FINANCIAL INSTITUTIONS INC
Form 10-Q
November 04, 2009

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

**Form 10-Q**

þ **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
**For the quarterly period ended September 30, 2009**
**or**

o **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
**Commission File Number: 000-26481**

(Exact name of registrant as specified in its charter)

| | |
|---|---|
| **NEW YORK** | **16-0816610** |
| (State or other jurisdiction of incorporation or organization) | (I.R.S. Employer Identification No.) |
| **220 LIBERTY STREET, WARSAW, NEW YORK** | **14569** |
| (Address of principal executive offices) | (Zip Code) |

Registrant s telephone number, including area code: **(585) 786-1100**

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 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 þ No o

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes o No o

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act.

| | | | |
|---|---|---|---|
| Large accelerated filer o | Accelerated filer þ | Non-accelerated filer o<br>(Do not check if a smaller company) | Smaller reporting company o |

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

The registrant had 10,820,268 shares of Common Stock, $0.01 par value, outstanding as of October 30, 2009.

**FINANCIAL INSTITUTIONS, INC.**
**Form 10-Q**
**For the Quarterly Period Ended September 30, 2009**
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## PART I. FINANCIAL INFORMATION

### ITEM 1. Financial Statements

### FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES
### Consolidated Statements of Financial Condition (Unaudited)

| *(Dollars in thousands, except share and per share data)* | | September 30, 2009 | | December 31, 2008 |
|---|---|---|---|---|
| **ASSETS** | | | | |
| Cash and cash equivalents: | | | | |
| Cash and due from banks | $ | 48,721 | $ | 34,528 |
| Federal funds sold and interest-bearing deposits in other banks | | 11,385 | | 20,659 |
| Total cash and cash equivalents | | 60,106 | | 55,187 |
| Securities available for sale, at fair value | | 625,744 | | 547,506 |
| Securities held to maturity, at amortized cost (fair value of $46,122 and $59,147, respectively) | | 45,056 | | 58,532 |
| Loans held for sale | | 1,032 | | 1,013 |
| Loans | | 1,259,362 | | 1,121,079 |
| Less: Allowance for loan losses | | 20,782 | | 18,749 |
| Loans, net | | 1,238,580 | | 1,102,330 |
| Company owned life insurance | | 24,532 | | 23,692 |
| Premises and equipment, net | | 35,210 | | 36,712 |
| Goodwill | | 37,369 | | 37,369 |
| Other assets | | 70,576 | | 54,578 |
| Total assets | $ | 2,138,205 | $ | 1,916,919 |
| **LIABILITIES AND SHAREHOLDERS EQUITY** | | | | |
| Deposits: | | | | |
| Noninterest-bearing demand | $ | 298,972 | $ | 292,586 |
| Interest-bearing demand | | 383,982 | | 344,616 |
| Savings and money market | | 402,042 | | 348,594 |
| Certificates of deposit | | 712,182 | | 647,467 |
| Total deposits | | 1,797,178 | | 1,633,263 |
| Short-term borrowings | | 73,265 | | 23,465 |
| Long-term borrowings | | 46,848 | | 47,355 |
| Other liabilities | | 24,979 | | 22,536 |
| Total liabilities | | 1,942,270 | | 1,726,619 |
| Shareholders equity: | | | | |
| Series A 3% Preferred Stock, $100 par value, 1,533 shares authorized and issued | | 153 | | 153 |

| | | | | |
|---|---|---|---|---|
| Series A Preferred Stock, $100 par value, 7,503 shares authorized and issued, aggregate liquidation preference of $37,515; net of $1,760 and $2,016 discount, respectively | | 35,755 | | 35,499 |
| Series B-1 8.48% Preferred Stock, $100 par value, 200,000 shares authorized, 174,223 shares issued | | 17,422 | | 17,422 |
| Total preferred equity | | 53,330 | | 53,074 |
| Common stock, $0.01 par value, 50,000,000 shares authorized, 11,348,122 shares issued | | 113 | | 113 |
| Additional paid-in capital | | 26,815 | | 26,397 |
| Retained earnings | | 127,941 | | 124,952 |
| Accumulated other comprehensive loss | | (2,381) | | (4,013) |
| Treasury stock, at cost 529,826 and 550,103 shares, respectively | | (9,883) | | (10,223) |
| Total shareholders equity | | 195,935 | | 190,300 |
| Total liabilities and shareholders equity | $ | 2,138,205 | $ | 1,916,919 |

See accompanying notes to the consolidated financial statements.

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**FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES**
**Consolidated Statements of Operations (Unaudited)**

| *(Dollars in thousands, except per share amounts)* | Three months ended September 30, 2009 | Three months ended September 30, 2008 | Nine months ended September 30, 2009 | Nine months ended September 30, 2008 |
|---|---|---|---|---|
| Interest income: | | | | |
| Interest and fees on loans | $ 18,712 | $ 17,018 | $ 53,618 | $ 50,146 |
| Interest and dividends on investment securities | 4,965 | 7,472 | 16,401 | 23,648 |
| Other interest income | 20 | 68 | 73 | 572 |
| Total interest income | 23,697 | 24,558 | 70,092 | 74,366 |
| Interest expense: | | | | |
| Deposits | 4,826 | 6,538 | 14,729 | 23,193 |
| Short-term borrowings | 77 | 287 | 171 | 571 |
| Long-term borrowings | 716 | 987 | 2,142 | 2,584 |
| Total interest expense | 5,619 | 7,812 | 17,042 | 26,348 |
| Net interest income | 18,078 | 16,746 | 53,050 | 48,018 |
| Provision for loan losses | 2,620 | 1,891 | 6,614 | 3,965 |
| Net interest income after provision for loan losses | 15,458 | 14,855 | 46,436 | 44,053 |
| Noninterest income: | | | | |
| Service charges on deposits | 2,643 | 2,794 | 7,480 | 7,812 |
| ATM and debit card | 920 | 852 | 2,639 | 2,460 |
| Loan servicing | 304 | 112 | 1,031 | 530 |
| Company owned life insurance | 271 | 223 | 806 | 269 |
| Broker-dealer fees and commissions | 238 | 363 | 741 | 1,223 |
| Net gain on sale of loans held for sale | 129 | 48 | 545 | 304 |
| Net gain on investment securities | 1,721 | 12 | 2,928 | 232 |
| Impairment charges on investment securities | (2,318) | (34,554) | (4,101) | (38,345) |
| Net gain on sale and disposal of other assets | 19 | 102 | 177 | 254 |
| Other | 479 | 700 | 1,366 | 1,589 |
| Total noninterest income (loss) | 4,406 | (29,348) | 13,612 | (23,672) |
| Noninterest expense: | | | | |
| Salaries and employee benefits | 8,253 | 7,021 | 25,421 | 23,626 |
| Occupancy and equipment | 2,730 | 2,642 | 8,289 | 7,789 |
| FDIC assessments | 753 | 236 | 3,026 | 369 |
| Professional services | 532 | 467 | 1,972 | 1,504 |
| Computer and data processing | 578 | 603 | 1,757 | 1,764 |
| Supplies and postage | 473 | 475 | 1,414 | 1,353 |

| | | | | |
|---|---|---|---|---|
| Advertising and promotions | 227 | 472 | 650 | 905 |
| Other | 1,596 | 1,493 | 5,131 | 4,757 |
| Total noninterest expense | 15,142 | 13,409 | 47,660 | 42,067 |
| Income (loss) before income taxes | 4,722 | (27,902) | 12,388 | (21,686) |
| Income tax expense | 1,313 | 524 | 3,384 | 1,330 |
| Net income (loss) | $ 3,409 | $ (28,426) | $ 9,004 | $ (23,016) |
| Preferred stock dividends, net of amortization | 927 | 371 | 2,770 | 1,112 |
| Net income (loss) applicable to common shareholders | $ 2,482 | $ (28,797) | $ 6,234 | $ (24,128) |
| Earnings (loss) per common share (Note 2): | | | | |
| Basic | $ 0.23 | $ (2.66) | $ 0.58 | $ (2.21) |
| Diluted | $ 0.23 | $ (2.66) | $ 0.57 | $ (2.21) |

See accompanying notes to the consolidated financial statements.

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**FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES**
**Consolidated Statement of Changes in Shareholders Equity (Unaudited)**

| *(Dollars in thousands, except per share data)* | Preferred Equity | Common Stock | Additional Paid-in Capital | Retained Earnings | Accumulated Other Comprehensive Loss | Treasury Stock | Total Shareholders Equity |
|---|---|---|---|---|---|---|---|
| **Balance at January 1, 2009** | **$ 53,074** | **$ 113** | **$ 26,397** | **$ 124,952** | **$ (4,013)** | **$ (10,223)** | **$ 190,300** |
| Comprehensive income: | | | | | | | |
| Net income | | | | 9,004 | | | 9,004 |
| Other comprehensive income, net of tax | | | | | 1,632 | | 1,632 |
| Total comprehensive income | | | | | | | 10,636 |
| Issuance costs of Series A Preferred Stock | | | (68) | | | | (68) |
| Share-based compensation plans: | | | | | | | |
| Share-based compensation | | | 690 | | | | 690 |
| Stock options exercised | | | (4) | | | 19 | 15 |
| Restricted stock awards issued, net | | | (170) | | | 170 | |
| Directors retainer | | | (30) | | | 151 | 121 |
| Accrued undeclared cumulative dividend on Series A Preferred Stock, net of amortization | 256 | | | (450) | | | (194) |
| Cash dividends declared: | | | | | | | |
| Series A 3% Preferred-$2.25 per share | | | | (3) | | | (3) |
| Series A Preferred-$161.11 per share | | | | (1,209) | | | (1,209) |
| Series B-1 8.48% Preferred-$6.36 per share | | | | (1,108) | | | (1,108) |
| Common-$0.30 per share | | | | (3,245) | | | (3,245) |
| **Balance at September 30, 2009** | **$ 53,330** | **$ 113** | **$ 26,815** | **$ 127,941** | **$ (2,381)** | **$ (9,883)** | **$ 195,935** |

See accompanying notes to the consolidated financial statements.

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**FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES**

**Consolidated Statements of Cash Flows (Unaudited)**

| *(Dollars in thousands)* | Nine months ended September 30, 2009 | 2008 |
|---|---|---|
| Cash flows from operating activities: | | |
| Net income (loss) | $ 9,004 | $ (23,016) |
| Adjustments to reconcile net income (loss) to net cash provided by operating activities: | | |
| Depreciation and amortization | 3,067 | 2,922 |
| Net amortization of premiums and discounts on investment securities | 1,792 | 374 |
| Provision for loan losses | 6,614 | 3,965 |
| Amortization of unvested stock-based compensation | 690 | 529 |
| Deferred income tax expense (benefit) | 5,562 | (1,865) |
| Proceeds from sale of loans held for sale | 76,704 | 25,401 |
| Originations of loans held for sale | (76,178) | (25,199) |
| Increase in company owned life insurance | (806) | (269) |
| Net gain on investment securities | (2,928) | (232) |
| Impairment charge on investment securities | 4,101 | 38,345 |
| Net gain on sale of loans held for sale | (545) | (304) |
| Net gain on sale and disposal of other assets | (177) | (254) |
| (Increase) decrease in other assets | (5,095) | 129 |
| Increase (decrease) in other liabilities | 1,562 | (2,727) |
| Net cash provided by operating activities | 23,367 | 17,799 |
| Cash flows from investing activities: | | |
| Purchase of investment securities: | | |
| Available for sale | (451,137) | (287,678) |
| Held to maturity | (22,350) | (44,065) |
| Proceeds from principal payments, maturities and calls on investment securities: | | |
| Available for sale | 243,439 | 270,367 |
| Held to maturity | 36,512 | 40,924 |
| Proceeds from sale of securities available for sale | 127,142 | 51,545 |
| Net loan originations | (159,750) | (116,772) |
| Purchase of company owned life insurance | (34) | (20,066) |
| Proceeds from sales of other assets | 1,577 | 1,395 |
| Purchase of premises and equipment | (1,439) | (4,058) |
| Net cash used by investing activities | (226,040) | (108,408) |
| Cash flows from financing activities: | | |
| Net increase in deposits | 163,915 | 84,443 |
| Net increase in short-term borrowings | 49,800 | 21,566 |
| Proceeds from long-term borrowings | | 30,000 |
| Repayment of long-term borrowings | (507) | (5,092) |

| | | | | |
|---|---|---|---|---|
| Purchase of common stock | | | | (4,698) |
| Issuance of preferred and common shares | | (68) | | 112 |
| Stock options exercised | | 15 | | 32 |
| Cash dividends paid to preferred shareholders | | (2,320) | | (1,112) |
| Cash dividends paid to common shareholders | | (3,243) | | (4,611) |
| Net cash provided by financing activities | | 207,592 | | 120,640 |
| Net increase in cash and cash equivalents | | 4,919 | | 30,031 |
| Cash and cash equivalents, beginning of period | | 55,187 | | 46,673 |
| Cash and cash equivalents, end of period | $ | 60,106 | $ | 76,704 |

See accompanying notes to the consolidated financial statements.

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**FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES**
**Notes to Consolidated Financial Statements (Unaudited)**

## (1.) SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

### Nature of Operations

Financial Institutions, Inc., a financial holding company organized under the laws of New York State, and its subsidiaries provide deposit, lending and other financial services to individuals and businesses in Central and Western New York. The Company owns 100% of Five Star Bank, a New York State-chartered bank, and Five Star Investment Services, Inc., a broker-dealer subsidiary offering noninsured investment products. The Company also owns 100% of FISI Statutory Trust I (the Trust ), which was formed in February 2001 for the purpose of issuing trust preferred securities. References to the Company mean the consolidated reporting entities and references to the Bank mean Five Star Bank.

### Basis of Presentation

The consolidated financial statements in this Quarterly Report on Form 10-Q include the accounts of the Company and its subsidiaries. The Trust is not included in the consolidated financial statements of the Company under the requirements of the Variable Interest Entities Subsections of the Financial Accounting Standards Board ( FASB ) Accounting Standards Codification ( ASC ). All significant intercompany accounts and transactions have been eliminated in consolidation. The accounting and reporting policies conform to general practices within the banking industry and to U.S. generally accepted accounting principles. Prior years consolidated financial statements are re-classified whenever necessary to conform to the current year s presentation.

These financial statements have been prepared by the Company, without audit, pursuant to the rules and regulations of the Securities and Exchange Commission ( SEC ). Certain information and footnote disclosures normally included in financial statements prepared in conformity with U.S. generally accepted accounting principles ( GAAP ) have been condensed or omitted pursuant to such rules and regulations. However, in the opinion of management, the accompanying consolidated financial statements reflect all adjustments of a normal and recurring nature necessary to present fairly the consolidated balance sheet, statements of operations, shareholders equity and cash flows for the periods indicated, and contain adequate disclosure to make the information presented not misleading. These consolidated financial statements should be read in conjunction with the Company s 2008 Annual Report on Form 10-K. The results of operations for any interim periods are not necessarily indicative of the results which may be expected for the entire year.

### Use of Estimates

The preparation of these financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. Actual results could differ from those estimates. Material estimates relate to the determination of the allowance for loan losses, assumptions used in the defined benefit pension plan accounting, the valuation of goodwill and deferred tax assets, and the valuation and other than temporary impairment considerations related to the securities portfolio.

### Cash Flow Information

Supplemental cash flow information addressing certain cash payments (receipts) and noncash investing and financing activities was as follows (in thousands):

| | Nine months ended September 30, 2009 | Nine months ended September 30, 2008 |
|---|---|---|
| Cash payments (receipts): | | |
| Interest | $ 15,338 | $ 28,306 |
| Income taxes | (1,312) | 2,349 |
| Noncash investing and financing activities: | | |
| Real estate and other assets acquired in settlement of loans | $ 903 | $ 756 |
| Accrued and declared unpaid dividends | 1,692 | 1,992 |
| Increase in net unsettled security transactions | 16,795 | 1,814 |

| | |
|---|---|
| Loans securitized | 15,983 |

**FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES**
**Notes to Consolidated Financial Statements (Unaudited)**

**(1.) SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)**

**Recently Adopted Accounting Pronouncements**

***Accounting Standards Codification.*** The ASC became effective on July 1, 2009. At that date, the ASC became FASB s officially recognized source of authoritative GAAP applicable to all public and non-public non-governmental entities, superseding existing FASB, American Institute of Certified Public Accountants, Emerging Issues Task Force and related literature. Rules and interpretive releases of the SEC under the authority of federal securities laws are also sources of authoritative GAAP for SEC registrants. All other accounting literature is considered non-authoritative. The switch to the ASC affects the way companies refer to GAAP in financial statements and accounting policies. The ASC was not intended to change or alter existing GAAP, and therefore did not have an impact on the Company s financial statements.

***Earnings Per Share.*** On January 1, 2009, the Company adopted the requirements of the ASC subsections regarding Participating Securities and the Two-Class Method as those requirements relate to the calculation of earnings per common share. The ASC provides that unvested share-based payment awards that contain nonforfeitable rights to dividends or dividend equivalents (whether paid or unpaid) are participating securities and shall be included in the computation of earnings per common share pursuant to the two-class method. The Company has shares of restricted stock outstanding that are participating securities under the provisions of the ASC. Accordingly, the Company has computed earnings per common share using the two-class method described in the ASC beginning January 1, 2009, and has retrospectively adjusted previously reported earnings per common share data to conform to the two-class method.

***Disclosures about Derivative Instruments and Hedging Activities.*** In March 2008, the FASB issued new guidance regarding disclosures in the Derivatives and Hedging Topic of the ASC (Derivative Disclosure Guidance). The Derivative Disclosure Guidance requires expanded disclosure to provide greater transparency about (i) how and why an entity uses derivative instruments, (ii) how derivative instruments and related hedge items are accounted for under the Derivatives and Hedging Topic, and (iii) how derivative instruments and related hedged items affect an entity s financial condition, results of operations and cash flows. To meet those objectives, the Derivative Disclosure Guidance requires qualitative disclosures about objectives and strategies for using derivatives, quantitative disclosures about fair value amounts of gains and losses on derivative instruments and disclosures about credit risk-related contingent features in derivative agreements. The Derivative Disclosure Guidance became effective for the Company on January 1, 2009 and its adoption did not have an impact on the Company s financial statements.

***Fair Value Determination.*** In April 2009, the FASB issued guidance ( Fair Value Determination Guidance ) in the Fair Value Measurements and Disclosures Topic of the ASC regarding the determination of fair value in instances where market conditions result in either inactive markets for assets and liabilities or disorderly transactions within markets. The Fair Value Determination Guidance affirms that the objective of fair value when the market for an asset is not active is the price that would be received to sell the asset in an orderly transaction, and clarifies and includes additional factors for determining whether there has been a significant decrease in market activity for an asset when the market for that asset is not active. The Fair Value Determination Guidance requires an entity to base its conclusion about whether a transaction was not orderly on the weight of the evidence and expands certain disclosure requirements. The Fair Value Determination Guidance became effective for the Company in the quarter ended June 30, 2009, and its adoption did not have a significant impact on the Company s financial statements.

***Other-Than-Temporary Impairments.*** In April 2009, the FASB issued guidance in the Investments-Debt and Equity Securities Topic of the ASC regarding the recognition and presentation of Other-Than-Temporary Impairments ( OTTI Guidance ). The OTTI Guidance (i) changes existing guidance for determining whether an impairment is other than temporary to debt securities and (ii) replaces the existing requirement that the entity s management assert it has both the intent and ability to hold an impaired security until recovery with a requirement that management assert: (a) it does not have the intent to sell the security; and (b) it is more likely than not it will not have to sell the security before recovery of its cost basis. Under the OTTI Guidance, declines in the fair value of held-to-maturity and available-for-sale securities below their cost that are deemed to be other than temporary are reflected in earnings as realized losses to the extent the impairment is related to credit losses. The amount of the impairment related to other factors is recognized in other comprehensive income. The OTTI Guidance became effective for the Company in the quarter ended June 30, 2009, and its adoption did not have a significant impact on the Company s financial statements.

***Interim Disclosure about Fair Value of Financial Instruments.*** In April 2009, the FASB amended the Fair Value of Financial Instruments Subsection of the ASC to require an entity to provide disclosures about fair value of financial instruments in interim financial information ( Fair Value Disclosure Amendment ). The Fair Value Disclosure Amendment requires a publicly traded company to include disclosures about the fair value of its financial instruments whenever it issues summarized financial information for interim reporting periods. In addition, entities must disclose, in the body or in the accompanying notes of its summarized financial information for interim reporting periods and in its financial statements for annual reporting periods, the fair value of all financial instruments for which it is practicable to estimate that value, whether recognized or not recognized in the statement of financial condition. The Fair Value Disclosure Amendment became effective for the Company in the quarter ended June 30, 2009, and its adoption did not have a significant effect on Company s financial statements. The Company has included the disclosures required by the Fair Value Disclosure Amendment in Note 9, Fair Value Measurements.

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**FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES**
**Notes to Consolidated Financial Statements (Unaudited)**

**(1.) SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)**

***Subsequent Events.*** The Company has applied the provisions of the Subsequent Events Topic of the ASC to its consolidated interim financial statements for periods ended after June 15, 2009. The Subsequent Event Topic establishes general standards of accounting for, and disclosure of, events that occur after the balance sheet date but before financial statements are issued or available to be issued. In particular, the Subsequent Events Topic sets forth the period after the balance sheet date during which management of a reporting entity should evaluate events or transactions that may occur for potential recognition or disclosure in the financial statements. Accordingly, the Company has evaluated events and transactions occurring through November 4, 2009, the date the consolidated interim financial statements were issued, for potential recognition or disclosure in the financial statements.

**Recently Issued Accounting Pronouncements not Yet Adopted**

In June 2009, the FASB issued two related accounting pronouncements changing the accounting principles and disclosures requirements related to securitizations and special-purpose entities. Specifically, these pronouncements eliminate the concept of a qualifying special-purpose entity , change the requirements for derecognizing financial assets and change how a company determines when an entity that is insufficiently capitalized or is not controlled through voting (or similar rights) should be consolidated. These pronouncements also expand existing disclosure requirements to include more information about transfers of financial assets, including securitization transactions, and where companies have continuing exposure to the risks related to transferred financial assets. These pronouncements will be effective as of the beginning of each reporting entity s first annual reporting period that begins after November 15, 2009, for interim periods within that first annual reporting period and for interim and annual reporting periods thereafter. Earlier application is prohibited. The recognition and measurement provisions regarding transfers of financial assets shall be applied to transfers that occur on or after the effective date. These new pronouncements will be effective January 1, 2010 and are not expected to have a significant impact on the Company s financial statements.

***Disclosures about Retirement Benefits.*** Effective for fiscal years ending after December 15, 2009, the *Compensation Retirement Benefits Topic*, requires additional disclosures about employers plan assets of a defined benefit pension or other postretirement plan. The requirements include disclosing investing strategies, major categories of plan assets, concentrations of risk within plan assets, information about fair value measurements of plan assets, and valuation techniques used to measure the fair value of plan assets. Adoption of these additional requirements will not have a significant impact on the Company s financial statements.

**(2.) EARNINGS PER COMMON SHARE**

The following table presents the computation of basic and diluted earnings per common share for the three and nine months ended September 30, 2009 and 2008 (in thousands, except per share amounts). The Company uses the two-class method prescribed by the Earnings Per Share Topic of the ASC to compute earnings per common share. Participating securities include non-vested restricted stock.

| | Three months ended September 30, | | Nine months ended September 30, | |
|---|---|---|---|---|
| | **2009** | **2008** | **2009** | **2008** |
| Net income (loss) applicable to common shareholders | $ 2,482 | (28,797) | 6,234 | (24,128) |
| Less: Earnings (loss) allocated to participating securities | 18 | (224) | 52 | (175) |
| Earnings allocated to common shares outstanding | $ 2,464 | $ (28,573) | $ 6,182 | $ (23,953) |
| | 10,738 | 10,738 | 10,726 | 10,852 |

| | | | | |
|---|---|---|---|---|
| Weighted average common shares used to calculate basic EPS | | | | |
| Add: Effect of common stock equivalents | 41 | | 38 | |
| Weighted average common shares used to calculate diluted EPS | 10,779 | 10,738 | 10,764 | 10,852 |
| Earnings (loss) per common share: | | | | |
| Basic | $ 0.23 | $ (2.66) | $ 0.58 | $ (2.21) |
| Diluted | $ 0.23 | $ (2.66) | $ 0.57 | $ (2.21) |

Shares subject to the following securities were considered antidilutive and, therefore, excluded from the computation of diluted EPS:

| | | | | |
|---|---|---|---|---|
| Stock options | 553 | 452 | 528 | 423 |
| Restricted stock awards | | 31 | 14 | 24 |
| Warrant | 378 | | 378 | |
| | 931 | 483 | 920 | 447 |

All shares of restricted stock are deducted from weighted average shares outstanding for the computation of basic EPS. Shares of restricted stock, stock options, and warrant are included in the calculation of diluted EPS using the treasury stock method.

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**FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES**
**Notes to Consolidated Financial Statements (Unaudited)**

**(3.) INVESTMENT SECURITIES**

The amortized cost and fair value of investment securities are summarized below (in thousands):

| | September 30, 2009 | | | |
|---|---|---|---|---|
| | Amortized Cost | Unrealized Gains | Unrealized Losses | Fair Value |
| **Securities available for sale:** | | | | |
| U.S. Government agencies and government sponsored enterprises | $ 177,237 | $ 270 | $ 242 | $ 177,265 |
| State and political subdivisions | 86,417 | 3,258 | 3 | 89,672 |
| Mortgage-backed securities: | | | | |
| Federal National Mortgage Association | 80,254 | 1,616 | 78 | 81,792 |
| Federal Home Loan Mortgage Corporation | 51,722 | 1,078 | 17 | 52,783 |
| Government National Mortgage Association | 118,154 | 917 | 35 | 119,036 |
| Collateralized mortgage obligations: | | | | |
| Federal National Mortgage Association | 18,121 | 244 | 122 | 18,243 |
| Federal Home Loan Mortgage Corporation | 23,481 | 486 | 20 | 23,947 |
| Government National Mortgage Association | 52,325 | 40 | 68 | 52,297 |
| Privately issued | 8,825 | 464 | 361 | 8,928 |
| Total collateralized mortgage obligations | 102,752 | 1,234 | 571 | 103,415 |
| Total mortgage-backed securities | 352,882 | 4,845 | 701 | 357,026 |
| Asset-backed securities | 1,415 | 366 | | 1,781 |
| Total available for sale securities | $ 617,951 | $ 8,739 | $ 946 | $ 625,744 |
| **Securities held to maturity:** | | | | |
| State and political subdivisions | $ 45,056 | $ 1,066 | $ | $ 46,122 |

| | December 31, 2008 | | | |
|---|---|---|---|---|
| | Amortized Cost | Unrealized Gains | Unrealized Losses | Fair Value |
| **Securities available for sale:** | | | | |
| U.S. Government agencies and government sponsored enterprises | $ 67,871 | $ 609 | $ 307 | $ 68,173 |
| State and political subdivisions | 129,572 | 2,181 | 42 | 131,711 |
| Mortgage-backed securities: | | | | |
| Federal National Mortgage Association | 136,348 | 3,725 | 86 | 139,987 |
| Federal Home Loan Mortgage Corporation | 94,960 | 2,649 | 14 | 97,595 |
| Government National Mortgage Association | 1,926 | 17 | 25 | 1,918 |
| Collateralized mortgage obligations: | | | | |
| Federal National Mortgage Association | 17,856 | 74 | 642 | 17,288 |
| Federal Home Loan Mortgage Corporation | 44,838 | 334 | 214 | 44,958 |
| Government National Mortgage Association | 1,350 | 9 | | 1,359 |

| | | | | |
|---|---|---|---|---|
| Privately issued | 42,296 | 5 | 2,854 | 39,447 |
| Total collateralized mortgage obligations | 106,340 | 422 | 3,710 | 103,052 |
| Total mortgage-backed securities | 339,574 | 6,813 | 3,835 | 342,552 |
| Asset-backed securities | 3,918 | | | 3,918 |
| Equity securities | 923 | 281 | 52 | 1,152 |
| Total available for sale securities | $ 541,858 | $ 9,884 | $ 4,236 | $ 547,506 |
| **Securities held to maturity:** | | | | |
| State and political subdivisions | $ 58,532 | $ 619 | $ 4 | $ 59,147 |

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**FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES**
**Notes to Consolidated Financial Statements (Unaudited)**

**(3.) INVESTMENT SECURITIES (Continued)**

Sales of securities available for sale were as follows (in thousands):

| | Three months ended September 30, 2009 | Three months ended September 30, 2008 | Nine months ended September 30, 2009 | Nine months ended September 30, 2008 |
|---|---|---|---|---|
| Proceeds from sales | $ 45,878 | $ 4,000 | $ 144,623 | $ 51,545 |
| Gross realized gains | 1,887 | 12 | 4,860 | 235 |
| Gross realized losses | 166 | | 1,932 | 3 |

The scheduled maturities of securities available for sale and securities held to maturity at September 30, 2009 are shown below. Actual expected maturities may differ from contractual maturities because issuers may have the right to call or prepay obligations.

| | Amortized Cost | Fair Value |
|---|---|---|
| **Debt securities available for sale:** | | |
| Due in one year or less | $ 47,364 | $ 47,864 |
| Due from one to five years | 196,173 | 200,082 |
| Due after five years through ten years | 72,306 | 73,301 |
| Due after ten years | 302,108 | 304,497 |
| | $ 617,951 | $ 625,744 |
| **Debt securities held to maturity:** | | |
| Due in one year or less | $ 35,689 | $ 35,940 |
| Due from one to five years | 7,087 | 7,572 |
| Due after five years through ten years | 1,791 | 2,022 |
| Due after ten years | 489 | 588 |
| | $ 45,056 | $ 46,122 |

The following tables show the investments   gross unrealized losses and fair value, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position at September 30, 2009 and December 31, 2008 (in thousands).

| | September 30, 2009 | | | | | |
|---|---|---|---|---|---|---|
| | Less than 12 months | | 12 months or longer | | Total | |
| | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses |
| **Securities available for sale:** | | | | | | |
| U.S. Government agencies and government sponsored enterprises | $ 70,112 | $ 37 | $ 10,303 | $ 205 | $ 80,415 | $ 242 |
| State and political subdivisions | 20 | 1 | 195 | 2 | 215 | 3 |
| Mortgage-backed securities: | | | | | | |

| | | | | | | |
|---|---|---|---|---|---|---|
| Federal National Mortgage Association | 16,716 | 77 | 3 | 1 | 16,719 | 78 |
| Federal Home Loan Mortgage Corporation | 5,346 | 17 | | | 5,346 | 17 |
| Government National Mortgage Association | 13,984 | 34 | 61 | 1 | 14,045 | 35 |
| Collateralized mortgage obligations: | | | | | | |
| Federal National Mortgage Association | 374 | 1 | 5,581 | 121 | 5,955 | 122 |
| Federal Home Loan Mortgage Corporation | 569 | 2 | 888 | 18 | 1,457 | 20 |
| Government National Mortgage Association | 15,961 | 68 | | | 15,961 | 68 |
| Privately issued | | | 3,427 | 361 | 3,427 | 361 |
| Total collateralized mortgage obligations | 16,904 | 71 | 9,896 | 500 | 26,800 | 571 |
| Total mortgage-backed securities | 52,950 | 199 | 9,960 | 502 | 62,910 | 701 |
| Total available for sale securities | 123,082 | 237 | 20,458 | 709 | 143,540 | 946 |
| **Securities held to maturity:** | | | | | | |
| State and political subdivisions | | | | | | |
| **Total temporarily impaired securities** | $ 123,082 | $ 237 | $ 20,458 | $ 709 | $ 143,540 | $ 946 |

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**FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES**
**Notes to Consolidated Financial Statements (Unaudited)**
**(3.) INVESTMENT SECURITIES (Continued)**

| | December 31, 2008 | | | | | |
|---|---|---|---|---|---|---|
| | Less than 12 months | | 12 months or longer | | Total | |
| | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses |
| **Securities available for sale:** | | | | | | |
| U.S. Government agencies and government sponsored enterprises | $ 50 | $ 1 | $ 11,704 | $ 306 | $ 11,754 | $ 307 |
| State and political subdivisions | 6,191 | 41 | 84 | 1 | 6,275 | 42 |
| Mortgage-backed securities: | | | | | | |
| Federal National Mortgage Association | 10,432 | 65 | 484 | 21 | 10,916 | 86 |
| Federal Home Loan Mortgage Corporation | 5,533 | 14 | | | 5,533 | 14 |
| Government National Mortgage Association | 227 | 3 | 1,059 | 22 | 1,286 | 25 |
| Collateralized mortgage obligations: | | | | | | |
| Federal National Mortgage Association | 828 | 1 | 7,181 | 641 | 8,009 | 642 |
| Federal Home Loan Mortgage Corporation | | | 7,224 | 214 | 7,224 | 214 |
| Privately issued | 24,425 | 2,045 | 10,975 | 809 | 35,400 | 2,854 |
| Total collateralized mortgage obligations | 25,253 | 2,046 | 25,380 | 1,664 | 50,633 | 3,710 |
| Total mortgage-backed securities | 41,445 | 2,128 | 26,923 | 1,707 | 68,368 | 3,835 |
| Equity securities | 310 | 52 | | | 310 | 52 |
| Total available for sale securities | 47,996 | 2,222 | 38,711 | 2,014 | 86,707 | 4,236 |
| **Securities held to maturity:** | | | | | | |
| State and political subdivisions | 554 | 4 | | | 554 | 4 |
| **Total temporarily impaired securities** | $ 48,550 | $ 2,226 | $ 38,711 | $ 2,014 | $ 87,261 | $ 4,240 |

The Company reviews investment securities on an ongoing basis for the presence of other-than-temporary-impairment ( OTTI ) with formal reviews performed quarterly. Declines in the fair value of held-to-maturity and available-for-sale securities below their cost that are deemed to be other than temporary are reflected in earnings as realized losses to the extent the impairment is related to credit losses or the security is intended to be sold. The amount of the impairment related to other factors is recognized in other comprehensive income. Evaluating whether the impairment of a debt security is other than temporary involves assessing i.) the intent to sell the debt security or ii.) the likelihood of being required to sell the security before the recovery of its amortized cost basis. In determining whether the other-than temporary impairment includes a credit loss, the Company uses its best estimate of the present value of cash flows expected to be collected from the debt security considering factors such as: a.) the length of time and the extent to which the fair value has been less than the amortized cost basis, b.) adverse conditions specifically related to the security, an industry, or a geographic area, c.) the historical and implied volatility of the fair value of the security, d.) the payment structure of the debt security and the likelihood of the issuer being able to make payments that increase in the future, e.) failure of the issuer of the security to make scheduled interest or principal payments, f.) any changes to the rating of the security by a rating agency, and g.) recoveries or additional declines in fair value subsequent to the balance sheet date.

During the third quarter of 2009, the Company recorded OTTI charges totaling $2.3 million on 12 pooled trust preferred securities, all of which were designated as impaired due to reasons of credit quality, and one privately issued whole loan collateralized mortgage obligation ( CMO ) which the Company has determined it intends to sell.

The following summarizes the amounts of OTTI recognized during the periods presented by investment category (in thousands):

| | Three months ended September 30, | | Nine months ended September 30, | |
|---|---|---|---|---|
| | 2009 | 2008 | 2009 | 2008 |
| Mortgage-backed securities Privately issued whole loan CMOs | $ 126 | $ | $ 1,859 | $ 1,728 |
| Other asset-backed securities Trust preferred securities | 2,192 | 3,529 | 2,242 | 5,592 |
| Equity securities Auction rate securities | | 31,025 | | 31,025 |
| | $ 2,318 | $ 34,554 | $ 4,101 | $ 38,345 |

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**FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES**
**Notes to Consolidated Financial Statements (Unaudited)**

**(3.) INVESTMENT SECURITIES (Continued)**

As of September 30, 2009, management does not have the intent to sell any of the securities in a loss position and believes that it is likely that it will not be required to sell any such securities before the anticipated recovery of amortized cost. The unrealized losses are largely due to increases in market interest rates over the yields available at the time the underlying securities were purchased. The fair value is expected to recover as the bonds approach their maturity date or repricing date or if market yields for such investments decline.

Management does not believe any of the securities in a loss position are impaired due to reasons of credit quality. Accordingly, as of September 30, 2009, management has concluded that unrealized losses on its investment securities are temporary and no further impairment loss has been realized in the Company s consolidated statements of operations.

**(4.) LOANS**

Loans outstanding, including net unearned income and net deferred fees and costs of $16.3 million and $12.3 million as of September 30, 2009 and December 31, 2008, respectively, are summarized as follows (in thousands):

| | September 30, 2009 | December 31, 2008 |
|---|---|---|
| Commercial | $ 197,404 | $ 158,543 |
| Commercial real estate | 296,648 | 262,234 |
| Agricultural | 42,545 | 44,706 |
| Residential real estate | 147,447 | 177,683 |
| Consumer indirect | 345,448 | 255,054 |
| Consumer direct and home equity | 229,870 | 222,859 |
| Total loans | 1,259,362 | 1,121,079 |
| Less: Allowance for loan losses | 20,782 | 18,749 |
| Total loans, net | $ 1,238,580 | $ 1,102,330 |

**(5.) GOODWILL AND OTHER INTANGIBLE ASSETS**

The carrying amount of goodwill totaled $37.4 million as of September 30, 2009 and December 31, 2008. The Company performs a goodwill impairment test on an annual basis or more frequently if events and circumstances warrant. As of September 30, 2009, the Company performed the annual goodwill impairment test and determined that no impairment existed.

Declines in the market value of the Company s publicly traded stock price or declines in the Company s ability to generate future cash flows may i