

COMMUNITY BANK SYSTEM INC
Form 10-K
February 29, 2012

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

FORM 10-K

X ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE
SECURITIES EXCHANGE ACT OF 1934
For the fiscal year ended December 31, 2011

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE
ACT OF 1934
For the transition period from _____ to _____
Commission file number 001-13695

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

Delaware 16-1213679
(State or other jurisdiction of incorporation or organization) (I.R.S. Employer Identification No.)

5790 Widewaters Parkway,
DeWitt, New York 13214-1883
(Address of principal executive offices) (Zip Code)

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

Securities registered pursuant of
Section 12(b) of the Act:
Title of each class Name of each exchange on which registered
Common Stock, Par Value \$1.00 New York Stock Exchange

Securities registered pursuant to Section 12(g) of the Act: None

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

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

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

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K (§229.405 of this chapter) is not contained herein, and will not be contained, to the best of the registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment of this Form 10-K. .

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

Large accelerated filer Accelerated filer Non-accelerated filer Smaller reporting company .

(Do not check if a smaller reporting company)

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

The aggregate market value of the common stock, \$1.00 par value, held by non-affiliates of the registrant computed by reference to the closing price as of the close of business on June 30, 2011 (the registrant's most recently completed second fiscal quarter): \$858,986,069.

The number of shares of the common stock, \$1.00 par value, outstanding as of the close of business on January 31, 2012: 39,196,328 shares

DOCUMENTS INCORPORATED BY REFERENCE.

Portions of the Definitive Proxy Statement for the Annual Meeting of the Shareholders to be held on May 9, 2012 (the "Proxy Statement") is incorporated by reference in Part III of this Annual Report on Form 10-K.

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Part I

This Annual Report on Form 10-K contains certain forward-looking statements with respect to the financial condition, results of operations and business of Community Bank System, Inc. These forward-looking statements by their nature address matters that involve certain risks and uncertainties. Factors that may cause actual results to differ materially from those contemplated by such forward-looking statements are set forth herein under the caption “Forward-Looking Statements.”

Item 1. Business

Community Bank System, Inc. (“the Company”) was incorporated on April 15, 1983, under the Delaware General Corporation Law. Its principal office is located at 5790 Widewaters Parkway, DeWitt, New York 13214. The Company is a single bank holding company which wholly-owns five subsidiaries: Community Bank, N.A. (“the Bank” or “CBNA”), Benefit Plans Administrative Services, Inc. (“BPAS”), CFSI Closeout Corp. (“CFSICC”), First of Jermyn Realty Company, Inc. (“FJRC”) and Town & Country Agency LLC (“T&C”). BPAS owns three subsidiaries, Benefit Plans Administrative Services LLC (“BPA”), a provider of defined contribution plan administration services; Harbridge Consulting Group LLC (“Harbridge”), a provider of actuarial and benefit consulting services; and Hand Benefits & Trust Company (“HB&T”), a provider of Collective Investment Fund administration and institutional trust services. CFSICC, FJRC and T&C are inactive companies. The Company also wholly-owns two unconsolidated subsidiary business trusts formed for the purpose of issuing mandatorily-redeemable preferred securities which are considered Tier I capital under regulatory capital adequacy guidelines.

The Bank’s business philosophy is to operate as a community bank with local decision-making, principally in non-metropolitan markets, providing a broad array of banking and financial services to retail, commercial, and municipal customers. The Bank operates 168 customer facilities throughout 35 counties of Upstate New York, where it operates as Community Bank, N.A. and five counties of Northeastern Pennsylvania, where it is known as First Liberty Bank & Trust, offering a range of commercial and retail banking services. The Bank owns the following subsidiaries: Community Investment Services, Inc. (“CISI”), CBNA Treasury Management Corporation (“TMC”), CBNA Preferred Funding Corporation (“PFC”), Nottingham Advisors, Inc. (“Nottingham”), First Liberty Service Corp. (“FLSC”), Brilie Corporation (“Brilie”), CBNA Insurance Agency, Inc. (“CBNA Insurance”) and Western Catskill Realty, LLC (“WCR”). CISI provides broker-dealer and investment advisory services. TMC provides cash management, investment, and treasury services to the Bank. PFC primarily acts as an investor in residential real estate loans. Nottingham provides asset management services to individuals, corporate pension and profit sharing plans, and foundations. FLSC provides banking-related services to the Pennsylvania branches of the Bank. Brilie and WCR are inactive companies. CBNA Insurance is a full-service insurance agency offering primarily property and casualty products.

The Company maintains websites at communitybankna.com and firstlibertybank.com. Annual reports on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, and amendments to those reports, are available on the Company’s website free of charge as soon as reasonably practicable after such reports or amendments are electronically filed with or furnished to the Securities and Exchange Commission (“SEC”). The information posted on the website is not incorporated into or a part of this filing. Copies of all documents filed with the SEC can also be obtained by visiting the SEC’s Public Reference Room at 100 F Street, NE, Washington, DC 20549, by calling the SEC at 1-800-SEC-0330 or by accessing the SEC’s website at <http://www.sec.gov>.

On January 19, 2012, the Bank, the wholly-owned banking subsidiary of the Company, entered into an Assignment, Purchase and Assumption Agreement (the “HSBC Branch Agreement”) and a Purchase and Assumption Agreement (the “First Niagara Branch Agreement”) (collectively, the “Agreements”) with First Niagara Bank, N.A. (“First Niagara”). Under the Agreements, the Bank will acquire 19 branches in Central, Northern, and Western New York consisting of three

branches purchased directly from First Niagara and 16 branches which are currently owned by HSBC Bank USA, National Association ("HSBC"). First Niagara is assigning its rights to the HSBC branches in connection with its pending acquisition of HSBC's Upstate New York banking franchise. Upon its completion, the branch acquisitions will strengthen and extend the Company's Upstate New York presence. Under the terms of the Agreements, Community Bank will acquire approximately \$218 million in loans and \$955 million in deposits at a blended deposit premium of 3.22%. The branch acquisitions are expected to close during the third quarter of 2012 subject to regulatory review and approval and customary closing conditions. The Company expects to incur certain one-time, transaction-related costs in 2012.

The Company completed a public stock offering in late January 2012. The offering raised \$57.5 million through the issuance of 2.13 million shares. The net proceeds of the offering were approximately \$54.9 million. The Company intends to use the net proceeds from this offering to support the HSBC and First Niagara branch acquisitions.

Acquisition History (2007-2011)

CAI Benefits, Inc.

On November 30, 2011, BPAS acquired, in an all-cash transaction, certain assets and liabilities of CAI, a provider of actuarial, consulting and retirement plan administration services, with offices in New York City and Northern New Jersey. The transaction is expected to add approximately \$4 million of revenue to this business line in 2012.

The Wilber Corporation Acquisition

On April 8, 2011, the Company acquired The Wilber Corporation, parent company of Wilber National Bank, and its 22 branch-banking centers in the Central, Greater Capital District and Catskill regions of New York for \$103 million of stock and cash. The Company acquired approximately \$462 million in loans, \$297 million of investment securities and \$772 million in deposits.

Citizens Branches Acquisition

On November 7, 2008, the Company acquired 18 branch-banking centers in northern New York from Citizens Financial Group, Inc. ("Citizens") in an all-cash transaction. The Company acquired approximately \$109 million in loans and \$565 million in deposits at a blended deposit premium of 13%. In support of the transaction, the Company issued approximately \$50 million of equity capital in the form of common stock in October 2008.

Alliance Benefit Group MidAtlantic

On July 7, 2008, BPAS acquired the Philadelphia division of Alliance Benefit Group MidAtlantic ("ABG") from BenefitStreet, Inc. in an all-cash transaction. ABG was a provider of retirement plan consulting, daily valuation administration, actuarial, and ancillary support services.

TLNB Financial Corporation

On June 1, 2007, the Company acquired TLNB Financial Corporation, parent company of Tupper Lake National Bank ("TLNB"), in an all-cash transaction valued at approximately \$17.8 million. Based in Tupper Lake, New York, TLNB operated five branches in the northeastern New York State cities of Tupper Lake, Plattsburgh and Saranac Lake, as well as an insurance subsidiary, TLNB Insurance Agency, Inc.

Hand Benefits & Trust, Company

On May 18, 2007, BPAS acquired HB&T in an all-cash transaction. HB&T was a Houston, Texas based provider of employee benefit plan administration and trust services.

Services

The Bank is a community bank committed to the philosophy of serving the financial needs of customers in local communities. The Bank's branches are generally located in smaller towns and cities within its geographic market areas of Upstate New York and Northeastern Pennsylvania. The Company believes that the local character of its business, knowledge of the customers and their needs, and its comprehensive retail and business products, together with responsive decision-making at the branch and regional levels, enable the Bank to compete effectively in its geographic market. The Bank is a member of the Federal Reserve System and the Federal Home Loan Bank of New York ("FHLB"), and its deposits are insured by the Federal Deposit Insurance Corporation ("FDIC") up to applicable limits.

Competition

The banking and financial services industry is highly competitive in the New York and Pennsylvania markets. The Company competes actively for loans, deposits and customers with other national and state banks, thrift institutions,

credit unions, retail brokerage firms, mortgage bankers, finance companies, insurance companies, and other regulated and unregulated providers of financial services. In order to compete with other financial service providers, the Company stresses the community nature of its operations and the development of profitable customer relationships across all lines of business.

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The table below summarizes the Bank's deposits and market share by the forty counties of New York and Pennsylvania in which it has customer facilities. Market share is based on deposits of all commercial banks, credit unions, savings and loan associations, and savings banks.

| County | State | Deposits as of 6/30/2011 (000's omitted) | Market Share (1) | Facilities | ATM's | Number of Towns/ Cities | Towns Where Company Has 1st or 2nd Market Position |
|--------------|-------|--|------------------|------------|-------|-------------------------|--|
| Hamilton | NY | \$35,739 | 52.50% | 2 | 1 | 2 | 2 |
| Lewis | NY | 113,165 | 46.57% | 4 | 4 | 3 | 3 |
| Franklin | NY | 244,835 | 46.07% | 8 | 8 | 7 | 6 |
| Allegany | NY | 205,771 | 44.42% | 9 | 10 | 8 | 8 |
| Otsego | NY | 427,769 | 40.69% | 10 | 9 | 6 | 5 |
| Yates | NY | 89,144 | 30.32% | 2 | 2 | 1 | 0 |
| Cattaraugus | NY | 313,215 | 29.24% | 10 | 9 | 6 | 7 |
| Wyoming | PA | 121,304 | 24.23% | 4 | 3 | 3 | 3 |
| Seneca | NY | 96,158 | 23.97% | 4 | 3 | 4 | 2 |
| St. Lawrence | NY | 372,524 | 22.66% | 14 | 8 | 11 | 10 |
| Essex | NY | 117,357 | 19.93% | 6 | 5 | 5 | 5 |
| Clinton | NY | 240,334 | 16.52% | 5 | 7 | 2 | 2 |
| Chautauqua | NY | 257,785 | 15.02% | 12 | 12 | 10 | 7 |
| Delaware | NY | 161,538 | 13.68% | 5 | 4 | 5 | 5 |
| Schuyler | NY | 19,625 | 12.36% | 1 | 1 | 1 | 0 |
| Jefferson | NY | 201,103 | 11.56% | 5 | 5 | 4 | 2 |
| Livingston | NY | 86,018 | 10.25% | 3 | 4 | 3 | 3 |
| Ontario | NY | 151,205 | 8.73% | 7 | 12 | 6 | 4 |
| Schoharie | NY | 32,763 | 8.48% | 1 | 1 | 1 | 0 |
| Steuben | NY | 171,285 | 7.90% | 8 | 7 | 7 | 4 |
| Lackawanna | PA | 404,132 | 7.76% | 11 | 11 | 8 | 4 |
| Tioga | NY | 31,465 | 7.63% | 2 | 2 | 2 | 1 |
| Chenango | NY | 42,282 | 7.19% | 2 | 2 | 1 | 1 |
| Chemung | NY | 80,554 | 7.08% | 2 | 2 | 1 | 0 |
| Herkimer | NY | 40,003 | 6.67% | 1 | 1 | 1 | 1 |
| Susquehanna | PA | 37,363 | 5.51% | 3 | 1 | 3 | 2 |
| Wayne | NY | 55,181 | 5.12% | 2 | 4 | 2 | 1 |
| Cayuga | NY | 42,963 | 4.28% | 2 | 2 | 2 | 1 |
| Luzerne | PA | 232,719 | 3.67% | 6 | 7 | 6 | 3 |
| Oswego | NY | 49,051 | 3.59% | 2 | 2 | 2 | 2 |
| Washington | NY | 19,238 | 3.05% | 1 | 0 | 1 | 1 |
| Bradford | PA | 29,293 | 2.55% | 2 | 2 | 2 | 1 |
| Warren | NY | 34,311 | 2.44% | 1 | 1 | 1 | 1 |
| Oneida | NY | 53,878 | 1.17% | 2 | 1 | 1 | 1 |
| Broome | NY | 39,611 | 0.83% | 1 | 1 | 1 | 1 |
| Ulster | NY | 24,981 | 0.65% | 1 | 1 | 1 | 1 |

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| | | | | | | | |
|----------|----|-------------|-------|-----|-----|-----|-----|
| Saratoga | NY | 15,126 | 0.41% | 1 | 1 | 1 | 0 |
| Onondaga | NY | 25,064 | 0.26% | 2 | 3 | 2 | 0 |
| Tompkins | NY | 4,946 | 0.21% | 1 | 0 | 1 | 0 |
| Erie | NY | 46,426 | 0.19% | 3 | 3 | 3 | 1 |
| | | \$4,767,224 | 5.09% | 168 | 162 | 137 | 101 |

(1) Deposit market share data as of June 30, 2011 the most recent information available.

Source: SNL Financial LLC

Employees

As of December 31, 2011, the Company employed 1,784 full-time employees, 144 part-time employees and 102 temporary employees. None of the Company's employees are represented by a collective bargaining agreement. The Company offers a variety of employment benefits and considers its relationship with its employees to be good.

Supervision and Regulation

General

The Company and its subsidiaries are subject to the laws and regulations of the federal government and the states in which they conduct business. The Company, as a bank holding company, is subject to extensive regulation, supervision and examination by the Board of Governors of the Federal Reserve System (“FRB”) as its primary federal regulator. The Bank is a nationally-chartered bank and is subject to extensive regulation, supervision and examination by the Office of the Comptroller of the Currency (“OCC”) as its primary federal regulator. The Bank is also subject to the regulations and supervision of the FRB and the Federal Deposit Insurance Corporation (“FDIC”).

The Company is subject to the jurisdiction of the Securities and Exchange Commission (“SEC”) and is subject to disclosure and regulatory requirement under the Securities Act of 1933, as amended, and the Securities Exchange Act of 1934, as amended. Nottingham Advisors, Inc., Community Investment Services, Inc. and Hand Securities, Inc. are subject to the jurisdiction of the SEC, the New York Stock Exchange, the Financial Industry Regulatory Authority (“FINRA”) and state securities regulators, among others.

Set forth below is a description of the material information governing the laws and regulations applicable to the Company:

Federal Bank Holding Company Regulation

The Company is registered under, and is subject to, the Bank Holding Company Act of 1956, as amended. This Act limits the type of companies that the Company may acquire or organize and the activities in which it or they may engage. In general, the Company and the Bank are prohibited from engaging in or acquiring direct or indirect control of any corporation engaged in non-banking activities unless such activities are so closely related to banking as to be a proper incident thereto. In addition, the Company must obtain the prior approval of the FRB to acquire control of any bank; to acquire, with certain exceptions, more than five percent of the outstanding voting stock of any other corporation; or to merge or consolidate with another bank holding company. As a result of such laws and regulation, the Company is restricted as to the types of business activities it may conduct and the Bank is subject to limitations on, among others, the types of loans and the amounts of loans it may make to any one borrower. The Financial Modernization Act of 1999 created, among other things, the “financial holding company”, a new entity which may engage in a broader range of activities that are “financial in nature”, including insurance underwriting, securities underwriting and merchant banking. Bank holding companies which are well capitalized and well managed under regulatory standards may convert to financial holding companies relatively easily through a notice filing with the FRB, which acts as the “umbrella regulator” for such entities. The Company may seek to become a financial holding company in the future.

Federal Reserve System Regulation

The Company, as a bank holding company, is subject to regulatory capital requirements and is required by the FRB to, among other things, maintain cash reserves against its deposits. The Bank is under similar capital requirements administered by the OCC. FRB policy has historically required a bank holding company to act as a source of financial and managerial strength to its subsidiary banks. The Dodd-Frank Act (as defined below) codifies this policy as a statutory requirement. After exhausting other sources of funds, the Company may seek borrowings from the FRB for such purposes. Bank holding companies registered with the FRB are, among other things, restricted from making direct investments in real estate. Both the Company and the Bank are subject to extensive supervision and regulation, which focus on, among other things, the protection of depositors’ funds.

The FRB also regulates the national supply of bank credit in order to influence general economic conditions. These policies have a significant influence on overall growth and distribution of loans, investments and deposits, and affect the interest rates charged on loans or paid for deposits.

Fluctuations in interest rates, which may result from government fiscal policies and the monetary policies of the FRB, have a strong impact on the income derived from loans and securities, and interest paid on deposits and borrowings. While the Company and the Bank strive to model various interest rate changes and adjust their strategies for such changes, the level of earnings can be materially affected by economic circumstances beyond their control.

The Company and the Bank are subject to minimum capital requirements established by the FRB, the OCC and the FDIC. For information on these capital requirements and the Company's and the Bank's capital ratios see "Management's Discussion and Analysis of Financial Condition and Results of Operations - Capital" and Note P to the Financial Statements.

Office of Comptroller of the Currency Regulation

The Bank is supervised and regularly examined by the OCC. The various laws and regulations administered by the OCC affect corporate practices such as payment of dividends, incurring debt, and acquisition of financial institutions and other companies. It also affects business practices, such as payment of interest on deposits, the charging of interest on loans, types of business conducted and location of offices. The OCC generally prohibits a depository institution from making any capital distributions (including payment of a dividend) or paying any management fee to its parent holding company if the depository institution would thereafter be undercapitalized. Undercapitalized institutions are subject to growth limitations and are required to submit a capital restoration plan to the OCC. The Bank is well capitalized under regulatory standards administered by the OCC.

Insurance of Deposit Accounts

The Bank is a member of the Deposit Insurance Fund (“DIF”), which is administered by the FDIC. On July 22, 2010, the FDIC amended its insurance regulations to insure deposit accounts up to a maximum of \$250,000 (previously \$100,000) for each separately insured depositor. Additionally, on November 9, 2010, the FDIC issued a final rule implementing Section 343 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (“the Dodd-Frank Act”) which provides certain noninterest-bearing transaction accounts with unlimited insurance coverage, regardless of the dollar amount, through December 31, 2012.

The FDIC imposes an assessment against all depository institutions for deposit insurance. This assessment is based on the risk category of the institution and, prior to 2009, ranged from five to 43 basis points of the institution’s deposits. On December 22, 2008, as a result of decreases in the reserve ratio of the DIF, the FDIC published a final rule raising the current deposit insurance assessment rates uniformly for all institutions by seven basis points for the first quarter of 2009. On May 22, 2009, the FDIC adopted a final rule imposing a five basis point special assessment on each insured depository institution’s assets minus Tier 1 capital as of June 30, 2009, payable on September 30, 2009. The Company’s special assessment amounted to \$2.5 million.

In the fourth quarter of 2009, the FDIC adopted a rule that required insured depository institutions to prepay their quarterly risk-based assessments for the fourth quarter of 2009, and for all of 2010, 2011 and 2012, on December 30, 2009. For purposes of calculating the amount to prepay, the FDIC required that institutions use their total base assessment rate in effect on September 30, 2009 and increase that assessment base quarterly at a 5 percent annual growth rate through the end of 2012. The FDIC also increased annual assessment rates uniformly by three basis points beginning in 2011. The Company’s prepayment for 2010, 2011 and 2012 amounted to \$21.4 million.

Effective April 1, 2011, the FDIC changed the basis for premium payments from a percentage of average deposits to a percentage of average consolidated Bank assets less average tangible capital, resulting in lower 2011 premiums for the Company.

Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010

On July 21, 2010, President Obama signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (“Dodd-Frank Act”). This law results in significant changes to the banking industry. The provisions that have received the most public attention have been those that apply to larger financial institutions; however, the Dodd-Frank Act does contain numerous other provisions that will affect all banks and bank holding companies and impacts how the Company and the Bank handle their operations. The Dodd-Frank Act requires various federal agencies, including those that regulate the Company and the Bank, to promulgate new rules and regulations and to conduct various studies and reports for Congress. The federal agencies are in the process of promulgating these rules and regulations and have been given significant discretion in drafting such rules and regulations. Several of the provisions of the Dodd-Frank Act may have the consequence of increasing the Bank’s expenses, decreasing its revenues, and changing the activities in which it chooses to engage. The specific impact of the Dodd-Frank Act on the Company’s current activities or new financial activities the Company may consider in the future, the Company’s financial performance, and the markets in

which the Company operates depends on the manner in which the relevant agencies develop and implement the required rules and regulations and the reaction of market participants to these regulatory developments.

The Dodd-Frank Act includes provisions that, among other things:

- Change the assessment base for federal deposit insurance from the amount of insured deposits to consolidated assets less tangible capital, eliminate the ceiling on the size of the DIF, and increase the floor applicable to the size of the DIF.
- Make permanent the \$250,000 limit on deposits for federal deposit insurance, retroactive to January 1, 2008, and provide unlimited federal deposit insurance through December 31, 2012 for non-interest bearing demand transaction accounts at all insured depository institutions.
- Repeal the federal prohibitions on the payment of interest on demand deposits, thereby permitting depository institutions to pay interest on business transaction and other accounts.

- Centralize responsibility for consumer financial protection by creating a new agency responsible for implementing, examining, and enforcing compliance with federal consumer financial laws under the newly created Consumer Financial Protection Bureau (“CFPB”).
- Restrict the preemption of state law by federal law and disallow subsidiaries and affiliates of national banks from availing themselves of such preemption.
- Apply the same leverage and risk-based capital requirements that apply to insured depository institutions to most bank holding companies, which, among other things as applied to the Company, going forward will preclude the Company from including in Tier 1 Capital trust preferred securities or cumulative preferred stock, if any, issued on or after May 19, 2010. The Company has not issued any trust preferred securities since May 19, 2010.
- Require the OCC to seek to make its capital requirements for national banks countercyclical.
- Impose comprehensive regulation of the over-the-counter derivatives market, which would include certain provisions that would effectively prohibit insured depository institutions from conducting certain derivatives businesses in the institution itself.
- Amend the Electronic Fund Transfer Act to, among other things, give the FRB the authority to establish rules regarding interchange fees charged for electronic debit transactions by payment card issuers having assets over \$10 billion and to enforce a new statutory requirement that such fees be reasonable and proportional to the actual cost of a transaction to the issuer.
- Increase the authority of the FRB to examine the Company and any of its non-bank subsidiaries.

Consumer Protection Laws

In connection with its lending activities, the Bank is subject to a number of federal and state laws designed to protect borrowers and promote lending to various sectors of the economy. These laws include the Equal Credit Opportunity Act, the Gramm-Leach-Bliley Act (“GLB Act”), the Fair Credit Reporting Act (“FCRA”), the Fair and Accurate Credit Transactions Act of 2003 (“FACT Act”), Electronic Funds Transfer Act, the Truth in Lending Act, the Home Mortgage Disclosure Act, the Dodd-Frank Act, the Real Estate Settlement Procedures Act, and various state law counterparts.

The Dodd-Frank Act creates the CFPB with broad powers to supervise and enforce consumer protection laws, including laws that apply to banks in order to prohibit unfair, deceptive or abusive practices. The CFPB has examination authority over all banks and savings institutions with more than \$10 billion in assets. The Dodd-Frank Act weakens the federal preemption rules that have been applicable to national banks and gives attorney generals for the states certain powers to enforce federal consumer protection laws.

In addition, the GLB Act requires all financial institutions to adopt privacy policies, restrict the sharing of nonpublic customer data with nonaffiliated parties and establishes procedures and practices to protect customer data from unauthorized access. In addition, the FCRA, as amended by the FACT Act, includes provisions affecting the Company, the Bank, and their affiliates, including provisions concerning obtaining consumer reports, furnishing information to consumer reporting agencies, maintaining a program to prevent identity theft, sharing of certain information among affiliated companies, and other provisions. The FACT Act requires persons subject to FCRA to notify their customers if they report negative information about them to a credit bureau or if they are granted credit on terms less favorable than those generally available. The FRB and the Federal Trade Commission have extensive rulemaking authority under the FACT Act, and the Company and the Bank are subject to the rules that have been created under the FACT Act, including rules regarding limitations on affiliate marketing and implementation of programs to identify, detect and mitigate certain identity theft red flags. The Bank is also subject to data security standards and data breach notice requirements issued by the OCC and other regulatory agencies. The Bank has created policies and procedures to comply with these consumer protection requirements.

USA Patriot Act

The Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001 (“USA Patriot Act”) imposes obligations on U.S. financial institutions, including banks and

broker-dealer subsidiaries, to implement policies, procedures and controls which are reasonably designed to detect and report instances of money laundering and the financing of terrorism. In addition, provisions of the USA Patriot Act require the federal financial institution regulatory agencies to consider the effectiveness of a financial institution's anti-money laundering activities when reviewing bank mergers and bank holding company acquisitions. The USA Patriot Act also encourages information-sharing among financial institutions, regulators, and law enforcement authorities by providing an exemption from the privacy provisions of the GLB Act for financial institutions that comply with the provision of the Act. Failure of a financial institution to maintain and implement adequate programs to combat money laundering and terrorist financing, or to comply with all of the relevant laws or regulations, could have serious legal, financial and reputational consequences for the institution. The Company has approved policies and procedures that are designed to comply with the USA Patriot Act.

Office of Foreign Assets Control Regulation

The United States has imposed economic sanctions that affect transactions with designated foreign countries, nationals and others administrated by the Treasury's Office of Foreign Assets Control ("OFAC"). The OFAC administered sanctions can take many different forms depending upon the country; however, they contain one or more of the following elements: (i) restrictions on trade with or investment in a sanctioned country, including prohibitions against direct or indirect imports from and exports to a sanctioned country and prohibitions on "U.S. persons" engaging in financial transactions relating to making investments in, or providing investment related advice or assistance to, a sanctioned country; and (ii) a blocking of assets in which the government or specially designated nationals of the sanctioned country have an interest, by prohibiting transfers of property subject to U.S. jurisdiction (including property in the possession or control of U.S. persons). Blocked assets (e.g., property and bank deposits) cannot be paid out, withdrawn, set off or transferred in any manner without a license from OFAC. Failure to comply with these sanctions could have serious legal, financial, and reputational consequences.

Sarbanes-Oxley Act of 2002

The Sarbanes-Oxley Act of 2002 ("Sarbanes-Oxley Act") implemented a broad range of corporate governance, accounting and reporting reforms for companies that have securities registered under the Securities Exchange Act of 1934 as amended. In particular, the Sarbanes-Oxley Act established, among other things: (i) new requirements for audit and other key Board of Directors committees involving independence, expertise levels, and specified responsibilities; (ii) additional responsibilities regarding the oversight of financial statements by the Chief Executive Officer and Chief Financial Officer of the reporting company; (iii) the creation of an independent accounting oversight board for the accounting industry; (iv) new standards for auditors and the regulation of audits, including independence provisions which restrict non-audit services that accountants may provide to their audit clients; (v) increased disclosure and reporting obligations for the reporting company and its directors and executive officers including accelerated reporting of company stock transactions; (vi) a prohibition of personal loans to directors and officers, except certain loans made by insured financial institutions on non-preferential terms and in compliance with other bank regulator requirements; and (vii) a range of new and increased civil and criminal penalties for fraud and other violation of the securities laws.

The Emergency Economic Stabilization Act of 2008

The Emergency Economic Stabilization Act of 2008 ("EESA") provides the U.S. Secretary of the Treasury with broad authority to implement certain actions to help restore stability and liquidity to U.S. markets. The EESA authorizes the U.S. Treasury to, among other things, purchase up to \$700 billion of mortgages, mortgage-backed securities and certain other financial instruments from financial institutions for the purpose of stabilizing and providing liquidity to the U.S. financial markets. The Company did not originate or invest in sub-prime assets and, therefore, does not expect to participate in the sale of any of our assets into these programs. One of the provisions resulting from the legislation is the Troubled Asset Relief Program Capital Purchase Program ("TARP Capital Purchase Program"), which provides direct equity investment in perpetual preferred stock by the U.S. Treasury Department in qualified financial institutions. The program is voluntary and requires an institution to comply with a number of restrictions and provisions, including limits on executive compensation, stock redemptions, and declaration of dividends. The Company chose not to participate in the TARP Capital Purchase Program.

Electronic Fund Transfer Act

Effective July 1, 2010, a new federal banking rule under the Electronic Fund Transfer Act prohibits financial institutions from charging consumers fees for paying overdrafts on automated teller machines and one-time debit card transactions, unless a consumer consents, or opts in, to the overdraft service for those types of transactions. The new rule does not govern overdraft fees on the payment of checks and regular electronic bill payments. The adoption of this regulation lowered fee income in the fourth quarter of 2010 and all of 2011.

Community Reinvestment Act of 1977

Under the Community Reinvestment Act of 1977 (“CRA”), the Bank is required to help meet the credit needs of its communities, including low- and moderate-income neighborhoods. Although the Bank must follow the requirements of CRA, it does not limit the Bank’s discretion to develop products and services that are suitable for a particular community or establish lending requirements or programs. In addition, the Equal Credit Opportunity Act and the Fair Housing Act prohibits discrimination in lending practices. The Bank’s failure to comply with the provisions of the CRA could, at a minimum, result in regulatory restrictions on its activities and the activities of the Company. The Bank’s failure to comply with the Equal Credit Opportunity Act and the Fair Housing Act could result in enforcement actions against it by its regulators as well as other federal regulatory agencies and the Department of Justice. The Bank’s latest CRA rating was Satisfactory.

The Bank Secrecy Act

The Bank Secrecy Act (“BSA”) requires all financial institutions, including banks and securities broker-dealers, to, among other things, establish a risk-based system of internal controls reasonably designed to prevent money laundering and the financing of terrorism. The BSA includes a variety of recordkeeping and reporting requirements (such as cash and suspicious activity reporting), as well as due diligence/know-your-customer documentation requirements. The Company has established an anti-money laundering program and taken other appropriate measures in order to comply with BSA requirements.

Item 1A. Risk Factors

There are risks inherent in the Company's business. The material risks and uncertainties that management believes affect the Company are described below. Adverse experience with these could have a material impact on the Company's financial condition and results of operations.

Changes in interest rates affect our profitability, assets and liabilities.

The Company's income and cash flow depends to a great extent on the difference between the interest earned on loans and investment securities, and the interest paid on deposits and borrowings. Interest rates are highly sensitive to many factors that are beyond the Company's control, including general economic conditions and policies of various governmental and regulatory agencies and, in particular, the FRB. Changes in monetary policy, including changes in interest rates, could influence not only the interest we receive on loans and securities and the amount of interest we pay on deposits and borrowings, but such changes could also affect (1) our ability to originate loans and obtain deposits, which could reduce the amount of fee income generated, (2) the fair value of our financial assets and liabilities and (3) the average duration of our mortgage-backed securities portfolio. If the interest rates paid on deposits and other borrowings increase at a faster rate than the interest rates received on loans and other investments, our net interest income could be adversely affected, which in turn could negatively affect our earnings. Earnings could also be adversely affected if the interest rates received on loans and other investments fall more quickly than the interest rates paid on deposit and other borrowings. Although management believes it has implemented effective asset and liability management strategies to reduce the potential effects of changes in interest rates on the results of operations, any substantial, unexpected, prolonged change in market interest rates could have a material adverse effect on the financial condition and results of operations.

Current levels of market volatility are unprecedented.

From December 2007 through June 2009, the U.S. economy was in recession. Although 2010 and 2011 have experienced modest improvements, the capital, credit and financial markets have experienced significant volatility and disruption during the last five years. These conditions have had significant adverse effects on our national and local economies, including declining real estate values, a widespread tightening of the availability of credit, illiquidity in certain securities markets, increasing loan delinquencies, historically unfavorable consumer confidence and spending, and a slow recovery of manufacturing and service business activity. Management does not expect these difficult market conditions to improve meaningfully over the short term, and a continuation of these conditions could exacerbate their adverse effects:

- A decrease in the demand for loans and other products and services offered
- A decrease in the value of loans held for sale or other assets secured by consumer or commercial real estate; and
 - An increase in the number of customers who may become delinquent or default on their loans

The Company operates in a highly regulated environment and may be adversely affected by changes in laws and regulations.

The Company and its subsidiaries are subject to extensive state and federal regulation, supervision and legislation that govern nearly every aspect of its operations. The Company, as a bank holding company is subject to regulation by the FRB and its banking subsidiary is subject to regulation by the OCC. These regulations affect deposit and lending practices, capital levels and structure, investment practices, dividend policy and growth. In addition, the non-bank subsidiaries are engaged in providing investment management and insurance brokerage service, which industries are also heavily regulated on both a state and federal level. Such regulators govern the activities in which the Company and its subsidiaries may engage. These regulatory authorities have extensive discretion in connection with their supervisory and enforcement activities, including the imposition of restrictions on the operation of a bank, the

classification of assets by a bank and the adequacy of a bank's allowance for loan losses. Any change in such regulation and oversight, whether in the form of regulatory policy, regulations, or legislation, could have a material impact on the Company and its operations. Changes to the regulatory laws governing these businesses could affect the Company's ability to deliver or expand its services and adversely impact its operations and financial condition.

In July 2010, the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) was signed into law. The Dodd-Frank Act is sweeping legislation intended to overhaul regulation of the financial services industry. Its goals are to establish a new council of "systemic risk" regulators, create a new consumer protection division within the Federal Reserve, empower the Federal Reserve to supervise the largest, most complex financial companies, allow the government to seize and liquidate failing financial companies, and give regulators new powers to oversee the derivatives market. The provisions of the Dodd-Frank Act are so extensive that full implementation may require several years, and an assessment of its full effect on the Company is not possible at this time.

The Dodd-Frank Act also established the Consumer Financial Protection Bureau (CFPB) and authorizes it to supervise certain consumer financial services companies and large depository institutions and their affiliates for consumer protection purposes. Subject to the provisions of the Act, the CFPB has responsibility to implement, examine for compliance with, and enforce “Federal consumer financial law.” As a depository institution, the Company will be subject to examinations by the CFPB, which will focus on the Company’s ability to detect, prevent, and correct practices that present a significant risk of violating the law and causing consumer harm.

Dodd-Frank provided that debit card interchange fees must be reasonable and proportional to the cost incurred by the issuer with respect to the transaction. This provision is known as the Durbin Amendment. In June 2011, the Federal Reserve Board adopted regulations setting the maximum permissible interchange fee as the sum of 21 cents per transaction and 5 basis points multiplied by the value of the transaction, with an additional adjustment of up to one cent per transaction if the issuer implements certain fraud-prevention standards. While the restrictions on interchange fees do not apply to banks that, together with their affiliates, have assets of less than \$10 billion, the rule could affect the competitiveness of debit cards issued by smaller banks.

Compliance with new laws and regulations will likely result in additional costs and/or decreases in revenue, which could adversely impact the Company’s results of operations, financial condition or liquidity.

The Company may be subject to more stringent capital requirements.

As discussed above, the Dodd-Frank Act would require the federal banking agencies to establish stricter risk-based capital requirements and leverage limits to apply to banks and bank holding companies. Under the legislation, the federal banking agencies would be required to develop capital requirements that address systemically-risky activities. The capital rules must address, at a minimum, risks arising from significant volumes of activity in derivatives, securities products, financial guarantees, securities borrowing and lending and repurchase agreements; concentrations in assets for which reported values are based on models; and concentrations in market share for any activity that would substantially disrupt financial markets if the institutions were forced to unexpectedly cease the activity. These requirements, and any other new regulations, could adversely affect the Company’s ability to pay dividends, or could require it to reduce business levels or to raise capital, including in ways that may adversely affect its results of operations or financial condition.

Regional economic factors may have an adverse impact on the Company’s business.

The Company’s main markets are located in the states of New York and Pennsylvania. Most of the Company’s customers are individuals and small and medium-sized businesses which are dependent upon the regional economy. Accordingly, the local economic conditions in these areas have a significant impact on the demand for the Company’s products and services as well as the ability of the Company’s customers to repay loans, the value of the collateral securing loans and the stability of the Company’s deposit funding sources. A prolonged economic downturn in these markets could negatively impact the Company.

The Company faces strong competition from other banks and financial institutions, which can negatively impact its business.

The Company conducts its banking operations in a number of competitive local markets. In those markets, it competes against commercial banks, savings banks, savings and loans associations, credit unions, mortgage banks, brokerage firms, and other financial institutions. Many of these entities are larger organizations with significantly greater financial, management and other resources than the Company has, and they offer the same or similar banking or financial services that it offers in its markets. Moreover, new and existing competitors may expand their business in or into the Company’s markets. Increased competition in its markets may result in a reduction in loans, deposits and

other sources of its revenues. Ultimately, the Company may not be able to compete successfully against current and future competitors.

The allowance for loan loss may be insufficient.

The Company's business depends on the creditworthiness of its customers. The Company periodically reviews the allowance for loan losses for adequacy considering economic conditions and trends, collateral values and credit quality indicators, including past charge-off experience and levels of past due loans and nonperforming assets. If the Company's assumptions prove to be incorrect, the Company's allowance for loan losses may not be sufficient to cover losses inherent in the Company's loan portfolio, resulting in additions to the allowance. Material additions to the allowance would materially decrease its net income. It is possible that over time the allowance for loan losses will be inadequate to cover credit losses in the portfolio because of unanticipated adverse changes in the economy, market conditions or events adversely affecting specific customers, industries or markets.

FDIC deposit insurance premiums have increased and may increase further in the future.

The Company is generally unable to control the amount of premiums that it is required to pay for FDIC insurance. In November 2009, the FDIC adopted a rule requiring banks to prepay their quarterly risk-based assessment for the fourth quarter of 2009 and for all of 2010, 2011 and 2012. In 2010, the FDIC increased the general assessment rate as compared to prior periods. Effective April 1, 2011, the FDIC changed the basis for premium payments from a percentage of average deposits to a percentage of average consolidated Bank assets less average tangible capital, resulting in lower 2011 premiums for the Company. However, if there are additional bank or financial institution failures, the Company may be required to pay higher FDIC premiums than the current levels. These announced increases and any future increases or required prepayments of FDIC insurance premiums may adversely impact the Company's earnings.

Changes in the equity markets could materially affect the level of assets under management and the demand for other fee-based services.

Economic downturns could affect the volume of income from and demand for fee-based services. Revenue from the wealth management and benefit plan administration businesses depends in large part on the level of assets under management and administration. Market volatility that leads customers to liquidate investment, as well as lower asset values, can reduce our level of assets under management and administration and thereby decrease our investment management and administration revenues.

Mortgage banking income may experience significant volatility.

Mortgage banking income is highly influenced by the level and direction of mortgage interest rates, and real estate and refinancing activity. In lower interest rate environments, the demand for mortgage loans and refinancing activity will tend to increase. This has the effect of increasing fee income, but could adversely impact the estimated fair value of our mortgage servicing rights as the rate of loan prepayments increase. In higher interest rate environments, the demand for mortgage loans and refinancing activity will generally be lower. This has the effect of decreasing fee income opportunities.

The Company depends on dividends from its banking subsidiary for cash revenues, but those dividends are subject to restrictions.

The ability of the company to satisfy its obligations and pay cash dividends to its shareholders is primarily dependent on the earnings of and dividends from the subsidiary bank. However, payment of dividends by the bank subsidiary is limited by dividend restrictions and capital requirements imposed by bank regulations. The ability to pay dividends is also subject to the continued payment of interest that the Company owes on its subordinated junior debentures. As of December 31, 2011, the Company had \$102 million of subordinated junior debentures outstanding. The Company has the right to defer payment of interest on the subordinated junior debentures for a period not exceeding 20 quarters, although the Company has not done so to date. If the Company defers interest payments on the subordinated junior debentures, it will be prohibited, subject to certain exceptions, from paying cash dividends on the common stock until all deferred interest has been paid and interest payments on the subordinated junior debentures resumes.

The risks presented by acquisitions could adversely affect the Company's financial condition and result of operations.

The business strategy of the Company includes growth through acquisition. The Company has announced that it has entered into a definitive agreement to acquire 19 branch-banking centers from First Niagara and HSBC. The acquisition is expected to close during the third quarter of 2012. This acquisition and any other future acquisitions will be accompanied by the risks commonly encountered in acquisitions. These risks include among other things: the

difficulty of integrating operations and personnel, the potential disruption of our ongoing business, the inability of our management to maximize our financial and strategic position, the inability to maintain uniform standards, controls, procedures and policies, and the impairment of relationships with employees and customers as a result of changes in ownership and management. Further, the asset quality or other financial characteristics of a company may deteriorate after the acquisition agreement is signed or after the acquisition closes.

The Company may be required to record impairment charges related to goodwill, other intangible assets and the investment portfolio.

The Company may be required to record impairment charges in respect to goodwill, other intangible assets and the investment portfolio. Numerous factors, including lack of liquidity for resale of certain investment securities, absence of reliable pricing information for investment securities, adverse changes in the business climate, adverse actions by regulators, unanticipated changes in the competitive environment or a decision to change the operations or dispose of an operating unit could have a negative effect on the investment portfolio, goodwill or other intangible assets in future periods.

During 2010 rating agencies imposed a number of downgrades and credit watches on certain securities in the Company's investment securities portfolio, which contributed to the decline in fair value of such securities. During 2011 additional securities were downgraded, none of which resulted in an impairment charge to the Company. These downgrades were primarily the result of Standard & Poor's downgrade of the U.S. government from AAA to AA+. However, any additional downgrades and credit watches may contribute to further declines in the fair value of these securities. In addition, the measurement of the fair value of these securities involves significant judgment due to the complexity of the factors contributing to the measurement. Market volatility makes measurement of the fair value even more difficult and subjective. To the extent that any portion of the unrealized losses in the investment portfolio is determined to be other than temporary, and the loss is related to credit factors, the Company could be required to recognize a charge to earnings in the quarter during which such determination is made.

The Company's financial statements are based in part on assumptions and estimates which, if incorrect, could cause unexpected losses in the future.

Pursuant to accounting principles generally accepted in the United States, the Company is required to use certain assumptions and estimates in preparing its financial statements, including in determining credit loss reserves, mortgage repurchase liability and reserves related to litigations, among other items. Certain of the Company's financial instruments, including available-for-sale securities and certain loans, among other items, require a determination of their fair value in order to prepare the Company's financial statements. Where quoted market prices are not available, the Company may make fair value determinations based on internally developed models or other means which ultimately rely to some degree on management judgment. Some of these and other assets and liabilities may have no direct observable price levels, making their valuation particularly subjective, as they are based on significant estimation and judgment. In addition, sudden illiquidity in markets or declines in prices of certain loans and securities may make it more difficult to value certain balance sheet items, which may lead to the possibility that such valuations will be subject to further change or adjustment. If assumptions or estimates underlying the Company's financial statements are incorrect, it may experience material losses.

The Company's information systems may experience an interruption or security breach.

The Company relies heavily on communications and information systems to conduct its business. Any failure, interruption or breach in security of these systems could result in failures or disruptions in the Company's online banking system, its general ledger, and its deposit and loan servicing and origination systems. Furthermore, if personal, confidential or proprietary information of customers or clients in the Company's possession were to be mishandled or misused, the Company could suffer significant regulatory consequences, reputational damage and financial loss. Such mishandling or misuse could include circumstances where, for example, such information was erroneously provided to parties who are not permitted to have the information, either by fault of the Company's systems, employees, or counterparties, or where such information was intercepted or otherwise inappropriately taken by third parties. The Company has policies and procedures designed to prevent or limit the effect of the possible failure, interruption or security breach of its information systems; however, any such failure, interruption or security breach could adversely affect the Company's business and results of operations by requiring it to expend significant resources to correct the defect, as well as exposing the Company to civil litigation, regulatory fines or penalties or losses not covered by insurance.

The Company may be adversely affected by the soundness of other financial institutions.

The Company owns common stock of Federal Home Loan Bank of New York ("FHLB NY") in order to qualify for membership in the FHLB system, which enables it to borrow funds under the FHLB NY advance program. The carrying value of the Company's FHLB NY common stock was \$37.3 million as of December 31, 2011. There are 12 branches of the FHLB, including New York. Several branches have warned that they have either breached risk-based

capital requirement or that they are close to breaching those requirements. To conserve capital, some FHLB branches have suspended dividends, cut dividend payments, and have not redeemed excess FHLB stock that members hold. The FHLB NY has stated that they expect to be able to continue to pay dividends, redeem excess capital stock, and provide competitively priced advances currently and in the future. Although most of the severe problems in the FHLB system have been at the other FHLB branches, nonetheless, the 12 FHLB branches are jointly liable for the consolidated obligations of the FHLB system. To the extent that one FHLB branch cannot meet its obligations to pay its share of the system's debt, other FHLB branches can be called upon to make any required payments. Any such adverse effects on the FHLB NY could adversely affect the value of the Company's investment in its common stock and negatively impact the Company's results of operations.

The Company continually encounters technological change and may have to continue to invest in technological improvements.

The financial services industry is continually undergoing rapid technological change with frequent introductions of new technology-driven products and services. The effective use of technology increases efficiency and enables financial institutions to better serve customers and to reduce costs. The Company's future success depends, in part, upon its ability to address the needs of its customers by using technology to provide products and services that will satisfy customer demands as well as to create additional efficiencies in the Company's operations. During the third quarter of 2010, the Company converted its core loan, deposit and financial reporting information technology platform from an outsourced, third-party provided system to an in-house, integrated solution. Although the Company expects to benefit from the enhanced functionality and process efficiencies of the new system, the conversion has created certain processing difficulties and continues to include the risk of integrating newly acquired banks and branches into the existing platform.

Trading activity in the Company's common stock could result in material price fluctuations.

The market price of the Company's common stock may fluctuate significantly in response to a number of other factors including, but not limited to:

- Changes in securities analysts' expectations of financial performance
 - Volatility of stock market prices and volumes
 - Incorrect information or speculation
 - Changes in industry valuations
- Variations in operating results from general expectations
- Actions taken against the Company by various regulatory agencies
- Changes in authoritative accounting guidance by the Financial Accounting Standards Board or other regulatory agencies
 - Changes in general domestic economic conditions such as inflation rates, tax rates, unemployment rates, labor and healthcare cost trend rates, recessions, and changing government policies, laws and regulations
 - Severe weather, natural disasters, acts of war or terrorism and other external events

The Company's ability to attract and retain qualified employees is critical to the success of its business, and failure to do so may have a materially adverse affect on the Company's performance.

The Company's employees are its most important resource, and in many areas of the financial services industry, competition for qualified personnel is intense. The imposition on the Company or its employees of certain existing and proposed restrictions or taxes on executive compensation may adversely affect the Company's ability to attract and retain qualified senior management and employees. If the Company is unable to continue to retain and attract qualified employees, the Company's performance, including its competitive position, could have a materially adverse affect.

Item 1B. Unresolved Staff Comments

None

Item 2. Properties

The Company's primary headquarters are located at 5790 Widewaters Parkway, Dewitt, New York, which is leased. In addition, the Company has 194 properties located in the counties identified in the table on page 5, of which 122 are owned and 72 are under lease arrangements. In total, the Company operates 168 full-service branches, 14 are other customer service facilities for our financial service subsidiaries and 12 are utilized for back office

operations. Some properties contain tenant leases or subleases.

Real property and related banking facilities owned by the Company at December 31, 2011 had a net book value of \$60.3 million and none of the properties were subject to any material encumbrances. For the year ended December 31, 2011, rental fees of \$4.2 million were paid on facilities leased by the Company for its operations. The Company believes that its facilities are suitable and adequate for the Company's current operations.

Item 3. Legal Proceedings

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

Item 4. Mine Safety Disclosures

Not Applicable

Item 4A. Executive Officers of the Registrant

The executive officers of the Company and the Bank who are elected by the Board of Directors are as follows:

| Name | Age | Position |
|------------------|-----|--|
| Mark E. Tryniski | 51 | Director, President and Chief Executive Officer of the Company and the Bank. Mr. Tryniski assumed his current position in August 2006. He served as Executive Vice President and Chief Operating Officer from March 2004 to July 2006 and as the Treasurer and Chief Financial Officer from June 2003 to March 2004. He previously served as a partner in the Syracuse office of PricewaterhouseCoopers LLP. |
| Scott Kingsley | 47 | Executive Vice President and Chief Financial Officer of the Company. Mr. Kingsley joined the Company in August 2004 in his current position. He served as Vice President and Chief Financial Officer of Carlisle Engineered Products, Inc., a subsidiary of the Carlisle Companies, Inc., from 1997 until joining the Company. |
| Brian D. Donahue | 55 | Executive Vice President and Chief Banking Officer. Mr. Donahue assumed his current position in August 2004. He served as the Bank's Chief Credit Officer from February 2000 to July 2004 and as the Senior Lending Officer for the Southern Region of the Bank from 1992 until June 2004. |
| George J. Getman | 55 | Executive Vice President and General Counsel. Mr. Getman assumed his current position in January 2008. Prior to joining the Company, he was a member with Bond, Schoeneck & King, PLLC and served as corporate counsel to the Company. |

Part II

Item 5. Market for the Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities

The Company's common stock has been trading on the New York Stock Exchange under the symbol "CBU" since December 31, 1997. Prior to that, the common stock traded over-the-counter on the NASDAQ National Market under the symbol "CBSI" beginning on September 16, 1986. There were 36,986,409 shares of common stock outstanding on December 31, 2011, held by approximately 3,716 registered shareholders of record. The following table sets forth the high and low prices for the common stock, and the cash dividends declared with respect thereto, for the periods indicated. The prices do not include retail mark-ups, mark-downs or commissions.

| | High | Low | Quarterly |
|-------------|---------|---------|-----------|
| Year | | | |
| / Qtr | Price | Price | Dividend |
| 2011 | | | |
| 4th | \$28.26 | \$21.86 | \$0.26 |
| 3rd | \$25.84 | \$21.67 | \$0.26 |
| 2nd | \$25.12 | \$22.78 | \$0.24 |
| 1st | \$28.45 | \$23.02 | \$0.24 |
| 2010 | | | |
| 4th | \$28.95 | \$22.12 | \$0.24 |
| 3rd | \$25.93 | \$21.52 | \$0.24 |
| 2nd | \$26.49 | \$21.33 | \$0.24 |
| 1st | \$24.25 | \$17.81 | \$0.22 |

The Company has historically paid regular quarterly cash dividends on its common stock, and declared a cash dividend of \$0.26 per share for the first quarter of 2012. The Board of Directors of the Company presently intends to continue the payment of regular quarterly cash dividends on the common stock, as well as to make payment of regularly scheduled dividends on the trust preferred stock when due, subject to the Company's need for those funds. However, because substantially all of the funds available for the payment of dividends by the Company are derived from the subsidiary Bank, future dividends will depend upon the earnings of the Bank, its financial condition, its need for funds and applicable governmental policies and regulations.

The Company completed a public stock offering in late January 2012. The offering raised \$57.5 million through the issuance of 2.13 million shares. The net proceeds of the offering were approximately \$54.9 million. The Company intends to use the net proceeds from this offering to support the HSBC and First Niagara branch acquisitions.

The following graph compares cumulative total shareholders returns on the Company's common stock over the last five fiscal years to the S&P 600 Commercial Banks Index, the NASDAQ Bank Index, the S&P 500 Index, and the KBW Regional Banking Index. Total return values were calculated as of December 31 of each indicated year assuming a \$100 investment on December 31, 2006 and reinvestment of dividends.

The following table provides information as of December 31, 2011 with respect to shares of common stock that may be issued under the Company's existing equity compensation plans.

| Plan Category | Number of Securities to be Issued upon Exercise of Outstanding Options, Warrants and Rights (1) | Weighted-average Exercise Price of Outstanding and Rights | Number of Securities Remaining Available For Future Issuance Under Equity Compensation Plans (excluding securities reflected in column (a)) |
|---|---|---|---|
| Equity compensation plans approved by security holders: | | | |
| 1994 Long-term Incentive Plan | 600,420 | \$20.11 | 0 |
| 2004 Long-term Incentive Plan | 2,616,436 | \$19.52 | 1,741,682 |
| Total | 3,216,856 | \$19.63 | 1,741,682 |

(1) The number of securities includes unvested restricted stock issued of 269,641.

On July 22, 2009, the Company announced an authorization to repurchase up to 1,000,000 of its outstanding shares in open market transactions or privately negotiated transactions in accordance with securities laws and regulations through December 31, 2011. Any repurchased shares will be used for general corporate purposes, including those related to stock plan activities. The timing and extent of repurchases will depend on market conditions and other corporate considerations as determined at the Company's discretion. There were no treasury stock purchases in 2011 or 2010. At its December 2011 meeting, the Board approved extending the stock repurchase program authorizing the repurchase, at the discretion of senior management, of up to 1,500,000 shares through December 31, 2012.

Item 6. Selected Financial Data

The following table sets forth selected consolidated historical financial data of the Company as of and for each of the years in the five-year period ended December 31, 2011. The historical information set forth under the captions "Income Statement Data" and "Balance Sheet Data" is derived from the audited financial statements while the information under the captions "Capital and Related Ratios", "Selected Performance Ratios" and "Asset Quality Ratios" for all periods is unaudited. All financial information in this table should be read in conjunction with the information contained in "Management's Discussion and Analysis of Financial Condition and Results of Operations" and with the Consolidated Financial Statements and the related notes thereto included elsewhere in this Annual Report on Form 10-K.

SELECTED CONSOLIDATED FINANCIAL INFORMATION

| | Years Ended December 31, | | | | |
|---|--------------------------|-----------|-----------|-----------|-----------|
| (In thousands except per share data and ratios) | 2011 | 2010 | 2009 | 2008 | 2007 |
| Income Statement Data: | | | | | |
| Loan interest income | \$192,981 | \$178,703 | \$185,119 | \$186,833 | \$186,784 |
| Investment interest income | 77,988 | 69,578 | 63,663 | 64,026 | 69,453 |
| Interest expense | 61,556 | 66,597 | 83,282 | 102,352 | 120,263 |
| Net interest income | 209,413 | 181,684 | 165,500 | 148,507 | 135,974 |
| Provision for loan losses | 4,736 | 7,205 | 9,790 | 6,730 | 2,004 |
| Noninterest income | 89,283 | 88,792 | 83,528 | 73,244 | 63,260 |
| Gain (loss) on investment securities & early retirement of long-term borrowings | (61) | 0 | 7 | 230 | (9,974) |
| Acquisition expenses & contract termination charges | 4,831 | 1,365 | 1,621 | 1,399 | 382 |
| Other noninterest expenses | 185,541 | 175,521 | 184,557 | 157,163 | 141,692 |
| Income before income taxes | 103,527 | 86,385 | 53,067 | 56,689 | 45,182 |
| Net income | 73,142 | 63,320 | 41,445 | 45,940 | 42,891 |
| Diluted earnings per share (1) | 2.01 | 1.89 | 1.26 | 1.49 | 1.42 |
| Balance Sheet Data: | | | | | |
| Cash equivalents | \$203,082 | \$114,996 | \$257,812 | \$112,181 | \$4,533 |
| Investment securities | 2,151,370 | 1,742,324 | 1,487,127 | 1,395,011 | 1,391,872 |
| Loans, net of unearned discount | 3,471,025 | 3,026,363 | 3,099,485 | 3,136,140 | 2,821,055 |
| Allowance for loan losses | (42,213) | (42,510) | (41,910) | (39,575) | (36,427) |
| Intangible assets | 360,564 | 311,714 | 317,671 | 328,624 | 256,216 |
| Total assets | 6,488,275 | 5,444,506 | 5,402,813 | 5,174,552 | 4,697,502 |
| Deposits | 4,795,245 | 3,934,045 | 3,924,486 | 3,700,812 | 3,228,464 |
| Borrowings | 830,329 | 830,484 | 856,778 | 862,533 | 929,328 |
| Shareholders' equity | 774,583 | 607,258 | 565,697 | 544,651 | 478,784 |
| Capital and Related Ratios: | | | | | |
| Cash dividends declared per share | \$1.00 | \$0.94 | \$0.88 | \$0.86 | \$0.82 |
| Book value per share | 20.94 | 18.23 | 17.25 | 16.69 | 16.16 |
| Tangible book value per share (2) | 11.85 | 9.49 | 8.09 | 6.62 | 7.51 |
| Market capitalization (in millions) | 1,028 | 925 | 633 | 796 | 589 |
| Tier 1 leverage ratio | 8.38% | 8.23% | 7.39% | 7.22% | 7.77% |
| Total risk-based capital to risk-adjusted assets | 15.51% | 14.74% | 13.03% | 12.53% | 14.05% |
| Tangible equity to tangible assets (2) | 7.12% | 6.14% | 5.20% | 4.74% | 5.01% |
| Dividend payout ratio | 49.3% | 49.2% | 69.5% | 57.3% | 57.1% |
| | 36,986 | 33,319 | 32,800 | 32,633 | 29,635 |

| | | | | | |
|---|--------|--------|--------|--------|--------|
| Period end common shares outstanding | | | | | |
| Diluted weighted-average shares outstanding | 36,454 | 33,553 | 32,992 | 30,826 | 30,232 |
| Selected Performance Ratios: | | | | | |
| Return on average assets | 1.18% | 1.16% | 0.78% | 0.97% | 0.93% |
| Return on average equity | 10.36% | 10.66% | 7.46% | 9.23% | 9.20% |
| Net interest margin | 4.07% | 4.04% | 3.80% | 3.82% | 3.64% |
| Noninterest income/operating income (FTE) | 28.4% | 31.1% | 31.6% | 31.0% | 26.1% |
| Efficiency ratio (3) | 57.6% | 59.4% | 65.5% | 62.7% | 63.3% |
| Asset Quality Ratios: | | | | | |
| Allowance for loan losses/total loans | 1.22% | 1.40% | 1.35% | 1.26% | 1.29% |
| Nonperforming loans/total loans | 0.85% | 0.61% | 0.61% | 0.40% | 0.32% |
| Allowance for loan losses/nonperforming loans | 144% | 230% | 222% | 312% | 410% |
| Net charge-offs/average loans | 0.15% | 0.21% | 0.24% | 0.20% | 0.10% |
| Loan loss provision/net charge-offs | 94% | 109% | 131% | 117% | 76% |

(1) Earnings per share amounts have been restated to reflect the effects of ASC 260-10-65.

(2) The tangible book value per share and the tangible equity to tangible asset ratio excludes goodwill and identifiable intangible assets, adjusted for deferred tax liabilities

generated from tax deductible goodwill. The ratio is not a financial measurement required by accounting principles generally accepted in the United States of America.

However, management believes such information is useful to analyze the relative strength of the Company's capital position and is useful to investors in evaluating Company performance.

(3) Efficiency ratio provides a ratio of operating expenses to operating income. It excludes intangible amortization, gain (loss) on investment securities & debt

extinguishments, goodwill impairment, acquisition expenses and contract termination charges from noninterest income and gains and losses on investment securities &

early retirement of long-term borrowings from income while adding a fully-taxable equivalent adjustment. The efficiency ratio is not a financial measurement

required by accounting principles generally accepted in the United States of America. However, the efficiency ratio is used by management in its assessment

of financial performance specifically as it relates to noninterest expense control. Management also believes such information is useful to investors in evaluating

Company performance.

Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations

This Management's Discussion and Analysis of Financial Condition and Results of Operations ("MD&A") primarily reviews the financial condition and results of operations of the Company for the past two years, although in some circumstances a period longer than two years is covered in order to comply with Securities and Exchange Commission disclosure requirements or to more fully explain long-term trends. The following discussion and analysis should be read in conjunction with the Selected Consolidated Financial Information on page 19 and the Company's Consolidated Financial Statements and related notes that appear on pages 49 through 88. All references in the discussion to the financial condition and results of operations are to the consolidated position and results of the Company and its subsidiaries taken as a whole.

Unless otherwise noted, all earnings per share ("EPS") figures disclosed in the MD&A refer to diluted EPS; interest income, net interest income and net interest margin are presented on a fully tax-equivalent ("FTE") basis. The term "this year" and equivalent terms refer to results in calendar year 2011, "last year" and equivalent terms refer to calendar year 2010, and all references to income statement results correspond to full-year activity unless otherwise noted.

This MD&A contains certain forward-looking statements with respect to the financial condition, results of operations and business of Community Bank System, Inc. These forward-looking statements involve certain risks and uncertainties. Factors that may cause actual results to differ materially from those contemplated by such forward-looking statements are set herein under the caption "Forward-Looking Statements" on page 46.

Critical Accounting Policies

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

- Acquired loans – Acquired loans are initially recorded at their acquisition date fair values. The carryover of allowance for loan losses is prohibited as any credit losses in the loans are included in the determination of the fair value of the loans at the acquisition date. Fair values for acquired loans are based on a discounted cash flow methodology that involves assumptions and judgments as to credit risk, prepayment risk, liquidity risk, default rates, loss severity, payment speeds, collateral values and discount rate. Subsequent to the acquisition of acquired impaired loans, GAAP requires the continued estimation of expected cash flows to be received. This estimation requires numerous assumptions, interpretations and judgments using internal and third-party credit quality information. Changes in expected cash flows could result in the recognition of impairment through provision for credit losses.

For acquired loans that are not deemed impaired at acquisition, credit discounts representing the principal losses expected over the life of the loan are a component of the initial fair value. Subsequent to the purchase date, the methods utilized to estimate the required allowance for loan losses for the non-impaired acquired loans is similar to originated loans, however, the Company records a provision for loan losses only when the required allowance exceeds any remaining pooled discounts for loans evaluated collectively for impairment.

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

- Investment securities – Investment securities are classified as held-to-maturity, available-for-sale, or trading. The appropriate classification is based partially on the Company’s ability to hold the securities to maturity and largely on management’s intentions with respect to either holding or selling the securities. The classification of investment securities is significant since it directly impacts the accounting for unrealized gains and losses on securities. Unrealized gains and losses on available-for-sale securities are recorded in accumulated other comprehensive income or loss, as a separate component of shareholders’ equity and do not affect earnings until realized. The fair values of investment securities are generally determined by reference to quoted market prices, where available. If quoted market prices are not available, fair values are based on quoted market prices of comparable instruments, or a discounted cash flow model using market estimates of interest rates and volatility. Investment securities with significant declines in fair value are evaluated to determine whether they should be considered other-than-temporarily impaired. An unrealized loss is generally deemed to be other-than-temporary and a credit loss is deemed to exist if the present value of the expected future cash flows is less than the amortized cost basis of the debt security. The credit loss component of an other-than-temporary impairment write-down is recorded in earnings, while the remaining portion of the impairment loss is recognized in other comprehensive income (loss), provided the Company does not intend to sell the underlying debt security, and it is not more likely than not that the Company will be required to sell the debt security prior to recovery of the full value of its amortized cost basis.
 - Retirement benefits - The Company provides defined benefit pension benefits to eligible employees and post-retirement health and life insurance benefits to certain eligible retirees. The Company also provides deferred compensation and supplemental executive retirement plans for selected current and former employees and officers. Expense under these plans is charged to current operations and consists of several components of net periodic benefit cost based on various actuarial assumptions regarding future experience under the plans, including, but not limited to, discount rate, rate of future compensation increases, mortality rates, future health care costs and the expected return on plan assets.
- Provision for income taxes – The Company is subject to examinations from various taxing authorities. Such examinations may result in challenges to the tax return treatment applied by the Company to specific transactions. Management believes that the assumptions and judgments used to record tax-related assets or liabilities have been appropriate. Should tax laws change or the taxing authorities determine that management’s assumptions were inappropriate, an adjustment may be required which could have a material effect on the Company’s results of operations.
- Intangible assets – As a result of acquisitions, the Company has acquired goodwill and identifiable intangible assets. Goodwill represents the cost of acquired companies in excess of the fair value of net assets at the acquisition date. Goodwill is evaluated at least annually, or when business conditions suggest impairment may have occurred and will be reduced to its carrying value through a charge to earnings if impairment exists. Core deposits and other identifiable intangible assets are amortized to expense over their estimated useful lives. The determination of whether or not impairment exists is based upon discounted cash flow modeling techniques that require management to make estimates regarding the amount and timing of expected future cash flows. It also requires them to select a discount rate that reflects the current return requirements of the market in relation to present risk-free interest rates, required equity market premiums and company-specific risk indicators, all of which are susceptible to change based on changes in economic and market conditions and other factors. Future events or changes in the estimates used to determine the carrying value of goodwill and identifiable intangible assets could have a material impact on the Company’s results of operations.

A summary of the accounting policies used by management is disclosed in Note A, “Summary of Significant Accounting Policies”, starting on page 54.

Executive Summary

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

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

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

On April 8, 2011 the Company acquired Wilber, the parent company of Wilber National Bank, for \$103 million in stock and cash, comprised of \$20.4 million in cash and the issuance of 3.35 million additional shares of the Company's common stock. Based in Oneonta, New York, Wilber operated 22 branches in the Central, Greater Capital District and Catskills regions of Upstate New York. The acquisition added approximately \$462 million of loans, \$297 million of investment securities and \$772 million of deposits.

On November 30, 2011, the Company, through its BPAS subsidiary, acquired certain assets and liabilities of CAI, a provider of actuarial, consulting and retirement plan administration services, with offices in New York City and Northern New Jersey. The transaction adds valuable service capacity and enhances distribution prospects in support of the Company's broader-based employee benefits business, including daily valuation plan and collective investment fund administration. The transaction is expected to add approximately \$4 million of revenue to this business line in 2012.

The Company reported net income for the year ended December 31, 2011 of \$73.1 million or 16% above 2010's reported net income of \$63.3 million. Earnings per share of \$2.01 for the full year 2011 were \$0.12 or 6.3% above the prior year level. The increase was due to higher revenue from both increased net interest income, as a result of earning asset growth, a higher net interest margin, and non-interest income. Also contributing to higher net income was a lower provision for loan losses. These were partially offset by higher operating expenses and a higher effective income tax rate due to a higher proportional level of fully taxable income. The 2011 results included \$4.8 million or \$0.09 per share of acquisition expenses related to the Company's merger with Wilber in early April 2011, as compared to \$1.4 million or \$0.03 per share of acquisition expenses in 2010.

Asset quality remained favorable in 2011, with lower loan net charge-offs and a lower provision for loan losses. Year-end non-performing loan ratios and loan delinquency ratios increased, but remained much better than peer company averages. The Company experienced year-over-year growth in interest-earning assets, reflective of the Wilber acquisition which added approximately \$462 million of loans and \$297 million of investments in the second quarter of 2011. Average deposits increased in 2011 as compared to 2010, reflective of the Wilber acquisition and organic growth in core deposits, offset by a reduction in time deposit balances. Average external borrowings were down slightly from 2010.

On January 19, 2012, the Bank, entered into the HSBC Branch Agreement and the First Niagara Branch Agreement with First Niagara. Under the Agreements, the Bank will acquire 19 branches in Central, Northern, and Western New York consisting of three branches purchased directly from First Niagara and 16 branches which are currently owned by HSBC. First Niagara is assigning its rights to the HSBC branches in connection with its pending acquisition of HSBC's Upstate New York banking franchise. The branch acquisitions will strengthen and extend the Company's Upstate New York presence. Under the terms of the Agreements, the Bank will acquire approximately \$218 million in loans and \$955 million in deposits at a blended deposit premium of 3.22%. The branch acquisitions are expected to close during the third quarter of 2012 subject to regulatory review and approval and customary closing conditions. The Company expects to incur certain one-time, transaction-related costs in 2012.

The Company completed public stock offering in late January 2012. The offering raised \$57.5 million through the issuance of 2.13 million shares. The net proceeds of the offering were approximately \$54.9. The Company intends to use the net proceeds from this offering to support the HSBC and First Niagara branch acquisitions.

Net Income and Profitability

Net income for 2011 was \$73.1 million, an increase of \$9.8 million, or 16%, from 2010's earnings of \$63.3 million. Earnings per share for 2011 were \$2.01, up 6.3% from 2010's earnings per share of \$1.89. The 2011 results included \$4.8 million, or \$0.09 per share, of acquisition expenses related principally to the Company's acquisition of

Wilber, which was completed in the second quarter of 2011. The 2010 results included \$1.4 million, or \$0.03 per share of acquisition expenses, principally related to the Wilber acquisition.

Net income for 2010 was \$63.3 million, up \$21.9 million, or 53% from 2009's earnings of \$41.4 million. Earnings per share for 2010 were \$1.89, up 50% from 2009's earnings per share. The 2010 results included \$1.4 million, or \$0.03 per share of acquisition expenses principally related to the Wilber acquisition. The 2009 results included a \$3.1 million or \$0.07 per share non-cash charge for impairment of goodwill associated with the Company's wealth management business as well as a \$1.4 million or \$0.03 per share special charge related to the planned early termination of its core banking system services contract in 2010. Additionally, during 2009, FDIC insurance costs increased \$6.9 million or \$0.16 per share as compared to 2008 and included a \$2.5 million one-time special assessment charge.

Table 1: Condensed Income Statements

| | Years Ended December 31, | | | | |
|---|--------------------------|-----------|-----------|-----------|-----------|
| (000's omitted, except per share data) | 2011 | 2010 | 2009 | 2008 | 2007 |
| Net interest income | \$209,413 | \$181,684 | \$165,500 | \$148,507 | \$135,974 |
| Loan loss provision | 4,736 | 7,205 | 9,790 | 6,730 | 2,004 |
| Noninterest income | 89,222 | 88,792 | 83,535 | 73,474 | 53,286 |
| Operating expenses | 190,372 | 176,886 | 186,178 | 158,562 | 142,074 |
| Income before taxes | 103,527 | 86,385 | 53,067 | 56,689 | 45,182 |
| Income taxes | 30,385 | 23,065 | 11,622 | 10,749 | 2,291 |
| Net income | \$73,142 | \$63,320 | \$41,445 | \$45,940 | \$42,891 |
| Diluted earnings per share | \$2.01 | \$1.89 | \$1.26 | \$1.49 | \$1.42 |

The primary factors explaining 2011 earnings performance are discussed in detail in the remaining sections of this document and are summarized as follows:

- As shown in Table 1 above, net interest income increased \$27.7 million, or 15.3%, due to a \$656.4 million increase in average earning assets combined with a three-basis point increase in the net interest margin. Average loans grew \$280.3 million due to the acquisition of Wilber and strong growth in the consumer mortgage portfolio aided by long-term interest rates remaining low and growth in the indirect consumer installment portfolio. The average book value of investments increased \$333.5 million or 19% in 2011 due to the investments acquired from Wilber and organic deposit growth. Short-term cash equivalents increased \$101.4 million as compared to 2010. Average interest-bearing deposits increased \$516.7 million or 16% due to the Wilber acquisition and organic growth. Average borrowings decreased slightly from the prior year.
- The loan loss provision of \$4.7 million decreased \$2.5 million, or 34%, from the prior year level. Net charge-offs of \$5.0 million declined by \$1.6 million from 2010, decreasing the net charge-off ratio (net charge-offs / total average loans) to 0.15% for the year. Nonperforming loans as a percentage of total loans and nonperforming assets as a percentage of loans and other real estate owned, increased in the fourth quarter primarily due to two commercial lending relationships, but remain well below averages for the Company's peers. Additional information on trends and policy related to asset quality is provided in the asset quality section on pages 36 through 40.
- Noninterest income for 2011 of \$89.2 million increased by \$0.4 million, or 0.5%, from 2010's level due to growth in financial services revenue, partially offset by lower fees from banking services. Fees from banking services were \$2.4 million or 4.8%, lower primarily due to decreased activity in the secondary mortgage banking business and lower deposit service fees due to lower utilization of overdraft protection programs, partially offset by higher debit

card related revenues. Financial services revenue was up \$2.8 million, or 7.2%, with solid growth in almost all lines of business.

- Total operating expenses increased \$13.5 million, or 7.6%, in 2011 to \$190.4 million, primarily due to the additional operating costs associated with the Wilber acquisition, partially offset by lower FDIC insurance costs and lower amortization of intangibles.
- The Company's combined effective federal and state income tax rate increased 2.7 percentage points in 2011 to 29.4%, reflective of a higher proportion of income from fully taxable sources.

Selected Profitability and Other Measures

Return on average assets, return on average equity, dividend payout and equity to asset ratios for the years indicated are as follows:

Table 2: Selected Ratios

| | 2011 | 2010 | 2009 |
|----------------------------------|--------|--------|--------|
| Return on average assets | 1.18% | 1.16% | 0.78% |
| Return on average equity | 10.36% | 10.66% | 7.46% |
| Dividend payout ratio | 49.3% | 49.2% | 69.5% |
| Average equity to average assets | 11.42% | 10.89% | 10.44% |

As displayed in Table 2 above, the returns on average assets increased in 2011 as compared to both 2010 and 2009 and the return on equity was down slightly from 2010 and up significantly from 2009. The increase in comparison to both years was a result of net income growing at a faster pace than average assets due to increasing net interest margins, non-interest income growth, lower provision for loan losses and operating expense containment. The return on equity declined in 2011 despite strong earnings growth because of the equity issued in conjunction with the Wilber acquisition, build up of capital through earnings retention and a substantial increase in the equity components of the investment market value adjustment due mostly to a decrease in medium to long-term interest rates.

The dividend payout ratio for 2011 increased slightly from 2010 as dividends declared increased 15.7% primarily as a result of a 6.4% increase in the dividends declared per share as well as the additional 3.4 million shares issued in conjunction with the Wilber acquisition in the second quarter of 2011, while net income increased a slightly smaller 15.5% from 2010. The dividend payout ratio for 2010 was below 2009 primarily due to the significant increase in net income partially offset by a smaller increase in the dividend declared. In 2010 net income increased 53% while dividends declared increased 8.2% as a result of a 6.8% increase in the dividend per share and a 1.6% increase in the number of shares outstanding.

Net Interest Income

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

As disclosed in Table 3, net interest income (with nontaxable income converted to a fully tax-equivalent basis) totaled \$225.1 million in 2011, up \$28.2 million, or 14%, from the prior year. A \$656.4 million increase in average interest-earning assets and a three-basis point increase in the net interest margin more than offset a \$510.5 million increase in average interest-bearing liabilities. As reflected in Table 4, the volume changes increased net interest income by approximately \$26.7 million, while the higher net interest margin had a \$1.5 million favorable impact.

The net interest margin increased three basis points from 4.04% in 2010 to 4.07% in 2011. This increase was primarily attributable to a 29-basis point decrease in interest-bearing liability yields having a greater impact than a 22-basis point decrease in the earning-asset yields. The yield on loans decreased five basis points in 2011, due to new volume coming on at lower yields in the current low-rate environment than the loans maturing or being prepaid and variable and adjustable rate loans repricing downward. The yield on investments, including cash equivalents, decreased from 4.70% in 2010 to 4.27% in 2011, with the yield decline being muted by the effective deployment of cash into higher yielding securities. The decreased cost of funds was reflective of disciplined deposit pricing, whereby interest rates on selected categories of deposit accounts were lowered throughout 2010 and 2011 in response to market conditions.

The net interest margin in 2010 was 4.04%, compared to 3.80% in 2009. This 24-basis point increase was primarily attributable to a 43-basis point decrease in interest-bearing liability yields having a greater impact than a 13-basis point decrease in earning-asset yields. The decreased cost of funds was reflective of deposit rate reductions throughout 2009 and 2010. Additionally, the proportion of customer deposits in higher cost time deposits declined 7.1 percentage points during 2010, while the percentage of deposits in non-interest bearing and lower cost checking and money market accounts increased throughout 2009 and 2010. The yield on loans decreased 15 basis points in 2010, mostly as a result of the low interest rate environment. The yield on investments, including cash equivalents, decreased from 4.73% in 2009 to 4.70% in 2010, with the yield decline being muted by the effective deployment of cash into higher yielding securities during 2010.

As shown in Table 3, total interest income increased by \$23.2 million, or 8.8%, in 2011 from 2010. Table 4 indicates that higher average earning assets contributed a positive \$34.4 million variance, offset by lower yields with a negative impact of \$11.2 million. Average loans increased a total of \$280.3 million in 2011, primarily as result of the Wilber acquisition and organic growth in the consumer mortgage and consumer indirect portfolios. Loan interest income and fees increased \$14.7 million in 2011 as compared to 2010, attributable to the higher average loan balances, partially offset by a five-basis point decrease in loan yields. Investment interest income, including cash equivalents, on an FTE basis of \$92.7 million in 2011 was \$8.4 million or 10.0% higher than the prior year as a result of a larger portfolio, partially offset by a 43-basis point decrease in the investment yield. Average investments, including cash equivalents, for 2011 were \$376.1 million higher than 2010, reflective of the acquired Wilber portfolio and deployment of excess funding supplied by organic deposit growth.

Total interest income decreased by \$1.0 million, or 0.4% in 2010 from 2009's level. Table 4 indicates that higher average earning assets contributed a positive \$5.3 million variance offset by lower yields with a negative impact of \$6.3 million. Average loans declined a total of \$29.8 million in 2010, adversely impacted by economic and demand conditions. Loan interest income and fees declined \$6.4 million in 2010 as compared to 2009, attributable to a 15-basis point decrease in loan yields and the lower average loan balances. Investment interest income, including cash equivalents, on an FTE basis in 2010 of \$84.3 million was \$5.4 million or 6.8% higher than the prior year as a result of a larger portfolio, partially offset by a three-basis point decrease in the investment yield. Average investments for 2010 were \$287.7 million higher than 2009, while overnight invested cash equivalents declined \$161.0 million from 2009 reflective of the deployment during the first quarter of 2010 of a portion of the Company's excess liquidity into intermediate-term U.S. Treasury securities.

The earning-asset yield declined 22 basis points to 5.19% in 2011 from 5.41% in 2010 because of the previously mentioned decrease in loan and investment yields. The change in the earning-asset yield is primarily a result of variable and adjustable-rate loans repricing downward and lower rates on new loan volume and investment purchases due to the decline in interest rates to levels below those prevalent in prior years, as well as the Company's increased holding of lower-yielding cash instruments, as it maintained a liquid position in anticipation of improved investment opportunities in future periods. The earning-asset yield declined 13 basis points from 2009 to 5.51% in 2010 because of the previously mentioned decreases in loan and investment yields, partially offset by the higher interest rates earned on the redeployment of cash equivalents into U.S. Treasury Securities.

Total average funding (deposits and borrowings) in 2011 increased \$607.4 million or 12.7%. Deposits increased \$613.6 million, \$559.7 million attributable to the Wilber acquisition and a \$53.9 million increase in organic deposits. Consistent with the Company's funding mix objective, organic average core deposit balances increased \$207.1 million, while time deposits declined \$153.2 million on an organic basis year-over-year. Average external borrowings decreased \$6.2 million in 2011 as compared to the prior year. In 2010 total average funding increased \$85.6 million or 1.8%. Deposits increased \$105.5 million due to organic growth. Consistent with the Company's funding mix objective, average core deposit balances increased \$400.1 million, while time deposits were managed downward \$294.6 million over the year. Average external borrowings decreased \$19.8 million in 2010 as compared to the prior year.

The cost of funding, including the impact of non-interest checking deposits, decreased 25 basis points during 2011 to 1.14% as compared to 1.39% for 2010. The decreased cost of funds was reflective of disciplined deposit pricing, whereby interest rates on selected categories of deposit accounts were lowered throughout 2010 and 2011 in response to market conditions. Additionally, the Company focused on expanding core account relationships while time deposit balances were allowed to decline. The cost of funding decreased 38 basis points during 2010 to 1.39% as compared to 1.77% for 2009. Interest rates on deposit accounts were lowered throughout 2010, with decreases in all product offerings. Additionally, the proportion of customer deposits in higher cost time deposits in 2010 declined 7.1 percentage points in comparison to the prior year, while the percentage of deposits in non-interest bearing and lower cost checking accounts increased.

Total interest expense decreased by \$5.0 million to \$61.6 million in 2011. As shown in Table 4, lower interest rates on deposits and external borrowings resulted in \$12.8 million of this decrease, while higher deposit balances, partially offset by the lower external borrowings balance, accounted for an increase of \$7.7 million in interest expense. Interest expense as a percentage of earning assets decreased by 26 basis points to 1.11%. The rate on interest-bearing deposits decreased 25 basis points to 0.70%, due largely to reductions of time deposit and money market rates throughout 2011 and the previously discussed balance decline of higher rate time deposits. The rate on external borrowings decreased four basis points to 4.25% in 2011. Total interest expense decreased by \$16.7 million to \$66.6 million in 2010 as compared to 2009. Lower interest rates on interest-bearing liabilities accounted for \$17.6 million of this decrease, while the higher interest-bearing liability balances accounted for an increase of \$0.9 million in interest expense. In

2010, the rate on interest-bearing deposits decreased 50 basis points to 0.95% and the rate on external borrowings decreased eight basis points to 4.29%.

The following table sets forth information related to average interest-earning assets and interest-bearing liabilities and their associated yields and rates for the years ended December 31, 2011, 2010 and 2009. Interest income and yields are on a fully tax-equivalent basis using marginal income tax rates of 38.8% in 2011 and 38.5% in 2010 and 2009. Average balances are computed by totaling the daily ending balances in a period and dividing by the number of days in that period. Loan yields and amounts earned include loan fees. Average loan balances include nonaccrual loans and loans held for sale.

Table 3: Average Balance Sheet

| | Year Ended December 31, 2011 | | | Year Ended December 31, 2010 | | | Year Ended December 31, 2009 | | |
|---|---------------------------------|--------------------|-------|---------------------------------|--------------------|-------|---------------------------------|--------------------|-------|
| | Average | Avg. Yield/Rate | | Average | Avg. Yield/Rate | | Average | Avg. Yield/Rate | |
| (000's omitted except yields and rates) | Balance | Interest | Paid | Balance | Interest | Paid | Balance | Interest | Paid |
| Interest-earning assets: | | | | | | | | | |
| Cash equivalents | \$202,885 | \$503 | 0.25% | \$101,507 | \$255 | 0.25% | \$262,479 | \$682 | 0.26% |
| Taxable investment securities (1) | | | | | | | | | |
| | 1,398,437 | 56,982 | 4.07% | 1,154,780 | 48,388 | 4.19% | 848,963 | 40,481 | 4.77% |
| Nontaxable investment securities (1) | | | | | | | | | |
| | 568,295 | 35,207 | 6.20% | 537,216 | 35,624 | 6.63% | 555,353 | 37,704 | 6.79% |
| Loans (net of unearned discount)(2) | | | | | | | | | |
| | 3,355,286 | 193,951 | 5.78% | 3,075,030 | 179,215 | 5.83% | 3,104,808 | 185,587 | 5.98% |
| Total interest-earning assets | | | | | | | | | |
| | 5,524,903 | 286,643 | 5.19% | 4,868,533 | 263,482 | 5.41% | 4,771,603 | 264,454 | 5.54% |
| Noninterest-earning assets | | | | | | | | | |
| | 659,267 | | | 590,464 | | | 546,595 | | |
| Total assets | | | | | | | | | |
| | \$6,184,170 | | | \$5,458,997 | | | \$5,318,198 | | |
| Interest-bearing liabilities: | | | | | | | | | |
| Interest checking, savings and money market deposits | | | | | | | | | |
| | \$2,640,239 | 10,103 | 0.38% | \$2,193,512 | 11,399 | 0.52% | \$1,835,138 | 11,448 | 0.62% |
| Time deposits | | | | | | | | | |
| | 1,101,013 | 16,053 | 1.46% | 1,030,995 | 19,160 | 1.86% | 1,325,598 | 34,328 | 2.59% |
| Borrowings | | | | | | | | | |
| | 833,075 | 35,400 | 4.25% | 839,314 | 36,038 | 4.29% | 859,155 | 37,506 | 4.37% |
| Total interest-bearing liabilities | | | | | | | | | |
| | 4,574,327 | 61,556 | 1.35% | 4,063,821 | 66,597 | 1.64% | 4,019,891 | 83,282 | 2.07% |
| Noninterest-bearing liabilities: | | | | | | | | | |
| Noninterest checking deposits | | | | | | | | | |
| | 825,277 | | | 728,408 | | | 686,692 | | |

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| | | | |
|--|-------------|-------------|-------------|
| Other liabilities | 78,221 | 72,520 | 56,147 |
| Shareholders' equity | 706,345 | 594,248 | 555,468 |
| Total liabilities and shareholders' equity | \$6,184,170 | \$5,458,997 | \$5,318,198 |
| Net interest earnings | \$225,087 | \$196,885 | \$181,172 |
| Net interest spread | 3.84% | 3.77% | 3.47% |
| Net interest margin on interest-earning assets | 4.07% | 4.04% | 3.80% |
| Fully tax-equivalent adjustment | \$15,674 | \$15,201 | \$15,672 |

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

(2) Includes nonaccrual loans. The impact of interest and fees not recognized on nonaccrual loans was immaterial.

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

| Table 4: Rate/Volume | | | | | | |
|--|--|-----------------|----------------|--|-----------------|-----------------|
| (000's omitted) | 2011 Compared to 2010 | | | 2010 Compared to 2009 | | |
| | Increase (Decrease) Due to Change in (1) | | | Increase (Decrease) Due to Change in (1) | | |
| | Volume | Rate | Net Change | Volume | Rate | Net Change |
| Interest earned on: | | | | | | |
| Cash equivalents | \$252 | (\$4) | \$248 | (\$406) | (\$21) | (\$427) |
| Taxable investment securities | 9,961 | (1,367) | 8,594 | 13,259 | (5,352) | 7,907 |
| Nontaxable investment securities | 1,998 | (2,415) | (417) | (1,214) | (866) | (2,080) |
| Loans (net of unearned discount) | 16,211 | (1,475) | 14,736 | (1,768) | (4,604) | (6,372) |
| Total interest-earning assets (2) | 34,399 | (11,238) | 23,161 | 5,312 | (6,284) | (972) |
| Interest paid on: | | | | | | |
| Interest checking, savings and money market deposits | 2,054 | (3,350) | (1,296) | 2,035 | (2,084) | (49) |
| Time deposits | 1,234 | (4,341) | (3,107) | (6,680) | (8,488) | (15,168) |
| Borrowings | (267) | (371) | (638) | (2,895) | 1,427 | (1,468) |
| Total interest-bearing liabilities (2) | 7,749 | (12,790) | (5,041) | 901 | (17,586) | (16,685) |
| Net interest earnings (2) | 26,732 | 1,470 | 28,202 | 3,736 | 11,977 | 15,713 |

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

(2) Changes due to volume and rate are computed from the respective changes in average balances and rates of the totals;

they are not a summation of the changes of the components.

Noninterest Income

The Company's sources of noninterest income are of three primary types: 1) general banking services related to loans, deposits and other core customer activities typically provided through the branch network and electronic banking channels (performed by CBNA and First Liberty Bank and Trust); 2) employee benefit trust, administration, actuarial and consulting services (performed by BPAS); and 3) wealth management services, comprised of trust services (performed by the personal trust units within CBNA), investment and insurance products and services (performed by CISI and CBNA Insurance), and asset management (performed by Nottingham). Additionally, the Company has periodic transactions, most often net gains (losses) from the sale of investment securities and prepayment of debt instruments.

Table 5: Noninterest Income

| (000's omitted except ratios) | Years Ended December 31, | | |
|--|--------------------------|----------|----------|
| | 2011 | 2010 | 2009 |
| Deposit service charges and fees | \$25,658 | \$29,485 | \$29,819 |
| Benefit trust, administration, consulting and actuarial fees | 31,601 | 29,616 | 27,771 |
| Wealth management services | 10,697 | 9,833 | 8,631 |
| Other fees | 4,808 | 4,514 | 4,457 |
| Electronic banking | 14,784 | 11,646 | 8,904 |
| Mortgage banking | 1,735 | 3,698 | 3,946 |
| Subtotal | 89,283 | 88,792 | 83,528 |
| (Loss) Gain on investment securities & debt extinguishments, net | (61) | 0 | 7 |
| Total noninterest income | \$89,222 | \$88,792 | \$83,535 |
| Noninterest income/operating income (FTE basis) (1) | 28.4% | 31.1% | 31.6% |

(1) For purposes of this ratio noninterest income excludes gains on investment securities and debt extinguishments. Operating income is defined as net interest income plus noninterest income, excluding gains on investment securities and debt extinguishments, plus a fully-tax equivalent basis adjustment.

As displayed in Table 5, noninterest income, excluding security gains and losses and debt extinguishments costs, of \$89.3 million for 2011 increased by \$0.5 million, largely as a result of increased debit card related income, growth in revenue from the Company's financial services businesses and incremental revenue produced by the acquired Wilber trust operations, partially offset by lower banking fees due to reduced utilization of certain services by the Bank's customers as well as lower mortgage banking income. Total noninterest income, excluding security gains and losses and debt extinguishments costs, increased by 6.3% to \$88.8 million in 2010 as compared to 2009 largely as a result of increased debit card related income and increased revenue from the Company's financial services businesses.

Noninterest income as a percent of operating income (FTE basis) was 28.4% in 2011, down 2.7 percentage points from the prior year and down 3.2 percentage points from 2009. The current year decrease was due to a 14.3% increase in net interest income, primarily the result of the Wilber acquisition, while noninterest income increased at a much smaller rate of 0.6% as discussed below. The decrease from 2009 to 2010 was primarily driven by an 8.7% increase in net interest income being larger than the 6.3 % increase in noninterest income. The reduction of the ratio in both years was influenced by expansion of the net interest margin.

The largest portion of the Company's recurring noninterest income is the wide variety of fees earned from general banking services, which was \$47.0 million in 2011, down \$2.4 million or 4.8% from the prior year. A large part of the decline was due to lower overdraft and deposit fees reflective of lower service utilization due to economic conditions and regulatory and policy changes. Effective July 1, 2010, Regulation E (a Federal Reserve Board Regulation) prohibited financial institutions from charging consumers fees for paying overdrafts on ATM and debit card transactions, unless the customer consents. The majority of the Company's customers have consented to protecting their accounts from electronic transaction rejection. Additionally, mortgage banking revenue declined \$2.0 million. Partially offsetting these declines was \$3.1 million of income growth from electronic banking fees due in large part to a concerted effort to increase the penetration and utilization of consumer debit cards.

In 2011, mortgage banking revenue declined \$2.0 million from the income generated in 2010, which had been down only slightly from the record level of 2009, reflective of the decision to hold a majority of secondary market eligible mortgages in portfolio in the latter half of 2011. Residential mortgage banking income consists of realized gains or losses from the sale of residential mortgage loans and the origination of mortgage loan servicing rights, unrealized gains and losses on residential mortgage loans held for sale and related commitments, mortgage loan servicing fees and other mortgage loan-related fee income. Included in mortgage banking income is a net impairment charge of \$0.1 million in 2011 for the fair value of the mortgage servicing rights due primarily to an increase in the expected prepayment speed of the Company's sold loan portfolio with servicing retained. Residential mortgage loans sold to investors, primarily Fannie Mae, totaled \$43.1 million in 2011 as compared to \$119.0 million and \$177.8 million during 2010 and 2009, respectively. Residential mortgage loans held for sale and recorded at fair value at December 31, 2011 totaled \$0.5 million. The continuation of the level of mortgage noninterest income produced in 2011 will be dependent on market conditions and the trend in long-term interest rates.

Fees from general banking services were \$49.3 million in 2010, up \$2.2 million or 4.7% from 2009. A large portion of the income growth was attributable to electronic banking fees (principally card-related), up \$2.7 million or 31%, and overdraft fees, up \$0.7 million, or 3.0%. Mortgage banking revenue remained strong during 2010, but was down \$0.2 million from the record secondary market income generated in 2009.

As disclosed in Table 5, noninterest income from financial services (including revenues from benefit trust, administration, consulting and actuarial fees and wealth management services) rose \$2.8 million, or 7.2%, in 2011 to \$42.3 million. Financial services revenue now comprises 47% of total noninterest income, excluding net gains (losses) on the sale of investment securities and debt extinguishments. BPAS generated revenue growth of \$2.0 million, or 6.7%, for the 2011 year, driven by a combination of new client generation, expanded service offerings,

increased asset-based revenue and one month of revenue from its CAI acquisition. BPAS offers their clients daily valuation, actuarial and employee benefit consulting services on a national basis from offices in New Jersey, New York, Pennsylvania and Texas. BPAS revenue of \$29.6 million in 2010 was \$1.8 million higher than 2009's results, driven by a combination of new client generation, expanded service offerings and increased asset-based revenue.

On November 30, 2011, BPAS acquired, in an all-cash transactions, certain assets and liabilities of CAI, a provider of actuarial, consulting and retirement plan administration services, with offices in New York City and Northern New Jersey. The transaction adds valuable service capacity and enhances distribution prospects in support of the Company's broader-based employee benefits business including daily valuation plan and collective investment fund administration. The transaction is expected to add an incremental \$4 million of revenue to this business line in 2012.

Wealth management services revenue increased \$0.9 million or 8.9% in 2011. Personal trust revenues increased \$1.6 million, principally due to incremental revenue produced by the acquired Wilber trust operations. Nottingham revenue increased \$0.2 million and CBNA Insurance revenue increased \$0.3 million. These increases were partially offset by \$1.2 million decrease in revenue at CISI due to lower production levels for broker advisory services. The improved revenue generation of the wealth management services was reflective of the Wilber acquisition, favorable market valuation comparisons and generally improving demand characteristics. Wealth management services revenue in 2010 increased \$1.2 million or 13.9% as compared to 2009. CISI revenue increased \$0.9 million from 2009, Nottingham revenue increased \$0.2 million and personal trust revenues increased \$0.1 million, while revenue generated at CBNA Insurance remained consistent with the prior year.

Assets under management and administration increased \$1.0 billion during 2011 from \$6.7 billion at year-end 2010. Market-driven gains in equity-based assets were augmented by the addition of new client assets. BPA, in particular, was successful at growing its asset base, as demonstrated by the approximately \$0.5 billion increase in its assets under administration during 2011. Additionally, the acquired Wilber trust operation added \$0.4 billion of assets under management in the second quarter of 2011. Assets under management and administration at the Company's financial services businesses increased \$1.1 billion during 2010 to \$6.7 billion, compared to \$5.6 billion at the end of 2009.

Noninterest Expenses

As shown in Table 6, operating expenses increased \$13.5 million, or 7.6%, in 2011 to \$190.4 million, primarily due to the acquisition of Wilber in April 2011, partially offset by lower FDIC premiums and lower amortization of intangibles. Operating expenses in 2010 were \$9.3 million or 5.0% lower than 2009 primarily due to several expense reduction initiatives, lower FDIC premiums, lower amortization of intangibles and no goodwill impairment charge in 2010 as compared to 2009. Operating expenses for 2011 as a percent of average assets were 2.93%, down 18 basis points from 3.11% in 2010. The improvement in this ratio was due to effective cost controls on operating expenses combined with an increase in average assets from the Wilber acquisition. This ratio was down 15 basis points in 2010 as compared to 2009 as a result of decreased operating expenses combined with higher average assets.

The efficiency ratio, a performance measurement tool widely used by banks, is defined by the Company as operating expenses (excluding acquisition expenses and contract termination charges, goodwill impairment and intangible amortization) divided by operating income (fully tax-equivalent net interest income plus noninterest income, excluding net securities and debt gains and losses). Lower ratios are often correlated to higher operating efficiency. The efficiency ratio for 2011 was 1.8 percentage points lower than the 59.4% ratio for 2010 due to a 6.8% decrease in operating expenses, as defined above, combined with a 14.3% increase in net interest income and a 0.6% increase in noninterest income. In 2010 the efficiency ratio declined 6.1 percentage points due to a 2.2% decrease in operating expenses, as defined above, combined with an 8.7% increase in net interest income and a 6.3% increase in noninterest income (excluding net securities gains and debt extinguishments costs). The significant increase in FDIC premiums with no corresponding income generation was the primary reason for the elevated efficiency ratio for 2009. In addition, the efficiency ratios for both periods were adversely affected by the growing proportion of financial services activities, which due to the differing nature of their business and income statement structure have comparatively higher efficiency ratios.

Table 6: Noninterest Expenses

| (000's omitted) | Years Ended December 31, | | |
|--------------------------------|--------------------------|----------|----------|
| | 2011 | 2010 | 2009 |
| Salaries and employee benefits | \$102,278 | \$91,399 | \$92,690 |

| | | | |
|---|-----------|-----------|-----------|
| Occupancy and equipment | 24,502 | 22,933 | 23,185 |
| Data processing and communications | 20,525 | 20,720 | 20,684 |
| Amortization of intangible assets | 4,381 | 5,957 | 8,170 |
| Legal and professional fees | 5,889 | 5,532 | 5,302 |
| Office supplies and postage | 5,246 | 5,469 | 5,243 |
| Business development and marketing | 5,931 | 5,237 | 6,086 |
| FDIC insurance premiums | 3,920 | 5,838 | 8,610 |
| Goodwill impairment | 0 | 0 | 3,079 |
| Acquisition expenses and contract termination charges | 4,831 | 1,365 | 1,621 |
| Other | 12,869 | 12,436 | 11,508 |
| Total noninterest expenses | \$190,372 | \$176,886 | \$186,178 |
| Operating expenses(1) /average assets | 2.93% | 3.11% | 3.26% |
| Efficiency ratio | 57.6% | 59.4% | 65.5% |

(1) Operating expenses are total noninterest expenses excluding acquisition expenses, contract termination charges, goodwill impairment and amortization of intangible assets

Salaries and employee benefits increased \$10.9 million or 11.9% in 2011, primarily due to the addition of approximately 200 employees as a result of the Wilber acquisition, as well as the impact of annual merit increases. Total salaries and employee benefits decreased in 2010, however, salaries expense increased \$2.8 million or 3.8%, primarily due to increased levels of incentive compensation. This increase was offset by a \$4.1 million or 22% decrease in employee benefit costs primarily due to modifications made to the Company's defined benefit pension plan and its post-retirement medical programs, partially offset by a higher contribution to the Company's 401(k) Employee Stock Ownership Plan ("401(k) Plan"). Total full-time equivalent staff at the end of 2011 was 1,831, compared to 1,624 at December 31, 2010 and 1,595 at the end of 2009.

Medical expenses increased \$0.9 million or 12.4% in 2011 due primarily to the additional employees added from the Wilber acquisition. Medical expenses decreased \$0.2 million in 2010, or 2.8%, primarily due to favorable experience in the Company's self-insured medical plans. This year's qualified and nonqualified retirement plan expense was consistent with 2010. Qualified pension plan expense decreased approximately \$0.3 million due primarily to higher returns on plan assets partially offset by a lower discount rate. The 401(k) Plan expense increased approximately \$0.2 million due to additional participants as a result of the Wilber acquisition. Qualified and nonqualified pension expense decreased \$4.2 million in 2010. The defined benefit pension plan was modified in the fourth quarter of 2009 to a new plan design, which combines service credits in the Company's Cash Balance Plan with additional contributions to be made to the 401(k) Plan. In the fourth quarter of 2009, the Company terminated its post-retirement medical program for certain current and all future employees. Additionally, effective January 1, 2010, the Company increased its discretionary matching contribution to the 401(k) Plan for employee participants who contribute 6% of eligible compensation from a maximum of 3.5% to 4.5%. The three assumptions that have the largest impact on the calculation of annual pension expense are the discount rate utilized, the rate applied to future compensation increases and the expected rate of return on plan assets. See Note K to the financial statements for further information about the pension plan.

Total non-personnel noninterest expenses, excluding one-time acquisition expenses and contract termination charges decreased \$0.9 million or 1.0% in 2011. Excluding expenses related to the retail branches acquired from Wilber, non-personnel noninterest expenses as defined above declined \$6.2 million or 7.3%. As displayed in Table 6, this was largely caused by lower FDIC insurance premiums (down \$1.9 million in total and down \$2.3 million excluding acquired Wilber branches), amortization of intangible assets (down \$1.6 million in total and down \$2.2 million excluding acquired Wilber branches), data processing and communications (down \$0.2 million in total and down \$1.1 million excluding acquired Wilber branches), occupancy & equipment (up \$1.6 million in total and down \$0.1 million excluding acquired Wilber branches), partially offset by higher business development and marketing costs (up \$0.7 million in total and up \$0.4 million excluding the acquired Wilber branches), higher legal and professional fees (up \$0.4 million in total and up \$0.2 million excluding the acquired Wilber branches). Amortization of intangibles decreased in 2011, a result of accelerated amortization methodologies employed and the core deposit intangible from a 2001 acquisition became fully amortized in 2010. The lower data processing and communications costs are a result of the conversion of the Company's core banking system in the second half of 2010.

The Company continually evaluates all aspects of its operating expense structure and is diligent about identifying opportunities to improve operating efficiencies. Over the last two years, the Company has consolidated certain of its branch offices. This realignment will reduce market overlap and further strengthen its branch network, and reflects management's focus on achieving long-term performance improvements through proactive, strategic decision making.

The FDIC imposes an assessment against all depository institutions for deposit insurance. This assessment is based on the risk category of the institution and, prior to 2009, ranged from five to 43 basis points of the institution's deposits. On December 22, 2008, as a result of decreases in the reserve ratio of the DIF, the FDIC published a final rule raising the current deposit insurance assessment rates uniformly for all institutions by seven basis points for the first quarter of 2009. On May 22, 2009, the FDIC adopted a final rule imposing a five basis point special assessment

on each insured depository institution's assets minus Tier 1 capital as of June 30, 2009, payable on September 30, 2009. The Company's special assessment amounted to \$2.5 million in June 2009. No additional special assessments were levied during 2010 and 2011. Effective in April 1, 2011, the FDIC changed the calculation of the assessment to be based upon a percentage of average consolidated Bank assets less average tangible capital as opposed to a percentage of average deposits which has been used in the past. The result for Company was a savings of approximately \$2 million a year in deposit insurance assessments.

Total non-personnel operating expenses, excluding acquisition expenses, contract termination charges, and goodwill impairment, decreased \$4.6 million or 5.2% in 2010. As displayed in Table 6, this was largely caused by lower FDIC insurance premiums (down \$2.8 million), amortization of intangible assets (down \$2.2 million), business development and marketing (down \$0.8 million), foreclosed property expenses (down \$0.7 million), occupancy and equipment expense (down \$0.3 million), partially offset by higher legal and professional (up \$0.3 million), office supplies and postage (up \$0.2 million), and miscellaneous other costs (up \$1.5 million). Amortization of intangibles decreased \$2.2 million in 2010, a result of no new acquisitions, accelerated amortization methodologies employed and the core deposit intangible from a 2001 acquisition became fully amortized.

Acquisition expenses and contract termination charges totaled \$4.8 million in 2011, primarily associated with the Wilber acquisition which closed in April 2011, up \$3.5 million from the costs incurred for acquisition and contract termination charges in the prior year. Acquisition expenses and contract termination charges totaled \$1.4 million in 2010, a decrease of \$0.3 million from 2009, and were comprised of \$0.9 million of acquisition expenses related to the Wilber acquisition and \$0.5 million of contract termination fees related to the core banking system conversion in the third quarter of 2010. Acquisition expenses and contract termination charges totaled \$1.6 million in 2009 and were comprised of a \$1.4 million charge related to the planned early termination of its core banking system services contract in 2010 as well as \$0.2 million of acquisition expenses related to the Citizens transaction in late 2008. In 2009, the Company recorded a \$3.1 million non-cash goodwill impairment charge in its wealth management businesses, a result of equity market valuation declines, changes in customer asset mixes and pricing compression related to the competitive environment.

Income Taxes

The Company estimates its income tax expense based on the amount it expects to owe the respective tax authorities, plus the impact of deferred tax items. Taxes are discussed in more detail in Note I of the Consolidated Financial Statements beginning on page 71. Accrued taxes represent the net estimated amount due or to be received from taxing authorities. In estimating accrued taxes, management assesses the relative merits and risks of the appropriate tax treatment of transactions taking into account statutory, judicial and regulatory guidance in the context of the Company's tax position. If the final resolution of taxes payable differs from its estimates due to regulatory determination or legislative or judicial actions, adjustments to tax expense may be required.

The effective tax rate for 2011 increased 2.7 percentage points to 29.4%, principally a result of a higher proportion of income being generated from fully taxable sources. The effective tax rate for 2010 increased 4.8 percentage points from 2009's level to 26.7%, reflecting the higher level of income from fully taxable sources. The effective tax rate for 2009 was 21.9%, reflecting a higher proportional mix of non-taxable revenue sources and the impact of a \$3.1 million goodwill impairment charge.

Capital

Shareholders' equity ended 2011 at \$774.6 million, up \$167.3 million, or 28%, from one year earlier. This increase reflects \$82.6 million from common stock, net income of \$73.1 million, a \$38.5 million increase in other comprehensive income, \$5.6 million from the issuance of shares through employee stock plans, and \$3.5 million from stock-based compensation. These increases were partially offset by common stock dividends declared of \$36.0 million. The change in other comprehensive income was comprised of a \$47.1 million increase in the market value adjustment ("MVA", represents the after-tax, unrealized change in value of available-for-sale securities in the Company's investment portfolio), a \$10.6 million charge based on the funded status of the Company's employee retirement plans and a \$2.0 million increase in the fair value of interest rate swaps designated as a cash flow hedge. Excluding accumulated other comprehensive income in both 2011 and 2010, capital rose by \$128.8 million, or 21%. Shares outstanding increased by 3.7 million during the year comprised of 3.35 million shares added through common stock issued from treasury shares in the Wilber acquisition in the second quarter and 314,000 added through employee stock plans.

Shareholders' equity ended 2010 at \$607.3 million, up \$41.6 million, or 7.3%, from one year earlier. This increase reflects net income of \$63.3 million, \$6.4 million from the issuance of shares through employee stock plans, and \$3.5 million from stock-based compensation. These increases were partially offset by common stock dividends declared of \$31.2 million and a \$0.6 million decrease in other comprehensive income. The change in other comprehensive income was comprised of a \$1.7 million decrease in the MVA and a \$1.1 million increase in the fair value of interest rate swaps designated as a cash flow hedge. Excluding accumulated other comprehensive income in both 2010 and

2009, capital rose by \$42.1 million, or 7.3%. Shares outstanding increased by 519,000 during the year as a result of issuances made through employee stock plans.

The Company's ratio of Tier 1 capital to assets (or tier 1 leverage ratio), the basic measure for which regulators have established a 5% minimum for an institution to be considered "well-capitalized," increased 15 basis points to end the year at 8.38%. This was the result of a 19.8% increase in Tier 1 capital primarily from net income generation and the stock offered in the Wilber acquisition, being greater than the 17.6% year-over-year increase in fourth quarter average net assets (excludes investment market value adjustment, intangible assets net of related deferred tax liabilities and disallowed mortgage service rights) due mostly to the Wilber acquisition. The tangible equity to tangible assets ratio was 7.12% at the end of 2011 versus 6.14% one year earlier. The increase was due to common shareholders' equity growing at a greater pace than tangible assets. The Company manages organic and acquired growth in a manner that enables it to continue to build upon its strong capital base, and maintain the Company's ability to take advantage of future strategic growth opportunities.

Cash dividends declared on common stock in 2011 of \$36.0 million represented an increase of 15.7% over the prior year. This growth was a result of the 3.4 million shares issued in conjunction with the Wilber acquisition in the second quarter of 2011, as well as dividends per share of \$1.00 for 2011 increasing from \$0.94 in 2010, a result of quarterly dividends per share being raised from \$0.24 to \$0.26 (+8.3%) in the third quarter of 2011 and from \$0.22 to \$0.24 in the third quarter of 2010. The dividend payout ratio for this year was 49.3% compared to 49.2% in 2010, and 69.5% in 2009. The payout ratio remained stable in 2011 because dividends paid increased 15.7% while net income increased 15.5%. The payout ratio declined significantly in 2010 because dividends paid increased 8.1% while net income increased 53%. In 2009, the dividends paid increased 9.6% in part due to the public issuance of 2.5 million common shares in October 2008 to support the Citizens acquisition while net income declined 9.8%.

The Company completed a public stock offering in late January 2012. The offering raised \$57.5 million through the issuance of 2.13 million shares. The net proceeds of the offering were approximately \$54.9 million. The Company intends to use the net proceeds from this offering to support the HSBC and First Niagara branch acquisitions.

Liquidity

Liquidity risk is a measure of the Company's ability to raise cash when needed at a reasonable cost and minimize any loss. The Bank maintains appropriate liquidity levels in both normal operating environments as well as stressed environments. The Company must be capable of meeting all obligations to its customers at any time and, therefore, the active management of its liquidity position remains an important management role. The Bank has appointed the Asset Liability Committee to manage liquidity risk using policy guidelines and limits on indicators of potential liquidity risk. The indicators are monitored using a scorecard with three risk level limits. These risk indicators measure core liquidity and funding needs, capital at risk and change in available funding sources. The risk indicators are monitored using such statistics as the core basic surplus ratio, unencumbered securities to average assets, free loan collateral to average assets, loans to deposits, deposits to total funding and borrowings to total funding ratios.

Given the uncertain nature of our customers' demands as well as the Company's desire to take advantage of earnings enhancement opportunities, the Company must have available adequate sources of on and off-balance sheet funds that can be acquired in time of need. Accordingly, in addition to the liquidity provided by balance sheet cash flows, liquidity must be supplemented with additional sources such as credit lines from correspondent banks, borrowings from the Federal Home Loan Bank of New York ("FHLB") and the Federal Reserve Bank of New York. Other funding alternatives may also be appropriate from time to time, including wholesale and retail repurchase agreements, large certificates of deposit and the brokered CD market. The primary source of non-deposit funds are FHLB advances, of which \$728 million are outstanding.

The Bank's primary sources of liquidity are its liquid assets, as well as unencumbered securities that can be used to collateralize additional funding. At December 31, 2011, the Bank had \$325 million of cash and cash equivalents of which \$203 million are interest earning deposits held at the Federal Reserve. The Bank also had \$424 million in unused FHLB borrowing capacity based on the Company's year-end collateral levels. Additionally, the Company has \$1.2 billion of unencumbered securities that could be pledged at the FHLB or Federal Reserve to obtain additional funding. There is \$65 million available in unsecured lines of credit with other correspondent banks.

The Company's primary approach to measuring short-term liquidity is known as the Basic Surplus/Deficit model. It is used to calculate liquidity over two time periods: first, the amount of cash that could be made available within 30 days (calculated as liquid assets less short-term liabilities as a percentage of average assets); and second, a projection of subsequent cash availability over an additional 60 days. As of December 31, 2011, this ratio was 20.5% for both time periods, excluding the Company's capacity to borrow additional funds from the FHLB and other sources. There is a sufficient amount of liquidity given the Company's internal policy requirement of 7.5%.

A sources and uses statement is used by the Company to measure intermediate liquidity risk over the next twelve months. As of December 31, 2011, there is ample liquidity available throughout 2012 to cover projected cash outflows. In addition, stress tests on the cash flows are performed in various scenarios ranging from high probability events with a low impact on the liquidity position to low probability events with high impact on the liquidity position. The results of the stress tests as of December 31, 2011 indicate the Bank has sufficient sources of funds for 2012 in all stressed scenarios.

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

Though remote, the possibility of a funding crisis exists at all financial institutions. Accordingly, management has addressed this issue by formulating a Liquidity Contingency Plan, which has been reviewed and approved by both the Board of Directors and the Company's Asset Liability Management Committee. The plan addresses the actions that the Company would take in response to both a short-term and long-term funding crisis.

A short-term funding crisis would most likely result from a shock to the financial system, either internal or external, which disrupts orderly short-term funding operations. Such a crisis should be temporary in nature and would not involve a change in credit ratings. A long-term funding crisis would most likely be the result of drastic credit deterioration at the Company. Management believes that both potential circumstances have been fully addressed through detailed action plans and the establishment of trigger points for monitoring such events.

Intangible Assets

The changes in intangible assets by reporting segment for the year ended December 31, 2011 are summarized as follows:

Table 7: Intangible Assets

| (000's omitted) | Balance at December 31, 2010 | Additions | Amortization | Impairment | Balance at December 31, 2011 |
|--|------------------------------------|-----------------|----------------|------------|------------------------------------|
| Banking Segment | | | | | |
| Goodwill | \$287,412 | \$47,142 | \$0 | \$0 | \$334,554 |
| Core deposit intangibles | | | | | |
| | 10,897 | 4,015 | 3,393 | 0 | 11,519 |
| Total | 298,309 | 51,157 | 3,393 | 0 | 346,073 |
| Other Segment | | | | | |
| Goodwill | 10,280 | 216 | 0 | 0 | 10,496 |
| Other intangibles | 3,125 | 1,858 | 988 | 0 | 3,995 |
| Total | 13,405 | 2,074 | 988 | 0 | 14,491 |
| Total Banking and Other Segment | \$311,714 | \$53,231 | \$4,381 | \$0 | \$360,564 |

Intangible assets at the end of 2011 totaled \$360.6 million, an increase of \$48.9 million from the prior year-end due to \$53.3 million of additional intangible assets arising from the acquisitions of Wilber and CAI, offset by \$4.4 million of amortization during the year. Intangible assets consist of goodwill, the value of core deposits and customer relationships that arise from acquisitions. Goodwill represents the excess cost of an acquisition over the fair value of the net assets acquired. Goodwill at December 31, 2011 totaled \$345 million, comprised of \$335 million related to banking acquisitions and \$10 million arising from the acquisition of financial services businesses. Goodwill is subjected to periodic impairment analysis to determine whether the carrying value of the acquired net assets exceeds their fair value, which would necessitate a write-down of the goodwill. The Company completed its goodwill impairment analyses during the first quarters of 2011 and 2010 and no adjustments were necessary on the subsidiary bank or financial services businesses. The impairment analysis was based upon discounted cash flow modeling techniques that require management to make estimates regarding the amount and timing of expected future cash flows. It also requires the selection of a discount rate that reflects the current return requirements of the market in relation to present risk-free interest rates, required equity market premiums and company-specific performance and risk indicators. Management believes that there is a low probability of future impairment with regard to the goodwill associated with its whole-bank, branch and financial services businesses acquisitions.

Core deposit intangibles represent the value of non-time deposits acquired in excess of funding that could have been obtained in the capital markets. Core deposit intangibles are amortized on either an accelerated or straight-line basis over periods ranging from seven to twenty years. The recognition of customer relationship intangibles arose due to the acquisitions of the trust department of Wilber, CAI, ABG, HB&T, Harbridge and the insurance agency of Tupper Lake National Bank. These assets were determined based on a methodology that calculates the present value of the projected future net income derived from the acquired customer base. These assets are being amortized on an accelerated basis over periods ranging from seven to twelve years.

Loans

The Company's loans outstanding, by type, as of December 31 are as follows:

Table 8: Loans Outstanding

| (000's omitted) | 2011 | 2010 | 2009 | 2008 | 2007 |
|---|-------------|-------------|-------------|-------------|-------------|
| Consumer mortgage | \$1,214,621 | \$1,057,332 | \$1,044,589 | \$1,078,545 | \$992,351 |
| Business lending | 1,226,439 | 1,023,286 | 1,066,730 | 1,042,999 | 969,727 |
| Consumer installment - indirect | 556,955 | 494,529 | 528,791 | 530,196 | 436,412 |
| Consumer installment - direct | 149,170 | 146,575 | 139,757 | 149,089 | 147,307 |
| Home equity | 323,840 | 304,641 | 319,618 | 335,311 | 275,258 |
| Gross loans | 3,471,025 | 3,026,363 | 3,099,485 | 3,136,140 | 2,821,055 |
| Allowance for loan losses | (42,213) | (42,510) | (41,910) | (39,575) | (36,427) |
| Loans, net of allowance for loan losses | \$3,428,812 | \$2,983,853 | \$3,057,575 | \$3,096,565 | \$2,784,628 |
| Daily average of total loans | \$3,355,286 | \$3,075,030 | \$3,104,808 | \$2,934,790 | \$2,743,804 |

As disclosed in Table 8 above, gross loans outstanding of \$3.5 billion as of year-end 2011 increased \$444.7 million or 15% compared to December 31, 2010, primarily as a result of the Wilber acquisition in April 2011. Excluding loans acquired from Wilber, loans increased \$49.1 million or 1.6%. The low interest rate environment and business development efforts contributed to strong organic consumer mortgage and consumer installment indirect lending activity during 2011. Excluding loans acquired from Wilber, the business lending and consumer installment direct portfolios declined as compared to year-end 2010. The home equity portfolio, excluding loans acquired from Wilber also decreased due primarily to pay downs associated with the high level of mortgage refinancing being conducted in the low interest rate environment, as well as the continued deleveraging activities being undertaken by consumers in the current economic environment.

The compounded annual growth rate ("CAGR") for the Company's total loan portfolio between 2007 and 2011 was 5.3% comprised of approximately 0.9% organic growth, with the remainder coming from acquisitions. The greatest overall expansion occurred in the business lending and consumer mortgage segments, which grew at a 6.0% and 5.2% CAGR (including the impact of acquisitions), respectively, over that time frame. The business lending growth was driven by acquisitions over the time period, while the consumer mortgage growth was driven by robust mortgage refinancing volumes over the last five years, as well as the acquisition of consumer-oriented banks and branches. The consumer installment segment grew at a compounded annual growth rate of 4.9% from 2007 to 2011. Consumer installment loans consist of personal loans originated both in the branch network and in automobile, marine and recreational vehicle dealerships. The home equity lending segment grew at a compounded annual growth rate of 2.6% from 2007

to 2011, including acquisitions.

The weighting of the components of the Company's loan portfolio enables it to be highly diversified. Approximately 65% of loans outstanding at the end of 2011 were made to consumers borrowing on an installment, line of credit or residential mortgage loan basis. The business lending portfolio is also broadly diversified by industry type as demonstrated by the following distributions at year-end 2011: commercial real estate (31%), restaurant & lodging (10%), healthcare (9%), general services (9%), agriculture (6%), retail trade (6%), manufacturing (7%), construction (5%), motor vehicle and parts dealers (4%), and wholesale trade (4%). A variety of other industries with less than a 2% share of the total portfolio comprise the remaining 9%.

The consumer mortgage portion of the Company's loan portfolio is comprised of fixed (98%) and adjustable rate (2%) residential lending and includes no exposure to subprime, Alt-A, or other higher-risk mortgage products. Consumer mortgages increased \$157.3 million or 15% in 2011. Excluding mortgage loans acquired from Wilber, mortgage lending increased \$78.4 million or 7.4%. During the year ended December 31, 2011, the Company originated and sold an additional \$43.1 million of longer-term, fixed-rate residential mortgages, principally to Fannie Mae. Consumer mortgage volume has been strong over the last few years due to historically low long-term interest rates and comparatively stable real estate valuations in the Company's primary markets. The Company's solid performance during a tumultuous period in the overall industry is a reflection of the high quality profile of its portfolio and its ability to successfully meet customer needs at a time when some national mortgage lenders have restricted their lending activities in many of the Company's markets. Interest rates and expected duration continue to be the most significant factors in determining whether the Company chooses to retain versus sell and service portions of its new mortgage generation.

The combined total of general-purpose business lending, including agricultural-related and dealer floor plans, as well as mortgages on commercial property, is characterized as the Company's business lending activity. The business lending portfolio increased \$203.2 million or 20% in 2011. Excluding loans acquired from Wilber, net business lending balances declined \$53.4 million from one year ago. Customer demand in this segment has remained soft primarily due to general economic conditions. In addition, in 2011 the Company experienced higher levels of unscheduled payoffs in this portfolio, as well as generally lower line utilization characteristics. The Company maintains its commitment to generating growth in its business portfolio in a manner that adheres to its twin goals of maintaining strong asset quality and producing profitable margins. The Company has continued to invest in additional personnel, technology, and business development resources to further strengthen its capabilities in this important product category.

The following table shows the maturities and type of interest rates for business and construction loans as of December 31, 2011:

Table 9: Maturity Distribution of Business and Construction Loans (1)

| (000's omitted) | Maturing | | | Total |
|--|---------------------------------------|------------------------------------|------------------------------------|--------------------|
| | Maturing in One Year or Less | One but Within Five Years | Maturing After Five Years | |
| Commercial, financial and agricultural | \$305,091 | \$456,846 | \$460,212 | \$1,222,149 |
| Real estate – construction | 23,569 | 0 | 0 | 23,569 |
| Total | \$328,660 | \$456,846 | \$460,212 | \$1,245,718 |
| Fixed or predetermined interest rates | \$108,762 | \$278,909 | \$234,844 | \$622,515 |
| Floating or adjustable interest rates | 219,898 | 177,937 | 225,368 | 623,203 |
| Total | \$328,660 | \$456,846 | \$460,212 | \$1,245,718 |

(1) Scheduled repayments are reported in the maturity category in which the payment is due.

Consumer installment loans, both those originated directly (such as personal installment loans and lines of credit), and indirectly (originated predominantly in automobile, marine and recreational vehicle dealerships), increased \$65.0 million or 10.1% from one year ago. Excluding the impact of consumer installment loans acquired from Wilber, the consumer installment indirect lending portfolio had organic growth of \$41.4 million or 8.4%, while the consumer installment direct lending portfolio declined \$6.1 million or 4.1%, after a year of somewhat softer demand due to consumers spending less and conducting deleveraging activities. The volume of new and used vehicles sales to upper tier credit profile customers in the Company's primary markets has improved in recent periods. The Company is focused on maintaining the solid profitability produced by its in-market and contiguous market indirect portfolio, while continuing to pursue its disciplined, long-term approach to expanding its dealer network. A by-product of the

still historically low new vehicle sales rates has been an improvement in used car valuations, where the majority of the Company's installment lending is concentrated. It is expected that continued improvement in the automotive market will create the opportunity for the Company to produce indirect loan growth that is consistent with its longer-term historical experience.

Home equity loans increased \$19.2 million or 6.3% from one year ago. Excluding the home equity loans acquired from Wilber, the home equity portfolio decreased \$11.2 million or 3.7% from one year ago, in part due to home equity loans being paid off or down as part of the high level of mortgage refinancing activity that occurred throughout 2011 in the low rate environment. In addition, home equity utilization has been adversely impacted by the heightened level of consumer deleveraging activity that is occurring in response to the continued longer-term weakened economic conditions.

Asset Quality

The following table presents information concerning nonperforming assets as of December 31:

Table 10: Nonperforming Assets

| (000's omitted) | 2011 | 2010 | 2009 | 2008 | 2007 |
|--|-----------------|-----------------|-----------------|-----------------|----------------|
| Nonaccrual loans | | | | | |
| Consumer mortgage | \$6,520 | \$4,737 | \$4,077 | \$3,500 | \$2,860 |
| Business lending | 18,535 | 9,715 | 11,207 | 6,730 | 3,358 |
| Consumer installment – indirect | 2 | 0 | 54 | 28 | 28 |
| Consumer installment – direct | 0 | 0 | 368 | 436 | 457 |
| Home equity | 1,205 | 926 | 558 | 428 | 437 |
| Total nonaccrual loans | 26,262 | 15,378 | 16,264 | 11,122 | 7,140 |
| Accruing loans 90+ days delinquent | | | | | |
| Consumer mortgage | 2,171 | 2,308 | 891 | 392 | 185 |
| Business lending | 398 | 247 | 662 | 71 | 329 |
| Consumer installment – indirect | 32 | 131 | 29 | 34 | 29 |
| Consumer installment – direct | 95 | 96 | 33 | 45 | 79 |
| Home equity | 393 | 309 | 135 | 11 | 0 |
| Total accruing loans 90+ days delinquent | 3,089 | 3,091 | 1,750 | 553 | 622 |
| Restructured loans | | | | | |
| Business lending | 0 | 0 | 896 | 1,004 | 1,126 |
| Nonperforming loans | | | | | |
| Consumer mortgage | 8,691 | 7,045 | 4,968 | 3,892 | 3,045 |
| Business lending | 18,933 | 9,962 | 12,765 | 7,805 | 4,813 |
| Consumer installment – indirect | 34 | 131 | 83 | 62 | 57 |
| Consumer installment – direct | 95 | 96 | 401 | 481 | 536 |
| Home equity | 1,598 | 1,235 | 693 | 439 | 437 |
| Total nonperforming loans | 29,351 | 18,469 | 18,910 | 12,679 | 8,888 |
| Other real estate (OREO) | 2,682 | 2,011 | 1,429 | 1,059 | 1,007 |
| Total nonperforming assets | \$32,033 | \$20,480 | \$20,339 | \$13,738 | \$9,895 |
| Allowance for loan losses / total loans | 1.22% | 1.40% | 1.35% | 1.26% | 1.29% |
| Allowance for legacy loan losses / total legacy loans (1) | 1.36% | 1.40% | 1.35% | 1.26% | 1.29% |

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| | | | | | |
|--|-------|-------|-------|-------|-------|
| Allowance for loan losses / nonperforming loans | 144% | 230% | 222% | 312% | 410% |
| Allowance for legacy loans / nonperforming legacy loans (1) | 197% | 230% | 222% | 312% | 410% |
| Nonperforming loans / total loans | 0.85% | 0.61% | 0.61% | 0.40% | 0.32% |
| Legacy nonperforming loans / legacy total loans | 0.69% | 0.61% | 0.61% | 0.40% | 0.32% |
| Nonperforming assets / total loans and other real estate | 0.92% | 0.68% | 0.66% | 0.44% | 0.35% |
| Delinquent loans (30 days old to nonaccruing) to total loans | 1.99% | 1.91% | 1.48% | 1.43% | 1.10% |
| Loan loss provision to net charge-offs | 94% | 109% | 131% | 117% | 76% |
| Legacy loan loss provision to net charge-offs (1) | 86% | 109% | 131% | 117% | 76% |

(1) Legacy loans exclude loans acquired after January 1, 2009. These ratios are included for comparative purposes to prior periods.

The Company places a loan on nonaccrual status when the loan becomes ninety days past due, or sooner if management concludes collection of interest is doubtful, except when, in the opinion of management, it is well-collateralized and in the process of collection. As shown in Table 10 above, nonperforming loans, defined as nonaccruing loans, accruing loans 90 days or more past due and restructured loans ended 2011 at \$29.4 million, up approximately \$10.9 million from one year earlier. The ratio of nonperforming loans to total loans increased 24 basis points from the prior year. Excluding nonperforming acquired loans, the ratio of nonperforming loans to total loans was 0.67%, an increase of six basis points from the prior year. The increase is primarily attributable to two large commercial relationships, one of which was acquired from Wilber, moving to non-accrual status during the fourth quarter of 2011. The ratio of nonperforming assets (which includes other real estate owned, or "OREO", in addition to nonperforming loans) to total loans plus OREO increased to 0.92% at year-end 2011, up 24 basis points from one year earlier. The Company's success at keeping these ratios at favorable levels despite weak economic conditions was the result of continued focus on maintaining strict underwriting standards, early problem recognition, and effective collection and recovery efforts. At year-end 2011, the Company was managing 28 OREO properties with a value of \$2.7 million, as compared to 22 OREO properties with a value of \$2.0 million a year earlier. Only one property has a carrying value in excess of \$275,000. Despite the increase in OREO balances, the current level still reflects the low level of foreclosure activity in the Company's markets and its specific portfolio in comparison to national markets.

Approximately 65% of the nonperforming loans at December 31, 2011 are related to the business lending portfolio, which is comprised of business loans broadly diversified by industry type. The increase in nonperforming loans in the business lending portfolio is primarily related to two large relationships, one of which was acquired in the Wilber acquisition and became impaired subsequent to acquisition. With the economic downturn, certain businesses' financial performance and position have deteriorated, and consequently the level of nonperforming loans remains higher than historical levels. Approximately 30% of nonperforming loans at December 31, 2011 are related to the consumer mortgage portfolio. Collateral values of residential properties within the Company's market area did not experience the significant declines in values that other parts of the country have encountered. However, the continued soft economic conditions and high unemployment levels have adversely impacted consumers and businesses alike and have resulted in higher nonperforming levels. The remaining five percent of nonperforming loans relate to consumer installment and home equity loans. The allowance for loan losses to nonperforming loans ratio, a general measure of coverage adequacy, was 144% at the end of 2011 compared to 230% at year-end 2010 and 222% at December 31, 2009, reflective of the higher level of nonperforming loans. Excluding acquired loans, the ratio of allowance for legacy loans to nonperforming legacy loans was 204% at the end of 2011, compared to 230% at year-end 2010 and 222% at December 31, 2009.

Members of senior management, special asset officers, and lenders review all delinquent and nonaccrual loans and OREO regularly, in order to identify deteriorating situations, monitor known problem credits and discuss any needed changes to collection efforts, if warranted. Based on the group's consensus, a relationship may be assigned a special assets officer or other senior lending officer to review the loan, meet with the borrowers, assess the collateral and recommend an action plan. This plan could include foreclosure, restructuring the loans, issuing demand letters, or other actions. The Company's larger criticized credits are also reviewed on at least a quarterly basis by senior credit administration, special assets and commercial lending management to monitor their status and discuss relationship management plans. Commercial lending management reviews the entire criticized loan portfolio on a monthly basis.

Total delinquencies, defined as loans 30 days or more past due or in nonaccrual status, finished the current year at 1.99% of total loans outstanding, versus 1.91% at the end of 2010. As of year-end 2011, total delinquency ratios for commercial loans, consumer installment loans, real estate mortgages and home equity loans were 2.21%, 1.67%, 2.12% and 1.34%, respectively. These measures were 1.56%, 2.03%, 2.24% and 1.71%, respectively, as of December 31, 2010. Delinquency levels, particularly in the 30 to 89 days category, tend to be somewhat volatile due to their measurement at a point in time, and therefore management believes that it is useful to evaluate this ratio over a longer period. The average quarter-end delinquency ratio for total loans in 2011 was 1.63%, as compared to an average of

1.61% in 2010 and 1.45% in 2009, reflective of the underlying economic conditions and the typical delayed impact they have on loan performance characteristics.

The changes in the allowance for loan losses for the last five years are as follows:

Table 11: Allowance for Loan Losses Activity

| (000's omitted except for ratios) | Years Ended December 31, | | | | |
|--|--------------------------|----------|----------|----------|----------|
| | 2011 | 2010 | 2009 | 2008 | 2007 |
| Allowance for loan losses at beginning of period | \$42,510 | \$41,910 | \$39,575 | \$36,427 | \$36,313 |
| Charge-offs: | | | | | |
| Consumer mortgage | 748 | 583 | 498 | 235 | 387 |
| Business lending | 2,964 | 3,950 | 3,324 | 2,516 | 1,088 |
| Consumer installment – indirect | 4,464 | 4,279 | 5,374 | 4,517 | 3,465 |
| Consumer installment – direct | 1,273 | 1,719 | 1,928 | 1,779 | 1,390 |
| Home equity | 265 | 181 | 36 | 29 | 110 |
| Total charge-offs | 9,714 | 10,712 | 11,160 | 9,076 | 6,440 |
| Recoveries: | | | | | |
| Consumer mortgage | 30 | 71 | 28 | 184 | 86 |
| Business lending | 692 | 730 | 374 | 478 | 844 |
| Consumer installment – indirect | 3,200 | 2,569 | 2,517 | 2,038 | 2,075 |
| Consumer installment – direct | 674 | 730 | 732 | 630 | 773 |
| Home equity | 85 | 7 | 54 | 7 | 25 |
| Total recoveries | 4,681 | 4,107 | 3,705 | 3,337 | 3,803 |
| Net charge-offs | 5,033 | 6,605 | 7,455 | 5,739 | 2,637 |
| Provision for loan losses | 4,350 | 7,205 | 9,790 | 6,730 | 2,004 |
| Provision for acquired impaired loans | 386 | 0 | 0 | 0 | 0 |
| Acquired allowance for loan losses (1) | 0 | 0 | 0 | 2,157 | 747 |
| Allowance for loan losses at end of period | \$42,213 | \$42,510 | \$41,910 | \$39,575 | \$36,427 |
| Net charge-offs to average loans outstanding: | | | | | |
| Business lending | 0.19% | 0.31% | 0.28% | 0.20% | 0.03% |
| Consumer mortgage | 0.06% | 0.05% | 0.04% | 0.00% | 0.03% |
| Consumer installment – indirect | 0.24% | 0.34% | 0.54% | 0.53% | 0.33% |
| Consumer installment – direct | 0.39% | 0.68% | 0.82% | 0.74% | 0.42% |
| Home equity | 0.06% | 0.06% | -0.01% | 0.01% | 0.03% |
| Total loans | 0.15% | 0.21% | 0.24% | 0.20% | 0.10% |

(1) This addition is attributable to loans acquired from Citizens in 2008 and TLNB in 2007.

As displayed in Table 11 above, total net charge-offs in 2011 were \$5.0 million, down \$1.6 million from the prior year due to lower charge-offs in the business lending and consumer installment portfolios, partially offset by higher levels of charge-offs in the consumer mortgage and home equity portfolios. Net charge-offs in 2010 were \$0.9 million lower than 2009's level, due to lower levels of net charge-offs in the consumer installment portfolios, partially offset by somewhat higher levels of charge-offs in the other lending portfolios.

Due to the significant increases in average loan balances over time due to acquisition and organic growth, management believes that net charge-offs as a percent of average loans ("net charge-off ratio") offers a more meaningful representation of asset quality trends. The net charge-off ratio for 2011 was down six basis points from 2010 and was nine basis points lower than 2009. Gross charge-offs as a percentage of average loans was 0.29% in 2011 as compared to 0.35% in 2010 and 0.36% in 2009. Continued strong recovery efforts were evidenced by recoveries of \$4.7 million in 2011, representing 46% of average gross charge-offs for the latest two years, compared to 38% in 2010 and 37% in 2009.

Business loan net charge-offs decreased in 2011, totaling \$2.3 million or 0.19% of average business loans outstanding versus \$3.2 million or 0.31% in 2010, reflective of the Company's disciplined risk management and underwriting standards. Consumer installment loan net charge-offs decreased to \$1.9 million this year from \$2.7 million in 2010, with a net charge-off ratio of 0.27% in 2011 and 0.41% in 2010. Higher used automobile valuations benefited consumer installment recovery efforts, which increased to 66% of current year gross charge-offs, compared to 55% in 2010. Consumer mortgage net charge-offs increased in 2011, and the net charge-off ratio increased one basis point to 0.06%. Home equity net charges offs were consistent at \$0.2 million in 2011 and 2010.

Management continually evaluates the credit quality of the Company's loan portfolio and conducts a formal review of the allowance for loan losses adequacy on a quarterly basis. The two primary components of the loan review process that are used to determine proper allowance levels are specific and general loan loss allocations. Measurement of specific loan loss allocations is typically based on expected future cash flows, collateral values and other factors that may impact the borrower's ability to pay. Impaired loans greater than \$0.5 million are evaluated for specific loan loss allocations. Consumer mortgages, consumer installment and home equity loans are considered smaller balance homogeneous loans and are evaluated collectively. The Company considers a loan to be impaired when, based on current information and events, it is probable that the Company will be unable to collect all amounts according to the contractual terms of the loan agreement or the loan is delinquent 90 days or more.

The second component of the allowance establishment process, general loan loss allocations, is composed of two calculations that are computed on the five main loan segments: business lending, consumer direct, consumer indirect, consumer mortgage and home equity. The first calculation determines an allowance level based on the latest 36 months of historical net charge-off data for each loan category (commercial loans exclude balances with specific loan loss allocations). The second calculation is qualitative and takes into consideration eight qualitative environmental factors: levels and trends in delinquencies and impaired loans; levels of and trends in charge-offs and recoveries; trends in volume and terms of loans; effects of any changes in risk selection and underwriting standards, and other changes in lending policies, procedure, and practices; experience, ability, and depth of lending management and other relevant staff; national and local economic trends and conditions; industry condition; and effects of changes in credit concentrations. The allowance levels computed from the specific and general loan loss allocation methods are combined with unallocated allowances, if any, to derive the required allowance for loan losses to be reflected on the Consolidated Statement of Condition. As it has in prior periods, the Company strives to refine and enhance its loss evaluation and estimation processes continually. In 2009, the Company developed and utilized more granular historical loss factors on a portfolio-specific basis, as well as enhanced its use of both Company-specific and macro-economic qualitative factors. These enhancements did not result in a significant change to the determined reserve levels.

The loan loss provision is calculated by subtracting the previous period allowance for loan losses, net of the interim period net charge-offs, from the current required allowance level. This provision is then recorded in the income statement for that period. Members of senior management and the Audit Committee of the Board of Directors review the adequacy of the allowance for loan losses quarterly. Management is committed to continually improving the credit assessment and risk management capabilities of the Company and has dedicated the resources necessary to ensure advancement in this critical area of operations.

Acquired loans are recorded at acquisition date at their acquisition date fair values, and therefore, are excluded from the calculation of loans loss reserves as of the acquisition date. To the extent there is a decrease in the present value of cash from the acquired impaired loans after the date of acquisition, the Company records a provision for potential losses. During the year ended December 31, 2011, the Company established an allowance for loan losses for acquired impaired loans of \$0.4 million for estimated additional losses on certain acquired impaired loans.

For acquired loans that are not deemed impaired at acquisition, credit discounts representing the principal losses expected over the life of the loan are a component of the initial fair value. Subsequent to the purchase date, the methods utilized to estimate the required allowance for loan losses for these loans is similar to originated loans, however, the Company records a provision for loan losses only when the required allowance exceeds any remaining pooled discounts for loans evaluated collectively for impairment. The Company did not record a provision for loan losses on acquired non-impaired loans in the year ended December 31, 2011.

The allowance for loan losses decreased to \$42.2 million at year-end 2011 from \$42.5 million at the end of 2010. The \$0.3 million decrease was primarily due to relatively stable asset quality metrics and only modest growth in legacy

loan balances. The ratio of the allowance for loan losses to total loans decreased 18 basis points to 1.22% for year-end 2011 as compared to 1.40% for 2010 and 1.35% for 2009. The ratio of allowance for loan losses to total legacy loans decreased four basis points to 1.36% for 2011 as compared to 2010, but was one basis point higher than the ratio at December 31, 2009. Management believes the year-end 2011 allowance for loan losses to be adequate in light of the probable losses inherent in the Company's loan portfolio.

The loan loss provision for legacy loans of \$4.3 million in 2011 decreased by \$2.9 million as a result of management's assessment of the probable losses in the loan portfolio, as discussed above. The loan loss provision as a percentage of average loans was 0.14% in 2011 as compared to 0.23% in 2010 and 0.32% in 2009. The loan loss provision was 94% of net charge-offs this year versus 109% in 2010 and 131% in 2009, reflective of the assessed risk in the portfolio.

The following table sets forth the allocation of the allowance for loan losses by loan category as of the dates indicated, as well as the percentage of loans in each category to total loans. This allocation is based on management's assessment, as of a given point in time, of the risk characteristics of each of the component parts of the total loan portfolio and is subject to changes when the risk factors of each component part change. The allocation is not indicative of either the specific amounts of the loan categories in which future charge-offs may be taken, nor should it be taken as an indicator of future loss trends. The allocation of the allowance to each category does not restrict the use of the allowance to absorb losses in any category.

Table 12: Allowance for Loan Losses by Loan Type

| (000's omitted except for ratios) | 2011 | | 2010 | | 2009 | | 2008 | | 2007 | |
|--|-----------|--------|-----------|--------|-----------|--------|-----------|--------|-----------|--------|
| | Loan | Loan | Loan | Loan | Loan | Loan | Loan | Loan | Loan | |
| | Allowance | Mix | Allowance | Mix | Allowance | Mix | Allowance | Mix | Allowance | Mix |
| Consumer mortgage | \$4,651 | 35.0% | \$2,451 | 34.9% | \$1,127 | 33.7% | \$3,298 | 34.4% | \$3,843 | 35.2% |
| Business lending | 20,575 | 34.8% | 22,326 | 33.8% | 23,577 | 34.4% | 18,750 | 33.3% | 17,284 | 34.4% |
| Consumer installment - indirect | 8,960 | 16.1% | 9,922 | 16.4% | 10,004 | 17.1% | 8,031 | 16.9% | 5,284 | 15.5% |
| Consumer installment - direct | 3,290 | 4.3% | 3,977 | 4.8% | 3,660 | 4.5% | 2,625 | 4.7% | 2,162 | 5.2% |
| Home equity | 1,130 | 9.3% | 689 | 10.1% | 374 | 10.3% | 1,570 | 10.7% | 814 | 9.7% |
| Acquired impaired loans | 386 | 0.5% | 0 | | 0 | | 0 | | 0 | |
| Unallocated | 3,221 | | 3,145 | | 3,168 | | 5,301 | | 7,040 | |
| Total | \$42,213 | 100.0% | \$42,510 | 100.0% | \$41,910 | 100.0% | \$39,575 | 100.0% | \$36,427 | 100.0% |

As demonstrated in Table 12 above and discussed previously, business lending and consumer installment by its nature carries higher credit risk than residential real estate, and as a result these loans carry allowance for loan losses that cover a higher percentage of their total portfolio balances. As in prior years, the unallocated allowance is maintained for inherent losses in the portfolio not reflected in the historical loss ratios, model imprecision, and for acquired loan portfolios in the process of being fully integrated at year-end. The unallocated allowance decreased from \$3.2 million in 2009 to \$3.1 million in 2010 and increased slightly to \$3.2 million in 2011. The general declines in the unallocated portion of the allowance, as well as changes in year-over-year allowance allocations reflect management's continued refinement of its loss estimation techniques. However, given the inherent imprecision in the many estimates used in the determination of the allocated portion of the allowance, management deliberately remained cautious and conservative in establishing the overall allowance for loan losses. Management considers the allocated and unallocated portions of the allowance for loan losses to be prudent and reasonable. Furthermore, the Company's allowance is general in nature and is available to absorb losses from any loan category.

Funding Sources

The Company utilizes a variety of funding sources to support the earning asset base as well as to achieve targeted growth objectives. Overall funding is comprised of three primary sources that possess a variety of maturity, stability, and price characteristics: deposits of individuals, partnerships and corporations (IPC deposits), municipal deposits that are collateralized for amounts not covered by FDIC insurance (public funds) and external borrowings. The average daily amount of deposits and the average rate paid on each of the following deposit categories are summarized below for the years indicated:

Table 13: Average Deposits

| (000's omitted, except rates) | 2011 | | 2010 | | 2009 | |
|--|--------------------|-------------------------|--------------------|-------------------------|--------------------|-------------------------|
| | Average Balance | Average Rate Paid | Average Balance | Average Rate Paid | Average Balance | Average Rate Paid |
| Noninterest checking deposits | \$825,277 | 0.00% | \$728,408 | 0.00% | \$686,692 | 0.00% |
| Interest checking deposits | 855,693 | 0.16% | 710,464 | 0.21% | 642,572 | 0.28% |
| Regular savings deposits | 628,394 | 0.23% | 532,475 | 0.26% | 481,655 | 0.26% |
| Money market deposits | 1,156,152 | 0.63% | 950,573 | 0.90% | 710,911 | 1.18% |
| Time deposits | 1,101,013 | 1.46% | 1,030,995 | 1.86% | 1,325,598 | 2.59% |
| Total deposits | \$4,566,529 | 0.57% | \$3,952,915 | 0.77% | \$3,847,428 | 1.19% |

As displayed in Table 13 above, total average deposits for 2011 equaled \$4.57 billion, up \$613.6 million or 16% from the prior year. Excluding the impact of the Wilber acquisition, average deposits increased \$53.9 million or 1.4% as compared to 2010. Consistent with the Company's focus on expanding core account relationships and reduced customer demand for time deposits, average non-acquired, non-time ("core") deposit balances grew \$207.1 million or 7.1% as compared to 2010 while time deposits balances were managed downward by \$153.2 million or 15%. This shift in mix also reflects the diminished rate differential between core and time deposits in the low interest rate environment. Average deposits in 2010 were up \$105.5 million or 2.7% from 2009, comprised of a \$400.1 million or 16% increase in core deposits, offset by a \$294.6 million or 22% decrease in time deposits.

The Company's funding composition continues to benefit from a high level of non-public deposits, which reached an all-time high in 2011 with an average balance of \$4.1 billion, an increase of \$524.9 million or 15% over the comparable 2010 period. Excluding the impact of the Wilber acquisition, average non-public deposits increased \$40.6 million or 1.1% during 2011. Non-public, core deposits are frequently considered to be a bank's most attractive source of funding because they are generally stable, do not need to be collateralized, have a relatively low cost, and provide a strong customer base for which a variety of loan, deposit and other financial service-related products can be sold.

Full-year average deposits of local municipalities increased \$88.7 million or 25% during 2011. Excluding the impact of the Wilber acquisition, average public deposits increased \$13.3 million or 3.7% during 2011. Municipal deposit balances tend to be more volatile than non-public deposits because they are heavily impacted by the seasonality of tax collection and fiscal spending patterns, as well as the longer-term financial position of the local government entities, which can change significantly from year to year. However, the Company has many strong, long-standing relationships with municipal entities throughout its markets and the diversified core deposits held by these customers has provided an attractive and comparatively stable funding source over an extended time period. The Company is required to collateralize all local government deposits in excess of FDIC coverage with marketable securities from its investment portfolio. Because of this stipulation, as well as the competitive bidding nature of this product, management considers municipal time deposit funding to be similar to external borrowings and thus prices these products on a consistent basis.

The mix of average deposits has been changing throughout the last several years. The weighting of core (interest checking, noninterest checking, savings and money market accounts) has increased, while time deposits' weighting decreased. This change in deposit mix reflects the Company's focus on expanding core account relationships and allowing higher-cost time deposits balances to fall. The average balance for time deposit accounts decreased from 30.9% of the total deposits in 2009 to 22.9% of total deposits in the first quarter of 2011. The Wilber acquisition in the second quarter of 2011 was comprised of a higher percent of time deposits, which drove the percent of time deposits in the total portfolio at June 30, 2011 up to 25.0%. Time deposits have been allowed to run off during the subsequent quarters and comprise 23.7% of total deposits in the fourth quarter of 2011. Similarly, average core deposit balances have increased from 69.1% in 2009 to 77.1% in the first quarter of 2011 and for the quarter ended December 31, 2011 made up 76.3% of total deposits. This shift in mix, combined with lower average interest rates in all interest-bearing deposit product categories caused the cost of interest bearing deposits to decline to 0.70% in 2011, as compared to 0.95% in 2010 and 1.45% in 2009. The total cost of deposit funding including demand deposits also declined significantly in 2011 to 0.57% versus 0.77% in 2010, benefiting from the 13.3% increase in non-interest bearing checking accounts.

The remaining maturities of time deposits in amounts of \$100,000 or more outstanding as of December 31 are as follows:

Table 14: Time Deposit > \$100,000 Maturities

| (000's omitted) | 2011 | 2010 |
|----------------------------|-----------|-----------|
| Less than three months | \$61,860 | \$37,128 |
| Three months to six months | 62,358 | 41,585 |
| Six months to one year | 69,005 | 42,895 |
| Over one year | 95,163 | 66,015 |
| Total | \$288,386 | \$187,623 |

External borrowings are defined as funding sources available on a national market basis, generally requiring some form of collateralization. Borrowing sources for the Company include the FHLB of New York and Federal Reserve Bank of New York, as well as access to the brokered CD and repurchase markets through established relationships with primary market security dealers. The Company also had approximately \$102 million in floating-rate subordinated debt outstanding at the end of 2011 that is held by unconsolidated subsidiary trusts. In December 2006, the Company completed a sale of \$75 million of trust preferred securities. The securities mature on December 15, 2036 and carry an annual rate equal to the three-month LIBOR rate plus 1.65%. The Company used the net proceeds of the offering for general corporate purposes including the early call of the \$30 million of fixed-rate trust preferred securities. At the time of the offering, the Company also entered into an interest rate swap agreement to convert the variable rate trust preferred securities into a fixed rate obligation for a term of five years at a fixed rate of 6.43%. The interest rate swap matured in the fourth quarter of 2011.

As shown in Table 15, year-end 2011 external borrowings totaled \$830.3 million, a decrease of \$0.2 million from 2010, primarily the result of maturing FHLB NY borrowings. External borrowings averaged \$833.1 million or 15.4% of total funding sources for all of 2011 as compared to \$839.3 million or 17.5% of total funding sources for 2010. The decrease in this ratio was primarily attributable to the deposits acquired in the Wilber transaction and organic deposit growth throughout the year.

As displayed in Table 3 on page 26, the overall mix of funding has shifted over the past two years. The percentage of funding derived from deposits increased to 84.6% in 2011 from 82.5% in 2010 and 81.7% in 2009. Average FHLB borrowings decreased slightly during 2011, while average deposits increased due to both acquired and organic growth. During 2010 average FHLB borrowings decreased slightly while average deposits increased through organic growth.

The following table summarizes the outstanding balance of borrowings of the Company as of December 31:

Table 15: Borrowings

| (000's omitted, except rates) | 2011 | 2010 | 2009 |
|--|-----------|-----------|-----------|
| Federal funds purchased | \$0 | \$0 | \$0 |
| Federal Home Loan Bank advances | 728,235 | 728,428 | 754,739 |
| Commercial loans sold with recourse | 0 | 26 | 30 |
| Capital lease obligation | 46 | 6 | 10 |
| Subordinated debt held by unconsolidated subsidiary trusts | 102,048 | 102,024 | 101,999 |
| Balance at end of period | \$830,329 | \$830,484 | \$856,778 |
| Daily average during the year | \$833,075 | \$839,314 | \$859,155 |
| Maximum month-end balance | 849,815 | 856,692 | 862,466 |
| Weighted-average rate during the year | 4.25% | 4.29% | 4.37% |
| Weighted-average year-end rate | 3.84% | 3.81% | 3.88% |

The following table shows the contractual maturities of various obligations as of December 31, 2011:

Table 16: Maturities of Contractual Obligations

| (000's omitted) | Maturing Within One Year Or Less | Maturing After One Year but Within Three Years | Maturing After Three Years but Within Five Years | Maturing After Five Years | Total |
|-----------------|--|---|---|------------------------------------|-------|
| | | | | | |

| | | | | | |
|---|----------|----------|-----------|-----------|-------------|
| Subordinated debt held by unconsolidated subsidiary trusts | 0 | 0 | 0 | 102,048 | 102,048 |
| Capital lease obligation | 19 | 25 | 2 | 0 | 46 |
| Interest on borrowings | 31,868 | 63,717 | 51,805 | 58,765 | 206,155 |
| Purchase commitments | 450 | 0 | 0 | 0 | 450 |
| Operating leases | 4,650 | 7,210 | 3,892 | 5,740 | 21,492 |
| Unrecognized tax benefits | 133 | 0 | 0 | 0 | 133 |
| Total | \$37,321 | \$70,986 | \$415,729 | \$534,553 | \$1,058,559 |

Financial Instruments with Off-Balance Sheet Risk

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

The contract amount of these off-balance sheet financial instruments as of December 31 is as follows:

Table 17: Off-Balance Sheet Financial Instruments

| | | |
|------------------------------------|-----------|-----------|
| (000's omitted) | 2011 | 2010 |
| Commitments to extend credit | \$572,393 | \$445,625 |
| Standby letters of credit | 25,279 | 21,456 |
| Total | \$597,672 | \$467,081 |

Investments

The objective of the Company's investment portfolio is to hold low-risk, high-quality earning assets that provide favorable returns and provide another effective tool to actively manage its asset/liability position in order to maximize future net interest income opportunities. This must be accomplished within the following constraints: (a) implementing certain interest rate risk management strategies which achieve a relatively stable level of net interest income; (b) providing both the regulatory and operational liquidity necessary to conduct day-to-day business activities; (c) considering investment risk-weights as determined by the regulatory risk-based capital guidelines; and (d) generating a favorable return without undue compromise of the other requirements.

The book value of the Company's investment portfolio increased \$333.5 million to \$2.066 billion at year-end 2011. In April 2011, investments increased \$297 million from the Wilber acquisition, primarily in government agency mortgage-backed securities, government agency collateralized mortgage obligations ("CMOs") and U.S. Treasury and Agency securities. Average investment balances including cash equivalents (book value basis) for 2011 increased \$376.1 million or 21% versus the prior year driven by the Wilber acquisition and deposit growth. Investment interest income (FTE basis) in 2011 was \$8.4 million or 10.0% higher than the prior year as a result of the higher average balances in the portfolio, partially offset by a 43-basis point decrease in the average investment yield from 4.70% to 4.27%. During 2011 market interest rates continued to be low, and as a result, cash flows from maturing investments were reinvested at lower interest rates.

Throughout 2009, cash equivalents remained above historical levels, as the Company maintained the liquidity provided in the Citizens acquisition and organic deposit growth in anticipation of improved investment opportunities in future periods. A portion of the liquidity generated was deployed during 2009 through the purchase of \$463.7 million of securities, principally GNMA mortgage-backed, obligations of state and political subdivisions and U.S. Treasury Notes. During 2010, interest rates continued to be low, and as a result, cash flows from maturing investments were reinvested at slightly lower interest rates. Partially offsetting this was the redeployment of cash equivalents into \$315 million of U.S. Treasury securities at higher yields.

Other than the pooled trust preferred securities discussed below, the investment portfolio has limited credit risk due to the composition continuing to heavily favor U.S. Agency debentures, U.S. Agency mortgage-backed pass-throughs, U.S. Agency CMOs and municipal bonds. The U.S. Agency debentures, U.S. Agency mortgage-backed pass-throughs and U.S. Agency CMOs are all AAA-rated (highest possible rating) by Moody's and AA+ by Standard and Poor's. The majority of the municipal bonds are AA rated or higher. The portfolio does not include any private label mortgage backed securities (MBSs) or private label collateralized mortgage obligations. The overall mix of securities within the portfolio over the last year has changed, with an increase in the proportion of U.S. Treasury and Agency securities, and government Agency mortgage-backed securities, with a decrease in the proportion of obligations of state and political subdivisions.

Seventy-two percent of the investment portfolio was classified as available-for-sale at year-end 2011, versus 62% at the end of 2010 due to the acquisition of Wilber and the cash flows from maturing investments, both held to maturity and available for sale, being reinvested in available for sale securities. The net pre-tax market value gain over book value for the available-for-sale portfolio as of December 31, 2011 was \$85.5 million, up \$75.6 million from one year earlier. This increase is indicative of the interest rate movements and changing spreads during the respective time periods and the changes in the size and composition of the portfolio. Although not reflected in the financial results of the Company, the held-to-maturity portfolio had an additional \$64.3 million of net unrealized gains as of December 31, 2011.

The following table sets forth the amortized cost and market value for the Company's investment securities portfolio:

Table 18: Investment Securities

| (000's omitted) | 2011 | | 2010 | | 2009 | |
|--|---------------------------------|------------------|---------------------------------|------------------|---------------------------------|------------------|
| | Amortized Cost/Book Value | Fair Value | Amortized Cost/Book Value | Fair Value | Amortized Cost/Book Value | Fair Value |
| Held-to-Maturity Portfolio: | | | | | | |
| U.S. Treasury and agency securities | \$448,260 | \$505,060 | \$478,100 | \$499,642 | \$153,761 | \$155,408 |
| Obligations of state and political subdivisions | 69,623 | 74,711 | 67,864 | 66,450 | 69,939 | 71,325 |
| Government agency mortgage-backed securities | 35,576 | 38,028 | 56,891 | 59,644 | 112,162 | 114,125 |
| Other securities | 36 | 36 | 53 | 53 | 74 | 74 |
| Total held-to-maturity portfolio | 553,495 | 617,835 | 602,908 | 625,789 | 335,936 | 340,932 |
| Available-for-Sale Portfolio: | | | | | | |
| Obligations of state and political subdivisions | 543,527 | 573,012 | 518,216 | 522,218 | 462,161 | 475,410 |
| U.S. Treasury and agency securities | 463,922 | 520,548 | 281,826 | 304,057 | 302,430 | 321,740 |
| Government agency mortgage-backed securities | 310,541 | 331,379 | 170,673 | 179,716 | 201,361 | 206,407 |
| Pooled trust preferred securities | 68,115 | 43,846 | 69,508 | 41,993 | 71,002 | 44,014 |
| Government agency collateralized mortgage obligations | 45,481 | 46,943 | 9,904 | 10,395 | 10,917 | 11,484 |
| Corporate debt securities | 21,495 | 22,855 | 25,523 | 27,157 | 35,561 | 37,117 |
| Marketable equity securities | 380 | 390 | 380 | 427 | 379 | 375 |
| Available-for-sale portfolio | 1,453,461 | 1,538,973 | 1,076,030 | 1,085,963 | 1,083,811 | 1,096,547 |
| Net unrealized gain on available-for-sale portfolio | 85,512- | | 9,933 - | | 12,736 - | |
| Total available-for-sale portfolio | 1,538,973 | 1,538,973 | 1,085,963 | 1,085,963 | 1,096,547 | 1,096,547 |

| | | | | | | |
|----------------------|-------------|-------------|-------------|-------------|-------------|-------------|
| Other Securities: | | | | | | |
| Federal Home Loan | | | | | | |
| Bank common stock | 38,343 | 38,343 | 37,301 | 37,301 | 38,410 | 38,410 |
| Federal Reserve Bank | | | | | | |
| common stock | 15,451 | 15,451 | 12,378 | 12,378 | 12,378 | 12,378 |
| Other equity | | | | | | |
| securities | 5,108 | 5,108 | 3,774 | 3,774 | 3,856 | 3,856 |
| Total other | | | | | | |
| securities | 58,902 | 58,902 | 53,453 | 53,453 | 54,644 | 54,644 |
| Total | \$2,151,370 | \$2,215,710 | \$1,742,324 | \$1,765,205 | \$1,487,127 | \$1,492,123 |

Included in the available-for-sale portfolio, as detailed in Table 18, are pooled trust preferred, class A-1 securities with a current par value of \$69.6 million and unrealized losses of \$24.3 million at December 31, 2011. The underlying collateral of these assets is principally trust-preferred securities of smaller regional banks and insurance companies. The Company's securities are in the super senior cash flow tranche of the investment pools. All other tranches in these pools will incur losses before this tranche is impacted. An additional 35% - 38% of the underlying collateral would have to be in deferral or default concurrently to result in the non-receipt of contractual cash flows. The market for these securities at December 31, 2011 is not active and markets for similar securities are also not active. The inactivity was evidenced first by a significant widening of the bid-ask spread in the brokered markets in which these securities trade and then by a significant decrease in the volume of trades relative to historical levels.

The fair value of these securities was determined by external pricing sources using a discounted cash flow model that incorporated market estimates of interest rates and volatility, as well as, observable quoted prices for similar assets in markets that have not been active. These assumptions may have a significant effect on the reported fair values. The use of different assumptions, as well as changes in market conditions, could result in materially different fair values.

A detailed review of the pooled trust preferred securities was completed at December 31, 2011. This review included an analysis of collateral reports, a cash flow analysis, including varying degrees of projected deferral/default scenarios, and a review of various financial ratios of the underlying issuers. Based on the analysis performed, significant further deferral/defaults and further erosion in other underlying performance conditions would have to exist before the Company would incur a loss. Therefore, the Company determined an other-than-temporary impairment did not exist at December 31, 2011. To date, the Company has received all scheduled principal and interest payments and expects to fully collect all future contractual principal and interest payments. The Company does not intend to sell the underlying securities nor is it more likely than not that the Company will be required to sell the securities. These securities represent less than 1% of the Company's average earning assets for the year ending December 31, 2011 and, thus, are not relied upon for meeting the daily liquidity needs of the Company. Subsequent changes in market or credit conditions could change these evaluations.

Table 19: Pooled Trust Preferred Securities as of December 31, 2011

| (000's omitted) | PreTSL XXVI | PreTSL XXVII | PreTSL XXVIII |
|---|--------------|----------------|---------------|
| Single issuer or pooled Class | Pooled A-1 | Pooled A-1 | Pooled A-1 |
| Book value at 12/31/11 | \$21,807 | \$22,900 | \$23,408 |
| Fair value at 12/31/11 | 13,572 | 15,281 | 14,993 |
| Unrealized loss at 12/31/11 | \$8,235 | \$7,619 | \$8,415 |
| Rating (Moody's/Fitch/S&P) | (Ba1/BB/CCC) | (Baa3/BB/CCC+) | (Baa3/BB/CCC) |
| Number of depository institutions/companies in issuance | 64/74 | 42/49 | 45/56 |
| Deferrals and defaults as a percentage of collateral | 28.3% | 28.1% | 24.9% |
| Excess subordination | 31.0% | 31.3% | 34.2% |

The following table sets forth as of December 31, 2011, the maturities of investment securities and the weighted-average yields of such securities, which have been calculated on the cost basis, weighted for scheduled maturity of each security:

Table 20: Maturities of Investment Securities

| (000's omitted, except rates) | Maturing | Maturing | Maturing | Total | |
|-------------------------------|-------------------------|--------------------------------------|------------------|--------------------------|---------------------------|
| | Within One Year or Less | After One Year But Within Five Years | After Five Years | Maturing After Ten Years | Amortized Cost/Book Value |
| | | | | | |

| | | | | | |
|--|----------|-----------|-----------|-----------|-----------|
| Held-to-Maturity Portfolio: | | | | | |
| U.S. Treasury and agency securities | \$0 | \$150,258 | \$282,370 | \$15,632 | \$448,260 |
| Obligations of state and political subdivisions | 11,069 | 2,295 | 3,111 | 53,148 | 69,623 |
| Government agency mortgage-backed securities (2) | 0 | 0 | 0 | 35,576 | 35,576 |
| Other securities | 5 | 31 | 0 | 0 | 36 |
| Held-to-maturity portfolio | \$11,074 | \$152,584 | \$285,481 | \$104,356 | \$553,495 |
| Weighted-average yield (1) | 2.62% | 3.26% | 3.39% | 4.27% | 3.50% |

| | | | | | |
|---|----------|-----------|-----------|-----------|-------------|
| Available-for-Sale Portfolio: | | | | | |
| Obligations of state and political subdivisions | \$24,337 | \$117,874 | \$162,011 | \$239,305 | \$543,527 |
| U.S. Treasury and agency securities | 0 | 78,727 | 251,147 | 134,048 | 463,922 |
| Government agency mortgage-backed securities (2) | 4 | 87 | 7,059 | 303,391 | 310,541 |
| Pooled trust preferred securities | 0 | 0 | 0 | 68,115 | 68,115 |
| Government agency collateralized mortgage obligations (2) | 0 | 5,780 | 4,931 | 34,770 | 45,481 |
| Corporate debt securities | 6,501 | 14,994 | 0 | 0 | 21,495 |
| Available-for-sale portfolio | \$30,842 | \$217,462 | \$425,148 | \$779,629 | \$1,453,081 |
| Weighted-average yield (1) | 3.98% | 3.50% | 3.59% | 3.94% | 3.77% |

(1) Weighted-average yields are an arithmetic computation of income (not fully tax-equivalent adjusted) divided by book balance;

they may differ from the yield to maturity, which considers the time value of money.

(2) Mortgage-backed securities and collateralized mortgage obligations are listed based on the contractual maturity. Actual

maturities will differ from contractual maturities because borrowers may have the right to call or prepay certain obligations

with or without penalties.

Impact of Inflation and Changing Prices

The Company's financial statements have been prepared in terms of historical dollars, without considering changes in the relative purchasing power of money over time due to inflation. Unlike most industrial companies, virtually all of the assets and liabilities of a financial institution are monetary in nature. As a result, interest rates have a more significant impact on a financial institution's performance than the effect of general levels of inflation. Interest rates do not necessarily move in the same direction or in the same magnitude as the prices of goods and services. Notwithstanding this, inflation can directly affect the value of loan collateral, in particular real estate.

New Accounting Pronouncements

See "New Accounting Pronouncements" Section of Note A of the notes to the consolidated financial statements on page 59 for additional accounting pronouncements.

Forward-Looking Statements

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

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

Item 7A. Quantitative and Qualitative Disclosures about Market Risk

Market Risk

Market risk is the risk of loss in a financial instrument arising from adverse changes in market rates, prices or credit risk. Credit risk associated with the Company's loan portfolio has been previously discussed in the asset quality section of Management's Discussion and Analysis of Financial Condition and Results of Operations starting on page 36. Management believes that the tax risk of the Company's municipal investments associated with potential future changes in statutory, judicial and regulatory actions is minimal. Other than the pooled trust preferred securities discussed beginning on page 44, the Company has a minimal amount of credit risk in the remainder of its investment portfolio. Treasury, agency, mortgage-backed and CMO securities issued by government agencies comprise 65% of the total portfolio and are currently rated AAA by Moody's Investor Services and AA+ by Standard & Poor's. Municipal and corporate bonds (excluding the pooled trust preferred securities) consist of 32% of the total portfolio, of which, 97% carry a minimum rating of A. The remaining 3% of the portfolio covers local municipal bonds, other investment grade securities and pooled trust preferred securities. The Company does not have material foreign currency exchange rate risk exposure. Therefore, almost all the market risk in the investment portfolio is related to interest rates.

The ongoing monitoring and management of both interest rate risk and liquidity, in the short and long term time horizons is an important component of the Company's asset/liability management process, which is governed by limits established in the policies reviewed and approved annually by the Board of Directors. The Board of Directors delegates responsibility for carrying out the policies to the Asset/Liability Management Committee ("ALCO"), which meets each month. The committee is made up of the Company's senior management as well as regional and line-of-business managers who oversee specific earning asset classes and various funding sources.

Asset/Liability Management

The primary objective of the Company's asset/liability management process is to maximize earnings and return on capital within acceptable levels of risk. As the Company does not believe it is possible to reliably predict future interest rate movements, it has maintained an appropriate process and set of measurement tools that enable it to identify and quantify sources of interest rate risk in varying rate environments. The primary tools used by the Company in managing interest rate risk are the income simulation model and economic value of equity modeling.

Interest Rate Risk

Interest rate risk ("IRR") can result from: the timing differences in the maturity/repricing of an institution's assets, liabilities, and off-balance-sheet contracts; the effect of embedded options, such as loan prepayments, interest rate caps/floors, and deposit withdrawals; and differences in the behavior of lending and funding rates, sometimes referred to as basis risk. An example of basis risk would occur if floating rate assets and liabilities, with otherwise identical repricing characteristics, were based on market indexes that were imperfectly correlated.

Given the potential types and differing related characteristics of IRR, it is important that the Company maintain an appropriate process and set of measurement tools that enable it to identify and quantify its primary sources of IRR. The Company also recognizes that effective management of IRR includes an understanding of when potential adverse changes in interest rates will flow through the income statement. Accordingly, the Company will manage its position so that it monitors its exposure to net interest income over both a one year planning horizon and a longer-term strategic horizon.

It is the Company's objective to manage its exposure to interest rate risk, but it should be understood that due to the nature of its business it will always be subject to rate risk and that rate risk immunization is not possible. Also, it is recognized that as exposure to interest rate risk is reduced, so too may net interest margin be reduced.

Income Simulation

Income simulation is tested on a wide variety of balance sheet and treasury yield curve scenarios. The simulation projects changes in net interest income, which are caused by the effect of changes in interest rates. The model requires management to make assumptions about how the balance sheet is likely to evolve through time in different interest rate environments. Loan and deposit growth rate assumptions are derived from management's outlook, as are the assumptions used for new loan yields and deposit rates. Loan prepayment speeds are projected based on a combination of current industry averages and internal historical prepayments. Balance sheet and yield curve assumptions are analyzed and reviewed by the ALCO regularly.

The following table reflects the Company's one-year net interest income sensitivity, using December 31, 2011 asset and liability levels as a starting point.

The prime rate and federal funds rates are assumed to move up 200 basis points over a 12-month period while moving the long end of the treasury curve to spreads over federal funds that are more consistent with historical norms (normalized yield curve). In the 0 basis point model, the prime and federal funds rate remains at current levels while longer-term rates are lowered to the historical low levels seen in the third quarter of 2011. Deposit rates are assumed to move in a manner that reflects the historical relationship between deposit rate movement and changes in the federal funds rate, generally reflecting 10%-65% of the movement of the federal funds rate. Cash flows are based on contractual maturity, optionality, amortization schedules and applicable prepayment assumptions derived from internal historical data and external sources.

Net Interest Income Sensitivity Model

| Changes in Interest Rates | Calculated Increase (Decrease) in Projected Net Income at December 31, | |
|---------------------------------|---|---------------|
| | 2011 | 2010 |
| +200 basis points | \$2,017,000 | \$1,641,000 |
| 0 basis points | (\$1,198,000) | (\$1,339,000) |

In the 2011 and 2010 models, the rising rate environment reflects an increase in net interest income (“NII”) from a flat rate environment. The increase in a rising rate environment is largely a result of slower investment cash flows, a higher reinvestment rate of excess cash, slower assumed prepayment speeds and the repricing of assets to higher rates offset by the increase of deposit and funding rates. Over a longer time period the growth in NII improves significantly in a rising rate environment as lower yielding assets mature and are replaced at higher rates.

For the 2011 and 2010 models, the Bank continues to show interest rate risk exposure if the yield curve continues to flatten despite Fed Funds trading at a range of 0 – 25 basis points. In the 0 basis point model, net interest income declines during the first twelve months as investment cash flows increase, assets reprice to lower rates and corresponding deposits are assumed to remain constant. Despite Fed Funds trading near 0%, the Company believes long-term treasury rates could potentially fall further in this scenario, and thus, the model tests the impact of this lower treasury rate scenario.

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

Item 8. Financial Statements and Supplementary Data

The following consolidated financial statements and independent registered public accounting firm’s report of Community Bank System, Inc. are contained on pages 49 through 90 of this item.

December 31, 2011 and 2010

- Consolidated Statements of Condition,

Years ended December 31, 2011, 2010, and 2009

- Consolidated Statements of Income,

Years ended December 31, 2011, 2010, and 2009

- Consolidated Statements of Comprehensive Income,

Years ended December 31, 2011, 2010, and 2009

- Consolidated Statements of Changes in Shareholders' Equity,

Years ended December 31, 2011, 2010, and 2009

- Consolidated Statements of Cash Flows,

December 31, 2011

- Notes to Consolidated Financial Statements,

- Management's Report on Internal Control Over Financial Reporting

- Report of Independent Registered Public Accounting Firm

Quarterly Selected Data (Unaudited) for 2011 and 2010 are contained on page 91.

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

| | December 31, | |
|--|--------------------|--------------------|
| | 2011 | 2010 |
| Assets: | | |
| Cash and cash equivalents | \$324,878 | \$211,837 |
| Available-for-sale investment securities (cost of \$1,453,460 and \$1,076,030, respectively) | 1,538,973 | 1,085,963 |
| Held-to-maturity investment securities (fair value of \$617,835 and \$625,789, respectively) | 553,495 | 602,908 |
| Other securities, at cost | 58,902 | 53,453 |
| Loans held for sale, at fair value | 532 | 3,952 |
| Loans | 3,471,025 | 3,026,363 |
| Allowance for loan losses | (42,213) | (42,510) |
| Net loans | 3,428,812 | 2,983,853 |
| Core deposit intangibles, net | 11,519 | 10,897 |
| Goodwill | 345,050 | 297,692 |
| Other intangibles, net | 3,995 | 3,125 |
| Intangible assets, net | 360,564 | 311,714 |
| Premises and equipment, net | 85,956 | 81,561 |
| Accrued interest receivable | 28,579 | 26,136 |
| Other assets | 107,584 | 83,129 |
| Total assets | \$6,488,275 | \$5,444,506 |
| Liabilities: | | |
| Noninterest-bearing deposits | \$894,464 | \$741,166 |
| Interest-bearing deposits | 3,900,781 | 3,192,879 |
| Total deposits | 4,795,245 | 3,934,045 |
| Borrowings | 728,281 | 728,460 |
| Subordinated debt held by unconsolidated subsidiary trusts | 102,048 | 102,024 |
| Accrued interest and other liabilities | 88,118 | 72,719 |
| Total liabilities | 5,713,692 | 4,837,248 |
| Commitments and contingencies (See Note N) | | |

| | | |
|---|-------------|-------------|
| Shareholders' equity: | | |
| Preferred stock \$1.00 par value, 500,000 shares authorized, 0 shares issued | - | - |
| Common stock, \$1.00 par value, 50,000,000 shares authorized; 37,794,532 and 34,131,289 shares issued, respectively | 37,795 | 34,131 |
| Additional paid-in capital | 313,501 | 225,543 |
| Retained earnings | 411,805 | 374,700 |
| Accumulated other comprehensive gain(loss) | 29,165 | (9,340) |
| Treasury stock, at cost (808,123 and 812,346 shares, respectively) | (17,683) | (17,776) |
| Total shareholders' equity | 774,583 | 607,258 |
| Total liabilities and shareholders' equity | \$6,488,275 | \$5,444,506 |

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

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

| | Years Ended December 31, | | |
|--|--------------------------|----------------|----------------|
| | 2011 | 2010 | 2009 |
| Interest income: | | | |
| Interest and fees on loans | \$192,981 | \$178,703 | \$185,119 |
| Interest and dividends on taxable investments | 55,634 | 47,241 | 40,030 |
| Interest and dividends on nontaxable investments | 22,354 | 22,337 | 23,633 |
| Total interest income | 270,969 | 248,281 | 248,782 |
| Interest expense: | | | |
| Interest on deposits | 26,156 | 30,559 | 45,776 |
| Interest on borrowings | 29,599 | 30,078 | 31,353 |
| Interest on subordinated debt held by unconsolidated subsidiary trusts | 5,801 | 5,960 | 6,153 |
| Total interest expense | 61,556 | 66,597 | 83,282 |
| Net interest income | 209,413 | 181,684 | 165,500 |
| Less: provision for loan losses | 4,736 | 7,205 | 9,790 |
| Net interest income after provision for loan losses | 204,677 | 174,479 | 155,710 |
| Noninterest income: | | | |
| Deposit service fees | 42,334 | 43,358 | 41,285 |
| Other banking services | 4,651 | 5,985 | 5,841 |
| Benefit trust, administration, consulting and actuarial fees | 31,601 | 29,616 | 27,771 |
| Wealth management services | 10,697 | 9,833 | 8,631 |
| (Loss)gain on investment securities and debt extinguishments, net | (61) | 0 | 7 |
| Total noninterest income | 89,222 | 88,792 | 83,535 |
| Noninterest expenses: | | | |
| Salaries and employee benefits | 102,278 | 91,399 | 92,690 |
| Occupancy and equipment | 24,502 | 22,933 | 23,185 |
| Data processing and communications | 20,525 | 20,720 | 20,684 |
| Amortization of intangible assets | 4,381 | 5,957 | 8,170 |
| Legal and professional fees | 5,889 | 5,532 | 5,302 |
| Office supplies and postage | 5,246 | 5,469 | 5,243 |
| Business development and marketing | 5,931 | 5,237 | 6,086 |
| FDIC insurance premiums | 3,920 | 5,838 | 8,610 |
| Goodwill impairment | 0 | 0 | 3,079 |
| | 4,831 | 1,365 | 1,621 |

| | | | |
|---|----------|----------|----------|
| Acquisition expenses and contract termination charges | | | |
| Other | 12,869 | 12,436 | 11,508 |
| Total noninterest expenses | 190,372 | 176,886 | 186,178 |
| Income before income taxes | 103,527 | 86,385 | 53,067 |
| Income taxes | 30,385 | 23,065 | 11,622 |
| Net income | \$73,142 | \$63,320 | \$41,445 |
| Basic earnings per share | \$2.03 | \$1.91 | \$1.26 |
| Diluted earnings per share | \$2.01 | \$1.89 | \$1.26 |
| Cash dividends declared per share | \$1.00 | \$0.94 | \$0.88 |

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

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

| | Years Ended December 31, | | |
|---|--------------------------|----------|-----------|
| | 2011 | 2010 | 2009 |
| Change in accumulated unrealized gain or loss for pension and other postretirement obligations | (\$17,213) | \$9 | \$12,434 |
| Change in unrealized losses on derivative instruments used in cash flow hedging relationships | 3,232 | 1,861 | 1,628 |
| Unrealized gains (losses) on securities: | | | |
| Unrealized holding (losses) gains arising during period | 75,609 | (2,803) | (7,286) |
| Reclassification adjustment for gains included in net income | (30) | 0 | (7) |
| Other comprehensive gain (loss), before tax | 61,598 | (933) | 6,769 |
| Income tax (expense) benefit related to other comprehensive loss | (23,093) | 377 | (2,689) |
| Other comprehensive gain (loss) income, net of tax | 38,505 | (556) | 4,080 |
| Net income | 73,142 | 63,320 | 41,445 |
| Comprehensive income | \$111,647 | \$62,764 | \$45,525 |
| Tax Effect Allocated To Each Component Of Comprehensive Income: | | | |
| Tax effect of unrealized gain (loss) for pension and other postretirement obligations | 6,631 | (2) | (4,783) |
| Tax effect of unrealized losses on derivative instruments used in cash flow hedging relationships | (\$1,252) | (\$716) | (\$626) |
| Tax effect of unrealized gains and losses on available-for-sale securities arising during period | (28,484) | 1,095 | 2,717 |
| Reclassification adjustment for gains included in net income | 12 | 0 | 3 |
| Tax effect of unrealized gains on available-for-sale securities arising during period | (28,472) | 1,095 | 2,720 |
| Income tax (expense) benefit related to other comprehensive loss | (\$23,093) | \$377 | (\$2,689) |

Accumulated Other Comprehensive Income
By Component:

| | | | |
|---|------------|------------|------------|
| Unrealized loss for pension and other postretirement obligations | (\$40,477) | (\$23,264) | (\$23,273) |
| Tax effect | 15,603 | 8,972 | 8,974 |
| Net unrealized loss for pension and other postretirement obligations | (24,874) | (14,292) | (14,299) |
| Unrealized losses on derivative instruments used in cash flow hedging relationships | 0 | (3,232) | (5,093) |
| Tax effect | 0 | 1,252 | 1,968 |
| Net unrealized losses on derivative instruments used in cash flow hedging relationships | 0 | (1,980) | (3,125) |
| Unrealized gain on available-for-sale securities | 85,512 | 9,933 | 12,736 |
| Tax effect | (31,473) | (3,001) | (4,096) |
| Net unrealized gain on available-for-sale securities | 54,039 | 6,932 | 8,640 |
| Accumulated other comprehensive income (loss) | \$29,165 | (\$9,340) | (\$8,784) |

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

COMMUNITY BANK SYSTEM, INC.
CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY
Years ended December 31, 2009, 2010 and 2011
(In Thousands, Except Share Data)

| | Common Stock Shares Outstanding | Additional Amount Issued | Additional Paid-in Capital | Accumulated Other Retained Earnings (Loss)/Income | Treasury Stock | Total |
|--|---------------------------------------|--------------------------------|----------------------------------|---|----------------------|-----------|
| Balance at December 31, 2008 | 32,633,404 | \$33,468 | \$212,400 | \$329,914 | (\$12,864)(\$18,267) | \$544,651 |
| Net income | | | | 41,445 | | 41,445 |
| Other comprehensive income, net of tax | | | | | 4,080 | 4,080 |
| Dividends declared: | | | | | | |
| Common, \$0.88 per share | | | | (28,820) | | (28,820) |
| Common stock issued under employee stock plan, including tax benefits of \$213 | 166,904 | 163 | 981 | | 97 | 1,241 |
| Stock-based compensation | | | 3,100 | | | 3,100 |
| Balance at December 31, 2009 | 32,800,308 | 33,631 | 216,481 | 342,539 | (8,784) (18,170) | 565,697 |
| Net income | | | | 63,320 | | 63,320 |
| Other comprehensive income, net of tax | | | | | (556) | (556) |
| Dividends declared: | | | | | | |
| Common, \$0.94 per share | | | | (31,159) | | (31,159) |
| Common stock issued under | | | | | | |

| | | | | | | | |
|--|------------|----------|-----------|-----------|----------|------------|-----------|
| employee stock plan, including tax benefits of \$842 | 518,635 | 500 | 5,539 | | | 394 | 6,433 |
| Stock-based compensation | | | 3,523 | | | | 3,523 |
| Balance at December 31, 2010 | 33,318,943 | 34,131 | 225,543 | 374,700 | (9,340) | (17,776) | 607,258 |
| Net income | | | | 73,142 | | | 73,142 |
| Other comprehensive income, net of tax | | | | | 38,505 | | 38,505 |
| Dividends declared: | | | | | | | |
| Common, \$1.00 per share | | | | (36,037) | | | (36,037) |
| Common stock issued under employee stock plan, including tax benefits of \$703 | 314,665 | 311 | 4,947 | | | 93 | 5,351 |
| Stock-based compensation | | | 3,784 | | | | 3,784 |
| Stock issued for acquisition | 3,352,801 | 3,353 | 79,227 | | | | 82,580 |
| Balance at December 31, 2011 | 36,986,409 | \$37,795 | \$313,501 | \$411,805 | \$29,165 | (\$17,683) | \$774,583 |

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

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

| | Years Ended December 31, | | |
|--|--------------------------|-----------|-----------|
| | 2011 | 2010 | 2009 |
| Operating activities: | | | |
| Net income | \$73,142 | \$63,320 | \$41,445 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | | |
| Depreciation | 11,374 | 10,219 | 10,299 |
| Amortization of intangible assets | 4,382 | 5,957 | 8,170 |
| Impairment of goodwill | 0 | 0 | 3,079 |
| Net (accretion)/amortization of premiums & discounts on securities, loans and borrowings | (1,934) | 2,249 | 2,141 |
| Stock-based compensation | 3,784 | 3,523 | 3,100 |
| Provision for loan losses | 4,736 | 7,205 | 9,790 |
| Provision for deferred income taxes | 12,942 | 9,199 | 3,434 |
| Amortization of mortgage servicing rights | 868 | 769 | 731 |
| Income from bank-owned life insurance policies | (894) | (458) | (476) |
| Loss (Gain) from sale of investment securities and debt extinguishments, net | 61 | 0 | (7) |
| Net gain on sale of loans and other assets | (422) | (1,032) | (1,098) |
| Net change in loans originated for sale | 4,047 | (309) | 1,092 |
| Change in other operating assets and liabilities | (14,269) | (3,554) | (37,566) |
| Net cash provided by operating activities | 97,817 | 97,088 | 44,134 |
| Investing activities: | | | |
| Proceeds from sales of available-for-sale investment securities | 15,330 | 0 | 27 |
| Proceeds from sales of other securities | 1,032 | 1,201 | 0 |
| Proceeds from maturities of held-to-maturity investment securities | 65,062 | 76,081 | 108,927 |
| Proceeds from maturities of available-for-sale investment securities | 254,368 | 157,563 | 253,629 |
| Purchases of held-to-maturity investment securities | (13,292) | (345,187) | (369,374) |
| Purchases of available-for-sale investment securities | (353,498) | (149,883) | (94,339) |
| Purchases of other securities | (2,908) | 0 | (390) |
| Net decrease in loans | 12,639 | 68,691 | 29,200 |
| Cash received /(paid) for acquisitions, net of cash acquired of \$26,901, \$0, and \$0, respectively | 4,746 | 0 | (358) |
| Purchases of premises and equipment | (9,613) | (15,716) | (13,894) |
| Net cash (used in) investing activities | (26,134) | (207,250) | (86,572) |
| Financing activities: | | | |
| Net change in noninterest checking, checking, and savings accounts | 199,812 | 246,453 | 491,821 |
| Net change in time deposits | (110,166) | (236,893) | (268,147) |
| Net change in borrowings, net of payments of \$25,938, \$26,318 and \$5,779 | (19,938) | (26,318) | (5,779) |
| Issuance of common stock | 5,351 | 6,433 | 1,241 |

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| | | | |
|---|-----------|-----------|-----------|
| Cash dividends paid | (34,404) | (30,394) | (28,788) |
| Tax benefits from share-based payment arrangements | 703 | 842 | 213 |
| Net cash provided by/(used in) financing activities | 41,358 | (39,877) | 190,561 |
| Change in cash and cash equivalents | 113,041 | (150,039) | 148,123 |
| Cash and cash equivalents at beginning of year | 211,837 | 361,876 | 213,753 |
| Cash and cash equivalents at end of year | \$324,878 | \$211,837 | \$361,876 |
| Supplemental disclosures of cash flow information: | | | |
| Cash paid for interest | \$61,564 | \$67,485 | \$85,011 |
| Cash paid for income taxes | 20,810 | 12,630 | 5,434 |
| Supplemental disclosures of noncash financing and investing activities: | | | |
| Dividends declared and unpaid | 9,609 | 7,976 | 7,211 |
| Transfers from loans to other real estate | 5,186 | 3,839 | 2,373 |
| Acquisitions: | | | |
| Fair value of assets acquired, excluding acquired cash and intangibles | 815,824 | 0 | 63 |
| Fair value of liabilities assumed | 791,222 | 0 | 0 |

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

COMMUNITY BANK SYSTEM, INC.

NOTE A: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Nature of Operations

Community Bank System, Inc. (the “Company”) is a single bank holding company which wholly-owns five consolidated subsidiaries: Community Bank, N.A. (the “Bank”), Benefit Plans Administrative Services, Inc. (“BPAS”), CFSI Closeout Corp. (“CFSICC”), First of Jermyn Realty Co. (“FJRC”), and Town & Country Agency LLC (“T&C”). BPAS owns three subsidiaries, Benefit Plans Administrative Services LLC (“BPA”), Harbridge Consulting Group LLC (“Harbridge”), and Hand Benefits & Trust, Inc. (“HB&T”), which owns two subsidiaries Hand Securities Inc. (“HSI”), and Flex Corporation (“Flex”). BPAS provides administration, consulting and actuarial services to sponsors of employee benefit plans. CFSICC, FJRC and T&C are inactive companies. The Company also wholly-owns two unconsolidated subsidiary business trusts formed for the purpose of issuing mandatorily-redeemable preferred securities which are considered Tier I capital under regulatory capital adequacy guidelines (see Note P).

The Bank operates 168 full service branches throughout 35 counties of Upstate New York, where it operates as Community Bank, N.A. and five counties of Northeastern Pennsylvania, where it is known as First Liberty Bank & Trust, offering a range of commercial and retail banking services. The Bank owns the following subsidiaries: Community Investment Services, Inc. (“CISI”), CBNA Treasury Management Corporation (“TMC”), CBNA Preferred Funding Corporation (“PFC”), Nottingham Advisors, Inc. (“Nottingham”), First Liberty Service Corp. (“FLSC”), Brilie Corporation (“Brilie”), CBNA Insurance Agency (“CBNA Insurance”) and Western Catskill Realty, LLC (“WCR”). CISI provides broker-dealer and investment advisory services. TMC provides cash management, investment, and treasury services to the Bank. PFC primarily is an investor in residential real estate loans. Nottingham provides asset management services to individuals, corporate pension and profit sharing plans, and foundations. FLSC provides banking-related services to the Pennsylvania branches of the Bank. Brilie and WCR are inactive companies. CBNA Insurance is a full service insurance agency offering primarily property and casualty products.

Principles of Consolidation

The consolidated financial statements include the accounts of the Company and its wholly-owned subsidiaries. All inter-company accounts and transactions have been eliminated in consolidation.

Variable Interest Entities (“VIE”) are required to be consolidated by a company if it is determined the company is the primary beneficiary of a VIE. The primary beneficiary of a VIE is the enterprise that has: (1) the power to direct the activities of the VIE that most significantly impact the VIE’s economic performance, and (2) the obligation to absorb losses of the VIE that could potentially be significant to the VIE or the right to receive benefits of the VIE that could potentially be significant to the VIE. The Company’s wholly-owned subsidiaries, Community Statutory Trust III and Community Capital Trust IV, are VIEs for which the Company is not the primary beneficiary. Accordingly, the accounts of these entities are not included in the Company’s consolidated financial statements.

Critical Accounting Estimates in the Preparation of Financial Statements

The preparation of 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 financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. Critical accounting estimates include the allowance for loan losses, actuarial assumptions associated with the pension, post-retirement and other employee benefit plans, the provision for income taxes, investment valuation and other-than-temporary impairment, the carrying value of goodwill and other intangible assets, and acquired loan valuations.

Risk and Uncertainties

In the normal course of its business, the Company encounters economic and regulatory risks. There are three main components of economic risk: interest rate risk, credit risk and market risk. The Company is subject to interest rate risk to the degree that its interest-bearing liabilities mature or reprice at different speeds, or on different basis, from its interest-earning assets. The Company's primary credit risk is the risk of default on the Company's loan portfolio that results from the borrowers' inability or unwillingness to make contractually required payments. Market risk reflects potential changes in the value of collateral underlying loans, the fair value of investment securities, and loans held for sale.

The Company is subject to regulations of various governmental agencies. These regulations can and do change significantly from period to period. The Company also undergoes periodic examinations by the regulatory agencies which may subject it to further changes with respect to asset valuations, amounts of required loan loss allowances, and operating restrictions resulting from the regulators' judgments based on information available to them at the time of their examinations.

Revenue Recognition

The Company recognizes income on an accrual basis. CISI recognizes fee income when investment and insurance products are sold to customers. Nottingham provides asset management services to brokerage firms and clients and recognizes income ratably over the contract period during which service is performed. Revenue from BPA's administration and recordkeeping services is recognized ratably over the service contract period. Revenue from consulting and actuarial services is recognized when services are rendered. CBNA Insurance recognizes commission revenue at the later of the effective date of the insurance policy, or the date on which the policy premium is billed to the customer. At that date, the earnings process has been completed and the impact of refunds for policy cancellations can be reasonably estimated to establish reserves. The reserve for policy cancellations is based upon historical cancellation experience adjusted for known circumstances. All intercompany revenue and expense among related entities are eliminated in consolidation.

Cash and Cash Equivalents

For purposes of reporting cash flows, cash and cash equivalents include cash on hand, amounts due from banks and highly liquid investments with original maturities of less than ninety days. The carrying amounts reported in the balance sheet for cash and cash equivalents approximate those assets' fair values.

Investment Securities

The Company has classified its investments in debt and equity securities as held-to-maturity or available-for-sale. Held-to-maturity securities are those for which the Company has the positive intent and ability to hold until maturity, and are reported at cost, which is adjusted for amortization of premiums and accretion of discounts. Securities not classified as held-to-maturity are classified as available-for-sale and are reported at fair value with net unrealized gains and losses reflected as a separate component of shareholders' equity, net of applicable income taxes. None of the Company's investment securities have been classified as trading securities at December 31, 2011. Certain equity securities are stated at cost and include restricted stock of the Federal Reserve Bank of New York and Federal Home Loan Bank of New York.

Fair values for investment securities are based upon quoted market prices, where available. If quoted market prices are not available, fair values are based upon quoted market prices of comparable instruments, or a discounted cash flow model using market estimates of interest rates and volatility.

The Company conducts an assessment of all securities in an unrealized loss position to determine if other-than-temporary impairment ("OTTI") exists on a monthly basis. An unrealized loss exists when the current fair value of an individual security is less than its amortized cost basis. The OTTI assessment considers the security structure, recent security collateral performance metrics, if applicable, external credit ratings, failure of the issuer to make scheduled interest or principal payments, judgment and expectations of future performance, and relevant independent industry research, analysis and forecasts. The severity of the impairment and the length of time the security has been impaired is also considered in the assessment. The assessment of whether an OTTI decline exists is performed on each security, regardless of the classification of the security as available-for-sale or held-to-maturity and involves a high degree of subjectivity and judgment that is based on the information available to management at a point in time.

An OTTI loss must be recognized for a debt security in an unrealized loss position if there is intent to sell the security or it is more likely than not the Company will be required to sell the security prior to recovery of its amortized cost basis. In this situation, the amount of loss recognized in income is equal to the difference between the fair value and the amortized cost basis of the security. Even if management does not have the intent and it is not more likely than not that the Company will be required to sell the securities, an evaluation of the expected cash flows to be received is performed to determine if a credit loss has occurred. For debt securities, a critical component of the evaluation for OTTI is the identification of credit-impaired securities, where the Company does not expect to receive cash flows

sufficient to recover the entire amortized cost basis of the security. In the event of a credit loss, only the amount of impairment associated with the credit loss would be recognized in income. The portion of the unrealized loss relating to other factors, such as liquidity conditions in the market or changes in market interest rates, is recorded in accumulated other comprehensive loss.

Equity securities are also evaluated to determine whether the unrealized loss is expected to be recoverable based on whether evidence exists to support a realizable value equal to or greater than the amortized cost basis. If it is probable that the amortized cost basis will not be recovered, taking into consideration the estimated recovery period and the ability to hold the equity security until recovery, OTTI is recognized in earnings equal to the difference between the fair value and the amortized cost basis of the security.

The specific identification method is used in determining the realized gains and losses on sales of investment securities and other-than-temporary impairment charges. Premiums and discounts on securities are amortized and accreted, respectively, on the interest method basis over the period to maturity or estimated life of the related security. Purchases and sales of securities are recognized on a trade date basis.

Derivative Financial Instruments

The Company has utilized interest rate swap agreements, considered to be cash flow hedges, as part of the management of interest rate risk to modify the repricing characteristics of certain portions of its portfolios of interest-bearing liabilities. These derivative instruments are required to be carried at fair value on the balance sheet.

Cash flow hedges are accounted for by recording the fair value of the derivative instrument on the balance sheet as either a freestanding asset or liability, with a corresponding offset recorded in other comprehensive income within shareholders' equity, net of income tax effect. Amounts are reclassified from other comprehensive income to the income statement in the period or periods the hedged transaction affects earnings. Derivative gains and losses not effective in hedging the expected cash flows of the hedged item are recognized immediately in the income statement. At the hedge's inception and at least quarterly thereafter, a formal assessment is performed to determine the effectiveness of the cash flow hedge. If it is determined that a derivative instrument has not been or will not continue to be highly effective as a hedge, hedge accounting is discontinued.

Loans

Loans are stated at unpaid principal balances, net of unearned income. Mortgage loans held for sale are carried at fair value and are included in loans held for sale. Fair values for variable rate loans that reprice frequently are based on carrying values. Fair values for fixed rate loans are estimated using discounted cash flows and interest rates currently being offered for loans with similar terms to borrowers of similar credit quality. The carrying amount of accrued interest approximates its fair value.

Interest on loans is accrued and credited to operations based upon the principal amount outstanding. Nonrefundable loan fees and related direct costs are deferred and included in the loan balances where they are amortized over the life of the loan as an adjustment to loan yield using the effective yield method. Premiums and discounts on purchased loans are amortized using the effective yield method over the life of the loans.

Acquired Loans

Acquired loans are initially recorded at their acquisition date fair values. The carryover of allowance for loan losses is prohibited as any credit losses in the loans are included in the determination of the fair value of the loans at the acquisition date. Fair values for acquired loans are based on a discounted cash flow methodology that involves assumptions and judgments as to credit risk, prepayment risk, liquidity risk, default rates, loss severity, payment speeds, collateral values and discount rate.

Acquired loans that have evidence of deterioration in credit quality since origination and for which it is probable, at acquisition, that the Company will be unable to collect all contractually required payments. The excess of cash flows expected at acquisition over the estimated fair value is referred to as the accretable discount and is recognized into interest income over the remaining life of the loans. The difference between contractually required payments at acquisition and the cash flows expected to be collected at acquisition is referred to as the non-accretable discount. The non-accretable discount represents estimated future credit losses expected to be incurred over the life of the loan. Subsequent decreases to the expected cash flows require the Company to evaluate the need for an allowance for loan losses on these loans. Subsequent improvements in expected cash flows result in the reversal of a corresponding amount of the non-accretable discount which the Company then reclassifies as an accretable discount that is recognized into interest income over the remaining life of the loans using the interest method.

Acquired loans that met the criteria for non-accrual of interest prior to acquisition may be considered performing upon acquisition, regardless of whether the customer is contractually delinquent, if the Company can reasonably estimate the timing and amount of the expected cash flows on such loans and if the Company expects to fully collect the new carrying value of the loans. As such, the Company may no longer consider the loan to be non-accrual or non-performing and may accrue interest on these loans, including the impact of any accretable discount. For acquired

loans that are not deemed impaired at acquisition, credit discounts representing the principal losses expected over the life of the loan are a component of the initial fair value and amortized over the life of the asset. Subsequent to the purchase date, the methods utilized to estimate the required allowance for loan losses for these loans is similar to originated loans, however, the Company records a provision for loan losses only when the required allowance exceeds any remaining pooled discounts for loans evaluated collectively for impairment.

Impaired and Other Nonaccrual Loans

The Company places a loan on nonaccrual status when the loan becomes ninety days past due (or sooner, if management concludes collection is doubtful), except when, in the opinion of management, it is well-collateralized and in the process of collection. A loan may be placed on nonaccrual status earlier than ninety days past due if there is deterioration in the financial position of the borrower or if other conditions of the loan so warrant. When a loan is placed on nonaccrual status, uncollected accrued interest is reversed against interest income and the amortization of nonrefundable loan fees and related direct costs is discontinued. Interest income during the period the loan is on nonaccrual status is recorded on a cash basis after recovery of principal is reasonably assured. Nonaccrual loans are returned to accrual status when management determines that the borrower's performance has improved and that both principal and interest are collectible. This generally requires a sustained period of timely principal and interest payments and a well-documented credit evaluation of the borrower's financial condition.

Commercial loans greater than \$0.5 million are evaluated individually for impairment. A loan is considered impaired, based on current information and events, if it is probable that the Company will be unable to collect the scheduled payments of principal or interest when due according to the contractual terms of the loan agreement. The measurement of impaired loans is generally based upon the present value of expected future cash flows or the fair value of the collateral, if the loan is collateral-dependent.

The Company's charge-off policy by loan type is as follows:

- Business lending loans are generally charged-off to the extent outstanding principal exceeds the fair value of estimated proceeds from collection efforts, including liquidation of collateral. The charge-off is recognized when the loss becomes reasonably quantifiable.
- Consumer installment loans are generally charged-off to the extent outstanding principal balance exceeds the fair value of collateral, and are recognized by the end of the month in which the loan becomes 90 days past due.
- Consumer mortgage and home equity loans are generally charged-off to the extent outstanding principal exceeds the fair value of the property, less estimated costs to sell, and are recognized when the loan becomes 180 days past due.

Allowance for Loan Losses

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

The general loan loss allocation is composed of two calculations that are computed on five main loan segments: business lending, consumer installment - direct, consumer installment - indirect, home equity and consumer mortgage. The first calculation determines an allowance level based on the latest 36 months of historical net charge-off data for each loan class (commercial loans exclude balances with specific loan loss allocations). The second calculation is qualitative and takes into consideration eight qualitative environmental factors: levels and trends in delinquencies and impaired loans; levels of and trends in charge-offs and recoveries; trends in volume and terms of loans; effects of any changes in risk selection and underwriting standards, and other changes in lending policies, procedure, and practices; experience, ability, and depth of lending management and other relevant staff; national and local economic trends and conditions; industry condition; and effects of changes in credit concentrations. These two calculations are added together to determine the general loan loss allocation. The specific loan loss allocation relates to individual commercial loans that are both greater than \$0.5 million and in a nonaccruing status with respect to interest. Specific losses are based on discounted estimated cash flows, including any cash flows resulting from the conversion of collateral or collateral shortfalls. The allowance levels computed from the specific and general loan loss allocation methods are combined with unallocated allowances, if any, to derive the required allowance for loan losses to be reflected on the Consolidated Statement of Condition. As it has in prior periods, the Company strives to refine and enhance its loss evaluation and estimation processes continually.

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

Intangible Assets

Intangible assets include core deposit intangibles, customer relationship intangibles and goodwill arising from acquisitions. Core deposit intangibles and customer relationship intangibles are amortized on either an accelerated or straight-line basis over periods ranging from 8 to 20 years. The initial and ongoing carrying value of goodwill and other intangible assets is based upon discounted cash flow modeling techniques that require management to make

estimates regarding the amount and timing of expected future cash flows. It also requires use of a discount rate that reflects the current return requirements of the market in relation to present risk-free interest rates, required equity market premiums, and company-specific risk indicators.

The Company evaluates goodwill for impairment on an annual basis, or more often if events or circumstances indicate there may be impairment. The implied fair value of the reporting units' goodwill is compared to its carrying amount and the impairment loss is measured by the excess of the carrying value over fair value. The fair value of each reporting unit is compared to the carrying amount of that reporting unit in order to determine if impairment is indicated.

Premises and Equipment

Premises and equipment are stated at cost less accumulated depreciation. Computer software costs that are capitalized only include external direct costs of obtaining and installing the software. The Company has not developed any internal use software. Depreciation is calculated using the straight-line method over the estimated useful lives of the assets. Useful lives range from five to ten years for equipment; three to seven years for software and hardware; and 10 to 40 years for building and building improvements. Land improvements are depreciated over 15 years and leasehold improvements are amortized over the shorter of the term of the respective lease plus any optional renewal periods that are reasonably assured or life of the asset. Maintenance and repairs are charged to expense as incurred.

Other Real Estate

Other real estate owned is comprised of properties acquired through foreclosure, or by deed in lieu of foreclosure. These assets are carried at fair value less estimated costs of disposal. At foreclosure, if the fair value, less estimated costs to sell, of the real estate acquired is less than the Company's recorded investment in the related loan, a write-down is recognized through a charge to the allowance for loan losses. Any subsequent reduction in value is recognized by a charge to income. Operating costs associated with the properties are charged to expense as incurred. At December 31, 2011 and 2010, other real estate, included in other assets, amounted to \$2.6 million and \$2.0 million, respectively.

Mortgage Servicing Rights

Originated mortgage servicing rights are recorded at their fair value at the time of sale of the underlying loan, and are amortized in proportion to and over the period of estimated net servicing income or loss. The Company uses a valuation model that calculates the present value of future cash flows to determine the fair value of servicing rights. In using this valuation method, the Company incorporates assumptions that market participants would use in estimating future net servicing income, which includes estimates of the servicing cost per loan, the discount rate, and prepayment speeds. The carrying value of the originated mortgage servicing rights is included in other assets and is evaluated quarterly for impairment using these same market assumptions.

Treasury Stock

Repurchases of shares of the Company's common stock are recorded at cost as a reduction of shareholders' equity. Reissuance of shares of treasury stock is recorded at average cost.

Income Taxes

The Company and its subsidiaries file a consolidated federal income tax return. Provisions for income taxes are based on taxes currently payable or refundable as well as deferred taxes that are based on temporary differences between the tax basis of assets and liabilities and their reported amounts in the financial statements. Deferred tax assets and liabilities are reported in the financial statements at currently enacted income tax rates applicable to the period in which the deferred tax assets and liabilities are expected to be realized or settled.

Benefits from tax positions should be recognized in the financial statements only when it is more likely than not that the tax position will be sustained upon examination by the appropriate taxing authority having full knowledge of all relevant information. A tax position meeting the more-likely-than-not recognition threshold should be measured at the largest amount of benefit for which the likelihood of realization upon ultimate settlement exceeds 50 percent.

Retirement Benefits

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

Assets Under Management or Administration

Assets held in fiduciary or agency capacities for customers are not included in the accompanying consolidated statements of condition as they are not assets of the Company. All fees associated with providing asset management services are recorded on an accrual basis of accounting and are included in noninterest income.

Advertising

Advertising costs amounting to approximately \$2.3 million, \$2.0 million and \$2.7 million for the years ending December 31, 2011, 2010 and 2009, respectively, are nondirect response in nature and expensed as incurred.

Earnings Per Share

Effective January 1, 2009, the Company adopted new authoritative accounting guidance under ASC 260, Earnings Per Share, which provides that unvested share-based payment awards that contain nonforfeitable rights to dividends are participating securities and shall be included in the computation of earnings per share pursuant to the two-class method. The Company has determined that its unvested restricted stock awards are participating securities. Accordingly, effective January 1, 2009, earnings per common share is computed using the two-class method prescribed by ASC 260. All previously reported earnings per share data has been retroactively adjusted to conform to the new computation method, resulting in minimal changes.

Using the two-class method, basic earnings per common share is computed based upon net income available to common shareholders divided by the weighted average number of common shares outstanding during each period, which exclude the outstanding unvested restricted stock. Diluted earnings per share is computed using the weighted average number of common shares determined for the basic earnings per common share computation plus the dilutive effect of stock options using the treasury stock method. Stock options where the exercise price is greater than the average market price of common shares were not included in the computation of earnings per diluted share as they would have been anti-dilutive.

Stock-based Compensation

Companies are required to measure and record compensation expense for stock options and other share-based payments on the instruments' fair value on the date of grant. The Company uses the modified prospective method. Under this method, expense is recognized for awards that are granted, modified, or settled after December 31, 2005, as well as for unvested awards that were granted prior to January 1, 2006. Stock-based compensation expense is recognized ratably over the requisite service period for all awards (see Note L).

Fair Values of Financial Instruments

The Company determines fair values based on quoted market values where available or on estimates using present values or other valuation techniques. Those techniques are significantly affected by the assumptions used, including the discount rate and estimates of future cash flows. In that regard, the derived fair value estimates cannot be substantiated by comparison to independent markets and, in many cases, could not be realized in immediate settlement of the instrument. Certain financial instruments and all nonfinancial instruments are excluded from this disclosure requirement. Accordingly, the aggregate fair value amounts presented do not represent the underlying value of the Company. The fair values of investment securities, loans, deposits, and borrowings have been disclosed in Note R.

Reclassifications

Certain reclassifications have been made to prior years' balances to conform to the current year presentation.

Subsequent Events

On January 19, 2012, the Bank, the wholly-owned banking subsidiary of the Company, entered into an Assignment, Purchase and Assumption Agreement (the "HSBC Branch Agreement") and a Purchase and Assumption Agreement (the "First Niagara Branch Agreement") (collectively, the "Agreements") with First Niagara Bank, N.A. ("First Niagara"). Under the Agreements, the Bank will acquire 19 branches in Central, Northern, and Western New York consisting of three branches purchased directly from First Niagara and 16 branches which are currently owned by HSBC Bank USA, National Association ("HSBC"). First Niagara is assigning its rights to the HSBC branches in connection with its pending acquisition of HSBC's Upstate New York banking franchise. Under the terms of the Agreements, Community Bank will acquire approximately \$218 million in loans and \$955 million in deposits at a blended deposit premium of 3.22%. The branch acquisitions are expected to close during the third quarter of 2012 subject to regulatory review and approval and customary closing conditions.

The Company completed a public stock offering in late January 2012. The offering raised \$57.5 million through the issuance of 2.13 million shares. The net proceeds of the offering were approximately \$54.9 million. The Company intends to use the net proceeds from this offering to support the HSBC and First Niagara branch acquisitions.

New Accounting Pronouncements

In June 2011, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update (ASU) No. 2011-05, Comprehensive Income (Topic 220) - Presentation of Comprehensive Income. This guidance eliminates the option to present the components of other comprehensive income as part of the statement of equity and requires an entity to present the total of comprehensive income, the components of net income, and the components of other comprehensive income either in a single continuous statement of comprehensive income or in two separate but

consecutive statements. The amendments are effective retrospectively for fiscal years, and interim periods within those years, beginning after December 15, 2011. On October 21, 2011, the FASB decided to propose a deferral of the new requirement to present reclassifications of other comprehensive income on the face of the income statement. Companies would still be required to adopt the other requirements contained in the new standard for the presentation of comprehensive income. The guidance requires changes in presentation only and will have no significant impact on the Company's consolidated financial statements.

In May 2011, the FASB and the International Accounting Standards Board both issued Common Fair Value Measurement and Disclosure Requirements in GAAP and International Financial Reporting Standards (IFRS). This new guidance results in a consistent definition of fair value and common requirements for measurement of and disclosures about fair value between GAAP and IFRS. While many of the amendments to GAAP are not expected to have a significant effect on practice, the new guidance changes some fair value measurement principles and disclosure requirements currently in GAAP. The new guidance goes into effect on January 1, 2012 for the Company and will be applied prospectively. The Company is currently evaluating the effect of the adoption of this guidance on the Company's financial condition, results of operations, and cash flows.

In September 2011, the FASB issued ASU No. 2011-8, Intangibles—Goodwill and Other (Topic 350): Testing Goodwill for Impairment. This pronouncement amends its guidance for goodwill impairment testing by allowing entities to first assess qualitative factors in determining whether or not the fair value of a reporting unit exceeds its carrying value. If an entity concludes from this qualitative assessment that it is more likely than not that the fair value of a reporting unit exceeds its carrying value, then performing a two-step impairment test is unnecessary. This standard is effective for fiscal years beginning after December 15, 2011. The adoption of this standard is not expected to have an impact on the Company's consolidated financial statements.

In December 2011, the FASB issued ASU No. 2011-11—Balance Sheet (Topic 210): Disclosures about Offsetting Assets and Liabilities. The standard requires new disclosures about certain financial instruments and derivative instruments that are either offset in the balance sheet (presented on a net basis) or subject to an enforceable master netting arrangement or similar arrangement. The standard requires disclosures that provide both gross and net information in the notes to the financial statements for relevant assets and liabilities. The new requirements do not change the accounting guidance on netting, but rather enhance the disclosures to more clearly show the impact of netting arrangements on a company's financial position. This new accounting guidance will be effective, on a retrospective basis for all comparative periods presented, beginning on January 1, 2013. The adoption of this standard is not expected to have an impact on the Company's consolidated financial statements.

NOTE B: ACQUISITIONS

On November 30, 2011 the Company, through its BPAS subsidiary, acquired certain assets and liabilities of CAI Benefits, Inc. ("CAI"), a provider of actuarial, consulting and retirement plan administration services, with offices in New York City and Northern New Jersey. The results of CAI's operations have been included in the consolidated financial statements since that date. The transaction adds valuable service capacity and enhances distribution prospects in support of the Company's broader-based employee benefits business, including daily valuation plan and collective investment fund administration.

On April 8, 2011, the Company acquired The Wilber Corporation ("Wilber"), parent company of Wilber National Bank, for approximately \$103 million in stock and cash, comprised of \$20.4 million in cash and the issuance of 3.35 million additional shares of the Company's common stock. Based in Oneonta, New York, Wilber operated 22 branches in the Central, Greater Capital District, and Catskill regions of Upstate New York. Wilber was merged into the Company and Wilber National Bank was merged into Community Bank, N.A. The results of Wilber's operations have been included in the Company's financial statements since that date.

The assets and liabilities assumed in these acquisitions were recorded at their estimated fair values based on management's best estimates using information available at the dates of the acquisitions. The following table summarizes the estimated fair value of the assets acquired and liabilities assumed.

| | |
|---|----------|
| (000's omitted) | |
| Consideration paid: | |
| Community Bank System, Inc. common stock | \$82,580 |
| Cash | 22,155 |
| | 104,735 |

| | |
|---|-----------|
| Total consideration paid | |
| Recognized amounts of identifiable assets acquired and liabilities assumed: | |
| Cash and cash equivalents | 26,901 |
| Investment securities | 297,573 |
| Loans | 462,334 |
| Premises and equipment | 6,360 |
| Accrued interest receivable | 2,615 |
| Other assets and liabilities, net | 46,943 |
| Core deposit intangibles | 4,015 |
| Other intangibles | 1,858 |
| Deposits | (771,554) |
| Borrowings | (19,668) |
| Total identifiable assets | 57,377 |
| Goodwill | \$ 47,358 |

The above recognized amounts of assets and liabilities, at fair value, are subject to adjustment based on updated information not available at the time of acquisition.

Acquired loans that have evidence of deterioration in credit quality since origination and for which it is probable, at acquisition, that the Company will be unable to collect all contractually required payments were aggregated by comparable characteristics and recorded at fair value without a carryover of the related allowance for loan losses. Cash flows for each pool were determined using an estimate of future credit losses and an estimated rate of prepayments. Projected monthly cash flows were then discounted to present value using a market-based discount rate. The excess of the undiscounted expected cash flows over the estimated fair value is referred to as the “accretable yield” and is recognized into interest income over the remaining lives of the acquired loans.

The following is a summary of the loans acquired in the Wilber acquisition:

| (000's omitted) | Acquired Impaired Loans | Acquired Non-Impaired Loans | Total Acquired Loans |
|--|-------------------------------|-----------------------------------|----------------------------|
| Contractually required principal and interest at acquisition | \$41,730 | \$680,516 | \$722,246 |
| Contractual cash flows not expected to be collected | (20,061) | (31,115) | (51,176) |
| Expected cash flows at acquisition | 21,669 | 649,401 | 671,070 |
| Interest component of expected cash flows | (2,509) | (206,227) | (208,736) |
| Fair value of acquired loans | \$19,160 | \$443,174 | \$462,334 |

The core deposit intangible and customer lists are being amortized over their estimated useful life of approximately eight years, using an accelerated method. The goodwill, which is not amortized for book purposes, was assigned to the Banking segment for the Wilber acquisition and to the Other segment for the CAI acquisition. The goodwill arising from the Wilber acquisition is not deductible for tax purposes while goodwill arising from the CAI acquisition is deductible for tax purposes.

The fair value of checking, savings and money market deposit accounts acquired from Wilber were assumed to approximate the carrying value as these accounts have no stated maturity and are payable on demand. Certificate of deposit accounts were valued as the present value of the certificates expected contractual payments discounted at market rates for similar certificates.

Direct costs related to the acquisitions were expensed as incurred. During 2011, the Company incurred \$4.8 million of merger and acquisition integration related expenses and have been separately stated in the Consolidated Statements of Income.

Supplemental Pro Forma Financial Information

The following unaudited condensed pro forma information assumes the Wilber acquisition had been completed as of January 1, 2011 for the year ended December 31, 2011 and January 1, 2010 for the year ended December 31, 2010. The pro forma information does not include amounts related to CAI as the amounts were immaterial and financial information is not available. The table below has been prepared for comparative purposes only and is not necessarily indicative of the actual results that would have been attained had the acquisition occurred as of the beginning of the years presented, nor is it indicative of the Company's future results. Furthermore, the unaudited pro forma information does not reflect management's estimate of any revenue-enhancing opportunities nor anticipated cost savings or the impact of conforming certain acquiree accounting policies to the Company's policies that may have occurred as a result of the integration and consolidation of the acquisitions.

The pro forma information set forth below reflects adjustments related to (a) certain purchase accounting fair value adjustments; (b) amortization of core deposit and other intangibles; and (c) income tax rate adjustment. Expenses related to the conversion of systems and other costs of integration, as well as certain one-time costs, are included in the periods in which they were incurred.

| | Pro Forma (Unaudited) Year Ended December 31, | |
|--|--|-----------|
| (000's omitted) | 2011 | 2010 |
| Total revenue, net of interest expense | \$308,559 | \$314,425 |
| Net income | 70,424 | 68,176 |
| Earnings per share: | | |
| Basic | \$1.92 | \$1.88 |
| Diluted | \$1.89 | \$1.85 |

NOTE C: INVESTMENT SECURITIES

The amortized cost and estimated fair value of investment securities as of December 31 are as follows:

| (000's omitted) | 2011 | | | | 2010 | | | |
|---|------------------|------------------------|-------------------------|----------------------|------------------|------------------------|-------------------------|----------------------|
| | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Estimated Fair Value | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Estimated Fair Value |
| Held-to-Maturity Portfolio: | | | | | | | | |
| U.S. Treasury and agency securities | \$448,260 | \$56,800 | \$0 | \$505,060 | \$478,100 | \$21,571 | \$29 | \$499,642 |
| Obligations of state and political subdivisions | 69,623 | 5,088 | 0 | 74,711 | 67,864 | 277 | 1,691 | 66,450 |
| Government agency mortgage-backed securities | 35,576 | 2,452 | 0 | 38,028 | 56,891 | 2,753 | 0 | 59,644 |
| Other securities | 36 | 0 | 0 | 36 | 53 | 0 | 0 | 53 |
| Total held-to-maturity portfolio | 553,495 | \$64,340 | \$0 | \$617,835 | 602,908 | \$24,601 | \$1,720 | \$625,789 |
| Available-for-Sale Portfolio: | | | | | | | | |
| Obligations of state and political subdivisions | 543,527 | \$29,721 | \$236 | 573,012 | 518,216 | \$10,197 | \$6,195 | 522,218 |
| U.S. Treasury and agency securities | 463,922 | 56,626 | 0 | 520,548 | 281,826 | 22,231 | 0 | 304,057 |
| Government agency mortgage-backed securities | 310,541 | 20,840 | 2 | 331,379 | 170,673 | 9,159 | 116 | 179,716 |
| Pooled trust preferred securities | 68,115 | 0 | 24,269 | 43,846 | 69,508 | 0 | 27,515 | 41,993 |
| Government agency collateralized mortgage obligations | 45,481 | 1,572 | 110 | 46,943 | 9,904 | 491 | 0 | 10,395 |
| Corporate debt securities | 21,495 | 1,360 | 0 | 22,855 | 25,523 | 1,634 | 0 | 27,157 |
| Marketable equity securities | 380 | 92 | 82 | 390 | 380 | 54 | 7 | 427 |
| Subtotal | 1,453,461 | 110,211 | 24,699 | 1,538,973 | 1,076,030 | 43,766 | 33,833 | 1,085,963 |
| Net unrealized gain on | 85,512 | | | - | 9,933 | | | - |

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| | | | | | | | | |
|-------------------------------------|-------------|-----------|----------|-------------|-------------|----------|----------|-------------|
| available-for-sale portfolio | | | | | | | | |
| Total available-for-sale portfolio | 1,538,973 | \$110,211 | \$24,699 | 1,538,973 | 1,085,963 | \$43,766 | \$33,833 | 1,085,963 |
| Other Securities: | | | | | | | | |
| Federal Home Loan Bank common stock | 38,343 | | | 38,343 | 37,301 | | | 37,301 |
| Federal Reserve Bank common stock | 15,451 | | | 15,451 | 12,378 | | | 12,378 |
| Other equity securities | 5,108 | | | 5,108 | 3,774 | | | 3,774 |
| Total other securities | 58,902 | | | 58,902 | 53,453 | | | 53,453 |
| Total | \$2,151,370 | | | \$2,215,710 | \$1,742,324 | | | \$1,765,205 |

A summary of investment securities that have been in a continuous unrealized loss position for less than or greater than twelve months is as follows:

As of December 31, 2011

| | Less than 12 Months | | 12 Months or Longer | | Total | | | | |
|---|---------------------|------------|---------------------|------------|----------|------------|----|----------|----------|
| | Gross | | Gross | | Gross | | | | |
| | Fair | Unrealized | Fair | Unrealized | Fair | Unrealized | | | |
| (000's omitted) | # | Value | Losses | # | Value | Losses | # | Value | Losses |
| Available-for-Sale Portfolio: | | | | | | | | | |
| Obligations of state and political subdivisions | 2 | \$211 | \$0 | 6 | \$6,038 | \$236 | 8 | \$6,249 | \$236 |
| Pooled trust preferred securities | 0 | 0 | 0 | 3 | 43,019 | 24,269 | 3 | 43,019 | 24,269 |
| Government agency mortgage-backed securities | 3 | 2,415 | 2 | 0 | 0 | 0 | 3 | 2,415 | 2 |
| Government agency collateralized mortgage obligations | 17 | 6,648 | 110 | 0 | 0 | 0 | 17 | 6,648 | 110 |
| Marketable equity securities | 1 | 123 | 78 | 3 | 12 | 4 | 4 | 135 | 82 |
| Total available-for-sale/investment portfolio | 23 | \$9,397 | \$190 | 12 | \$49,069 | \$24,509 | 35 | \$58,466 | \$24,699 |

As of December 31, 2010

| (000's omitted) | # | Less than 12 Months | | 12 Months or Longer | | | Total | | |
|---|------------|---------------------|-------------------------|---------------------|-----------------|-------------------------|------------|------------------|-------------------------|
| | | Fair Value | Gross Unrealized Losses | # | Fair Value | Gross Unrealized Losses | # | Fair Value | Gross Unrealized Losses |
| Held-to-Maturity Portfolio: | | | | | | | | | |
| U.S. Treasury and agency securities | 2 | \$14,967 | \$29 | 0 | \$0 | \$0 | 2 | \$14,967 | \$29 |
| Obligations of state and political subdivisions | 48 | 43,851 | 1,691 | 0 | 0 | 0 | 48 | 43,851 | 1,691 |
| Total held-to-maturity portfolio | 50 | 58,818 | 1,720 | 0 | 0 | 0 | 50 | 58,818 | 1,720 |
| Available-for-Sale Portfolio: | | | | | | | | | |
| Obligations of state and political subdivisions | 174 | 197,066 | 5,705 | 4 | 4,049 | 490 | 178 | 201,115 | 6,195 |
| Pooled trust preferred securities | 0 | 0 | 0 | 3 | 41,993 | 27,515 | 3 | 41,993 | 27,515 |
| Government agency mortgage-backed securities | 6 | 14,690 | 116 | 0 | 0 | 0 | 6 | 14,690 | 116 |
| Marketable equity securities | 2 | 210 | 2 | 3 | 11 | 5 | 5 | 221 | 7 |
| Total available-for-sale portfolio | 182 | 211,966 | 5,823 | 10 | 46,053 | 28,010 | 192 | 258,019 | 33,833 |
| Total investment portfolio | 232 | \$270,784 | \$7,543 | 10 | \$46,053 | \$28,010 | 242 | \$316,837 | \$35,553 |

Included in the available-for-sale portfolio are pooled trust preferred, class A-1 securities with a current par value of \$69.6 million and unrealized losses of \$24.3 million at December 31, 2011. The underlying collateral of these assets is principally trust-preferred securities of smaller regional banks and insurance companies. The Company's securities are in the super-senior cash flow tranche of the investment pools. All other tranches in these pools will incur losses before this tranche is impacted. An additional 35% - 38% of the underlying collateral would have to be in deferral or default concurrently to result in the non-receipt of contractual cash flows.

In determining if unrealized losses are other-than-temporary, management considers the following factors: the length of time and extent that fair value has been less than cost, the financial condition and near term prospects of the issuers, any external credit ratings, the level of excess cash flows generated from the underlying collateral supporting the principal and interest payments of the debt securities, the level of credit enhancement provided by the structure, and the Company's ability and intent to hold the security for a period sufficient to allow for any anticipated recovery in fair value. A detailed review of the pooled trust preferred securities was completed as of December 31, 2011. This review included an analysis of collateral reports, a cash flow analysis, including varying degrees of projected deferral/default scenarios, and a review of various financial ratios of the underlying issuers. Based on the analysis performed, significant further deferral/defaults and further erosion in other underlying performance conditions would have to exist before the Company would incur a loss. Therefore, the Company determined an other-than-temporary impairment did not exist at December 31, 2011. To date, the Company has received all scheduled principal and interest payments and expects to fully collect all future contractual principal and interest payments. The Company does not intend to sell the securities nor is it more likely than not that the Company will be required to sell the securities. Subsequent changes in market or credit conditions could change those evaluations.

Management does not believe any individual unrealized loss as of December 31, 2011 represents an other-than-temporary impairment. The unrealized losses reported pertaining to government guaranteed mortgage-backed securities relate primarily to securities issued by GNMA, FNMA and FHLMC, who are currently rated AAA by Moody's Investor Services, AA+ by Standard & Poor's and are guaranteed by the U.S. government. The obligations of state and political subdivisions are largely general-purpose debt obligations of various states and political subdivisions. The majority of the municipal portfolio carries a credit rating of A or better, as well as, a secondary level of credit enhancement. The unrealized losses in the portfolios are primarily attributable to changes in interest rates. The Company does not intend to sell these securities, nor is it more likely than not that the Company will be required to sell these securities prior to recovery of the amortized cost.

The amortized cost and estimated fair value of debt securities at December 31, 2011, by contractual maturity, are shown below. Expected maturities will differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

| (000's omitted) | Held-to-Maturity | | Available-for-Sale | |
|--|------------------|------------|--------------------|-------------|
| | Amortized Cost | Fair Value | Amortized Cost | Fair Value |
| Due in one year or less | \$11,074 | \$11,183 | \$30,838 | \$31,243 |
| Due after one through five years | 152,584 | 169,672 | 211,594 | 224,297 |
| Due after five years through ten years | 285,481 | 321,967 | 413,159 | 449,799 |
| Due after ten years | 68,780 | 76,985 | 441,468 | 454,922 |
| Subtotal | 517,919 | 579,807 | 1,097,059 | 1,160,261 |
| Collateralized mortgage obligations | 0 | 0 | 45,481 | 46,943 |
| Mortgage-backed securities | 35,576 | 38,028 | 310,541 | 331,379 |
| Total | \$553,495 | \$617,835 | \$1,453,081 | \$1,538,583 |

Cash flow information on investment securities for the years ended December 31 is as follows:

| (000's omitted) | 2011 | 2010 | 2009 |
|--|---------|--------|---------|
| Gross gains on sales of investment securities | 349 | 0 | 7 |
| Gross losses on sales of investment securities | 319 | 0 | 0 |
| Proceeds from the maturities of mortgage-backed securities and CMO's | 97,224 | 93,171 | 101,176 |
| Purchases of mortgage-backed securities and CMO's | 253,378 | 9,132 | 214,275 |

Investment securities with a carrying value of \$1.015 billion and \$848.6 million at December 31, 2011 and 2010, respectively, were pledged to collateralize certain deposits and borrowings.

NOTE D: LOANS

The segments of the Company's loan portfolio are disaggregated into levels that allow management to monitor risk and performance. Consumer mortgages consist primarily of fixed rate residential instruments, typically 15 – 30 years in contractual term, secured by first liens on a property. Business lending is comprised of general purpose commercial and industrial loans including agricultural-related and dealer floor plans, as well as mortgages on commercial property. Consumer installment – indirect consists primarily of loans originated through selected dealerships and are secured by automobiles, marine and other recreational vehicles. Home equity products are consumer purpose

installment loans or lines of credit most often secured by a first or second lien position on residential real estate with terms of 15 years or less. Consumer installment – direct are all other loans to consumers such as personal installment loans and lines of credit. Loans at December 31 are summarized as follows:

| (000's omitted) | 2011 | 2010 |
|---|-------------|-------------|
| Consumer mortgage | \$1,214,621 | \$1,057,332 |
| Business lending | 1,226,439 | 1,023,286 |
| Consumer installment - indirect | 556,955 | 494,529 |
| Consumer installment - direct | 149,170 | 146,575 |
| Home equity | 323,840 | 304,641 |
| Gross loans, including deferred origination costs | 3,471,025 | 3,026,363 |
| Allowance for loan losses | (42,213) | (42,510) |
| Loans, net of allowance for loan losses | \$3,428,812 | \$2,983,853 |

The Company had approximately \$13.7 million and \$12.3 million of net deferred loan origination costs as of December 31, 2011 and 2010, respectively.

Certain directors and executive officers of the Company, as well as associates of such persons, are loan customers. Loans to these individuals were made in the ordinary course of business under normal credit terms and do not have more than a normal risk of collection. Following is a summary of the aggregate amount of such loans during 2011 and 2010.

| | | |
|------------------------------------|----------|----------|
| (000's omitted) | 2011 | 2010 |
| Balance at beginning of year | \$18,765 | \$28,289 |
| New loans | 2,690 | 3,050 |
| Payments | (9,905) | (12,574) |
| Balance at end of year | \$11,550 | \$18,765 |

Credit Quality

Management monitors the credit quality of its loan portfolio on an ongoing basis. Measurement of delinquency and past due status are based on the contractual terms of each loan. Past due loans are reviewed on a monthly basis to identify loans for non-accrual status. The following is an aged analysis of the Company's past due loans, by class as of December 31, 2011:

Legacy Loans (excludes loans acquired after January 1, 2009)

| (000's omitted) | 30 - 89 days | 90+ Days Past Due | | Total Past Due | Total Current | Total Loans |
|---------------------------------------|-----------------|--------------------------|------------|----------------------|------------------|----------------|
| | | and Still Accruing | Nonaccrual | | | |
| Consumer mortgage | \$16,026 | \$2,144 | \$5,755 | \$23,925 | \$1,111,795 | \$1,135,720 |
| Business lending | 4,799 | 389 | 10,966 | 16,154 | 953,745 | 969,899 |
| Consumer installment - indirect | 8,847 | 32 | 0 | 8,879 | 527,030 | 535,909 |
| Consumer installment - direct | 1,912 | 95 | 0 | 2,007 | 138,500 | 140,507 |
| Home equity | 2,269 | 218 | 864 | 3,351 | 290,093 | 293,444 |
| Total | \$33,853 | \$2,878 | \$17,585 | \$54,316 | \$3,021,163 | \$3,075,479 |

Acquired Loans (includes loans acquired after January 1, 2009)

| (000's omitted) | 30 - 89 days | 90+ Days Past Due | | Total Past Due | Purchased Impaired | Total Current | Total Loans |
|--------------------|-----------------|--------------------------|------------|----------------------|-----------------------|------------------|----------------|
| | | and Still Accruing | Nonaccrual | | | | |

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| | | | | | | | |
|---------------------------------|---------|-------|----------|----------|----------|-----------|-----------|
| Consumer mortgage | \$985 | \$27 | \$765 | \$1,777 | \$0 | \$77,124 | \$78,901 |
| Business lending | 3,473 | 10 | 9,592 | 13,075 | 17,428 | 226,037 | 256,540 |
| Consumer installment - indirect | 737 | 0 | 2 | 739 | 0 | 20,307 | 21,046 |
| Consumer installment - direct | 167 | 0 | 0 | 167 | 0 | 8,496 | 8,663 |
| Home equity | 465 | 175 | 341 | 981 | 0 | 29,415 | 30,396 |
| Total | \$5,827 | \$212 | \$10,700 | \$16,739 | \$17,428 | \$361,379 | \$395,546 |

The following is an aged analysis of the Company's past due loans by class as of December 31, 2010:

| (000's omitted) | 90+ Days Past Due and | | | Total Past Due | Current | Total Loans |
|---------------------------------|-----------------------|----------------|------------|----------------|-------------|-------------|
| | 30 - 89 days | Still Accruing | Nonaccrual | | | |
| Consumer mortgage | \$16,614 | \$2,308 | \$4,737 | \$23,659 | \$1,033,673 | \$1,057,332 |
| Business lending | 5,965 | 247 | 9,715 | 15,927 | 1,007,359 | 1,023,286 |
| Consumer installment - indirect | 10,246 | 131 | 0 | 10,377 | 484,152 | 494,529 |
| Consumer installment - direct | 2,514 | 96 | 0 | 2,610 | 143,965 | 146,575 |
| Home equity | 3,960 | 309 | 926 | 5,195 | 299,446 | 304,641 |
| Total | \$39,299 | \$3,091 | \$15,378 | \$57,768 | \$2,968,595 | \$3,026,363 |

The Company uses several credit quality indicators to assess credit risk in an ongoing manner. The Company's primary credit quality indicator for its business lending portfolio is an internal credit risk rating system that categorizes loans as "pass", "special mention", or "classified". Credit risk ratings are applied individually to those classes of loans that have significant or unique credit characteristics that benefit from a case-by-case evaluation. The following are the definitions of the Company's credit quality indicators:

| | |
|-----------------|---|
| Pass | In general, the condition of the borrower and the performance of the loans are satisfactory or better. |
| Special mention | In general, the condition of the borrower has deteriorated although the loan performs as agreed. |
| Classified | In general, the condition of the borrower has significantly deteriorated and the performance of the loan could further deteriorate if deficiencies are not corrected. |

The following table shows the amount of business lending loans by credit quality category:

| (000's omitted) | December 31, 2011 | | | December 31, 2010 |
|--------------------|-------------------|------------------|--------------------|--------------------|
| | Legacy | Acquired | Total | |
| Pass | \$732,873 | \$157,494 | \$890,367 | \$753,252 |
| Special mention | 118,800 | 47,890 | 166,690 | 159,906 |
| Classified | 118,226 | 33,728 | 151,954 | 110,128 |
| Purchased impaired | 0 | 17,428 | 17,428 | 0 |
| Total | \$969,899 | \$256,540 | \$1,226,439 | \$1,023,286 |

All other loans are underwritten and structured using standardized criteria and characteristics, primarily payment performance, and are normally risk rated and monitored collectively on a monthly basis. These are typically loans to individuals in the consumer categories and are delineated as either performing or nonperforming.

The following tables detail the balances in all loan categories except for business lending at December 31, 2011:

Legacy loans (excludes loans acquired after January 1, 2009)

| (000's omitted) | Consumer Mortgage | Consumer Indirect | Consumer Direct | Home Equity | Total |
|-----------------|--------------------|-------------------|------------------|------------------|--------------------|
| Performing | \$1,127,821 | \$535,877 | \$140,412 | \$292,362 | \$2,096,472 |
| Nonperforming | 7,899 | 32 | 95 | 1,082 | 9,108 |
| Total | \$1,135,720 | \$535,909 | \$140,507 | \$293,444 | \$2,105,580 |

Acquired loans (includes loans acquired after January 1, 2009)

| (000's omitted) | Consumer Mortgage | Consumer Indirect | Consumer Direct | Home Equity | Total |
|-----------------|-------------------|-------------------|-----------------|-----------------|------------------|
| Performing | \$78,109 | \$21,044 | \$8,663 | \$29,880 | \$137,696 |
| Nonperforming | 792 | 2 | 0 | 516 | 1,310 |
| Total | \$78,901 | \$21,046 | \$8,663 | \$30,396 | \$139,006 |

The following table details the balances in all other loan categories at December 31, 2010:

| | Consumer | Consumer | Consumer | Home | |
|-----------------|-------------|-----------|-----------|-----------|-------------|
| (000's omitted) | Mortgage | Indirect | Direct | Equity | Total |
| Performing | \$1,052,595 | \$494,529 | \$146,575 | \$303,715 | \$1,997,414 |
| Nonperforming | 4,737 | 0 | 0 | 926 | 5,663 |
| Total | \$1,057,332 | \$494,529 | \$146,575 | \$304,641 | \$2,003,077 |

All loan classes are collectively evaluated for impairment except business lending, as described in Note A. A summary of impaired loans, excluding purchased impaired, as of December 31, 2011 and 2010 are summarized as follows:

| (000's omitted) | 2011 | 2010 |
|----------------------------------|---------|---------|
| Loans with reserve | \$4,118 | \$1,465 |
| Loans without reserve | 2,308 | 3,846 |
| Carrying balance | 6,426 | 5,311 |
| Contractual balance | 8,527 | 7,042 |
| Specifically allocated allowance | 895 | 762 |
| Average impaired loans | 5,652 | 9,752 |
| Interest income recognized | 314 | 263 |
| Troubled debt restructured loans | 0 | 0 |

The changes in the accretable discount related to the credit impaired acquired loans are as follows:

| | |
|---|---------|
| Balance at December 31, 2010 | \$0 |
| Wilber acquisition | 2,509 |
| Accretion income recognized, to-date | (844) |
| Net reclassification from nonaccretable to accretable | 945 |
| Balance at December 31, 2011 | \$2,610 |

Allowance for Loan Losses

The allowance for loan losses is general in nature and is available to absorb losses from any loan type despite the analysis below. The following presents by class the activity in the allowance for loan losses:

| (000's omitted) | Consumer Business Home Consumer Consumer | | | | | Acquired | | Total |
|------------------------------------|--|----------|---------|----------|---------|-------------|----------|----------|
| | Mortgage | Lending | Equity | Indirect | Direct | Unallocated | Impaired | |
| Balance at December 31, 2009 | \$1,127 | \$23,577 | \$374 | \$10,004 | \$3,660 | \$3,168 | \$0 | \$41,910 |
| Charge-offs | (583) | (3,950) | (181) | (4,279) | (1,719) | 0 | 0 | (10,712) |
| Recoveries | 71 | 730 | 7 | 2,569 | 730 | 0 | 0 | 4,107 |
| Provision | 1,836 | 1,969 | 489 | 1,628 | 1,306 | (23) | 0 | 7,205 |
| Balance at December 31, 2010 | 2,451 | 22,326 | 689 | 9,922 | 3,977 | 3,145 | 0 | 42,510 |
| Charge-offs | (748) | (2,964) | (265) | (4,464) | (1,273) | 0 | 0 | (9,714) |
| Recoveries | 30 | 692 | 85 | 3,200 | 674 | 0 | 0 | 4,681 |
| Provision | 2,918 | 520 | 621 | 302 | (88) | 77 | 386 | 4,736 |
| Balance at December 31, 2011 | \$4,651 | \$20,574 | \$1,130 | \$8,960 | \$3,290 | \$3,222 | \$386 | \$42,213 |

NOTE E: PREMISES AND EQUIPMENT

Premises and equipment consist of the following at December 31:

| (000's omitted) | 2011 | 2010 |
|---|----------|----------|
| Land and land improvements | \$15,069 | \$13,300 |
| Bank premises | 86,318 | 76,980 |
| Equipment and construction in progress | 75,074 | 71,863 |
| Premises and equipment, gross | 176,461 | 162,143 |
| Accumulated depreciation | (90,505) | (80,582) |
| Premises and equipment, net | \$85,956 | \$81,561 |

NOTE F: GOODWILL AND IDENTIFIABLE INTANGIBLE ASSETS

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

| (000's omitted) | As of December 31, 2011 | | As of December 31, 2010 | | Carrying Amount | Net Carrying Amount |
|--------------------------------------|-------------------------|--------------------------|-------------------------|--------------------------|-------------------|---------------------|
| | Gross Carrying Amount | Accumulated Amortization | Gross Carrying Amount | Accumulated Amortization | | |
| Amortizing intangible assets: | | | | | | |
| Core deposit intangibles | \$64,610 | (\$53,091) | \$11,519 | \$60,595 | (\$49,698) | \$10,897 |
| Other intangibles | 9,752 | (5,757) | 3,995 | 7,894 | (4,769) | 3,125 |
| Total amortizing intangibles | \$74,362 | (\$58,848) | \$15,514 | \$68,489 | (\$54,467) | \$14,022 |

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

| | |
|--------------|-----------------|
| 2012 | 4,112 |
| 2013 | 3,304 |
| 2014 | 2,579 |
| 2015 | 1,905 |
| 2016 | 1,314 |
| Thereafter | 2,300 |
| Total | \$15,514 |

Shown below are the components of the Company's goodwill at December 31, 2011 and 2010:

| (000's omitted) | Year Ended December 31, 2009 | | Year Ended December 31, 2010 | | Year Ended December 31, 2011 | |
|------------------------|------------------------------|------------|------------------------------|-----------------|------------------------------|--|
| | Activity | | Activity | | Activity | |
| Goodwill | \$302,516 | \$0 | \$302,516 | \$47,358 | \$349,874 | |
| Accumulated impairment | (4,824) | 0 | (4,824) | 0 | (4,824) | |
| Goodwill, net | \$297,692 | \$0 | \$297,692 | \$47,358 | \$345,050 | |

During the first quarter, the Company performed its annual internal valuation of goodwill and impairment analysis by comparing the fair value of each reporting unit to its carrying value. Results of the valuations indicate there was no goodwill impairment.

Mortgage Servicing Rights

Under certain circumstances, the Company sells consumer residential mortgage loans in the secondary market and typically retains the right to service the loans sold. Generally, the Company's residential mortgage loans sold to third parties are sold on a non-recourse basis. Upon sale, a mortgage servicing right ("MSR") is established, which represents the then current fair value of future net cash flows expected to be realized for performing the servicing activities. The Company stratifies these assets based on predominant risk characteristics, namely expected term of the underlying

financial instruments, and uses a valuation model that calculates the present value of future cash flows to determine the fair value of servicing rights. MSR's are recorded in other assets at the lower of the initial capitalized amount, net of accumulated amortization or fair value. Mortgage loans serviced for others are not included in the accompanying consolidated statements of condition.

The following table summarizes the changes in carrying value of MSR's and the associated valuation allowance:

| (000's omitted) | 2011 | 2010 |
|---|-----------|-----------|
| Balance at beginning of period | \$2,773 | \$2,551 |
| Additions | 239 | 991 |
| Amortization | (867) | (769) |
| Carrying value before valuation allowance at end of period | 2,145 | 2,773 |
| Valuation allowance balance at beginning of period | (351) | (80) |
| Impairment charges | (526) | (351) |
| Impairment recoveries | 480 | 80 |
| Valuation allowance balance at end of period | (397) | (351) |
| Net carrying value at end of period | \$1,748 | \$2,422 |
| Fair value of MSR's at end of period | \$1,748 | \$2,422 |
| Principal balance of loans sold during the year | \$34,625 | \$119,018 |
| Principal balance of loans serviced for others | \$458,836 | \$496,269 |
| Custodial escrow balances maintained in connection with loans serviced for others | \$5,823 | \$6,139 |

The following table summarizes the key economic assumptions used to estimate the value of the MSR's at December 31:

| | 2011 | 2010 |
|---|-------|-------|
| Weighted-average contractual life (in years) | 19.5 | 20.2 |
| Weighted-average constant prepayment rate (CPR) | 24.7% | 19.2% |
| Weighted-average discount rate | 3.2% | 4.9% |

NOTE G: DEPOSITS

Deposits consist of the following at December 31:

| (000's omitted) | 2011 | 2010 |
|----------------------|-----------|-----------|
| Noninterest checking | \$894,464 | \$741,166 |

| | | |
|----------|-------------|-------------|
| Interest | | |
| checking | 918,716 | 721,391 |
| Savings | 660,981 | 546,649 |
| Money | | |
| market | 1,196,835 | 1,003,973 |
| Time | 1,124,249 | 920,866 |
| Total | | |
| deposits | \$4,795,245 | \$3,934,045 |

At December 31, 2011 and 2010, time certificates of deposit in denominations of \$100,000 and greater totaled \$288.4 million and \$187.6 million, respectively. The approximate maturities of these time deposits at December 31, 2011 are as follows:

| | |
|------------|-----------|
| (000's | |
| omitted) | Amount |
| 2012 | \$193,223 |
| 2013 | 44,992 |
| 2014 | 26,746 |
| 2015 | 9,610 |
| 2016 | 10,648 |
| Thereafter | 3,167 |
| Total | \$288,386 |

NOTE H: BORROWINGS

Outstanding borrowings at December 31 are as follows:

| (000's omitted) | 2011 | 2010 |
|------------------------|-----------|-----------|
| Federal Home Loan | | |
| Bank advances | \$728,235 | \$728,428 |
| Commercial loans sold | | |
| with recourse | 0 | 26 |
| Capital lease | | |
| obligations | 46 | 6 |
| Subordinated debt held | | |
| by unconsolidated | | |
| subsidiary trusts, | | |
| net of discount of | | |
| \$479 and \$503, | | |
| respectively | 102,048 | 102,024 |
| Total borrowings | \$830,329 | \$830,484 |

Borrowings at December 31, 2011 have contractual maturity dates as follows:

| (000's omitted, except rate) | Carrying Value | Weighted-average Rate at December 31, 2011 |
|------------------------------|----------------|--|
| July 15, 2012 | \$3 | 4.30% |
| January 17, 2013 | 235 | 4.00% |
| April 1, 2013 | 6 | 5.55% |
| January 1, 2014 | 5 | 7.42% |
| February 1, 2015 | 32 | 3.25% |
| June 22, 2015 (Callable) | 50,000 | 3.62% |
| October 14, 2015 (Callable) | 15,000 | 3.95% |
| November 10, 2015 (Callable) | 75,000 | 4.24% |
| January 27, 2016 | 10,000 | 3.98% |

| | | |
|----------------------|-----------|-------|
| (Callable) | | |
| May 19, 2016 | | |
| (Callable) | 100,000 | 4.72% |
| August 8, 2016 | | |
| (Callable) | 60,000 | 4.28% |
| October 11, 2016 | | |
| (Callable) | 25,000 | 4.62% |
| October 11, 2016 | | |
| (Callable) | 25,000 | 4.35% |
| July 31, 2017 | | |
| (Callable) | 50,000 | 4.05% |
| July 31, 2017 | | |
| (Callable) | 50,000 | 4.04% |
| July 31, 2017 | | |
| (Callable) | 100,000 | 4.03% |
| December 21, 2017 | | |
| (Callable) | 31,600 | 3.16% |
| December 21, 2017 | | |
| (Callable) | 126,400 | 3.40% |
| January 25, 2018 | | |
| (Callable) | 10,000 | 2.73% |
| July 31, 2031 | 24,728 | 4.01% |
| December 15, 2036 | 77,320 | 2.20% |
| Total | \$830,329 | 3.84% |

The weighted-average interest rate on borrowings was 4.25% and 4.29% for the years ended December 31, 2011 and 2010, respectively. Instruments noted above as callable are Federal Home Loan Bank advances. These advances have characteristics that include an initial lockout period, followed by a quarterly call option at the discretion of the Federal Home Loan Bank. Federal Home Loan Bank advances are collateralized by a blanket lien on the Company's residential real estate loan portfolio and various investment securities.

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

| Issuance Date | Amount | Interest Rate | Maturity Date | Call Provision | Call Price |
|------------------|----------|---|------------------|-----------------------------|---------------|
| III 7/31/2001 | \$24,450 | 3 month LIBOR plus 3.58% (4.01%) | 7/31/2031 | 5 year beginning 2006 | Par |
| IV 12/8/2006 | \$75,000 | 3 month LIBOR plus 1.65% (2.20%) | 12/15/2036 | 5 year beginning 2011 | Par |

On December 8, 2006, the Company established Community Capital Trust IV, which completed the sale of \$75 million of trust preferred securities. At the time of the offering, the Company also entered into an interest rate swap agreement to convert the variable rate trust preferred securities into fixed rate securities for a term of five years at a fixed rate of 6.43%. The interest rate swap agreement expired December 15, 2011. Additional interest expense of \$3.2 million and \$3.4 million was recognized in the years ended December 31, 2011 and 2010, respectively, due to the interest rate swap agreement.

NOTE I: INCOME TAXES

The provision for income taxes for the years ended December 31 is as follows:

| (000's omitted) | 2011 | 2010 | 2009 |
|---|-----------------|-----------------|-----------------|
| Current: | | | |
| Federal | \$17,145 | \$13,090 | \$6,400 |
| State and other | 375 | 776 | 1,788 |
| Deferred: | | | |
| Federal | 10,674 | 7,633 | 3,929 |
| State and other | 2,191 | 1,566 | (495) |
| Provision for income taxes | \$30,385 | \$23,065 | \$11,622 |

Components of the net deferred tax liability, included in other liabilities, as of December 31 are as follows:

| (000's omitted) | 2011 | 2010 |
|-----------------|------|------|
|-----------------|------|------|

| | | |
|----------------------------|------------|------------|
| Allowance for loan losses | \$16,371 | \$16,437 |
| Employee benefits | 6,718 | 5,843 |
| Interest rate swap | 0 | 1,243 |
| Debt extinguishment | 1,821 | 2,111 |
| Other | 2,169 | 1,440 |
| Deferred tax asset | 27,079 | 27,074 |
| Investment securities | 37,386 | 7,487 |
| Intangible assets | 9,448 | 16,962 |
| Loan origination costs | 5,041 | 4,397 |
| Depreciation | 5,779 | 3,700 |
| Mortgage servicing rights | 678 | 933 |
| Pension | 2,860 | 4,163 |
| Prepaid FDIC insurance | 3,079 | 2,913 |
| Deferred tax liability | 64,271 | 40,555 |
| Net deferred tax liability | (\$37,192) | (\$13,481) |

The Company has a state tax net operating loss carry forward of \$25.7 million that resulted in a gross deferred tax asset of \$1.4 million prior to federal tax effect. This net operating loss carry forward will expire between 2026 and 2029, but is expected to be substantially utilized over the next two years and completely utilized over the next five years.

The Company has determined that no valuation allowance is necessary as it is more likely than not that the gross deferred tax assets will be realized through carryback of future deductions to taxable income in prior years, future reversals of existing temporary differences, and through future taxable income.

A reconciliation of the differences between the federal statutory income tax rate and the effective tax rate for the years ended December 31 is shown in the following table:

| | 2011 | 2010 | 2009 |
|---|-------|-------|--------|
| Federal statutory income tax rate | 35.0% | 35.0% | 35.0% |
| Increase (reduction) in taxes resulting from: | | | |
| Tax-exempt interest | (7.1) | (8.3) | (14.1) |
| State income taxes, net of federal benefit | 1.6 | 1.8 | 1.7 |
| Other | (0.1) | (1.8) | (0.7) |
| Effective income tax rate | 29.4% | 26.7% | 21.9% |

A reconciliation of the unrecognized tax benefits for the years ended December 31 is shown in the following table:

| (000's omitted) | 2011 | 2010 | 2009 |
|--|-------|-------|-------|
| Unrecognized tax benefits at beginning of year | \$98 | \$708 | \$856 |
| Changes related to: | | | |
| Positions taken during the current year | 35 | 35 | 79 |
| Settlements with taxing authorities | 0 | (408) | 0 |
| Lapse of statutes of limitation | 0 | (237) | (227) |
| Unrecognized tax benefits at end of year | \$133 | \$98 | \$708 |

As of December 31, 2011, the total amount of unrecognized tax benefits that would impact the Company's effective tax rate if recognized is \$0.1 million. It is reasonably possible that the amount of unrecognized tax benefits could change in the next twelve months as a result of the New York State examination and expiration of statutes of limitations on prior tax returns.

The Company's policy is to recognize interest and penalties related to unrecognized tax benefits as part of income taxes in the consolidated statement of income. The accrued interest related to tax positions was approximately \$10,000 at December 31, 2011 and \$20,000 at December 31, 2010 and \$0.2 million at December 31, 2009.

The Company's federal and state income tax returns are routinely subject to examination from various governmental taxing authorities. Such examinations may result in challenges to the tax return treatment applied by the Company to

specific transactions. Management believes that the assumptions and judgment used to record tax-related assets or liabilities have been appropriate. Future examinations by taxing authorities of the Company's federal or state tax returns could have a material impact on the Company's results of operations. The Company's federal income tax returns for years after 2007 may still be examined by the Internal Revenue Service. New York State income tax returns for years after 2007 may still be examined by the New York Department of Taxation and Finance. It is not possible to estimate when those examinations may be completed.

NOTE J: LIMITS ON DIVIDENDS AND OTHER REVENUE SOURCES

The Company's ability to pay dividends to its shareholders is largely dependent on the Bank's ability to pay dividends to the Company. In addition to state law requirements and the capital requirements discussed below, the circumstances under which the Bank may pay dividends are limited by federal statutes, regulations, and policies. For example, as a national bank, the Bank must obtain the approval of the Office of the Comptroller of the Currency ("OCC") for payments of dividends if the total of all dividends declared in any calendar year would exceed the total of the Bank's net profits, as defined by applicable regulations, for that year, combined with its retained net profits for the preceding two years. Furthermore, the Bank may not pay a dividend in an amount greater than its undivided profits then on hand after deducting its losses and bad debts, as defined by applicable regulations. At December 31, 2011, the Bank had approximately \$92 million in undivided profits legally available for the payments of dividends.

In addition, the Federal Reserve Board and the OCC are authorized to determine under certain circumstances that the payment of dividends would be an unsafe or unsound practice and to prohibit payment of such dividends. The Federal Reserve Board has indicated that banking organizations should generally pay dividends only out of current operating earnings.

There are also statutory limits on the transfer of funds to the Company by its banking subsidiary, whether in the form of loans or other extensions of credit, investments or assets purchases. Such transfer by the Bank to the Company generally is limited in amount to 10% of the Bank's capital and surplus, or 20% in the aggregate. Furthermore, such loans and extensions of credit are required to be collateralized in specific amounts.

NOTE K: BENEFIT PLANS

Pension and post-retirement plans

The Company provides a qualified defined benefit pension to qualified employees and retirees, and other post-retirement health and life insurance benefits to certain retirees, an unfunded supplemental pension plan for certain key executives, and an unfunded stock balance plan for certain of its nonemployee directors. Using a measurement date of December 31, the following table shows the funded status of the Company's plans reconciled with amounts reported in the Company's consolidated statements of condition:

| (000's omitted) | Pension Benefits | | Post-retirement Benefits | |
|---|------------------|----------|--------------------------|-----------|
| | 2011 | 2010 | 2011 | 2010 |
| Change in benefit obligation: | | | | |
| Benefit obligation at the beginning of year | \$81,321 | \$72,350 | \$3,594 | \$4,449 |
| Service cost | 2,959 | 2,780 | 0 | 0 |
| Interest cost | 4,497 | 3,909 | 153 | 195 |
| Participant contributions | 0 | 0 | 706 | 529 |
| Plan acquisition/amendment | 17,511 | 882 | 0 | 0 |
| Deferred actuarial loss (gain) | 11,713 | 4,971 | 46 | (706) |
| Benefits paid | (5,144) | (3,571) | (1,147) | (873) |
| Benefit obligation at end of year | 112,857 | 81,321 | 3,352 | 3,594 |
| Change in plan assets: | | | | |
| Fair value of plan assets at beginning of year | 96,439 | 74,628 | 0 | 0 |
| Actual return of plan assets | 1,479 | 9,758 | 0 | 0 |
| Participant contributions | 0 | 0 | 706 | 529 |
| Employer contributions | 11,623 | 15,624 | 441 | 344 |
| Plan acquisition | 21,912 | 0 | 0 | 0 |
| Benefits paid | (5,144) | (3,571) | (1,147) | (873) |
| Fair value of plan assets at end of year | 126,309 | 96,439 | 0 | 0 |
| Funded status at year end | \$13,452 | \$15,118 | (\$3,352) | (\$3,594) |
| Amounts recognized in the consolidated balance sheet were: | | | | |
| Other assets | \$22,929 | \$23,777 | \$0 | \$0 |

| | | | | |
|-------------------|---------|-----------|-----------|-----------|
| Other liabilities | (9,477) | (\$8,659) | (\$3,352) | (\$3,594) |
|-------------------|---------|-----------|-----------|-----------|

Amounts recognized in
accumulated other
comprehensive
income ("AOCI") were:

| | | | | |
|-----------------------------|----------|----------|-----------|-----------|
| Net loss | \$44,119 | \$28,152 | \$371 | \$333 |
| Net prior service credit | (674) | (824) | (3,339) | (4,397) |
| Pre-tax AOCI | 43,445 | 27,328 | (2,968) | (4,064) |
| Taxes | (16,738) | (10,529) | 1,135 | 1,557 |
| AOCI at year end | \$26,707 | \$16,799 | (\$1,833) | (\$2,507) |

The benefit obligation for the defined benefit pension plan was \$103.4 million and \$72.7 million as of December 31, 2011 and 2010, respectively, and the fair value of plan assets as of December 31, 2011 and 2010 was \$126.3 million and \$96.4 million, respectively. Effective January 1, 2010, the defined benefit pension plan was modified to a new plan design, which combines service credits in the defined benefit plan with additional interest credit contributions to be made to the 401(k) Plan. Effective September 30, 2011, the Wilber National Bank Retirement Plan was merged into the Community Bank System, Inc. Pension Plan and the combined plan was revalued.

The Company has unfunded supplemental pension plans for certain key active and retired executives. The projected benefit obligation for the unfunded supplemental pension plan for certain key executives was \$9.3 million for 2011 and \$8.5 million for 2010, respectively. The Company also has an unfunded stock balance plan for certain of its nonemployee directors. The projected benefit obligation for the unfunded stock balance plan was \$0.2 million for 2011 and \$0.1 million for 2010, respectively. The plan was frozen effective December 31, 2009.

Effective December 31, 2009, the Company terminated its post-retirement medical program for current and future employees. Remaining plan participants will include only existing retirees as of December 31, 2010. This change was accounted for as a negative plan amendment and a \$3.5 million, net of income taxes, benefit for prior service was recognized in AOCI in 2009. This negative plan amendment is being amortized over the expected benefit utilization period of remaining plan participants.

Amounts recognized in accumulated other comprehensive income, net of tax, for the year ended December 31, are as follows:

| (000's omitted) | Pension Benefits | | Post-retirement Benefits | |
|--------------------|------------------|----------------|--------------------------|--------------|
| | 2011 | 2010 | 2011 | 2010 |
| Prior service cost | \$92 | \$96 | \$650 | \$651 |
| Net (gain) loss | 9,816 | (307) | 24 | (445) |
| Total | \$9,908 | (\$211) | \$674 | \$206 |

The estimated costs, net of tax, that will be amortized from accumulated other comprehensive (income) loss into net periodic (income) cost over the next fiscal year are as follows:

| (000's omitted) | Pension Post-retirement Benefits | |
|----------------------|----------------------------------|----------------|
| | Benefits | Benefits |
| Prior service credit | (\$147) | (\$823) |
| Net loss | 3,681 | 12 |
| Total | \$3,534 | (\$811) |

The weighted-average assumptions used to determine the benefit obligations as of December 31 are as follows:

| | Pension Benefits | | Post-retirement Benefits | |
|--------------------------------|------------------|-------|--------------------------|-------|
| | 2011 | 2010 | 2011 | 2010 |
| Discount rate | 4.10% | 5.00% | 3.90% | 4.50% |
| Expected return on plan assets | 7.50% | 7.50% | N/A | N/A |
| Rate of compensation increase | 4.00% | 4.00% | N/A | N/A |

The net periodic benefit cost as of December 31 is as follows:

| (000's omitted) | Pension Benefits | | | Post-retirement Benefits | | |
|-----------------|------------------|------|------|--------------------------|------|------|
| | 2011 | 2010 | 2009 | 2011 | 2010 | 2009 |

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| | | | | | | |
|---------------------------------------|---------|---------|---------|---------|---------|---------|
| Service cost | \$2,959 | \$2,780 | \$3,496 | \$0 | \$0 | \$575 |
| Interest cost | 4,497 | 3,909 | 3,676 | 153 | 195 | 494 |
| Expected return on plan assets | (8,097) | (6,470) | (4,686) | 0 | 0 | 0 |
| Amortization of unrecognized net loss | 2,362 | 2,421 | 2,761 | 8 | 17 | 0 |
| Amortization of prior service cost | (149) | (189) | (123) | (1,057) | (1,057) | 54 |
| Amortization of transition obligation | 0 | 0 | 0 | 0 | 0 | 41 |
| Net periodic benefit cost | \$1,572 | \$2,451 | \$5,124 | (\$896) | (\$845) | \$1,164 |

Prior service costs in which all or almost all of the plan's participants are fully eligible for benefits under the plan are amortized on a straight-line basis over the expected future working years of all active plan participants. Prior service costs associated with transferring individual nonqualified plans are amortized on a straight-line basis over a three-year period. Unrecognized gains or losses are amortized using the "corridor approach", which is the minimum amortization required. Under the corridor approach, the net gain or loss in excess of 10 percent of the greater of the projected benefit obligation or the market-related value of the assets is amortized on a straight-line basis over the expected future working years of all active plan participants.

The weighted-average assumptions used to determine the net periodic pension cost for the years ended December 31 are as follows:

| | Pension Benefits | | | Post-retirement Benefits | | |
|--------------------------------|------------------|-------|-------|--------------------------|-------|-------|
| | 2011 | 2010 | 2009 | 2011 | 2010 | 2009 |
| Discount rate | 4.40% | 5.60% | 6.10% | 4.50% | 5.15% | 6.10% |
| Expected return on plan assets | 7.50% | 7.50% | 8.00% | N/A | N/A | N/A |
| Rate of compensation increase | 4.00% | 4.00% | 4.00% | N/A | N/A | N/A |

The amount of benefit payments that are expected to be paid over the next ten years are as follows:

| (000's omitted) | Pension Post-retirement | |
|-----------------|-------------------------|----------|
| | Benefits | Benefits |
| 2012 | 6,259 | 390 |
| 2013 | 6,850 | 360 |
| 2014 | 7,224 | 284 |
| 2015 | 6,926 | 268 |
| 2016 | 7,555 | 229 |
| 2017-2021 | 42,873 | 1,009 |

The payments reflect future service and are based on various assumptions including retirement age and form of payment (lump-sum versus annuity). Actual results may differ from these estimates.

The assumed discount rate is used to reflect the time value of future benefit obligations. The discount rate was determined based upon the yield on high-quality fixed income investments expected to be available during the period to maturity of the pension benefits. This rate is sensitive to changes in interest rates. A decrease in the discount rate would increase the Company's obligation and future expense while an increase would have the opposite effect. The expected long-term rate of return was estimated by taking into consideration asset allocation, reviewing historical returns on the type of assets held and current economic factors. The appropriateness of the assumptions is reviewed annually.

Plan Assets

The investment objective for the defined benefit pension plan is to achieve an average annual total return over a five-year period equal to the assumed rate of return used in the actuarial calculations. At a minimum performance level, the portfolio should earn the return obtainable on high quality intermediate-term bonds. The Company's perspective regarding portfolio assets combines both preservation of capital and moderate risk-taking. Asset allocation favors equities, with a target allocation of approximately 60% equity securities and 40% fixed income securities. In order to diversify the risk within the pension portfolio, the pension committee authorized that up to 15% of the assets may be in alternative investments, which are primarily hedge funds. No more than 10% of the portfolio can be in stock of the Company. Due to the volatility in the market, the target allocation is not always desirable and asset allocations will fluctuate between acceptable ranges. Prohibited transactions include purchase of securities on margin, uncovered call options, and short sale transactions.

The fair values of the Company's defined benefit pension plan assets at December 31, 2011 by asset category are as follows:

| Asset category (000's omitted) | Quoted Prices in Active Markets for Identical Assets | Significant Observable Inputs Level 2 | Significant Unobservable Inputs Level 3 | Total |
|-----------------------------------|--|--|--|--------|
| | Level 1 | Level 2 | Level 3 | |
| Cash | \$31,389 | \$0 | \$0 | 31,389 |

| | | | | |
|-----------------------------|-----------|---------|-----|-----------|
| Equity securities: | | | | |
| U.S. large-cap | 26,468 | 0 | 0 | 26,468 |
| U.S. mid/small cap | 6,004 | 0 | 0 | 6,004 |
| CBSI stock | 10,512 | 0 | 0 | 10,512 |
| International | 10,923 | 0 | 0 | 10,923 |
| Global (a) | 2,936 | 0 | 0 | 2,936 |
| Commodities | 1,837 | 0 | 0 | 1,837 |
| (b) | 58,680 | 0 | 0 | 58,680 |
| Fixed income securities: | | | | |
| Government securities | 8,600 | 8,000 | 0 | 16,600 |
| Investment grade bonds | 4,965 | 0 | 0 | 4,965 |
| High yield(c) | 9,401 | 496 | 0 | 9,897 |
| | 22,966 | 8,496 | 0 | 31,462 |
| Other types of investments: | | | | |
| Alternative investments (d) | 4,684 | 94 | 0 | 4,778 |
| Total (e) | \$117,719 | \$8,590 | \$0 | \$126,309 |

The fair values of the Company's defined benefit pension plan assets at December 31, 2010 by asset category are as follows:

| Asset category (000's omitted) | Quoted Prices in Active Markets for Identical Assets Level 1 | Significant Observable Inputs Level 2 | Significant Unobservable Inputs Level 3 | Total |
|-----------------------------------|---|--|--|----------|
| Cash | \$10,851 | \$0 | \$0 | \$10,851 |
| Equity securities: | | | | |
| U.S. large-cap | 30,547 | 0 | 0 | 30,547 |
| U.S. mid/small cap | 6,130 | 0 | 0 | 6,130 |
| CBSI stock | 8,728 | 0 | 0 | 8,728 |
| International | 12,866 | 0 | 0 | 12,866 |
| Global (a) | 3,153 | 0 | 0 | 3,153 |
| Commodities | 694 | 0 | 0 | 694 |
| (b) | 62,118 | 0 | 0 | 62,118 |
| Fixed income securities: | | | | |
| Government securities | 4,900 | 7,212 | 0 | 12,112 |
| Investment grade bonds | 5,367 | 0 | 0 | 5,367 |
| High yield(c) | 5,509 | 0 | 0 | 5,509 |
| | 15,776 | 7,212 | 0 | 22,988 |
| Other types of investments: | | | | |
| Alternative investments (d) | 0 | 482 | 0 | 482 |
| Total (e) | \$88,745 | \$7,694 | \$0 | \$96,439 |

(a) This category includes securities that invest approximately 50% in

U.S. equity securities and 50% international equity securities.

(b) This category includes investments in exchange traded funds reflecting

the performance of an underlying commodity index.

(c) This category is exchange-traded funds representing a diversified index of high yield corporate bonds.

(d) This category is comprised of non-traditional investment classes including private equity funds and alternative exchange funds.

(e) Excludes dividends and interest receivable totaling \$306,000 and

\$317,000 at December 31, 2011 and 2010, respectively

The Company makes contributions to its funded qualified pension plan as required by government regulation or as deemed appropriate by management after considering the fair value of plan assets, expected return on such assets, and the value of the accumulated benefit obligation. The Company made a contribution to its defined benefit pension plan of \$11 million during the fourth quarter of 2011. The Company funds the payment of benefit obligations for the supplemental pension and post-retirement plans because such plans do not hold assets for investment.

Tupper Lake National Bank (“TLNB”) participated in the Pentegra Defined Benefit Plan for Financial Institutions (“Pentegra DB Plan”), a multi-employer tax qualified defined benefit pension plan. The identification number and plan number of the Pentegra DB Plan are 13-5645888 and 333, respectively. All employees of TLNB who met minimum service requirements participated in the plan. As of June 30, 2010, the Pentegra DB Plan had total assets of \$2.4 billion, actuarial present value of accumulated benefits of \$2.7 billion and was at least 80 percent funded. The assets of the multi-employer plan may be used to satisfy obligations of any of the employers participating in the plan. As a result, contributions made by the Company may be used to provide benefits to participants of other participating employers. Contributions for 2011, 2010 and 2009 were \$131,000, \$39,000 and \$21,000, respectively. Contributions made by the Company to the Pentegra DB Plan do not represent more than 5% of contributions made to the Pentegra DB Plan.

The assumed health care cost trend rate used in the post-retirement health plan at December 31, 2011 was 8.50% for the pre-65 participants and 6.75% for the post-65 participants for medical costs and 8.50% for prescription drugs. The rate to which the cost trend rate is assumed to decline (the ultimate trend rate) and the year that the rate reaches the ultimate trend rate is 5.0% and 2018, respectively.

Assumed health care cost trend rates have a significant effect on the amounts reported for the health care plan. A one-percentage-point increase in the trend rate would increase the service and interest cost components by \$600 and increase the benefit obligation by \$14,000. A one-percentage-point decrease in the trend rate would decrease the service and interest cost components by \$600 and decrease the benefit obligation by \$13,000.

401(k) Employee Stock Ownership Plan

The Company has a 401(k) Employee Stock Ownership Plan in which employees can contribute from 1% to 90% of eligible compensation, with the first 3% being eligible for a 100% matching contribution in the form of Company common stock and the next 3% being eligible for a 50% matching contributions in the form of Company common stock. The expense recognized under this plan for the years ended December 31, 2011, 2010 and 2009 was \$2,752,000, \$2,536,000, and \$2,342,000, respectively. Effective January 1, 2010 the defined benefit pension plan was modified to a new plan design that includes an interest credit contribution to be made to the 401(k) plan. The expense recognized for this interest credit contribution for the year ended December 31, 2011 was \$203,000.

Other Deferred Compensation Arrangements

In addition to the supplemental pension plans for certain executives, the Company has nonqualified deferred compensation arrangements for several former directors, officers and key employees. All benefits provided under these plans are unfunded and payments to plan participants are made by the Company. At December 31, 2011 and 2010, the Company has recorded a liability of \$4,734,000 and \$3,693,000, respectively. The expense recognized under these plans for the years ended December 31, 2011, 2010, and 2009 was \$584,000, \$546,000, and \$616,000, respectively.

Deferred Compensation Plan for Directors

Directors may defer all or a portion of their director fees under the Deferred Compensation Plan for Directors. Under this plan, there is a separate account for each participating director which is credited with the amount of shares that could have been purchased with the director's fees as well as any dividends on such shares. On the distribution date, the director will receive common stock equal to the accumulated share balance in his account. As of December 31, 2011 and 2010 there were 140,029 and 127,761 shares credited to the participants' accounts, for which a liability of \$2,863,000 and \$2,519,000 was accrued, respectively. The expense recognized under the plan for the years ended December 31, 2011, 2010 and 2009, was \$125,000, \$107,000, and \$89,000, respectively.

NOTE L: STOCK-BASED COMPENSATION PLANS

The Company has a long-term incentive program for directors, officers and employees. Under this program, the Company initially authorized 4,000,000 shares of Company common stock for the grant of incentive stock options, nonqualified stock options, restricted stock awards, and retroactive stock appreciation rights. The long-term incentive program was amended effective May 25, 2011 to authorize an additional 900,000 shares of Company common stock for the grant of incentive stock options, nonqualified stock options, restricted stock awards, and retroactive stock appreciation rights. As of December 31, 2011, the Company has authorization to grant up to 1,741,682 additional shares of Company common stock for these instruments. The nonqualified (offset) stock options in its Director's Stock Balance Plan vest and become exercisable immediately and expire one year after the date the director retires or two years in the event of death. The remaining options have a ten-year term, and vest and become exercisable on a grant-by-grant basis, ranging from immediate vesting to ratably over a five-year period.

Activity in this long-term incentive program is as follows:

| | Stock Options | Weighted-average Exercise Price of |
|---|---------------|---------------------------------------|
| | Outstanding | Shares |
| Outstanding at December 31, 2009 | 3,082,815 | \$20.22 |

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| | | |
|-------------|-----------|---------|
| Granted | 352,365 | 19.49 |
| Exercised | (411,507) | 17.09 |
| Forfeited | (46,781) | 21.27 |
| Outstanding | | |
| at | | |
| December | | |
| 31, 2010 | 2,976,892 | 20.55 |
| Granted | 274,828 | 27.36 |
| Exercised | (282,930) | 17.97 |
| Forfeited | (21,575) | 20.58 |
| Outstanding | | |
| at | | |
| December | | |
| 31, 2011 | 2,947,215 | \$21.43 |
| Exercisable | | |
| at | | |
| December | | |
| 31, 2011 | 2,199,737 | \$21.44 |

The following table summarizes the information about stock options outstanding under the Company's stock option plan at December 31, 2011:

| Range of Exercise Price | Options outstanding | | | Options exercisable | | |
|-------------------------|---------------------|---------------------------------|---|---------------------|---------------------------------|--|
| | Shares | Weighted-average Exercise Price | Weighted-average Remaining Life (years) | Shares | Weighted-average Exercise Price | |
| \$0.00 – \$18.00 | 428,377 | \$16.84 | 4.20 | 428,377 | \$16.84 | |
| \$18.001 – \$23.001 | 1,272,667 | 19.64 | 6.48 | 741,585 | 20.12 | |
| \$23.001 – \$28.001 | 1,246,171 | 24.83 | 4.76 | 1,029,775 | 24.30 | |
| TOTAL | 2,947,215 | \$21.43 | 5.42 | 2,199,737 | \$21.44 | |

The weighted-average remaining contractual term of outstanding and exercisable stock options at December 31, 2011 is 5.4 years and 4.6 years, respectively. The aggregate intrinsic value of outstanding and exercisable stock options at December 31, 2011 is \$18.8 million and \$14.0 million, respectively.

The Company recognized stock-based compensation expense related to incentive and non-qualified stock options of \$1.8 million, \$2.0 million and \$2.3 million for the years ended December 31, 2011, 2010 and 2009, respectively. A related income tax benefit was recognized of \$0.8 million, \$0.9 million and \$0.8 million for the 2011, 2010 and 2009 years, respectively. Compensation expense related to restricted stock vesting recognized in the income statement for 2011, 2010 and 2009 was approximately \$2.0 million, \$1.6 million and \$0.8 million, respectively.

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

| | 2011 | 2010 | 2009 |
|--|--------|--------|--------|
| Weighted-average Fair Value of Options Granted | \$6.69 | \$5.56 | \$4.66 |
| Assumptions: | | | |
| Weighted-average expected life (in years) | 7.72 | 7.68 | 7.77 |
| Future dividend yield | 3.90% | 3.00% | 3.00% |
| Share price volatility | 32.12% | 32.03% | 30.66% |
| Weighted-average risk-free interest rate | 3.34% | 3.66% | 2.86% |

Unrecognized stock-based compensation expense related to non-vested stock options totaled \$2.8 million at December 31, 2011, which will be recognized as expense over the next five years. The weighted-average period over which this unrecognized expense would be recognized is 3.0 years. The total fair value of shares vested during 2011, 2010, and 2009 were \$1.8 million, \$3.3 million and \$1.7 million, respectively.

During the twelve months ended December 31, 2011 and 2010, proceeds from stock option exercises totaled \$5.3 million and \$5.9 million, respectively, and the related tax benefits from exercise were approximately \$0.5 million and \$0.4 million, respectively. During the twelve months ended December 31, 2011 and 2010, 274,330 and 337,652 shares, respectively, were issued in connection with stock option exercise. The total intrinsic value of options exercised during 2011, 2010 and 2009 were \$2.3 million, \$3.1 million and \$0.6 million, respectively.

A summary of the status of the Company's unvested restricted stock awards as of December 31, 2011, and changes during the twelve months ended December 31, 2011 and 2010, is presented below:

| | Restricted Shares | Weighted-average grant date fair value |
|--|----------------------|--|
| Unvested at December 31, 2009 | 174,008 | \$18.90 |
| Awards | 173,341 | 18.34 |
| Forfeitures | (9,284) | 18.17 |
| Vestings | (53,479) | 19.19 |
| Unvested at December 31, 2010 | 284,586 | 18.53 |
| Awards | 54,958 | 27.36 |
| Forfeitures | (9,061) | 18.91 |
| Vestings | (60,842) | 19.40 |
| Unvested at December 31, 2011 | 269,641 | \$20.12 |

NOTE M: EARNINGS PER SHARE

Basic earnings per share are computed based on the weighted-average common shares outstanding for the period. Diluted earnings per share are based on the weighted-average shares outstanding adjusted for the dilutive effect of restricted stock and the assumed exercise of stock options during the year. The dilutive effect of options is calculated using the treasury stock method of accounting. The treasury stock method determines the number of common shares that would be outstanding if all the dilutive options (those where the average market price is greater than the exercise price) were exercised and the proceeds were used to repurchase common shares in the open market at the average market price for the applicable time period. There were approximately 0.6 million, 1.2 million and 2.4 million weighted-average anti-dilutive stock options outstanding at December 31, 2011, 2010 and 2009, respectively, which were not included in the computation below.

The following is a reconciliation of basic to diluted earnings per share for the years ended December 31, 2011, 2010 and 2009.

| (000's omitted, except per share data) | 2011 | 2010 | 2009 |
|---|----------|----------|----------|
| Net income | \$73,142 | \$63,320 | \$41,445 |
| Income attributable to unvested stock-based compensation awards | (553) | (542) | (215) |
| Income available to common shareholders | \$72,589 | \$62,778 | \$41,230 |

| | | | |
|---|----------|----------|----------|
| Weighted-average common shares outstanding - basic | 35,767 | 32,951 | 32,673 |
| Basic earnings per share | \$2.03 | \$1.91 | \$1.26 |
| Net income | \$73,142 | \$63,320 | \$41,445 |
| Income attributable to unvested stock-based compensation awards | (553) | (542) | (215) |
| Income available to common shareholders | \$72,589 | \$62,778 | \$41,230 |
| Weighted-average common shares outstanding | 35,767 | 32,951 | 32,673 |
| Assumed exercise of stock options | 415 | 318 | 148 |
| Weighted-average common shares outstanding – diluted | 36,182 | 33,269 | 32,821 |
| Diluted earnings per share | \$2.01 | \$1.89 | \$1.26 |

Stock Repurchase Program

On July 22, 2009, the Company announced an authorization to repurchase up to 1,000,000 of its outstanding shares in open market transactions or privately negotiated transactions in accordance with securities laws and regulations through December 31, 2011. Any repurchased shares will be used for general corporate purposes, including those related to stock plan activities. The timing and extent of repurchases will depend on market conditions and other corporate considerations as determined at the Company's discretion. There were no treasury stock purchases in 2011 or 2010. At its December 2011 meeting, the Board approved extending the stock repurchase program authorizing the repurchase, at the discretion of senior management, of up to 1,500,000 shares through December 31, 2012.

NOTE N: COMMITMENTS, CONTINGENT LIABILITIES AND RESTRICTIONS

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

| (000's omitted) | 2011 | 2010 |
|------------------------------------|-----------|-----------|
| Commitments to extend credit | \$572,393 | \$445,625 |
| Standby letters of credit | 25,279 | 21,456 |
| Total | \$597,672 | \$467,081 |

The Company has unused lines of credit of \$65.0 million at December 31, 2011. The Company has unused borrowing capacity of approximately \$424.4 million through collateralized transactions with the Federal Home Loan Bank and \$16.4 million through collateralized transactions with the Federal Reserve Bank.

The Company is required to maintain a reserve balance, as established by the Federal Reserve Bank of New York. The required average total reserve for the 14-day maintenance period of December 29, 2011 through January 11, 2012 was \$28.5 million of which \$2.0 million was required to be on deposit with the Federal Reserve Bank of New York. The remaining \$26.5 million was represented by cash on hand.

The Company is subject in the normal course of business to various pending and threatened legal proceedings in which claims for monetary damages are asserted. Management, after consultation with legal counsel, does not anticipate that the aggregate ultimate liability arising out of litigation pending or threatened against the Company will be material to its consolidated financial position. On an on-going basis the Company assesses its liabilities and contingencies in connection with such legal proceedings. For those matters where it is probable that the Company will incur losses and the amounts of the losses can be reasonably estimated, the Company records an expense and corresponding liability in its consolidated financial statements. To the extent the pending or threatened litigation could result in exposure in excess of that liability, the amount of such excess is not currently estimable. Although not considered probable, the range of reasonably possible losses for such matters in the aggregate, beyond the existing recorded liability, was between \$0 and \$2 million. Although the Company does not believe that the outcome of pending litigations will be material to the Company's consolidated financial position, it cannot rule out the possibility that such outcomes will be material to the consolidated results of operations for a particular reporting period in the future.

NOTE O: LEASES

The Company leases buildings, office space, and equipment under agreements that expire in various years. Rental expense included in operating expenses amounted to \$4.2 million, \$3.9 million and \$4.0 million in 2011, 2010 and 2009, respectively. The future minimum rental commitments as of December 31, 2011 for all non-cancelable operating leases are as follows:

| | |
|------------|----------|
| 2012 | \$4,650 |
| 2013 | 4,164 |
| 2014 | 3,046 |
| 2015 | 2,078 |
| 2016 | 1,814 |
| Thereafter | 5,740 |
| Total | \$21,492 |

NOTE P: REGULATORY MATTERS

The Company and the Bank 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 the Company's financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the Company and the Bank must meet specific capital guidelines that involve quantitative measures of the Company's and the Bank's assets, liabilities, and certain off-balance sheet items as calculated under regulatory accounting practices. The Company's and the Bank's 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 the Company and Bank to maintain minimum total core capital to risk-weighted assets of 8%, and Tier I capital to risk-weighted assets and Tier I capital to average assets of 4%. Management believes, as of December 31, 2011, that the Company and Bank meet all capital adequacy requirements to which they are subject.

As of December 31, 2011 and 2010, the most recent notification from the Office of the Comptroller of the Currency ("OCC") categorized the Company and Bank as "well capitalized" under the regulatory framework for prompt corrective action. To be categorized as "well capitalized," the Company and Bank must maintain minimum total core capital to risk-weighted assets of 10%, Tier I capital to risk-weighted assets of 6% and Tier I capital to average assets of 5%. There are no conditions or events since that notification that management believes have changed the institution's category. Except in connection with the regulatory approval of the Citizens branch acquisition in November 2008 by the OCC, there were no significant capital requirements imposed or agreed to during the regulatory approval process of any of our acquisitions. In connection with the Citizens acquisition, the Bank agreed to an approval condition to maintain capital at the "well-capitalized" level.

The capital ratios and amounts of the Company and the Bank as of December 31 are presented below:

| | 2011 | | 2010 | |
|--|-----------|-----------|-----------|-----------|
| (000's omitted) | Company | Bank | Company | Bank |
| Tier 1 capital to average assets | | | | |
| Amount | \$508,250 | \$459,680 | \$424,408 | \$380,174 |
| Ratio | 8.38% | 7.60% | 8.23% | 7.40% |
| Minimum required amount | \$242,559 | \$241,995 | \$206,206 | \$205,622 |
| Tier 1 capital to risk-weighted assets | | | | |
| Amount | \$508,250 | \$502,193 | \$424,408 | \$380,174 |
| Ratio | 14.31% | 12.99% | 13.49% | 12.13% |
| Minimum required amount | \$142,074 | \$141,529 | \$125,840 | \$125,404 |
| Total core capital to risk-weighted assets | | | | |

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| | | | | |
|----------------------------|-----------|-----------|-----------|-----------|
| Amount | \$550,763 | \$502,193 | \$463,777 | \$419,408 |
| Ratio | 15.51% | 14.19% | 14.74% | 13.38% |
| Minimum required amount | \$284,148 | \$283,058 | \$251,680 | \$250,809 |

NOTE Q: PARENT COMPANY STATEMENTS

The condensed balance sheets of the parent company at December 31 are as follows:

| (000's omitted) | 2011 | 2010 |
|--|-----------|-----------|
| Assets: | | |
| Cash and cash equivalents | \$38,853 | \$35,969 |
| Investment securities | 3,572 | 3,612 |
| Investment in and advances to subsidiaries | 838,130 | 674,516 |
| Other assets | 8,145 | 8,243 |
| Total assets | \$888,700 | \$722,340 |
| Liabilities and shareholders' equity: | | |
| Accrued interest and other liabilities | \$12,069 | \$13,058 |
| Borrowings | 102,048 | 102,024 |
| Shareholders' equity | 774,583 | 607,258 |
| Total liabilities and shareholders' equity | \$888,700 | \$722,340 |

The condensed statements of income of the parent company for the years ended December 31 is as follows:

| (000's omitted) | 2011 | 2010 | 2009 |
|---|----------|---------|----------|
| Revenues: | | | |
| Dividends from subsidiaries | \$52,251 | \$3,500 | \$36,000 |
| Interest and dividends on investments | 87 | 345 | 656 |
| Other income | 0 | 2 | 45 |
| Total revenues | 52,338 | 3,847 | 36,701 |
| Expenses: | | | |
| Interest on borrowings | 5,815 | 5,960 | 6,153 |
| Other expenses | 273 | 14 | 101 |
| Total expenses | 6,088 | 5,974 | 6,254 |
| Income (Loss) before tax benefit and equity in undistributed net income of subsidiaries | 46,250 | (2,127) | 30,447 |

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| | | | |
|---|----------|----------|----------|
| Income tax benefit | 2,237 | 2,131 | 1,529 |
| Income before equity in undistributed net income of subsidiaries | 48,487 | 4 | 31,976 |
| Equity in undistributed net income of subsidiaries | 24,655 | 63,316 | 9,469 |
| Net income | \$73,142 | \$63,320 | \$41,445 |

The statements of cash flows of the parent company for the years ended December 31 is as follows:

| (000's omitted) | 2011 | 2010 | 2009 |
|--|-----------|----------|----------|
| Operating activities: | | | |
| Net income | \$73,142 | \$63,320 | \$41,445 |
| Gain on sale of fixed assets and investment securities | 0 | 0 | (7) |
| Adjustments to reconcile net income to net cash provided by operating activities | | | |
| Equity in undistributed net (income)/loss of subsidiaries | (24,655) | (63,316) | (9,469) |
| Net change in other assets and other liabilities | (504) | (2,397) | 1,190 |
| Net cash provided by (used in) operating activities | 47,983 | (2,393) | 33,159 |
| Investing activities: | | | |
| Purchase of investment securities | 0 | (10) | 0 |
| Proceeds from sale of investment securities | 2 | 0 | 26 |
| Repayments from subsidiaries, net | 51 | 1,712 | 1,656 |
| Capital contributions to subsidiaries | (102,462) | 0 | 0 |
| Net cash (used in)/provided by investing activities | (102,409) | 1,702 | 1,682 |
| Financing activities: | | | |
| Issuance of common stock | 91,714 | 9,957 | 4,341 |
| Cash dividends paid | (34,404) | (30,394) | (28,789) |
| Net cash provided by/(used in) financing activities | 57,310 | (20,437) | (24,448) |
| Change in cash and cash equivalents | 2,884 | (21,128) | 10,393 |
| Cash and cash equivalents at beginning of year | 35,969 | 57,097 | 46,704 |
| Cash and cash equivalents at end of year | \$38,853 | \$35,969 | \$57,097 |
| Supplemental disclosures of cash flow information: | | | |
| Cash paid for interest | \$5,959 | \$5,960 | \$6,283 |
| Supplemental disclosures of noncash financing activities | | | |
| Dividends declared and unpaid | \$9,609 | \$7,976 | \$7,211 |

NOTE R: FAIR VALUE

Accounting standards allow entities an irrevocable option to measure certain financial assets and financial liabilities at fair value. Unrealized gains and losses on items for which the fair value option has been elected are reported in earnings. The Company has elected to value mortgage loans held for sale at fair value in order to more closely match the gains and losses associated with loans held for sale with the gains and losses on forward sales contracts. Accordingly the impact on the valuation will be recognized in the Company's consolidated statement of income. All mortgage loans held for sale are current and in performing status.

Accounting standards establish a framework for measuring fair value and require disclosures about such fair value instruments. It defines fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date (exit price). Inputs used to measure fair value are classified into the following hierarchy:

- Level 1 – Quoted prices in active markets for identical assets or liabilities.
- Level 2 – Quoted prices in active markets for similar assets or liabilities, or quoted prices for identical or similar assets or liabilities in markets that are not active, or inputs other than quoted prices that are observable for the asset or liability.
- Level 3 – Significant valuation assumptions not readily observable in a market.

A financial instrument's categorization within the valuation hierarchy is based upon the lowest level of input that is significant to the fair value measurement. The following tables set forth the Company's financial assets and liabilities that were accounted for at fair value on a recurring basis. There were no transfers between Level 1 and Level 2 for any of the periods presented.

| (000's omitted) | December 31, 2011 | | | Total Fair Value |
|---|-------------------|-------------|----------|------------------|
| | Level 1 | Level 2 | Level 3 | |
| Available-for-sale investment securities: | | | | |
| Obligations of state and political subdivisions | \$0 | \$573,012 | \$0 | \$573,012 |
| U.S. Treasury and agency securities | 311,958 | 208,590 | 0 | 520,548 |
| Government agency mortgage-backed securities | 0 | 331,379 | 0 | 331,379 |
| Pooled trust preferred securities | 0 | 0 | 43,846 | 43,846 |
| Government agency collateralized mortgage obligations | 0 | 46,943 | 0 | 46,943 |
| Corporate debt securities | 0 | 22,855 | 0 | 22,855 |
| Marketable equity securities | 390 | 0 | 0 | 390 |
| Total available-for-sale investment securities | 312,348 | 1,182,779 | 43,846 | 1,538,973 |
| Mortgage loans held for sale | 0 | 532 | 0 | 532 |
| Total | \$312,348 | \$1,183,311 | \$43,846 | \$1,539,505 |

| (000's omitted) | December 31, 2010 | | | Total Fair Value |
|---|-------------------|-----------|---------|------------------|
| | Level 1 | Level 2 | Level 3 | |
| Available-for-sale investment securities: | | | | |
| | \$0 | \$522,218 | \$0 | \$522,218 |

| | | | | |
|---|---------|-------------|----------|-------------|
| Obligations of state and political subdivisions | | | | |
| U.S. Treasury and agency securities | 1,026 | 303,031 | 0 | 304,057 |
| Government agency mortgage-backed securities | 0 | 179,716 | 0 | 179,716 |
| Pooled trust preferred securities | 0 | 0 | 41,993 | 41,993 |
| Government agency collateralized mortgage obligations | 0 | 10,395 | 0 | 10,395 |
| Corporate debt securities | 0 | 27,157 | 0 | 27,157 |
| Marketable equity securities | 427 | 0 | 0 | 427 |
| Total available-for-sale investment securities | 1,453 | 1,042,517 | 41,993 | 1,085,963 |
| Forward sales contracts | 0 | 322 | 0 | 322 |
| Commitments to originate real estate loans for sale | 0 | 0 | 58 | 58 |
| Mortgage loans held for sale | 0 | 3,952 | 0 | 3,952 |
| Interest rate swap | 0 | (3,232) | 0 | (3,232) |
| Total | \$1,453 | \$1,043,559 | \$42,051 | \$1,087,063 |

The valuation techniques used to measure fair value for the items in the table above are as follows:

- Available for sale investment securities – The fair value of available-for-sale investment securities is based upon quoted prices, if available. If quoted prices are not available, fair values are measured using quoted market prices for similar securities or model-based valuation techniques. Level 1 securities include U.S. Treasury obligations and marketable equity securities that are traded by dealers or brokers in active over-the-counter markets. Level 2 securities include U.S. agency securities, mortgage-backed securities issued by government-sponsored entities, municipal securities and corporate debt securities that are valued by reference to prices for similar securities or through model-based techniques in which all significant inputs, such as dealer quotes, reported trades, trade execution data, LIBOR swap yield curve, market prepayment speeds, credit information, market spreads, and security's terms and conditions, are observable. Securities classified as Level 3 include pooled trust preferred securities in less liquid markets. The value of these instruments is determined using multiple pricing models or similar techniques as well as significant unobservable inputs such as judgment or estimation by the Company in the weighting of the models.
- Mortgage loans held for sale – Mortgage loans held for sale are carried at fair value, which is determined using quoted secondary-market prices of loans with similar characteristics and, as such, have been classified as a Level 2 valuation. The unpaid principal value of mortgage loans held for sale at December 31, 2011 is approximately \$532,000, which approximated fair value.

- Forward sales contracts – The Company enters into forward sales contracts to sell certain residential real estate loans. Such commitments are considered to be derivative financial instruments and, therefore, are carried at estimated fair value in the other asset or other liability section of the consolidated balance sheet. The fair value of these forward sales contracts is primarily measured by obtaining pricing from certain government-sponsored entities and reflects the underlying price the entity would pay the Company for an immediate sale on these mortgages. These instruments are classified as Level 2 in the fair value hierarchy.
- Commitments to originate real estate loans for sale – The Company enters into various commitments to originate residential real estate loans for sale. Such commitments are considered to be derivative financial instruments and, therefore, are carried at estimated fair value in the other asset or other liability section of the consolidated balance sheet. The estimated fair value of these commitments is determined using quoted secondary market prices obtained from certain government-sponsored entities. Additionally, accounting guidance requires the expected net future cash flows related to the associated servicing of the loan to be included in the fair value measurement of the derivative. The expected net future cash flows are based on a valuation model that calculates the present value of estimated net servicing income. The valuation model incorporates assumptions that market participants would use in estimating future net servicing income. Such assumptions include estimates of the cost of servicing loans, appropriate discount rate and prepayment speeds. The determination of expected net cash flows is considered a significant unobservable input contributing to the Level 3 classification of commitments to originate real estate loans for sale.
- Interest rate swap – The Company has utilized interest rate swap agreements to modify the repricing characteristics of certain of its interest-bearing liabilities. The fair value of these interest rate swaps traded in over-the-counter markets where quoted market prices are not readily available, are measured using models for which the significant assumptions such as yield curves and option volatilities are market observable and, therefore, classified as Level 2 in the fair value hierarchy.

The changes in Level 3 assets measured at fair value on a recurring basis are summarized in the following tables:

| | Year Ended December 31, | | | 2010 | | |
|---|-------------------------|-----------------------|----------|------------|-----------------------|----------|
| | 2011 | | | 2010 | | |
| | Pooled | Commitments | | Pooled | Commitments | |
| | trust | to | | trust | to | |
| | preferred | originate real | | preferred | originate real | |
| | securities | estate loans for sale | Total | securities | estate loans for sale | Total |
| (000's omitted) | | | | | | |
| Beginning balance | \$41,993 | \$58 | \$42,051 | \$44,014 | \$31 | \$44,045 |
| Total gains/(losses) included in earnings (1) | 94 | (258) | (164) | 99 | (1,421) | (1,322) |
| Total gains/(losses) included in other comprehensive income | 3,248 | 0 | 3,248 | (527) | 0 | (527) |
| Principal reductions | (1,489) | 0 | (1,489) | (1,593) | 0 | (1,593) |
| Commitments to originate real | | | | | | |

estate loans

| | | | | | | |
|-----------------------|----------|-----|----------|----------|-------|----------|
| held for sale, net | 0 | 200 | 200 | 0 | 1,448 | 1,448 |
| Ending balance | \$43,846 | \$0 | \$43,846 | \$41,993 | \$58 | \$42,051 |

(1) Amounts included in earnings associated with the pooled trust preferred securities relate to accretion of related discount

Assets and liabilities measured on a non-recurring basis:

| (000's omitted) | December 31, 2011 | | | | December 31, 2010 | | | |
|------------------------------|-------------------|---------|---------|------------------------|-------------------|---------|---------|------------------------|
| | Level 1 | Level 2 | Level 3 | Total Fair Value | Level 1 | Level 2 | Level 3 | Total Fair Value |
| Impaired loans | \$0 | \$0 | \$4,118 | \$4,118 | \$0 | \$0 | \$703 | \$703 |
| Other real estate owned | 0 | 0 | 2,682 | 2,682 | 0 | 0 | 2,011 | 2,011 |
| Mortgage servicing rights | 0 | 0 | 1,747 | 1,747 | 0 | 0 | 2,422 | 2,422 |
| Total | \$0 | \$0 | \$8,547 | \$8,547 | \$0 | \$0 | \$5,136 | \$5,136 |

Originated mortgage servicing rights are recorded at their fair value at the time of sale of the underlying loan, and are amortized in proportion to and over the period of estimated net servicing income. In accordance with GAAP, the Company must record impairment charges, on a nonrecurring basis, when the carrying value of certain strata exceeds their estimated fair value. The fair value of mortgage servicing rights is based on a valuation model incorporating inputs that market participants would use in estimating future net servicing income. Such inputs include estimates of the cost of servicing loans, appropriate discount rate and prepayment speeds. These inputs are considered to be unobservable and contribute to the Level 3 classification of mortgage servicing rights. The amount of impairment recognized is the amount by which the carrying value of the capitalized servicing rights for a stratum exceeds estimated fair value. Impairment is recognized through a valuation allowance.

Loans are generally not recorded at fair value on a recurring basis. Periodically, the Company records nonrecurring adjustments to the carrying value of loans based on fair value measurements for partial charge-offs of the uncollectible portions of those loans. Nonrecurring adjustments also include certain impairment amounts for collateral-dependent loans calculated when establishing the allowance for credit losses. Such amounts are generally based on the fair value of the underlying collateral supporting the loan and, as a result, the carrying value of the loan less the calculated valuation amount does not necessarily represent the fair value of the loan. Real estate collateral is typically valued using independent appraisals or other indications of value based on recent comparable sales of similar properties or assumptions generally observable in the marketplace, adjusted based on non-observable inputs and the related nonrecurring fair value measurement adjustments and have generally been classified as Level 3. Estimates of fair value used for other collateral supporting commercial loans generally are based on assumptions not observable in the marketplace and, therefore, such valuations have been classified as Level 3.

The Company evaluates goodwill for impairment on an annual basis, or more often if events or circumstances indicate there may be impairment. The fair value of each reporting unit is compared to the carrying amount of that reporting unit in order to determine if impairment is indicated. If so, the implied fair value of the reporting units' goodwill is compared to its carrying amount and the impairment loss is measured by the excess of the carrying value of the goodwill over fair value of the goodwill. In such situations, the Company performs a discounted cash flow modeling technique that requires management to make estimates regarding the amount and timing of expected future cash flows of the assets and liabilities of the reporting unit that enable the Company to calculate the implied fair value of the goodwill. It also requires use of a discount rate that reflects the current return requirement of the market in relation to present risk-free interest rates, required equity market premiums and company-specific risk indicators. As a result of the significant declines the equity markets experienced in 2008 and 2009, management determined triggering events had occurred and the goodwill associated with Nottingham Advisors, one of the Company's wealth management businesses, was tested for impairment during the fourth quarter of 2009 and 2008. Based on those goodwill valuations performed using Level 3 inputs, the Company recognized an impairment charge and wrote down the carrying value of the goodwill by \$3.1 and \$1.7 million, respectively, to \$2.5 million.

The Company determines fair values based on quoted market values where available or on estimates using present values or other valuation techniques. Those techniques are significantly affected by the assumptions used, including the discount rate and estimates of future cash flows. In that regard, the derived fair value estimates cannot be substantiated by comparison to independent markets and, in many cases, could not be realized in immediate settlement of the instrument. Certain financial instruments and all nonfinancial instruments are excluded from fair value disclosure requirements. Accordingly, the aggregate fair value amounts presented do not represent the underlying value of the Company. The fair value of investment securities has been disclosed in Note C.

The carrying amounts and estimated fair values of the Company's other financial instruments at December 31, 2011 and 2010 are as follows:

| December 31, 2011 | December 31, 2010 |
|-------------------|-------------------|
|-------------------|-------------------|

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| (000's omitted) | Carrying Value | Fair Value | Carrying Value | Fair Value |
|--|-------------------|---------------|-------------------|---------------|
| Financial assets: | | | | |
| Net loans | \$3,471,025 | \$3,491,729 | \$3,026,363 | \$3,039,331 |
| Financial liabilities: | | | | |
| Deposits | 4,795,245 | 4,810,856 | 3,934,045 | 3,944,261 |
| Borrowings | 728,281 | 828,018 | 728,460 | 808,902 |
| Subordinated debt held by unconsolidated subsidiary trusts | 102,048 | 73,211 | 102,024 | 82,490 |

The following is a further description of the principal valuation methods used by the Company to estimate the fair values of its financial instruments.

Loans – Fair values for variable rate loans that reprice frequently are based on carrying values. Fair values for fixed rate loans are estimated using discounted cash flows and interest rates currently being offered for loans with similar terms to borrowers of similar credit quality.

Deposits – The fair value of demand deposits, interest-bearing checking deposits, savings accounts and money market deposits is the amount payable on demand at the reporting date. The fair value of time deposit obligations are based on current market rates for similar products.

Borrowings - Fair values for long-term borrowings are estimated using discounted cash flows and interest rates currently being offered on similar borrowings.

Subordinated debt held by unconsolidated subsidiary trusts - The fair value of subordinated debt held by unconsolidated subsidiary trusts are estimated using discounted cash flows and interest rates currently being offered on similar securities.

Other financial assets and liabilities – Cash and cash equivalents, accrued interest receivable and accrued interest payable have fair values which approximate the respective carrying values because the instruments are payable on demand or have short-term maturities and present relatively low credit risk and interest rate risk.

NOTE S: DERIVATIVE INSTRUMENTS

The Company is party to derivative financial instruments in the normal course of its business to meet the financing needs of its customers and to manage its own exposure to fluctuations in interest rates. These financial instruments have been limited to interest rate swap agreements, commitments to originate real estate loans held for sale and forward sales commitments. The Company does not hold or issue derivative financial instruments for trading or other speculative purposes.

The Company has entered, at times, into forward sales commitments for the future delivery of residential mortgage loans, and interest rate lock commitments to fund loans at a specified interest rate. The forward sales commitments are utilized to reduce interest rate risk associated with interest rate lock commitments and loans held for sale. Changes in the estimated fair value of the forward sales commitments and interest rate lock commitments subsequent to inception are based on changes in the fair value of the underlying loan resulting from the fulfillment of the commitment and changes in the probability that the loan will fund within the terms of the commitment, which is affected primarily by changes in interest rates and the passage of time. At inception and during the life of the interest rate lock commitment, the Company includes the expected net future cash flows related to the associated servicing of the loan as part of the fair value measurement of the interest rate lock commitments. These derivatives are recorded at fair value.

The Company utilized interest rate swap agreements as part of the management of interest rate risk to modify the repricing characteristics of certain of its borrowings. The interest rate swap was designated as a qualifying cash flow hedge and expired December 15, 2011. See further details of interest rate swap agreements in Note H.

The Company did not have any active derivatives at December 31, 2011 but did utilize them during the year then ended. The following table presents the Company's derivative financial instruments and the location of the net gain or loss recognized in the statement of income for the year ended December 31, 2011:

| (000's omitted) | Location | Loss recognized in the Statement of Income for the Year Ending December 31, 2011 |
|-----------------------------------|---|---|
| Interest rate swap agreement | Interest on subordinated debt held by unconsolidated subsidiary trusts | (\$3,246) |
| Interest rate lock commitments | Mortgage banking and other services | (58) |
| Forward sales commitments | Mortgage banking and other services | (322) |
| Total | | (\$3,626) |

The amount of gain recognized during the year ended December 31, 2011 in other comprehensive income related to the interest rate swap accounted for as a hedging instrument was approximately \$1,980,000.

NOTE T: SEGMENT INFORMATION

Operating segments are components of an enterprise, which are evaluated regularly by the chief operating decision maker in deciding how to allocate resources and assess performance. The Company's chief operating decision maker is the President and Chief Executive Officer of the Company. The Company has identified Banking as its reportable operating business segment. The banking segment provides full-service banking to consumers, businesses and governmental units in northern, central and western New York as well as Northern Pennsylvania.

Other operating segments of the Company's operations, which do not have similar characteristics to the banking segment and do not meet the quantitative thresholds requiring disclosure, are included in the Other category. Revenues derived from these segments includes administration, consulting and actuarial services to sponsors of employee benefit plans, broker-dealer and investment advisory services, asset management services to individuals, corporate pension and profit sharing plans, trust services and insurance commissions from various insurance related products and services. The accounting policies used in the disclosure of business segments are the same as those described in the summary of significant accounting policies (See Note A).

Information about reportable segments and reconciliation of the information to the consolidated financial statements follows:

| (000's omitted) | Banking | Other | Eliminations | Consolidated Total |
|---|-------------|----------|--------------|-----------------------|
| 2011 | | | | |
| Net interest income | \$209,302 | \$111 | \$0 | \$209,413 |
| Provision for loan losses | 4,736 | 0 | 0 | 4,736 |
| Noninterest income | 46,921 | 44,142 | (1,841) | 89,222 |
| Amortization of intangible assets | 3,393 | 988 | 0 | 4,381 |
| Other operating expenses | 152,468 | 35,364 | (1,841) | 185,991 |
| Income before income taxes | \$95,626 | \$7,901 | \$0 | \$103,527 |
| Assets | \$6,461,694 | \$38,557 | (\$11,976) | \$6,488,275 |
| Goodwill | \$334,554 | \$10,496 | \$0 | \$345,050 |
| 2010 | | | | |
| Net interest income | \$181,582 | \$102 | \$0 | \$181,684 |
| Provision for loan losses | 7,205 | 0 | 0 | 7,205 |
| Noninterest income | 49,342 | 41,066 | (1,616) | 88,792 |
| Amortization of intangible | 5,081 | 876 | 0 | 5,957 |

| | | | | |
|---------------|-------------|----------|------------|-------------|
| assets | | | | |
| Other | | | | |
| operating | | | | |
| expenses | 140,267 | 32,278 | (1,616) | 170,929 |
| Income | | | | |
| before | | | | |
| income taxes | \$78,371 | \$8,014 | \$0 | \$86,385 |
| Assets | \$5,420,990 | \$33,129 | (\$9,613) | \$5,444,506 |
| Goodwill | \$287,412 | \$10,280 | \$0 | \$297,692 |
| 2009 | | | | |
| Net interest | | | | |
| income | \$165,429 | \$71 | \$0 | \$165,500 |
| Provision for | | | | |
| loan losses | 9,790 | 0 | 0 | 9,790 |
| Noninterest | | | | |
| income | 47,133 | 37,708 | (1,306) | 83,535 |
| Amortization | | | | |
| of intangible | | | | |
| assets | 7,176 | 994 | 0 | 8,170 |
| Goodwill | | | | |
| impairment | 0 | 3,079 | 0 | 3,079 |
| Other | | | | |
| operating | | | | |
| expenses | 143,760 | 32,475 | (1,306) | 174,929 |
| Income | | | | |
| before | | | | |
| income taxes | \$51,836 | \$1,231 | \$0 | \$53,067 |
| Assets | \$5,378,916 | \$35,201 | (\$11,304) | \$5,402,813 |
| Goodwill | \$287,412 | \$10,280 | \$0 | \$297,692 |

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 Rule 13a – 15(f). Under the supervision and with the participation of our management, including our principal executive officer and principal financial officer, we conducted an evaluation of the effectiveness of our internal control over financial reporting based on the framework in Internal Control – Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission. Based on our evaluation management concluded that our internal control over financial reporting was effective as of December 31, 2011.

The consolidated financial statements of the Company have been audited by PricewaterhouseCoopers LLP, an independent registered public accounting firm that was engaged to express an opinion as to the fairness of presentation of such financial statements. PricewaterhouseCoopers LLP was also engaged to assess the effectiveness of the Company's internal control over financial reporting. The report of PricewaterhouseCoopers LLP follows this report.

Community Bank System, Inc.

By: /s/ Mark E. Tryniski
Mark E. Tryniski,
President, Chief Executive Officer and Director

By: /s/ Scott Kingsley
Scott Kingsley,
Treasurer and Chief Financial Officer

Report of Independent Registered Public Accounting Firm

To the Board of Directors and Shareholders of
Community Bank System, Inc.

In our opinion, the consolidated statements of condition and the related consolidated statements of income, changes in shareholders' equity, comprehensive income, and cash flows present fairly, in all material respects, the financial position of Community Bank System, Inc. and its subsidiaries (the "Company") at December 31, 2011 and 2010, and the results of its operations and its cash flows for each of the three years in the period ended December 31, 2011 in conformity with accounting principles generally accepted in the United States of America. Also in our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 2011, 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 these financial statements, for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying Report on Internal Control Over Financial Reporting. Our responsibility is to express opinions on these financial statements and on the Company's internal control over financial reporting based on our integrated 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 audits to obtain reasonable assurance about whether the financial statements are free of material misstatement and whether effective internal control over financial reporting was maintained in all material respects. Our audits of the financial statements included examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. Our audit of internal control over financial reporting included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audits also included performing such other procedures as we considered necessary in the circumstances. We believe that our audits provide a reasonable basis for our opinions.

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 (i) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (ii) 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 (iii) 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.

/s/PricewaterhouseCoopers LLP

Buffalo, New York
February 29, 2012

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TWO YEAR SELECTED QUARTERLY DATA (Unaudited)

| 2011 Results (000's omitted, except per share data) | 4th Quarter | 3rd Quarter | 2nd Quarter | 1st Quarter | Total |
|--|----------------|----------------|----------------|----------------|-----------|
| Net interest income | \$55,135 | \$54,568 | \$54,187 | \$45,523 | \$209,413 |
| Provision for loan losses | 1,593 | 1,043 | 1,050 | 1,050 | \$4,736 |
| Net interest income after provision for loan losses | 53,542 | 53,525 | 53,137 | 44,473 | 204,677 |
| Noninterest income | 22,399 | 23,216 | 22,765 | 20,842 | 89,222 |
| Operating expenses | 47,837 | 48,093 | 51,126 | 43,316 | 190,372 |
| Income before income taxes | 28,104 | 28,648 | 24,776 | 21,999 | 103,527 |
| Income taxes | 9,116 | 8,640 | 6,790 | 5,839 | 30,385 |
| Net income | \$18,988 | \$20,008 | \$17,986 | \$16,160 | \$73,142 |
| Basic earnings per share | \$0.51 | \$0.54 | \$0.49 | \$0.48 | \$2.03 |
| Diluted earnings per share | \$0.51 | \$0.54 | \$0.49 | \$0.48 | \$2.01 |
| 2010 Results (000's omitted, except per share data) | 4th Quarter | 3rd Quarter | 2nd Quarter | 1st Quarter | Total |
| Net interest income | \$46,133 | \$46,324 | \$45,945 | \$43,282 | \$181,684 |
| Provision for loan losses | 1,935 | 1,400 | 2,050 | 1,820 | 7,205 |
| Net interest income after provision for loan losses | 44,198 | 44,924 | 43,895 | 41,462 | 174,479 |
| Noninterest income | 21,783 | 22,914 | 22,378 | 21,717 | 88,792 |
| Operating expenses | 44,121 | 44,352 | 44,220 | 44,193 | 176,886 |
| Income before income taxes | 21,860 | 23,486 | 22,053 | 18,986 | 86,385 |
| Income taxes | 5,966 | 6,224 | 5,891 | 4,984 | 23,065 |
| Net income | \$15,894 | \$17,262 | \$16,162 | \$14,002 | \$63,320 |
| Basic earnings per share | \$0.48 | \$0.52 | \$0.49 | \$0.42 | \$1.91 |
| Diluted earnings per share | \$0.47 | \$0.51 | \$0.48 | \$0.42 | \$1.89 |

Item 9. Changes in and Disagreements with Accountants on Accounting and Financial Disclosure
None

Item 9A. Controls and Procedures

Evaluation of Disclosure Controls and Procedures

The Company maintains disclosure controls and procedures, as defined in Rule 13a -15(e) and 15d – 15(e) under the Securities Exchange Act of 1934, as amended, designed to: (i) record, process, summarize, and report within the time periods specified in the Securities and Exchange Commission’s (“SEC”) rules and forms, and (ii) accumulate and communicate to management, including the principal executive and principal financial officers, as appropriate, to allow timely decisions regarding disclosure. Based on management’s evaluation of the Company’s disclosure controls and procedures, with the participation of the Chief Executive Officer and the Chief Financial Officer, it has concluded that, as of the end of the period covered by this Annual Report on Form 10-K, these disclosure controls and procedures were effective as of December 31, 2011.

Management’s Annual Report on Internal Control over Financial Reporting

Management’s annual report on internal control over financial reporting is included under the heading “Report on Internal Control Over Financial Reporting” at Item 8 of this Annual Report on Form 10-K.

Attestation Report of the Registered Public Accounting Firm

The attestation report of the Company’s registered public accounting firm is included under the heading “Report of the Independent Registered Public Accounting Firm” at Item 8 of this Annual Report on Form 10-K.

Changes in Internal Control over Financial Reporting

The Company continually assesses the adequacy of its internal control over financial reporting and enhances its controls in response to internal control assessments, and internal and external audit and regulatory recommendations. No change in internal control over financial reporting during the quarter ended December 31, 2011 or through the date of this Annual Report on Form 10-K have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

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 due to changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

Item 9B. Other Information

None

Part III

Item 10. Directors, Executive Officers and Corporate Governance

The information concerning the Directors of the Company required by this Item 10 is incorporated herein by reference to the sections entitled "Nominees for Director and Directors Continuing in Office" in the Company's Definitive Proxy Statement for its 2012 Annual Meeting of Shareholders, which will be filed with the Securities and Exchange Commission on or about April 4, 2012 (the "Proxy Statement"). The information concerning executive officers of the Company required by this Item 10 is presented in Item 4A of this Annual Report on Form 10-K. Disclosure of compliance with Section 16(a) of the Securities Exchange Act of 1934, as amended, by the Company's directors and executive officers is incorporated by reference to the section entitled "Section 16(a) Beneficial Ownership Reporting Compliance" in the Proxy Statement. In addition, information concerning Audit Committee and Audit Committee Financial Expert is included in the Proxy Statement under the caption "Audit Committee Report" and is incorporated herein by reference.

The Company has adopted a code of ethics that applies to its principal executive officer, principal financial officer, principal accounting officer or controller, or persons performing similar functions. The text of the code of ethics is posted on the Company's website at www.communitybankna.com, and is available free of charge in print to any person who requests it. The Company intends to satisfy the requirements under Item 5.05 of Form 8-K regarding an amendment to, or a waiver from, the code of ethics that relates to certain elements thereof, by posting such information on its website referenced above.

Item 11. Executive Compensation

The information required by this Item 11 is incorporated herein by reference to the section entitled "Compensation of Executive Officers" in the Company's Proxy Statement.

Item 12. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters

The information required by this Item 12 is incorporated herein by reference to the section entitled "Nominees for Director and Directors Continuing in Office" in the Company's Proxy Statement.

Item 13. Certain Relationships and Related Transactions and Director Independence

The information required by this Item 13 is incorporated herein by reference to the sections entitled “Corporate Governance” and “Transactions with Related Parties” in the Company’s Proxy Statement.

Item 14. Principal Accounting Fees and Services

The information required by this Item 14 is incorporated herein by reference to the section entitled “Audit Fees” in the Company’s Proxy Statement.

Part IV

Item 15. Exhibits, Financial Statement Schedules

(a) Documents filed as part of this report

(1) All financial statements. The following consolidated financial statements of Community Bank System, Inc. and subsidiaries are included in Item 8:

- Consolidated Statements of Condition,
December 31, 2011 and 2010
- Consolidated Statements of Income,
Years ended December 31, 2011, 2010, and 2009
- Consolidated Statements of Comprehensive Income,
Years ended December 31, 2011, 2010, and 2009
- Consolidated Statements of Changes in Shareholders' Equity,
Years ended December 31, 2011, 2010, and 2009
- Consolidated Statement of Cash Flows,
Years ended December 31, 2011, 2010, and 2009
- Notes to Consolidated Financial Statements,
December 31, 2011
- Report of Independent Registered Public Accounting Firm
- Quarterly selected data,
Years ended December 31, 2011 and 2010 (unaudited)

(2) Financial statement schedules. Schedules are omitted since the required information is either not applicable or shown elsewhere in the financial statements.

(3) Exhibits. The exhibits filed as part of this report and exhibits incorporated herein by reference to other documents are listed below:

2.1 Agreement and Plan of Merger, dated August 2, 2006, by and among Community Bank System, Inc., Seneca Acquisition Corp. and ONB Corporation. Incorporated by reference to Exhibit 2.2 to the Quarterly Report on Form 10-Q filed on November 8, 2006 (Registration No. 001-13695).

2.2 Agreement and Plan of Merger dated April 20, 2006, by and among Community Bank System, Inc., ESL Acquisition Corp., and ES&L Bancorp, Inc. Incorporated by reference to Exhibit 2.1 to the Current Report on Form 8-K filed on April 25, 2006 (Registration No. 001-13695).

2.3 Purchase and Assumption Agreement, dated June 24, 2008, by and among RBS Citizens, NA., Community Bank System, Inc., and Community Bank, N.A. Incorporated by reference to Exhibit 2.1 to the Current Report on Form 8-K filed on June 26, 2008 (Registration No. 001-13695).

2.4 Agreement and Plan of Merger, dated October 22, 2010, by and among Community Bank System, Inc. and The Wilber Corporation. Incorporated by reference to Exhibit 2.1 to the Current Report on Form 8-K filed on October 25, 2010 (Registration No. 001-13695).

3.1 Certificate of Incorporation of Community Bank System, Inc., as amended. Incorporated by reference to Exhibit No. 3.1 to the Registration Statement on Form S-4 filed on October 20, 2000 (Registration No. 333-48374).

3.2 Certificate of Amendment of Certificate of Incorporation of Community Bank System, Inc. Incorporated by reference to Exhibit No. 3.1 to the Quarterly Report on Form 10-Q filed on May 5, 2004 (Registration No. 001-13695).

3.3 Bylaws of Community Bank System, Inc., amended July 18, 2007. Incorporated by reference to Exhibit 3.2 to the Current Report on Form 8-K filed on July 24, 2007. (Registration No. 001-13695).

4.1 Form of Common Stock Certificate. Incorporated by reference to Exhibit No. 4.1 to the Amendment No. 1 to the Registration Statement on Form S-3 filed on September 29, 2008 (Registration No. 333-153403).

10.1 Supplemental Retirement Plan Agreement, effective as of December 31, 2008, by and among Community Bank, N.A., Community Bank System, Inc. and Mark E. Tryniski. Incorporated by reference to Exhibit No. 10.2 to the Current Report on Form 8-K filed on March 19, 2009 (Registration No. 001-13695).**

10.2 Indenture dated as of December 8, 2006, between Community Bank System, Inc. and Wilmington Trust Company, as trustee. Incorporated by reference to Exhibit No. 4.1 to the Current Report on Form 8-K filed on December 12, 2006 (Registration No. 001-13695).

10.3 Amended and Restated Declaration of Trust dated as of December 8, 2006, among Community Bank System, Inc., as sponsor, Wilmington Trust Company, as Delaware trustee, Wilmington Trust Company, as institutional trustee, and Mark E. Tryniski, Scott A. Kingsley, and Joseph J. Lemchak as administrators. Incorporated by reference to Exhibit 10.1 to the Current Report on Form 8-K filed on December 12, 2006 (Registration No. 001-13695).

10.4 Guarantee Agreement dated as of December 8, 2006, between Community Bank System, Inc., as guarantor, and Wilmington Trust Company, as guarantee trustee. Incorporated by reference to Exhibit 10.1 to the Form 8-K filed on December 12, 2006 (Registration No. 001-13695).

10.5 Employment Agreement, effective January 1, 2012, by and between Community Bank System, Inc., Community Bank, N.A. and Mark E. Tryniski. Incorporated by reference to Exhibit No. 10.1 to the Current Report on Form 8-K filed on December 30, 2011 (Registration No. 001-13695). **

10.6 Post-2004 Supplemental Retirement Agreement, effective January 1, 2005, by and between Community Bank System, Inc., Community Bank, N.A. and Sanford Belden. Incorporated by reference to Exhibit No. 10.2 to the Annual Report on Form 10-K filed on March 15, 2005 (Registration No. 001-13695). **

10.7 Pre-2005 Supplemental Retirement Agreement, effective December 31, 2004, by and between Community Bank System, Inc., Community Bank, N.A. and Sanford Belden. Incorporated by reference to Exhibit No. 10.3 to the Annual Report on Form 10-K filed on March 15, 2005 (Registration No. 001-13695).**

10.8 Supplemental Retirement Plan Agreement, effective September 29, 2009, by and between Community Bank System Inc., Community Bank, N.A., and Scott A. Kingsley. Incorporated by reference to Exhibit No. 10.1 to the Current Report on Form 8-K filed on October 1, 2009 (Registration No. 001-13695). **

10.9 Employment Agreement, effective January 29, 2010, by and between Community Bank System, Inc., Community Bank N.A. and Brian D. Donahue. Incorporated by reference to Exhibit No. 10.1 to the Current Report on Form 8-K filed on February 3, 2010 (Registration No. 001-13695). **

10.10 Supplemental Retirement Plan Agreement, effective March 26, 2003, by and between Community Bank System Inc. and Thomas McCullough. Incorporated by reference to Exhibit No. 10.11 to the Annual Report on Form 10-K filed on March 12, 2004 (Registration No. 001-13695). **

10.11 2004 Long-Term Incentive Compensation Program, as to be amended. Incorporated by reference to Exhibit No. 10.1 to the Current Report on Form 8-K filed on May 12, 2011 (Registration No. 001-13695). **

10.12 Stock Balance Plan for Directors, as amended. Incorporated by reference to Annex I to the Definitive Proxy Statement on Schedule 14A filed on March 31, 1998 (Registration No. 001-13695). **

10.13 Deferred Compensation Plan for Directors, as amended. Incorporated by reference to Annex I to the Definitive Proxy Statement on Schedule 14A filed on March 31, 1998 (Registration No. 001-13695). **

10.14 Community Bank System, Inc. Pension Plan Amended and Restated as of January 1, 2004. Incorporated by reference to Exhibit No. 10.27 to the Annual Report on Form 10-K filed on March 15, 2005 (Registration No. 001-13695). **

10.15 Amendment #1 to the Community Bank System, Inc. Pension Plan, as amended and restated as of January 1, 2004 (“Plan”). Incorporated by reference to Exhibit No. 10.27 to the Annual Report on Form 10-K filed on March 15, 2005 (Registration No. 001-13695). **

10.16 Amendment #1 to the Deferred Compensation Plan For Certain Executive Employees of Community Bank System, Inc., as amended and restated as of January 1, 2002. Incorporated by reference to Exhibit No. 10.33 to the Annual Report on Form 10-K filed on March 15, 2005 (Registration No. 001-13695). **

10.17 Employment Agreement, dated January 3, 2011, by and among Community Bank System, Inc., Community Bank N.A. and George J. Getman. Incorporated by reference to Exhibit No. 10.2 to the Current Report on Form 8-K filed on January 6, 2011 (Registration No. 001-13695). **

10.18 Employment Agreement, dated January 3, 2011, by and among Community Bank System, Inc., Community Bank N.A. and Scott Kingsley. Incorporated by reference to Exhibit No. 10.1 to the Current Report on Form 8-K filed on January 6, 2011 (Registration No. 001-13695). **

10.19 Supplemental Retirement Plan Agreement, effective April 9, 2009, by and among Community Bank System, Inc., Community Bank, N.A. and George J. Getman. Incorporated by reference to Exhibit 10.1 to the Current Report on Form 8-K filed on April 14, 2009 (Registration No. 001-13695). **

14.1 Community Bank System, Inc., Code of Ethics. Incorporated by reference to Exhibit No. 1 to the Annual Report on Form 10-K filed on March 15, 2005 (Registration No. 001-13695).

21.1 Subsidiaries of Registrant. *

23.1 Consent of PricewaterhouseCoopers LLP. *

31.1 Certification of Mark E. Tryniski, President and Chief Executive Officer of the Registrant, pursuant to Rule 13a-15(e) or Rule 15d-15(e) under the Securities Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002. *

31.2 Certification of Scott Kingsley, Treasurer and Chief Financial Officer of the Registrant, pursuant to
Rule 13a-15(e) or Rule 15d-15(e) under the Securities Exchange Act of 1934, as
adopted pursuant to Section
302 of the Sarbanes-Oxley Act of 2002. *

32.1 Certification of Mark E. Tryniski, President and Chief Executive Officer of the Registrant, pursuant to 18
U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of
2002. ***

32.2 Certification of Scott Kingsley, Treasurer and Chief Financial Officer of the Registrant, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the

Sarbanes-Oxley Act of 2002. ***

* Filed herewith

** Denotes management contract or compensatory plan or arrangement

*** Furnished herewith.

B. Not applicable

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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.

COMMUNITY BANK SYSTEM, INC.

By

/s/ Mark E. Tryniski

Mark E. Tryniski

President and Chief Executive Officer

February 29, 2012

Pursuant to the requirements of the Securities and Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacities indicated on the 29th day of February 2012.

/s/ Mark E. Tryniski

Mark E. Tryniski

President, Chief Executive Officer and Director

(Principal Executive Officer)

/s/ Scott Kingsley

Scott Kingsley

Treasurer and Chief Financial Officer

(Principal Financial Officer and Principal Accounting Officer)

Directors:

/s/ Brian R. Ace

Brian R. Ace, Director

/s/ Edward S. Mucenski

Edward S. Mucenski, Director

/s/ Mark J. Bolus

Mark J. Bolus, Director

/s/ John Parente

John Parente, Director

/s/ Paul M. Cantwell, Jr.

Paul M. Cantwell, Jr., Director

/s/ Sally A. Steele

Sally A. Steele, Director

/s/ Nicholas A. DiCerbo

/s/ John F. Whipple, Jr.

Nicholas A. DiCerbo, Director and Chairman of the John F. Whipple Jr., Director
Board of Directors

/s/ Neil E. Fesette

/s/ Alfred S. Whittet

Neil E. Fesette, Director

Alfred S. Whittet, Director

/s/ James A. Gabriel

/s/ James A. Wilson

James A. Gabriel, Director

James A. Wilson, Director

/s/ James W. Gibson, Jr.

/s/ Brian R. Wright

James W. Gibson, Jr., Director

Brian R. Wright, Director

