COMMUNITY BANK SYSTEM INC
Form 10-Q
August 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 June 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

[LOGO] 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.

29,853,043 shares of Common Stock, $1.00 par value, were outstanding on August 3, 2006.

TABLE OF CONTENTS

Page

Part I. Financial Information

Item 1. Financial Statements (Unaudited)

Consolidated Statements of Condition
June 30, 2006 and December 31, 2005 3

Consolidated Statements of Income
Three and six months ended June 30, 2006 and 2005 4

Consolidated Statement of Changes in Shareholders' Equity
Six months ended June 30, 2006 5

Consolidated Statements of Comprehensive Income
Three and six months ended June 30, 2006 and 2005 6

Consolidated Statements of Cash Flows
Six months ended June 30, 2006 and 2005 7

Notes to the Consolidated Financial Statements
June 30, 2006 8

Item 2. Management's Discussion and Analysis of Financial Condition
and Results of Operations 14

Item 3. Quantitative and Qualitative Disclosure about Market Risk 28

Item 4. Controls and Procedures 29

Part II. Other Information

Item 1. Legal Proceedings 29

Item 1A. Risk Factors 29

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

Item 3. Defaults Upon Senior Securities 29

Item 4. Submission of Matters to a Vote of Securities Holders 29

Item 5. Other Information 29

Item 6. Exhibits 30

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 $135,767 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
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;
32,603,192 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 (2,752,761 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 June 30,	
	2006	2005
Interest income:		
Interest and fees on loans	$ 39,760	$ 36,157
Interest and dividends on taxable investments	10,735	12,925
Interest and dividends on nontaxable investments	5,883	5,701
Total interest income	56,378	54,783
Interest expense:		
Interest on deposits	14,620	10,284
Interest on short-term borrowings	1,150	3,852
Interest on subordinated debt held by unconsolidated subsidiary trusts	1,872	1,627
Interest on long-term borrowings	5,231	2,964
Total interest expense	22,873	18,727
Net interest income	33,505	36,056
Less: provision for loan losses	1,725	2,134
Net interest income after provision for loan losses	31,780	33,922
Non-interest income:		
Deposit service fees	7,167	6,703
Other banking services	361	241
Benefit plan administration, consulting and actuarial fees	3,155	2,639
Trust, investment and asset management fees	1,766	1,859
Gain on sales of investment securities	--	5,164
Total non-interest income	12,449	16,606
Operating expenses:		
Salaries and employee benefits	16,425	16,212
Occupancy and equipment	4,448	4,282
Data processing and communications	3,333	3,479
Amortization of intangible assets	1,489	1,984
Legal and professional fees	1,108	1,107
Office supplies and postage	1,083	952
Business development and marketing	1,084	898
Other	2,238	2,286
Total operating expenses	31,208	31,200

Income before income taxes	13,021	19,328
Income taxes	3,137	5,047
Net income	$ 9,884	$ 14,281
Basic earnings per share	$ 0.33	$ 0.47
Diluted earnings per share	$ 0.33	$ 0.46
Dividends declared per share	$ 0.19	$ 0.18

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

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

	Common Stock		Additional		Accumulated Other
	Shares Outstanding	Amount Issued	Paid-In Capital	Retained Earnings	Comprehensiv Income
Balance at December 31, 2005	29,956,852	$32,451	$196,312	$276,809	$8,420
Net income				19,346	
Other comprehensive loss, net of tax					(12,058)
Dividends declared:					
Common, $0.38 per share				(11,354)	
Common stock issued under employee stock plan, including tax benefits of $381	152,629	152	2,251		
Employee stock options earned			1,047		
Treasury stock purchased	(259,050)				
Balance at June 30, 2006	29,850,431	$32,603	$199,610	$284,801	($3,638)

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

COMMUNITY BANK SYSTEM, INC.

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (Unaudited)
(In Thousands)

	Three Months Ended June 30,	
	2006	2005
Other comprehensive loss, before tax:		
Change in minimum pension liability adjustment	$0	$0
Unrealized losses on securities:		
Unrealized holding losses arising during period	(11,572)	15,551
Reclassification adjustment for gains included in net income	0	(5,164)
Other comprehensive loss, before tax:	(11,572)	10,387
Income tax benefit related to other comprehensive loss	4,439	(4,008)
Other comprehensive loss, net of tax:	(7,133)	6,379
Net income	9,884	14,281
Comprehensive income	$2,751	$20,660

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

6

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

	Six Mo Ju
	2006
Operating activities:	
Net income	$ 19,346
Adjustments to reconcile net income to net cash provided by operating activities:	
Depreciation	4,348
Amortization of intangible assets	2,982
Net amortization of premiums and discounts on securities and loans	440
Amortization of unearned compensation and discount on subordinated debt	64
Provision for loan losses	3,875
Gain on investment securities and debt extinguishments	0
Gain on sale of loans and other assets	(187)
Proceeds from the sale of loans held for sale	9,372
Origination of loans held for sale	(9,375)
Excess tax benefits from share-based payment arrangements	(198)
Change in other operating assets and liabilities	6,607
Net cash provided by operating activities	37,274

Investing Activities:	
Proceeds from sales of available-for-sale investment securities	28,409
Proceeds from maturities of held-to-maturity investment securities	3,299
Proceeds from maturities of available-for-sale investment securities	56,987
Purchases of held-to-maturity investment securities	(3,682)
Purchases of available-for-sale investment securities	(55,042)
Net increase in loans outstanding	(36,044)
Capital expenditures	(2,810)
Net cash (used in) provided by investing activities	(8,883)
Financing Activities:	
Net change in demand deposits, NOW accounts and savings accounts	(22,642)
Net change in time deposits	78,255
Net change in federal funds purchased	(29,500)
Net change in short-term borrowings	(140,000)
Change in long-term borrowings (net of payments of $91 and $148)	109,909
Issuance of common stock	2,150
Purchase of treasury stock	(5,534)
Cash dividends paid	(11,379)
Tax benefits from share-based payment arrangements	198
Net cash provided by (used in) financing activities	(18,543)
Change in cash and cash equivalents	9,848
Cash and cash equivalents at beginning of period	114,605
Cash and cash equivalents at end of period	$ 124,453
Supplemental disclosures of cash flow information:	
Cash paid for interest	$ 41,457
Cash paid for income taxes	2,082
Supplemental disclosures of non-cash financing and investing activities:	
Dividends declared and unpaid	5,670
Gross change in unrealized gains on available-for-sale investment securities	(19,495)

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

7

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

NOTE A: BASIS OF PRESENTATION

The interim financial data as of June 30, 2006 and for the three and six months ended June 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: OTHER MATTERS

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 June 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.

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, New York, as well as mortgage and title insurance subsidiaries, all of which combine to total approximately $210 million in assets, including $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 June 30, 2006, the Company has repurchased against this authorization 852,761 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 prescribes a recognition threshold and measurement attribute for financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return, and also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure, and transition. FIN 48 is effective for fiscal years beginning after December 15, 2006. The Company is currently analyzing the effects FIN 48 will have on its financial statements.

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	Weigh Gran Valu
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	(161,793)	13.93	(7,545)	
Forfeited	(14,888)	22.72	(4,106)	
Outstanding at June 30, 2006	2,761,220	19.22	9,443	
Exercisable at June 30, 2006	1,864,717	$17.58	--	

The weighted average remaining contractual term of outstanding and exercisable stock options at June 30, 2006 is 7.0 years and 6.4 years, respectively. The aggregate intrinsic value of outstanding and exercisable stock options at June 30, 2006 is $8.0 million and $7.3 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.

As a result of applying the provisions of SFAS 123(R) during the three and six months ended June 30, 2006, the Company recognized stock-based compensation expense related to incentive and non-qualified stock options of $421,000 and $1.0 million, respectively and a related income tax benefit of $53,000 and $188,000, respectively. Compensation expense related to restricted stock recognized in the income statement for the three and six months ended June 30, 2006 was $15,000 and $31,000, respectively. Compensation expense related to restricted stock recognized in the income statement for the three and six months

ended June 30, 2005 was $86,000 and $122,000, 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 June 30, 2005	Six months June 30
Net income, as reported	$14,281	$
Plus: stock-based compensation expense as reported, net of tax	43	
Less: stock-based compensation expense determined under fair value method, net of tax	(390)	
Pro forma net income	$13,934	$
Earnings per share:		
As reported:		
Basic	$ 0.47	$
Diluted	$ 0.46	$
Pro forma:		
Basic	$ 0.46	$
Diluted	$ 0.45	$

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.

	Six months ended June 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 $4.7 million at June 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 1.8 years. The total fair value of shares vested during the six months ended June 30, 2006 and 2005 were $1.5 million and $1.7 million, respectively.

During the six months ended June 30, 2006 and 2005, proceeds from stock option exercises totaled $2.3 million and $2.6 million and the related windfall tax benefits from exercise were approximately $198,000 and $562,000, respectively. During the six months ended June 30, 2006 and 2005, 161,793 and 248,927 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 six months ended June 30, 2006 and 2005 were $1.3 million and $3.2 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 1,382,613 anti-dilutive stock options outstanding for the three and six months ended June 30, 2006 compared to 412,561 anti-dilutive stock options outstanding for the three and six months ended June 30, 2005. The following is a reconciliation of basic to diluted earnings per share for the three and six months ended June 30, 2006 and 2005.

(000's omitted, except per share data)	Income	Shares	Per Share Amount
Three Months Ended June 30, 2006			
Basic EPS	$9,884	29,946	$0.33
Stock options		362	
Diluted EPS	$9,884	30,308	$0.33
Three Months Ended June 30, 2005			
Basic EPS	$14,281	30,401	$0.47
Stock options		539	
Diluted EPS	$14,281	30,940	$0.46
Six Months Ended June 30, 2006			
Basic EPS	$19,346	29,984	$0.65
Stock options		409	
Diluted EPS	$19,346	30,393	$0.64
Six Months Ended June 30, 2005			
Basic EPS	$27,615	30,490	$0.91
Stock options		575	
Diluted EPS	$27,615	31,065	$0.89

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 June 30, 2006 Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount	As of Gross Carrying Amount	A
Amortizing intangible assets:					
Core deposit intangibles	$63,161	($37,815)	$25,346	$63,161	
Other intangibles	2,750	(1,395)	1,355	2,750	
Total amortizing intangibles	65,911	(39,210)	26,701	65,911	
Non-amortizing intangible assets:					
Goodwill	195,195	0	195,195	195,195	
Total intangible assets, net	$261,106	($39,210)	$221,896	$261,106	

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
July-Dec 2006	$2,962
2007	5,569
2008	5,262
2009	4,777
2010	2,965
Thereafter	5,166
Total	$26,701

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 Pr

I	2/3/1997	$30 million	9.75%	2/03/2027	10 year beg
II	7/16/2001	$25 million	6 month LIBOR plus 3.75% (8.56%)	7/16/2031	5 year beg
III	7/31/2001	$24.5 million	3 month LIBOR plus 3.58% (8.73%)	7/31/2031	5 year beg

12

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 six months ended June 30 is as follows:

	Pension Benefits				
	Three Months Ended June 30,		Six Months Ended June 30,		Three Mo Ju
(000's omitted)	2006	2005	2006	2005	2006
Service cost	$ 748	$ 630	$ 1,496	$ 1,282	$ 127
Interest cost	634	657	1,267	1,302	116
Expected return on plan assets	(827)	(876)	(1,654)	(1,754)	0
Net amortization and deferral	315	331	631	635	26
Amortization of prior service cost	(42)	29	(84)	59	26
Amortization of transition obligation	$ 0	0	0	0	11
Net periodic benefit cost	$ 828	$ 771	$ 1,656	$ 1,524	$ 306

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)	June 30, 2006	December 31, 2005
Commitments to extend credit	$420,000	$434,640
Standby letters of credit	23,157	25,638
Total	$443,157	$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 six months ended June 30, 2006 and 2005, although in some circumstances the first 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, "second quarter" refers to the quarter ended June 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 27.

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.

- 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.

Second quarter and June year-to-date (YTD) earnings per share were $0.33 and $0.64, respectively, a decrease of $0.13 and $0.25 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 Standard (FAS) 123R, Share-Based Payment, and the absence of gains on the sale of investment securities recorded in the second quarter and first half 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 $0.37 versus $0.52 for the prior year's second quarter and $0.35 for the first quarter of 2006.

Asset quality improved in the second quarter of 2006 in comparison to the first quarter 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. The size of the investment portfolio was below that of second 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 second quarter of 2006 as compared to the first quarter of 2006 and the second quarter of 2005. Borrowings, principally overnight borrowings and other short-term instruments, decreased during the same time periods.

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. As of June 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.

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. The transaction is expected to close in the third quarter.

Net Income and Profitability

As shown in Table 2, earnings per share for the second quarter and June YTD of $0.33 were $0.64, respectively, were $0.13 and $0.25 lower than the EPS generated in the same periods of last year. Net income for the quarter of $9.9 million was 31% lower than the second quarter of 2005 and net income of $19.3 million for the first six months of 2006 decreased 30% from the amount earned in the first six months of 2005. As compared to the first quarter of 2006, net income increased $0.4 million or 4.5% and earnings per share increased $0.02 or 6.5%.

Second quarter net interest income of $33.5 million was down $2.6 million or 7.1% from the prior year comparable period, while net interest income for the first six months of 2006 decreased $6.6 million or 9.0% over the first half of 2005. The provision for loan losses decreased $0.4 million or 19.2% as compared to the second quarter of 2005 and decreased $0.1 million for the first six months of 2006 compared to 2005 as a result of strong asset quality. Second quarter non-interest income, excluding securities gains was $12.4 million, up $1.0 million (8.8%) from second quarter 2005 and the YTD amount of $25.0 million

rose $2.4 million or 10.4% from the prior year level. Security gains for the second quarter and YTD period decreased $5.2 million and $6.9 million, respectively. Operating expenses of $31.2 million for the quarter and $62.6 million for the first six months of 2006 were up less than one percent from the comparable prior year periods. Excluding the impact of adopting FASB 123R, Accounting for Stock Based Compensation, operating expenses for the second quarter and YTD period decreased 1.3% and 1.0%, respectively, from the prior year periods.

15

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 second quarter and the first six months of 2006 were $0.37 and $0.72, respectively, down 29% and 27% from the $0.52 and $0.99 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 gains 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 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 $5.2 million and $6.9 million of gains on the sale of securities recognized in the second quarter and first six 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 decreased primarily due to reductions in the amortization of intangibles and customer processing costs, partially offset by increased occupancy costs and business development and marketing expenditures.

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 June 30,		Six Months Ended June 30,	
(000's omitted)	2006	2005	2006	2005
Net income	$ 9,884	$14,281	$19,346	$27,615
After-tax cash adjustments:				
Amortization of premium on net assets acquired in merger	207	241	412	214
Amortization of intangible assets	1,130	1,465	2,250	2,955
Net income - cash	$11,221	$15,987	$22,008	$30,784

Table 2: Summary Income Statements

(000's omitted, except per share data)	Three Months Ended June 30, 2006	Three Months Ended June 30, 2005	Six Months Ende June 30, 2006	20
Net interest income	$33,505	$36,056	$67,125	$73
Provision for loan losses	1,725	2,134	3,875	4
Non-interest income excluding security gains	12,449	11,442	25,030	22
Gains on sales of investment securities	0	5,164	0	6
Operating expenses	31,208	31,200	62,643	62
Income before taxes	13,021	19,328	25,637	37
Income taxes	3,137	5,047	6,291	9
Net income	$9,884	$14,281	$19,346	$27
Diluted earnings per share	$ 0.33	$ 0.46	$ 0.64	$
Diluted earnings per share - cash (1)	$ 0.37	$ 0.52	$ 0.72	$

(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.

16

As shown in Table 3, net interest income (with non-taxable income converted to a fully tax-equivalent basis) for second quarter 2006 was $37.3 million, down $2.3 million or 5.9% from the same period last year. A $77.6 million decrease in interest earning assets and a 16basis point decrease in the net interest margin more than offset a $90.1 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 $0.8 million and $1.5 million, respectively, for the second quarter of 2006 as compared to the second quarter of 2005. June 2006 YTD net interest income of $74.3 million was down $6.7 million or 8.3% from the year-earlier period. A $122.8 million decrease in earning assets and a 22 basis point decrease in the net interest margin more than offset a $152.6 million decrease in interest bearing liabilities. Interest bearing asset and liability volume changes resulted in $2.5 million less net interest income, while a lower net interest margin had a negative $4.2 million impact on net interest income.

Higher second quarter and June YTD average loan balances were attributable to $73.3 million of organic loan growth since the second quarter of 2005, driven by growth in all portfolios: consumer installment, consumer mortgage and business

lending. Average investments for the second quarter and YTD periods were $174 million and $201 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 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. Total average deposits were up $54.7 million or 1.8% and $43.2 million or 1.5% for the quarter and YTD periods, respectively, as compared to the previous year as a result of growth in both IPC and public fund balances. Cash flows from the investment sales were used to pay down external borrowings throughout 2005, resulting in average quarterly and YTD borrowings being $166 million and $204 million lower in the second quarter of 2006 and the first six months of 2006, in comparison to the comparable 2005 periods.

The net interest margin of 4.00% for the second quarter and 4.03% for the year to date period dropped 16 basis points and 22 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 51 basis points, YTD up 50 basis points), due principally to the effect of the eight rate hikes (25 basis points each) by the Federal Reserve since June 2005, while earning assets yields increased at a slower rate (quarter up 32 basis points, YTD up 25 basis points). The change in the earning-asset yield was driven by increases in loan yields of 41 basis points for the quarter and 37 basis points for the YTD period, while investment yields increased 14 basis points for the quarter and two basis points for the YTD period.

The second quarter cost of funds increased 51 basis points due to a 55 basis point increase in deposit costs and a 98 basis point increase in the average interest rate paid on external borrowings. The increase in the YTD cost of funds was driven by a 53 basis point increase in deposit costs and borrowing rates that were up 111 basis points. Interest rates on selected categories of deposit accounts were raised throughout 2005 and the first half of 2006 in response to the Federal Reserve rate increases. Additionally, customers continued to transfer funds from low rate and non-interest earning instruments to higher yielding money market 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 approximately 190 basis point increase in the 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 June 30, 2006

	Average Balance	Interest	Avg. Yield/Rate Paid
Interest-earning assets:			
Time deposits in other banks	$ 24,084	$ 299	4.98%
Taxable investment securities (1)	770,614	10,843	5.64%
Non-taxable investment securities (1)	518,309	9,093	7.04%
Loans (net of unearned discount)	2,425,763	39,890	6.60%
Total interest-earning assets	3,738,770	60,125	6.45%
Non-interest earning assets	429,125		
Total assets	$4,167,895		
Interest-bearing liabilities:			
Interest checking, savings and money market deposits	$1,130,655	$ 2,775	0.98%
Time deposits	1,330,126	11,845	3.57%
Short-term borrowings	127,208	1,150	3.63%
Long-term borrowings	509,102	7,103	5.60%
Total interest-bearing liabilities	3,097,091	22,873	2.96%
Non-interest bearing liabilities:			
Demand deposits	566,143		
Other liabilities	52,253		
Shareholders' equity	452,408		
Total liabilities and shareholders' equity	$4,167,895		
Net interest earnings		$37,252	
Net interest spread			3.49%
Net interest margin on interest-earnings assets			4.00%
Fully tax-equivalent adjustment		$ 3,747	

(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.

18

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

(000's omitted except yields and rates)	Six Months Ended June 30, 2006		
	Average Balance	Interest	Avg. Yield/Rate Paid

Interest-earning assets:			
Time deposits in other banks	$ 12,652	$ 310	4.94%
Taxable investment securities (1)	775,477	21,685	5.64%
Non-taxable investment securities (1)	520,200	17,867	6.93%
Loans (net of unearned discount)	2,413,414	78,322	6.54%
Total interest-earning assets	3,721,743	118,184	6.40%
Non-interest earning assets	434,689		
Total assets	$4,156,432		
Interest-bearing liabilities:			
Interest checking, savings and money market deposits	$1,128,696	$ 5,289	0.94%
Time deposits	1,307,007	22,352	3.45%
Short-term borrowings	145,473	2,608	3.62%
Long-term borrowings	489,104	13,597	5.61%
Total interest-bearing liabilities	3,070,280	43,846	2.88%
Non-interest bearing liabilities:			
Demand deposits	577,711		
Other liabilities	53,171		
Shareholders' equity	455,270		
Total liabilities and shareholders' equity	$4,156,432		
Net interest earnings		$ 74,338	
Net interest spread			3.52%
Net interest margin on interest-earnings assets			4.03%
Fully tax-equivalent adjustment		$ 7,213	

(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.

19

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

2nd Quarter 2006 versus 2nd Quarter 2005			Six Mo
Increase (Decrease) Due to Change in (1)			Increase
Volume	Rate	Net Change	Volume

(000's omitted)				
Interest earned on:				
Time deposits in other banks	$ 289	$ 0	$ 289	$ 286
Taxable investment securities	(2,430)	(16)	(2,446)	(5,096
Non-taxable investment securities	(26)	378	352	(630
Loans (net of unearned discount)	1,154	2,460	3,614	2,058
Total interest-earning assets (2)	(1,203)	3,012	1,809	(3,812
Interest paid on:				
Interest checking, savings and money market deposits	(101)	687	586	(201
Time deposits	931	2,819	3,750	815
Short-term borrowings	(3,009)	307	(2,702)	(4,327
Long-term borrowings	2,370	142	2,512	2,219
Total interest-bearing liabilities (2)	(543)	4,689	4,146	(970
Net interest earnings (2)	$ (794)	$(1,543)	$(2,337)	$(2,536

(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.

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

	Three Months Ended June 30,		Six Months June 3
(000's omitted)	2006	2005	2006
Deposit service charges and fees	$ 7,167	$ 6,703	$13,841
Benefit plan administration, consulting and actuarial fees	3,155	2,639	6,536
Trust, investment and asset management fees	1,766	1,859	3,816
Other banking services	303	297	593
Mortgage banking	58	(56)	244
Subtotal	12,449	11,442	25,030
Gain on sales of investment securities	0	5,164	0
Total non-interest income	$12,449	$16,606	$25,030

Non-interest income/total income (FTE)	25.0%	29.6%	25.2%

As displayed in Table 5, non-interest income (excluding securities gains) was $12.4 million in the second quarter and $25.0 million for the first half of 2006. This corresponded to increases of $1.0 million (8.8%) for the quarter and $2.4 million (10.4%) for the YTD period in comparison to one year earlier. A significant portion of the growth in both time intervals was attributable to the $0.5 million and $1.1 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 higher utilization of deposit service products. Offsetting these increases, was the absence of gains on the sales of investment securities which equaled $5.2 million and $6.9 million for the second quarter and first six months of 2005, as the Company took advantage of market conditions to sell certain securities in the first half 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 (20%) for the quarter and $1.0 million (19%) for the first six months of 2006, achieved primarily through enhanced service offerings to both new and existing clients. Trust service revenue was up $0.1 million or 17% for the quarter and $0.3 million or 30% for the first six months of 2006 as compared to the prior year periods, primarily as a result of the generation of estate settlement fees. In comparison to the second quarter of the prior year, EAM and CISI revenues were down due to softer demand for their traditional investment products. Year-to-date, CISI revenue has increased as compared to the first half of 2005, while EAM was down for the same period.

The ratio of non-interest income to total income (FTE basis) was 25.0% for the quarter and 25.2% for the year-to-date period versus 29.6% and 26.7% for the comparable periods in 2005. Excluding net security gains, the ratio of non-interest income to total income (FTE basis) was 25.0% and 25.2% for the second quarter and YTD periods of 2006, respectively, as compared to 22.4% and 21.9% 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 June 30,		Six Months Ended June 30,	
(000's omitted)	2006	2005	2006	2005
Salaries and employee benefits	$16,004	$16,212	$32,402	$32,37
Stock option expense	421	0	1,047	

Occupancy and equipment	4,448	4,282	9,207	8,87
Data processing and communications	3,333	3,479	6,564	6,78
Amortization of intangible assets	1,489	1,984	2,982	3,96
Legal and professional fees	1,108	1,107	2,149	2,29
Office supplies and postage	1,083	952	2,059	1,89
Business development and marketing	1,084	898	1,814	1,58
Other	2,238	2,286	4,419	4,46
Total operating expenses	$31,208	$31,200	$62,643	$62,23
Operating expenses/average assets	3.00%	2.91%	3.04%	2.8
Efficiency ratio	59.8%	57.2%	60.0%	56.

As shown in Table 6, second quarter 2006 operating expenses were $31.2 million, consistent with the prior year level and $0.2 million below the first quarter of 2006. Year-to-date operating expenses of $62.6 rose $0.4 million or 0.7% compared to 2005. Excluding the effect of adopting FASB 123R, Share-Based Payment, operating expenses decreased $0.4 million or 1.3% for the second quarter and $0.6 million or 1.0% for the first six months of 2006 as compared to the prior year periods. The decrease was primarily attributable to a reduction in the amortization of intangible assets ($0.5 million for the quarter, $1.0 million YTD) and a reduction in data processing and communication expenses ($0.1 million for the quarter, $0.2 million YTD), partially offset by an increased level of business development and marketing expenses ($0.2 million for both the quarter and YTD) associated with a bankwide deposit generation program and an increase in occupancy-related costs ($0.2 million for the quarter and $0.3 million YTD). Additionally, the second quarter of 2006 included $0.2 million of costs associated with two branch consolidations.

The Company continued to manage all aspects of its operating expense structure in the first half of 2006, resulting in operating expense, excluding the effect of adopting FASB 123R, reductions as compared to the year earlier period. The Company recently announced that it will consolidate 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 59.8% for the second quarter, 2.6 percentage points above the comparable quarter of 2005. This resulted from operating expenses (as described above) increasing 1.7% primarily due to stock option expense, while recurring operating income decreased 2.6% due to $2.4 million lower net interest income, partially offset by a $1.0 million increase in non-interest income excluding security gains. The efficiency ratio for the second quarter of 2006, excluding stock option expense was 59.0%, as compared to 57.2% in the comparable second quarter of 2005. The efficiency ratio of 60.0% for the first half of 2006 was up 3.9 percentage points from a year earlier due to core operating expenses increasing 2.5% while recurring operating income decreased 4.2%. Operating expenses as a percentage of average assets increased nine basis points and 15 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 second quarter effective income tax rate was 24.1%, compared to the 26.1% effective tax rate in the second quarter of 2005. The year-to-date effective tax rate was 24.5% as compared to 25.5% for the first half 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 second quarter, a decrease of $50 million and $253 million from December 31, 2005 and June 30, 2005, respectively. The book value (excluding unrealized gains) of investments decreased $30 million from year-end 2005 and declined $202 million versus June 30, 2005. The decrease in the portfolio from the second 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. 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 June 30, 2006, the portfolio had a $5.8 million net unrealized loss, a decrease of $19.5 million and $51.5 million from the unrealized gains at December 31, 2005 and June 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. In addition, the decrease in net unrealized gains from one year ago was impacted by the sale of $122 million of securities over the last 12 months, which generated pre-tax gains of $5.3 million.

Table 7: Investments

	June 30, 2006		December
(000's omitted)	Amortized Cost/Book Value	Fair Value	Amortized Cost/Book Value
Held-to-Maturity Portfolio:			
U.S. Treasury and Agency securities	$ 127,273	$ 120,240	$ 127,345
Obligations of state and political subdivisions	6,052	6,053	5,709
Other securities	9,474	9,474	9,451
Total held-to-maturity portfolio	142,799	135,767	142,505
Available-for-Sale Portfolio:			
U.S. Treasury and Agency securities	399,555	390,970	420,062
Obligations of state and political subdivisions	510,831	517,673	519,661
Corporate securities	35,674	34,193	35,744
Collateralized mortgage obligations	57,934	56,827	78,708
Mortgage-backed securities	75,086	73,632	53,021
Sub-total	1,079,080	1,073,295	1,107,196
Equity securities	37,108	37,108	39,706

Total available-for-sale portfolio	1,116,188	1,110,403	1,146,902
Net unrealized gain(loss) on available-for-sale portfolio	(5,785)	0	13,710
Total	$1,253,202	$1,246,170	$1,303,117

Loans

As shown in Table 8, loans ended the second quarter at $2.44 billion, up $32.5 million (1.3%) year-to-date and up $65.4 (2.8%) versus one year earlier. As compared to the prior quarter and one year earlier, growth was produced in all three categories. 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. In the second quarter, loans increased $36.0 million with increases in the consumer installment portfolio ($22.4 million), consumer mortgage portfolio ($7.4 million) and the business lending portfolio ($6.3 million).

Table 8: Loans

(000's omitted)	June 30, 2006		December 31, 2005		June 30, 200	
Business lending	$ 827,021	33.8%	$ 819,605	34.0%	$ 824,007	
Consumer mortgage	822,235	33.7%	815,463	33.8%	802,787	
Consumer installment	795,010	32.5%	776,701	32.2%	752,043	
Total loans	$2,444,266	100.0%	$2,411,769	100.0%	$2,378,837	1

Business lending increased $7.4 million in the first six months of 2006 and increased $3.0 million versus one year ago. Strong commercial line of credit activity during the first six months has more than offset a reduction in the dealer floor plan portfolio. 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. Total consumer mortgages increased $19.4 million year over year and $6.8 million in the first six months of 2006, despite the Company continuing to sell certain 30 year fixed rate new mortgage originations into the secondary market for the third consecutive quarter. Consumer mortgage growth has remained steady over the last few quarters despite rising interest rates. Consumer installment loans, including borrowings originated in automobile, marine and recreational vehicle dealerships as well as branch originated home equity and installment loans, rose $43.0 million (5.7%) on a year-over-year basis and increased $18.3 million (2.4%) in the first six 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 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 June 30, 2006 and 2005 and

December 31, 2005.

Table 9: Non-performing Assets

(000's omitted)	June 30, 2006	December 31 2005
Non-accrual loans	$ 9,002	$10,85
Accruing loans 90+ days delinquent	765	1,07
Restructured loans	1,325	1,37
Total non-performing loans	11,092	13,30
Other real estate (OREO)	1,353	1,04
Total non-performing assets	$12,445	$14,35
Allowance for loan losses to total loans	1.35%	1.3
Allowance for loan losses to non-performing loans	297%	24
Non-performing loans to total loans	0.45%	0.5
Non-performing assets to total loans and other real estate	0.51%	0.5
Delinquent loans (30 days old to non-accruing) to total loans	1.15%	1.4
Net charge-offs to average loans outstanding (quarterly)	0.26%	0.3
Loan loss provision to net charge-offs (quarterly)	112%	10

As displayed in Table 9, non-performing assets at June 30, 2006 were $11.1 million, a decrease of $2.2 million versus year-end 2005 and a $2.3 million decrease as compared to the level at the end of the second quarter 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 $0.7 million from one-year ago and increased $0.3 million from year-end 2005, a result of the Company managing 22 properties at June 30, 2006 as compared to 15 OREO properties at the end of 2005. No one property has a carrying value in excess of $350,000.

24

Non-performing loans were 0.45% of total loans outstanding at the end of the second quarter, significantly below the 0.56% at June 30, 2005 and the 0.55% at year-end 2005. The allowance for loan losses to non-performing loans ratio, a general measure of coverage adequacy, was 297% at the end of the second quarter compared to 245% at year-end 2005 and 240% at June 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 1.15% at the end of the second quarter, substantially below the 1.46% at year-end 2005 and 17 basis points below the 1.32% delinquency ratio at June 30, 2005. Commercial and installment loan delinquency ratios at the end of the second quarter improved in comparison to both of the earlier periods. Real estate loan delinquency ratios increased slightly from the second quarter of 2005, but were improved from December 31, 2005. The delinquency level at the end of the current quarter was 26 basis points below the Company's average of 1.41% over the previous eight quarters.

Table 10: Allowance for Loan Losses Activity

(000's omitted)	Three Months Ended June 30, 2006	Three Months Ended June 30, 2005	Six Month June 2006
Allowance for loan losses at beginning of period	$32,720	$31,898	$32,581
Charge-offs:			
Business lending	1,201	854	2,556
Consumer mortgage	67	379	102
Consumer installment	1,237	1,882	2,862
Total charge-offs	2,505	3,115	5,520
Recoveries:			
Business lending	125	330	239
Consumer mortgage	19	127	77
Consumer installment	816	637	1,648
Total recoveries	960	1,094	1,964
Net charge-offs	1,545	2,021	3,556
Provision for loan losses	1,725	2,134	3,875
Allowance for loan losses at end of period	$32,900	$32,011	$32,900
Net charge-offs to average loans outstanding:			
Business lending	0.52%	0.26%	0.57%
Consumer mortgage	0.02%	0.13%	0.01%
Consumer installment	0.22%	0.68%	0.31%
Total loans	0.26%	0.34%	0.30%

As displayed in Table 10, net charge-offs during the second quarter were $1.5 million, $0.5 million lower than the equivalent 2005 period. The consumer mortgage and 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 second quarter was 0.26%, eight basis points lower than the comparable quarter of 2005, and seven basis points lower than average charge-off ratio for the previous eight quarters. On a year to date basis, net charge-offs decreased $0.2 million versus the prior year period, while average loans were up $65.9 million, resulting in a two basis point decline in the net charge-off ratio to 0.30%. Net charge-offs and the corresponding net charge-off ratios are at their lowest level in two years.

The business lending net charge-off ratio for the quarter increased 26 basis points to 0.52%, the consumer installment net charge-off ratio improved by 46 basis points to 0.22%, and the consumer mortgage portfolio experienced an 11 basis point improvement in it's net charge-off ratio. The increase in business lending charge-offs was adversely impacted by three commercial relationships in the auto industry.

A required loan loss allowance of $32.9 million was determined as of June 30, 2006, necessitating a $1.7 million loan loss provision for the quarter, compared to $2.1 million one year earlier. The second quarter 2006 loan loss provision was $0.2 million higher than net charge-offs. The allowance for loan losses rose $0.9 million or 2.7% over the last 12 months, consistent with the 2.8% growth in the loan portfolio. Consequently, the ratio of allowance for loan loss to loans

outstanding remained at 1.35% for the second quarter, consistent with the levels at December 31, 2005 and June 30, 2005.

Deposits

As shown in Table 11, average deposits of $3.0 billion in the second quarter were up $47.8 million compared to fourth quarter 2005 and increased $54.7 million versus the same quarter of last year. The mix of average deposits changed slightly in the first half 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 7.4% and 10.7% increases as compared to the fourth and second 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 2.38% in the most recent quarter, noticeably above the 1.73% for the quarter ended June 30, 2005.

Average second quarter IPC (individuals and businesses) deposits increased $16.2 million or 0.6% versus the first quarter of 2006, and were up $9.4 million or 0.3% compared to the year earlier period. Average public funds have increased $11.0 million or 4.6% and $45.3 million or 22% 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)	June 30, 2006	December 31, 2005	June 30, 2005
Demand deposits	$ 566,143	$ 596,508	$ 586,812
Interest checking deposits	331,554	307,738	311,932
Savings deposits	462,110	484,908	521,969
Money market deposits	336,991	351,029	349,382
Time deposits	1,330,126	1,238,945	1,202,087
Total deposits	$3,026,924	$2,979,128	$2,972,182
IPC deposits	$2,775,319	$2,785,967	$2,765,920
Public fund deposits	251,605	193,161	206,262
Total deposits	$3,026,924	$2,979,128	$2,972,182

Borrowings

At the end of the second quarter, borrowings of $594 million were down $59.6 million from December 31, 2005 and down $205 million versus the end of the second quarter of 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 1.5 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 June 30, 2006, the Company had repurchased 852,761 shares at an aggregate cost of $19.5 million.

Total shareholders' equity of $452 million at the end of the second quarter decreased $6.0 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 $12.0 million, dividends declared of $11.3 million and treasury stock purchases of $5.5 million, partially offset by net income of $19.4 million, $2.3 million from shares issued under the employee stock plan and $1.1 from employee stock options earned. Over the past 12 months total shareholders' equity decreased by $21.5 million, as dividends declared, treasury stock purchases, and a lower market value adjustment more than offset net income and positive contributions from shares issued under the employee stock plan.

The Company's Tier I leverage ratio, a primary measure of regulatory capital for which 5% is the requirement to be "well-capitalized," was 7.73% at the end of the second quarter, up 16 basis points from year-end 2005 and 59 basis points higher than its level one year ago. The increase in the Tier I leverage ratio compared to December 31, 2005 is primarily the result of a 3.0% increase in shareholders equity excluding intangibles and market value adjustment, with a smaller 0.8% increase in average assets excluding intangibles and market value adjustment. The increase in Tier I as compared to the prior year second quarter is the result of a 5.8% increase in shareholders equity excluding intangibles and market value adjustment combined with a 2.2 % decrease in average assets excluding intangibles and market value adjustment, primarily due to the sale of investments. The tangible equity-to-assets ratio of 5.86% decreased six basis points versus December 31, 2005 and 13 basis points versus June 30, 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 half of 2006 was 58.7%, up from 39.5% for the first half of 2005. The ratio increased because dividends declared increased 4.1%, while net income including securities gains decreased 29.9%. 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 1.3% 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 June 30, 2006, this ratio was 13.6% for 30 days and 13.4% 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 June 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 June 30, 2006
+ 200 basis points	(0.9%)
- 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 June 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 second 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 Numbe That May Yet Under the Plan
April 2006	--	$ --	751,836	
May 2006	100,925	19.96	852,761	
June 2006	--	--	852,761	
Total	100,925	$ 19.96	852,761	

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 June 30, 2006.

Item 5. Other Information.

Not applicable

Item 6. Exhibits

Exhibit No.	Description
3.2	Bylaws of Community Bank System, Inc., amended March 15, 2006. Incorporated by reference to Exhibit 3.2 to the Form 8-K filed on June 30, 2006.
31.1	Certification of Mark E. Tryniski, President and Chief Executive Officer of the Registrant, pursuant to Rule 13a-15(e) or Rule 15d-15(e) under the Securities Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31.2	Certification of Scott Kingsley, Treasurer and Chief Financial Officer of the Registrant, pursuant to Rule 13a-15(e) or Rule 15d-15(e) under the Securities Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32.1	Certification of Mark E. Tryniski, President and Chief Executive Officer of the Registrant, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
32.2	Certification of Scott Kingsley, Treasurer and Chief Financial Officer of the Registrant, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

SIGNATURES

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

Community Bank System, Inc.

Date: August 8, 2006

/s/ Mark E. Tryniski

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

Date: August 8, 2006

/s/ Scott Kingsley

Scott A. Kingsley, Treasurer and Chief Financial Officer