COMMUNITY BANK SYSTEM INC
Form 10-Q
November 08, 2006

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

FORM 10-Q

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

For the quarterly period ended September 30, 2006

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

For the transition period from _____ to _____

Commission File Number 001-13695

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

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

(315) 445-2282
(Registrant's telephone number, including area code)

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

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

Large accelerated filer |_| Accelerated filer |X| Non-accelerated filer |_|

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

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

29,931,042 shares of Common Stock, $1.00 par value, were outstanding on November 2, 2006.

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Part 1. Financial Information
Item 1. Financial Statements

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

Cash and cash equivalents	
Available-for-sale investment securities, at fair value	
Held-to-maturity investment securities (fair value of $140,832 and $139,512, respectively)	
Total investment securities	
Loans	
Allowance for loan losses	
Net loans	
Core deposit intangibles, net	
Goodwill	
Other intangibles, net	
Intangible assets, net	
Premises and equipment, net	
Accrued interest receivable and other assets	
Total assets	
Liabilities:	
Non-interest bearing deposits	
Interest bearing deposits	
Total deposits	
Federal funds purchased	
Borrowings	
Subordinated debt held by unconsolidated subsidiary trusts	
Accrued interest and other liabilities	
Total liabilities	
Commitment and contingencies (See Note I)	
Shareholders' equity:	
Preferred stock $1.00 par value, 500,000 shares authorized, 0 shares issued	
Common stock, $1.00 par value, 50,000,000 shares authorized; 32,620,463 and 32,450,563 shares issued in 2006 and 2005, respectively	
Additional paid-in capital	
Retained earnings	
Accumulated other comprehensive income	
Treasury stock, at cost (2,753,161 and 2,493,711 shares, respectively)	
Employee stock plan - unearned	
Total shareholders' equity	
Total liabilities and shareholders' equity	

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

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

	Three Months Ended September 30,	
	2006	2005
Interest income:		
Interest and fees on loans	$43,482	$37,13
Interest and dividends on taxable investments	10,033	11,31
Interest and dividends on nontaxable investments	5,646	5,72
Total interest income	59,161	54,17
Interest expense:		
Interest on deposits	16,357	11,14
Interest on short-term borrowings	1,327	2,52
Interest on subordinated debt held by unconsolidated subsidiary trusts	1,937	1,71
Interest on long-term borrowings	5,748	3,74
Total interest expense	25,369	19,12
Net interest income	33,792	35,04
Less: provision for loan losses	1,300	2,27
Net interest income after provision for loan losses	32,492	32,77
Non-interest income:		
Deposit service fees	7,329	7,13
Other banking services	1,329	1,41
Benefit plan administration, consulting and actuarial fees	3,271	2,76
Trust, investment and asset management fees	1,815	1,82
Gain on sales of investment securities	--	5,30
Total non-interest income	13,744	18,44
Operating expenses:		
Salaries and employee benefits	16,741	16,45
Occupancy and equipment	4,350	4,48
Data processing and communications	3,359	3,46
Amortization of intangible assets	1,520	1,55
Legal and professional fees	1,119	92
Office supplies and postage	1,004	1,02
Business development and marketing	1,095	54
Other	2,652	2,27

Total operating expenses	31,840	30,72
Income before income taxes	14,396	20,48
Income taxes	3,517	5,62
Net income	$10,879	$14,86
Basic earnings per share	$ 0.36	$ 0.4
Diluted earnings per share	$ 0.36	$ 0.4
Dividends declared per share	$ 0.20	$ 0.1

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

COMMUNITY BANK SYSTEM, INC.
CONSOLIDATED STATEMENT OF CHANGES IN SHAREHOLDERS' EQUITY (Unaudited)
Nine Months Ended September 30, 2006
(In Thousands, Except Share Data)

	Common Stock		Additional		Accumulated
	Shares Outstanding	Amount Issued	Paid-In Capital	Retained Earnings	Other Comprehensiv Income
Balance at December 31, 2005	29,956,852	$32,451	$196,312	$276,809	$ 8,420
Net income				30,225	
Other comprehensive loss, net of tax					(4,622)
Dividends declared: Common, $0.58 per share				(17,326)	
Common stock issued under employee stock plan, including tax benefits of $458	169,900	169	2,498		
Employee stock options earned			1,455		
Treasury stock purchased	(259,450)				
Reclassification of unearned restricted stock awards to additional paid-in capital in accordance with SFAS No. 123(R)			(176)		
Balance at September 30, 2006	29,867,302	$32,620	$200,089	$289,708	$ 3,798

The accompanying notes are an integral part of the consolidated financial

statements.

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

	Three Months Ended September 30,	
	2006	2005
Other comprehensive loss, before tax:		
Change in minimum pension liability adjustment	$ 0	$
Unrealized gain (loss) on securities:		
Unrealized holding gain (loss) arising during period	12,063	(16,84
Reclassification adjustment for gain included in net income	0	(5,30
Other comprehensive gain (loss), before tax:	12,063	(22,14
Income tax (expense) benefit related to other comprehensive gain (loss)	(4,627)	8,54
Other comprehensive gain (loss), net of tax:	7,436	(13,60
Net income	10,879	14,86
Comprehensive income	$ 18,315	$ 1,26

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

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

	Nine Sep
	2006
Operating activities:	
Net income	$ 30,225
Adjustments to reconcile net income to net cash provided by operating activities:	
Depreciation	6,456
Amortization of intangible assets	4,502
Net amortization of premiums and discounts on securities and loans	971
Amortization of unearned compensation and discount on subordinated debt	95
Provision for loan losses	5,175
Gain on investment securities	0

Gain on sale of loans and other assets	(97
Proceeds from the sale of loans held for sale	14,388
Origination of loans held for sale	(14,347
Excess tax benefits from share-based payment arrangements	(245
Change in other operating assets and liabilities	4,577
Net cash provided by operating activities	51,700
Investing activities:	
Proceeds from sales of available-for-sale investment securities	33,719
Proceeds from maturities of held-to-maturity investment securities	3,802
Proceeds from maturities of available-for-sale investment securities	88,118
Purchases of held-to-maturity investment securities	(6,627
Purchases of available-for-sale investment securities	(70,909
Net increase in loans outstanding	(56,110
Cash paid for acquisition, net of cash acquired of $1,097 and $0	(38,971
Capital expenditures	(4,142
Net cash (used in) provided by investing activities	(51,120
Financing activities:	
Net change in demand deposits, NOW accounts and savings accounts	(35,057
Net change in time deposits	53,091
Net change in federal funds purchased	(26,400
Net change in short-term borrowings	(70,000
Change in long-term borrowings (net of payments of $91 and $148)	102,648
Issuance of common stock	2,309
Purchase of treasury stock	(5,542
Cash dividends paid	(17,049
Tax benefits from share-based payment arrangements	245
Net cash provided by (used in) financing activities	4,245
Change in cash and cash equivalents	4,825
Cash and cash equivalents at beginning of period	114,605
Cash and cash equivalents at end of period	$ 119,430
Supplemental disclosures of cash flow information:	
Cash paid for interest	$ 66,919
Cash paid for income taxes	5,621
Supplemental disclosures of non-cash financing and investing activities:	
Dividends declared and unpaid	5,972
Gross change in unrealized gain on available-for-sale investment securities	(7,432
Acquisitions:	
Fair value of assets acquired, excluding acquired cash and intangibles	208,963
Fair value of liabilities assumed	188,155

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

COMMUNITY BANK SYSTEM, INC.
NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)
September 30, 2006

NOTE A: BASIS OF PRESENTATION

The interim financial data as of September 30, 2006 and for the three and nine months ended September 30, 2006 and 2005 is unaudited; however, in the opinion of the Company, the interim data includes all adjustments, consisting only of normal recurring adjustments, necessary for a fair statement of the results for the interim periods. The results of operations for the interim periods are not necessarily indicative of the results that may be expected for the full year or any other interim period.

NOTE B: ACQUISITION AND OTHER MATTERS

ES&L Bancorp

On August 11, 2006, the Company acquired ES&L Bancorp ("Elmira"), the parent company of Elmira Savings and Loan, F.A., a federally chartered thrift in an all-cash transaction valued at approximately $40 million. Elmira operated two branches in the cities of Elmira and Ithaca, New York. The results of Elmira's operations have been included in the consolidated financial statements since that date.

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

(000's omitted)	
Cash and due from banks	$ 1,097
Available-for-sale investment securities	3,651
Loans net of allowance for loan losses	195,911
Premises and equipment, net	2,134
Other assets	6,170
Goodwill	17,947
Core deposits intangibles	1,313
Total assets acquired	228,223
Deposits	138,301
Borrowings	49,576
Other liabilities	278
Total liabilities assumed	188,155
Net assets acquired	$ 40,068

ONB Corporation

On August 3, 2006, the Company announced an agreement to acquire ONB Corporation ("ONB") in an all-cash transaction valued at approximately $15.7 million. ONB is the parent company of Ontario National Bank, a federally chartered national bank operating four branches in the villages of Clifton Springs, Phelps and Palmyra, New York. As of September 30, 2006 the Company held approximately $95 million in assets, including $60 million in loans. The acquisition is expected to close in the fourth quarter of 2006.

Stock Repurchase Program

On April 20, 2005, the Company announced a twenty-month authorization to repurchase up to 1,500,000 of its outstanding shares. Through September 30, 2006, the Company has repurchased against this authorization 853,161 shares at an aggregate cost of $19.5 million and an average price per share of $22.86. The repurchased shares will be used for general corporate purposes, including those related to stock plan activities.

NOTE C: ACCOUNTING POLICIES

Critical Accounting Policies

Allowance for Loan Losses

Management continually evaluates the credit quality of the Company's loan portfolio and performs a formal review of the adequacy of the allowance for loan losses on a quarterly basis. The allowance reflects management's best estimate of probable losses inherent in the loan portfolio. Determination of the allowance is subjective in nature and requires significant estimates. The Company's allowance methodology consists of two broad components, general and specific loan loss allocations.

The general loan loss allocation is composed of two calculations that are computed on four main loan segments: commercial, consumer direct, consumer indirect and residential real estate. The first calculation determines an allowance level based on the latest three years of historical net charge-off data for each loan category (commercial loans exclude balances with specific loan loss allocations). The second calculation is qualitative and takes into consideration five major factors affecting the level of loan loss risk: portfolio risk migration patterns (internal credit quality trends); the growth of the segments of the loan portfolio; economic and business environment trends in the Company's markets (includes review of bankruptcy, unemployment, population, consumer spending and regulatory trends); industry, geographical and product concentrations in the portfolio; and the perceived effectiveness of managerial resources and lending practices and policies. These two calculations are added together to determine the general loan loss allocation. The specific loan loss allocation relates to individual commercial loans that are both greater than $0.5 million and in a non-accruing status with respect to interest. Specific losses are based on discounted estimated cash flows, including any cash flows resulting from the conversion of collateral.

Loan losses are charged off against the allowance, while recoveries of amounts previously charged off are credited to the allowance. A provision for loan loss is charged to operations based on management's periodic evaluation of factors previously mentioned.

Income Taxes

Provisions for income taxes are based on taxes currently payable or refundable, and deferred taxes which are based on temporary differences between the tax basis of assets and liabilities and their reported amounts in the financial statements. Deferred tax assets and liabilities are reported in the financial statements at currently enacted income tax rates applicable to the period in which the deferred tax assets and liabilities are expected to be realized or settled.

Intangible Assets

Intangible assets include core deposit intangibles, customer relationship intangibles and goodwill arising from acquisitions. Core deposit intangibles and customer relationship intangibles are amortized on either an accelerated or straight-line basis over periods ranging from 7 to 20 years. Goodwill is evaluated at least annually for impairment. The carrying value of goodwill and other intangible assets is based upon discounted cash flow modeling techniques that require management to make estimates regarding the amount and timing of expected future cash flows. It also requires use of a discount rate that

reflects the current return requirements of the market in relation to present risk-free interest rates, required equity market premiums, and company-specific risk indicators.

Retirement Benefits

The Company provides defined benefit pension benefits and post-retirement health and life insurance benefits to eligible employees. The Company also provides deferred compensation and supplemental executive retirement plans for selected current and former employees and officers. Expense under these plans is charged to current operations and consists of several components of net periodic benefit cost based on various actuarial assumptions regarding future experience under the plans, including discount rate, rate of future compensation increases and expected return on plan assets.

New Accounting Pronouncements

In June 2006, the Financial Accounting Standards Board ("FASB") issued FASB Interpretation No. 48, "Accounting for Uncertainty in Income Taxes - an interpretation of FASB Statement No. 109" (FIN 48). FIN 48 clarifies the accounting for uncertainty in income taxes recognized in a company's financial statements and prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in an income tax return. FIN 48 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 is currently analyzing the effects FIN 48 will have on its financial statements.

In March 2006, the FASB issued SFAS No. 156, "Accounting for Servicing of Financial Assets, an amendment of FASB Statement No. 140" (SFAS 158"). SFAS 156 requires all separately recognized servicing assets and servicing liabilities to be initially measured at fair value, if practicable. The standard permits an entity to subsequently measure each class of servicing assets or servicing liabilities at fair value and report changes in fair value in the statement of income in the period in which the changes occur. SFAS 156 is effective for the Company as of January 1, 2007. The Company is currently evaluating the impact of adopting SFAS 156.

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 158"). SFAS 158 requires an employer to recognize the funded status of defined benefit pension and other postretirement benefit plans as an asset or liability. SFAS 158 is effective for the Company as of December 31, 2006. The Company is currently evaluating the effects SFAS 158 will have on its financial statements.

In September 2006, the Securities and Exchange Commission issued Staff Accounting Bulletin No. 108, "Considering the Effects of Prior Year Misstatements When Quantifying Misstatements in Current Year Financial Statements" ("SAB 108"), which provides interpretive guidance on how the effects of the carryover or reversal of prior year misstatements should be considered in quantifying a current year misstatement. The provisions of SAB 108 are required in annual financial statements for fiscal year 2006. The Company does not believe that the adoption of SAB 108 will materially impact our consolidated financial statements.

In September 2006, the FASB issued SFAS No. 157, "Fair Value Measurements"

("SFAS 157"). SFAS 157 does not address "what" to measure at fair value; instead, it addresses "how" to measure fair value. SFAS 157 applies (with limited exceptions) to existing standards that require assets or liabilities to be measured at fair value. SFAS 157 establishes a fair value hierarchy, giving the highest priority to quoted prices in active markets and the lowest priority to unobservable data and requires new disclosures for assets and liabilities measured at fair value based on their level in the hierarchy. SFAS 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007. The Company is currently evaluating the impact of adopting SFAS 157.

NOTE D: STOCK BASED COMPENSATION

The Company has a long-term incentive program for directors, officers and employees. Under this program, the Company authorized 4,024,000 shares of Company common stock for the grant of incentive stock options, nonqualified stock options, restricted stock awards, retroactive stock appreciation rights, and offset options. The offset options in its Director's Stock Balance Plan vest and become exercisable immediately and expire one year after the date the director retires or two years in the event of death. The remaining options have a ten-year term, and vest and become exercisable on a grant-by-grant basis, ranging from immediate vesting to ratably over a five-year period. Activity in this long-term incentive program is as follows:

	Stock Options		Rest
	Outstanding	Weighted Average Exercise Price of Shares	Outstanding
December 31, 2004	2,400,932	$15.59	34,818
Granted	579,484	24.33	3,197
Exercised	(417,824)	11.55	(16,921)
Forfeited	(16,902)	17.86	0
Outstanding at December 31, 2005	2,545,690	18.23	21,094
Granted	392,211	23.61	0
Exercised	(179,164)	13.65	(7,545)
Forfeited	(21,296)	23.03	(4,206)
Outstanding at September 30, 2006	2,737,441	19.26	9,343
Exercisable at September 30, 2006	1,851,534	$17.65	0

The weighted average remaining contractual term of outstanding and exercisable stock options at September 30, 2006 is 6.8 years and 6.2 years, respectively. The aggregate intrinsic value of outstanding and exercisable stock options at September 30, 2006 is $10.6 million and $9.6 million, respectively.

The Company adopted Statement of Financial Accounting Standards No. 123(R), Share-Based Payment ("SFAS 123(R)"), on January 1, 2006 using the modified prospective method. Under this method, awards that are granted, modified, or settled after December 31, 2005, are measured and accounted for in accordance with SFAS 123(R). Also under this method, expense is recognized for unvested awards that were granted prior to January 1, 2006, based upon the fair value determined at the grant date under SFAS 123(R). Stock based compensation expense is recognized ratably over the requisite service period for all awards. Prior to

the adoption of SFAS 123(R), the Company accounted for stock compensation under the intrinsic value method permitted by Accounting Principles Board Opinion No 25, Accounting for Stock Issued to Employees ("APB No. 25") and related interpretations. Accordingly, the Company previously recognized no compensation cost for employee stock options that were granted with an exercise price equal to the market value of the underlying common stock on the date of grant.

As a result of applying the provisions of SFAS 123(R) during the three and nine months ended September 30, 2006, the Company recognized stock-based compensation expense related to incentive and non-qualified stock options of $0.4 million and $1.5 million, respectively and a related income tax benefit of $51,000 and $238,000, respectively. Compensation expense related to restricted stock recognized in the income statement for the three and nine months ended September 30, 2006 was $16,000 and $47,000, respectively. Compensation expense related to restricted stock recognized in the income statement for the three and nine months ended September 30, 2005 was $59,000 and $180,000, respectively.

The following table illustrates the effect on net income and earnings per share if the fair value based method established in SFAS No. 123(R) had been applied in 2005:

(000's omitted except per share amounts)	Three months ended September 30, 2005	Nine mo Septemb
Net income, as reported	$14,864	
Plus: stock-based compensation expense as reported, net of tax	41	
Less: stock-based compensation expense determined under fair value method, net of tax	(332)	
Pro forma net income	$14,573	
Earnings per share:		
As reported:		
Basic	$0.49	
Diluted	$0.48	
Pro forma:		
Basic	$0.48	
Diluted	$0.47	

Management estimated the fair value of options granted using the Black-Scholes option-pricing model. This model was originally developed to estimate the fair value of exchange-traded equity options, which (unlike employee stock options) have no vesting period or transferability restrictions. As a result, the Black-Scholes model is not necessarily a precise indicator of the value of an option, but it is commonly used for this purpose. The Black-Scholes model requires several assumptions, which management developed based on historical trends and current market observations.

	Nine months ended September 30,

	2006	2005
Weighted Average Fair Value of Options Granted	$ 6.10	$ 6.37
Assumptions:		
Weighted-average expected life (in years)	7.78	7.76
Future dividend yield	3.00%	3.00%
Share price volatility	26.46%	26.78%
Weighted average risk-free interest rate	4.37%	4.17%

Unrecognized stock based compensation expense related to non-vested stock options totaled $4.3 million at September 30, 2006, which will be recognized as expense over the next five years. The weighted average period over which this unrecognized expense is expected to be recognized is 1.7 years. The total fair value of shares vested during the nine months ended September 30, 2006 and 2005 were $1.5 million and $1.7 million, respectively.

During the nine months ended September 30, 2006 and 2005, proceeds from stock option exercises totaled $2.4 million and $3.1 million, respectively, and the related windfall tax benefits from exercise were approximately $245,000 and $694,000, respectively. During the nine months ended September 30, 2006 and 2005, 179,164 and 292,370 shares, respectively, were issued in connection with stock option exercise. All shares issued were new shares issued from available authorized shares. The total intrinsic value of options exercised during the nine months ended September 30, 2006 and 2005 were $1.5 million and $3.8 million, respectively.

NOTE E: EARNINGS PER SHARE

Basic earnings per share are computed based on the weighted-average common shares outstanding for the period. Diluted earnings per share are based on the weighted-average shares outstanding adjusted for the dilutive effect of the assumed exercise of stock options during the year. The dilutive effect of options is calculated using the treasury stock method of accounting. The treasury stock method determines the number of common shares that would be outstanding if all the dilutive options (average market price is greater than the exercise price) were exercised and the proceeds were used to repurchase common shares in the open market at the average market price for the applicable time period. There were 1,376,605 and 1,353,086 weighted-average anti-dilutive stock options outstanding for the three and nine months ended September 30, 2006 compared to 831,447 and 804,451 weighted-average anti-dilutive stock options outstanding for the three and nine months ended September 30, 2005. The following is a reconciliation of basic to diluted earnings per share for the three and nine months ended September 30, 2006 and 2005.

(000's omitted, except per share data)	Income	Shares	Per Share Amount
Three Months Ended September 30, 2006			
Basic EPS	$10,879	29,932	$ 0.36
Stock options		402	

Diluted EPS	$10,879	30,334	$ 0.36
Three Months Ended September 30, 2005			
Basic EPS	$14,864	30,178	$ 0.49
Stock options		534	
Diluted EPS	$14,864	30,712	$ 0.48
Nine Months Ended September 30, 2006			
Basic EPS	$30,225	29,967	$ 1.01
Stock options		406	
Diluted EPS	$30,225	30,373	$ 1.00
Nine Months Ended September 30, 2005			
Basic EPS	$42,479	30,385	$ 1.40
Stock options		562	
Diluted EPS	$42,479	30,947	$ 1.37

NOTE F: INTANGIBLE ASSETS

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

	As of September 30, 2006			
(000's omitted)	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount	Gross Carryin Amoun
Amortizing intangible assets:				
Core deposit intangibles	$ 64,474	($39,248)	$ 25,226	$ 63,16
Other intangibles	2,750	(1,483)	1,267	2,75
Total amortizing intangibles	67,224	(40,731)	26,493	65,91
Non-amortizing intangible assets:				
Goodwill	213,142	0	213,142	195,19
Total intangible assets, net	$280,366	($40,731)	$239,635	$261,10

No goodwill impairment adjustments were recognized in 2006 or 2005.

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

(000's omitted)	Amount
Oct-Dec 2006	$ 1,551
2007	5,847
2008	5,503
2009	4,982

2010	3,133
Thereafter	5,477
Total	$26,493

NOTE G: MANDATORILY REDEEMABLE PREFERRED SECURITIES

The Company sponsors three business trusts, Community Capital Trust I, Community Capital Trust II, and Community Statutory Trust III, of which 100% of the common stock is owned by the Company. The trusts were formed for the purpose of issuing company-obligated mandatorily redeemable preferred securities to third-party investors and investing the proceeds from the sale of such preferred securities solely in junior subordinated debt securities of the Company. The debentures held by each trust are the sole assets of that trust. Distributions on the preferred securities issued by each trust are payable semi-annually or quarterly at a rate per annum equal to the interest rate being earned by the trust on the debentures held by that trust. The preferred securities are subject to mandatory redemption, in whole or in part, upon repayment of the debentures. The Company has entered into agreements which, taken collectively, fully and unconditionally guarantee the preferred securities subject to the terms of each of the guarantees. The terms of the preferred securities of each trust are as follows:

	Issuance Date	Par Amount	Interest Rate	Maturity Date	Call Provision
I	2/3/1997	$30 million	9.75%	2/03/2027	10 year beginning 2007
II	7/16/2001	$25 million	6 month LIBOR plus 3.75% (9.30%)	7/16/2031	5 year beginning 2006
III	7/31/2001	$24.5 million	3 month LIBOR plus 3.58% (9.07%)	7/31/2031	5 year beginning 2006

NOTE H: BENEFIT PLANS

The Company provides defined benefit pension benefits and post-retirement health and life insurance benefits to eligible employees. The Company also provides supplemental pension retirement benefits for several current and former key employees. The Company accrues for the estimated cost of these benefits through charges to expense during the years that employees earn these benefits. The net periodic benefit cost for the three and nine months ended September 30 is as follows:

	Pension Benefits				
	Three Months Ended September 30,		Nine Months Ended September 30,		Three Sept
(000's omitted)	2006	2005	2006	2005	2006
Service cost	$ 719	$ 641	$ 2,216	$ 1,922	$130
Interest cost	635	651	1,902	1,953	119
Expected return on plan assets	(827)	(877)	(2,482)	(2,631)	0
Net amortization and deferral	270	318	900	953	27

Amortization of prior service cost	13	29	(71)	89	27
Amortization of transition obligation	$ 0	0	0	0	10
Net periodic benefit cost	$ 810	$ 762	$ 2,465	$ 2,286	$313

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

NOTE I: COMMITMENTS, CONTINGENT LIABILITIES AND RESTRICTIONS

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

The contract amount of commitment and contingencies are as follows:

(000's omitted)	September 30, 2006	December 31, 2005
Commitments to extend credit	$437,628	$434,640
Standby letters of credit	24,337	25,638
Total	$461,965	$460,278

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

Introduction

This Management's Discussion and Analysis of Financial Condition and Results of Operations ("MD&A") primarily reviews the financial condition and results of operations of Community Bank System, Inc. ("the Company" or "CBSI") as of and for the three and nine months ended September 30, 2006 and 2005, although in some circumstances the second quarter of 2006 is also discussed in order to more fully explain recent trends. The following discussion and analysis should be read in conjunction with the Company's Consolidated Financial Statements and related notes that appear on pages 3 through 13. All references in the discussion to the financial condition and results of operations are to those of the Company and its subsidiaries taken as a whole.

Unless otherwise noted, the term "this year" refers to results in calendar year 2006, "third quarter" refers to the quarter ended September 30, 2006, earnings per share ("EPS") figures refer to diluted EPS, and net interest income and net interest margin are presented on a fully tax-equivalent ("FTE") basis.

This MD&A contains certain forward-looking statements with respect to the financial condition, results of operations and business of the Company. These forward-looking statements involve certain risks and uncertainties. Factors that may cause actual results to differ materially from those proposed by such forward-looking statements are set herein under the caption, "Forward-Looking Statements," on page 28.

Critical Accounting Policies

As a result of the complex and dynamic nature of the Company's business, management must exercise judgment in selecting and applying the most appropriate accounting policies for its various areas of operations. The policy decision process not only ensures compliance with the latest generally accepted accounting principles, but also reflects on management's discretion with regard to choosing the most suitable methodology for reporting the Company's financial performance. It is management's opinion that the accounting estimates covering certain aspects of the business have more significance than others due to the relative importance of those areas to overall performance, or the level of subjectivity in the selection process. These estimates affect the reported amounts of assets and liabilities and disclosures of revenues and expenses during the reporting period. Actual results could differ from those estimates. Management believes that critical accounting estimates include:

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

- Actuarial assumptions associated with pension, post-retirement and other employee benefit plans - These assumptions include discount rate, rate of future compensation increases and expected return on plan assets.

- Provision for income taxes - The Company is subject to examinations from various taxing authorities. Such examinations may result in challenges to the tax return treatment applied by the Company to specific transactions. Management believes that the assumptions and judgements used to record tax related assets or liabilities have been appropriate. Should tax laws change or the taxing authorities determine that management's assumptions were inappropriate an adjustment may be required which could have a material effect on the Company's results of operations.

- Carrying value of goodwill and other intangible assets - The carrying value of goodwill and other intangible assets is based upon discounted cash flow modeling techniques that require management to make estimates regarding the amount and timing of expected future cash flows. It also requires use of a discount rate that reflects the current return requirements of the market in relation to present risk-free interest rates, required equity market premiums, and company-specific risk indicators.

A summary of the accounting policies used by management is disclosed in Note A, "Summary of Significant Accounting Policies" on pages 44-49 of the most recent Form 10-K (fiscal year ended December 31, 2005).

Executive Summary

The Company's business philosophy is to operate as a community bank with local decision-making, principally in non-metropolitan markets, providing a broad array of banking and financial services to retail, commercial and municipal customers.

The Company's core operating objectives are: (i) grow the branch network, primarily through a disciplined acquisition strategy, and certain selective de novo expansions, (ii) build high-quality, profitable loan and deposit portfolios using both organic and acquisition strategies, (iii) increase the non-interest income component of total revenues through development of banking-related fee income, growth in existing financial services business units, and the acquisition of additional financial services and banking businesses, and (iv) utilize technology to deliver customer-responsive products and services and to reduce operating costs.

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

On August 11, 2006, the Company completed its acquisition of ES&L Bancorp, Inc. ("Elmira"), a $210 million asset bank based in Elmira, New York, in an all-cash transaction valued at approximately $40 million.

Third quarter and September year-to-date ("YTD") earnings per share were $0.36 and $1.00, respectively, a decrease of $0.12 and $0.37 as compared to the respective prior year periods. The decrease was driven by a higher cost of funds, lower investment interest income, stock option expense as a result of the adoption of Statement of Financial Accounting Standards (SFAS) 123(R), Share-Based Payment, and the absence of gains on the sale of investment securities recorded in the third quarter and first nine months of 2005. These were partially offset by higher loan interest income and higher non-interest income (excluding gain on sales of investment securities). Cash earnings per share (which excludes the after-tax effect of the amortization of intangibles assets and acquisition-related market value adjustments) were $0.40 versus $0.53 for the prior year's third quarter and $0.37 for the second quarter of 2006.

Asset quality continued to improve in the third quarter of 2006 in comparison to the first two quarters of 2006 and the same period last year, with reductions in the net charge-off, non-performing loan and total delinquent loan ratios. The Company experienced year-over-year loan growth in all portfolios: consumer installment, consumer mortgage and business lending, due to both the Elmira acquisition and organic loan growth. The size of the investment portfolio was below that of third quarter of the prior year as the Company repositioned its balance sheet in 2005 by selling certain securities in its investment portfolio and using the proceeds to pay off variable and short-term borrowings. Average deposits increased in the third quarter of 2006 as compared to the second quarter of 2006 and the third quarter of 2005, again due to both organic growth and the Elmira acquisition. External borrowings, principally overnight borrowings and other short-term instruments, increased during the same time periods, due to the funding requirements of Elmira.

On August 3, 2006, the Company announced an agreement to acquire ONB Corporation (ONB) in an all-cash transaction valued at approximately $15.7 million. ONB is the parent company of Ontario National Bank, a federally chartered national bank

operating four branches in the villages of Clifton Springs, Phelps and Palmyra, New York. As of September 30, 2006, ONB held approximately $95 million in assets, including $60 million in loans. The acquisition is expected to close in the fourth quarter of 2006.

Net Income and Profitability

As shown in Table 2, earnings per share for the third quarter and September YTD of $0.36 and $1.00, respectively, were $0.12 and $0.37 lower than the EPS generated in the same periods of last year. Net income for the quarter of $10.9 million was 27% lower than the third quarter of 2005 and net income of $30.2 million for the first nine months of 2006 decreased 29% from the amount earned in the first nine months of 2005. As compared to the second quarter of 2006, net income increased $1.0 million or 10.1% and earnings per share increased $0.03 or 9.1%.

Third quarter net interest income of $33.8 million was down $1.3 million or 3.6% from the comparable prior year period, while net interest income for the first nine months of 2006 decreased $7.8 million or 7.2% over the first nine months of 2005. The provision for loan losses decreased $1.0 million or 43% as compared to the third quarter of 2005 and decreased $1.1 million or 18% for the first nine months of 2006 compared to the equivalent period of 2005 as a result of strong asset quality. Third quarter non-interest income, excluding securities gains, was $13.7 million, up $0.6 million (4.6%) from third quarter 2005 and the YTD amount of $38.6 million rose $2.9 million or 8.0% from the prior year level. There were no security gains recorded in 2006, while the third quarter and YTD periods of 2005 included $5.3 million and $12.2 million of net gains, respectively. Operating expenses of $31.8 million for the quarter and $94.5 million for the first nine months of 2006 were up 3.6% and 1.6%, respectively, from the comparable prior year periods.

Excluding the impact of adopting SFAS 123(R), Share-Based Payment, total operating expenses for the third quarter increased 2.3% versus the prior year and were consistent for the YTD periods.

In addition to the earnings results presented above in accordance with generally accepted accounting principles ("GAAP"), the Company provides cash earnings per share, which excludes the after-tax effect of the amortization of intangible assets and acquisition-related market value adjustments. Management believes that this information helps investors better understand the effect of acquisition activity in reported results. Cash earnings per share for the third quarter and the first nine months of 2006 were $0.40 and $1.13, respectively, down 25% and 26% from the $0.53 and $1.52 earned in the comparable periods of 2005.

As reflected in Table 2, the primary reasons for lower earnings in both periods were lower net interest income, gains on sales of investment securities and slightly higher operating expenses, partially offset by increases in non-interest income excluding securities gain and a lower loan loss provision. The decrease in net interest income for both periods was due to a higher cost of funds and lower average investment balances, partially offset by both acquired and organic loan growth and higher loan yields. Excluding security gains, non-interest income increased due to a strong performance by the employee benefits consulting and plan administration business and higher banking service fees. The decrease in security gains was due to $5.3 million and $12.2 million of gains on the sale of securities recognized in the third quarter and first nine months of 2005, respectively, with no corresponding gains in the comparable period of 2006. Improved net charge-off and non-performing loan ratios were the

primary reasons for the decrease in loan loss provision, despite an increase in total loans outstanding. Excluding stock option costs, operating expenses increased for the quarter primarily due to higher business development and marketing expenditures as well as costs associated with the Elmira acquisition, partially offset by reductions in customer processing costs and occupancy costs.

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

Table 1: Reconciliation of GAAP Net Income to Cash Net Income

	Three Months Ended September 30,		Nine Month Septembe
(000's omitted)	2006	2005	2006
Net income	$10,879	$14,864	$30,225
After-tax cash adjustments:			
Amortization of premium on net assets acquired in merger	200	222	612
Amortization of intangible assets	1,149	1,119	3,399
Net income - cash	$12,228	$16,205	$34,236

Table 2: Summary Income Statements

	Three Months Ended September 30,		Nin
(000's omitted, except per share data)	2006	2005	2006
Net interest income	$33,792	$35,046	$101,08
Provision for loan losses	1,300	2,275	5,17
Non-interest income excluding security gains	13,744	13,136	38,60
Gains on sales of investment securities	0	5,305	
Operating expenses	31,840	30,727	94,48
Income before taxes	14,396	20,485	40,03
Income taxes	3,517	5,621	9,80
Net income	$10,879	$14,864	$ 30,22
Diluted earnings per share	$ 0.36	$ 0.4	$ 1.0
Diluted earnings per share - cash (1)	$ 0.40	$ 0.5	$ 1.1

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

Net Interest Income

Net interest income is the amount by which interest and fees on earning assets (loans, investments and cash) exceed the cost of funds, primarily interest paid to the Company's depositors and interest on external borrowings. Net interest margin is the difference between the gross yield on earning assets and the cost of interest-bearing funds as a percentage of earning assets.

As shown in Table 3, net interest income (with non-taxable income converted to a fully tax-equivalent basis) for third quarter 2006 was $37.6 million, down $1.0 million or 2.7% from the same period last year. A $103.4 million increase in interest-bearing liabilities and a 19 basis point decrease in the net interest margin more than offset a $72.3 million increase in average interest-earning assets. As reflected in Table 4, the volume and rate increases to interest bearing liabilities had a $6.2 million negative impact on net interest income, while the volume and rate increases to interest bearing assets had a smaller $5.2 million favorable impact to net interest income. September 2006 YTD net interest income of $112.1 million was down $7.7 million or 6.4% from the year-earlier period. A $55.7 million decrease in earning assets and a 21 basis point decrease in the net interest margin more than offset a $66.3 million decrease in interest bearing liabilities. Interest bearing asset and liability volume changes resulted in $1.7 million less net interest income, while a lower net interest margin had a negative $5.9 million impact on net interest income.

Higher third quarter and September YTD average loan balances were attributable to $55.7 million of quarterly average organic loan growth since the third quarter of 2005, driven by growth in all portfolios: consumer installment, consumer mortgage and business lending, as well as a $105.0 million increase in third quarter 2006 average loans from the Elmira acquisition. Average investments for the third quarter and YTD periods were $110 million and $170 million less than the respective periods of 2005. The decrease was principally a result of the Company's decision to sell certain securities and not fully reinvest cash flows from maturing securities in a flat yield-curve environment, in order to take advantage of market conditions to shorten the average life of the portfolio, improve its interest-rate sensitivity profile in a rising-rate environment, and maximize the expected total return. In comparison to the prior year, total average deposits were up $110.2 million or 3.7% for the quarter and $65.8 million or 2.2% for the YTD period as a result of growth in both IPC and public fund balances. Average deposits acquired in the Elmira acquisition for the third quarter and YTD periods were $68.1 million and $22.9 million, respectively. Cash flows from the investment sales and maturities were used to pay down external borrowings over the last twelve months, resulting in average quarterly and YTD borrowings being $50.5 million and $152.2 million lower in the third quarter of 2006 and the first nine months of 2006, in comparison to the comparable 2005 periods.

The net interest margin of 3.87% for the third quarter and 3.98% for the year to date period dropped 19 basis points and 21 basis points, respectively, versus the same periods in the prior year. These declines were primarily attributable to an increase in the cost of funds (quarter up 63 basis points, YTD up 55 basis points), due principally to the effect of the eight rate hikes (25 basis points each) by the Federal Reserve since September 2005, while earning assets yields increased at a slower rate (quarter up 42 basis points, YTD up 31 basis points). The change in the earning-asset yield was driven by an increase in loan yields of 60 basis points for the quarter and 45 basis points for the YTD period, while investment yields increased 5 basis points for the quarter and three basis points for the YTD period. Results included the impact of the Elmira acquisition, which had lower net interest margin attributes than the Company's historical averages.

The third quarter cost of funds increased 63 basis points due to a 62 basis point increase in deposit costs and a 96 basis point increase in the average

interest rate paid on external borrowings. The increase in the YTD cost of funds was driven by a 56 basis point increase in deposit costs and borrowing rates that were up 108 basis points. Interest rates on selected categories of deposit accounts were raised throughout 2005 and the first nine months of 2006 in response to the Federal Reserve rate increases. Additionally, customers continued to transfer funds from low rate and non-interest earning accounts to higher yielding checking and time deposit accounts. The increase in the borrowing rates is mostly attributable to the rate increases by the Federal Reserve. Additionally, the long-term rate was impacted by the more than 100 basis point increase in three and six month LIBOR (London Interbank Offered Rates) over the last twelve months, from which the interest rate on the majority of the mandatorily redeemable preferred securities is based.

Table 3 below sets forth information related to average interest-earning assets and interest-bearing liabilities and their associated yields and rates for the periods indicated. Interest income and yields are on a fully tax-equivalent basis using marginal income tax rates of 38.4% in 2006 and 38.6% in 2005. Average balances are computed by summing the daily ending balances in a period and dividing by the number of days in that period. Loan yields and amounts earned include loan fees. Average loan balances include non-accrual loans and loans held for sale.

Table 3: Quarterly Average Balance Sheet

(000's omitted except yields and rates)	Three Months Ended September 30, 2006		
	Average Balance	Interest	Avg. Yield/Rate Paid
Interest-earning assets:			
Time deposits in other banks	$ 34,264	$ 431	4.99%
Taxable investment securities (1)	741,764	10,031	5.37%
Non-taxable investment securities (1)	512,721	8,823	6.83%
Loans (net of unearned discount)	2,558,137	43,640	6.77%
Total interest-earning assets	3,846,886	62,925	6.49%
Non-interest earning assets	425,828		
Total assets	$4,272,714		
Interest-bearing liabilities:			
Interest checking, savings and money market deposits	$1,161,076	3,186	1.09%
Time deposits	1,379,074	13,171	3.79%
Short-term borrowings	125,013	1,327	4.21%
Long-term borrowings	534,811	7,685	5.70%
Total interest-bearing liabilities	3,199,974	25,369	3.15%
Non-interest bearing liabilities:			
Demand deposits	558,060		
Other liabilities	57,684		

Shareholders' equity	456,996		
Total liabilities and shareholders' equity	$4,272,714		
Net interest earnings		$37,556	
Net interest spread			3.34%
Net interest margin on interest-earnings assets			3.87%
Fully tax-equivalent adjustment		$ 3,764	

(1) Averages for investment securities are based on historical cost basis and the yields do not give effect to changes in fair value that is reflected as a component of shareholders' equity and deferred taxes.

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

(000's omitted except yields and rates)	Nine Months Ended September 30, 2006		
	Average Balance	Interest	Avg. Yield/Rate Paid
Interest-earning assets:			
Time deposits in other banks	$ 24,917	$ 910	4.88%
Taxable investment securities (1)	764,116	31,715	5.55%
Non-taxable investment securities (1)	517,680	26,689	6.89%
Loans (net of unearned discount)	2,462,185	121,962	6.62%
Total interest-earning assets	3,768,898	181,276	6.43%
Non-interest earning assets	426,721		
Total assets	$4,195,619		
Interest-bearing liabilities:			
Interest checking, savings and money market deposits	$1,139,608	8,475	0.99%
Time deposits	1,331,294	35,523	3.57%
Short-term borrowings	138,578	3,935	3.80%
Long-term borrowings	504,507	21,282	5.64%
Total interest-bearing liabilities	3,113,987	69,215	2.97%
Non-interest bearing liabilities:			
Demand deposits	571,088		
Other liabilities	54,692		
Shareholders' equity	455,852		
Total liabilities and shareholders' equity	$4,195,619		

Net interest earnings	$112,061	
Net interest spread		3.46%
Net interest margin on interest-earnings assets		3.98%
Fully tax-equivalent adjustment	$ 10,975	

(1) Averages for investment securities are based on historical cost basis and the yields do not give effect to changes in fair value that is reflected as a component of shareholders' equity and deferred taxes.

As discussed above and disclosed in Table 4 below, the quarterly change in net interest income (fully tax-equivalent basis) may be analyzed by segregating the volume and rate components of the changes in interest income and interest expense for each underlying category.

Table 4: Rate/Volume

	3rd Quarter 2006 versus 3rd Quarter 2005			Nine
	Increase (Decrease) Due to Change in (1)			Increa
(000's omitted)	Volume	Rate	Net Change	Volume
Interest earned on:				
Time deposits in other banks	$ 242	$ 83	$ 325	$ 532
Taxable investment securities	(1,344)	(206)	(1,550)	(6,407
Non-taxable investment securities	(177)	248	71	(806
Loans (net of unearned discount)	2,597	3,777	6,374	4,638
Total interest-earning assets (2)	1,122	4,098	5,220	(2,580
Interest paid on:				
Interest checking, savings and money market deposits	(14)	848	834	(221
Time deposits	1,269	3,114	4,383	2,690
Short-term borrowings	(1,993)	797	(1,196)	(7,320
Long-term borrowings	2,342	(120)	2,222	5,093
Total interest-bearing liabilities (2)	657	5,586	6,243	(1,177
Net interest earnings (2)	$ 729	$(1,752)	$(1,023)	$(1,724

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

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

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Non-interest Income

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

Table 5: Non-interest Income

	Three Months Ended September 30,	
(000's omitted)	2006	2005
Deposit service charges and fees	$ 7,329	$ 7,135
Benefit plan administration, consulting and actuarial fees	3,271	2,767
Trust, investment and asset management fees	1,815	1,823
Other banking services	1,113	1,122
Mortgage banking	216	289
Subtotal	13,744	13,136
Gain on sales of investment securities	0	5,305
Total non-interest income	$13,744	$18,441
Non-interest income/total income (FTE)	26.8%	32.3%

As displayed in Table 5, non-interest income (excluding securities gains) was $13.7 million in the third quarter and $38.6 million for the first nine months of 2006. This corresponded to increases of $0.6 million (4.6%) for the quarter and $2.9 million (8.0%) for the YTD period in comparison to one year earlier. A significant portion of the growth in both time intervals was attributable to the $0.2 million and $1.2 million increases in recurring bank fees for the quarter and year-to-date periods, respectively, driven by several revenue enhancement initiatives put into place during 2005 and core deposit account growth. Offsetting these increases, was the absence of gains on the sales of investment securities which equaled $5.3 million and $12.2 million for the third quarter and first nine months of 2005, respectively, as the Company took advantage of market conditions to sell certain securities in the first nine months of 2005 in order to shorten the average length of the portfolio and maximize their expected total return. Consistent with prior years, other banking revenues for the third quarter include the annual dividends from creditor insurance programs in which the Company participates approximating $0.9 million.

Strong performance at BPA-Harbridge generated revenue growth of $0.5 million (18%) for the quarter and $1.6 million (19%) for the first nine months of 2006, achieved primarily through enhanced service offerings to both new and existing clients. In comparison to the third quarter of the prior year, trust, investment and asset management fees were down due to softer demand for their traditional investment products. Year-to-date, trust, investment and asset management fees

have increased as compared to the first nine months of 2005, as a result of development of new client relationships and improved market conditions. During the third quarter, our wealth management and advisory firm completed its re-branding efforts to become Nottingham Advisors, to underscore the increased product and service offerings it has recently developed.

The ratio of non-interest income to total income (FTE basis) was 26.8% for the quarter and 25.6% for the year-to-date period versus 32.3% and 28.6% for the comparable periods in 2005. Excluding net security gains, the ratio of non-interest income to total income (FTE basis) was 26.8% and 25.6% for the third quarter and YTD periods of 2006, respectively, as compared to 25.4% and 23.0% for the same periods of 2005. This improvement is a function of rising non-interest banking and financial services income (excluding net security gains), combined with lower net interest income, attributable to reduced investment portfolio levels and a decline in the net interest margin.

Operating Expenses

Table 6 below sets forth the quarterly results of the major operating expense categories for the current and prior year, as well as efficiency ratios (defined below), a standard measure of overhead utilization used in the banking industry.

Table 6: Operating Expenses

	Three Months Ended September 30,	
(000's omitted)	2006	2005
Salaries and employee benefits	$16,332	$16,458
Stock option expense	409	0
Occupancy and equipment	4,350	4,483
Data processing and communications	3,359	3,467
Amortization of intangible assets	1,520	1,553
Legal and professional fees	1,119	923
Office supplies and postage	1,004	1,024
Business development and marketing	1,095	545
Other	2,652	2,274
Total operating expenses	$31,840	$30,727
Operating expenses/average assets	2.96%	2.88%
Efficiency ratio	58.8%	56.4%

As shown in Table 6, third quarter 2006 operating expenses were $31.8 million, up $1.1 million or 3.6% from the prior year level and year-to-date operating expenses of $94.5 million rose $1.5 million or 1.6% compared to 2005. Excluding the effect of adopting SFAS 123(R), Share-Based Payment, operating expenses increased $0.7 million or 2.3% for the third quarter and were essentially flat with the first nine months of 2006 as compared to the prior year periods. The increase was primarily attributable to an increased level of business development and marketing expenses ($0.6 million for the quarter and $0.8 million YTD) associated with a bank-wide deposit generation program, an increased level of acquisition related costs ($0.2 million for the quarter and

$0.1 million for the YTD) as well as a month and a half of incremental operating expense related to the Elmira acquisition ($0.2 million for both the quarter and YTD), partially offset by a reduction in the amortization of intangible assets (no impact for the quarter, $1.0 million YTD) and a reduction in data processing and communication expenses ($0.1 million for the quarter, $0.3 million YTD).

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

The Company's efficiency ratio (recurring operating expense excluding intangible amortization divided by the sum of net interest income (FTE) and recurring non-interest income) was 58.8% for the third quarter, 2.4 percentage points above the comparable quarter of 2005. This resulted from operating expenses (as described above) increasing 3.4% primarily due to stock option expense, while recurring operating income decreased 0.8% due to $1.0 million lower net interest income, partially offset by a $0.5 million increase in non-interest income excluding security gains. The efficiency ratio for the third quarter of 2006, excluding stock option expense was 58.0%, as compared to 56.4% in the comparable third quarter of 2005. The efficiency ratio of 59.6% for the first nine months of 2006 was up 3.4 percentage points from a year earlier due to core operating expenses increasing 2.8% while recurring operating income decreased 3.1% primarily as a result of the planned reduction of investment securities and a lower net interest margin. Operating expenses as a percentage of average assets increased eight basis points and 12 basis points for the quarter and year to date periods, respectively, primarily driven by the decrease in the investment portfolio during the comparable time periods.

Income Taxes

The third quarter effective income tax rate was 24.4%, compared to the 27.4% effective tax rate in the third quarter of 2005. The year-to-date effective tax rate was 24.5% as compared to 26.2% for the first nine months of 2005. The lower effective tax rate for 2006 was principally a result of a higher proportion of income being generated from tax-exempt securities and loans.

Investments

As reflected in Table 7 below, the carrying value of investments (including unrealized gains on available-for-sale securities) was $1.25 billion at the end of the third quarter, a decrease of $53 million and $68 million from December 31, 2005 and September 30, 2005, respectively. The book value (excluding unrealized gains) of investments decreased $45 million from year-end 2005 and declined $51 million versus September 30, 2005. Over the last twelve months, the investment portfolio has been allowed to run off in the current flat yield curve environment. Cash flows have been used to support loan growth and repay borrowings until more advantageous investment opportunities become available. The overall mix of securities within the portfolio over the last year has remained relatively consistent, with a small increase in the proportion of obligations of state and political subdivisions and mortgage-backed securities, and a corresponding decrease in the proportion of U.S. Treasury and Agency securities. The change in the carrying value of investments is impacted by the amount of net unrealized gains in the available for sale portfolio at a point in

time. At September 30, 2006, the portfolio had a $6.3 million net unrealized gain, a decrease of $7.4 million and $17.3 million from the unrealized gain at December 31, 2005 and September 30, 2005, respectively. This fluctuation is indicative of the interest rate movements during the respective time periods and the reduction in the size of the portfolio.

Table 7: Investments

	September 30, 2006		December 31,	
(000's omitted)	Amortized Cost/Book Value	Fair Value	Amortized Cost/Book Value	
Held-to-Maturity Portfolio:				
U.S. Treasury and Agency securities	$ 127,236	$ 122,998	$ 127,345	$
Obligations of state and political subdivisions	8,495	8,508	5,709	
Other securities	9,326	9,326	9,451	
Total held-to-maturity portfolio	145,057	140,832	142,505	
Available-for-Sale Portfolio:				
U.S. Treasury and Agency securities	385,424	382,178	420,062	
Obligations of state and political subdivisions	507,804	519,697	519,661	
Corporate securities	35,639	35,021	35,744	
Collateralized mortgage obligations	49,081	48,374	78,708	
Mortgage-backed securities	78,247	77,204	53,021	
Subtotal	1,056,195	1,062,474	1,107,196	1
Equity securities	42,720	42,720	39,706	
Total available-for-sale portfolio	1,098,915	1,105,194	1,146,902	1
Net unrealized gain on available-for-sale portfolio	6,279	--	13,710	
Total	$1,250,251	$1,246,026	$1,303,117	$1

Loans

As shown in Table 8, loans ended the third quarter at $2.66 billion, up $249.8 million (10.4%) year-to-date and up $249.7 (10.4%) versus one year earlier. The Elmira acquisition added approximately $191 million of loans to the loan portfolio as of September 30, 2006. Excluding the impact of the Elmira acquisition, loans increased $59 million or 2.5% from the end of the prior year-end and third quarter 2005. As compared to the prior quarter and one year earlier, growth was produced in all three categories. During the third quarter, excluding the impact of the Elmira acquisition, loans increased $26.7 million with increases in the consumer installment portfolio ($14.1 million), consumer mortgage portfolio ($10.2 million) and the business lending portfolio ($2.4 million).

Table 8: Loans

(000's omitted)	September 30, 2006		December 31, 2005	
Business lending	$ 953,808	35.8%	$ 819,605	34.0%
Consumer mortgage	890,939	33.5%	815,463	33.8%
Consumer installment	816,815	30.7%	776,701	32.2%
Total loans	$2,661,562	100.0%	$2,411,769	100.0%

Business lending increased $134.2 million in the first nine months of 2006 and increased $137.7 million versus one year ago. Excluding the impact of the Elmira acquisition, business lending was up $9.8 million over the last three quarters and $13.3 million over the last year. Growth in commercial mortgage and business line of credit activity during the first nine months has more than offset a planned and managed decline in automotive dealer floor plan outstandings. The Company continues to face competitive conditions in most of its markets and it maintains its commitment to generating growth in its business portfolio in a manner that adheres to its twin goals of maintaining strong asset quality and producing profitable margins.

Consumer mortgages increased $77.7 million year over year and $75.5 million in the first nine months of 2006, despite the Company continuing to sell certain 30-year, fixed-rate new mortgage originations in the secondary market for the third consecutive quarter. Excluding the impact of the Elmira acquisition, consumer mortgage lending increased $17.0 million and $19.2 million for the past nine and twelve month periods, respectively. Consumer mortgage growth has remained steady over the last few quarters despite interest rates rising above prior year levels.

Consumer installment loans, including borrowings originated in automobile, marine and recreational vehicle dealerships, as well as branch originated home equity and installment loans, rose $40.1 million (5.2%) in the first nine months of 2006 and increased $34.4 million (4.4%) on a year-over-year basis. Excluding the impact of the Elmira acquisition, consumer installment lending increased $32.4 million and $26.7 million for the first nine months and year-over-year periods, respectively. Continued moderate interest rates (by historical standards), aggressive dealer and manufacturer incentives on new vehicles, and enhanced business development efforts have helped drive profitable growth in this segment in all our markets.

Asset Quality

Table 9 below exhibits the major components of non-performing loans and assets and key asset quality metrics for the periods ending September 30, 2006 and 2005 and December 31, 2005.

Table 9: Non-performing Assets

(000's omitted)	September 30, 2006	De

Non-accrual loans	$10,114
Accruing loans 90+ days delinquent	1,133
Restructured loans	1,300
Total non-performing loans	12,547
Other real estate (OREO)	1,320
Total non-performing assets	$13,867
Allowance for loan losses to total loans	1.33%
Allowance for loan losses to non-performing loans	283%
Non-performing loans to total loans	0.47%
Non-performing assets to total loans and other real estate	0.52%
Delinquent loans (30 days old to non-accruing) to total loans	1.22%
Net charge-offs to average loans outstanding (quarterly)	0.17%
Loan loss provision to net charge-offs (quarterly)	117%

As displayed in Table 9, non-performing assets at September 30, 2006 were $13.9 million, a decrease of $0.5 million versus year-end 2005 and a $0.6 million decrease as compared to the level at the end of the third quarter of 2005. Non-performing loans are at the lowest level in over three years, reflective of disciplined credit management and a steady improvement in economic conditions over the past few years. Other real estate increased $0.4 million from one-year ago and increased $0.3 million from year-end 2005, a result of the Company managing 24 properties at September 30, 2006 as compared to 15 OREO properties at the end of 2005. No single property has a carrying value in excess of $350,000.

Non-performing loans were 0.47% of total loans outstanding at the end of the third quarter, significantly below the 0.56% at September 30, 2005, 0.55% at year-end 2005 and 0.58% average for the previous eight quarters. The allowance for loan losses to non-performing loans ratio, a general measure of coverage adequacy, was 283% at the end of the third quarter compared to 245% at year-end 2005 and 239% at September 30, 2005, reflective of the low level of non-performing loans.

Delinquent loans (30 days through non-accruing) as a percent of total loans was 1.22% at the end of the third quarter, substantially below the 1.46% at year-end 2005 and at September 30, 2005. Commercial and installment loan delinquency ratios at the end of the third quarter improved in comparison to both of the earlier periods. Real estate loan delinquency ratios increased slightly from the third quarter of 2005, but were improved from December 31, 2005. The delinquency level at the end of the current quarter was 15 basis points below the Company's average of 1.37% over the previous eight quarters.

Table 10: Allowance for Loan Losses Activity

	Three Months Ended September 30,		Nin
(000's omitted)	2006	2005	2006

Allowance for loan losses at beginning of period	$32,900	$32,011	$32,58
Charge-offs:			
Business lending	582	577	3,13
Consumer mortgage	54	87	15
Consumer installment	1,548	2,130	4,41
Total charge-offs	2,184	2,794	7,70
Recoveries:			
Business lending	425	231	66
Consumer mortgage	23	3	10
Consumer installment	621	734	2,26
Total recoveries	1,069	968	3,03
Net charge-offs	1,115	1,826	4,67
Provision for loans losses	1,300	2,275	5,17
Allowance for acquired loans(1)	2,432	0	2,43
Allowance for loan losses at end of period	$35,517	$32,460	$35,51
Net charge-offs to average loans outstanding:			
Business lending	0.07%	0.17%	0.3
Consumer mortgage	0.01%	0.04%	0.0
Consumer installment	0.46%	0.72%	0.3
Total loans	0.17%	0.30%	0.2

(1) This reserve is attributable to loans purchased from ES&L Bancorp in August 2006.

As displayed in Table 10, net charge-offs during the third quarter were $1.1 million, $0.7 million lower than the equivalent 2005 period. All portfolios, consumer mortgage, installment portfolios and business lending, experienced decreased levels of charge-offs. The net charge-off ratio (net charge-offs as a percentage of average loans outstanding) for the third quarter was 0.17%, thirteen basis points lower than the comparable quarter of 2005, and 16 basis points lower than average charge-off ratio for the previous eight quarters. On a year to date basis, net charge-offs decreased $0.9 million versus the prior year period, while average loans were up $97.9 million, resulting in a seven basis point decline in the net charge-off ratio to 0.25%. Net charge-offs and the corresponding net charge-off ratios are at their lowest level in years.

The business lending net charge-off ratio for the quarter improved 45 basis points to 0.07%, the consumer mortgage portfolio experienced a one basis point improvement in it's net charge-off ratio and the consumer installment net charge-off ratio increased by 24 basis points to 0.46%. For the year-to-date period, the business lending net charge-off ratio increased 14 basis points, while the consumer mortgage and consumer installment charge-off ratios improved five basis points and 31 basis points, respectively. The increase in business lending charge-offs was adversely impacted by three commercial relationships in the auto industry.

A loan loss allowance of $35.5 million was determined as of September 30, 2006, necessitating a $1.3 million loan loss provision for the quarter, compared to $2.3 million one year earlier. The third quarter 2006 loan loss provision was $0.2 million higher than net charge-offs. The allowance for loan losses rose $3.1 million or 9.4% over the last 12 months, slightly less than the 10.4% growth in the loan portfolio. Contributing to the changes was the acquired

Elmira loans and reserves, with a coverage ratio of 1.27%. Consequently, the ratio of allowance for loan loss to loans outstanding decreased two basis points to 1.33% for the third quarter, as compared to the levels at December 31, 2005 and September 30, 2005. The decrease is attributable to the favorable charge-off, non-performing and delinquencies trends experienced over the same time period.

Deposits

As shown in Table 11, average deposits of $3.1 billion in the third quarter were up $119.1 million compared to fourth quarter 2005 and increased $110.2 million versus the same quarter of last year. Excluding the impact of the Elmira acquisition, average deposits increased $51.0 million and $42.1 million as compared to the fourth and third quarters of the prior year, respectively. The mix of average deposits changed slightly in the first nine months of 2006. The weightings of time deposits and interest checking deposits increased from their fourth quarter levels, while demand, savings and money market deposit weightings decreased. As interest rates continue to rise, time deposits have continued to attract more funds, as evidenced by their 7.6% and 9.4% increases, excluding the impact of the Elmira acquisition, as compared to the fourth and third quarters of 2005, respectively. Interest checking account

balances are above the prior year levels primarily as a result of new product initiatives that commenced in the second quarter of 2006. This shift in mix, combined with increasing interest rates on money market and time deposit accounts increased the quarterly cost of interest-bearing deposits from 2.19% in the first quarter of 2006 to 2.55% in the most recent quarter, noticeably above the 1.83% for the quarter ended September 30, 2005.

Average third quarter IPC (individuals and businesses) deposits increased $88.6 million or 3.2% versus the fourth quarter of 2005, and were up $73.3 million or 2.6% compared to the year earlier period. Excluding the impact of the Elmira acquisition, average third quarter IPC deposits increased $20.5 million and $5.3 million from the fourth and third quarters of the prior years, respectively. Average public funds have increased $30.5 million or 15.8% and $36.8 million or 19.7% over the same periods. The increase in core deposits is the result of ongoing enhanced marketing efforts and new product offerings introduced throughout 2006.

Table 11: Quarterly Average Deposits

(000's omitted)	September 30, 2006	December 31, 2005	September 30, 2005
Demand deposits	$ 558,060	$ 596,508	$ 601,702
Interest checking deposits	364,762	307,738	308,297
Savings deposits	464,037	484,908	506,408
Money market deposits	332,277	351,029	353,342
Time deposits	1,379,074	1,238,945	1,218,291
Total deposits	$3,098,210	$2,979,128	$2,988,040
IPC deposits	$2,874,584	$2,785,967	$2,801,255
Public fund deposits	223,626	193,161	186,785
Total deposits	$3,098,210	$2,979,128	$2,988,040

Borrowings

At the end of the third quarter, borrowings of $709 million were up $55.9 million from December 31, 2005 and up $2.3 million versus the end of the third quarter of 2005. Excluding the borrowings related to the Elmira acquisition, external borrowings have declined approximately $33 million and $87 million from the fourth quarter and third quarter of 2005. The reduction in borrowings was principally the result of the decision to use a portion of the cash flows from the maturities of investments to reduce debt levels in the current flat or inverted yield curve environment.

The Company is currently in the process of reviewing market alternatives for the replacement of its $30 million, fixed-rate trust preferred obligations, which include a premium call provision currently at 4.54%, starting in February 2007. The Company estimates the impact of the one-time charge associated with this refinancing to be between $0.04 and $0.05 per share, and expects to conclude its evaluation in the fourth quarter.

Shareholders' Equity

On April 20, 2005, the Company announced that its Board of Directors had authorized a stock repurchase program to acquire up to 1.5 million of its shares, or approximately 5% of its outstanding common stock. The shares may be repurchased from time to time, in open market or privately negotiated transactions through December 31, 2006. All reacquired shares will become treasury shares and will be used for general corporate purposes. Through September 30, 2006, the Company had repurchased 853,161 shares at an aggregate cost of $19.5 million.

Total shareholders' equity of $465 million at the end of the third quarter increased $7.0 million from the balance at December 31, 2005. This change consisted of net income of $30.2 million, $2.8 million from shares issued under the employee stock plan and $1.5 million from employee stock options earned, partially offset by a decrease in the after-tax market value adjustment on the available-for-sale investment portfolio of $4.6 million, dividends declared of $17.3 million and treasury stock purchases of $5.5 million. Over the past 12 months total shareholders' equity increased by $4.1 million, as net income and positive contributions from shares issued under the employee stock plan more than offset dividends declared, treasury stock purchases, and a lower market value adjustment.

The Company's Tier I leverage ratio, a primary measure of regulatory capital for which 5% is the requirement to be "well-capitalized," was 7.26% at the end of the third quarter, down 31 basis points from year-end 2005 and eight basis points lower than its level one year ago. The decrease in the Tier I leverage ratio compared to December 31, 2005 is primarily the result of a 1.1% decrease in shareholders equity excluding intangibles and market value adjustment, with a 3.1% increase in average assets excluding intangibles and market value adjustment, primarily as a result of the Elmira acquisition. The decrease in Tier I as compared to the prior year third quarter is the result of a 0.5% increase in shareholders equity excluding intangibles and market value adjustment combined with a 1.7 % increase in average assets excluding intangibles and market value adjustment. The tangible equity-to-assets ratio of 5.44% decreased 48 basis points versus December 31, 2005 and 42 basis points versus September 30, 2005 due to the acquisition of Elmira, treasury share purchases and a decline in the market value adjustment.

The dividend payout ratio (dividends declared divided by net income) for the first nine months of 2006 was 57.3%, up from 39.1% for the first nine months of 2005. Excluding securities gains, the dividend payout ratio for 2005 was 49.6%. The ratio increased because dividends declared increased 4.4%, while net income including securities gains decreased 28.8% and net income excluding securities gains decreased 9.7%. The expansion of dividends declared was caused by the dividend per share being raised 5.3% in August 2006, from $0.19 to $0.20 and 5.6% in August 2005 from $0.18 to $0.19, partially offset by a reduction in the number of shares outstanding.

Liquidity

Management of the Company's liquidity is critical due to the potential for unexpected fluctuations in deposits and loans. Adequate sources of both on and off-balance sheet funding are in place to effectively respond to such unexpected fluctuations.

The Company's primary approach to measuring liquidity is known as the Basic Surplus/Deficit model. It is used to calculate liquidity over two time periods: first, the amount of cash that could be made available within 30 days (calculated as liquid assets less short-term liabilities); and second, a projection of subsequent cash availability over an additional 60 days. The minimum policy level of liquidity under the Basic Surplus/Deficit approach is 7.5% of total assets for both the 30 and 90-day time horizons. As of September 30, 2006, this ratio was 13.8% for 30 days and 13.7% for 90 days, excluding the Company's capacity to borrow additional funds from the Federal Home Loan Bank.

To measure longer-term liquidity, a baseline projection of loan and deposit growth for five years is made to reflect how current liquidity levels could change over time. This five-year measure reflects adequate liquidity to fund loan and other asset growth over the next five years.

Forward-Looking Statements

This document contains comments or information that constitute forward-looking statements (within the meaning of the Private Securities Litigation Reform Act of 1995), which involve significant risks and uncertainties. Actual results may differ materially from the results discussed in the forward-looking statements. Moreover, the Company's plans, objectives and intentions are subject to change based on various factors (some of which are beyond the Company's control). Factors that could cause actual results to differ from those discussed in the forward-looking statements include: (1) risks related to credit quality, interest rate sensitivity and liquidity; (2) the strength of the U.S. economy in general and the strength of the local economies where the Company conducts its business; (3) the effect of, and changes in, monetary and fiscal policies and laws, including interest rate policies of the Board of Governors of the Federal Reserve System; (4) inflation, interest rate, market and monetary fluctuations; (5) the timely development of new products and services and customer perception of the overall value thereof (including features, pricing and quality) compared to competing products and services; (6) changes in consumer spending, borrowing and savings habits; (7) technological changes; (8) any acquisitions or mergers that might be considered or consummated by the Company and the costs and factors associated therewith; (9) the ability to maintain and increase market share and control expenses; (10) the effect of changes in laws and regulations (including laws and regulations concerning taxes, banking, securities and insurance) and accounting principles generally accepted in the United States; (11) changes in the Company's organization, compensation and benefit plans and in the availability of, and compensation levels for, employees in its geographic markets; (12) the costs and effects of litigation and of any adverse outcome in such litigation; (13) other risk factors outlined in the Company's filings with the Securities and Exchange Commission from time to time; and (14) the success of the Company at managing the risks of the foregoing.

The foregoing list of important factors is not all-inclusive. Such forward-looking statements speak only as of the date on which they are made and the Company does not undertake any obligation to update any forward-looking statement, whether written or oral, to reflect events or circumstances after the date on which such statement is made. If the Company does update or correct one or more forward-looking statements, investors and others should not conclude that the Company would make additional updates or corrections with respect thereto or with respect to other forward-looking statements.

Item 3. Quantitative and Qualitative Disclosure about Market Risk

Market risk is the risk of loss in a financial instrument arising from adverse changes in market rates, prices or credit risk. Credit risk associated with the Company's loan portfolio has been previously discussed in the asset quality section of Management's Discussion and Analysis of Financial Condition and Results of Operations. Management believes that the tax risk of the Company's municipal investments associated with potential future changes in statutory, judicial and regulatory actions is minimal. The Company has an insignificant amount of credit risk in its investment portfolio because essentially all of the fixed-income securities in the portfolio are AAA-rated (highest possible rating). Therefore, almost all the market risk in the investment portfolio is related to interest rates.

The ongoing monitoring and management of both interest rate risk and liquidity, in the short and long term time horizons is an important component of the Company's asset/liability management process, which is governed by limits established in the policies reviewed and approved annually by the Board of Directors. The Board of Directors delegates responsibility for carrying out the policies to the Asset/Liability Committee (ALCO) which meets each month and is made up of the Company's senior management as well as regional and line-of-business managers who oversee specific earning asset classes and various funding sources. As the Company does not believe it is possible to reliably predict future interest rate movements, it has maintained an appropriate process and set of measurement tools, which enable it to identify and quantify sources of interest rate risk in varying rate environments. The primary tool used by the Company in managing interest rate risk is income simulation.

While a wide variety of strategic balance sheet and treasury yield curve scenarios are tested on an ongoing basis, the following reflects the Company's one-year net interest income sensitivity based on:

- Asset and liability levels using September 30, 2006 as a starting point.
- There are assumed to be conservative levels of balance sheet growth--low to mid single digit growth in loans and deposits, while using the cashflows from investment contractual maturities and prepayments to repay short-term capital market borrowings.
- The prime rate and federal funds rates are assumed to move up 200 basis points and down 100 basis points over a 12-month period while moving the long end of the treasury curve to spreads over federal funds that are more consistent with historical norms. Deposit rates are assumed to move in a manner that reflects the historical relationship between deposit rate movement and changes in the federal funds rate.
- Cash flows are based on contractual maturity, optionality and amortization schedules along with applicable prepayments derived from internal

historical data and external sources.

Net Interest Income Sensitivity Model

Change in interest rates	Calculated annualized increase (decrease) in projected net interest income at September 30, 2006
+ 200 basis points	(0.8%)
- 100 basis points	(0.3%)

The modeled net interest income remains neutral to changes in interest rates over a 12-month period. Over a longer time period, however, the growth in net interest income improves in a rising rate environment as a result of lower yielding earning assets running off and being replaced at increased rates.

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

Item 4. Controls and Procedures

The Company maintains disclosure controls and procedures, as defined in Rule 13a - 15(e) under the Securities Exchange Act of 1934, designed to ensure that it is able to collect the information it is required to disclose in the reports that are filed with the Securities and Exchange Commission, (SEC), and to process, summarize and disclose this information within the time periods specified in the rules of the SEC. Based on management's evaluation of the Company's disclosure controls and procedures, with the participation of the Chief Executive Officer and the Chief Financial Officer, it has concluded that, as of the end of the period covered by this Quarterly Report on Form 10-Q, these disclosure controls and procedures were effective as of September 30, 2006.

There have been no changes in the Company's internal controls over financial reporting in connection with the evaluation referenced in the paragraph above that occurred during the Company's last fiscal quarter that has materially affected, or is reasonably likely to materially affect, the Company's internal control over financial reporting.

Part II. Other Information

Item 1. Legal Proceedings.

The Company and its subsidiaries are subject in the normal course of business to various pending and threatened legal proceedings in which claims for monetary damages are asserted. Management, after consultation with legal counsel, does not anticipate that the aggregate liability, if any, arising out of litigation pending against the Company or its subsidiaries will have a material effect on

the Company's consolidated financial position or results of operations.

Item 1A. Risk Factors

There has not been any material change in the risk factors disclosure from that contained in the Company's 2005 Form 10-K for the fiscal year ended December 31, 2005.

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

On April 20, 2005, the Company announced a twenty-month authorization to repurchase up to 1,500,000 of its outstanding shares in open market or privately negotiated transactions. These repurchases will be for general corporate purposes, including those related to stock plan activities. The following table shows treasury stock purchases during the third quarter 2006.

	Number of Shares Purchased	Average Price Paid Per share	Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs
July 2006	--	$ --	852,761
August 2006	400	20.17	853,161
September 2006	--	--	853,161
Total	400	$ 20.17	853,161

Item 3. Defaults Upon Senior Securities.

Not applicable.

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

There were no matters submitted to a vote of the shareholders during the quarter ending September 30, 2006.

Item 5. Other Information.

Not applicable

Item 6. Exhibits

Exhibit No.	Description
2.2	Agreement and Plan of Merger, dated August 2, 2006, by and among Community Bank System, Inc., Seneca Acquisition Corp. and ONB Corporation.
31.1	Certification of Mark E. Tryniski, President and Chief Executive Officer of the Registrant, pursuant to Rule 13a-15(e) or Rule 15d-15(e) under the Securities Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.

31.2	Certification of Scott Kingsley, Treasurer and Chief Financial Officer of the Registrant, pursuant to Rule 13a-15(e) or Rule 15d-15(e) under the Securities Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32.1	Certification of Mark E. Tryniski, President and Chief Executive Officer of the Registrant, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
32.2	Certification of Scott Kingsley, Treasurer and Chief Financial Officer of the Registrant, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

SIGNATURES

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

Community Bank System, Inc.

Date: November 8, 2006

/s/ Mark E. Tryniski

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

Date: November 8, 2006

/s/ Scott Kingsley

Scott Kingsley, Treasurer and Chief Financial Officer