and the banking system as a whole, and not for the protection of shareholders or creditors of bank holding companies. The various bank regulatory

agencies have broad enforcement power over bank holding companies and banks, including the power to impose substantial fines, operational restrictions and other penalties for violations of laws and regulations. In addition, payments of dividends by FSB to FII are limited or restricted in certain circumstances under banking regulations.

Table of Contents

The Company is also subject to varying regulatory capital requirements administered by the federal banking agencies. Failure to meet minimum capital requirements can initiate certain mandatory, and possibly additional discretionary, actions by regulators that, if undertaken, could have a direct material impact on the Company s consolidated financial statements.

For evaluating regulatory capital adequacy, companies are required to determine capital and assets under regulatory accounting practices. Quantitative measures established by regulation to ensure capital adequacy require the Company to maintain minimum amounts and ratios. The leverage ratio requirement is based on period-end capital to average adjusted total assets during the previous three months. Compliance with risk-based capital requirements is determined by dividing regulatory capital by the sum of a company s weighted asset values. Risk weightings are established by the regulators for each asset category according to the perceived degree of risk. As of September 30, 2007 and December 31, 2006, the Company and FSB met all capital adequacy requirements to which they are subject.

(9) Income Taxes

The Company adopted the provisions FIN 48 effective January 1, 2007. There was no cumulative effect adjustment related to the adoption of FIN 48. As of January 1, 2007, the Company s unrecognized tax benefits totaled $50,000, of which $32,000 would impact the Company s effective tax rate, if recognized or reversed. The Company is currently under exam by New York State and upon conclusion of the examination the uncertain tax position is expected to be resolved.

The tax years that remain subject to examination by major tax jurisdictions are as follows:

Federal	2003 - 2006
New York	2002 - 2006

The Company accounts for interest and penalties related to uncertain tax positions as part of its provision for federal and state income taxes. As of January 1, 2007, the Company had accrued $17,000 of interest related to uncertain tax positions. As of September 30, 2007, the total amount of accrued interest was $21,000.

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

FORWARD-LOOKING STATEMENTS

This report contains certain forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended (the Securities Act), and Section 21E of the Securities Exchange Act of 1934, as amended (the Exchange Act), that involve substantial risks and uncertainties. When used in this report, or in the documents incorporated by reference herein, the words anticipate , believe , estimate , expect , intend , may , project , pla similar expressions identify such forward-looking statements. Actual results, performance or achievements could differ materially from those contemplated, expressed or implied by the forward-looking statements contained herein. There are a number of important factors that could affect the Company s forward-looking statements which include the quality of collateral associated with nonperforming loans, the ability of customers to continue to make payments on criticized or substandard loans, the impact of rising interest rates on customer cash flows, the inability to re-price existing loans or to replace older, lower-rate loans with newer, higher-rate loans, the impact of the yield curve, the speed or cost of resolving bad loans, the ability to hire and train personnel, the economic conditions in the area in which the Company operates, customer preferences, competition and other factors discussed in the Company s filings with the Securities and Exchange Commission. Many of these factors are beyond the Company s control.

GENERAL

The principal objective of this discussion is to provide an overview of the financial condition and results of operations of the Company for the periods covered in this quarterly report. This discussion and tabular presentations should be read in conjunction with the accompanying consolidated financial statements and accompanying notes.

The Company s revenues are dependent primarily on net interest income, which is the difference between the income earned on loans and securities and the interest paid on deposits and borrowings. Revenues are also affected by service charges on deposits, ATM and debit card income, broker-dealer fees and commissions, loan servicing

Table of Contents

income, gain or loss on the sale of securities, gain or loss on sale of loans held for sale, gain or loss on the sale and disposal of other assets and other miscellaneous noninterest income.

The Company s expenses primarily consist of the provision (credit) for loan losses, salaries and employee benefits, occupancy and equipment, supplies and postage, amortization of other intangible assets, computer and data processing, professional fees and services, other miscellaneous noninterest expense and income tax expense (benefit). Results of operations are also affected by the general economic and competitive conditions, particularly changes in interest rates, government policies and the actions of regulatory authorities.

OVERVIEW

Net income for the third quarter of 2007 was $5.3 million, or $0.44 per diluted share, compared with $5.2 million, or $0.43 per diluted share, for the third quarter of 2006. For the first nine months of 2007, net income was $12.3 million, or $1.00 per diluted share, compared with $14.4 million, or $1.17 per diluted share, for the first nine months of 2006.

Net interest income was $14.9 million for the third quarter of 2007, up $179,000 versus the third quarter of 2006. Net interest margin improved 7 basis points, to 3.63%, for the third quarter of 2007, compared with 3.56% in the same quarter last year. On a quarter-to-date basis, the improvement in net interest margin from prior year resulted principally from growth in earning asset yields, due in part to a more positively sloped yield curve, which outpaced the rise in cost of funds. Net interest income was $42.9 million for the nine months ended September 30, 2007, down $2.3 million in comparison to the same period in the prior year. On a year-to-date basis, net interest margin was down 14 basis points to 3.45% versus 3.59% in the prior year. The flat-to-inverted interest rate yield curve, which prevailed throughout the first half of 2007, contributed to a reduced spread on asset transactions and caused nonpublic deposits to shift into higher cost certificates of deposits from lower cost deposit products in comparison to the prior year.

Noninterest income for the third quarter of 2007 included $1.1 million (pre and post-tax) in proceeds from corporate owned life insurance and the third quarter of 2006 included a $1.4 million (pre-tax) net gain from the sale of trust relationships.

The Company experienced an increase of $23.2 million in loans to $949.7 million at September 30, 2007, compared with $926.5 million at December 31, 2006. The increase reflects execution of the Company s business plan to rebuild, in a disciplined manner, the commercial loan portfolio and grow its portfolio of consumer indirect auto loans.

Asset quality showed continued improvement as nonperforming assets totaled $9.9 million at September 30, 2007, down $7.1 million, or 42%, from December 31, 2006. However, net loan charge-offs increased to $829,000, or 0.35% of average loans (annualized) in the third quarter of 2007, compared with $418,000 or 0.18% of average loans (annualized) for the third quarter of 2006. Net loan charge-offs for the first nine months of 2007 were $1.2 million, or 0.17% of average loans (annualized), compared with $708,000, or 0.10% of average loans (annualized), for the same period in the prior year.

CRITICAL ACCOUNTING POLICIES

The Company s consolidated financial statements are prepared in accordance with accounting principles generally accepted in the United States of America and are consistent with predominant practices in the financial services industry. Application of critical accounting policies, which are those policies that management believes are the most important to the Company s financial position and results, requires management to make estimates, assumptions, and judgments that affect the amounts reported in the consolidated financial statements and accompanying notes and are based on information available as of the date of the consolidated financial statements. Future changes in information may affect these estimates, assumptions and judgments, which, in turn, may affect amounts reported in the consolidated financial statements.

The Company has numerous accounting policies, of which the most significant are presented in Note 1 of the notes to consolidated financial statements included in the Company s Annual Report on Form 10-K as of December 31, 2006, dated March 13, 2007, as filed with the Securities and Exchange Commission. These policies, along with the disclosures presented in the other financial statement notes and in this discussion, provide information on how significant assets, liabilities, revenues and expenses are reported in the consolidated financial statements and how those reported amounts are determined. Based on the sensitivity of financial statement amounts to the methods,

Table of Contents

assumptions, and estimates underlying those amounts, management has determined that the accounting policies with respect to the allowance for loan losses, goodwill and defined benefit pension plan require particularly subjective or complex judgments important to the Company s consolidated financial statements, results of operations, and, as such, are considered to be critical accounting policies as discussed below.

Allowance for Loan Losses: The allowance for loan losses represents management s estimate of probable credit losses inherent in the loan portfolio. Determining the amount of the allowance for loan losses is considered a critical accounting estimate because it requires significant judgment and the use of subjective measurements including management s assessment of the internal risk classifications of loans, changes in the nature of the loan portfolio, industry concentrations and the impact of current local, regional and national economic factors on the quality of the loan portfolio. Changes in these estimates and assumptions are reasonably possible and may have a material impact on the Company s consolidated financial statements, results of operations or liquidity.

A loan is considered impaired when, based on current information and events, it is probable that a creditor will be unable to collect all amounts of principal and interest under the original terms of the agreement or the loan is restructured in a troubled debt restructuring. Accordingly, the Company evaluates impaired commercial and agricultural loans individually based on the present value of future cash flows discounted at the loan s effective interest rate, or at the loan s observable market price or the net realizable value of the collateral if the loan is collateral dependent. The majority of the Company s loans are secured.

Loans, including impaired loans, are generally classified as nonaccruing if they are past due as to maturity or payment of principal or interest for a period of more than 90 days (120 days for consumer loans), unless such loans are well-collateralized and in the process of collection. Loans that are on a current payment status or past due less than 90 days may also be classified as nonaccruing if repayment in full of principal and/or interest is uncertain.

For additional discussion related to the Company s accounting policies for the allowance for loan losses, see the section titled Analysis of the Allowance for Loan Losses.

Goodwill: Statement of Financial Accounting Standards (SFAS) No. 142, Goodwill and Other Intangible Assets prescribes the accounting for goodwill and intangible assets subsequent to initial recognition. The provisions of SFAS No. 142 discontinue the amortization of goodwill and intangible assets with indefinite lives. Instead, these assets are subject to at least an annual impairment review, and more frequently if certain impairment indicators are in evidence. Changes in the estimates and assumptions are reasonably possible and may have a material impact on the Company s consolidated financial statements, results of operations or liquidity. During the fourth quarter of 2006, the Company evaluated goodwill for impairment using a discounted cash flow analysis and determined no impairment existed. There were no material events or transactions that occurred subsequent to that evaluation that indicates any impairment at the current period end.

Defined Benefit Pension Plan: Management is required to make various assumptions in valuing its defined benefit pension plan assets and liabilities. These assumptions include, but are not limited to, the expected long-term rate of return on plan assets, the weighted average discount rate used to value certain liabilities and the rate of compensation increase. The Company uses a third-party specialist to assist in making these estimates and assumptions. Changes in these estimates and assumptions are reasonably possible and may have a material impact on the Company s consolidated financial statements, results of operations or liquidity.

Table of Contents

SELECTED FINANCIAL DATA

The following tables present certain information and ratios that management of the Company considers important in evaluating performance:

	At or For the Three Months Ended September 30,	
(Dollars in thousands, except per share amounts)	2007	2006
Per common share data:		
Net income - basic	$ 0.44	$ 0.43
Net income - diluted	$ 0.44	$ 0.43
Cash dividends declared	$ 0.12	$ 0.09
Book value	$ 15.41	$ 14.49
Tangible book value	$ 11.98	$ 11.11
Common shares outstanding:		
Weighted average shares basic	11,090,519	11,327,362
Weighted average shares diluted	11,113,553	11,371,963
Period end	11,081,625	11,347,375
Performance ratios (annualized) and data:		
Return on average assets	1.10%	1.09%
Return on average common equity	11.60%	12.17%
Return on average tangible common equity	15.03%	16.04%
Common dividend payout ratio	27.27%	20.93%
Net interest margin (tax-equivalent)	3.63%	3.56%
Efficiency ratio (1)	67.07%	67.20%
Full-time equivalent employees	636	640
Asset quality data:		
Loans past due 90 days or more	$	$
Nonaccruing loans	8,295	12,804
Total nonperforming loans	8,295	12,804
Other real estate owned (ORE) and repossessed assets (repos)	1,625	1,551
Total nonperforming assets	$ 9,920	$ 14,355
Gross loan charge-offs	$ 1,310	$ 949
Net loan charge-offs	$ 829	$ 418
Allowance for loan losses	$ 15,611	$ 17,681
Asset quality ratios:		
Nonperforming loans to total loans	0.87%	1.36%
Nonperforming assets to total loans, ORE and repos	1.04%	1.52%
Nonperforming assets to total assets	0.52%	0.74%
Allowance for loan losses to total loans	1.64%	1.88%
Allowance for loan losses to nonperforming loans	188%	138%
Net loan charge-offs to average loans (annualized)	0.35%	0.18%
Capital ratios:		
Period-end common equity to total assets	8.97%	8.42%
Period-end tangible common equity to total tangible assets	7.12%	6.58%
Leverage ratio	9.23%	8.87%
Tier 1 risk-based capital ratio	15.71%	15.33%
Total risk-based capital ratio	16.96%	16.58%

(1) The efficiency ratio represents noninterest expense less other real estate expense and amortization of intangibles divided by net interest income (tax-equivalent) plus other noninterest income less net gain on sale of securities, income from proceeds from corporate owned life insurance, net gain on sale of commercial-related loans held for sale and net gain on sale of trust relationships calculated using the following detail:

Noninterest expense	$ 14,609	$ 14,593
Less: Other real estate expense	(283)	(58)
Amortization of other intangible assets	(77)	(108)
Net expense (numerator)	$ 14,249	$ 14,427
Net interest income	$ 14,861	$ 14,682
Plus: Tax-equivalent adjustment	1,190	1,174
Net interest income (tax-equivalent)	16,051	15,856
Plus: Noninterest income	6,334	6,979
Less: Net gain on sale of securities	(67)	
Less: Income from proceeds from corporate owned life insurance	(1,073)	
Less: Net gain on sale of trust relationships		1,365
Net revenue (denominator)	$ 21,245	$ 21,470

Table of Contents

(Dollars in thousands, except per share amounts)	At or For the Nine Months Ended September 30, 2007	2006
Per common share data:		
Net income - basic	$ 1.00	$ 1.17
Net income - diluted	$ 1.00	$ 1.17
Cash dividends declared	$ 0.33	$ 0.25
Book value	$ 15.41	$ 14.49
Tangible book value	$ 11.98	$ 11.11
Common shares outstanding:		
Weighted average shares basic	11,197,895	11,326,482
Weighted average shares diluted	11,231,347	11,357,678
Period end	11,081,625	11,347,375
Performance ratios (annualized) and data:		
Return on average assets	0.86%	0.99%
Return on average common equity	9.00%	11.35%
Return on average tangible common equity	11.68%	15.08%
Common dividend payout ratio	33.00%	21.37%
Net interest margin (tax-equivalent)	3.45%	3.59%
Efficiency ratio (1)	69.45%	68.60%
Full-time equivalent employees	636	640
Asset quality data:		
Gross loan charge-offs	$ 2,972	$ 3,139
Net loan charge-offs	$ 1,202	$ 708
Asset quality ratio:		
Net loan charge-offs to average loans (annualized)	0.17%	0.10%
Capital ratios:		
Period-end common equity to total assets	8.97%	8.42%
Period-end tangible common equity to total tangible assets	7.12%	6.58%
Leverage ratio	9.23%	8.87%
Tier 1 risk-based capital ratio	15.71%	15.33%
Total risk-based capital ratio	16.96%	16.58%

(1) The efficiency ratio represents noninterest expense less other real estate expense and amortization of intangibles divided by net interest income (tax-equivalent) plus other noninterest income less net gain on sale of securities, income from

proceeds from corporate owned life insurance, net gain on sale of commercial-related loans held for sale and net gain on sale of trust relationships calculated using the following detail:

Noninterest expense	$ 42,886	$ 44,449
Less: Other real estate expense	(417)	(188)
Amortization of other intangible assets	(230)	(323)
Net expense (numerator)	$ 42,239	$ 43,938
Net interest income	$ 42,869	$ 45,173
Plus: Tax-equivalent adjustment	3,480	3,628
Net interest income (tax-equivalent)	46,349	48,801
Plus: Noninterest income	15,678	17,116
Less: Net gain on sale of securities	(118)	
Less: Income from proceeds from corporate owned life insurance	(1,073)	(419)
Less: Net gain on sale of commercial-related loans held for sale		(82)
Less: Net gain on sale of trust relationships	(13)	(1,365)
Net revenue (denominator)	$ 60,823	$ 64,051

Table of Contents

NET INCOME ANALYSIS

The following tables present, for the periods indicated, information regarding: (i) the average balance sheet; (ii) the amount of interest income from interest-earning assets and the resulting annualized yields (tax-exempt yields and tax-preferred yields on securities that qualify for the Federal dividend received deduction (DRD) have been adjusted to a tax-equivalent basis using the applicable Federal tax rate in each year); (iii) the amount of interest expense on interest-bearing liabilities and the resulting annualized rates; (iv) net interest income; (v) net interest rate spread; (vi) net interest income as a percentage of average interest-earning assets (net interest margin); and (vii) the ratio of average interest-earning assets to average interest-bearing liabilities. Average balances are calculated using daily balances. Investment securities are at amortized cost for both held to maturity and available for sale securities. Loans include net unearned income, net deferred loan fees and costs and nonaccruing loans.

	For the Three Months Ended September 30,					
	2007			2006		
(Dollars in thousands)	Average Outstanding Balance	Interest Earned/ Paid	Annualized Yield/ Rate	Average Outstanding Balance	Interest Earned/ Paid	Annualized Yield/ Rate
Interest-earning assets:						
Federal funds sold and interest-bearing deposits	$ 12,552	$ 168	5.32%	$ 39,574	$ 518	5.19%
Commercial paper due in less than 90 days			%	975	13	5.19%
Investment securities:						
Taxable	555,330	6,404	4.61%	548,166	5,817	4.24%
Tax-exempt	227,684	3,149	5.53%	243,477	3,345	5.49%
Tax-preferred	27,778	451	6.50%	81	13	66.09%
Total investment securities	810,792	10,004	4.94%	791,724	9,175	4.64%
Loans held for sale	528	9	6.73%	570	9	6.56%
Loans:						
Commercial and agricultural	418,750	8,351	7.91%	417,101	8,201	7.80%
Residential real estate	166,589	2,736	6.57%	164,272	2,681	6.53%
Consumer indirect	122,055	2,130	6.92%	101,252	1,636	6.41%
Consumer direct and home equity	235,245	4,345	7.33%	262,051	4,764	7.21%
Total loans	942,639	17,562	7.40%	944,676	17,282	7.27%
Total interest-earning assets	1,766,511	$ 27,743	6.25%	1,777,519	$ 26,997	6.05%
Allowance for loans losses	(16,450)			(18,653)		
Other noninterest-earning assets	140,608			143,244		
Total assets	$ 1,890,669			$ 1,902,110		
Interest-bearing liabilities:						
Savings and money market	$ 333,895	$ 1,349	1.60%	$ 324,571	$ 1,108	1.35%
Interest-bearing demand	325,675	1,339	1.63%	357,405	1,582	1.76%

Certificates of deposit	663,845	7,740	4.63%	650,712	6,801	4.15%
Short-term borrowings	37,699	360	3.79%	27,204	166	2.41%
Long-term borrowings	35,911	472	5.21%	70,608	1,052	5.91%
Junior subordinated debentures	16,702	432	10.35%	16,702	432	10.35%
Total interest-bearing liabilities	1,413,727	$ 11,692	3.28%	1,447,202	$ 11,141	3.06%
Noninterest-bearing demand deposits	275,228			260,585		
Other noninterest-bearing liabilities	17,156			17,750		
Total liabilities	1,706,111			1,725,537		
Shareholders equity	184,558			176,573		
Total liabilities and shareholders equity	$ 1,890,669			$ 1,902,110		
Net interest income (tax-equivalent)		$ 16,051			$ 15,856	
Less: tax-exempt equivalent adjustment		1,071			1,171	
Less: tax-preferred equivalent adjustment		119			3	
Net interest income		$ 14,861			$ 14,682	
Net interest rate spread			2.97%			2.99%
Net earning assets	$ 352,784			$ 330,317		
Net interest margin (tax-equivalent)			3.63%			3.56%
Ratio of average interest-earning assets to average interest-bearing liabilities			124.95%			122.82%

Table of Contents

	For the Nine Months Ended September 30,					
	2007			2006		
(Dollars in thousands)	Average Outstanding Balance	Interest Earned/ Paid	Annualized Yield/ Rate	Average Outstanding Balance	Interest Earned/ Paid	Annualized Yield/ Rate
Interest-earning assets:						
Federal funds sold and interest-bearing deposits	$ 37,595	$ 1,494	5.31%	$ 26,877	$ 1,003	4.99%
Commercial paper due in less than 90 days			%	8,380	304	4.85%
Investment securities:						
Taxable	569,692	19,273	4.51%	563,659	17,851	4.22%
Tax-exempt	234,363	9,659	5.50%	255,122	10,336	5.40%
Tax-preferred	15,412	740	6.40%	81	38	62.27%
Total investment securities	819,467	29,672	4.83%	818,862	28,225	4.60%
Loans held for sale	587	29	6.48%	615	29	6.37%
Loans:						
Commercial and agricultural	416,055	24,210	7.78%	431,248	24,575	7.62%
Residential real estate	164,443	8,051	6.53%	165,106	8,005	6.46%
Consumer indirect	113,315	5,783	6.82%	92,968	4,310	6.20%
Consumer direct and home equity	238,533	13,057	7.32%	269,902	14,025	6.95%
Total loans	932,346	51,101	7.32%	959,224	50,915	7.09%
Total interest-earning assets	1,789,995	$ 82,296	6.14%	1,813,958	$ 80,476	5.92%
Allowance for loans losses	(16,892)			(19,898)		
Other noninterest-earning assets	141,458			149,189		
Total assets	$ 1,914,561			$ 1,943,249		
Interest-bearing liabilities:						
Savings and money market	$ 342,064	$ 4,327	1.69%	$ 335,635	$ 3,087	1.23%
Interest-bearing demand	338,713	4,390	1.73%	380,383	4,836	1.70%
Certificates of deposit	684,510	23,811	4.65%	662,661	18,910	3.82%
Short-term borrowings	29,933	682	3.05%	24,819	404	2.17%
Long-term borrowings	37,182	1,441	5.18%	73,939	3,142	5.68%
Junior subordinated debentures	16,702	1,296	10.35%	16,702	1,296	10.35%
Total interest-bearing liabilities	1,449,104	$ 35,947	3.32%	1,494,139	$ 31,675	2.83%
	262,769			258,147		

Noninterest-bearing demand deposits						
Other noninterest-bearing liabilities	18,809			17,366		
Total liabilities	1,730,682			1,769,652		
Shareholders equity	183,879			173,597		
Total liabilities and shareholders equity	$ 1,914,561			$ 1,943,249		
Net interest income (tax-equivalent)		$ 46,349			$ 48,801	
Less: tax-exempt equivalent adjustment		3,284			3,618	
Less: tax-preferred equivalent adjustment		196			10	
Net interest income		$ 42,869			$ 45,173	
Net interest rate spread			2.82%			3.09%
Net earning assets	$ 340,891			$ 319,819		
Net interest margin (tax-equivalent)			3.45%			3.59%
Ratio of average interest-earning assets to average interest-bearing liabilities			123.52%			121.40%

Net Interest Income

For the three months ended September 30, 2007, net interest income was $14.9 million, up $179,000 versus the same quarter last year. Net interest margin was 3.63% for the third quarter of 2007, 7 basis points higher than 3.56% in the same period last year. The yield on interest-earning assets increased 20 basis points, to 6.25%, for the quarter ended September 30, 2007, compared to 6.05% in the same quarter a year ago. The Company s cost of funds increased 13 basis points, to 2.62%, for the third quarter of 2007, versus 2.49% in the same quarter last year.

For the first nine months of 2007, net interest income was $42.9 million, a decline of $2.3 million from the nine months ended September 30, 2006. For the first nine months of 2007, average earning assets declined $24.0 million from the first nine months of 2006 and, together with a 14 basis point decline in net interest margin, resulted in the

Table of Contents

$2.3 million drop in net interest income. The decline in average earning assets for the first nine months of 2007 was affected by average borrowings declining $31.6 million due to the repayment and maturity of borrowings. The drop in net interest margin resulted as the average cost of funds increased 36 basis points, while average earning asset yield increased only 22 basis points. For most of the first half of 2007, a flat to inverted yield curve contributed to reduced spread on asset transactions and nonpublic deposits shifted into higher cost certificates of deposits from lower cost deposit products.

Rate/Volume Analysis

The following table presents the extent to which changes in interest rates and changes in the volume of average interest-earning assets and average interest-bearing liabilities have affected the Company s interest income (on a tax-equivalent basis) and interest expense during the periods indicated. Information is provided in each category with respect to: (i) changes attributable to changes in volume (changes in volume multiplied by current year rate); (ii) changes attributable to changes in rate (changes in rate multiplied by prior volume); and (iii) the net change. The changes attributable to the combined impact of volume and rate have been allocated proportionately to the changes due to volume and the changes due to rate.

	Three Months Ended September 30, 2007 vs. 2006			Nine Months Ended September 30, 2007 vs. 2006		
	Increase/(Decrease) Due To		Total Increase/	Increase/(Decrease) Due To		Total Increase/
(Dollars in thousands)	Volume	Rate	(Decrease)	Volume	Rate	(Decrease)
Interest-earning assets:						
Federal funds sold and interest-bearing deposits	$ (363)	$ 13	$ (350)	$ 427	$ 64	$ 491
Commercial paper due in less than 90 days	(13)		(13)	(304)		(304)
Investment securities:						
Taxable	83	504	587	202	1,220	1,422
Tax-exempt	(220)	24	(196)	(871)	194	(677)
Tax Preferred	450	(12)	438	736	(34)	702
Total investment securities	313	516	829	67	1,380	1,447
Loans:						
Commercial and agricultural	34	116	150	(877)	512	(365)
Residential real estate	39	16	55	(26)	72	46
Consumer indirect	363	131	494	1,041	432	1,473
Consumer direct and home equity	(498)	79	(419)	(1,713)	745	(968)
Total loans	(62)	342	280	(1,575)	1,761	186
Total interest-earning assets	$ (125)	$ 871	$ 746	$ (1,385)	$ 3,205	$ 1,820
Interest-bearing liabilities:						
Savings and money market	$ 37	$ 204	$ 241	$ 81	$ 1,159	$ 1,240

Interest-bearing demand	(128)	(115)	(243)	(529)	83	(446)
Certificates of deposit	154	785	939	764	4,137	4,901
Short-term borrowings	99	95	194	116	162	278
Long-term borrowings	(456)	(124)	(580)	(1,424)	(277)	(1,701)
Total interest-bearing liabilities	$ (294)	$ 845	$ 551	$ (992)	$ 5,264	$ 4,272
Net interest income (tax-equivalent)	$ 169	$ 26	$ 195	$ (393)	$ (2,059)	$ (2,452)

Table of Contents

Credit for Loan Losses

The credit for loan losses represents management s estimate of the adjustment necessary to maintain the allowance for loan losses at a level representative of probable credit losses inherent in the portfolio. The credit for loan losses recorded for the third quarter of 2007 was $82,000, compared with a credit for loan losses of $491,000 for the third quarter of 2006. For the nine months ended September 30, 2007, the credit for loan losses was $235,000, compared with $1.8 million for the same period last year. The credit for loans losses in each of these periods resulted from the continued improvement in the risk profile of the loan portfolio, as well as reduced levels of nonperforming loans, improved loan delinquencies and improved economic conditions, especially related to the agricultural loan portfolio.

Noninterest Income

The following table details the major categories of noninterest income for the periods presented:

	Three Months Ended September 30,		Nine Months Ended September 30,	
(Dollars in thousands)	2007	2006	2007	2006
Noninterest income:				
Service charges on deposits	$ 2,778	$ 3,054	$ 8,114	$ 8,559
ATM and debit card income	735	558	2,079	1,645
Broker-dealer fees and commissions	323	375	1,053	1,182
Trust fees		116		377
Loan servicing income	259	208	707	668
Income from corporate owned life insurance	1,090	14	1,139	466
Net gain on sale of securities	67		118	
Net gain on sale of loans held for sale	313	503	589	916
Net gain on sale and disposal of other assets	59	(56)	147	65
Net gain on sale of trust relationships		1,365	13	1,365
Other	710	842	1,719	1,873
Total noninterest income	$ 6,334	$ 6,979	$ 15,678	$ 17,116

Noninterest income for the three months ended September 30, 2007 and 2006 was $6.3 million and $7.0 million, respectively. Noninterest income for the nine months ended September 30, 2007 and 2006 was $15.7 million and $17.1 million, respectively.

Service charges on deposits declined 9% on a quarter-to-date basis and 5% on a year-to-date basis in 2007 versus 2006. The declines primarily related to fewer customer overdraft transactions and related service fees.

Automated Teller Machine (ATM) and debit card income, which is comprised of foreign ATM usage fees and income associated with customer debit card purchases, totaled $735,000 and $2.1 million for the quarter and nine months ended September 30, 2007, respectively, compared to $558,000 and $1.6 million for the same periods in the prior year. ATM and debit card income has increased as a result of higher ATM usage fees and an increase in customer utilization of debit card point-of-sale transactions.

Broker-dealer fees and commissions have declined on both a quarter-to-date and year-to-date basis as a result of lower sales volumes. There were no trust fees in 2007, as the Company sold its trust relationships in 2006, as reflected by the $1.4 million (pre-tax) net gain on sale of trust relationships included in noninterest income in the third quarter of 2006.

Income from corporate owned life insurance included $1.1 million (pre and post-tax) and $419,000 (pre and post-tax) of death benefit proceeds in the third quarter of 2007 and second quarter of 2006, respectively.

Net gain on sale of loans held for sale is down from prior year due primarily to lower student loan sale volumes that resulted from increased competition and changing market conditions for student loans. The Company realized $231,000 and $427,000 in net gains on the sale of student loans in the third quarters of 2007 and 2006, respectively. For the first nine months of 2007 and 2006, student loan sale net gains were $401,000, and $604,000, respectively.

In 2007, other noninterest income declined 16% for the third quarter and 8% for the nine-month period when compared to 2006. The declines were primarily the result of equity method losses on Small Business Investment Company (SBIC) limited partnership investments and a decline in rent income associated with a real estate lease that terminated during the first quarter of 2007.

Table of Contents

Noninterest Expense

The following table details the major categories of noninterest expense for the periods presented:

	Three Months Ended September 30,		Nine Months Ended September 30,	
(Dollars in thousands)	2007	2006	2007	2006
Noninterest expense:				
Salaries and employee benefits	$ 8,574	$ 8,510	$ 24,935	$ 25,294
Occupancy and equipment	2,422	2,293	7,321	7,083
Supplies and postage	443	442	1,283	1,452
Amortization of other intangible assets	77	108	230	323
Computer and data processing	547	469	1,593	1,312
Professional fees and services	476	698	1,548	2,247
Other	2,070	2,073	5,976	6,738
Total noninterest expense	$ 14,609	$ 14,593	$ 42,886	$ 44,449

Noninterest expense for the third quarter of 2007 was up slightly compared to the third quarter of 2006. For the first nine months of 2007, noninterest expense was $42.9 million, down 4% from $44.4 million for the same period last year. The lower year-to-date expense levels reflect operational efficiencies gained from the consolidation of administrative and operational functions, improved asset quality and lower advertising costs.

For the third quarter of 2007, salaries and benefits were up slightly in comparison to the third quarter of 2006. For the nine months ended September 30, 2007, salaries and benefits were $24.9 million, compared to $25.3 million for the first nine months of 2006. Consolidation activities have resulted in a reduction of 4 full-time equivalent employees (FTEs) to 636 at September 30, 2007, down from 640 at September 30, 2006. Salaries and wages also decreased during 2007 due to the increase in deferred loan origination salary and wage costs, which resulted from higher loan origination volumes. The reduction in salaries and wages was partially offset by increases in employee benefits, namely, stock-based compensation expense, health care costs and the Company s 401(k) benefit plan match, which in turn was offset by a reduction in pension expense.

The Company experienced a 6% increase in occupancy and equipment expense in the third quarter of 2007 compared to the same quarter a year ago. For the nine months ended September 30, 2007, occupancy and equipment expense was up 3% compared to the first nine months of 2006. Both the quarter-to-date and year-to-date increases primarily resulted from an increase in service contract related expenses associated with equipment and computer software.

For the third quarter of 2007, supplies and postage were relatively flat in comparison to the third quarter of 2006. Supplies and postage were down 12% on a year-to-date basis in 2007 compared to 2006. The decline resulted from cost reduction efforts and higher than normal expense incurred in the first quarter of 2006 due to the purchase of branding-related stationery and supplies as a result of the reorganization.

Amortization of other intangibles declined in 2007 versus 2006 as a result of certain intangible assets being fully amortized during 2006.

Computer and data processing costs increased 17% on a quarter-to-date basis and 21% on a year-to-date basis when 2007 is compared to 2006. The quarter-to-date increase resulted from an increase in debit card point-of-sale transactions and the data processing costs associated with those transactions, while the year-to-date increase resulted from a combination of the increased debit card data processing expense and the timing of an annual software upgrade that occurred during the second quarter of 2007 versus the fourth quarter of 2006.

Professional fees and services have declined 32% and 31% for the three and nine-month periods ended September 30, 2007, respectively, as compared to the same periods a year ago. The decline in professional fees was primarily related to lower legal and external loan review costs associated with commercial-related loans.

Other expenses are down slightly on a quarter-to-date basis in 2007 versus 2006, but decreased 11% on a year-to-date basis. A major branding campaign was initiated in 2006 due to the consolidation of our banks, which resulted in

higher advertising and promotion costs in the prior year. In addition, the Company experienced a reduction in commercial-related loan expense during 2007 from the lower level of nonperforming loans, which was partially offset by an increase other real estate expense (ORE) due to higher ORE write-downs experienced in 2007 than 2006.

Table of Contents

The efficiency ratio for the third quarter of 2007 was 67.07%, compared with 67.20% for the third quarter of 2006, and 69.45% for the nine months ended September 30, 2007, compared to 68.60% for the same period a year ago. The efficiency ratio represents noninterest expense less other real estate expense and amortization of intangibles divided by net interest income (tax-equivalent) plus other noninterest income less net gain on sale of securities, income from death benefit proceeds associated with corporate owned life insurance, net gain on sale of commercial-related loans held for sale and net gain on sale of trust relationships.

Income Taxes

The income tax provision provides for Federal and New York State income taxes and amounted to $1.4 million and $2.3 million for the three months ended September 30, 2007 and 2006, respectively. For the nine months ended September 30, 2007 and 2006, the income tax provision amounted to $3.6 million and $5.3 million, respectively. The effective tax rates recorded for 2007 on a quarter-to-date and year-to-date basis were 21.2% and 22.6% of income before income taxes, respectively, in comparison to the September 30, 2006 quarter-to-date and year-to-date effective tax rates of 30.6% and 27.1%, respectively. The lower effective tax rates in 2007 versus 2006 were primarily the result of the $1.1 million in non-taxable death benefit proceeds from corporate owned life insurance recorded during in third quarter of 2007.

ANALYSIS OF FINANCIAL CONDITION

Lending Activities

Loans Held for Sale

Loans held for sale (not included in the table below) totaled $107,000 and $992,000 at September 30, 2007 and December 31, 2006, respectively, all of which were residential real estate loans.

Loan Portfolio Composition

The following table sets forth selected information regarding the composition of the Company s loan portfolio at the dates indicated:

(Dollars in thousands)	September 30, 2007		December 31, 2006	
Commercial	$ 123,226	13.0%	$ 105,806	11.4%
Commercial real estate	241,981	25.5	243,966	26.3
Agricultural	53,877	5.7	56,808	6.2
Residential real estate	167,771	17.6	163,243	17.6
Consumer indirect	128,016	13.5	106,391	11.5
Consumer direct and home equity	234,800	24.7	250,268	27.0
Total loans	949,671	100.0	926,482	100.0
Allowance for loan losses	(15,611)		(17,048)	
Total loans, net	$ 934,060		$ 909,434	

Total loans increased $23.2 million to $949.7 million at September 30, 2007 from $926.5 million at December 31, 2006. Commercial loans and commercial real estate loans increased $15.4 million to $365.2 million or 38.5% of the portfolio at September 30, 2007 from $349.8 million or 37.7% of the portfolio at December 31, 2006. Commercial loans increased $17.4 million over December 31, 2006, as our commercial business development program over the past year delivered results. Agricultural loans decreased $2.9 million, to $53.9 million at September 30, 2007 from $56.8 million at December 31, 2006.

Residential real estate loans increased $4.5 million to $167.8 million at September 30, 2007 in comparison to $163.2 million at December 31, 2006. This category of loans increased as we added certain residential mortgages to our portfolio rather than selling the mortgages to the secondary market. The consumer indirect portfolio increased

$21.6 million to $128.0 million at September 30, 2007 from $106.4 million at December 31, 2006. The Company has expanded its relationships with franchised new car dealers and has selectively originated, in the first nine months of 2007, a mix of approximately 42% new automobile loans and 58% used automobile loans from those dealers. The consumer direct and home equity portfolio decreased $15.5 million to $234.8 million at September 30, 2007 in

Table of Contents

comparison to $250.3 million at December 31, 2006. We maintained a firm pricing and underwriting discipline on direct consumer and home equity products, which led to slower loan originations in these product categories.

Nonaccruing Loans and Nonperforming Assets

Information regarding nonaccruing loans and other nonperforming assets is as follows:

(Dollars in thousands)	September 30, 2007	December 31, 2006
Nonaccruing loans (1)		
Commercial	$ 725	$ 2,205
Commercial real estate	2,475	4,661
Agricultural	1,133	4,836
Residential real estate	3,387	3,127
Consumer indirect	14	166
Consumer direct and home equity	561	842
Total nonaccruing loans	8,295	15,837
Loans past due 90 days or more		3
Total nonperforming loans	8,295	15,840
Other real estate owned (ORE) and repossessed assets (repos)	1,625	1,203
Total nonperforming assets	$ 9,920	$ 17,043
Total nonperforming loans to total loans	0.87%	1.71%
Total nonperforming assets to total loans, ORE and repos	1.04%	1.84%
Total nonperforming assets to total assets	0.52%	0.89%

(1) Although loans are generally placed on nonaccruing status when they become 90 days or more past due, they may be placed on nonaccruing status earlier if they have been identified by the Company as

presenting uncertainty with respect to the collectibility of interest or principal. Loans past due 90 days or more may remain on accruing status if they are both well secured and in the process of collection.

The Company experienced a $7.1 million decline in total nonperforming assets to $9.9 million at September 30, 2007 compared to $17.0 million on December 31, 2006. Total nonaccruing loans declined $7.5 million at September 30, 2007 compared to December 31, 2006, as $5.4 million in nonaccruing loans returned to accruing status in the first nine months of 2007, which included a single $3.1 million agricultural relationship that returned to accruing status during the second quarter of 2007 as a result of improved cash flow from the increase in the price of milk. The Company experienced a $422,000 increase in ORE and repos to $1.6 million at September 30, 2007, compared to $1.2 million on December 31, 2006.

Information regarding the activity in nonaccruing loans is as follows:

	Three Months Ended September 30, 2007	Nine Months Ended September 30, 2007
Nonaccruing loans, beginning of period	$ 10,402	$ 15,837
Additions	1,887	6,636
Payments	(1,274)	(4,451)
Charge-offs	(1,099)	(2,431)
Returned to accruing status	(770)	(5,366)
Transferred to other real estate or repossessed assets	(851)	(1,930)
Nonaccruing loans, end of period	$ 8,295	$ 8,295

Potential problem loans are loans that are currently performing, but information known about possible credit problems of the borrowers causes management to have concern as to the ability of such borrowers to comply with the present loan payment terms and may result in disclosure of such loans as nonperforming at some point in the future. These loans remain in a performing status due to a variety of factors, including payment history, the value of collateral supporting the credits, and/or personal or government guarantees. Management considers loans classified as substandard, which continue to accrue interest, to be potential problem loans. The Company identified $17.6 million and $16.2 million in loans that continued to accrue interest which were classified as substandard as of September 30, 2007 and December 31, 2006, respectively.

Table of Contents

Analysis of the Allowance for Loan Losses

The allowance for loan losses represents the estimated amount of probable credit losses inherent in the Company s loan portfolio. The Company performs periodic, systematic reviews of the Bank s loan portfolio to estimate probable losses in the respective loan portfolios. In addition, the Company regularly evaluates prevailing economic and business conditions, industry concentrations, changes in the size and characteristics of the portfolio and other environmental factors. The process used by the Company to determine the overall allowance for loan losses is based on this analysis. Based on this analysis the Company believes the allowance for loan losses is adequate at September 30, 2007. Assessing the adequacy of the allowance for loan losses involves substantial uncertainties and is based upon management s evaluation of the amounts required to meet estimated charge-offs in the loan portfolio after weighing various factors. The adequacy of the allowance for loan losses is subject to ongoing management review. While management evaluates currently available information in establishing the allowance for loan losses, future adjustments to the allowance may be necessary if conditions differ substantially from the assumptions used in making the evaluations. In addition, various regulatory agencies, as an integral part of their examination process, periodically review a financial institution s allowance for loan losses. Such agencies may require the financial institution to recognize additions to the allowance based on their judgments about information available to them at the time of their examination.

The following table sets forth an analysis of the activity in the allowance for loan losses for the periods indicated:

	Three Months Ended September 30,		Nine Months Ended September 30,	
(Dollars in thousands)	2007	2006	2007	2006
Balance at beginning of period	$ 16,522	$ 18,590	$ 17,048	$ 20,231
Charge-offs:				
Commercial	127	363	426	900
Commercial real estate	227	58	413	455
Agricultural	40	87	56	340
Residential real estate	148		209	169
Consumer indirect	319	122	741	359
Consumer direct and home equity	449	319	1,127	916
Total charge-offs	1,310	949	2,972	3,139
Recoveries:				
Commercial	227	169	784	1,280
Commercial real estate	51	4	198	116
Agricultural	1	181	126	339
Residential real estate	1		48	1
Consumer indirect	76	62	165	184
Consumer direct and home equity	125	115	449	511
Total recoveries	481	531	1,770	2,431
Net charge-offs	829	418	1,202	708
Provision for loan losses	(82)	(491)	(235)	(1,842)

Balance at end of period	$ 15,611	$ 17,681	$ 15,611	$ 17,681
Ratio of net loan charge-offs to average loans (annualized)	0.35%	0.18%	0.17%	0.10%
Ratio of allowance for loan losses to total loans (1)	1.64%	1.88%	1.64%	1.88%
Ratio of allowance for loan losses to nonperforming loans (1)	188%	138%	188%	138%

(1) Ratios exclude loans held for sale from total loans.

Net charge-offs were $829,000 and $1.2 million for the third quarter and year-to-date 2007, respectively, compared with $418,000 and $708,000 for the same 2006 periods. The ratio of net loan charge-offs to average loans (annualized) was 0.35% and 0.17% for the third quarter and first nine months of 2007, respectively, compared to 0.18% and 0.10% for the same 2006 periods. The Company s current year net charge-off experience has increased in comparison to prior year, due in part to the combination of an increase in charge-offs in the consumer-related portfolios (residential real estate, indirect, direct and home equity) on a quarter-to-date basis and a decrease in commercial and agricultural recoveries on a year-to-date basis. The ratio of the allowance for loan losses to nonperforming loans was 188% at September 30, 2007, improved from 108% at December 31, 2006 and 138% at September 30, 2006, as a result of the reduction in nonperforming loans. The ratio of the allowance for loan losses

Table of Contents

to total loans was 1.64% at September 30, 2007, down from 1.84% at December 31, 2006 and 1.88% at September 30, 2006, as a result of the improvement in the risk profile of the loan portfolio.

Investing Activities

The Company s total investment security portfolio totaled $799.6 million as of September 30, 2007 compared to $775.5 million as of December 31, 2006. The net unrealized loss on securities available for sale amounted to $5.8 million and $11.1 million as of September 30, 2007 and December 31, 2006, respectively. The unrealized loss present does not reflect deterioration in the credit worthiness of the issuing securities and resulted primarily from fluctuations in market interest rates. The Company has the intent and ability to hold these securities until their fair value recovers to their amortized cost; therefore, management has determined that the securities that were in an unrealized loss position at September 30, 2007 and December 31, 2006 represent only temporary declines in fair value. Further detail regarding the Company s investment portfolio follows.

U.S. Government Agency Obligations

The U.S. Government agency obligations portfolio, all of which is classified as available for sale, is comprised of debt obligations issued directly by U.S. Government agencies or U.S. Government-sponsored enterprises (GSEs) and totaled $195.5 million at September 30, 2007. The portfolio consisted of approximately $97.1 million, or 50%, callable securities at September 30, 2007. At September 30, 2007, this category of securities also includes $74.3 million of structured notes, the majority of which were step callable agency debt issues. The step callable bonds step-up in rate at specified intervals and are periodically callable by the issuer. At September 30, 2007, the structured notes had a current average coupon of 4.47% that adjust on average to 6.68% within five years. However, under current market conditions these notes are likely to be called. At December 31, 2006, the available for sale U.S. Government agency securities portfolio totaled $231.8 million.

State and Municipal Obligations

At September 30, 2007, the portfolio of state and municipal obligations totaled $233.0 million, of which $176.1 million was classified as available for sale. At that date, $56.9 million was classified as held to maturity, with a fair value of $56.6 million. At December 31, 2006, the portfolio of state and municipal obligations totaled $238.7 million, of which $198.3 million was classified as available for sale. At that date, $40.4 million was classified as held to maturity, with a fair value of $40.4 million.

Mortgage-Backed Pass-through Securities (MBS), Collateralized Mortgage Obligations (CMO) and Other Asset-Backed Securities (ABS)

MBS, CMO and ABS securities, all of which were classified as available for sale, totaled $338.2 million and $303.9 million at September 30, 2007 and December 31, 2006, respectively. The unrealized loss on these securities totaled $5.6 million and $8.1 million at September 31, 3007 and December 31, 2006, respectively. The decline in unrealized losses resulted primarily from fluctuations in market interest rates. The portfolio was comprised of $166.0 million of MBSs, $143.8 million of CMOs and $28.4 million of ABSs at September 30, 2007. The majority of the MBSs were in fixed rate securities that were most frequently formed with mortgages having an original balloon payment of five or seven years. The adjustable rate MBS portfolio was principally indexed to the one-year Treasury bill. The CMO portfolio consisted primarily of fixed and variable rate government issues and fixed rate privately issued AAA rated securities. At September 30, 2007, ABSs were primarily trust preferred equity securities, the majority of which were purchased during 2007 due to the attractive yield this type of security offered. In addition, ABSs included $1.0 million of Student Loan Marketing Association (SLMA) floaters at September 30, 2007, which were variable rate securities backed by student loans. At December 31, 2006, the portfolio consisted of $189.4 million of MBSs, $107.4 million of CMOs and $7.1 million of ABSs.

Other Securities

The Company s investment policy limits investments in other securities to no more than 10% of total investments. The types of allowable investment grade securities are as follows: corporate debt, qualified preferred equity securities of U.S. based corporations or U.S. Government instrumentalities and other investment grade securities. In addition, corporate equity securities can be purchased at the holding company level.

At September 31, 2007, the Company held $32.9 million in other securities that included $31.9 million of U.S. Government instrumentality issued auction market qualified preferred equity securities and $1.0 million of corporate

25

Table of Contents

equity securities. At December 31, 2006, the Company held $1.1 million in other securities, all of which were corporate equity securities. This portfolio of equity securities qualifies for the Federal dividend received deduction. During 2007, the Company has invested in the U.S. Government instrumentality issued auction market qualified preferred equity securities in an effort to raise the tax-equivalent yield of the securities portfolio.

Funding Activities

The Company manages funding from the following principal components: nonpublic deposits, public deposits, brokered deposits, borrowings and junior subordinated debentures.

Nonpublic Deposits

Nonpublic deposits represent the largest component of the Company s funding sources. The Company offers a broad array of nonpublic deposit products including noninterest-bearing demand, interest-bearing demand, savings and money market accounts and certificates of deposit. Total nonpublic deposits were $1.248 billion at both September 30, 2007 and December 31, 2006. The Company has managed this segment of funding through a strategy of competitive pricing that minimizes the number of customer relationships that have only a single service high cost deposit account. In addition, the Company has recently managed overall pricing of its nonpublic deposits in a manner that recognizes sufficient liquidity is already in place to expand the loan portfolio and the flat-to-inverted interest yield curve provides marginal opportunity to deploy new funding at a profitable spread.

Public Deposits

The Company offers a variety of deposit products to the many towns, villages, counties and school districts within our market. Public deposits generally range from 20% to 25% of the Company s total deposits. There is a high degree of seasonality in this component of funding, as the level of deposits varies with the seasonal cash flows for these public customers. The Company maintains the necessary levels of short-term liquid assets to accommodate the seasonality associated with public deposits. At September 30, 2007, total public deposits were $353.2 million compared to $352.9 million and $381.0 million at December 31, 2006 and September 30, 2006, respectively. In general, the number of public relationships remained stable in comparison to prior year, however public deposits at September 30, 2007 were $27.8 million lower than September 30, 2006. The year-over-year decline primarily resulted from the Company maintaining a firm pricing discipline on public deposits, while market demand increased the funding cost associated with this component of deposits during the third quarter of 2007.

Brokered Deposits

The Company has also utilized brokered certificates of deposit as a funding source and brokered deposits totaled $14.7 million and $16.7 million at September 30, 2007 and December 31, 2006, respectively. The Company intends to utilize its favorable position of liquidity to repay the brokered deposits as they mature throughout the remainder of 2007 and 2008.

Borrowings

The Company s primary borrowings were FHLB term advances, which amounted to $29.1 million and $38.2 million at September 30, 2007 and December 31, 2006, respectively. The FHLB borrowings mature on various dates through 2009. The Company also has an overnight line of credit with FHLB and there was $8.5 million in overnight borrowings outstanding at September 30, 2007. The Company had approximately $54.9 million and $31.5 million of immediate credit capacity with FHLB at September 30, 2007 and December 31, 2006, respectively. The FHLB credit capacity is collateralized by U.S. Government agency and GSE securities. The Company also had $81.0 million and $102.1 million of credit available under unsecured lines of credit with various banks at September 30, 2007 and December 31, 2006, respectively. There were no advances outstanding on these lines of credit at September 30, 2007 and December 31, 2006. The Company also utilizes securities sold under agreements to repurchase as a source of funds. These short-term repurchase agreements amounted to $24.9 million and $32.3 million as of September 30, 2007 and December 31, 2006, respectively.

The Company also had a credit agreement with another commercial bank. The credit agreement included a $25.0 million term loan facility and a $5.0 million revolving loan facility. During October 2006, FII repaid the $25.0 million term loan. The $5.0 million revolving loan matured April 30, 2007 with no advances outstanding.

Junior Subordinated Debentures

In February 2001, the Company issued $16.7 million of junior subordinated debentures to a statutory trust subsidiary. The junior subordinated debentures have a fixed interest rate equal to 10.20% and mature in 30 years. The Company incurred $487,000 in costs related to the issuance that are being amortized over 20 years using the straight-line method. The statutory trust subsidiary then participated in the issuance of trust preferred securities of

Table of Contents

similar terms and maturity. As of December 31, 2003, the Company deconsolidated the subsidiary trust, which had issued trust preferred securities, and replaced the presentation of such instruments with the Company s junior subordinated debentures issued to the subsidiary trust. Such presentation reflects the adoption of FASB Interpretation No. 46 (FIN 46 R), Consolidation of Variable Interest Entities.

Equity Activities

Total shareholders equity amounted to $188.3 million at September 30, 2007, an increase of $5.9 million from $182.4 million at December 31, 2006. The increase in shareholders equity during the nine months ended September 30, 2007 primarily resulted from $15.5 million of comprehensive income, offset by $4.8 million in preferred and common dividends declared and $5.8 million in treasury stock acquisitions under the common stock repurchase program.

LIQUIDITY AND CAPITAL RESOURCES

Liquidity

The objective of maintaining adequate liquidity is to assure the ability of the Company to meet its financial obligations. These obligations include the withdrawal of deposits on demand or at their contractual maturity, the repayment of borrowings as they mature, the ability to fund new and existing loan commitments and the ability to take advantage of new business opportunities. The Company achieves liquidity by maintaining a strong base of customer funds, maturing short-term assets, and the ability to sell securities, lines of credit, and access to capital markets. Liquidity at the Bank is managed through the monitoring of anticipated changes in loans, the investment portfolio, deposits and wholesale funds. The strength of the Bank s liquidity position is a result of its base of customer deposits. Deposits are supplemented by wholesale funding sources that include credit lines with other banking institutions, the FHLB and the Federal Reserve Bank.

The primary sources of liquidity for FII are dividends from the Bank and access to capital markets. Dividends from the Bank are limited by various regulatory requirements related to capital adequacy and earnings trends. The Bank relies on cash flows from operations, deposits, borrowings and short-term liquid assets. FSIS relies on cash flows from operations and funds from FII when necessary.

The Company s cash and cash equivalents were $58.4 million at September 30, 2007, a decrease of $51.4 million from $109.8 million at December 31, 2006. The Company s net cash provided by operating activities totaled $12.0 million and the principal source of operating activity cash flow was net income adjusted for noncash income and expense items and changes in other assets and other liabilities. Net cash used in investing activities totaled $43.9 million, which included net purchases of $15.7 million in securities, $26.3 million of loan originations in excess of loan payments, and a purchase of premises and equipment for $2.9 million dollars. Net cash used in financing activities of $19.5 million was primarily attributed to the $9.0 million reduction in long-term borrowings, $5.9 million of preferred and common share repurchases and $4.5 million in dividends paid. The Company s cash and cash equivalents were $133.1 million at September 30, 2006 an increase of $41.2 million from $91.9 million at December 31, 2005.

Capital Resources

The Federal Reserve Board has adopted a system using risk-based capital guidelines to evaluate the capital adequacy of bank holding companies on a consolidated basis. The leverage ratio is utilized in assessing capital adequacy with a minimum requirement that can range from 4.0% to 5.0%. The guidelines also require a minimum total risk-based capital ratio of 8.0%.

The Company s Tier 1 leverage ratio was 9.23% at September 30, 2007, an increase from 8.91% at December 31, 2006. Total Tier 1 capital of $171.7 million at September 30, 2007 was up from $168.7 million at December 31, 2006. The Company s Tier 1 risk-based capital ratio was 15.71% at September 30, 2007, down slightly from 15.85% at December 31, 2006. The Company s total risk-weighted capital ratio was 16.96% at September 30, 2007, down slightly from 17.10% at December 31, 2006.

Table of Contents

The following is a summary of the risk-based capital ratios for the Company and FSB:

	September 30, 2007	December 31, 2006
Tier 1 leverage ratio		
Company	9.23%	8.91%
FSB	8.58%	8.06%
Tier 1 risk-based capital ratio		
Company	15.71%	15.85%
FSB	14.63%	14.35%
Total risk-based capital ratio		
Company	16.96%	17.10%
FSB	15.89%	15.61%

Item 3. Quantitative and Qualitative Disclosures About Market Risk

The principal objective of the Company s interest rate risk management is to evaluate the interest rate risk inherent in certain assets and liabilities, determine the appropriate level of risk to the Company given its business strategy, operating environment, capital and liquidity requirements and performance objectives, and manage the risk consistent with the guidelines approved by FII s Board of Directors. The Company s management is responsible for reviewing with the Board its activities and strategies, the effect of those strategies on the net interest margin, the fair value of the portfolio and the effect that changes in interest rates will have on the portfolio and exposure limits. Management develops an Asset-Liability Policy that meets strategic objectives and regularly reviews the activities of the Bank.

The primary tool the Company uses to manage interest rate risk is a rate shock simulation to measure the rate sensitivity of the balance sheet. Rate shock simulation is a modeling technique used to estimate the impact of changes in rates on net interest income and economic value of equity. The Company measures net interest income at risk by estimating the changes in net interest income resulting from instantaneous and sustained parallel shifts in interest rates of different magnitudes over a period of twelve months. This simulation is based on management s assumption as to the effect of interest rate changes on assets and liabilities and assumes a parallel shift of the yield curve. It also includes certain assumptions about the future pricing of loans and deposits in response to changes in interest rates. Further, it assumes that delinquency rates would not change as a result of changes in interest rates, although there can be no assurance that this will be the case. While this simulation is a useful measure as to net interest income at risk due to a change in interest rates, it is not a forecast of the future results and is based on many assumptions that, if changed, could cause a different outcome.

In addition to the changes in interest rate scenarios listed above, the Company typically runs other scenarios to measure interest rate risk, which vary depending on the economic and interest rate environments.

The Company has experienced no significant changes in market risk due to changes in interest rates since the Company s Annual Report on Form 10-K for the year ended December 31, 2006, dated March 13, 2007, as filed with the Securities and Exchange Commission.

Item 4. Controls and Procedures

a) As of September 30, 2007, the Company carried out an evaluation, under the supervision and with the participation of the Company s management, including the Company s Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of the Company s disclosure controls and procedures pursuant to Rule 13a-15(b), as adopted by the Securities and Exchange Commission (SEC) under the Securities Exchange Act of 1934 (Exchange Act). Based upon that evaluation, the Chief Executive Officer and Chief Financial Officer concluded that the Company s disclosure controls and procedures were effective as of the end of the period covered by this report. Disclosure controls and procedures are the controls and other procedures that are designed to ensure that information required to be disclosed in the reports that the Company files or submits under the Exchange Act is recorded,

processed, summarized and reported within the time periods specified in the SEC s rules and forms. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed in the reports that the Company files or submits under the Exchange Act is accumulated and

Table of Contents

communicated to management, including the Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosure.

b) Changes to Internal Control Over Financial Reporting

There were no changes in the Company s internal control over financial reporting that occurred during the quarter ended September 30, 2007 that have materially affected, or are reasonably likely to materially affect, the Company s internal control over financial reporting.

PART II OTHER INFORMATION

Item 1. Legal Proceedings

The Company has experienced no significant changes in its legal proceedings from the disclosure included in the Company s Annual Report on Form 10-K for the year ended December 31, 2006, dated March 13, 2007, as filed with the Securities and Exchange Commission.

Item 1A. Risk Factors

The Company has experienced no material changes in its risk factors from the disclosure included in the Company s Annual Report on Form 10-K for the year ended December 31, 2006, dated March 13, 2007, as filed with the Securities and Exchange Commission.

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

The table below sets forth the information with respect to purchases made by the Company (as defined in Rule 10b-18(a)(3) under the Securities Exchange Act of 1934), of our common stock during the three months ended September 30, 2007:

Period	Total Number of Shares Purchased	Average Price Paid per Share	Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs	Approximate Dollar Value of Shares that May Yet Be Purchased Under the Plans or Programs (1)
07/01/07 07/31/07	45,496	$ 19.75	45,496	$ 4,840,000
08/01/07 08/31/07	33,598	18.02	33,598	4,235,000
09/01/07 09/30/07	20,950	19.02	20,950	3,836,000
Total	100,044	$ 19.01	100,044	$ 3,836,000

(1) On October 25, 2006, the Company s Board of Directors approved a one-year, $5.0 million common stock repurchase program. On July 25, 2007,

the Company s Board of Directors approved a new one-year $5.0 million common stock repurchase program and canceled the remaining portion of the Company s one-year $5.0 million stock repurchase program that was approved October 25, 2006. Under the programs, stock repurchases may be made either in the open market or through privately negotiated transactions.

Table of Contents

Item 6. Exhibits

The following is a list of all exhibits filed or incorporated by reference as part of this Report.

Exhibit No.	Description	Location
3.1	Amended and Restated Certificate of Incorporation	Incorporated by reference to Exhibit 3.1 of the Registrant s Registration Statement on Form S-1 dated June 25, 1999 (File No. 333-76865) (The S-1 Registration Statement)
3.2	Amended and Restated Bylaws dated May 23, 2001	Incorporated by reference to Exhibit 3.2 of the Form 10-K for the year ended December 31, 2001, dated March 11, 2002
3.3	Amended and Restated Bylaws dated February 18, 2004	Incorporated by reference to Exhibit 3.3 of the Form 10-K for the year ended December 31, 2003, dated March 12, 2004
3.4	Amended and Restated Bylaws dated February 22, 2006	Incorporated by reference to Exhibit 3.4 of the Form 10-K for the year ended December 31, 2005, dated March 15, 2006
10.1	1999 Management Stock Incentive Plan	Incorporated by reference to Exhibit 10.1 of the S-1 Registration Statement
10.2	Amendment Number One to the FII 1999 Management Stock Incentive Plan	Incorporated by reference to Exhibit 10.1 of the Form 8-K, dated July 28, 2006
10.3	Form of Non-Qualified Stock Option Agreement Pursuant to the FII 1999 Management Stock Incentive Plan	Incorporated by reference to Exhibit 10.2 of the Form 8-K, dated July 28, 2006
10.4	Form of Restricted Stock Award Agreement Pursuant to the FII 1999 Management Stock Incentive Plan	Incorporated by reference to Exhibit 10.3 of the Form 8-K, dated July 28, 2006
10.5	1999 Directors Stock Incentive Plan	Incorporated by reference to Exhibit 10.2 of the S-1 Registration Statement
10.6	Executive Agreement with Peter G. Humphrey	Incorporated by reference to Exhibit 10.1 of the Form 8-K, dated June 30, 2005
10.7	Executive Agreement with James T. Rudgers	Incorporated by reference to Exhibit 10.2 of the Form 8-K, dated June 30, 2005
10.8	Executive Agreement with Ronald A. Miller	Incorporated by reference to Exhibit 10.3 of the Form 8-K, dated June 30, 2005

10.9	Executive Agreement with Martin K. Birmingham	Incorporated by reference to Exhibit 10.4 of the Form 8-K, dated June 30, 2005
10.10	Agreement with Peter G. Humphrey	Incorporated by reference to Exhibit 10.6 of the Form 8-K, dated June 30, 2005
10.11	Executive Agreement with John J. Witkowski	Incorporated by reference to Exhibit 10.7 of the Form 8-K, dated September 14, 2005
10.12	Executive Agreement with George D. Hagi	Incorporated by reference to Exhibit 10.7 of the Form 8-K, dated February 2, 2006
10.13	Term and Revolving Credit Loan Agreements between FII and M&T Bank, dated December 15, 2003	Incorporated by reference to Exhibit 1.1 of the Form 10-K for the year ended December 31, 2003, dated March 12, 2004
10.14	Second Amendment to Term Loan Credit Agreement between FII and M&T Bank, dated September 30, 2005	Incorporated by reference to Exhibit 10.17 of the Form 10-Q for the quarterly period ended September 30, 2005, dated November 4, 2005

Table of Contents

Exhibit No.	Description	Location
10.15	Fourth Amendment to Revolving Credit Agreement between FII and M&T Bank, dated September 30, 2005	Incorporated by reference to Exhibit 10.17 of the Form 10-Q for the quarterly period ended September 30, 2005, dated November 4, 2005
10.16	Amended Stock Ownership Requirements, dated December 14, 2005	Incorporated by reference to Exhibit 10.19 of the Form 10-K for the year ended December 31, 2005, dated March 15, 2006
10.17	2006 Annual Incentive Plan, dated March 13, 2006	Incorporated by reference to Exhibit 10.20 of the Form 10-K for the year ended December 31, 2005, dated March 15, 2006
10.18	Executive Enhanced Incentive Plan dated January 25, 2006	Incorporated by reference to Exhibit 10.21 of the Form 10-K for the year ended December 31, 2005, dated March 15, 2006
10.19	Trust Company Agreement and Plan of Merger	Incorporated by reference to Exhibit 10.1 of the Form 8-K, dated April 3, 2006
10.20	2007 Annual Incentive Plan, dated March 13, 2007	Incorporated by reference to Exhibit 10.21 of the Form 10-K for the year ended December 31, 2006, dated March 13, 2007
10.21	2007 Director (Non-Management) Compensation	Incorporated by reference to Exhibit 10.22 of the Form 10-K for the year ended December 31, 2006, dated March 13, 2007
11.1	Statement of Computation of Per Share Earnings	Incorporated by reference to Note 3 of the Registrant s unaudited consolidated financial statements under Item 1 filed herewith.
31.1	Certification pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 - CEO	Filed Herewith
31.2	Certification pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 - CFO	Filed Herewith
32.1	Certification pursuant to18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 - CEO	Filed Herewith
32.2	Certification pursuant to18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 - CFO	Filed Herewith

Table of Contents

Signatures

Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

FINANCIAL INSTITUTIONS, INC.

Date	Signatures
November 6, 2007	By: /s/ Peter G. Humphrey Peter G. Humphrey President and Chief Executive Officer (Principal Executive Officer)
November 6, 2007	By: /s/ Ronald A. Miller Ronald A. Miller Executive Vice President and Chief Financial Officer (Principal Accounting Officer)