

ARROW FINANCIAL CORP  
Form 10-K/A  
October 13, 2006

**UNITED STATES**

**SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

**FORM 10-K/A**

**Amendment No. 1**

Annual Report Pursuant to Section 13 or 15(d) of  
The Securities Exchange Act of 1934

**For the Fiscal Year Ended December 31, 2005**

**Commission File Number: 0-12507**

**ARROW FINANCIAL CORPORATION**

(Exact name of registrant as specified in its charter)

New York

(State or other jurisdiction of  
incorporation or organization)

22-2448962

(IRS Employer Identification  
Number)

250 GLEN STREET, GLENS FALLS, NEW YORK 12801

(Address of principal executive offices) (Zip Code)

Registrant's telephone number, including area code: (518) 745-1000

SECURITIES REGISTERED PURSUANT TO SECTION 12(b) OF THE ACT NONE

SECURITIES REGISTERED PURSUANT TO SECTION 12(g) OF THE ACT

Common Stock, Par Value \$1.00

(Title of Class)

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.

Yes  No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act.

Yes  No

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.

X Yes No

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III

of this Form 10-K or any amendment to this Form 10-K:

x



ARROW FINANCIAL CORPORATION

FORM 10-K/A INDEX

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Explanatory Note

This Amendment No. 1 on Form 10-K/A ("Form 10-K/A") to the Registrant's Annual Report on Form 10-K for the year ended December 31, 2005 is being filed with the U.S. Securities and Exchange Commission to restate the Registrant's consolidated financial statements as of and for the year ended December 31, 2005 for the purpose of providing a corrected Consolidated Statement of Cash Flows. The restatement of the Registrant's consolidated financial statements in this Form 10-K/A primarily corrects and reclassifies the presentation of the cash flow for acquisitions from financing activities to investing activities and reports the additional shares issued for the acquisition of a subsidiary as a supplemental disclosure to the statement of cash flow information. Except as set forth in this Form 10-K/A, all other Items included in the Registrant's Annual Report on Form 10-K for the year ended December 31, 2005 are unaffected by the changes described above and have been omitted from this amendment. The information in this Form 10-K/A is stated as of December 31, 2005 and except as specifically noted herein does not

reflect any subsequent information or events.

**Item 8. Financial Statements and Supplementary Data**

The following audited consolidated financial statements and supplementary data are submitted herewith:

Reports of Independent Registered Public Accounting Firm

Financial Statements:

Consolidated Balance Sheets

as of December 31, 2005 and 2004

Consolidated Statements of Income

for the Years Ended December 31, 2005, 2004 and 2003

Consolidated Statements of Changes in Shareholders' Equity

for the Years Ended December 31, 2005, 2004 and 2003

Consolidated Statements of Cash Flows

for the Years Ended December 31, 2005 (restated), 2004 and 2003

Notes to Consolidated Financial Statements

Supplementary Data: (Unaudited)

Summary of Quarterly Financial Data for the Years Ended December 31, 2005 and 2004

**Report of Independent Registered Public Accounting Firm**

The Board of Directors and Stockholders

of Arrow Financial Corporation:

We have audited the accompanying consolidated balance sheets of Arrow Financial Corporation and subsidiaries (the Company ) as of December 31, 2005 and 2004, and the related consolidated statements of income, changes in shareholders' equity and cash flows for each of the years in the three-year period ended December 31, 2005. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Arrow Financial Corporation and subsidiaries as of December 31, 2005 and 2004, and the results of their operations and their cash flows for each of the years in the three-year period ended December 31, 2005, in conformity with U.S. generally accepted accounting principles.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the effectiveness of the Company's internal control over financial reporting as of December 31, 2005, based on criteria established in *Internal Control - Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO), and our report dated March 13, 2006, expressed an unqualified opinion on management's assessment of, and the effective operation of, internal control over financial reporting.

As discussed in Note 1 to the consolidated financial statements, the Company has restated its financial statements for the year ended December 31, 2005.

/s/ KPMG LLP

Albany, New York

March 13, 2006, except for Note 1, as to which

the date is October 12, 2006

**Report of Independent Registered Public Accounting Firm**

The Board of Directors and Stockholders

of Arrow Financial Corporation:

We have audited management's assessment, included in the accompanying *Management's Report on Internal Control Over Financial Reporting* that Arrow Financial Corporation (the Company) maintained effective internal control over financial reporting as of December 31, 2005, based on criteria established in *Internal Control - Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). The Company's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express an opinion on management's assessment and an opinion on the effectiveness of the Company's internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, evaluating management's assessment, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.



In our opinion, management's assessment that Arrow Financial Corporation maintained effective internal control over financial reporting as of December 31, 2005, is fairly stated, in all material respects, based on criteria established in *Internal Control Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission ( COSO ). Also, in our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 2005, based on criteria established in *Internal Control Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission ( COSO ).

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheets of Arrow Financial Corporation and subsidiaries as of December 31, 2005 and 2004, and the related consolidated statements of income, changes in shareholders' equity, and cash flows for each of the years in the three-year period ended December 31, 2005, and our report dated March 13, 2006, expressed an unqualified opinion on those consolidated financial statements.

/s/ KPMG LLP

Albany, New York

March 13, 2006

## ARROW FINANCIAL CORPORATION AND SUBSIDIARIES

## CONSOLIDATED BALANCE SHEETS

(Dollars in Thousands)

	December 31,	
	<u>2005</u>	<u>2004</u>
<b>ASSETS</b>		
Cash and Due from Banks	\$ 35,558	\$ 29,805
Federal Funds Sold	<u>---</u>	<u>7,000</u>
Cash and Cash Equivalents	<u>35,558</u>	<u>36,805</u>
Securities Available-for-Sale	326,363	325,248
Securities Held-to-Maturity (Approximate Fair Value of \$118,495 in 2005 and \$111,058 in 2004)	118,123	108,117
Loans	996,545	875,311
Allowance for Loan Losses	<u>(12,241)</u>	<u>(12,046)</u>
Net Loans	984,304	863,265
Premises and Equipment, Net	15,884	14,939
Other Real Estate and Repossessed Assets, Net	124	136
Goodwill	14,452	10,717
Other Intangible Assets, Net	2,885	1,019
Other Assets	<u>21,910</u>	<u>17,703</u>
Total Assets	<u>\$1,519,603</u>	<u>\$1,377,949</u>
<b>LIABILITIES</b>		
Deposits:		
Demand	\$ 179,441	\$ 167,667
Regular Savings, N.O.W. & Money Market Deposit Accounts	610,524	607,820
Time Deposits of \$100,000 or More	154,626	85,906
Other Time Deposits	<u>221,172</u>	<u>170,887</u>
Total Deposits	<u>1,165,763</u>	<u>1,032,280</u>
Short-Term Borrowings:		
Federal Funds Purchased and Securities Sold Under Agreements to Repurchase	41,195	42,256
Other Short-Term Borrowings	1,859	1,720

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Federal Home Loan Bank Advances	157,000	150,000
Junior Subordinated Obligations Issued to Unconsolidated Subsidiary Trusts		
(Junior Subordinated Obligations)	20,000	20,000
Other Liabilities	<u>16,365</u>	<u>13,659</u>
Total Liabilities	<u>1,402,182</u>	<u>1,259,915</u>

Commitments and Contingent Liabilities (Notes 22 and 23)

**SHAREHOLDERS EQUITY**

Preferred Stock, \$5 Par Value; 1,000,000 Shares Authorized	---	---
Common Stock, \$1 Par Value; 20,000,000 Shares Authorized		
(13,883,064 Shares Issued at December 31, 2005 and		
13,478,703 Shares Issued at December 31, 2004	13,883	13,479
Surplus	139,442	127,312
Undivided Profits	21,402	23,356
Unallocated ESOP Shares (83,312 Shares in 2005		
and 93,273 Shares in 2004)	(1,163)	(1,358)
Accumulated Other Comprehensive (Loss) Income	(4,563)	429
Treasury Stock, at Cost (3,434,589 Shares at December 31,		
2005 and 3,189,452 Shares at December 31, 2004)	<u>(51,580)</u>	<u>(45,184)</u>
Total Shareholders Equity	<u>117,421</u>	<u>118,034</u>
Total Liabilities and Shareholders Equity	<u>\$1,519,603</u>	<u>\$1,377,949</u>

See Notes to Consolidated Financial Statements.



## ARROW FINANCIAL CORPORATION AND SUBSIDIARIES

## CONSOLIDATED STATEMENTS OF INCOME

(In Thousands, Except Per Share Amounts)

	Years Ended December 31,		
	<u>2005</u>	<u>2004</u>	<u>2003</u>
<b>INTEREST AND DIVIDEND INCOME</b>			
Interest and Fees on Loans	\$54,361	\$50,598	\$54,571
Interest on Federal Funds Sold	96	138	92
Interest and Dividends on Securities Available-for-Sale	13,579	13,759	12,439
Interest on Securities Held-to-Maturity	<u>4,091</u>	<u>3,948</u>	<u>3,629</u>
Total Interest and Dividend Income	<u>72,127</u>	<u>68,443</u>	<u>70,731</u>
<b>INTEREST EXPENSE</b>			
Interest on Deposits:			
Time Deposits of \$100,000 or More	3,937	1,504	1,756
Other Deposits	11,989	9,973	11,973
Interest on Short-Term Borrowings:			
Federal Funds Purchased and Securities Sold			
Under Agreements to Repurchase	725	369	356
Other Short-Term Borrowings	21	9	7
Federal Home Loan Bank Advances	6,243	6,207	6,751
Guaranteed Preferred Beneficial Interests in			
Corporation's Junior Subordinated Debentures	<u>1,199</u>	<u>1,144</u>	<u>767</u>
Total Interest Expense	<u>24,114</u>	<u>19,206</u>	<u>21,610</u>
<b>NET INTEREST INCOME</b>	48,013	49,237	49,121
Provision for Loan Losses	<u>1,030</u>	<u>1,020</u>	<u>1,460</u>
<b>NET INTEREST INCOME AFTER</b>			
<b>PROVISION FOR LOAN LOSSES</b>	<u>46,983</u>	<u>48,217</u>	<u>47,661</u>
<b>OTHER INCOME</b>			
Income from Fiduciary Activities	4,676	4,226	3,647
Fees for Other Services to Customers	7,372	7,512	6,776
Net Gains on Securities Transactions	364	362	755
Insurance Commissions	1,682	261	16
Other Operating Income	<u>854</u>	<u>831</u>	<u>1,153</u>
Total Other Income	<u>14,948</u>	<u>13,192</u>	<u>12,347</u>

**OTHER EXPENSE**

Salaries and Employee Benefits	20,693	19,824	18,967
Occupancy Expense of Premises, Net	2,914	2,695	2,524
Furniture and Equipment Expense	2,875	2,648	2,774
Other Operating Expense	<u>8,707</u>	<u>7,805</u>	<u>8,220</u>
Total Other Expense	<u>35,189</u>	<u>32,972</u>	<u>32,485</u>

**INCOME BEFORE PROVISION FOR INCOME TAXES**

	26,742	28,437	27,523
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Provision for Income Taxes	<u>8,103</u>	<u>8,959</u>	<u>8,606</u>
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<b>NET INCOME</b>	<u>\$18,639</u>	<u>\$19,478</u>	<u>\$18,917</u>
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## Average Shares Outstanding:

Basic	10,420	10,426	10,452
Diluted	10,596	10,675	10,693

## Earnings Per Common Share:

Basic	\$ 1.79	\$ 1.87	\$ 1.81
Diluted	1.76	1.82	1.77

All share and per share amounts have been adjusted for the 2005 3% stock dividend.

See Notes to Consolidated Financial Statements.



## ARROW FINANCIAL CORPORATION AND SUBSIDIARIES

## CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS EQUITY, Continued

(In Thousands, Except Share and Per Share Amounts)

	Common Shares <u>Issued</u>	Common <u>Stock</u>	<u>Surplus</u>	Undivided <u>Profits</u>	Unallo- cated ESOP <u>Shares</u>	Accumulated Other Com- prehensive Income <u>(Loss)</u>	Treasury <u>Stock</u>	<u>Total</u>
Balance at December 31, 2002	10,468,895	\$10,469	\$115,110	\$13,611	\$(1,822)	\$ 3,253	\$(39,219)	\$101,402
Comprehensive Income, Net of Tax:								
Net Income	---	---	---	18,917	---	---	---	<u>18,917</u>
Decrease in Additional Pension  Liability Over Unrecognized								
Prior Service Cost (Pre-tax \$726)	---	---	---	---	---	436	---	436
Net Unrealized Securities Holding  Losses Arising During the Period,								
Net of Tax (Pre-tax \$3,578)	---	---	---	---	---	(2,151)	---	(2,151)
Reclassification Adjustment for  Net Securities Gains Included	---	---	---	---	---	(454)	---	<u>(454)</u>



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in Net Income, Net  
of Tax

(Pre-tax \$755)								
Other								
Comprehensive Loss								<u>(2,169)</u>
Comprehensive								
Income								<u>16,748</u>
Five for Four Stock								
Split	2,617,224	2,617	(2,617)	---	---	---	---	---
Cash Dividends Paid,								
\$ .79 per Share	---	---	---	(8,225)	---	---	---	(8,225)
Stock Options								
Exercised								
(55,150 Shares)	---	---	265	---	---	---	378	643
Shares Issued Under								
the Directors' Stock								
Plan (2,253 Shares)	---	---	41	---	---	---	16	57
Shares Issued Under								
the Employee Stock								
Purchase Plan								
(29,026 Shares)	---	---	389	---	---	---	209	598
Tax Benefit for								
Disposition of								
Stock Options	---	---	109	---	---	---	---	109
Purchase of Treasury								
Stock								
(234,357 Shares)	---	---	---	---	---	---	(5,558)	(5,558)
Allocation of ESOP								
Stock (4,254 Shares)	<u>---</u>	<u>---</u>	<u>38</u>	<u>---</u>	<u>53</u>	<u>---</u>	<u>---</u>	<u>91</u>
Balance at December								
31, 2003	<u>13,086,119</u>	<u>\$13,086</u>	<u>\$113,335</u>	<u>\$24,303</u>	<u>\$(1,769)</u>	<u>\$ 1,084</u>	<u>\$(44,174)</u>	<u>\$105,865</u>

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## ARROW FINANCIAL CORPORATION AND SUBSIDIARIES

## CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS EQUITY, Continued

(In Thousands, Except Share and Per Share Amounts)

	Common Shares <u>Issued</u>	Common Stock <u>Stock</u>	Surplus <u>Surplus</u>	Undivided Profits <u>Profits</u>	Unallo- cated ESOP Shares <u>Shares</u>	Accumulated Other Com- prehensive Income <u>(Loss)</u>	Treasury Stock <u>Stock</u>	<u>Total</u>
Balance at December 31, 2003	13,086,119	\$13,086	\$113,335	\$24,303	\$(1,769)	\$ 1,084	\$(44,174)	\$105,865
Comprehensive Income, Net of Tax:								
Net Income	---	---	---	19,478	---	---	---	<u>19,478</u>
Increase in Additional Pension  Liability Over Unrecognized  Prior Service Cost (Pre-tax \$131)	---	---	---	---	---	(79)	---	(79)
Net Unrealized Securities Holding  Losses Arising During the Period,  Net of Tax (Pre-tax \$602)	---	---	---	---	---	(362)	---	(362)
Reclassification Adjustment for  Net Securities Gains Included	---	---	---	---	---	(214)	---	<u>(214)</u>

in Net Income, Net  
of Tax

(Pre-tax \$362)								
Other Comprehensive Loss								<u>(655)</u>
Comprehensive Income								<u>18,823</u>
3% Stock Dividend	392,584	393	11,032	(11,425)	---	---	---	---
Cash Dividends Paid, \$.86 per Share	---	---	---	(9,000)	---	---	---	(9,000)
Stock Options Exercised								
(98,104 Shares)	---	---	243	---	---	---	750	993
Shares Issued Under the Directors' Stock								
Plan (2,533 Shares)	---	---	56	---	---	---	19	75
Shares Issued Under the Employee Stock								
Purchase Plan (24,776 Shares)	---	---	405	---	---	---	193	598
Tax Benefit for Disposition of								
Stock Options	---	---	409	---	---	---	---	409
Purchase of Treasury Stock								
(89,554 Shares)	---	---	---	---	---	---	(2,453)	(2,453)
Acquisition of Subsidiary (62,805 Shares)	---	---	1,427	---	---	---	481	1,908
Allocation of ESOP Stock (29,626 Shares)	---	---	405	---	411	---	---	816
Balance at December 31, 2004	<u>13,478,703</u>	<u>\$13,479</u>	<u>\$127,312</u>	<u>\$23,356</u>	<u>\$(1,358)</u>	<u>\$ 429</u>	<u>\$(45,184)</u>	<u>\$118,034</u>

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See Notes to Consolidated Financial Statements.

## ARROW FINANCIAL CORPORATION AND SUBSIDIARIES

## CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS EQUITY, Continued

(In Thousands, Except Share and Per Share Amounts)

	Common Shares Issued	Common Stock	Undivided Surplus	Undivided Profits	Unallo- cated ESOP Shares	Accumulated Other Com- prehensive Income _(Loss)	Treasury Stock	Total
Balance at December 31, 2004	13,478,703	\$13,479	\$127,312	\$23,356	\$(1,358)	\$ 429	\$(45,184)	\$118,034
Comprehensive Income, Net of Tax:								
Net Income	---	---	---	18,639	---	---	---	<u>18,639</u>
Increase in Additional Pension  Liability Over Unrecognized  Prior Service Cost (Pre-tax \$742) Net Unrealized Securities Holding  Losses Arising During the Period,  Net of Tax (Pre-tax \$7,197) Reclassification Adjustment for  Net Securities Gains Included								
	---	---	---	---	---	(446)	---	(446)
	---	---	---	---	---	(4,327)	---	(4,327)
	---	---	---	---	---	(219)	---	<u>(219)</u>

in Net Income, Net  
of Tax

(Pre-tax \$364)								
Other Comprehensive Loss								<u>(4,992)</u>
Comprehensive Income								<u>13,647</u>
3% Stock Dividend	404,361	404	10,631	(11,035)	---	---	---	---
Cash Dividends Paid, \$.92 per Share	---	---	---	(9,558)	---	---	---	(9,558)
Stock Options Exercised								
(95,849 Shares)	---	---	117	---	---	---	864	981
Shares Issued Under the Directors' Stock								
Plan (4,381 Shares)	---	---	81	---	---	---	39	120
Shares Issued Under the Employee Stock								
Purchase Plan (22,243 Shares)	---	---	377	---	---	---	200	577
Tax Benefit for Disposition of								
Stock Options	---	---	684	---	---	---	---	684
Purchase of Treasury Stock								
(270,659 Shares)	---	---	---	---	---	---	(7,528)	(7,528)
Acquisition of Subsidiary (3,227 Shares)	---	---	62	---	---	---	29	91
Allocation of ESOP Stock (13,397 Shares)	---	---	<u>178</u>	---	<u>195</u>	---	---	<u>373</u>
Balance at December 31, 2005	<u>13,883,064</u>	<u>\$13,883</u>	<u>\$139,442</u>	<u>\$21,402</u>	<u>\$(1,163)</u>	<u>\$(4,563)</u>	<u>\$(51,580)</u>	<u>\$117,421</u>

Per share amounts and share data have been adjusted for subsequent stock splits and dividends, including the most recent 2005 3% stock dividend.

Included in the shares issued for the stock dividend in 2005 were treasury shares of 100,145 and unallocated ESOP shares of 2,436.

See Notes to Consolidated Financial Statements.



## ARROW FINANCIAL CORPORATION AND SUBSIDIARIES

## CONSOLIDATED STATEMENTS OF CASH FLOWS

(Dollars in Thousands)

	Years Ended December 31,		
	2005	2004	2003
<b>Operating Activities:</b>	<u>(Restated)</u>	<u>2004</u>	<u>2003</u>
Net Income	\$ 18,639	\$ 19,478	\$ 18,917
Adjustments to Reconcile Net Income to Net Cash Provided by Operating Activities:			
Provision for Loan Losses	1,030	1,020	1,460
Depreciation and Amortization	2,807	3,150	4,912
Compensation Expense for Allocated ESOP Shares	195	405	91
Gains on the Sale of Securities Available-for-Sale	(372)	(532)	(988)
Losses on the Sale of Securities Available-for-Sale	8	170	233
Loans Originated and Held-for-Sale	(8,581)	(17,675)	(18,049)
Proceeds from the Sale of Loans Held-for-Sale	8,632	18,078	18,539
Net Gains on the Sale of Loans	(122)	(336)	(489)
Net (Gains) Losses on the Sale of Premises and			
Equipment and Other Real Estate Owned and Repossessed Assets	(32)	93	152
Deferred Income Tax Expense	190	597	2,231
Shares Issued Under the Directors' Stock Plan	120	75	57
Net Increase in Other Assets	(1,680)	(856)	(3,013)
Net Increase (Decrease) in Other Liabilities	<u>2,938</u>	<u>(2,053)</u>	<u>1,989</u>
<b>Net Cash Provided By Operating Activities</b>	<u>23,772</u>	<u>21,614</u>	<u>26,042</u>
<b>Investing Activities:</b>			
Proceeds from the Sale of Securities Available-for-Sale	50,289	39,337	122,458
Proceeds from the Maturities and Calls of Securities Available-for-Sale	31,840	57,168	152,763
Purchases of Securities Available-for-Sale	(91,534)	(73,883)	(294,011)
Proceeds from the Maturities of Securities Held-to-Maturity	8,481	4,851	2,116
Purchases of Securities Held-to-Maturity	(18,688)	(7,402)	(33,477)
Net Increase in Loans	(114,525)	(21,944)	(57,198)
Proceeds from the Sales of Premises and Equipment and Other			
Real Estate Owned and Repossessed Assets	939	891	874

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Purchase of Premises and Equipment	(1,587)	(1,846)	(1,531)
Acquisition of Subsidiary	---	31	---
Net Increase from Branch Acquisitions	<u>47,083</u>	<u>---</u>	<u>---</u>
<b>Net Cash Used In Investing Activities</b>	<b><u>(87,702)</u></b>	<b><u>(2,797)</u></b>	<b><u>(108,006)</u></b>

**Financing Activities:**

Net Increase (Decrease) in Deposits	71,271	(14,336)	88,144
Net (Decrease) Increase in Short-Term Borrowings	(922)	3,040	(7,562)
Proceeds from Federal Home Loan Bank Advances	162,000	79,800	40,000
Repayments of Federal Home Loan Bank Advances	(155,000)	(79,800)	(35,000)
Repayment of Trust Preferred Securities	---	(5,000)	---
Proceeds from Issuance of Trust Preferred Securities	---	10,000	10,000
Purchase of Treasury Stock	(7,528)	(2,453)	(5,558)
Exercise of Stock Options and Shares Issued to Employees Stock Purchase Plan	1,558	1,591	---
Tax Benefit for Disposition of Stock Options	684	409	1,241
Common Stock Purchased by ESOP	178	411	109
Cash Dividends Paid	<u>(9,558)</u>	<u>(9,000)</u>	<u>(8,225)</u>
<b>Net Cash Provided By (Used In) Financing Activities</b>	<b><u>62,683</u></b>	<b><u>(15,338)</u></b>	<b><u>83,149</u></b>
<b>Net (Decrease) Increase in Cash and Cash Equivalents</b>	<b>(1,247)</b>	<b>3,479</b>	<b>1,185</b>
Cash and Cash Equivalents at Beginning of Year	<u>36,805</u>	<u>33,326</u>	<u>32,141</u>
<b>Cash and Cash Equivalents at End of Year</b>	<b><u>\$35,558</u></b>	<b><u>\$36,805</u></b>	<b><u>\$33,326</u></b>

**Supplemental Disclosures to Statements of Cash Flow Information:**

Cash Paid During the Year for:			
Interest on Deposits and Borrowings	\$22,933	\$19,332	\$22,055
Income Taxes	6,447	10,228	1,224
Non-cash Investing Activity:			
Transfer of Loans to Other Real Estate Owned and Repossessed Assets	893	928	990
Shares Issued for Acquisition	91	1,908	---
Loans Securitized and Transferred to Securities Available-for-Sale	---	---	11,512
Decrease in Trust Preferred Securities	---	---	(15,000)
Increase in Junior Subordinated Obligations	---	---	15,000
Increase in Other Assets Representing Investment in Subsidiary Trusts	---	---	(465)
Increase in Deposits Representing Cash Held at Subsidiary Banks by Subsidiary Trusts	---	---	465
See Notes to Consolidated Financial Statements			



## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

### NOTE 1:

#### SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (In Thousands, Except Per Share Amounts)

Arrow Financial Corporation ( Arrow ) is a bank holding company organized in 1983 under the laws of New York and registered under the Bank Holding Company Act of 1956. The accounting and reporting policies of Arrow Financial Corporation and its subsidiaries conform to accounting principles generally accepted in the United States of America and general practices within the banking industry in all material respects.

**Principles of Consolidation** - The financial statements of Arrow and its wholly owned subsidiaries are consolidated and all material inter-company transactions have been eliminated. In the Parent Company Only financial statements in Note 25, the investment in wholly owned subsidiaries is carried under the equity method of accounting. When necessary, prior years consolidated financial statements have been reclassified to conform with the current-year financial statement presentation.

**Cash and Cash Equivalents** - Cash and cash equivalents include the following items: cash at branches, due from bank balances, cash items in the process of collection and federal funds sold.

**Restatement of the Consolidated Statement of Cash Flows** - During the third quarter of 2006, Arrow determined that it was necessary to restate our previously issued financial statements for the year ended December 31, 2005 to correct certain misclassifications in the Consolidated Statement of Cash Flows.

The restatement principally involves the reclassification of certain cash flows related to Arrow's acquisition of three HSBC Bank U.S.A., N.A. branches in the second quarter of 2005. Those cash flows, totaling \$47,083, should have been presented as investing activities as opposed to financing activities in the Consolidated Statement of Cash Flows for the year ended December 31, 2005. The reclassification of these cash flows affects the subtotals of cash flows from investing and financing activities but does not affect the total amount of net increase (decrease) in cash and cash equivalents as presented in the 2005 Consolidated Statement of Cash Flows. Two additional items are also reclassified on the Consolidated Statements of Cash Flows, altering subtotals of cash flows. A total of \$31 of net cash received in Arrow's acquisition of Capital Financial Group, Inc. in 2004 has been reclassified out of financing activities to investing activities in the 2004 Consolidated Statement of Cash Flows and \$91 of additional share value issued by us in the first quarter of 2005, related to the same acquisition, has been reclassified out of financing activities and reflected as a supplemental disclosure with a commensurate increase of \$91 to the line item, Increase in Other Assets under operating activities in the 2005 Consolidated Statement of Cash Flows. Again, even though these reclassifications affect the subtotals of cash flows from operating, investing and financing activities in the respective

Consolidated Statements of Cash Flows, collectively they have no impact on the net increase (decrease) in total cash and cash equivalents set forth in the Consolidated Statements.

In addition to the foregoing, in the previously filed Consolidated Statement of Cash Flows for the year ended December 31, 2005, under operating activities, the line item (Increase) Decrease in Interest Receivable incorrectly excluded an amount, (\$532), that was instead included under Increase in Other Assets, and the line item Increase (Decrease) in Interest Payable incorrectly excluded an amount, \$914, that was instead included under Increase (Decrease) in Other Liabilities. Under supplemental disclosures, Cash Paid During the Year for Interest on Deposits and Borrowings incorrectly included an amount, \$914, that was a correction commensurate to the change identified in the previous sentence.

In order to conform to common industry presentation practice, and more readily correspond to changes in balance sheet captions, Arrow has combined in the restated Consolidated Statements of Cash Flows, and will combine in future filed Consolidated Statements of Cash Flows, the line item (Increase) Decrease in Interest Receivable and Increase in Other Assets into a single line item, Net Increase in Other Assets and will combine the line items Increase (Decrease) in Interest Payable and Increase (Decrease) in Other Liabilities into a single line item Net Increase (Decrease) in Other Liabilities. The combination of these line items, for all periods presented, has no effect on the amount of net cash provided by operating activities as disclosed in the previously filed Consolidated Statements of Cash Flows.

The restatement does not affect Arrow's Consolidated Statements of Income, Consolidated Balance Sheets or Consolidated Statements of Changes in Stockholders' Equity for any of the affected periods. Accordingly, Arrow's previously reported net income, earnings per share, total assets and regulatory capital as of and for the years ended December 31, 2005 and 2004 remain unchanged.

The Consolidated Statement of Cash Flows for the year ended December 31, 2005, as previously reported and as restated, is reflected on the following table:

**NOTE 1:****SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)****ARROW FINANCIAL CORPORATION AND SUBSIDIARIES****CONSOLIDATED STATEMENT OF CASH FLOWS**

(Dollars in Thousands)

	Year Ended December 31,	
	2005	2005
	(As Previously Reported)	(Restated)
<b>Operating Activities:</b>		
Net Income	\$ 18,639	\$ 18,639
Adjustments to Reconcile Net Income to Net Cash Provided by Operating Activities:		
Provision for Loan Losses	1,030	1,030
Depreciation and Amortization	2,807	2,807
Compensation Expense for Allocated ESOP Shares	195	195
Gains on the Sale of Securities Available-for-Sale	(372)	(372)
Losses on the Sale of Securities Available-for-Sale	8	8
Loans Originated and Held-for-Sale	(8,581)	(8,581)
Proceeds from the Sale of Loans Held-for-Sale	8,632	8,632
Net Gains on the Sale of Loans	(122)	(122)
Net (Gains) Losses on the Sale of Premises and Equipment and Other Real Estate Owned and Repossessed Assets	(32)	(32)
Deferred Income Tax Expense	190	190
Shares Issued Under the Directors' Stock Plan	120	120
(Increase) Decrease in Interest Receivable	(532)	---
Increase (Decrease) in Interest Payable	267	---
Increase in Other Assets	(1,239)	---
Increase (Decrease) in Other Liabilities	2,671	---
Net Increase in Other Assets	---	(1,680)
Net Increase (Decrease) in Other Liabilities	---	2,938
<b>Net Cash Provided By Operating Activities</b>	<u>23,681</u>	<u>23,772</u>

**Investing Activities:**

Proceeds from the Sale of Securities Available-for-Sale	50,289	50,289
Proceeds from the Maturities and Calls of Securities Available-for-Sale	31,840	31,840
Purchases of Securities Available-for-Sale	(91,534)	(91,534)
Proceeds from the Maturities of Securities Held-to-Maturity	8,481	8,481
Purchases of Securities Held-to-Maturity	(18,688)	(18,688)
Net Increase in Loans	(114,525)	(114,525)
Proceeds from the Sales of Premises and Equipment and Other		
Real Estate Owned and Repossessed Assets	939	939
Purchase of Premises and Equipment	(1,587)	(1,587)
Net Increase from Branch Acquisitions	---	<u>47,083</u>
<b>Net Cash Used In Investing Activities</b>	<u>(134,785)</u>	<u>(87,702)</u>

**Financing Activities:**

Net Increase (Decrease) in Deposits	71,271	71,271
Net (Decrease) Increase in Short-Term Borrowings	(922)	(922)
Proceeds from Federal Home Loan Bank Advances	162,000	162,000
Repayments of Federal Home Loan Bank Advances	(155,000)	(155,000)
Purchase of Treasury Stock	(7,528)	(7,528)
Net Increase from Branch Acquisitions	47,083	---
Exercise of Stock Options and Shares Issued to Employees Stock Purchase Plan	1,558	1,558
Tax Benefit for Disposition of Stock Options	684	684
Acquisition of Subsidiary	91	---
Common Stock Purchased by ESOP	178	178
Cash Dividends Paid	<u>(9,558)</u>	<u>(9,558)</u>
<b>Net Cash Provided By Financing Activities</b>	<u>109,857</u>	<u>62,683</u>
<b>Net (Decrease) Increase in Cash and Cash Equivalents</b>	<u>(1,247)</u>	<u>(1,247)</u>
Cash and Cash Equivalents at Beginning of Year	<u>36,805</u>	<u>36,805</u>
<b>Cash and Cash Equivalents at End of Year</b>	<u>\$35,558</u>	<u>\$35,558</u>

**Supplemental Disclosures to Statement of Cash Flow Information:**

Cash Paid During the Year for:		
Interest on Deposits and Borrowings	\$23,847	\$22,933
Income Taxes	6,447	6,447
Non-cash Investing Activity:		
Transfer of Loans to Other Real Estate Owned and Repossessed Assets	893	893
Shares Issued for Acquisition	---	91





**NOTE 1:**

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

**Securities** - Management determines the appropriate classification of securities at the time of purchase. Securities reported as held-to-maturity are those debt securities which Arrow has both the positive intent and ability to hold to maturity and are stated at amortized cost. Securities available-for-sale are reported at fair value, with unrealized gains and losses reported in accumulated other comprehensive income or loss, net of taxes. Realized gains and losses are based upon the amortized cost of the specific security sold. Any unrealized losses on securities which reflect a decline in value which is other than temporary are charged to income. The cost of securities is adjusted for amortization of premium and accretion of discount, which is calculated on an effective interest rate method.

**Loans and Allowance for Loan Losses** - Interest income on loans is accrued and credited to income based upon the principal amount outstanding. Loan fees and costs directly associated with loan originations are deferred and amortized as an adjustment to yield over the lives of the loans originated.

From time to time, Arrow has sold (with servicing retained) residential real estate loans at or shortly after origination. At any point, the amount of loans pending settlement are not material, as well as any loan commitments on loans intended for sale (which under Statement of Financial Accounting Standards ( SFAS ) No. 133 Accounting for Derivative Instruments and Hedging Activities are considered derivatives). All student loans are sold to Sallie Mae (along with servicing) at origination. Any gain or loss on the sale of loans is recognized at the time of sale as the difference between the recorded basis in the loan and net proceeds from the sale.

Loans are placed on nonaccrual status either due to the delinquency status of principal and/or interest (generally when past due 90 or more days) or a judgment by management that the full repayment of principal and interest is unlikely.

The allowance for loan losses is maintained by charges to operations based upon an evaluation of the loan portfolio, current economic conditions, past loan losses and other factors. Provisions to the allowance for loan losses are offset by actual loan charge-offs (net of any recoveries). In general, when loans are 120 days past due, an evaluation of estimated proceeds from the liquidation of the loan's collateral is compared to the loan carrying amount and a charge to the allowance for loan losses is taken for any deficiency. In management's opinion, the balance of the allowance for loan losses, at each balance sheet date, is sufficient to provide for probable loan losses. While management uses available information to recognize losses on loans, future additions to the allowance may be necessary based on changes in economic conditions in Arrow's market area. In addition, various Federal and State regulatory agencies, as an integral part of their examination process, review Arrow's allowance for loan losses. Such agencies may require Arrow to recognize additions to the allowance in future periods, based on their judgments about information available to them at the time of their examination, which may not be currently available to management.

Arrow accounts for impaired loans under SFAS No. 114, "Accounting by Creditors for Impairment of a Loan." SFAS No. 114, as amended, which requires that impaired loans, except for large groups of smaller-balance homogeneous loans, be measured based on the present value of expected future cash flows discounted at the loan's effective interest rate, the loan's observable market price or the fair value of the collateral if the loan is collateral dependent. If the measurement of the impaired loan is less than the recorded investment in the loan, an impairment reserve is recognized as part of the allowance for loan losses.

**NOTE 1:**

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

Arrow applies the provisions of SFAS No. 114 to all impaired commercial and commercial real estate loans over \$250, and to all loans restructured subsequent to the adoption of SFAS No. 114. Allowances for loan losses for the remaining loans are recognized in accordance with SFAS No. 5. Under the provisions of SFAS No. 114, Arrow determines impairment for collateralized loans based on fair value of the collateral less estimated costs to sell. For other loans, impairment is determined by comparing the recorded investment in the loan to the present value of the expected cash flows, discounted at the loan's effective interest rate. Arrow determines the interest income recognition method on a loan-by-loan basis. Based upon the borrowers' payment histories and cash flow projections, interest recognition methods include full accrual or cash basis.

**Other Real Estate Owned and Repossessed Assets** - Real estate acquired by foreclosure and assets acquired by repossession are recorded at the lower of the recorded investment in the loan or the fair value of the property less estimated costs to sell. Subsequent declines in fair value, after transfer to other real estate owned and repossessed assets, are recognized through a valuation allowance. Such declines in fair value along with related operating expenses to administer such properties or assets are charged directly to operating expense.

**Premises and Equipment** - Premises and equipment are stated at cost, less accumulated depreciation and amortization. Depreciation and amortization included in operating expenses are computed largely on the straight-line method. The provision is based on the estimated useful lives of the assets and, in the case of leasehold improvements, amortization is computed over the terms of the respective leases or their estimated useful lives, whichever is shorter. Gains or losses on disposition are reflected in earnings.

**Income Taxes** - Arrow accounts for income taxes under the asset and liability method required by SFAS No. 109. Deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income tax expense in the period that includes the enactment date. Arrow's policy is that deferred tax assets are reduced by a valuation allowance if, based on the weight of available evidence, it is more likely than not that some or all of the deferred tax assets will not be realized.

**Goodwill and Other Intangible Assets** - Arrow adopted SFAS No. 147, "Acquisitions of Certain Financial Institutions," during the quarter ended September 30, 2002. SFAS No. 147 affects the accounting for an unidentifiable intangible asset acquired in the acquisition of a bank or thrift (including acquisitions of branches), where the fair value

of the liabilities assumed exceeded the fair value of the assets acquired. Under SFAS No. 147, if such a transaction met the criteria for a business combination, the carrying amount of the unidentifiable intangible asset is reclassified to goodwill (reclassified goodwill) as of the date SFAS No. 142 was applied in its entirety, which for Arrow was January 1, 2002. The carrying amounts of any recognized intangible assets that meet the recognition criteria of SFAS No. 141 that have been included in the amount reported as an unidentifiable intangible asset, and for which separate accounting records have been maintained, should be accounted for apart from the unidentifiable intangible asset and should not be reclassified to goodwill. The reclassified goodwill should be accounted for and reported prospectively as goodwill under SFAS No. 142, for which amortization is not required, but which must be evaluated annually for impairment. Annually, we test for any impairment of goodwill and other intangible assets by comparing the carrying amount of those assets to the fair value of each reporting unit's intangible assets, applying rates derived from recent actual transactions.

In April 2005, Arrow completed the cash purchase of three branches from HSBC Bank USA, N.A. Arrow recorded the following intangible assets as a result of the acquisition: goodwill (\$3,690) and core deposit intangible asset (\$2,247). The value of the core deposit intangible asset is being amortized over ten years.

In November 2004, Arrow acquired all of the outstanding shares of common stock of CFG in a tax-free exchange for Arrow's common stock (62,805 shares, as restated for stock dividends). As adjusted for subsequent contingency payments, Arrow recorded the following intangible assets as a result of the acquisition (none of which are deductible for income tax purposes): goodwill (\$1,460), covenant (\$117) and expirations (\$686). The value of the covenant is being amortized over five years and the value of the expirations is being amortized over twenty years. The agreement provides for annual contingent future payments of Company stock, based upon earnings, over a five-year period. Management has concluded that, under criteria established by SFAS No. 141, these payments will be recorded as additional goodwill at the time of payment. The amount of additional goodwill recorded in 2005 was \$91 (3,227 shares).

**NOTE 1:**

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

The carrying amounts of other recognized intangible assets that meet the recognition criteria of SFAS No. 141 and for which separate accounting records have been maintained (core deposit intangibles and mortgage servicing rights), have been included in the consolidated balance sheet as Other Intangible Assets, Net. Core deposit intangibles are being amortized on a straight-line basis over a period of ten to fifteen years.

Arrow has sold residential real estate loans (primarily to Freddie Mac) with servicing retained. Arrow accounts for mortgage servicing rights under SFAS No. 140 Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities. Mortgage servicing rights are recognized as an asset when loans are sold with servicing retained, by allocating the cost of an originated mortgage loan between the loan and servicing right based on estimated relative fair values. The cost allocated to the servicing right is capitalized as a separate asset and amortized in proportion to, and over the period of, estimated net servicing income. Capitalized mortgage servicing rights are evaluated for impairment by comparing the asset's carrying value to its current estimated fair value. Fair values are estimated using a discounted cash flow approach, which considers future servicing income and costs, current market interest rates, and anticipated prepayment, and default rates. Impairment losses are recognized through a valuation allowance for servicing rights having a current fair value that is less than amortized cost. Adjustments to increase (decrease) the valuation allowance are charged (credited) to income as a component of other operating income. There was no allowance for impairment losses at December 31, 2005 or 2004.

**Pension and Postretirement Benefits** - Arrow maintains a non-contributory, defined benefit pension plan covering substantially all employees, as well as a supplemental pension plan covering certain executive officers selected by the Board of Directors. The costs of these plans, based on actuarial computations of current and future benefits for employees, are charged to current operating expenses. Arrow also provides certain post-retirement medical, dental and life insurance benefits to substantially all employees and retirees. The cost of post-retirement benefits other than pensions is recognized on an accrual basis as employees perform services to earn the benefits.

**Stock-Based Compensation Plans** Arrow also sponsors an Employee Stock Purchase Plan ( ESPP ) under which employees purchased Arrow's common stock at a 15% discount below market price at the time of purchase for the first two months of 2005 and prior to then. This discount was changed to 5% discount below market price for all subsequent purchases. Under APB 25, a plan with a discount of 15% or less is not considered compensatory and expense is not recognized. Under SFAS No. 123, however, a stock purchase plan with a discount in excess of 5% is considered a compensatory plan and thus the ESPP was considered a compensatory plan for the first two months of 2005, and the entire discount for that period was considered compensation expense in the pro forma disclosures set forth below.

Arrow has two stock option plans, which are described more fully in Notes 17 and 18. Arrow accounted for those plans under the recognition and measurement principles of APB Opinion No. 25, *Accounting for Stock Issued to Employees*, and related Interpretations. Prior to 2006, no stock-based employee compensation cost is reflected in net income, as all options granted under those plans have an exercise price equal to the market value of the underlying common stock on the date of grant. However, options granted did impact diluted earnings per share by increasing the weighted average diluted shares outstanding and thereby decreasing diluted earnings per share as compared to basic earnings per share. See also Note 14. Beginning in 2006, one of the provisions of FASB Statement 123(R), *Accounting for Stock-Based Compensation*, requires that a company expense, at grant date, the fair value of options granted. This requirement was optional under SFAS No. 123.

**NOTE 1:****SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)**

In December 2005, Arrow's Compensation Committee of the Board of Directors accelerated the vesting for all the remaining unvested shares from stock options granted in 2002 through 2004. The action to accelerate the vesting of the stock options was made to eliminate the non-cash compensation expense that would otherwise have been recognized by the Company in the 2006-2008 period, due to the required adoption of FASB Statement 123(R) on January 1, 2006. The cost of accelerating the vesting, in the 2005 period, that would have been recognized under FASB Statement No. 123 is reflected in the following table, which illustrates the effect on net income and earnings per share if Arrow had applied the fair value recognition provisions of SFAS No. 123 to stock-based employee compensation.

	Year Ended December 31,		
	<u>2005</u>	<u>2004</u>	<u>2003</u>
Net Income, as Reported	<b>\$18,639</b>	\$19,478	\$18,917
Deduct: Total stock-based employee compensation expense			
determined under fair value based method for all awards, net of			
related tax effects	<u>944</u>	<u>553</u>	<u>426</u>
Pro Forma Net Income	<b>\$17,695</b>	<b>\$18,925</b>	<b>\$18,491</b>
Earnings per Share:			
Basic - as Reported	<b>\$1.79</b>	\$1.87	\$1.81
Basic - Pro Forma	<b>1.70</b>	1.82	1.77
Diluted - as Reported	<b>1.76</b>	1.82	1.77
Diluted - Pro Forma	<b>1.67</b>	1.77	1.73

No options were granted in 2005. The weighted-average fair value of options granted during 2004 and 2003 was \$8.01 and \$6.12, respectively. The fair value of each option grant is estimated on the date of grant using the Black-Scholes option-pricing model with the following weighted-average assumptions used for grants in 2004 and 2003, respectively: dividend yields of 2.88% and 3.28%; expected volatility of 28.4% and 27.2%; risk free interest rates of 3.78% and 3.76%; and expected lives of 7.0 years for each year. The effects of applying SFAS No. 123 on the pro forma net income may not be representative of the effects of future grants on pro forma net income for future years.

**Securities Sold Under Agreements to Repurchase** - In securities repurchase agreements, Arrow receives cash from a counterparty in exchange for the transfer of securities to a third party custodian's account that explicitly recognizes Arrow's interest in the securities. These agreements are accounted for by Arrow as secured financing transactions, since it maintains effective control over the transferred securities, and meets other criteria for such accounting as specified in SFAS No. 140. Accordingly, the cash proceeds are recorded as borrowed funds, and the underlying securities continue to be carried in Arrow's securities available-for-sale portfolio.

**Earnings Per Share ( EPS )** - Basic EPS excludes dilution and is computed by dividing income available to common stockholders by the weighted average number of common shares outstanding for the period. Diluted EPS reflects the potential dilution that could occur if securities or other contracts to issue common stock were exercised or converted into common stock or resulted in the issuance of common stock that then shared in the earnings of the entity (such as Arrow's stock options), computed using the treasury stock method. Unallocated common shares held by Arrow's Employee Stock Ownership Plan are not included in the weighted average number of common shares outstanding for either the basic or diluted EPS calculation.



**NOTE 1:**

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

**Financial Instruments** - Arrow is a party to certain financial instruments with off-balance sheet risk, such as: commercial lines of credit, construction lines of credit, overdraft protection, home equity lines of credit and standby letters of credit. Arrow's policy is to record such instruments when funded. Fair value estimates are made at a specific point in time, based on relevant market information and information about the financial instrument. These estimates do not reflect any premium or discount that could result from offering for sale at one time Arrow's entire holdings of a particular financial instrument. Because no market exists for a significant portion of Arrow's financial instruments, fair value estimates are based on judgments regarding future expected loss experience, current economic conditions, risk characteristics of various financial instruments, and other factors. These estimates are subjective in nature and involve uncertainties and matters of significant judgment and therefore cannot be determined with precision. Changes in assumptions could significantly affect the estimates.

Fair value estimates are based on existing on- and off-balance sheet financial instruments without attempting to estimate the value of anticipated future business and the value of assets and liabilities that are not considered financial instruments. For example, Arrow has a substantial trust department that contributes net fee income annually. The value of trust department customer relationships is not considered a financial instrument, and therefore this value has not been incorporated into the fair value estimates. Other significant assets and liabilities that are not considered financial assets or liabilities include deferred taxes, premises and equipment, the value of low-cost, long-term core deposits and goodwill. In addition, the tax ramifications related to the realization of the unrealized gains and losses can have a significant effect on fair value estimates and have not been considered in any of the estimates.

The carrying amount of the following short-term assets and liabilities is a reasonable estimate of fair value: cash and due from banks, federal funds sold and purchased, securities sold under agreements to repurchase, demand deposits, savings, N.O.W. and money market deposits, other short-term borrowings, accrued interest receivable and accrued interest payable. The fair value estimates of other on- and off-balance sheet financial instruments, as well as the method of arriving at fair value estimates, are included in the related footnotes and summarized in Note 24. As of December 31, 2005 and 2004, and during 2005, 2004 and 2003, Arrow had no derivative instruments within the meaning of SFAS No. 133, Accounting for Derivative Instruments and Hedging Activities, as amended.

**Trust Assets and Fiduciary Income** - Assets held by Arrow in a fiduciary or agency capacity for its customers are not included in the consolidated balance sheets since these assets are not assets of Arrow. Income from fiduciary activities is reported on the accrual basis.

**Segment Reporting** - Management evaluates the operations of Arrow based solely on one business segment - commercial banking, which constitutes Arrow's only segment for financial reporting purposes. Arrow operates primarily in northern New York State in Warren, Washington, Saratoga, Essex and Clinton counties and surrounding areas.

**Management's Use of Estimates** -The preparation of the consolidated financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the consolidated financial statements and the reported amounts of income and expenses during the reporting period. Actual results could differ from those estimates.

A material estimate that is particularly susceptible to significant change in the near term is the allowance for loan losses. In connection with the determination of the allowance for loan losses, management obtains appraisals for properties. The allowance for loan losses is management's best estimate of probable loan losses incurred as of the balance sheet date. While management uses available information to recognize losses on loans, future adjustments to the allowance for loan losses may be necessary based on changes in economic conditions. In addition, various regulatory agencies, as an integral part of their examination process, periodically review Arrow's allowance for loan losses. Such agencies may require Arrow to recognize adjustments to the allowance for loan losses based on their judgments about information available to them at the time of their examination, which may not be currently available to management.

**Recent Accounting Pronouncements** In December 2004, the FASB issued a revised Statement of Financial Accounting Standards No. 123 ( SFAS No. 123R ), Share-Based Payment. For Arrow, SFAS No. 123R, as amended, requires that, beginning with the first quarter of 2006, the cost of employee services received in exchange for an award of equity instruments be measured on the grant date at the fair value of the award. That cost will be recognized over the period during which an employee is required to provide service in exchange for the award (i.e. the vesting period), which was typically four years for Arrow.

**NOTE 2:****CASH AND DUE FROM BANKS (In Thousands)**

The bank subsidiaries are required to maintain certain reserves of vault cash and/or deposits with the Federal Reserve Bank. The total amount of the required reserves at December 31, 2005 and 2004 was approximately \$13,915 and \$15,043, respectively.

**NOTE 3:****SECURITIES (In Thousands)**

The fair value of securities, except certain state and municipal securities, is estimated based on published prices or bid quotations received from securities dealers. The fair value of certain state and municipal securities is not readily available through market sources, so fair value estimates are based on the discounted contractual cash flows using estimated market discount rates that reflect the credit and interest rate risk inherent in the instrument. For short-term securities the estimated fair value is the carrying amount.

Included in mutual funds and equity securities are Federal Home Loan Bank ( FHLB ) and Federal Reserve Bank ( FRB ) stock. FHLB and FRB stock are restricted investment securities and amounted to \$8,499 and \$802 at December 31, 2005, respectively and \$7,613 and \$745 at December 31, 2004, respectively. The required level of FHLB stock is based on the amount of FHLB borrowings (see Note 11) and is pledged to secure those borrowings.

A summary of the amortized costs and the approximate fair values of securities at December 31, 2005 and 2004 is presented below:

**Securities Available-for-Sale:**

	Amortized	Fair	Gross Unrealized Gains	Gross Unrealized Losses
	<u>Cost</u>	<u>Value</u>		
<b>December 31, 2005:</b>				
<b>U.S. Treasury and Agency Obligations</b>	\$ 65,904	\$ 64,408	\$ ---	\$1,496
<b>State and Municipal Obligations</b>	10,725	10,815	154	64
<b>Collateralized Mortgage Obligations</b>	123,978	122,141	---	1,837

<b>Other Mortgage-Backed Securities</b>	<b>109,396</b>	<b>106,753</b>	<b>255</b>	<b>2,898</b>
<b>Corporate and Other Debt Securities</b>	<b>12,223</b>	<b>11,838</b>	<b>---</b>	<b>385</b>
<b>Mutual Funds and Equity Securities</b>	<b><u>10,401</u></b>	<b><u>10,408</u></b>	<b><u>10</u></b>	<b><u>3</u></b>
<b>Total Securities Available-for-Sale</b>	<b><u>\$332,627</u></b>	<b><u>\$326,363</u></b>	<b><u>\$ 419</u></b>	<b><u>\$6,683</u></b>

December 31, 2004:

U.S. Treasury and Agency Obligations	\$ 56,918	\$ 56,329	\$ 4	\$ 593
State and Municipal Obligations	8,340	8,492	152	---
Collateralized Mortgage Obligations	120,697	121,732	1,085	50
Other Mortgage-Backed Securities	116,334	116,809	1,465	990
Corporate and Other Debt Securities	12,333	12,500	235	68
Mutual Funds and Equity Securities	<u>9,328</u>	<u>9,386</u>	<u>61</u>	<u>3</u>
Total Securities Available-for-Sale	<u>\$323,950</u>	<u>\$325,248</u>	<u>\$3,002</u>	<u>\$1,704</u>

**Securities Held-to-Maturity:**

	<b>Amortized</b>	<b>Fair</b>	<b>Gross</b>	<b>Gross</b>
	<b><u>Cost</u></b>	<b><u>Value</u></b>	<b><u>Unrealized</u></b>	<b><u>Unrealized</u></b>
			<b><u>Gains</u></b>	<b><u>Losses</u></b>
<b>December 31, 2005:</b>				
<b>State and Municipal Obligations</b>	<b><u>\$118,123</u></b>	<b><u>\$118,495</u></b>	<b><u>\$ 1,418</u></b>	<b><u>\$ 1,046</u></b>
<b>December 31, 2004:</b>				
State and Municipal Obligations	<u>\$108,117</u>	<u>\$111,058</u>	<u>\$ 3,352</u>	<u>\$ 411</u>

**NOTE 3:****SECURITIES (Continued)**

A summary of the maturities of securities as of December 31, 2005 is presented below. Mutual funds and equity securities, which have no stated maturity, are included in the over ten-year category. Collateralized mortgage obligations and other mortgage-backed securities are included in the schedule based on their expected average lives. Actual maturities may differ from the table below because issuers may have the right to call or prepay obligations with or without prepayment penalties.

<b>Securities:</b>	<b><u>Available-for-Sale</u></b>		<b><u>Held-to-Maturity</u></b>	
	<b>Amortized</b>	<b>Fair</b>	<b>Amortized</b>	<b>Fair</b>
	<b><u>Cost</u></b>	<b><u>Value</u></b>	<b><u>Cost</u></b>	<b><u>Value</u></b>
<b><u>Within One Year:</u></b>				
U.S. Treasury and Agency Obligations	\$ 997	\$ 990	\$ ---	\$ ---
State and Municipal Obligations	2,429	2,428	26,140	26,170
Collateralized Mortgage Obligations	3,867	3,855	---	---
Other Mortgage-Backed Securities	<u>883</u>	<u>889</u>	<u>---</u>	<u>---</u>
Total	<u>8,176</u>	<u>8,162</u>	<u>26,140</u>	<u>26,170</u>
<b><u>From 1 - 5 Years:</u></b>				
U.S. Treasury and Agency Obligations	64,907	63,418	---	---
State and Municipal Obligations	6,078	6,057	62,416	63,020
Collateralized Mortgage Obligations	110,053	108,300	---	---
Other Mortgage-Backed Securities	89,770	87,291	---	---
Corporate and Other Debt Securities	<u>9,227</u>	<u>8,842</u>	<u>---</u>	<u>---</u>
Total	<u>280,035</u>	<u>273,908</u>	<u>62,416</u>	<u>63,020</u>
<b><u>From 5 - 10 Years:</u></b>				
State and Municipal Obligations	396	410	26,743	26,512
Collateralized Mortgage Obligations	10,058	9,986	---	---
Other Mortgage-Backed Securities	<u>16,172</u>	<u>15,987</u>	<u>---</u>	<u>---</u>
Total	<u>26,626</u>	<u>26,383</u>	<u>26,743</u>	<u>26,512</u>

**Over 10 Years:**

State and Municipal Obligations	1,822	1,920	2,824	2,793
Other Mortgage-Backed Securities	2,571	2,586	---	---
Corporate and Other Debt Securities	2,996	2,996	---	---
Mutual Funds and Equity Securities	<u>10,401</u>	<u>10,408</u>	<u>---</u>	<u>---</u>
Total	<u>17,790</u>	<u>17,910</u>	<u>2,824</u>	<u>2,793</u>
Total Securities	<u>\$332,627</u>	<u>\$326,363</u>	<u>\$118,123</u>	<u>\$118,495</u>

The following table sets forth the components of interest and dividend income on securities available-for-sale and securities held-to-maturity for the year ending December 31:

<b>Components of Investment Securities Interest and Dividend Income</b>	<u>2005</u>	<u>2004</u>	<u>2003</u>
Securities Available-for-Sale:			
Taxable Interest Income	\$ 7,526	\$ 7,588	\$ 7,664
Nontaxable Interest Income	5,456	5,575	4,191
Dividend Income	<u>597</u>	<u>596</u>	<u>584</u>
Total Interest and Dividend Income, on Securities Available-for-Sale	<u>\$13,579</u>	<u>\$13,759</u>	<u>\$12,439</u>
Securities Held-to-Maturity			
Taxable Interest Income	\$ 581	\$ 313	\$ 246
Nontaxable Interest Income	<u>3,510</u>	<u>3,635</u>	<u>3,383</u>
Total Interest Income, on Securities Held-to-Maturity	<u>\$4,091</u>	<u>\$3,948</u>	<u>\$3,629</u>

**NOTE 3:****SECURITIES (Continued)**

The fair value of securities pledged to secure repurchase agreements amounted to \$41,195 and \$42,256 at December 31, 2005 and 2004, respectively. The fair value of securities pledged to secure public and trust deposits and for other purposes totaled \$317,730 and \$282,290 at December 31, 2005 and 2004, respectively. Other mortgage-backed securities at December 31, 2005 and 2004 included \$5,468 and \$17,213, respectively, of loans previously securitized by Arrow, which it continues to service.

Information on temporarily impaired securities at December 31, 2005 and 2004, segregated according to the length of time such securities had been in a continuous unrealized loss position, is summarized as follows:

December 31, 2005	<u>Less than 12 Months</u>		<u>12 Months or Longer</u>		<u>Total</u>	
	Fair	Unrealized	Fair	Unrealized	Fair	Unrealized
<b><u>Available-for-Sale Portfolio:</u></b>	<b><u>Value</u></b>	<b><u>Losses</u></b>	<b><u>Value</u></b>	<b><u>Losses</u></b>	<b><u>Value</u></b>	<b><u>Losses</u></b>
U.S. Treasury and Agency Obligations	\$23,600	\$396	\$40,808	\$ 1,100	\$ 64,408	\$1,496
State & Municipal Obligations	5,387	64	26	---	5,413	64
Collateralized Mortgage Obligations	112,385	1,564	9,721	273	122,106	1,837
Other Mortgage-Backed Securities	37,438	659	56,383	2,239	93,821	2,898
Corporate & Other Debt Securities	3,915	235	4,927	150	8,842	385
Mutual Funds and Equity Securities	<u>22</u>	<u>3</u>	<u>23</u>	<u>---</u>	<u>45</u>	<u>3</u>
<b>Total Securities Available-for-Sale</b>	<b><u>\$182,747</u></b>	<b><u>\$2,921</u></b>	<b><u>\$111,888</u></b>	<b><u>\$3,762</u></b>	<b><u>\$294,635</u></b>	<b><u>\$6,683</u></b>
<b><u>Held-to-Maturity Portfolio</u></b>						
State & Municipal Obligations	15,615	221	18,845	825	34,460	1,046

The table above for December 31, 2005 consists of 290 securities where the current fair value is less than the related amortized cost. With the exception of one holding, these unrealized losses do not reflect any deterioration of the credit worthiness of the issuing entities. The U.S. government agency securities are all rated AAA, as are the agency-backed CMOs and the mortgage-backed securities. The unrealized losses on these temporarily impaired securities are primarily the result of changes in interest rates for fixed rate securities where the interest rate received is less than the current rate available for new offerings of similar securities, changes in market spreads as a result of

shifts in supply and demand, and/or changes in the level of prepayments for mortgage related securities. The municipal obligations are partially insured, with the remainder supported by the general taxing authority of the municipality and, in the cases of school districts, are supported by state aid. For any non-rated municipal securities, third party credit analysis shows no deterioration in the credit worthiness of the municipalities. The corporate bonds consist of four holdings where there has been no deterioration in credit worthiness of the issuing entity, and one corporate holding, General Motors Acceptance Corp. ( GMAC ), has experienced a deterioration in credit worthiness. As of December 31, 2005 the GMAC note bond had a fair value of \$1,799 and an amortized cost of \$2,018, resulting in an unrealized loss of \$219. This unrealized loss represented 10.9% of the amortized cost.

GMAC is the primary finance arm of General Motors Corporation. GMAC has had its credit rating dropped to Ba1 (Moody) as a result of the well-reported operational, financial and other issues of General Motors. Our analysis of GMAC, which has included recent discussions with analysts, reading relevant published General Motors and GMAC business articles and investor reports, has revealed that General Motors is considering selling all or part of GMAC. Reportedly, the sale of GMAC would provide GM with a much needed cash inflow, as General Motors reportedly will be in a cash shortage within the next twelve to eighteen months. Some analysts believe that if GMAC is not sold, General Motors may file for bankruptcy. Our research has shown that if GMAC is sold to an entity with a strong credit assessment, GMAC or the new entity would likely have a stronger credit rating, which could cause an increase in GMAC debt pricing. Reportedly, the sale of GMAC is likely. The recent increase in GMAC bond prices provides an indicator that a sale may be forthcoming. Our GMAC holding had a fair value of \$1,799 at December 31, 2005 but has a fair value of \$1,825 as of February 28, 2006. Based upon our analysis of the GMAC situation, and our intent and ability to hold the GMAC note until our full value is recovered, we believe the GMAC loss is temporary.

The conclusion of management's analysis is that the loss in this particular corporate bond is considered temporary and Arrow will continue to monitor the credit as appropriate.



**NOTE 3:****SECURITIES (Continued)**

December 31, 2004	<u>Less than 12 Months</u>		<u>12 Months or Longer</u>		<u>Total</u>	
	Fair	Unrealized	Fair	Unrealized	Fair	Unrealized
<u>Available-for-Sale Portfolio:</u>	<u>Value</u>	<u>Losses</u>	<u>Value</u>	<u>Losses</u>	<u>Value</u>	<u>Losses</u>
U.S. Treasury and Agency Obligations	\$19,665	\$259	\$21,609	\$ 334	\$ 41,274	\$ 593
State & Municipal Obligations	577	1	---	---	577	1
Collateralized Mortgage Obligations	4,997	18	4,947	32	9,944	50
Other Mortgage-Backed Securities	21,710	231	46,704	759	68,414	990
Corporate & Other Debt Securities	5,049	68	---	---	5,049	68
Mutual Funds and Equity Securities	<u>82</u>	<u>2</u>	<u>---</u>	<u>---</u>	<u>82</u>	<u>2</u>
Total Securities Available-for-Sale	<u>\$52,080</u>	<u>\$579</u>	<u>\$73,260</u>	<u>\$1,125</u>	<u>\$125,340</u>	<u>\$1,704</u>
<u>Held-to-Maturity Portfolio</u>						
State & Municipal Obligations	247	1	19,191	410	19,438	411

The above table represents 131 securities where the current fair value is less than the related amortized cost. These unrealized losses do not reflect any deterioration of the credit worthiness of the issuing entities. Except for one unrated municipal obligation, no debt security has a current rating that is below investment grade, and most of the securities are rated AAA. The unrealized losses on these temporarily impaired securities are primarily the result of changes in interest rates for fixed-rate securities where the interest rate received is less than the current rate available for new offerings of similar securities, changes in market spreads as a result of shifts in supply and demand, and/or changes in the level of prepayments for mortgage related securities.

**NOTE 4:****LOANS (In Thousands)**

Loans at December 31, 2005 and 2004 consisted of the following:

	<u>2005</u>	<u>2004</u>
Commercial, Financial and Agricultural	\$ 84,300	\$ 76,379

Real Estate - Commercial	<b>168,101</b>	137,107
Real Estate - Residential	<b>376,820</b>	342,957
Real Estate - Construction	<b>10,082</b>	7,868
Indirect Consumer Loans	<b>352,014</b>	300,672
Other Loans to Individuals	<u><b>5,228</b></u>	<u>10,328</u>
Total Loans	<u><b>\$996,545</b></u>	<u>\$875,311</u>

The carrying amount of net loans at December 31, 2005 and 2004 was \$984,304 and \$863,265, respectively. The estimated fair value of net loans at December 31, 2005 and 2004 was \$971,835 and \$869,252, respectively. Included in the carrying amount of loans in the table above are unamortized deferred loan origination costs, net of deferred loan origination fees, of \$1,554 and \$1,466 at December 31, 2005 and 2004, respectively.

Fair values are estimated for portfolios of loans with similar financial characteristics. Loans are segregated by type such as commercial, commercial real estate, residential mortgage, indirect and other consumer loans. Each loan category is further segmented into fixed and adjustable rate interest terms and by performing and nonperforming categories.

The fair value of performing loans is calculated by discounting scheduled cash flows through the estimated maturity using estimated market discount rates that reflect the credit and interest rate risk inherent in the loan. The estimate of maturity is based on historical experience with repayments for each loan classification, modified, as required, by an estimate of the effect of current economic and lending conditions. Fair value for nonperforming loans is generally based on recent external appraisals. If appraisals are not available, estimated cash flows are discounted using a rate commensurate with the risk associated with the estimated cash flows. Assumptions regarding credit risk, cash flows and discount rates are judgmentally determined using available market information and specific borrower information.

Certain executive officers and directors, including their immediate families and organizations in which they are principals of Arrow or affiliates, have various loan, deposit and other transactions with Arrow. Such transactions are entered into on substantially the same terms, including interest rates and collateral, as those prevailing at the time for comparable transactions with others. The amount of such related party loans was \$8,190 at December 31, 2005 and \$7,589 at December 31, 2004. During 2005, the amount of new loans and renewals extended to such related parties was \$23,713 and the total of loan repayments was \$23,112.

**NOTE 4:****LOANS (Continued)**

Arrow has pledged certain loans secured by one-to-four family residential mortgages under a blanket collateral agreement to secure borrowings from the Federal Home Loan Bank (see Note 11). As of December 31, 2005, the amount of such pledged loans amounted to \$211,945.

Arrow designates certain loans as nonaccrual and suspends the accrual of interest and the amortization of net deferred fees or costs when payment of interest and/or principal is due and unpaid for a period of, generally, ninety days or the likelihood of repayment is uncertain in the opinion of management. The following table presents information concerning nonperforming loans at December 31:

	<u>2005</u>	<u>2004</u>	<u>2003</u>
Nonaccrual Loans	<b>\$1,875</b>	\$2,103	\$1,822
Loans Past Due 90 or More Days and Still Accruing Interest	<b>373</b>	6	685
Restructured Loans	<u>---</u>	<u>---</u>	<u>---</u>
Total Nonperforming Loans	<b><u>\$2,248</u></b>	<b><u>\$2,109</u></b>	<b><u>\$2,507</u></b>

Arrow has no material commitments to make additional advances to borrowers with nonperforming loans. The following table presents information with respect to interest on the nonaccrual loans shown in the table above for the years ended December 31:

	<u>2005</u>	<u>2004</u>	<u>2003</u>
Gross Interest That Would Have Been Earned Under Original Terms	<b>\$156</b>	\$161	\$160
Interest Included in Income	<b>81</b>	115	107

**NOTE 5:****ALLOWANCE FOR LOAN LOSSES AND IMPAIRED LOANS (In Thousands)**

The following summarizes the changes in the allowance for loan losses during the years ended December 31:

	<u>2005</u>	<u>2004</u>	<u>2003</u>
Balance at Beginning of Year	<b>\$12,046</b>	\$11,842	\$11,193
Provision for Loan Losses	<b>1,030</b>	1,020	1,460
Recoveries	<b>293</b>	246	342
Charge-Offs	<u><b>(1,128)</b></u>	<u>(1,062)</u>	<u>(1,153)</u>
Balance at End of Year	<b><u>\$12,241</u></b>	<u>\$12,046</u>	<u>\$11,842</u>

The balance of impaired loans, within the scope of SFAS No. 114, was \$512 and \$515 at December 31, 2005 and 2004, respectively. The allowance for loan losses included \$96 and \$112 allocated to impaired loans at the same respective dates. The average recorded investment in impaired loans for 2005, 2004 and 2003 was \$512, \$236 and \$254, respectively. For all years, no interest income was recorded on such loans during the period of impairment.

**NOTE 6:**

**PREMISES AND EQUIPMENT (In Thousands)**

A summary of premises and equipment at December 31, 2005 and 2004 is presented below:

	<u>2005</u>	<u>2004</u>
Land and Bank Premises	<b>\$19,746</b>	\$18,269
Equipment, Furniture and Fixtures	<b>13,681</b>	13,119
Leasehold Improvements	<u><b>562</b></u>	<u>461</u>
Total Cost	<b>33,989</b>	31,849
Accumulated Depreciation and Amortization	<u><b>(18,105)</b></u>	<u>(16,910)</u>
Net Premises and Equipment	<b><u>\$15,884</u></b>	<u>\$14,939</u>

Amounts charged to expense for depreciation and amortization totaled \$1,230, \$1,208 and \$1,046 in 2005, 2004 and 2003, respectively.

**NOTE 7:****OTHER REAL ESTATE OWNED AND REPOSSESSED ASSETS (In Thousands)**

There was no other real estate owned at December 31, 2005 or 2004. Repossessed assets totaled \$124 and \$136 at December 31, 2005 and 2004, respectively, and consisted solely of motor vehicles repossessed in satisfaction of loans.

**NOTE 8:****INTANGIBLE ASSETS OTHER THAN GOODWILL (In Thousands)**

The following table presents information on Arrow's intangible assets (other than goodwill) as of December 31, 2005, 2004 and 2003:

	Depositor	Mortgage Servicing			
	<u>Intangibles<sup>1</sup></u>	<u>Rights<sup>2</sup></u>	<u>Covenants<sup>3</sup></u>	<u>Expirations<sup>4</sup></u>	<u>Total</u>
Gross Carrying Amount,					
December 31, 2005	\$2,247	\$283	\$117	\$686	\$3,333
Accumulated Amortization	<u>(307)</u>	<u>(79)</u>	<u>(25)</u>	<u>(37)</u>	<u>(448)</u>
Net Carrying Amount,					
December 31, 2005	<u>\$1,940</u>	<u>\$204</u>	<u>\$ 92</u>	<u>\$649</u>	<u>\$2,885</u>
Gross Carrying Amount,					
December 31, 2004	\$ 560	\$236	\$117	\$686	\$1,599
Accumulated Amortization	<u>(538)</u>	<u>(38)</u>	<u>(2)</u>	<u>(2)</u>	<u>(580)</u>
Net Carrying Amount,					
December 31, 2004	<u>\$ 22</u>	<u>\$198</u>	<u>\$115</u>	<u>\$684</u>	<u>\$1,019</u>
Gross Carrying Amount,					
December 31, 2003	\$ 560	\$118	---	---	\$ 678

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December 31, 2003					
Accumulated Amortization	<u>(501)</u>	<u>(11)</u>	---	---	<u>(512)</u>
Net Carrying Amount,					
December 31, 2003	<u>\$ 59</u>	<u>\$107</u>	---	---	<u>\$ 166</u>
Amortization Expense:					
2005	\$328	\$41	\$23	\$35	\$427
2004	\$37	\$27	\$ 2	\$ 2	\$68
2003	\$37	\$11	---	---	\$48
Estimated Annual Amortization Expense: <sup>1,2,3,4</sup>					
2006	\$378	\$47	\$24	\$34	\$483
2007	337	47	24	34	442
2008	296	47	23	34	400
2009	255	36	21	34	346
2010	214	20		34	268
Later Years	460	7		479	946

<sup>1</sup> Amortization of Depositor Intangibles is reported in the income statement as a component of other operating expense.

<sup>2</sup> Amortization of Mortgage Servicing Rights is reported in the income statement as a reduction of servicing fee income.

<sup>3</sup> Amortization of Covenants is reported in the income statement as a component of other operating expense.

<sup>4</sup> Amortization of Expirations is reported in the income statement as a component of other operating expense.

During 2005, Arrow acquired three branches in one transaction and recorded a core deposit intangible asset of \$2,247. During 2004, Arrow acquired all the common stock of an insurance agency and at the date of acquisition recorded intangible assets for a non-compete covenant of \$117 and for the value of the existing customer base of \$686. During 2005 there were no impairment losses recognized with respect to Arrow's existing goodwill or intangible assets.

**NOTE 9:****TIME DEPOSITS (In Thousands)**

The following summarizes the contractual maturities of time deposits during years subsequent to December 31, 2005:

	Time Deposits of \$100,000 <u>or More</u>	Other Time <u>Deposits</u>
2006	\$134,863	\$146,911
2007	11,544	39,329
2008	2,433	10,724
2009	3,173	13,471
2010	2,500	7,237
2011 and Beyond	<u>113</u>	<u>3,500</u>
Total	<u>\$154,626</u>	<u>\$221,172</u>

The carrying value of time deposits at December 31, 2005 and 2004 was \$375,798 and \$256,793, respectively. The estimated fair value of time deposits at December 31, 2005 and 2004 was \$373,171 and \$256,404, respectively. The fair value of time deposits is based on the discounted value of contractual cash flows, except that the fair value is limited to the extent that the customer could redeem the certificate after imposition of a premature withdrawal penalty. The discount rates are estimated using the FHLB yield curve, which is considered representative of Arrow's time deposit rates.

**NOTE 10:****SHORT-TERM BORROWINGS (Dollars in Thousands)**

A summary of short-term borrowings is presented below:

Federal Funds Purchased and Securities Sold	<u>2005</u>	<u>2004</u>	<u>2003</u>
Under Agreements to Repurchase:			
Balance at December 31	<b>\$41,195</b>	\$42,256	\$39,515
Maximum Month-End Balance	<b>74,203</b>	58,555	52,988
Average Balance During the Year	<b>48,810</b>	46,597	43,501
Average Rate During the Year	<b>1.48%</b>	0.79%	0.82%
Rate at December 31	<b>1.90%</b>	0.83%	0.50%
Other Short-Term Borrowings:			
Balance at December 31	<b>\$1,859</b>	\$1,720	\$1,421
Maximum Month-End Balance	<b>1,859</b>	3,021	3,234
Average Balance During the Year	<b>684</b>	836	770
Average Rate During the Year	<b>3.06%</b>	1.06%	0.86%
Rate at December 31	<b>3.93%</b>	2.03%	0.73%
Average Aggregate Short-Term Borrowing Rate During the Year	<b>1.51%</b>	0.79%	0.82%

Securities sold under agreements to repurchase generally mature within ninety days. Arrow maintains effective control over the securities underlying the agreements. Federal funds purchased represent overnight transactions.

Other short-term borrowings primarily include demand notes issued to the U.S. Treasury. In addition, Arrow has in place borrowing facilities from correspondent banks, the Federal Home Loan Bank of New York ( FHLB ) and the Federal Reserve Bank of New York.



**NOTE 11:****FHLB ADVANCES (Dollars in Thousands)**

Arrow has established overnight and 30 day term lines of credit with the FHLB each in the amount of \$118,312. If advanced, such lines of credit will be collateralized by mortgage-backed securities, loans and FHLB stock. Participation in the FHLB program requires an investment in FHLB stock. The investment in FHLB stock, included in Securities Available-for-Sale on the Consolidated Balance Sheets, amounted to \$8,499 and \$7,613 at December 31, 2005 and 2004, respectively. Arrow also borrows longer-term funds from the FHLB. Certain borrowings are in the form of convertible advances. These advances have a set final maturity, but are callable by the FHLB at certain dates beginning no earlier than one year from the issuance date. If the advances are called, Arrow may elect to have the funds replaced by the FHLB at the then prevailing market rate of interest. The borrowings are secured by mortgage loans and/or mortgage-backed securities and/or FHLB stock held by Arrow. The total amount of assets pledged to the FHLB for borrowing arrangements at December 31, 2005 and 2004 amounted to \$220,441 and \$226,503, respectively. The table below presents information applicable to FHLB advances as of December 31, 2005 and 2004:

<u>2005 Amount</u>	<u>2004 Amount</u>	<u>Effective Rate</u>	<u>First Call Date</u>	<u>Call Frequency</u>	<u>Maturity Date</u>
\$ 2,000	\$ ---	4.30%		Overnight	January 2, 2006
5,000	5,000	5.43%	March 11, 2001	Quarterly	March 11, 2008
10,000	10,000	4.73%			March 1, 2006
10,000	10,000	5.12%			February 14, 2011
10,000	10,000	5.18%			February 23, 2011
10,000	---	4.41%			April 5, 2006
10,000	---	4.46%	May 18, 2006	Quarterly	November 18, 2007
10,000	---	4.44%	May 25, 2006	Quarterly	November 26, 2007
10,000	10,000	4.44%	June 3, 2006	One Time	June 4, 2012
10,000	---	3.67%	October 6, 2006	Quarterly	October 6, 2015
10,000	10,000	2.89%			November 17, 2006
20,000	---	4.22%	November 30, 2006	Quarterly	November 30, 2010
10,000	---	4.24%	October 6, 2007	Quarterly	October 6, 2010
10,000	---	3.88%	October 6, 2007	Quarterly	October 6, 2015
10,000	---	4.41%	December 19, 2007	Quarterly	December 19, 2010
10,000	---	4.32%	October 6, 2008	One Time	October 9, 2012
---	10,000	4.01%	June 3, 2005	One Time	June 4, 2012
---	5,000	5.85%	February 22, 2001	Quarterly	November 22, 2005
---	5,000	5.90%	May 22, 2001	Quarterly	November 22, 2005
---	20,000	5.93%	November 2, 2001	Quarterly	November 2, 2005
---	5,000	5.98%	November 22, 2001	Quarterly	November 22, 2005

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---	10,000	3.02%	August 22, 2005	One Time	August 7, 2007
---	10,000	1.91%			April 28, 2005
---	10,000	2.26%			November 17, 2005
---	10,000	2.55%			January 31, 2005
---	<u>10,000</u>	2.58%			February 15, 2005
	<u>\$157,000</u>				<u>\$150,000</u>

The estimated fair value of FHLB advances was \$156,851 and \$152,675 at December 31, 2005 and 2004, respectively. The fair value of FHLB advances is estimated based on the discounted value of contractual cash flows.

The discount rate is estimated using current rates on FHLB advances with similar maturities and call features. The table below presents the amounts of FHLB advances maturing in the next five years and beyond:

<u>Final Maturity</u>	<u>Amount</u>
2006	\$ 32,000
2007	20,000
2008	5,000
2009	---
2010	40,000
Beyond	<u>60,000</u>
Total FHLB Advances	<u>\$157,000</u>

**NOTE 12:**

**GUARANTEED PREFERRED BENEFICIAL INTERESTS IN CORPORATION S JUNIOR SUBORDINATED**

**DEBENTURES**

**(In Thousands)**

During 2005, there were outstanding two classes of financial instruments issued by two separate subsidiary business trusts of Arrow, having an aggregate amount of \$20,000.

The first of the two classes of trust-issued instruments outstanding at year-end was issued by Arrow Capital Statutory Trust II ("ACST II"), a Delaware business trust established on July 16, 2003, upon the filing of a certificate of trust with the Delaware Secretary of State. In July 2003, ACST II issued all of its voting (common) stock to Arrow and issued and sold to an unaffiliated purchaser 30-year guaranteed preferred beneficial interests in the trust's assets ("ACST II trust preferred securities") in the aggregate amount of \$10,000. The ACST II trust preferred securities bear a rate of 6.53% until September 30, 2008. After that date, the rate will become a variable rate adjusted quarterly to the 3-month LIBOR plus 3.15%. ACST II used the proceeds of the sale of its trust preferred securities to purchase an identical amount (\$10,000) of junior subordinated debentures issued by Arrow that bear an interest rate identical at all times to the rate payable on the ACST II trust preferred securities.

The second of the two classes of trust-issued instruments outstanding at year-end was issued by Arrow Capital Statutory Trust III ("ACST III"), a Delaware business trust established on December 23, 2004, upon the filing of a certificate of trust with the Delaware Secretary of State. On December 28, 2004, the ACST III issued all of its voting (common) stock to Arrow and issued and sold to an unaffiliated purchaser 30-year guaranteed preferred beneficial interests in the trust's assets ("ACST III trust preferred securities") in the aggregate amount of \$10,000. The rate on the ACST III trust preferred securities is a variable rate, adjusted quarterly, equal to the 3-month LIBOR plus 2.00%. ACST III used the proceeds of the sale of its trust preferred securities to purchase an identical amount (\$10,000) of junior subordinated debentures issued by Arrow that bear an interest rate identical at all times to the rate payable on the ACST III trust preferred securities.

On December 31, 2004, a third outstanding class of instruments previously issued by a subsidiary trust of Arrow was redeemed by that trust at a redemption price equal to the aggregate liquidation amount of the instruments, or \$5,000. The trust, Arrow Capital Trust I ("ACT I"), was established as a Delaware business trust in November 1999. In December 1999, ACT I issued and sold to several unaffiliated purchasers 30-year guaranteed preferred beneficial interests in the trust's assets ("ACT I trust preferred securities") in the aggregate amount of \$5,000 at a fixed rate of 9.50%. ACT I used the proceeds from the sale of the ACT I trust preferred securities to acquire an identical amount (\$5,000) of junior subordinated debentures issued by Arrow bearing an identical interest rate (9.50%). On December

31, 2004, at the same time that ACT I redeemed all outstanding ACT I trust preferred securities, Arrow redeemed all \$5,000 in aggregate principal amount of its junior subordinated debentures held by ACT I.

The primary assets of the two subsidiary trusts having trust preferred securities outstanding at year-end, ACST II and ACST III (the Trusts ), are Arrow's junior subordinated debentures discussed above, and the sole revenues of the Trusts are payments received by them from Arrow with respect to the junior subordinated debentures. The trust preferred securities issued by the Trusts are non-voting. All common voting securities of the Trusts are owned by Arrow. Arrow used the net proceeds from its sale of junior subordinated debentures to the Trusts, facilitated by the Trusts sale of their trust preferred securities to the purchasers thereof, for general corporate purposes. The trust preferred securities and underlying junior subordinated debentures, with associated expense that is tax deductible, qualify as Tier I capital under regulatory definitions.

Arrow's primary source of funds to pay interest on the debentures held by the Trusts are current dividends received by Arrow from its subsidiary banks. Accordingly, Arrow's ability to make payments on the debentures, and the ability of the Trusts to make payments on their trust preferred securities, are dependent upon the continuing ability of Arrow's subsidiary banks to pay dividends to Arrow. Since the trust preferred securities issued by the subsidiary trusts and the underlying junior subordinated debentures issued by Arrow at December 31, 2005, 2004 and 2003 are classified as debt for financial statement purposes, the expense associated with these securities is recorded as interest expense in the consolidated statements of income for the three years.

The estimated fair value of the outstanding trust preferred securities and underlying junior subordinated debentures was \$20,007 and \$20,651 at December 31, 2005 and 2004, respectively. The fair value of these securities was estimated based on the discounted value of contractual cash flows. The discount rate utilized in the estimate was the published yield on seasoned BAA corporate debt securities on the date of valuation.

**NOTE 13:****ACCUMULATED OTHER COMPREHENSIVE (LOSS) INCOME (In Thousands)**

The following table presents the components, net of tax, of accumulated other comprehensive (loss) income as of December 31:

	<u>2005</u>	<u>2004</u>
Excess of Additional Pension Liability Over Unrecognized Prior Service Cost	\$ (796)	\$(351)
Net Unrealized Securities Holding (Losses) Gains	<u>(3,767)</u>	<u>780</u>
Total Accumulated Other Comprehensive (Loss) Income	<u>\$(4,563)</u>	<u>\$ 429</u>

**NOTE 14:****EARNINGS PER COMMON SHARE (In Thousands, Except Per Share Amounts)**

The following table presents a reconciliation of the numerator and denominator used in the calculation of basic and diluted earnings per common share ( EPS ) for each of the years in the three-year period ended December 31, 2005. All share and per share amounts have been adjusted for the 2005 3% stock dividend.

	Net Income	Weighted-Average Shares	Per Share
	<u>(Numerator)</u>	<u>(Denominator)</u>	<u>Amount</u>
<b>For the Year Ended December 31, 2005:</b>			
Basic EPS	\$18,639	10,420	<u>\$1.79</u>
Dilutive Effect of Stock Options	---	<u>176</u>	
Diluted EPS	<u>\$18,639</u>	<u>10,596</u>	<u>\$1.76</u>
For the Year Ended December 31, 2004:			
Basic EPS	\$19,478	10,426	<u>\$1.87</u>
Dilutive Effect of Stock Options	---	<u>249</u>	
Diluted EPS	<u>\$19,478</u>	<u>10,675</u>	<u>\$1.82</u>
For the Year Ended December 31, 2003:			
Basic EPS	\$18,917	10,452	<u>\$1.81</u>
Dilutive Effect of Stock Options	---	<u>241</u>	

Diluted EPS	<u>\$18.917</u>	<u>10.693</u>	<u>\$1.77</u>
-------------	-----------------	---------------	---------------

During a portion of 2005, options to purchase 66 shares of common stock at an average price of \$31.09 per share were outstanding but were not included in the computation of diluted EPS because the options' exercise price was greater than the average market price of the common shares during that period. Antidilutive shares for 2004 and 2003 were 66 at an average price of \$31.09 per share and 143 at an average price of \$25.88, for the respective years.

**NOTE 15:****REGULATORY MATTERS (Dollars in Thousands)**

In the normal course of business, Arrow and its subsidiaries operate under certain regulatory restrictions, such as the extent and structure of covered intercompany borrowings and maintenance of reserve requirement balances.

The principal source of the funds for the payment of shareholder dividends by Arrow has been from dividends declared and paid to Arrow by its bank subsidiaries. As of December 31, 2005, the maximum amount that could have been paid by subsidiary banks to Arrow, without prior regulatory approval, was approximately \$35,820.

Under current Federal Reserve regulations, Arrow is prohibited from borrowing from the subsidiary banks unless such borrowings are secured by specific obligations. Additionally, the maximum of any such borrowing is limited to 10% of an affiliate's capital and surplus.

Arrow and its subsidiary banks are subject to various regulatory capital requirements administered by the federal banking agencies. Failure to meet minimum capital requirements can initiate certain mandatory--and possibly additional discretionary--actions by regulators that, if undertaken, could have a direct material effect on an institution's financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, Arrow and its subsidiary banks must meet specific capital guidelines that involve quantitative measures of assets, liabilities, and certain off-balance sheet items as calculated under regulatory accounting practices. Capital amounts and classification are also subject to qualitative judgments by the regulators about components, risk weightings, and other factors.

Quantitative measures established by regulation to ensure capital adequacy require Arrow and its subsidiary banks to maintain minimum capital amounts and ratios (set forth in the table below) of total and Tier I capital (as defined in the regulations) to risk-weighted assets (as defined), and of Tier I capital (as defined) to average assets (as defined). Management believes, as of December 31, 2005 and 2004, that Arrow and both subsidiary banks meet all capital adequacy requirements to which they are subject.

**NOTE 15:****REGULATORY MATTERS (Continued)**

As of December 31, 2005, Arrow and both subsidiary banks qualified as well capitalized under the regulatory framework for prompt corrective action. To be categorized as Well Capitalized, Arrow and its subsidiary banks must maintain minimum total risk-based, Tier I risk-based, and Tier I leverage ratios as set forth in the table below. There are no conditions or events that management believes have changed Arrow's or its subsidiary banks' categories.

Arrow's and its subsidiary banks', Glens Falls National Bank and Trust Company (Glens Falls National) and Saratoga National Bank and Trust Company (Saratoga National), actual capital amounts and ratios are presented in the table below as of December 31, 2005 and 2004:

			Minimum Amounts		Minimum Amounts	
			For Capital		To Be	
	<u>Actual</u>		<u>Adequacy Purposes</u>		<u>Well Capitalized</u>	
	<u>Amount</u>	<u>Ratio</u>	<u>Amount</u>	<u>Ratio</u>	<u>Amount</u>	<u>Ratio</u>
<b>As of December 31, 2005:</b>						
<b>Total Capital</b>						
<b>(to Risk Weighted Assets):</b>						
Arrow	\$138,043	13.8%	\$80,083	8.0%	\$100,104	10.0%
Glens Falls National	119,707	14.3%	66,782	8.0%	83,478	10.0%
Saratoga National	20,381	12.2%	13,365	8.0%	16,706	10.0%
<b>Tier I Capital</b>						
<b>(to Risk Weighted Assets):</b>						
Arrow	125,799	12.6%	40,063	4.0%	60,095	6.0%
Glens Falls National	109,526	13.1%	33,392	4.0%	50,088	6.0%
Saratoga National	17,121	10.3%	6,681	4.0%	10,022	6.0%
<b>Tier I Capital</b>						
<b>(to Average Assets):</b>						
Arrow	125,799	8.4%	60,263	4.0%	60,263	4.0%
Glens Falls National	109,526	8.4%	52,217	4.0%	65,272	5.0%
Saratoga National	17,121	8.3%	8,271	4.0%	10,339	5.0%

	<u>Actual</u>		Minimum Amounts		Minimum Amounts	
	<u>Amount</u>	<u>Ratio</u>	For Capital		To Be	
			<u>Adequacy Purposes</u>		<u>Well Capitalized</u>	
	<u>Amount</u>	<u>Ratio</u>	<u>Amount</u>	<u>Ratio</u>	<u>Amount</u>	<u>Ratio</u>
As of December 31, 2004:						
Total Capital						
(to Risk Weighted Assets):						
Arrow	\$138,085	15.8%	\$70,049	8.0%	\$87,562	10.0%
Glens Falls National	110,739	14.9%	59,338	8.0%	74,172	10.0%
Saratoga National	20,771	15.1%	11,026	8.0%	13,783	10.0%
Tier I Capital						
(to Risk Weighted Assets):						
Arrow	127,086	14.5%	35,010	4.0%	52,515	6.0%
Glens Falls National	101,443	13.7%	29,662	4.0%	44,493	6.0%
Saratoga National	17,245	12.5%	5,514	4.0%	8,271	6.0%
Tier I Capital						
(to Average Assets):						
Arrow	127,086	9.2%	55,075	4.0%	55,075	4.0%
Glens Falls National	101,443	8.4%	48,421	4.0%	60,527	5.0%
Saratoga National	17,245	10.0%	6,919	4.0%	8,648	5.0%



**NOTE 16:****RETIREMENT PLANS (Dollars in Thousands)**

Arrow sponsors qualified and nonqualified defined benefit pension plans and other postretirement benefit plans for its employees. Arrow maintains a non-contributory pension plan, which covers substantially all employees. Effective December 1, 2002, all active participants in the qualified defined benefit pension plan were given a one-time irrevocable election to continue participating in the traditional plan design, for which benefits were based on years of service and the participant's final compensation (as defined), or to begin participating in the new cash balance plan design. All employees who participate in the plan after December 1, 2002 automatically participate in the cash balance plan design. The interest credits under the cash balance plan are based on the 30-year U.S. Treasury rate. The service credits under the cash balance plan are equal to 6.0% for employees who become participants on or after January 1, 2003. For employees in the plan prior to January 1, 2003, the service credits are scaled based on the age of the participant, and range from 6.0% to 12.0%. The funding policy is to contribute up to the maximum amount that can be deducted for federal income tax purposes and to make all payments required under ERISA. Arrow also maintains a supplemental non-qualified unfunded retirement plan to provide eligible employees of Arrow and its subsidiaries with benefits in excess of qualified plan limits imposed by federal tax law.

Arrow has multiple non-pension postretirement benefit plans. The health care, dental and life insurance plans are contributory, with participants' contributions adjusted annually. Arrow's policy is to fund the cost of postretirement benefits based on the current cost of the underlying policies. However, the health care plan provision for automatic increases of Company contributions each year is based on the increase in inflation and is limited to a maximum of 5%.

In December 2003, the Medicare Prescription Drug, Improvement and Modernization Act of 2003 (the Act) became law in the United States. The Act introduced a prescription drug benefit under Medicare as well as a federal subsidy to sponsors of retiree health care benefit plans that provide a benefit that is at least actuarially equivalent to Medicare Part D under the Act. At December 31, 2005, in the following tables, the measures of the accumulated non-pension postretirement benefit obligation and net periodic non-pension postretirement benefit cost reflect the amount associated with the subsidy.

The following tables provide a reconciliation of the changes in the plans' benefit obligations (projected benefit obligation for pension benefits and accumulated benefit obligation for postretirement benefits) and fair value of the plans' assets during the years ended December 31, 2005 and 2004, and a reconciliation of the funded status to the net amount recognized in the consolidated balance sheets as of December 31 of both years:

Pension		Postretirement	
<u>Benefits</u>		<u>Benefits</u>	
<u>2005</u>	<u>2004</u>	<u>2005</u>	<u>2004</u>

**Change in Benefit Obligation:**

Benefit Obligation at January 1	<b>\$25,549</b>	\$23,627	<b>\$8,956</b>	\$6,645
Service Cost	<b>1,132</b>	1,011	<b>113</b>	199
Interest Cost	<b>1,479</b>	1,389	<b>386</b>	491
Plan Participants Contributions	<b>---</b>	---	<b>186</b>	154
Amendments	<b>---</b>	285	<b>(876)</b>	---
Actuarial Loss (Gain)	<b>696</b>	1,074	<b>(943)</b>	1,968
Benefits Paid	<b><u>(1,430)</u></b>	<u>(1,837)</u>	<b><u>(590)</u></b>	<u>(501)</u>
Benefit Obligation at December 31 <sup>1</sup>	<b><u>\$27,426</u></b>	<u>\$25,549</u>	<b><u>\$7,232</u></b>	<u>\$8,956</u>

**Change in Plan Assets:**

Fair Value of Plan Assets at January 1	<b>\$24,423</b>	\$23,810	<b>\$ ---</b>	\$ ---
Actual Return on Plan Assets	<b>1,013</b>	2,105	<b>---</b>	---
Employer Contributions	<b>1,074</b>	345	<b>405</b>	347
Plan Participants Contributions	<b>---</b>	---	<b>186</b>	154
Benefits Paid	<b><u>(1,430)</u></b>	<u>(1,837)</u>	<b><u>(591)</u></b>	<u>(501)</u>
Fair Value of Plan Assets at December 31	<b><u>\$25,080</u></b>	<u>\$24,423</u>	<b><u>\$ ---</u></b>	<u>\$ ---</u>

<b>Funded Status</b>	<b>\$(2,346)</b>	\$(1,127)	<b>\$(7,232)</b>	\$(8,956)
Unrecognized Transition Obligation	<b>---</b>	---	<b>193</b>	790
Unrecognized Prior Service Benefit	<b>(1,177)</b>	(1,280)	<b>(499)</b>	(244)
Unrecognized Net Loss	<b><u>9,271</u></b>	<u>7,913</u>	<b><u>2,513</u></b>	<u>3,576</u>
Net Amount Recognized	<b><u>\$ 5,748</u></b>	<u>\$ 5,506</u>	<b><u>\$(5,025)</u></b>	<u>\$(4,834)</u>

<sup>1</sup> Represents the projected benefit obligation for pension benefits and the accumulated benefit obligations for postretirement benefits.

**NOTE 16:****RETIREMENT PLANS (Continued)**

At December 31, 2005 and 2004, the accumulated benefit obligation (the actuarial present value of benefits, vested and non-vested, earned by employees based on current and past compensation levels) for Arrow's qualified defined benefit pension plan totaled \$22,488 and \$21,689, respectively, which compared with total plan assets of \$25,080 and \$24,423, respectively. At December 31, 2005 and 2004, the accumulated benefit obligation for Arrow's non-qualified defined benefit pension plan was \$3,359 and \$2,607, respectively, which compared with no plan assets at December 31, 2005 and 2004.

The following table provides the amounts recognized in the consolidated balance sheets as of December 31 of both years:

	Pension Benefits		Pension Benefits		Postretirement	
	<u>Qualified Plan</u>		<u>Non-Qualified Plan</u>		<u>Benefits</u>	
	<u>2005</u>	<u>2004</u>	<u>2005</u>	<u>2004</u>	<u>2005</u>	<u>2004</u>
Prepaid Benefit Cost	\$7,783	\$7,531	\$ ---	\$ ---	\$ ---	\$ ---
Accrued Benefit Cost	---	---	(3,359)	(2,607)	(5,025)	(4,834)
Excess of Additional Pension Liability Over						
Unrecognized Prior Service Cost (Pre-Tax						
Charge)	<u>---</u>	<u>---</u>	<u>1,324</u>	<u>582</u>	<u>---</u>	<u>---</u>
Net Amount Recognized	<u>\$7,783</u>	<u>\$7,531</u>	<u>\$(2,035)</u>	<u>\$(2,025)</u>	<u>\$(5,025)</u>	<u>\$(4,834)</u>

The following table provides the components of net periodic benefit costs for the plans for the years ended December 31:

	Pension Benefits			Postretirement		
	<u>2005</u>	<u>2004</u>	<u>2003</u>	<u>2005</u>	<u>2004</u>	<u>2003</u>

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Service Cost	<b>\$1,132</b>	\$1,011	\$ 738	<b>\$113</b>	\$199	\$153
Interest Cost	<b>1,479</b>	1,389	1,344	<b>386</b>	491	384
Expected Return on Plan Assets	<b>(2,143)</b>	(2,093)	(1,623)	---	---	---
Amortization of Prior Service Cost (Credit)	<b>(102)</b>	(123)	(118)	<b>(52)</b>	(24)	(69)
Amortization of Transition (Asset) Obligation	---	---	---	<b>29</b>	111	40
Amortization of Net Loss	<u><b>466</b></u>	<u>326</u>	<u>356</u>	<u><b>120</b></u>	<u>180</u>	<u>175</u>
Net Periodic Benefit Cost	<u><b>\$ 832</b></u>	<u>\$ 510</u>	<u>\$ 697</u>	<u><b>\$596</b></u>	<u>\$957</u>	<u>\$683</u>

The prior service costs or credits are amortized on a straight-line basis over the average remaining service period of active participants. Gains and losses in excess of 10% of the greater of the benefit obligation or the fair value of assets are amortized over the average remaining service period of active participants.

<b>Additional Information:</b>	<u>Pension Benefits</u>			<u>Postretirement Benefits</u>		
	<u>2005</u>	<u>2004</u>	<u>2003</u>	<u>2005</u>	<u>2004</u>	<u>2003</u>
Increase (Decrease) in Minimum Liability						
Included In Other Comprehensive						
Income or Loss	<b>\$742</b>	\$131	\$(726)	---	---	---
Weighted-Average Assumptions Used To Determine Benefit Obligation at						
December 31:						
Discount Rate	<b>5.50%</b>	5.75%	6.00%	<b>5.50%</b>	5.75%	6.00%
Rate of Compensation Increase	<b>3.50%</b>	3.50%	3.50%	---	---	---
Interest Rate Credit for Determining						
Projected Cash Balance Account Interest Rate to Annuitize Cash						
Balance Account	<b>4.75%</b>	5.25%	5.25%	---	---	---



**NOTE 16:****RETIREMENT PLANS (Continued)**

<b>Additional Information (Continued):</b>	<u>Pension Benefits</u>			<u>Postretirement Benefits</u>		
	<u>2005</u>	<u>2004</u>	<u>2003</u>	<u>2005</u>	<u>2004</u>	<u>2003</u>
Weighted-Average Assumptions Used						
To Determine Net Periodic Benefit						
Cost for Years Ended December 31:						
Discount Rate	<b>5.75%</b>	6.00%	6.50%	<b>5.75%</b>	6.00%	6.50%
Expected Long-Term Return on						
Plan Assets	<b>9.00%</b>	9.00%	9.00%	---	---	---
Rate of Compensation Increase	<b>3.50%</b>	3.50%	3.50%	---	---	---
Interest Rate Credit for Determining						
Projected Cash Balance Account	<b>5.25%</b>	5.25%	5.00%	---	---	---
Interest Rate to Annuitize Cash						
Balance Account	<b>5.25%</b>	5.25%	5.00%	---	---	---

Arrow's overall expected long-term rate of return on assets is 8.75%. The expected long-term rate of return is based on the portfolio as a whole and not on the sum of the returns on individual asset categories. The return is based principally on Arrow's ten-year time-weighted historical returns of 8.95%, with an adjustment for expected returns.

The following table presents management's estimated benefit payments for the next ten years:

<u>Payment Period</u>	<b>Estimated Future Benefit Payments</b>			
	<u>Qualified Pension Plans</u>	<u>Non-Qualified Pension Plan</u>	<u>Post Retirement Plan</u>	
			<u>Gross</u>	<u>Subsidy</u>
2006	\$ 769	\$ 278	\$ 413	\$64
2007	758	264	412	72
2008	820	256	423	79
2009	868	243	475	44

2010	903	234	472	44
2011-2015	5,062	1,694	2,431	193

**Assumed Health Care Cost Trend Rates at December 31**

	<u>Health Care</u>	<u>Pre 65</u>	<u>Health Care</u>	<u>Post 65</u>	<u>Drug Benefits</u>		<u>Dental Care</u>	
	<u>2005</u>	<u>2004</u>	<u>2005</u>	<u>2004</u>	<u>2005</u>	<u>2004</u>	<u>2005</u>	<u>2004</u>
Health Care Cost Trend								
Rate Assumed for Next Year	<b>10.00%</b>	7.50%	<b>8.00%</b>	7.50%	<b>12.00%</b>	10.00%	<b>5.50%</b>	6.25%
Rate to which the Cost Trend								
Rate is Assumed to Decline								
(the Ultimate Trend Rate)	<b>5.00%</b>	5.00%	<b>5.00%</b>	5.00%	<b>5.00%</b>	5.00%	<b>5.50%</b>	5.50%
Year that the Rate Reaches the								
Ultimate Trend Rate	<b>2013</b>	2010	<b>2012</b>	2010	<b>2013</b>	2010	<b>2005</b>	2005

Assumed health care cost trend rates have a significant effect on the amounts reported for the health care plans. A one-percentage-point change in assumed health care cost trend rates would have the following effects:

	<u>1-Percentage- Point Increase</u>	<u>1-Percentage- Point Decrease</u>
Effect on Total Service and Interest Cost Components of Net Periodic		
Postretirement Benefit Cost For the Year Ended December 31, 2005	\$ 19	\$(15)
Effect on the Accumulated Postretirement Benefit Obligation as of		
December 31, 2005	265	(234)





**NOTE 16:****RETIREMENT PLANS (Continued)**

Arrow's pension plan weighted-average asset allocations at December 31, 2005, and 2004, by asset category are as follows:

Asset Category:	Plan Assets	
	<u>At December 31,</u>	
	<u>2005</u>	<u>2004</u>
Cash	1.0%	0.6%
Mortgages	0.3	0.5
Debt Securities	---	1.0
Company Stock	5.3	5.8
Mutual Funds - Equity	73.8	72.4
Mutual Funds - Fixed Income	<u>19.6</u>	<u>19.7</u>
Total	<u>100.0%</u>	<u>100.0%</u>

At December 31, 2005 and 2004, plan assets included shares of mutual funds advised by Arrow's subsidiary, North Country Investment Advisers, Inc., with a market value of \$16,846 and \$17,676, respectively. At December 31, 2005 and 2004, plan assets also included 51 and 47 shares, respectively, of Arrow Financial Corporation common stock with a market value of \$1,334 and \$1,457, respectively. During the respective years, the plan received \$46 and \$40 from cash dividends on Arrow's common stock. In accordance with ERISA guidelines, the Board authorized the purchase of Arrow Financial Corp. common stock up to 10% of the fair market value of the plan's assets at the time of acquisition.

**Pension Plan Investment Policies and Strategies:**

## Return Requirements:

The portfolio should achieve an inflation-protected rate of return at least equal to the actuarial assumption of 8.75%.

Risk Tolerance:

The Plan has the flexibility to accept an average to above-average degree of risk. Key factors to consider in reaching conclusions regarding risk tolerance are: (i) the pension plan must meet ERISA prudence requirements, which apply to the entire portfolio, not just its individual component securities, (ii) the Plan's two key actuarial assumptions with regard to expected long-term return on plan assets and salary progression are 8.75% and 3.50%, respectively. The expected long-term return on plan assets is reasonable relative to historic results over the last ten years of 8.95%. The salary progression rate is in line with past results, (iii) the plan is valued annually, (iv) Arrow's average employee age is reasonably low (43.0), and the time horizon is long, and (v) the Plan's operating results have been relatively strong and consistent.

Asset Allocation:

The Plan's limited liquidity requirements permit a low level of short-term reserves, which in any event do not meet the plan's 8.75% return requirement. All of the constraints suggest that moderate emphasis on common stocks is appropriate. With historically low interest rates, a lower weighting in bonds is appropriate. A separate asset allocation policy is reviewed by the Board on a regular basis and documented.

Investment Strategy:

The equity portion of the plan will be invested in a diversified portfolio of equity securities of companies with small, mid, and large capitalizations. Both domestic and international equities are allowed. While the plan is allowed to invest in the common stock of Arrow Financial up to 10% of the fair market value of plan assets at purchase, the plan assets will not be concentrated in any particular industry. Both growth and value styles will be employed to increase the diversification and offer varying opportunities for appreciation.

**NOTE 16:**

**RETIREMENT PLANS (Continued)**

The fixed income portion of the plan will be invested in U.S. dollar denominated investment grade bonds or debt securities. Portfolio securities shall be rated within the top four ratings categories by nationally recognized ratings agencies such as Moody's and Standard & Poor's. The bond portfolio will maintain a dollar-weighted average quality of A or better and an average dollar-weighted maturity between 1 and 10 years. The bond portion will be invested without regard to industry or sector based on analysis of each target security's structural and repayment features, current pricing and trading opportunities as well as credit quality of the issuer. Bonds with ratings that fall below the portfolio's rating requirements will be sold only when it is in the best interests of the plan.

**Cash Flows**

Based on the funded status at December 31, 2005, Arrow does not expect to make a contribution to the qualified defined benefit pension plan during 2006. Arrow makes contributions for its postretirement benefits in an amount equal to actual expenses for the year. That amount is estimated to be \$350 for 2006.

**NOTE 17:**

**OTHER EMPLOYEE BENEFIT PLANS (In Thousands)**

Arrow maintains an employee stock ownership plan (ESOP). Substantially all employees of Arrow and its subsidiaries are eligible to participate upon satisfaction of applicable service requirements. The ESOP borrowed \$105, \$464 and \$853 in 2001, 2000 and 1999, respectively, from one of Arrow's subsidiary banks to purchase outstanding shares of Arrow's common stock. The notes require annual payments of principal and interest through 2011. Arrow's ESOP expense amounted to \$196, \$500 and \$450 in 2005, 2004 and 2003, respectively. As the debt is repaid, shares are released from collateral based on the proportion of debt paid to total debt outstanding for the year and allocated to active employees.

Shares pledged as collateral are reported as unallocated ESOP shares in shareholders' equity. As shares are released from collateral, Arrow reports compensation expense equal to the current average market price of the shares, and the shares become outstanding for earnings per share computations. The ESOP shares as of December 31, 2005 were as follows:

Allocated Shares	737
Shares Released for Allocation During 2005	14
Unallocated Shares	<u>82</u>
Total ESOP Shares	<u>833</u>
Market Value of Unallocated Shares	\$2,153

Under the employee stock purchase plan ( ESPP ), employees may purchase shares of Arrow s common stock, up to \$24 annually, at a discount to the prevailing market price (currently a 5% discount). Under the ESPP, shares are issued by Arrow without a charge to earnings in accordance with SFAS No. 123. Substantially all employees of Arrow and its subsidiaries are eligible to participate upon satisfaction of applicable service requirements.

Arrow also sponsors a Short-Term Incentive Award Plan for senior management and a Profit Sharing Plan for substantially all employees. The combined cost of these plans was \$323, \$667 and \$525 for 2005, 2004 and 2003, respectively.

**NOTE 18:**

**STOCK OPTION PLANS**

Arrow has established fixed Incentive Stock Option and Non-qualified Stock Option Plans. At December 31, 2005, approximately 221,000 shares remained available for grant under these plans. Options may be granted at a price no less than the greater of the par value or fair market value of such shares on the date on which such option is granted, and generally expire ten years from the date of grant. The options usually vest over a four-year period, however, in December 2005 Arrow s Compensation Committee of the Board of Directors accelerated the vesting for all the remaining unvested shares from stock options granted in 2002 through 2004. The action to accelerate the vesting of the stock options was made to eliminate the non-cash compensation expense that would otherwise have been recognized by the Company in the 2006-2008 period due to the required adoption of FASB Statement 123(R) on January 1, 2006.

A summary of the status of Arrow s stock option plans as of December 31, 2005, 2004 and 2003 and changes during the years then ended is presented below (all share and per share data have been adjusted for stock splits and dividends, including the September 2005 3% stock dividend).

## NOTE 18:

## STOCK OPTION PLANS (Continued)

	<u>2005</u>		<u>2004</u>		<u>2003</u>	
	Weighted-		Weighted-		Weighted-	
	Average		Average		Average	
	Exercise		Exercise		Exercise	
Options:	<u>Shares</u>	<u>Price</u>	<u>Shares</u>	<u>Price</u>	<u>Shares</u>	<u>Price</u>
Outstanding at January 1	636,482	\$18.34	669,048	\$15.83	657,925	\$14.44
Granted	---	---	65,920	31.09	66,412	26.24
Exercised	(98,723)	9.93	(98,074)	9.82	(55,147)	11.66
Forfeited	(615)	28.68	(412)	25.92	(142)	20.32
Outstanding at December 31	<u>537,144</u>	<u>19.87</u>	<u>636,482</u>	18.33	<u>669,048</u>	15.84
Exercisable at December 31	<u>537,144</u>	<u>19.87</u>	463,494	15.00	484,518	12.97

The following table summarizes information about Arrow's stock options at December 31, 2005:

	<u>Options Outstanding</u>			<u>Options Exercisable</u>		
	Weighted-			Weighted-		
	Average			Average		
Range of	Number	Remaining		Number		
Exercise	Outstanding	Contractual	Exercise	Exercisable	Exercisable	Exercise
<u>Prices</u>	<u>At 12/31/05</u>	<u>Life</u>	<u>Price</u>	<u>at 12/31/05</u>	<u>Price</u>	<u>Price</u>
\$11.00-\$11.99	46,449	0.9	\$11.34	46,449	\$11.34	\$11.34
\$12.00-\$15.99	157,222	3.8	13.70	157,222	13.70	13.70
\$16.00-\$19.99	59,993	1.9	16.32	59,993	16.32	16.32
\$20.00-\$23.99	73,544	6.0	20.39	73,544	20.39	20.39
\$24.00-\$27.99	134,428	7.4	25.89	134,428	25.89	25.89
\$28.00-\$32.00	<u>65,508</u>	8.6	31.09	<u>65,508</u>	31.09	31.09
	<u>537,144</u>	5.2	19.87	<u>537,144</u>	19.87	19.87

**NOTE 19:****SHAREHOLDER RIGHTS PLAN**

In 1997, the Board of Directors of Arrow adopted a shareholder rights plan. The plan provides for the distribution of one preferred stock purchase right for each outstanding share of common stock of Arrow. Each right entitles the holder, following the occurrence of certain events, to purchase a unit consisting of one-hundredth of a share of Series 1 Junior Participating Preferred Stock, at a purchase price of \$35.51 (adjusted for stock dividends and stock splits) per unit, subject to adjustment. The rights will not be exercisable or transferable apart from the common stock except under certain circumstances in which a person or group of affiliated persons acquires, or commences a tender offer to acquire, 20% or more of Arrow's common stock. Rights held by such an acquiring person or persons may thereafter become void. Under certain circumstances a right may become a right to purchase common stock or assets of Arrow or common stock of an acquiring corporation at a substantial discount. Under certain circumstances, Arrow may redeem the rights at \$.01 per right. The rights will expire in April 2007 unless earlier redeemed or exchanged by Arrow.

**NOTE 20:****OTHER OPERATING EXPENSE (In Thousands)**

Other operating expenses included in the consolidated statements of income are as follows:

	<u>2005</u>	<u>2004</u>	<u>2003</u>
Legal and Other Professional Fees	<b>\$1,393</b>	\$1,225	\$1,229
Computer Services	<b>1,270</b>	1,365	1,234
Postage	<b>1,196</b>	1,090	1,097
Stationery and Printing	<b>1,035</b>	864	933
Telephone and Communications	<b>735</b>	716	750
Advertising and Promotion	<b>700</b>	639	672
Intangible Asset Amortization (see Notes 1 and 8)	<b>386</b>	42	37
FDIC and Other Insurance	<b>359</b>	356	344
Charitable Contributions	<b>164</b>	170	160
All Other	<b><u>1,469</u></b>	<u>1,338</u>	<u>1,764</u>
Total Other Operating Expense	<b><u>\$8,707</u></b>	<u>\$7,805</u>	<u>\$8,220</u>



**NOTE 21:****INCOME TAXES (In Thousands)**

The provision for income taxes is summarized below:

Current Tax Expense:	<u>2005</u>	<u>2004</u>	<u>2003</u>
Federal	\$7,134	\$7,433	\$5,940
State	<u>779</u>	<u>929</u>	<u>435</u>
Total Current Tax Expense	<u>7,913</u>	<u>8,362</u>	<u>6,375</u>
Deferred Tax Expense			
Federal	154	531	1,817
State	<u>36</u>	<u>66</u>	<u>414</u>
Total Deferred Tax Expense	<u>190</u>	<u>597</u>	<u>2,231</u>
Total Provision for Income Taxes	<u>\$8,103</u>	<u>\$8,959</u>	<u>\$8,606</u>

The provisions for income taxes differed from the amounts computed by applying the U.S. Federal Income Tax Rate of 35% for 2005, 2004 and 2003 to pre-tax income as a result of the following:

	<u>2005</u>	<u>2004</u>	<u>2003</u>
Computed Tax Expense at Statutory Rate	\$9,360	\$9,953	\$9,633
Increase (Decrease) in Income Taxes Resulting From:			
Tax-Exempt Income	(1,757)	(1,747)	(1,685)
Nondeductible Interest Expense	151	119	130
State Taxes, Net of Federal Income Tax Benefit	533	647	552
Other Items, Net	<u>(184)</u>	<u>(13)</u>	<u>(24)</u>
Total Provision for Income Taxes	<u>\$8,103</u>	<u>\$8,959</u>	<u>\$8,606</u>

The tax effects of temporary differences that give rise to significant portions of the deferred tax assets and deferred tax liabilities at December 31, 2005 and 2004 are presented below:



Deferred Tax Assets:	<u>2005</u>	<u>2004</u>
Allowance for Loan Losses	<b>\$ 4,761</b>	\$4,687
Pension and Deferred Compensation Plans	<b>3,160</b>	3,061
Minimum Pension Liability	<b>528</b>	232
Net Unrealized Losses on Securities Available-for-Sale	<b>2,498</b>	---
Other	<u><b>272</b></u>	<u>235</u>
Total Gross Deferred Tax Assets	<u><b>11,219</b></u>	<u><b>8,215</b></u>
Deferred Tax Liabilities:		
Pension Plans	<b>3,123</b>	3,003
Depreciation	<b>709</b>	818
Deferred Income	<b>2,473</b>	2,398
Net Unrealized Gains on Securities Available-for-Sale	---	517
Goodwill	<b>1,677</b>	1,352
Other	<u><b>15</b></u>	<u>26</u>
Total Gross Deferred Tax Liabilities	<u><b>7,997</b></u>	<u><b>8,114</b></u>
Net Deferred Tax Assets	<u><b>\$3,222</b></u>	<u><b>\$ 101</b></u>

Management believes that the realization of the recognized net deferred tax assets at December 31, 2005 and 2004 is more likely than not, based on existing loss carryback ability, available tax planning strategies and expectations as to future taxable income. Accordingly, there was no valuation allowance for deferred tax assets as of December 31, 2005 and 2004.

**NOTE 22:****LEASE COMMITMENTS (In Thousands)**

At December 31, 2005, Arrow was obligated under a number of noncancelable operating leases for buildings and equipment. Certain of these leases provide for escalation clauses and contain renewal options calling for increased rentals if the lease is renewed.

Future minimum lease payments on operating leases at December 31, 2005 were as follows:

	Operating <u>Leases</u>
2006	\$ 267
2007	269
2008	266
2009	218
2010	219
Later Years	<u>1,524</u>
Total Minimum Lease Payments	<u>\$2,763</u>

Arrow leases two of its branch offices, at market rates, from Stewart's Shops Corp. Gary Dake, president of Stewart's Shops Corp., serves on both the boards of Arrow and Saratoga National Bank and Trust Company.

**NOTE 23:****FINANCIAL INSTRUMENTS WITH OFF-BALANCE SHEET RISK AND CONTINGENT LIABILITIES****(In Thousands)**

Arrow is 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 include commitments to extend credit and standby letters of credit. Commitments to extend credit include home equity lines of credit, commitments for residential and commercial construction loans and other personal and commercial lines of credit. Those instruments involve, to varying degrees, elements of credit and interest rate risk in excess of the amount recognized in the consolidated balance sheets. The contract or notional amounts of those instruments reflect the extent of the involvement Arrow has

in particular classes of financial instruments.

Arrow's exposure to credit loss in the event of nonperformance by the other party to the financial instrument for commitments to extend credit and standby letters of credit is represented by the contractual notional amount of those instruments. Arrow uses the same credit policies in making commitments and conditional obligations as it does for on-balance sheet instruments.

Commitments to extend credit were \$142,299 and \$138,338 at December 31, 2005 and 2004, respectively. These commitments are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Since many of the commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. Arrow evaluates each customer's creditworthiness on a case-by-case basis. Home equity lines of credit are secured by residential real estate. Construction lines of credit are secured by underlying real estate. For other lines of credit, the amount of collateral obtained, if deemed necessary by Arrow upon extension of credit, is based on management's credit evaluation of the counterparty. Collateral held varies, but may include accounts receivable, inventory, property, plant and equipment, and income-producing commercial properties. Most of the commitments are variable rate instruments.

In November 2002, the FASB issued FASB Interpretation No. 45 ( FIN No. 45 ), "Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others; an Interpretation of FASB Statements No. 5, 57, and 107 and rescission of FASB Interpretation No. 34." FIN No. 45 requires certain new disclosures and potential liability-recognition for the fair value at issuance of guarantees that fall within its scope.

Under FIN No. 45, Arrow does not issue any guarantees that would require liability-recognition or disclosure, other than its standby letters of credit.

**NOTE 23:**

**FINANCIAL INSTRUMENTS WITH OFF-BALANCE SHEET RISK AND CONTINGENT LIABILITIES**

**(Continued)**

Arrow has issued conditional commitments in the form of standby letters of credit to guarantee payment on behalf of a customer and guarantee the performance of a customer to a third party. Standby letters of credit generally arise in connection with lending relationships. The credit risk involved in issuing these instruments is essentially the same as that involved in extending loans to customers. Contingent obligations under standby letters of credit totaled \$2,984 and \$2,630 at December 31, 2005 and 2004, respectively, and represent the maximum potential future payments Arrow could be required to make. Typically, these instruments have terms of 12 months or less and expire unused; therefore, the total amounts do not necessarily represent future cash requirements. Each customer is evaluated individually for creditworthiness under the same underwriting standards used for commitments to extend credit and on-balance sheet instruments. Company policies governing loan collateral apply to standby letters of credit at the time of credit extension. Loan-to-value ratios will generally range from 50% for movable assets, such as inventory, to 100% for liquid assets, such as bank CD's. Fees for standby letters of credit range from 1% to 3% of the notional amount. Fees are collected upfront and amortized over the life of the commitment. The carrying amount and fair value of Arrow's standby letters of credit at December 31, 2005 and 2004 were insignificant. The fair value of standby letters of credit is based on the fees currently charged for similar agreements or the cost to terminate the arrangement with the counterparties.

Under SFAS No. 107 the fair value of commitments to extend credit is determined by estimating the fees to enter into similar agreements, taking into account the remaining terms and present creditworthiness of the counterparties, and for fixed rate loan commitments, the difference between the current and committed interest rates. Arrow provides several types of commercial lines of credit and standby letters of credit to its commercial customers. The pricing of these services is not isolated as Arrow considers the customer's complete deposit and borrowing relationship in pricing individual products and services. The commitments to extend credit also include commitments under home equity lines of credit, for which Arrow charges no fee. The carrying value and fair value of commitments to extend credit are not material and Arrow does not expect to incur any material loss as a result of these commitments.

In the normal course of business, Arrow and its subsidiary banks become involved in a variety of routine legal. At present, there are no legal proceedings pending or threatened, which in the opinion of management and counsel, would result in a material loss to Arrow.

**NOTE 24:**

**FAIR VALUE OF FINANCIAL INSTRUMENTS (In Thousands)**

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The following table presents a summary at December 31 of the carrying amount and fair value of Arrow's financial instruments not carried at fair value or an amount approximating fair value:

	<u>2005</u>		<u>2004</u>	
	<b>Carrying</b>	<b>Fair</b>	Carrying	Fair
	<u>Amount</u>	<u>Value</u>	<u>Amount</u>	<u>Value</u>
Securities Held-to-Maturity (Note 3)	<b>\$118,123</b>	<b>\$118,495</b>	\$108,117	\$111,058
Net Loans (Note 4)	<b>984,304</b>	<b>971,835</b>	863,265	869,252
Time Deposits (Note 9)	<b>375,798</b>	<b>373,171</b>	256,793	256,404
FHLB Advances (Note 11)	<b>157,000</b>	<b>156,851</b>	150,000	152,675
Junior Subordinated Obligations Issued to				
Unconsolidated Subsidiary Trusts (Note 12)	<b>20,000</b>	<b>20,007</b>	20,000	20,651

**NOTE 25:****PARENT ONLY FINANCIAL INFORMATION (In Thousands)**

Condensed financial information for Arrow Financial Corporation is as follows:

<b>BALANCE SHEETS</b>	<b>December 31,</b>		
	<b><u>2005</u></b>	<b><u>2004</u></b>	<b><u>2003</u></b>
<b>ASSETS</b>			
Interest-Bearing Deposits with Subsidiary Banks	\$ 382	\$ 9,293	
Securities Available-for-Sale	491	453	
Investment in Subsidiaries at Equity	139,121	130,443	
Other Assets	<u>3,921</u>	<u>3,745</u>	
Total Assets	<b><u>\$143,915</u></b>	<b><u>\$143,934</u></b>	
<b>LIABILITIES</b>			
Junior Subordinated Obligations Issued to Unconsolidated Subsidiary Trusts	\$ 20,000	\$ 20,000	
Other Liabilities	<u>6,494</u>	<u>5,900</u>	
Total Liabilities	<b>26,494</b>	<b>25,900</b>	
<b>SHAREHOLDERS EQUITY</b>			
Total Shareholders Equity	<u>117,421</u>	<u>118,034</u>	
Total Liabilities and Shareholders Equity	<b><u>\$143,915</u></b>	<b><u>\$143,934</u></b>	
<b>STATEMENTS OF INCOME</b>	<b>Years Ended December 31,</b>		
	<b><u>2005</u></b>	<b><u>2004</u></b>	<b><u>2003</u></b>
<b>Income:</b>			
Dividends from Bank Subsidiaries	\$ 6,100	\$ 6,975	\$ 9,726
Interest and Dividends on Securities Available-for-Sale	32	41	7
Other Income (Including Management Fees)	645	758	753
Net Gains on the Sale of Securities Available-for-Sale	<u>45</u>	<u>11</u>	<u>13</u>
Total Income	<b><u>6,822</u></b>	<b><u>7,785</u></b>	<b><u>10,499</u></b>
<b>Expense:</b>			
Interest Expense	<b>1,270</b>	1,208	842

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Salaries and Benefits	<b>219</b>	202	199
Occupancy and Equipment	<b>3</b>	4	1
Other Expense	<u><b>632</b></u>	<u>763</u>	<u>669</u>
Total Expense	<u><b>2,124</b></u>	<u>2,177</u>	<u>1,711</u>
Income Before Income Tax Benefit and Equity in Undistributed Net Income of Subsidiaries	<b>4,698</b>	5,608	8,788
Income Tax Benefit	<u><b>746</b></u>	<u>579</u>	<u>410</u>
Income Before Equity in Undistributed Net Income of Subsidiaries	<b>5,444</b>	6,187	9,198
Equity in Undistributed Net Income of Subsidiaries	<u><b>13,195</b></u>	<u>13,291</u>	<u>9,719</u>
Net Income	<u><b>\$18,639</b></u>	<u>\$19,478</u>	<u>\$18,917</u>

## NOTE 25:

**PARENT ONLY FINANCIAL INFORMATION (Continued)**

<b>STATEMENTS OF CASH FLOWS</b>	<b>Years Ended December 31,</b>		
	<b><u>2005</u></b>	<b><u>2004</u></b>	<b><u>2003</u></b>
<b>Operating Activities:</b>			
Net Income	<b>\$18,639</b>	\$19,478	\$18,917
Adjustments to Reconcile Net Income to Net Cash Provided by Operating Activities:			
Undistributed Net Income of Subsidiaries	<b>(13,195)</b>	(13,291)	(9,719)
Net Gains on the Sale of Securities Available-for-Sale	<b>(45)</b>	(11)	(13)
Shares Issued Under the Directors' Stock Plan	<b>120</b>	75	57
Compensation Expense for Allocated ESOP Shares	<b>178</b>	405	91
Changes in Other Assets and Other Liabilities	<b><u>633</u></b>	<u>497</u>	<u>(1,328)</u>
Net Cash Provided by Operating Activities	<b><u>6,330</u></b>	<u>7,153</u>	<u>8,005</u>
<b>Investing Activities:</b>			
Proceeds from the Sale of Securities Available-for-Sale	<b>469</b>	160	331
Purchases of Securities Available-for-Sale	<b><u>(512)</u></b>	<u>(202)</u>	<u>(346)</u>
Net Cash Used in Investing Activities	<b><u>(43)</u></b>	<u>(42)</u>	<u>(15)</u>
<b>Financing Activities:</b>			
Exercise of Stock Options and Shares Issued to the Employees			
Stock Purchase Plan	<b>1,204</b>	1,591	1,241
Proceeds from Issuance of Trust Preferred Securities	<b>---</b>	10,000	10,000
Repayment of Trust Preferred Security	<b>---</b>	(5,000)	---
Tax Benefit for Disposition of Stock Options	<b>684</b>	409	109
Purchase of Treasury Stock	<b>(7,528)</b>	(2,453)	(5,557)
Cash Dividends Paid	<b><u>(9,558)</u></b>	<u>(9,000)</u>	<u>(8,225)</u>
Net Cash Used in Financing Activities	<b><u>(15,198)</u></b>	<u>(4,453)</u>	<u>(2,432)</u>
<b>Net Increase in Cash and Cash Equivalents</b>	<b>(8,911)</b>	2,658	5,558
Cash and Cash Equivalents at Beginning of the Year	<b><u>9,293</u></b>	<u>6,635</u>	<u>1,077</u>
Cash and Cash Equivalents at End of the Year	<b><u>\$ 382</u></b>	<u>\$ 9,293</u>	<u>\$ 6,635</u>

**Supplemental Disclosures to Statements of****Cash Flow Information:**

Interest Paid	<b>\$ 1,270</b>	\$ 1,208	\$ 842
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Impact of Deconsolidation of Subsidiary Trusts upon Adoption of

FIN 46R as Described in Note 1:

Increase in Junior Subordinated Obligations	---	---	15,000
Decrease in Trust Preferred Securities	---	---	(15,000)
Increase in Other Assets Representing Investment in Unconsolidated Trusts	---	---	(465)

**NOTE 26:**

**CONCENTRATIONS OF CREDIT RISK**

Most of Arrow's loans are with customers in northern New York. Although the loan portfolios of the subsidiary banks are well diversified, tourism has a substantial impact on the northern New York economy. The commitments to extend credit are fairly consistent with the distribution of loans presented in Note 4. Generally, the loans are secured by assets and are expected to be repaid from cash flow or the sale of selected assets of the borrowers. Arrow evaluates each customer's creditworthiness on a case-by-case basis. The amount of collateral obtained, if deemed necessary by Arrow upon extension of credit, is based upon management's credit evaluation of the counterparty. The nature of the collateral varies with the type of loan and may include: residential real estate, cash and securities, inventory, accounts receivable, property, plant and equipment, income producing commercial properties and automobiles.

**SUMMARY OF QUARTERLY FINANCIAL DATA (Unaudited)**

The following quarterly financial information for 2005 and 2004 is unaudited, but, in the opinion of management, fairly presents the results of Arrow. Earnings per share amounts have been adjusted for the 2005 3% stock dividend.

**SELECTED QUARTERLY FINANCIAL DATA**

(In Thousands, Except Per Share Amounts)

	<u>2005</u>			
	First	Second	Third	Fourth
	<u>Quarter</u>	<u>Quarter</u>	<u>Quarter</u>	<u>Quarter</u>
Total Interest and Dividend Income	\$16,867	\$17,776	\$18,294	\$19,190
Net Interest Income	11,804	12,155	12,136	11,918
Provision for Loan Losses	232	176	218	404
Net Securities Gains	64	125	151	24
Income Before Provision for Income Taxes	6,381	6,686	6,999	6,676
Net Income	4,430	4,680	4,839	4,690
Basic Earnings Per Common Share	.42	.45	.47	.45
Diluted Earnings Per Common Share	.41	.44	.46	.45
	<u>2004</u>			
	First	Second	Third	Fourth
	<u>Quarter</u>	<u>Quarter</u>	<u>Quarter</u>	<u>Quarter</u>
Total Interest and Dividend Income	\$17,302	\$17,062	\$17,038	\$17,041
Net Interest Income	12,304	12,111	12,502	12,320
Provision for Loan Losses	285	254	205	276
Net Securities Gains (Losses)	210	---	(9)	161
Income Before Provision for Income Taxes	7,117	6,819	7,273	7,229
Net Income	4,865	4,698	4,968	4,948
Basic Earnings Per Common Share	.47	.45	.48	.47

Diluted Earnings Per Common Share	.46	.44	.47	.46
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## **Item 9A: Controls and Procedures**

Senior management maintains disclosure controls and procedures that are designed to ensure that information required to be disclosed in our Exchange Act reports is recorded, processed, summarized and reported within the time periods provided in the SEC's rules and forms, and that such information is accumulated and communicated to our management, including the Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosure. In designing and evaluating the disclosure controls and procedures, senior management has recognized that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving the desired control objectives, and therefore has been required to apply its judgment in evaluating the cost-benefit relationship of possible controls and procedures.

Senior management, including the Chief Executive Officer and Chief Financial Officer, evaluated the effectiveness of the design and operation of our disclosure controls and procedures (as defined in Rule 13(a)-15(e) under the Exchange Act) as of December 31, 2005. Based upon that evaluation, including the effects of the restatement of the Consolidated Statement of Cash Flows as described in Note 1 to the Consolidated Financial Statements, senior management, including the Chief Executive Officer and Chief Financial Officer, concluded that our disclosure controls and procedures were effective on that date. There were no changes made in our internal controls or in other factors that could significantly affect these internal controls subsequent to the date of the evaluation performed by the Chief Executive Officer and Chief Financial Officer.

### **Management's Report on Internal Control Over Financial Reporting**

Our management is responsible for establishing and maintaining adequate internal control over financial reporting, as such term is defined in Exchange Act Rules 13a-15(f). Under the supervision and with the participation of our management, including our chief executive officer and chief financial officer, we conducted an assessment of the effectiveness of our internal control over financial reporting. Our evaluation is based on the framework set forth in *Internal Control - Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission. Based on our assessment, our management concluded that our internal control over financial reporting was effective as of December 31, 2005. Our management's assessment of the effectiveness of our internal control over financial reporting as of December 31, 2005 has been audited by KPMG LLP, an independent registered public accounting firm, as stated in their report, which is included herein on page 4.



**PART IV**

**Item 15. Exhibits and Financial Statement Schedules**

1. Financial Statements

The following financial statements, the notes thereto, and the independent auditors' report thereon are filed in Part II, Item 8 of this report. See the index to such financial statements at the beginning of Item 8.

Reports of Independent Registered Public Accounting Firm

Consolidated Balance Sheets as of December 31, 2005 and 2004

Consolidated Statements of Income for the Years Ended December 31, 2005, 2004 and 2003

Consolidated Statements of Changes in Shareholders

Equity for the Years Ended December 31, 2005, 2004 and 2003

Consolidated Statements of Cash Flows for the Years Ended December 31, 2005 (Restated), 2004 and 2003

Notes to Consolidated Financial Statements

2. Schedules

All schedules are omitted as the required information is either not applicable or not required or is contained in the respective financial statements or in the notes thereto.



3. Exhibits:

The following exhibits are incorporated by reference herein.

**Exhibit**

<b>Number</b>	<b><u>Exhibit</u></b>
3.(i)	Certificate of Incorporation of the Registrant, as amended, incorporated herein by reference from the Registrant's Annual Report on Form 10-K for the year ended December 31, 1990, Exhibit 3.(a).
4.1	Shareholder Protection Rights Agreement dated as of May 1, 1997, between Arrow Financial Corporation and Glens Falls National Bank and Trust Company, as Rights Agent, incorporated herein by reference from the Registrant's Statement on Form 8-A, dated May 16, 1997, Exhibit 4.
4.2	Amended and Restated Declaration of the Trust by and among U.S. Bank National Association, as Institutional Trustee, Arrow Financial Corporation, as Sponsor and certain Administrators named therein, dated as of July 23, 2003, relating to Arrow Capital Statutory Trust II, incorporated herein by reference from the Registrant's Quarterly Report on Form 10-Q for the quarter ended September 30, 2003, Exhibit 4.1.
4.3	Indenture between Arrow Financial Corporation, as Issuer, and U.S. Bank National Association, as Trustee, dated as of July 23, 2003, incorporated herein by reference from the Registrant's Quarterly Report on Form 10-Q for the quarter ended September 30, 2003, Exhibit 4.2.
4.4	Placement Agreement by and among Arrow Financial Corporation, Arrow Capital Statutory Trust II and SunTrust Capital Markets, Inc., dated July 23, 2003, incorporated herein by reference from the Registrant's Quarterly Report on Form 10-Q for the quarter ended September 30, 2003, Exhibit 4.3.
4.5	Guarantee Agreement by and between Arrow Financial Corporation and U.S. Bank National Association, dated as of July 23, 2003, incorporated herein by reference from the Registrant's Quarterly Report on Form 10-Q for the quarter ended September 30, 2003, Exhibit 4.4.
4.6	Amended and Restated Trust Agreement by and among Wilmington Trust Company, as Institutional Trustee, Arrow Financial Corporation, as Sponsor and certain Administrators named therein, dated as of December 28, 2004, relating to Arrow Capital Statutory Trust III, incorporated herein by reference from the Registrant's Annual Report on Form 10-K for the year ended December 31, 2004, Exhibit 4.6.
4.7	Junior Subordinated Indenture between Arrow Financial Corporation, as Issuer, and Wilmington Trust Company, as Trustee, dated as of December 28, 2004, incorporated herein by reference from the Registrant's Annual Report on Form 10-K for the year ended December 31, 2004, Exhibit 4.7.
4.8	Placement Agreement by and among Arrow Financial Corporation, Arrow Capital Statutory Trust III and SunTrust Capital Markets, Inc., dated December 28, 2004, incorporated herein by reference from the Registrant's Annual Report on Form 10-K for the year ended December 31, 2004, Exhibit 4.8.
4.9	Guarantee Agreement by and between Arrow Financial Corporation and Wilmington Trust Company, dated as of December 28, 2004, incorporated herein by reference from the Registrant's Annual Report on Form 10-K for the year ended December 31, 2004, Exhibit 4.9.
10.1	



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Select Executive Retirement Plan of the Registrant effective January 1, 1992 incorporated herein by reference from Registrant's Annual Report on Form 10-K for the year ended December 31, 1992, Exhibit 10(m). \*

- 10.2 1993 Long Term Incentive Plan of the Registrant, incorporated herein by reference from Registrant's 1933 Act Registration Statement on Form S-8, Exhibit 4.1 (File number 33-66192; filed July 19, 1993). \*
- 10.3 1998 Long Term Incentive Plan of the Registrant, incorporated herein by reference from Registrant's 1933 Act Registration Statement on Form S-8, Exhibit 4.1 (File number 333-62719; filed September 2, 1998). \*
- 10.4 Directors Deferred Compensation Plan of Registrant, incorporated herein by reference from Registrant's Annual Report on Form 10-K for the year ended December 31, 1993, Exhibit 10(n).\*
- 10.5 Senior Officers Deferred Compensation Plan of the Registrant, incorporated herein by reference from Registrant's Annual Report on Form 10-K for the year ended December 31, 1993, Exhibit 10(o).\*
- 10.6 Directors Stock Plan of the Registrant, as amended, incorporated herein by reference from Registrant's 1933 Act Registration Statement on Form S-8 (file number 333-110445, filed November 13, 2003).\*

Exhibits incorporated by reference, continued:

**Exhibit**

<b>Number</b>	<b><u>Exhibit</u></b>
10.7	2000 Employee Stock Purchase Plan of the Registrant, incorporated herein by reference from Registrant's 1933 Act Registration Statement on Form S-3 (File number 333-47912; filed on October 11, 2000).*
10.8	Award under Schedule A of Select Executive Retirement Plan to Thomas L. Hoy, dated May 2, 2001, incorporated herein by reference from the Registrant's Annual Report on Form 10-K for the year ended December 31, 2001, Exhibit 10.15.*
10.9	Award under Schedule A of Select Executive Retirement Plan to John J. Murphy, dated May 2, 2001, incorporated herein by reference from the Registrant's Annual Report on Form 10-K for the year ended December 31, 2001, Exhibit 10.16.*
10.10	Prototype of a change of control agreement between the Registrant and certain officers (excluding senior officers) of the Registrant or its subsidiaries, as entered into from time to time, incorporated herein by reference from the Registrant's Annual Report on Form 10-K for the year ended December 31, 2003, Exhibit 10.11.*
10.11	Agreement and Plan of Reorganization by and among Glens Falls National Bank and Trust Company, Arrow Financial Corporation, 429 Saratoga Road Corporation, Capital Financial Group, Inc. and John Weber dated November 22, 2004, incorporated herein by reference from the Registrant's Annual Report on Form 10-K for the year ended December 31, 2004, Exhibit 10.14.
10.12	Post-Closing Payment Agreement by and among Glens Falls National Bank and Trust Company, Arrow Financial Corporation, 429 Saratoga Road Corporation, Capital Financial Group, Inc. and John Weber dated November 22, 2004, incorporated herein by reference from the Registrant's Annual Report on Form 10-K for the year ended December 31, 2004, Exhibit 10.15.
10.13	Employment Agreement between Arrow Financial Corporation, Glens Falls national Bank and Trust Company, Capital Financial Group, Inc. and John Weber dated November 29, 2004, incorporated herein by reference from the Registrant's Annual Report on Form 10-K for the year ended December 31, 2004, Exhibit 10.16.*
14	Financial Code of Ethics, incorporated herein by reference from the Registrant's Annual Report on Form 10-K for the year ended December 31, 2003, Exhibit 14.

\* Management contracts or compensation plans required to be filed as an exhibit.

The following exhibits were submitted with the original filing:

**Exhibit**

<b>Number</b>	<b><u>Exhibit</u></b>
3.(ii)	By-laws of the Registrant, as amended.
10.14	Employment Agreement among the Registrant, its subsidiary bank, Glens Falls National Bank and Trust Company, and Thomas L. Hoy dated January 1, 2006.*
10.15	Employment Agreement among the Registrant, its subsidiary bank, Glens Falls National Bank and Trust Company and John J. Murphy dated January 1, 2006.*
21	Subsidiaries of Arrow

\* Management contracts or compensation plans required to be filed as an exhibit.

The following exhibits are submitted herewith:

**Exhibit**

<b>Number</b>	<b><u>Exhibit</u></b>
23	Consent of Independent Registered Public Accounting Firm
31.1	Certification of Chief Executive Officer under SEC Rule 13a-14(a)/15d-14(a)
31.2	Certification of Chief Financial Officer under SEC Rule 13a-14(a)/15d-14(a)
32	Certification of Chief Executive Officer under 18 U.S.C. Section 1350 and Certification of Chief Financial Officer under 18 U.S.C. Section 1350

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) 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.

ARROW FINANCIAL CORPORATION

Date: October 12, 2006

By: /s/ Thomas L. Hoy

Thomas L. Hoy

President and Chief Executive Officer

Date: October 12, 2006

By: /s/ John J. Murphy

John J. Murphy

Executive Vice President, Treasurer and

Chief Financial Officer

(Principal Financial and Accounting Officer)

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below on September 12, 2006 by the following persons in the capacities indicated.

/s/ Jan-Eric O. Bergstedt

/s/ Thomas L. Hoy

Jan-Eric O. Bergstedt

Thomas L. Hoy

Director, Chairman and President

Director

/s/ John J. Carusone, Jr.

/s/ David G. Kruczynicki

John J. Carusone, Jr.

David G. Kruczynicki

Director

Director

/s/ Michael B. Clarke

/s/ Elizabeth O. C. Little

Michael B. Clarke

Elizabeth O. C. Little

Director

Director

/s/ Gary C. Dake

/s/ Michael F. Massiano

Gary C. Dake

Michael F. Massiano

Director

Director

/s/ Mary Elizabeth T. FitzGerald

/s/ David L. Moynehan

Mary Elizabeth T. FitzGerald

David L. Moynehan

Director

Director

/s/ Kenneth C. Hopper, M.D.

/s/ Richard J. Reisman, D.M.D.

Kenneth C. Hopper, M.D.

Richard J. Reisman, D.M.D.

Director and Vice Chairman

Director