

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

COMMUNITY BANK SYSTEM INC  
Form 10-Q  
May 09, 2006

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

FORM 10-Q

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

For the quarterly period ended March 31, 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

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[GRAPHIC]

COMMUNITY BANK SYSTEM, INC.  
(Exact name of registrant as specified in its charter)  
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Delaware  
(State or other jurisdiction of  
incorporation or organization)

16-1213679  
(I.R.S. Employer  
Identification No.)

5790 Widewaters Parkway, DeWitt, New York  
(Address of principal executive offices)

13214-1883  
(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  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  Non-accelerated filer

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

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

29,881,458 shares of Common Stock, \$1.00 par value,  
were outstanding on May 5, 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)

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Cash and cash equivalents

Available-for-sale investment securities, at fair value

Held-to-maturity investment securities (fair value of \$138,918 and \$139,512, respectively)

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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

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;

32,559,456 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 (2,651,836 and 2,493,711 shares, respectively)

Employee stock plan - unearned

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Total shareholders' equity

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Total liabilities and shareholders' equity

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

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

	Three Months Ended March 31,	
	2006	2005
<hr style="border-top: 1px dashed black;"/>		
Interest income:		
Interest and fees on loans	\$38,328	\$35,502
Interest and dividends on taxable investments	10,470	13,570
Interest and dividends on nontaxable investments	5,795	6,151
	<hr style="border-top: 1px dashed black;"/>	
Total interest income	54,593	55,223
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Interest expense:		
Interest on deposits	13,021	9,179
Interest on short-term borrowings	1,458	2,926
Interest on subordinated debt held by unconsolidated subsidiary trusts	1,815	1,569
Interest on long-term borrowings	4,679	3,847
	<hr style="border-top: 1px dashed black;"/>	
Total interest expense	20,973	17,521
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Net interest income	33,620	37,702
Less: provision for loan losses	2,150	1,875
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Net interest income after provision for loan losses	31,470	35,827
<hr style="border-top: 1px dashed black;"/>		
Non-interest income:		
Deposit service fees	6,674	6,077
Other banking services	476	525
Benefit plan administration, consulting and actuarial fees	3,381	2,850
Trust, investment and asset management fees	2,050	1,781
Gain on sales of investment securities	--	1,726
	<hr style="border-top: 1px dashed black;"/>	
Total non-interest income	12,581	12,959
<hr style="border-top: 1px dashed black;"/>		
Operating expenses:		
Salaries and employee benefits	16,782	16,166
Occupancy and equipment	4,759	4,590
Data processing and communications	3,231	3,306
Amortization of intangible assets	1,493	1,984
Legal and professional fees	1,283	1,183
Office supplies and postage	976	938
Business development and marketing	730	689
Acquisition expenses	0	41

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Other	2,181	2,134
-----		
Total operating expenses	31,435	31,031
-----		
Income before income taxes	12,616	17,755
Income taxes	3,154	4,421
-----		
Net income	\$ 9,462	\$13,334
=====		
Basic earnings per share	\$ 0.32	\$ 0.44
Diluted earnings per share	\$ 0.31	\$ 0.43
Dividends declared per share	\$ 0.19	\$ 0.18

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

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COMMUNITY BANK SYSTEM, INC.  
CONSOLIDATED STATEMENT OF CHANGES IN SHAREHOLDERS' EQUITY (Unaudited)  
Three Months Ended March 31, 2006  
(In Thousands, Except Share Data)

	Common Stock		Additional Paid-In Capital	Retained Earnings	Accumulated Other Comprehensive Income
	Shares Outstanding	Amount Issued			
Balance at December 31, 2005	29,956,852	\$32,451	\$196,312	\$ 276,809	\$8,420
Net income				9,462	
Other comprehensive loss, net of tax					(4,925)
Dividends declared:					
Common, \$0.19 per share				(5,683)	
Common stock issued under employee stock plan, including tax benefits of \$892	108,893	109	2,249		
Treasury stock purchased	(158,125)				
-----					
Balance at March 31, 2006	29,907,620	\$32,560	\$198,561	\$ 280,588	\$3,495
=====					

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

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

	Three Months Ended March 31,	
	2006	2005
Other comprehensive loss, before tax:		
Change in minimum pension liability adjustment	(\$118)	\$0
Unrealized losses on securities:		
Unrealized holding losses arising during period	(7,923)	(18,719)
Reclassification adjustment for gains included in net income	0	(1,726)
Other comprehensive loss, before tax:	(8,041)	(20,445)
Income tax benefit related to other comprehensive loss	3,116	7,954
Other comprehensive loss, net of tax:	(4,925)	(12,491)
Net income	9,462	13,334
Comprehensive income	\$4,537	\$843

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

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

	Three Mo Marc
	2006
Operating activities:	
Net income	\$ 9,462
Adjustments to reconcile net income to net cash provided by operating activities:	
Depreciation	2,190
Amortization of intangible assets	1,493
Net amortization of premiums and discounts on securities and loans	215
Amortization of unearned compensation and discount on subordinated debt	36
Provision for loan losses	2,150
Gain on investment securities and debt extinguishments	0
Gain on loans and other assets	(23)
Proceeds from the sale of loans held for sale	4,314
Origination of loans held for sale	(4,291)
Excess tax benefits from share-based payment arrangements	(169)
Change in other operating assets and liabilities	(1,763)

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Net cash provided by operating activities	13,614
-----	
Investing Activities:	
Proceeds from sales of available-for-sale investment securities	14,342
Proceeds from maturities of held-to-maturity investment securities	709
Proceeds from maturities of available-for-sale investment securities	14,512
Purchases of held-to-maturity investment securities	(2,482)
Purchases of available-for-sale investment securities	(39,148)
Net decrease in loans outstanding	1,542
Capital expenditures	(1,867)
-----	
Net cash (used in) provided by investing activities	(12,392)
-----	
Financing Activities:	
Net change in demand deposits, NOW accounts and savings accounts	23,115
Net change in time deposits	56,443
Net change in federal funds purchased	(36,300)
Net change in short-term borrowings	(40,000)
Change in long-term borrowings (net of payments of \$47 and \$89)	9,953
Issuance of common stock	1,566
Purchase of treasury stock	(3,521)
Cash dividends paid	(5,457)
Tax benefits from share-based payment arrangements	169
-----	
Net cash provided by (used in) financing activities	5,968
-----	
Change in cash and cash equivalents	7,190
Cash and cash equivalents at beginning of period	114,605
-----	
Cash and cash equivalents at end of period	\$121,795
=====	
Supplemental disclosures of cash flow information:	
Cash paid for interest	\$ 21,144
Cash paid for income taxes	39
Supplemental disclosures of non-cash financing and investing activities:	
Dividends declared and unpaid	5,683
Gross change in unrealized gains on available-for-sale investment securities	(7,923)

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

COMMUNITY BANK SYSTEM, INC.  
NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)  
March 31, 2006

NOTE A: BASIS OF PRESENTATION

The interim financial data as of March 31, 2006 and for the three months ended March 31, 2006 and March 31, 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: OTHER MATTERS

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On April 21, 2006, the Company announced an agreement to acquire ES&L Bancorp, Inc. (ES&L) in an all-cash transaction valued at approximately \$39 million. ES&L is the parent company of Elmira Savings and Loan, F.A., a federally chartered thrift operating as a community bank. The company has two branches in the cities of Elmira and Ithaca, as well as mortgage and title insurance subsidiaries, all of which combine to total approximately \$210 million in assets and \$190 million in loans. The acquisition is expected to close in August 2006.

On April 20, 2005, the Company announced a twenty-month authorization to repurchase up to 1,500,000 of its outstanding shares. Through March 31, 2006, the Company has repurchased against this authorization 751,836 shares at an aggregate cost of \$17.5 million and an average price per share of \$23.25. The repurchased shares will be used for general corporate purposes, including those related to stock plan activities.

### NOTE C: SIGNIFICANT 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.

## 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		Restricted	
	Outstanding	Weighted Average Exercise Price of Shares	Outstanding	Wei Gra Val
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	380,540	23.73	0	
Exercised	(121,113)	14.13	(7,545)	
Forfeited	(9,747)	21.86	(4,106)	

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Outstanding at March 31, 2006	2,795,370	\$19.14	9,443
Exercisable at March 31, 2006	1,895,483	\$17.47	

The weighted average remaining contractual term of outstanding and exercisable stock options at March 31, 2006 is 7.2 years and 6.6 years, respectively. The aggregate intrinsic value of outstanding and exercisable stock options at March 31, 2006 is \$11.3 million and \$10.3 million, respectively.

The Company adopted Statement of Financial Accounting Standards ("SFAS") No. 123(R), Share-Based Payment, 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 No. 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, Accounting for Stock-Based Compensation. 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.

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As a result of applying the provisions of SFAS 123(R) during the three months ended March 31, 2006, the Company recognized stock-based compensation expense related to incentive and non-qualified stock options of \$626,000 and a related income tax benefit of \$135,000. Compensation expense related to restricted stock recognized in the income statement for the three months ended March 31, 2006 and March 31, 2005 was \$16,000 and \$57,000, respectively.

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

(000's omitted except per share amounts)	Three months ended March 31, 2005
Net income, as reported	\$13,334
Plus: stock-based compensation expense as reported, net of tax	35
Less: stock-based compensation expense determined under fair value method, net of tax	(505)
<b>Pro forma net income</b>	<b>\$12,864</b>
Earnings per share:	
As reported:	
Basic	\$ 0.44
Diluted	\$ 0.43
Pro forma:	
Basic	\$ 0.42
Diluted	\$ 0.41

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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. These assumptions include:

	Three months ended	
	March 31, 2006	March 31, 2005
Weighted-average expected life (in years)	7.78	7.76
Future dividend yield	3.00%	3.00%
Share price volatility	26.47%	26.78%
Weighted average risk-free interest rate	4.34%	4.17%

The weighted average grant date fair value of stock options granted during the three months ended March 31, 2006 and 2005 was \$6.12 and \$6.37, respectively. Unrecognized stock based compensation expense related to non-vested stock options totaled \$5.0million at March 31, 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 1.9 years. The total fair value of shares vested during the three months ended March 31, 2006 and 2005 was \$1.4 million and \$1.7 million, respectively.

During the three months ended March 31, 2006 and 2005, proceeds from stock option exercises totaled \$1.7 million and \$1.8 million and the related windfall tax benefits from exercise were approximately \$169,000 and \$503,000, respectively. During the three months ended March 31, 2006 and 2005, 121,113 shares and 184,378 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 three months ended March 31, 2006 and 2005 were \$1.0 million and \$2.5 million, respectively.

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### 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 1,388,800 anti-dilutive stock options outstanding for the three months ended March 31, 2006 compared to 838,424 anti-dilutive stock options outstanding for the three months ended March 31, 2005. The following is

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a reconciliation of basic to diluted earnings per share for the three months ended March 31, 2006 and 2005.

(000's omitted, except per share data)	Income	Shares	Per Share Amount
<hr/>			
Three Months Ended March 31, 2006			
Basic EPS	\$ 9,462	30,023	\$ 0.32
Stock options		456	
<hr/>			
Diluted EPS	\$ 9,462	30,479	\$ 0.31
<hr/>			
Three Months Ended March 31, 2005			
Basic EPS	\$13,334	30,580	\$ 0.44
Stock options		612	
<hr/>			
Diluted EPS	\$13,334	31,192	\$ 0.43
<hr/>			

### NOTE F: INTANGIBLE ASSETS

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

(000's omitted)	As of March 31, 2006			As of
	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount	Gross Carrying Amount
<hr/>				
Amortizing intangible assets:				
Core deposit intangibles	\$ 63,161	(\$36,416)	\$ 26,745	\$ 63,161
Other intangibles	2,750	(1,305)	1,445	2,750
<hr/>				
Total amortizing intangibles	65,911	(37,721)	28,190	65,911
Non-amortizing intangible assets:				
Goodwill	195,195	0	195,195	195,195
<hr/>				
Total intangible assets, net	\$261,106	(\$37,721)	\$223,385	\$261,106
<hr/>				

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
<hr/>	
Apr-Dec 2006	\$4,451
2007	5,569
2008	5,262
2009	4,777
2010	2,965
Thereafter	5,166
<hr/>	
Total	\$28,190
<hr/>	

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
II	7/16/2001	\$25 million	6 month LIBOR plus 3.75% (8.56%)	7/16/2031	5 year beginning
III	7/31/2001	\$24.5 million	3 month LIBOR plus 3.58% (8.25%)	7/31/2031	5 year beginning

NOTE H: BENEFIT PLANS

The Company provides defined benefit pension benefits and post-retirement health and life insurance benefits to eligible employees. The Company also provides supplemental pension retirement benefits for several current and former key employees. The Company accrues for the estimated cost of these benefits through charges to expense during the years that employees earn these benefits. The net periodic benefit cost for the three months ended March 31 is as follows:

(000's omitted)	Pension Benefits		Post-retirement Benefits	
	2006	2005	2006	2005
Service cost	\$ 748	\$ 652	\$ 134	\$ 110
Interest cost	660	645	121	104
Expected return on plan assets	(827)	(878)	0	0
Net amortization and deferral	315	305	29	19
Amortization of prior service cost	(43)	29	27	28
Amortization of transition obligation	0	0	10	10
Net periodic benefit cost	\$ 853	\$ 753	\$ 321	\$ 271

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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)	March 31, 2006	December 31, 2005
Commitments to extend credit	\$420,321	\$434,640
Standby letters of credit	24,458	25,638
Total	\$444,779	\$460,278

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

### Introduction

This Management's Discussion and Analysis of Financial Condition and Results of Operations ("MD&A") primarily reviews the financial condition and results of operations of Community Bank System, Inc. ("the Company" or "CBSI") as of and for the three months ended March 31, 2006 and 2005, although in some circumstances the fourth quarter of 2005 is also discussed in order to more fully explain recent trends. The following discussion and analysis should be read in conjunction with the Company's Consolidated Financial Statements and related notes that appear on pages 3 through 12. All references in the discussion to the financial condition and results of operations are to those of the Company and its subsidiaries taken as a whole.

Unless otherwise noted, the term "this year" refers to results in calendar year 2006, "first quarter" refers to the quarter ended March 31, 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 24.

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### 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:

- o 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.
- o 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.
- o 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.
- o 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.

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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.

Net income for the first quarter of 2006 was \$9.5 million, a decrease of \$3.9 million as compared to the first quarter of 2005, 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 Standard (FAS) 123R, Share-Based Payments, and the absence of gains on the sale of investment securities recorded in the first quarter of 2005. These were partially offset by higher loan interest income, higher non-interest income, (excluding gains on sales of investment securities), and lower recurring operating expenses, excluding stock option expense. Cash earnings per share (which excludes the after-tax effect of the amortization of intangibles assets and acquisition-related market value adjustments) were \$0.35 versus \$0.47 for the prior year's first quarter.

Asset quality remained stable in the first quarter of 2006 in comparison to the same period last year, with reductions in non-performing loan and delinquent loan ratios and a net charge-off ratio slightly below the average for the previous eight quarters. The Company experienced year-over-year loan growth in all portfolios; consumer installment, consumer mortgage and business lending. The size of the investment portfolio was below that of first quarter of the prior year as the Company repositioned its balance sheet in 2005 by selling certain securities in its investment portfolio and used the proceeds to pay off variable and short-term borrowings. Total deposits increased in the first quarter of 2006 as compared to December 31, 2005 and the first quarter of 2005. Borrowings, principally overnight borrowings and other short-term instruments, decreased during the same time periods.

The Company announced in April 2006 it had entered into an agreement to acquire ES&L Bancorp, Inc. (ES&L), a \$210 million asset bank based in Elmira, New York, in an all-cash transaction valued at approximately \$39 million.

### Net Income and Profitability

As shown in Table 2, earnings per share for the first quarter of \$0.31 were \$0.12 lower than the EPS generated in the same period of last year. Net income for the quarter of \$9.5 million was 29% lower than the first quarter of 2005. Net interest income for the first quarter of \$33.6 million was down \$4.1 million or 10.8% from the comparable prior year period. First quarter non-interest income, including securities gains, was \$12.6 million, down \$0.4 million (2.9%) from the first quarter 2005. Operating expenses of \$31.4 million for the quarter were up 1.3% from the comparable prior year period. Excluding the impact of adopting FASB 123R, Accounting for Stock Based Compensation, operating expenses for the first quarter decreased 0.7% from the prior year.

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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 the market value adjustments on net assets acquired in mergers. Management believes that this information helps investors better understand the effect of acquisition activity in reported results. Cash earnings per share for the first quarter of 2006 was \$0.35, down 26% from the \$0.47 earned in the first quarter of 2005.

As reflected in Table 2, the primary reasons for lower earnings for the quarter were lower net interest income and non-interest income including securities gains, and slightly higher loan loss provision and operating expenses. The decrease in net interest income for the quarter was due to a higher cost of funds and lower average investment balances, partially offset by organic loan growth. The decrease in non-interest income was due to \$1.7 million of gains on the sale of securities recognized in the first quarter of 2005, with no corresponding gain in the first quarter of 2006. 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 increase in total loans outstanding and additional allocations for specific loans were the primary reasons for the increase in loan loss provision. Excluding stock option costs, operating expenses decreased primarily due to reductions in the amortization of intangibles, legal and professional costs and foreclosed property costs, partially offset by increased occupancy and equipment costs and business development and marketing costs.

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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 March 31,	
(000's omitted)	2006	2005
Net income	\$ 9,462	\$13,334
After-tax cash adjustments:		
Amortization of premium on net assets acquired in merger	205	(27)
Amortization of intangible assets	1,120	1,490
Net income - cash	\$10,787	\$14,797

Table 2: Summary Income Statements

	Three Months Ended March 31,	
(000's omitted, except per share data)	2006	2005
Net interest income	\$33,620	\$37,702
Provision for loan losses	2,150	1,875
Non-interest income including security gains	12,581	12,959
Operating expenses	31,435	31,031

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Income before taxes	12,616	17,755
Income taxes	3,154	4,421
Net income	\$ 9,462	\$13,334
Diluted earnings per share	\$ 0.31	\$ 0.43
Diluted earnings per share - cash (1)	\$ 0.35	\$ 0.47

(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 first quarter 2006 was \$37.1 million, down \$4.4 million or 10.6% from the same period last year. A \$168 million decrease in interest earning assets and a 28-basis point decrease in the net interest margin more than offset a \$216 million decrease in average interest-bearing liabilities. As reflected in Table 4, the volume and net interest margin changes mentioned above adversely impacted net interest income by \$1.8 million and \$2.6 million, respectively, for the first quarter of 2006 as compared to the first quarter of 2005.

Higher first quarter average loan balances were attributable to \$58.5 million of organic loan growth since the first quarter of 2005, driven principally by growth of consumer installment and consumer mortgage loans. Average investments for the first quarter were \$227 million less than the first quarter of 2005 due principally to the sales made throughout 2005. Total average deposits were up \$31.6 million or 1.1% for the quarter as compared to the previous year as a result of growth in public fund balances. Cash flows from the investment sales were used to pay down external borrowings throughout 2005, resulting in average quarterly borrowings being \$243 million lower in the first quarter of 2006 in comparison to the first quarter of 2005.

The net interest margin of 4.06% for the first quarter dropped 28 basis points versus the same period in the prior year. This decline was primarily attributable to an increase in the cost of funds (up 49 basis points), due principally to the effect of the eight rate hikes (25 basis points each) by the Federal Reserve since last March, while earning assets yields increased at a much slower rate (up 18 basis points). The change in the earning-asset yield was driven by a 33 basis point increase in loan yields, partially offset by an investment yield decline of nine basis points quarter over quarter. The decrease in investment yields was the result of the sale and maturity of

certain higher yielding investments from the portfolio. In 2005, the Company decided to sell certain securities and not fully reinvest cash flows from maturing securities in a flat yield 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.

The first quarter cost of funds increased 49 basis points due to a 51 basis

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point increase in deposit costs and a 124 basis point increase in the average interest rate paid on external borrowings. Interest rates on selected categories of deposit accounts were raised throughout 2005 and the first quarter of 2006 in response to the increased rates by the Federal Reserve. Additionally, customers continued to transfer funds from lower rate interest accounts to higher yielding money market and time deposit accounts. Short-term borrowing rates increased 89 basis points and long-term rates increased 62 basis points as compared to the first quarter of 2005. 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 approximately 190 basis point increase in the LIBOR (London Interbank Offered Rates), from which the interest rate on the majority of the mandatorily redeemable preferred securities is based.

Table 3 below set forth information related to average interest-earning assets and interest-bearing liabilities and their associated yields and rates for the periods indicated. Interest income and yields are on a fully tax-equivalent basis using marginal income tax rates of 38.4% 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 March 31, 2006		
	Average Balance	Interest	Avg. Yield/Rate Paid
<b>Interest-earning assets:</b>			
Time deposits in other banks	\$ 1,093	\$ 10	3.71%
Taxable investment securities (1)	780,395	10,841	5.63%
Non-taxable investment securities (1)	522,112	8,774	6.82%
Loans (net of unearned discount)	2,400,926	38,432	6.49%
Total interest-earning assets	3,704,526	58,057	6.36%
<b>Non-interest earning assets</b>	440,315		
Total assets	\$4,144,841		
<b>Interest-bearing liabilities:</b>			
Interest checking, savings and money market deposits	\$1,126,716	\$ 2,513	0.90%
Time deposits	1,283,632	10,508	3.32%
Short-term borrowings	163,940	1,458	3.61%
Long-term borrowings	468,884	6,494	5.62%
Total interest-bearing liabilities	3,043,172	20,973	2.80%
<b>Non-interest bearing liabilities:</b>			
Demand deposits	589,407		
Other liabilities	54,099		
Shareholders' equity	458,163		
Total liabilities and shareholders' equity	\$4,144,841		

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Net interest earnings	\$37,084	
	=====	
Net interest spread		3.56%
Net interest margin on interest-earnings assets		4.06%
Fully tax-equivalent adjustment	\$ 3,464	

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

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

Table 4: Rate/Volume

(000's omitted)	1st Quarter 2006 versus 1st Quarter 2005	
	Volume	Rate
Interest earned on:		
Time deposits in other banks	\$ 1	\$ 5
Taxable investment securities	(2,673)	(399)
Non-taxable investment securities	(597)	(121)
Loans (net of unearned discount)	904	1,937
Total interest-earning assets (2)	(2,611)	1,668
Interest paid on:		
Interest checking, savings and money market deposits	(99)	660
Time deposits	540	2,741
Short-term borrowings	(2,217)	749
Long-term borrowings	381	697
Total interest-bearing liabilities (2)	(1,222)	4,674
Net interest earnings (2)	(1,757)	(2,638)

- (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 (Elias Asset Management or EAM); and periodic transactions, most often net gains (losses) from the sale of investment securities and prepayment of term debt.

Table 5: Non-interest Income

(000's omitted)	Three Months Ended March 31,	
	2006	2005
Deposit service charges and fees	\$ 6,674	\$ 6,077
Benefit plan administration, consulting and actuarial fees	3,381	2,850
Trust, investment and asset management fees	2,050	1,781
Other banking services	290	360
Mortgage banking	186	165
Subtotal	12,581	11,233
Gain on sales of investment securities	0	1,726
Total non-interest income	\$12,581	\$12,959
Non-interest income/total income (FTE)	25.3%	23.8%

As displayed in Table 5, non-interest income (excluding securities gains) was \$12.6 million in the first quarter, an increase of \$1.3 million or 12.0% from one year earlier. General recurring banking fees of \$7.2 million were up \$0.5 million or 8.3% compared to the first quarter of 2005, driven by several revenue enhancement initiatives put into place during 2005. Offsetting these increases, was a decrease in gain on the sale of investment securities of \$1.7 million for the quarter, as the Company took advantage of market conditions to sell certain securities in the first quarter of 2005 in order to shorten the average length of the portfolio and maximize their expected total return. Strong performance at BPA-Harbridge generated revenue growth of \$0.5 million (19%) for the quarter, achieved primarily through enhanced service offerings to both new and existing clients. First quarter revenue for trust services was up \$0.2 million or 43% versus the prior year primarily as a result of the generation of estate settlement fees. The \$0.1 million or 16% revenue growth at CISI can be attributable to the addition of new financial consultants as well as higher sales of fixed annuity products, which become more attractive as interest rates rise. In comparison to the first quarter of the prior year, EAM revenues were down slightly due to softer demand for their investment products.

The ratio of non-interest income to total income (FTE basis) was 25.3% for the quarter as compared to 23.8% for the comparable period in 2005. Excluding net security gains, the ratio of non-interest income to total income (FTE basis) was 25.3% for the first quarter of 2006, as compared to 21.3% for the comparable period in 2005. This improvement is a function of rising non-interest income (excluding net security gains) combined with lower net interest income and a reduction of investment portfolio levels.

## Operating Expenses

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

Table 6: Operating Expenses

(000's omitted)	Three Months Ended March 31,	
	2006	2005
Salaries and employee benefits	\$16,398	\$16,166
Stock option expense	626	0
Occupancy and equipment	4,759	4,590
Data processing and communications	3,231	3,306
Amortization of intangible assets	1,493	1,984
Legal and professional fees	1,041	1,183
Office supplies and postage	976	938
Business development and marketing	730	689
Acquisition expenses	0	41
Other	2,181	2,134
<b>Total operating expenses</b>	<b>\$31,435</b>	<b>\$31,031</b>
Operating expenses/average assets	3.08%	2.87%
Efficiency ratio	60.3%	55.0%

As shown in Table 6, first quarter 2006 operating expenses were \$31.4 million, up \$0.4 million or 1.3% from the prior year level. Excluding the effect of adopting FASB 123R, Share-Based Payments, operating expenses decreased \$0.2 million or 0.7% from \$31.0 million in the first quarter of 2005 to \$30.8 million in this year's first quarter. The decrease was primarily attributable to a \$0.5 million reduction in the amortization of intangible assets, and a \$0.1 million reduction in legal and professional expenses, partially offset by a \$0.2 million or 1.8% increase in salaries and a \$0.2 million increase in occupancy related costs.

The Company continued to aggressively manage all aspects of its operating expense structure in the first quarter of 2006, resulting in operating expenses that were essentially flat with the year earlier period. The Company recently announced that it will consolidate two of its Pennsylvania branch offices into nearby sister branches. This realignment will reduce inefficiencies and further strengthen its branch network, and reflects management's dedication to 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 60.3% for the first quarter, 5.3 percentage points above the comparable quarter of 2005. This resulted from operating expenses (as described above) increasing 3.2% primarily due to stock option expense, while recurring operating income decreased 5.8% due to 10.6% lower net interest income, more than offsetting a 12.0% increase in non-interest income excluding security gains. The efficiency ratio for the first quarter of 2006, excluding stock option expense was 59.0%, as compared to 55.0% in the comparable first quarter of 2005.

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### Income Taxes

The first quarter effective income tax rate was 25.0%, comparable to the 24.9% effective tax rate in the first quarter of 2005.

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### Investments

As reflected in Table 7 below, the carrying value of investments (including unrealized gains on available-for-sale securities) was \$1.31 billion at the end of the first quarter, an increase of \$3.9 million and a decrease of \$248 million from December 31, 2005 and March 31, 2005, respectively. The book value (excluding unrealized gains) of investments was up \$11.8 million from year-end 2005 and down \$218 million versus March 31, 2005. The decrease in the portfolio from the first quarter of the prior year was the result of the decision to sell certain securities and not fully reinvest cash flows from these sales and from contractual maturities to take advantage of market conditions to shorten the average life of the portfolio and maximize the expected total return. As a result, the expected life-to-maturity of the portfolio was reduced to just over five years at the end of the current quarter. 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. Net unrealized gains decreased by \$7.9 million and \$29.6 million since December 31, 2005 and March 31, 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. In addition, the decrease in net unrealized gains from one year ago was impacted by the sale of \$193 million of securities over the last 12 months, which generated realized pre-tax gains of \$10.5 million.

Table 7: Investments

(000's omitted)	March 31, 2006		December 31, 2005	
	Amortized Cost/Book Value	Fair Value	Amortized Cost/Book Value	Fair Value
<b>Held-to-Maturity Portfolio:</b>				
U.S. treasury and agency securities	\$ 127,309	\$ 122,011	\$ 127,345	\$ 122,011
Obligations of state and political subdivisions	7,445	7,419	5,709	5,709
Other securities	9,488	9,488	9,451	9,451
Total held-to-maturity portfolio	144,242	138,918	142,505	137,171
<b>Available-for-Sale Portfolio:</b>				
U.S. treasury and agency securities	419,808	415,366	420,062	415,366
Obligations of state and political subdivisions	518,680	531,316	519,661	531,316
Corporate securities	35,709	34,728	35,744	34,728
Collateralized mortgage obligations	67,858	66,944	78,708	66,944
Mortgage-backed securities	78,212	77,700	53,021	77,700

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Sub-total	1,120,267	1,126,054	1,107,196	1,113,880
Equity securities	36,745	36,745	39,706	39,706
Total available-for-sale portfolio	1,157,012	1,162,799	1,146,902	1,153,586
Net unrealized gain on available-for-sale portfolio	5,787	0	13,710	13,710
Total	\$1,307,041	\$1,301,717	\$1,303,117	\$1,303,117

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Loans

As shown in Table 8, loans ended the first quarter at \$2.41 billion, consistent with year-end 2005 and up \$74 million (3.2%) versus one year earlier. The business lending portfolio increased in the first quarter, while small declines were incurred in the consumer mortgage and consumer installment portfolios. As compared to one year earlier, all portfolios have demonstrated growth. Consistent with prior years, the Company experienced softness within our lending portfolio in the first quarter, due principally to seasonal (weather-related) trends and demands. The first quarter 2006 decline was limited to \$3.5 million as compared to the \$24 and \$23 million declines in the first quarter of 2005 and 2004, respectively.

Table 8: Loans

(000's omitted)	March 31 2006		December 31, 2005		March 31 2004
Consumer mortgage	\$ 814,885	33.8%	\$ 815,463	33.8%	\$ 801,600
Business lending	820,722	34.1%	819,605	34.0%	816,616
Consumer installment	772,614	32.1%	776,701	32.2%	716,124
Total loans	\$2,408,221	100.0%	\$2,411,769	100.0%	\$2,334,340

Total consumer mortgages decreased \$0.6 million in the first quarter of 2006 and increased \$13.3 million over the last twelve months, even though the Company continued selling certain new mortgage originations into the secondary market for the second consecutive quarter. Consumer mortgage growth has slowed over the last few quarters as interest rates have risen and demand lessened after a prolonged period of elevated activity driven by historically low interest rates. Business lending increased \$1.1 million in the first quarter of 2006 and increased \$4.1 million versus one year ago. Consumer installment loans, including borrowings originated in automobile, marine and recreational vehicle dealerships as well as branch originated home equity and installment loans, rose \$56 million (7.9%) on a year-over-year basis and decreased \$4.1 million (0.5%) in the first three months of 2006. Continued moderate interest rates (by historical standards), aggressive dealer and manufacturer incentives on new vehicles, and enhanced business development efforts have helped drive strong growth in this segment year-over-year in all our markets.

Asset Quality

Table 9 below exhibits the major components of non-performing loans and assets

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and key asset quality metrics for the periods ending March 31, 2006 and 2005 and December 31, 2005.

Table 9: Non-performing Assets

(000's omitted)	March 31, 2006	December 31 2005
Non-accrual loans	\$12,351	\$10,85
Accruing loans 90+ days delinquent	1,213	1,07
Restructured loans	1,350	1,37
Total non-performing loans	14,914	13,30
Other real estate (OREO)	1,613	1,04
Total non-performing assets	\$16,527	\$14,35
Allowance for loan losses to total loans	1.36%	1.3
Allowance for loan losses to non-performing loans	219%	24
Non-performing loans to total loans	0.62%	0.5
Non-performing assets to total loans and other real estate	0.69%	0.5
Delinquent loans (30 days old to non-accruing) to total loans	1.26%	1.4
Net charge-offs to average loans outstanding (quarterly)	0.34%	0.3
Loan loss provision to net charge-offs (quarterly)	107%	10

As displayed in Table 9, non-performing assets at March 31, 2006 were \$16.5 million, an increase of \$2.2 million versus year-end 2005 and a \$0.4 million increase as compared to the level at the end of the first quarter 2005. Most of the increase over the last three months in non-performing loans was due to two commercial relationships moving to non-accrual status. The increase in total non-performing assets from the prior year was 2.4%, well below the 3.2% increase in the loan portfolio over the same period. Other real estate increased \$0.2 million from one-year ago and increased \$0.6 million from year-end 2005, a result of the Company managing 20 properties at March 31, 2006 as compared to 15 OREO properties at the end of 2005. No one property has a carrying value in excess of \$350,000.

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Non-performing loans were 0.62% of total loans outstanding at the end of the first quarter, slightly below the 0.63% at March 31, 2005 and above the 0.55% at year-end 2005. The allowance for loan losses to non-performing loans ratio, a general measure of coverage adequacy, was 219% at the end of the first quarter compared to 245% at year-end 2005 and 217% at March 31, 2005.

Delinquent loans (30 days through non-accruing) as a percent of total loans was 1.26% at the end of the first quarter, substantially below the 1.46% at year-end 2005 and nine basis points below the 1.35% delinquency ratio at March 31, 2005. Real estate and installment loan delinquency ratios at the end of the first quarter improved in comparison to both of the earlier periods. Commercial loan delinquency ratios increased slightly from both the first and fourth quarters of 2005. The delinquency level at the end of the current quarter was 20 basis points below the Company's average of 1.46% over the previous eight quarters.

Table 10: Allowance for Loan Losses Activity

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(000's omitted)	Three Months Ended March 31,	
	2006	2005
Allowance for loan losses at beginning of period	\$32,581	\$31,778
Charge-offs:		
Business lending	1,355	707
Consumer mortgage	35	23
Consumer installment	1,625	1,715
Total charge-offs	3,015	2,445
Recoveries:		
Business lending	114	41
Consumer mortgage	58	7
Consumer installment	832	642
Total recoveries	1,004	690
Net charge-offs	2,011	1,755
Provision for loan losses	2,150	1,875
Allowance for loan losses at end of period	\$32,720	\$31,898
Net charge-offs to average loans outstanding:		
Business lending	0.62%	0.33%
Consumer mortgage	-0.01%	0.01%
Consumer installment	0.42%	0.61%
Total loans	0.34%	0.30%

As displayed in Table 10, net charge-offs during the first quarter were \$2.0 million, \$0.3 million higher than the equivalent 2005 period. The consumer mortgage and consumer installment portfolios experienced decreased levels of charge-offs, while business lending charge-offs increased. The net charge-off ratio (net charge-offs as a percentage of average loans outstanding) for the first quarter was 0.34%, four basis points higher than the comparable quarter of 2005, and one basis point lower than average charge-off ratio for the previous eight quarters.

The business lending net charge-off ratio increased 29 basis points to 0.62%, the consumer installment net charge-off ratio improved by 19 basis points to 0.42%, while consumer mortgages experienced a small net recovery for the first quarter of 2006 as compared to a 0.01% net charge-off ratio in the comparable period of 2005. The increase in business lending charge-offs was adversely impacted by one commercial relationship .

A required loan loss allowance of \$32.7 million was determined as of March 31, 2006, necessitating a \$2.2 million loan loss provision for the quarter, compared to \$1.9 million one year earlier. The first quarter 2006 loan loss provision was \$0.1 million higher than net charge-offs. The allowance for loan losses rose \$0.8 million or 2.6% over the last 12 months, while the loan portfolio grew 3.2%. Consequently, the ratio of allowance for loan loss to loans outstanding decreased from 1.37% at the end of last year's first quarter to 1.36%, which was slightly higher than the 1.35% level reported at December 31, 2005.

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### Deposits

As shown in Table 11, average deposits of \$3.0 billion in the first quarter were up \$20.6 million compared to fourth quarter 2005 and increased \$31.6 million versus the same quarter of last year. The mix of average deposits changed slightly in the first quarter of 2006. The weightings of time deposits increased from their fourth quarter levels, while demand, interest checking, savings and money market deposit weightings decreased. As interest rates have risen since June 2004, time deposits have continued to attract more funds, as evidenced by their 3.6% increase in the current quarter versus fourth quarter 2005. 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 2.02% in the last quarter of 2005 to 2.19% in the most recent quarter, well above the 1.56% for the quarter ended March 31, 2005.

Average first quarter IPC (individuals and businesses) deposits decreased \$26.9 million or 1.0% versus the quarter ended December 31, 2005, and were down \$4.4 million or 0.2% compared to the year earlier period. Average public funds have increased \$47.5 million or 25% and \$36.0 million or 18% over the same periods. A decrease in IPC deposits and an inflow of public fund deposits in the first quarter is a typical seasonal fluctuation in our markets, as payment of local property taxes tends to shift funds from one category to the other.

Table 11: Quarterly Average Deposits

(000's omitted)	March 31, 2006	December 31, 2005	March 31, 2005
Demand deposits	\$ 589,407	\$ 596,508	\$ 584,669
Interest checking deposits	299,637	307,738	310,546
Savings deposits	475,970	484,908	534,951
Money market deposits	351,108	351,029	338,904
Time deposits	1,283,632	1,238,945	1,199,076
Total deposits	\$2,999,754	\$2,979,128	\$2,968,146
IPC deposits	\$2,759,111	\$2,785,967	\$2,763,523
Public fund deposits	240,643	193,161	204,623
Total deposits	\$2,999,754	\$2,979,128	\$2,968,146

### Borrowings

At the end of the first quarter, borrowings of \$587 million were down \$66.3 million from December 31, 2005 and down \$268 million versus the end of the first quarter 2005. The reduction in borrowings over the last twelve months was principally the result of the decision to use a portion of the cash flows from the sales and maturities of investments to reduce debt levels in the current flat yield curve environment.

### Shareholders' Equity

On April 20, 2005, the Company announced that its Board of Directors had authorized a stock repurchase program to acquire up to 1,500,000 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 over the course of the subsequent 20 months. All reacquired shares will become treasury shares and will be used for general corporate purposes.

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Through March 31, 2006, the Company has repurchased 751,836 shares at an aggregate cost of \$17.5 million.

Total shareholders' equity of \$455 million at the end of the first quarter was a decrease of \$2.2 million from the balance at December 31, 2005. This change consisted of a decrease in the after-tax market value adjustment on the available-for-sale investment portfolio of \$4.9 million, dividends declared of \$5.7 million and treasury stock purchases of \$3.5 million, partially offset by net income of \$9.5 million and \$2.4 million from shares issued under the employee stock plan. Over the past 12 months total shareholders' equity decreased by \$5.0 million, as dividends declared, treasury stock purchases, and a lower market value adjustment more than offset net income and increases from shares issued under the employee stock plan.

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The Company's Tier I leverage ratio, a primary measure of regulatory capital for which 5% is the requirement to be "well-capitalized," was 7.68% at the end of the first quarter, up 11 basis points from year-end 2005 and 85 basis points higher than its level one year ago. These increases were primarily the result of a decrease in average assets excluding intangibles and market value adjustments, while shareholders equity excluding intangibles and market value adjustments increased, mostly due to reductions in the investment portfolio. The tangible equity-to-assets ratio of 5.89% increased 32 basis points versus March 31, 2005, for similar reasons and decreased 3 basis points versus year-end 2005 due to treasury share purchases and a decline in the market value adjustment having a greater impact on this ratio than lower asset levels.

The dividend payout ratio (dividends declared divided by net income) for the first three months of 2006 was 60.1%, up from 40.9% in the first quarter of 2005. The ratio increased because dividends declared increased 4.2%, while net income including securities gains decreased 29.0%. The expansion of dividends declared was caused by the dividend per share being raised 5.6% in August 2005, from \$0.18 to \$0.19, offset by a 1.4% decrease 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 March 31, 2006, this ratio was 15.0% for 30 days and 14.9% 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

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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.

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### 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

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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:

- o Asset and liability levels using March 31, 2006 as a starting point.
- o 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.
- o 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.
- o Cash flows are based on contractual maturity, optionality and amortization schedules along with applicable prepayments derived from internal historical data and external sources.

### Net Interest Income Sensitivity Model

Change in interest rates	Calculated annualized increase (decrease) in projected net interest income at March 31, 2006
+ 200 basis points	(0.4%)
- 100 basis points	(0.4%)

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.

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### Item 4. Controls and Procedures

The Company maintains disclosure controls and procedures, as defined in Rule 13a - 15(e) under the Securities Exchange Act of 1934, designed to ensure that it is able to collect the information it is required to disclose in the reports that are filed with the Securities and Exchange Commission, (SEC), and to process, summarize and disclose this information within the time periods specified in the rules of the SEC. Based on management's evaluation of the Company's disclosure controls and procedures, with the participation of the Chief Executive Officer and the Chief Financial Officer, it has concluded that, as of the end of the period covered by this Quarterly Report on Form 10-Q, these disclosure controls and procedures were effective as of March 31, 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 first quarter 2006.

	Number of Shares Purchased	Average Price Paid Per share	Total Number of Shares Purchased as part of Publicly Announced Plans or Programs	Maximum Number that May yet be Under the Plan
January 2006	0	\$ 0.00	593,711	906,
February 2006	98,825	22.84	692,536	807,
March 2006	59,300	21.29	751,836	748,
Total	158,125	\$22.26	751,836	748,

#### Item 3. Defaults Upon Senior Securities.

Not applicable.

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

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

Item 5. Other Information.

Not applicable

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Item 6. Exhibits

Exhibit No. -----	Description -----
2.1	Agreement and Plan of Merger dated April 20, 2006, by and among Community Bank System, Inc., ESL Acquisition Corp., and ES&L Bancorp.. Inc. Incorporated by reference to Exhibit 2.1 to the Form 8-K filed on April 25, 2006.
31.1	Certification of Sanford A. Belden, 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 A. 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 Sanford A. Belden, 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 A. 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

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SIGNATURES

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

Community Bank System, Inc.

Date: May 9, 2006

/s/ Sanford A. Belden

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Sanford A. Belden, President, Chief

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Executive Officer and Director

Date: May 9, 2006

/s/ Scott A. Kingsley

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Scott A. Kingsley, Treasurer and Chief  
Financial Officer