

COMMUNITY BANK SYSTEM INC  
Form 10-Q  
May 09, 2011

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

FORM 10-Q

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

For the quarterly period ended March 31, 2011

OR

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  
(State or other jurisdiction of  
incorporation or organization)

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

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

13214-1883  
(Zip Code)

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

NONE

(Former name, former address and former fiscal year, if changed since last report)

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 to its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of

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

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

Large accelerated filer  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 Exchange Act). Yes  No .

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

36,786,561 shares of Common Stock, \$1.00 par value, were outstanding on April 30, 2011.

---

TABLE OF CONTENTS

ion

nts (Unaudited)

tements of Condition

and December 31, 2010.....

tements of Income

ended March 31, 2011 and 2010.....

atement of Changes in Shareholders' Equity

ended March 31, 2011.....

tements of Comprehensive Income

ended March 31, 2011 and 2010.....

tements of Cash Flows

ended March 31, 2011 and 2010.....

olidated Financial Statements

Discussion and Analysis of Financial Condition and Results of Operations.....

Qualitative Disclosures about Market Risk.....

cedures.....

of Equity Securities and Use of Proceeds.....

ior Securities.....

served).....

## Part I. Financial Information

## Item 1. Financial Statements

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

	March 31, 2011	December 31, 2010
Assets:		
Cash and cash equivalents	\$296,938	\$211,837
Held-to-maturity investment securities (fair value of \$613,258 and \$625,789, respectively)	593,325	602,908
Available-for-sale investment securities (cost of \$1,126,565 and \$1,076,030, respectively)	1,145,475	1,085,963
Other securities, at cost	53,446	53,453
Loans held for sale, at fair value	282	3,952
Loans	3,000,444	3,026,363
Allowance for loan losses	(42,147)	(42,510)
Net loans	2,958,297	2,983,853
Core deposit intangibles, net	10,197	10,897
Goodwill	297,692	297,692
Other intangibles, net	3,187	3,125
Intangible assets, net	311,076	311,714
Premises and equipment, net	81,048	81,561
Accrued interest receivable	26,760	26,136
Other assets	82,725	83,129
Total assets	\$5,549,372	\$5,444,506
Liabilities:		
Noninterest-bearing deposits	\$754,892	\$741,166
Interest-bearing deposits	3,266,139	3,192,879
Total deposits	4,021,031	3,934,045
Borrowings	728,385	728,460
Subordinated debt held by unconsolidated subsidiary trusts	102,030	102,024
Accrued interest and other liabilities	73,826	72,719
Total liabilities	4,925,272	4,837,248
Commitments and contingencies (See Note H)		

## 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; 34,241,019 and 34,131,289 shares issued, respectively	34,241	34,131
Additional paid-in capital	228,019	225,543
Retained earnings	382,838	374,700
Accumulated other comprehensive loss	(3,222)	(9,340)
Treasury stock, at cost (812,346 and 812,346 shares, respectively)	(17,776)	(17,776)
Total shareholders' equity	624,100	607,258
Total liabilities and shareholders' equity	\$5,549,372	\$5,444,506

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

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

	Three Months Ended March 31, 2011 2010	
Interest income:		
Interest and fees on loans	\$42,297	\$44,673
Interest and dividends on taxable investments	12,229	10,933
Interest and dividends on nontaxable investments	5,761	5,446
Total interest income	60,287	61,052
Interest expense:		
Interest on deposits	6,006	8,603
Interest on borrowings	7,291	7,703
Interest on subordinated debt held by unconsolidated subsidiary trusts	1,467	1,464
Total interest expense	14,764	17,770
Net interest income	45,523	43,282
Less: provision for loan losses	1,050	1,820
Net interest income after provision for loan losses	44,473	41,462
Noninterest income:		
Deposit service fees	9,685	10,519
Mortgage banking and other services	794	923
Benefit plan administration, consulting and actuarial fees	8,183	7,899
Wealth management services	2,180	2,376
Total noninterest income	20,842	21,717
Operating expenses:		
Salaries and employee benefits	23,111	22,936
Occupancy and equipment	6,057	6,225
Data processing and communications	4,771	5,114
Amortization of intangible assets	901	1,859
Legal and professional fees	1,339	1,300
Office supplies and postage	1,196	1,249
Business development and marketing	1,254	1,014
FDIC insurance premiums	1,361	1,572
Acquisition expenses	691	0
Other	2,635	2,924
Total operating expenses	43,316	44,193
Income before income taxes	21,999	18,986

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

Income taxes	5,839	4,984
Net income	\$16,160	\$14,002
Basic earnings per share	\$0.48	\$0.42
Diluted earnings per share	\$0.48	\$0.42
Dividends declared per share	\$0.24	\$0.22

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

COMMUNITY BANK SYSTEM, INC.  
CONSOLIDATED STATEMENT OF CHANGES IN SHAREHOLDERS' EQUITY (Unaudited)  
Three Months Ended March 31, 2011  
(In Thousands, Except Share Data)

	Common Stock Shares Outstanding	Common Stock Amount Issued	Additional Paid-In Capital	Retained Earnings	Accumulated Other Comprehensive (Loss)Income	Treasury Stock	Total
Balance at December 31, 2010	33,318,943	\$34,131	\$225,543	\$374,700	(\$9,340)	(\$17,776)	\$607,258
Net income				16,160			16,160
Other comprehensive income, net of tax					6,118		6,118
Dividends declared: Common, \$0.24 per share				(8,022)			(8,022)
Common stock issued under Stock Plan, including tax benefits of \$286	109,730	110	1,214				1,324
Stock-based compensation			1,262				1,262
Balance at March 31, 2011	33,428,673	\$34,241	\$228,019	\$382,838	(\$3,222)	(\$17,776)	\$624,100

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



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

	Three Months Ended March 31,	
	2011	2010
Other comprehensive income, before tax:		
Change in pension liabilities	\$174	\$307
Change in unrealized loss on derivative instruments used in cash flow hedges	788	105
Unrealized gains on securities:		
Unrealized holding gains arising during period	8,977	4,362
Other comprehensive income, before tax:	9,939	4,774
Income tax expense related to other comprehensive income	(3,821)	(1,764)
Other comprehensive income, net of tax:	6,118	3,010
Net income	16,160	14,002
Comprehensive income	\$22,278	\$17,012

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

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

	Three Months Ended March 31,	
	2011	2010
Operating activities:		
Net income	\$16,160	\$14,002
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation	2,739	2,449
Amortization of intangible assets	901	1,859
Net amortization (accretion) of premiums & discounts on securities, loans and borrowings	(314)	796
Stock-based compensation	1,262	1,298
Provision for loan losses	1,050	1,820
Amortization of mortgage servicing rights	224	192
Income on bank-owned life insurance policies	(113)	(141)
Net gain on sale of loans and other assets	(388)	(125)
Net change in loans held for sale	3,976	941
Change in other assets and liabilities	(2,416)	(11,659)
Net cash provided by operating activities	23,081	11,432
Investing activities:		
Proceeds from maturities of held-to-maturity investment securities	11,703	28,375
Proceeds from maturities of available-for-sale investment securities	36,760	35,765
Purchases of held-to-maturity investment securities	(2,299)	(318,451)
Purchases of available-for-sale investment securities	(86,795)	(1,560)
Sales of other securities	7	7
Purchases of other securities	0	(3)
Net decrease in loans	24,506	35,329
Cash paid for acquisition	(270)	-
Capital expenditures	(2,137)	(2,999)
Net cash used in investing activities	(18,525)	(223,537)
Financing activities:		
Net increase in deposits	86,986	63,791
Net decrease in borrowings	(75)	(173)
Issuance of common stock	1,324	1,658
Cash dividends paid	(7,976)	(7,211)
Excess tax benefits from stock-based compensation	286	431
Net cash provided by financing activities	80,545	58,496
Change in cash and cash equivalents	85,101	(153,609)
Cash and cash equivalents at beginning of period	211,837	361,876
Cash and cash equivalents at end of period	\$296,938	\$208,267

Supplemental disclosures of cash flow information:

Cash paid for interest	\$14,882	\$17,814
Cash paid for income taxes	124	-
Supplemental disclosures of noncash financing and investing activities:		
Dividends declared and unpaid	8,022	7,268
Transfers from loans to other real estate	912	1,244

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

COMMUNITY BANK SYSTEM, INC.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)

March 31, 2011

NOTE A: BASIS OF PRESENTATION

The interim financial data as of and for the three months ended March 31, 2011 is unaudited; however, in the opinion of Community Bank System, Inc. (the "Company"), the interim data includes all adjustments, consisting only of normal recurring adjustments, necessary for a fair statement of the results for the interim periods in accordance with generally accepted accounting principles ("GAAP"). The results of operations for the interim periods are not necessarily indicative of the results that may be expected for the full year or any other interim period. Certain prior year amounts in the consolidated financial statements and notes thereto have been reclassified to conform to the current year's presentation.

NOTE B: ACCOUNTING POLICIES

The accounting policies of the Company, as applied in the consolidated interim financial statements presented herein, are substantially the same as those followed on an annual basis as presented on pages 53 through 58 of the Annual Report on Form 10-K for the year ended December 31, 2010.

Critical Accounting Policies

Allowance for Loan Losses

Management continually evaluates the credit quality of the Company's loan portfolio, and performs a formal review of the adequacy of the allowance for loan losses on a quarterly basis. The allowance reflects management's best estimate of probable losses incurred 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 categories: business lending; consumer installment – direct; consumer installment – indirect; home equity; and consumer mortgage. The first calculation determines an allowance level based on 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. 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 continually refine and enhance its loss evaluation and estimation processes.

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.

#### 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 to 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 market 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 March 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. See Notes C and J for further information.

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 it is not expected that the security will be sold, 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 a systematic 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.

#### 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.

#### 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 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 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.

#### Retirement Benefits

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

#### New Accounting Pronouncements

In April 2011, the FASB issued ASU 2011-02, Receivables (Topic 310), A Creditor's Determination of Whether a Restructuring Is a Troubled Debt Restructuring. This guidance amends accounting and disclosure guidance relating to a creditor's determination of whether a restructuring is a troubled debt restructuring. The amendments clarify the guidance on a creditor's evaluation of whether it has granted a concession and whether a debtor is experiencing financial difficulties. The updated guidance and related disclosure requirements are effective for financial statements issued for the first interim or annual period beginning on or after June 15, 2011, and should be applied retroactively to the beginning of the annual period of adoption. Early adoption is permitted. Management is currently evaluating the impact of the guidance on the Company's financial position or results of operations.

## NOTE C: INVESTMENT SECURITIES

The amortized cost and estimated fair value of investment securities as of March 31, 2011 and December 31, 2010 are as follows:

(000's omitted)	March 31, 2011				December 31, 2010			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
<b>Held-to-Maturity Portfolio:</b>								
U.S. Treasury and agency securities	\$478,190	\$17,852	\$0	\$496,042	\$478,100	\$21,571	\$29	\$499,642
Government agency mortgage-backed securities	48,489	2,365	0	50,854	56,891	2,753	0	59,644
Obligations of state and political subdivisions	66,599	802	1,086	66,315	67,864	277	1,691	66,450
Other securities	47	0	0	47	53	0	0	53
<b>Total held-to-maturity portfolio</b>	<b>\$593,325</b>	<b>\$21,019</b>	<b>\$1,086</b>	<b>\$613,258</b>	<b>\$602,908</b>	<b>\$24,601</b>	<b>\$1,720</b>	<b>\$625,789</b>
<b>Available-for-Sale Portfolio:</b>								
U.S. Treasury and agency securities	\$323,545	\$21,743	\$0	\$345,288	\$281,826	\$22,231	\$0	\$304,057
Obligations of state and political subdivisions	534,421	11,472	3,615	542,278	518,216	10,197	6,195	522,218
Government agency mortgage-backed securities	165,374	8,434	182	173,626	170,673	9,159	116	179,716
Pooled trust preferred securities	69,164	0	20,992	48,172	69,508	0	27,515	41,993
Corporate debt securities	24,016	1,573	0	25,589	25,523	1,634	0	27,157
Government agency collateralized mortgage obligations	9,665	410	0	10,075	9,904	491	0	10,395
Marketable equity securities	380	67	0	447	380	54	7	427
	<b>\$1,126,565</b>	<b>\$43,699</b>	<b>\$24,789</b>	<b>\$1,145,475</b>	<b>\$1,076,030</b>	<b>\$43,766</b>	<b>\$33,833</b>	<b>\$1,085,963</b>

Total  
available-for-sale  
portfolio

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 March 31, 2011

(000's omitted)	Less than 12 Months Gross		12 Months or Longer Gross		Total Gross	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
<b>Held-to-Maturity Portfolio:</b>						
Obligations of state and political subdivisions	\$26,414	\$1,086	\$0	\$0	\$26,414	\$1,086
Total held-to-maturity portfolio	26,414	1,086	0	0	26,414	1,086
<b>Available-for-Sale Portfolio:</b>						
Obligations of state and political subdivisions	130,033	3,081	4,034	534	134,067	3,615
Government agency mortgage-backed securities	17,257	182	0	0	17,257	182
Pooled trust preferred securities	0	0	48,172	20,992	48,172	20,992
Total available-for-sale portfolio	147,290	3,263	52,206	21,526	199,496	24,789
<b>Total investment portfolio</b>	<b>\$173,704</b>	<b>\$4,349</b>	<b>\$52,206</b>	<b>\$21,526</b>	<b>\$225,910</b>	<b>\$25,875</b>

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

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
<b>Held-to-Maturity Portfolio:</b>						
U.S. Treasury and agency securities	\$14,967	\$29	\$0	\$0	\$14,967	\$29
Obligations of state and political subdivisions	43,851	1,691	0	0	43,851	1,691
<b>Total held-to-maturity portfolio</b>	<b>58,818</b>	<b>1,720</b>	<b>0</b>	<b>0</b>	<b>58,818</b>	<b>1,720</b>
<b>Available-for-Sale Portfolio:</b>						
Obligations of state and political subdivisions	197,066	5,705	4,049	490	201,115	6,195
Pooled trust preferred securities	0	0	41,993	27,515	41,993	27,515
Government agency mortgage-backed securities	14,690	116	0	0	14,690	116
Marketable equity securities	210	2	11	5	221	7
<b>Total available-for-sale portfolio</b>	<b>211,966</b>	<b>5,823</b>	<b>46,053</b>	<b>28,010</b>	<b>258,019</b>	<b>33,833</b>
<b>Total investment portfolio</b>	<b>\$270,784</b>	<b>\$7,543</b>	<b>\$46,053</b>	<b>\$28,010</b>	<b>\$316,837</b>	<b>\$35,553</b>

Included in the available-for-sale portfolio are pooled trust preferred, class A-1 securities with a current total par value of \$70.8 million and unrealized losses of \$21.0 million at March 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 the super senior tranche is impacted. As of March 31, 2011, an additional 31% - 38% of the underlying collateral in these securities would have to be in deferral or default concurrently to result in an expectation of 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 for the quarter ended March 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 banks and insurance companies that make up the collateral pool. 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 March 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 and it is not more likely than not that

the Company will be required to sell the underlying securities. Subsequent changes in market or credit conditions could change those evaluations.

Management does not believe any individual unrealized loss as of March 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 and Standard & Poor's and are guaranteed by the U.S. government. The obligations of state and political subdivisions are general purpose debt obligations of various states and political subdivisions. 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 March 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. Securities not due at a single maturity date are shown separately.

(000's omitted)	Held-to-Maturity		Available-for-Sale	
	Amortized Cost	Fair Value	Amortized Cost	Fair Value
Due in one year or less	\$8,583	\$8,688	\$73,566	\$74,914
Due after one through five years	63,550	66,662	168,362	176,258
Due after five years through ten years	401,953	416,729	298,970	316,620
Due after ten years	70,750	70,325	410,248	393,535
Subtotal	544,836	562,404	951,146	961,327
Government agency collateralized mortgage obligations	0	0	9,665	10,075
Government agency mortgage-backed securities	48,489	50,854	165,374	173,626
Total	\$593,325	\$613,258	\$1,126,185	\$1,145,028

#### NOTE D: LOANS

The segments of the Company's loan portfolio are disaggregated into classes to a level that allows 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 are summarized as follows:

(000's omitted)	March 31, 2011	December 31, 2010
Consumer mortgage	\$1,055,164	\$1,057,332
Business lending	1,006,114	1,023,286
Consumer installment - indirect	500,058	494,813
Home equity	299,925	305,936
Consumer installment - direct	139,183	144,996
Gross loans, including	3,000,444	3,026,363

deferred origination costs		
Allowance for loan losses	(42,147)	(42,510)
Loans, net of allowance for loan losses	\$2,958,297	\$2,983,853

### 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 March 31, 2011:

(000's omitted)	30 - 89 days	90+ Days Past Due and Still Accruing	Nonaccrual	Total Past Due	Current	Total Loans
Consumer mortgage	\$10,752	\$2,203	\$5,832	\$18,787	\$1,036,377	\$1,055,164
Business lending	5,421	184	7,788	13,393	992,721	1,006,114
Consumer installment - indirect	6,426	37	0	6,463	493,595	500,058
Home equity	2,084	273	1,333	3,690	296,235	299,925
Consumer installment - direct	1,524	77	0	1,601	137,582	139,183
Total	\$26,207	\$2,774	\$14,953	\$43,934	\$2,956,510	\$3,000,444

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

(000's omitted)	30 - 89 days	90+ Days Past Due and Still Accruing	Nonaccrual	Total Past Due	Current	Total Loans
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	484,436	494,813
Home equity	3,960	309	926	5,195	300,741	305,936
Consumer installment – direct	2,514	96	0	2,610	142,386	144,996
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)	March 31, 2011	December 31, 2010
Pass	\$752,274	\$753,252
Special Mention	145,031	159,906
Classified	108,809	110,128
Total	\$1,006,114	\$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 table details the balances in all other loan categories at March 31, 2011:

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

	Consumer Mortgage	Indirect Consumer	Home Equity	Direct Consumer	Total
(000's omitted) Performing	\$1,047,129	\$500,021	\$298,319	\$139,106	\$1,984,575
Nonperforming	8,035	37	1,606	77	9,755
Total	\$1,055,164	\$500,058	\$299,925	\$139,183	\$1,994,330

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

	Consumer Mortgage	Indirect Consumer	Home Equity	Direct Consumer	Total
(000's omitted) Performing	\$1,050,287	\$494,682	\$304,701	\$144,900	\$1,994,570
Nonperforming	7,045	131	1,235	96	8,507
Total	\$1,057,332	\$494,813	\$305,936	\$144,996	\$2,003,077

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

	March 31, 2011	December 31, 2010
(000's omitted)		
Loans with reserve	\$782	\$1,465
Loans without reserve	2,564	3,846
Carrying balance	3,346	5,311
Contractual balance	4,167	7,042
Specifically allocated allowance	387	762

Allowance for Loan Losses

The following presents by class the activity in the allowance for loan losses:

(000's omitted)	Consumer Mortgage	Business Lending	Home Equity	Direct Installment	Indirect Installment	Unallocated	Total
Balance at December 31, 2010	\$2,451	\$22,326	\$689	\$3,977	\$9,922	\$3,145	\$42,510
Charge-offs	(236)	(843)	(36)	(417)	(1,026)	0	(2,558)
Recoveries	19	86	7	216	817	0	1,145
Provision	865	(10)	200	18	(74)	51	1,050
Balance at March 31, 2011	\$3,099	\$21,559	\$860	\$3,794	\$9,639	\$3,196	\$42,147

(000's omitted)	Consumer Mortgage	Business Lending	Home Equity	Direct Installment	Indirect Installment	Unallocated	Total
Balance at December 31, 2009	\$1,127	\$23,577	\$374	\$3,660	\$10,004	\$3,168	\$41,910
Charge-offs	(87)	(1,368)	0	(426)	(1,049)	0	(2,930)
Recoveries	27	285	1	159	823	0	1,295
Provision	223	922	(15)	288	152	250	1,820
Balance at March 31, 2010	\$1,290	\$23,416	\$360	\$3,681	\$9,930	\$3,418	\$42,095

Despite the above allocation, the allowance for loan losses is general in nature and is available to absorb losses from any loan type.

NOTE E: 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 March 31, 2011		As of December 31, 2010	
	Gross Carrying Amount	Net Accumulated Amortization	Gross Carrying Amount	Net Accumulated Amortization
Amortizing intangible assets:				
Core deposit intangibles	\$60,595	(\$50,398)	\$10,197	(\$49,698)
Other intangibles	8,157	(4,970)	3,187	(4,769)
Total amortizing intangibles	\$68,752	(\$55,368)	\$13,384	(\$54,467)

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

Apr – Dec  
2011 \$2,627

2012	2,950
2013	2,305
2014	1,743
2015	1,232
Thereafter	2,527
Total	\$13,384

Shown below are the components of the Company's goodwill at March 31, 2011:

(000's omitted)	December 31, 2010	Activity	March 31, 2011
Goodwill	\$302,516		\$0\$302,516
Accumulated impairment	(4,824)	0	(4,824)
Goodwill, net	\$297,692		\$0\$297,692

## NOTE F: MANDATORILY REDEEMABLE PREFERRED SECURITIES

The Company sponsors two business trusts, Community Statutory Trust III and Community Capital Trust IV (“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 from the sale of such preferred securities solely in junior subordinated debt securities of the Company. The debentures held by each trust are the sole assets of that trust. Distributions on the preferred securities issued by each trust are payable quarterly at a rate per annum equal to the interest rate being earned by the trust on the debentures held by that trust and are recorded as interest expense in the consolidated financial statements. 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:

Trust	Issuance Date	Par Amount	Interest Rate	Maturity Date	Call Provision	Call Price
III	7/31/2001	\$24.5 million	3 month LIBOR plus 3.58% (3.88%)	7/31/2031	5 year beginning 2006	101.5% declining to par at July 31, 2011
IV	12/8/2006	\$75 million	3 month LIBOR plus 1.65% (1.96%)	12/15/2036	5 year beginning 2012	Par

Upon the issuance of Trust IV, the Company entered into an interest rate swap agreement to convert the variable rate trust preferred securities into a fixed rate security for a term of five years at a fixed rate of 6.43%. Additional interest expense of \$839,000 was recognized based on the interest rate swap agreement for the three months ended March 31, 2011, compared to \$848,000 for the three months ended March 31, 2010.

## NOTE G: BENEFIT 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. The Company accrues for the estimated cost of these benefits through charges to expense during the years that employees earn these benefits. The net periodic benefit cost for the three months ended March 31 is as follows:

	Pension Benefits		Post-retirement Benefits	
	Three Months Ended March 31, 2011	Three Months Ended March 31, 2010	Three Months Ended March 31, 2011	Three Months Ended March 31, 2010
(000's omitted)				
Service cost	\$686	\$693	\$0	\$0
Interest cost	961	987	38	49
Expected return on plan assets	(1,767)	(1,617)	0	0
Amortization of unrecognized net loss	474	614	2	4
	(37)	(47)	(264)	(264)

Amortization of prior service cost				
Amortization of transition obligation	0	0	0	0
Net periodic benefit cost	\$317	\$630	(\$224)	(\$211)

## NOTE H: 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 weighted-average anti-dilutive stock options outstanding at March 31, 2011 compared to approximately 1.8 million weighted-average anti-dilutive stock options outstanding at March 31, 2010 that were not included in the computation below.

The following is a reconciliation of basic to diluted earnings per share for the three months ended March 31, 2011 and 2010.

	Three Months Ended March 31,	
(000's omitted, except per share data)	2011	2010
Net income	\$16,160	\$14,002
Income attributable to unvested stock-based compensation awards	(131)	(112)
Income available to common shareholders	16,029	13,890
Weighted-average common shares outstanding – basic	33,245	32,824
Basic earnings per share	\$0.48	\$0.42
Net income	\$16,160	\$14,002
Income attributable to unvested stock-based compensation awards	(131)	(112)
Income available to common shareholders	16,029	13,890
Weighted-average common shares outstanding	33,245	32,824
Assumed exercise of stock options	472	238
Weighted-average shares – diluted	33,717	33,062
Diluted earnings per share	\$0.48	\$0.42

#### 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. No repurchases have been made under the repurchase authorization since it was approved, and the full 1,000,000 shares of common shares remain available to be purchased under the authorization.

#### NOTE I: COMMITMENTS, CONTINGENT LIABILITIES AND RESTRICTIONS

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

The contract amount of commitments and contingencies are as follows:

	March	December
(000's omitted)	31, 2011	31, 2010
Commitments to extend credit	\$475,249	\$445,625
Standby letters of credit	21,332	21,456
Total	\$496,581	\$467,081

#### NOTE J: 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 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 certain 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)	March 31, 2011			Total Fair Value
	Level 1	Level 2	Level 3	
Available-for-sale investment securities:				
U.S. Treasury and agency securities	\$61,807	\$283,481	\$0	\$345,288
Obligations of state and political subdivisions	0	542,278	0	542,278
Government agency mortgage-backed securities	0	173,626	0	173,626
Pooled trust preferred securities	0	0	48,172	48,172
Corporate debt securities	0	25,589	0	25,589
Government agency collateralized mortgage obligations	0	10,075	0	10,075
Marketable equity securities	447	0	0	447
Total available-for-sale investment securities	62,254	1,035,049	48,172	1,145,475
Forward sales commitments	0	3	0	3
Commitments to originate real estate loans for sale	0	0	58	58
Mortgage loans held for sale	0	282	0	282
Interest rate swap	0(2,445)		0	(2,445)
<b>Total</b>	<b>\$62,254</b>	<b>\$1,032,889</b>	<b>\$48,230</b>	<b>\$1,143,373</b>

(000's omitted)	December 31, 2010			Total Fair Value
	Level 1	Level 2	Level 3	
Available-for-sale investment securities:				
U.S. Treasury and agency securities	\$1,026	\$303,031	\$0	\$304,057
Obligations of state and political subdivisions	0	522,218	0	522,218

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

Government agency mortgage-backed securities	0	179,716	0	179,716
Pooled trust preferred securities	0	0	41,993	41,993
Corporate debt securities	0	27,157	0	27,157
Government agency collateralized mortgage obligations	0	10,395	0	10,395
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 commitments	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 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 March 31, 2011 is \$0.3 million. The unrealized gain on mortgage loans held for sale of \$3,000 was recognized in mortgage banking and other services income in the consolidated statement of income for the quarter ended March 31, 2011.
- 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 realization rate, 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 utilizes interest rate swap agreements to modify the repricing characteristics of certain of its interest-bearing liabilities. The fair value of these interest rate swaps, which are 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:

	2011			2010		
	Pooled trust preferred securities	Commitments to originate real estate loans for sale	Total	Pooled trust preferred securities	Commitments to originate real 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)	23	(58)	(35)	25	(31)	(6)
Total gains included in other comprehensive income	6,523	0	6,523	2,356	0	2,356
Principal reductions	(367)	0	(367)	(374)	0	(374)
Commitments to originate real estate loans held for sale, net	0	58	58	0	106	106
Ending balance	\$48,172	\$58	\$48,230	\$46,021	\$106	\$46,127

(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)	March 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	\$395	\$395	\$0	\$0	\$703	\$703
Other real estate owned	0	0	1,945	1,945	\$0	\$0	2,011	2,011
Mortgage servicing rights	0	0	1,606	1,606	0	0	2,422	2,422
Total	\$0	\$0	\$3,946	\$3,946	\$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 estimated period of net servicing income. In accordance with generally accepted accounting principles, the Company must record impairment charges, on a nonrecurring basis, when the carrying value of certain strata exceed 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 and 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 exceed estimated fair value. Impairment is recognized through a valuation allowance. There is a valuation allowance of approximately \$428,000 at March 31, 2011.

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. The Company did not recognize an impairment charge during 2010 or the three months ended March 31, 2011.

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, but not limited to, 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 that are not accounted for at fair value at March 31, 2011 and December 31, 2010 are as follows:

(000's omitted)	March 31, 2011		December 31, 2010	
	Carrying Value	Fair Value	Carrying Value	Fair Value
Financial assets:				
Net loans	\$3,000,444	\$3,002,970	\$3,026,363	\$3,039,331
Financial liabilities:				
Deposits	4,021,031	4,029,840	3,934,045	3,944,261
Borrowings	728,385	800,142	728,460	808,902
Subordinated debt held by unconsolidated subsidiary trusts	102,030	83,999	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 values 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 K: 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 enters 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 utilizes 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 has been designated as a qualifying cash flow hedge. See further details of interest rate swap agreements in Note F.

The following table presents the Company's derivative financial instruments, their estimated fair values, and balance sheet location as of March 31, 2011:

(000's omitted)	Asset Derivatives	Liability Derivatives
	Location Notional	Location Notional

		Fair Value	Fair Value
Derivatives designated as hedging instruments:			
Interest rate swap agreement			Other liabilities \$75,000 \$2,445
Derivatives not designated as hedging instruments:			
Commitments to originate real estate loans for sale	Other assets	\$4,701	\$58
Forward sales commitments	Other assets	2,933	3
Total derivatives		\$61	\$2,445

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 three months ended March 31, 2011:

(000's omitted)	Location	Loss recognized in the Statement of Income Three Months Ending March 31, 2011
Interest rate swap agreement	Interest on subordinated debt held by unconsolidated subsidiary trusts	(\$839)
Interest rate lock commitments	Mortgage banking and other services	-
Forward sales commitments	Mortgage banking and other services	(319)
Total		(\$1,158)

The amount of gain recognized during the three months ended March 31, 2011 in other comprehensive income related to the interest rate swap accounted for as a hedging instrument was approximately \$788,000. The amount of loss reclassified from accumulated other comprehensive income into income (effective portion) amounted to approximately \$839,000 for the three months ended March 31, 2011, and is located in interest expense on subordinated debt held by unconsolidated trusts.

#### NOTE L: 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.

Immaterial 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 include 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, Summary of Significant Accounting Policies of the most recent Form 10-K for the year ended December 31, 2010 filed with the SEC on March 15, 2011).

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

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

(000's omitted)	Banking	Other	Eliminations	Consolidated Total
Three Months Ended				
March 31, 2011				
Net interest income	\$45,501	\$22	\$0	\$45,523
Provision for loan losses	1,050	0	0	1,050
Noninterest income	10,480	10,843	(481)	20,842
Amortization of intangible assets	700	201	0	901
Other operating expenses	34,575	8,321	(481)	42,415
Income before income taxes	\$19,656	\$2,343	\$0	\$21,999
Assets	\$5,525,773	\$33,141	(\$9,542)	\$5,549,372
Goodwill	\$287,411	\$10,281	\$0	\$297,692
Three Months Ended				
March 31, 2010				
Net interest income	\$43,255	\$27	\$0	\$43,282
Provision for loan losses	1,820	0	0	1,820
Noninterest income	11,442	10,687	(412)	21,717
Amortization of intangible assets	1,630	229	0	1,859
Other operating expenses	34,558	8,188	(412)	42,334
Income before income taxes	\$16,689	\$2,297	(\$0)	\$18,986
Assets	\$5,461,834	\$33,045	(\$9,079)	\$5,485,800
Goodwill	\$287,411	\$10,281	\$0	\$297,692

NOTE M: SUBSEQUENT EVENTS

Companies are required to evaluate events and transactions that occur after the balance sheet date but before the date the financial statements are issued, or available to be issued in the case of non-public entities. They must recognize in the financial statements the effect of all events or transactions that provide additional evidence of conditions that existed at the balance sheet date, including the estimates inherent in the financial preparation process. Entities do not recognize the impact of events or transactions that provide evidence about conditions that did not exist at the balance sheet date but arose after that date.

On April 8, 2011 the Company acquired The Wilber Corporation (“Wilber”) the parent company of the Wilber National Bank for \$103 million in stock and cash, expected to be 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. Upon completion of the merger, the Company added approximately \$480 million of loans, \$280 million of investment securities and \$750 million of deposits. The Company has not yet finalized its determination of the fair values of acquired assets and liabilities relating to the Wilber acquisition.

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

### Introduction

This Management's Discussion and Analysis of Financial Condition and Results of Operations ("MD&A") primarily reviews the financial condition and results of operations of Community Bank System, Inc. (the "Company" or "CBSI") as of and for the three months ended March 31, 2011 and 2010, although in some circumstances the fourth quarter of 2010 is also discussed in order to more fully explain recent trends. The following discussion and analysis should be read in conjunction with the Company's Consolidated Financial Statements and related notes that appear on pages 3 through 21. All references in the discussion to the financial condition and results of operations are to those of the Company and its subsidiaries taken as a whole. Unless otherwise noted, the term "this year" refers to results in calendar year 2011, "first quarter" refers to the quarter ended March 31, 2011, and earnings per share ("EPS") figures refer to diluted EPS.

This MD&A contains certain forward-looking statements with respect to the financial condition, results of operations and business of the Company. These forward-looking statements involve certain risks and uncertainties. Factors that may cause actual results to differ materially from those proposed by such forward-looking statements are set herein under the caption, "Forward-Looking Statements," on page 35.

### 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 those estimates. Management believes that critical accounting estimates include:

- 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.

- Retirement benefits – The Company provides defined benefit pension benefits and post-retirement health and life insurance benefits to eligible employees. The Company also provides deferred compensation and supplemental executive retirement plans for selected current and former employees and officers. Expense under these plans is charged to current operations and consists of several components of net periodic benefit cost based on various actuarial assumptions regarding future experience under the plans, including, but not limited to, discount rate, rate of future compensation increases, mortality rates, future health care costs and expected return on plan assets.
- Provision for income taxes – The Company is subject to examinations from various taxing authorities. Such examinations may result in challenges to the tax return treatment applied by the Company to specific transactions. Management believes that the assumptions and 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 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" on pages 53-58 of the most recent Form 10-K (fiscal year ended December 31, 2010) filed with the Securities and Exchange Commission on March 15, 2011.

#### Executive Summary

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

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

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

First quarter net income of \$16.2 million or \$0.48 per share, was 15% higher than the first quarter of 2010's reported earnings of \$14.0 million, or \$0.42 per share. The increase was due in large part to higher net interest income that resulted from earning asset growth and a higher net interest margin. Also contributing to higher net income was a lower provision for loan losses and a decline in expenses as a result of general cost management initiatives and lower amortization of intangibles, partially offset by higher acquisition expenses. These were partially offset by lower deposit service fees from a reduction in certain product utilization and a slightly higher effective income tax rate.

Asset quality in the first quarter of 2011 remained stable, and favorable as compared to averages for peer financial organizations. First quarter loan net charge-offs and the current quarter provision for loan losses were below those experienced in the first quarter of 2010 and the fourth quarter of 2010. Nonperforming loans were at their lowest level since mid-2009. Delinquency ratios decreased from both the first quarter of 2010 and the fourth quarter of 2010. The Company experienced year-over-year growth in first quarter average interest-earning assets, driven by higher average

investment securities, including cash equivalents. Average loans declined as compared to both the first and fourth quarters of 2010 as a result of low demand in the current economic environment. Average deposits in the first quarter of 2011 were higher than the first quarter of 2010 and the fourth quarter of 2010, reflective of organic growth in core deposits. Average external borrowings were lower than the first quarter of 2010.

On April 8, 2011 the Company acquired The Wilber Corporation, (“Wilber”) parent company of the Wilber National Bank for \$103 million in stock and cash, expected to be 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. Upon completion of the merger, the Company added approximately \$480 million of loans, \$280 million of investment securities and \$750 million of deposits. The Company has not yet finalized its determination of the fair values of acquired assets and liabilities relating to the Wilber acquisition.

## Net Income and Profitability

As shown in Table 1, net income for the first quarter of \$16.2 million increased 15% versus the comparable period of 2010. Earnings per share for the first quarter of \$0.48 were \$0.06 higher than the EPS generated in the first quarter of 2010. As reflected in Table 1, first quarter net interest income of \$45.5 million was up \$2.2 million, or 5.2%, from the comparable prior year period. The current quarter's provision for loan losses decreased \$0.8 million as compared to the first quarter of 2010, reflective of lower levels of net charge-offs, a decline in loan balances, and generally stable asset quality. First quarter noninterest income was \$20.8 million, down \$0.9 million, or 4.0%, from the first quarter of 2010. Contributing to the decrease was lower mortgage-banking related revenues as well as lower deposit service fees, reflective of the second full quarter of activity following certain amendments to Regulation E (a Federal Reserve Board Regulation), which has resulted in lower net product utilization. Additionally, revenue from wealth management services declined principally due to lower production levels of the branch-based investment advisory group, which is in the process of converting its operational platform. Offsetting this decline was a 3.6% increase in the revenues generated by the Company's employee benefits consulting and plan administration business. Operating expenses of \$43.3 million for the first quarter of 2011 decreased \$0.9 million or 2.0%, as compared to the first quarter of 2010, reflective of solid cost management programs across all functional areas of the Company, as well as lower amortization of intangibles.

A condensed income statement is as follows:

Table 1: Condensed Income Statements

	Three Months Ended March 31,	
(000's omitted, except per share data)	2011	2010
Net interest income	\$45,523	\$43,282
Provision for loan losses	1,050	1,820
Noninterest income	20,842	21,717
Operating expenses	43,316	44,193
Income before taxes	21,999	18,986
Income taxes	5,839	4,984
Net income	\$16,160	\$14,002
Diluted earnings per share	\$0.48	\$0.42

## Net Interest Income

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

As shown in Table 2, net interest income (with nontaxable income converted to a fully tax-equivalent basis) for the first quarter of 2011 was \$49.5 million, a \$2.5 million or 5.3% increase from the same period last year. The increase was a result of a \$64.5 million increase in first quarter interest-earning assets, a 15-basis point increase in net interest

margin versus the prior year and a \$13.3 million decrease in average interest-bearing liabilities. As reflected in Table 3, the volume increase from interest-bearing assets combined with the volume decrease from interest-bearing liabilities and the rate decrease on interest-bearing liabilities had a \$3.9 million favorable impact on net interest income, while the rate decrease on interest bearing assets had a \$1.4 million unfavorable impact on net interest income. The lower cost of funding had a greater favorable impact on the net interest margin than the lower yields on interest-bearing assets.

Average investments for the first quarter were \$162.8 million higher than the comparable period of 2010, while overnight invested cash equivalents for the first quarter declined \$28.0 million from the comparable prior year period, reflective of continuing deployment during the last twelve months of a larger portion of the Company's excess liquidity into intermediate-term U.S. Treasury securities. First quarter average loan balances decreased \$70.3 million as compared to the comparable period of 2010, primarily from continued declines in the consumer installment and business lending portfolios as a result of lower demand characteristics due to current economic conditions, partially offset by strong consumer mortgage volume that continues to benefit from low long-term interest rates. In comparison to the prior year, total average interest-bearing deposits were up \$12.9 million or 0.4% for the quarter, reflective of organic growth in core deposits partially offset by a reduction in time deposits. Quarterly average borrowings declined \$26.2 million or 3.1% as compared to the first quarter of 2010 and reflect the maturity of \$25 million of term borrowings in the second quarter of 2010.

The net interest margin of 4.08% for the first quarter increased 15 basis points versus the same period in the prior year. The improvement was attributable to a 25-basis point decrease in the cost of funds year-over-year, partially offset by an 11-basis point decrease in earning-asset yields. The decrease in the earning-asset yield was driven by an 18-basis point decline in the loan yields for the first quarter, as compared to the like period of 2010. Partially offsetting this decrease for the first quarter was a six-basis point increase in investment yield, including cash equivalents, due to a more productive deployment of net liquidity. The decline in loan yields is primarily a result of lower rates on new volume due to the decline in interest rates to levels below those prevalent in prior years and certain adjustable-rate loans repricing downward.

The first quarter cost of funds decreased versus the prior year quarter due to a 33-basis point decrease in interest-bearing deposit rates, a higher proportion of funding being supplied from non-interest bearing deposits and a six-basis point decrease in the average interest rate paid on external borrowings. 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 the first quarter of 2011 in response to market conditions. Additionally, the proportion of customer deposits in higher cost time deposits has declined five percentage points over the last twelve months, while the percentage of deposits in non-interest bearing and lower-cost checking and savings accounts increased two percentage points.

Table 2 below sets forth information related to average interest-earning assets and interest-bearing liabilities and their associated yields and rates for the periods indicated. Interest income and yields are on a fully tax-equivalent basis using a marginal income tax rate of 38.53% and 38.46% in 2011 and 2010, respectively. Average balances are computed by accumulating 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 and deferred loan costs. Average loan balances include nonaccrual loans and loans held for sale.

Table 2: Quarterly Average Balance Sheet

	Three Months Ended March 31, 2011			Three Months Ended March 31, 2010		
	Average Balance	Interest	Avg. Yield/Rate Paid	Average Balance	Interest	Avg. Yield/Rate Paid
(000's omitted except yields and rates)						
<b>Interest-earning assets:</b>						
Cash equivalents	\$159,044	\$98	0.25%	\$187,030	\$115	0.25%
Taxable investment securities (1)	1,188,182	12,585	4.30%	1,071,955	11,146	4.22%
Nontaxable investment securities (1)	565,564	9,076	6.51%	518,962	8,708	6.81%
Loans (net of unearned discount)(2)	3,005,926	42,497	5.73%	3,076,230	44,795	5.91%
<b>Total interest-earning assets</b>	<b>4,918,716</b>	<b>64,256</b>	<b>5.30%</b>	<b>4,854,177</b>	<b>64,764</b>	<b>5.41%</b>
Noninterest-earning assets	568,902			570,868		
<b>Total assets</b>	<b>\$5,487,618</b>			<b>\$5,425,045</b>		
<b>Interest-bearing liabilities:</b>						
Interest checking, savings and money market deposits	\$2,323,181	2,361	0.41%	\$2,095,769	2,915	0.56%

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

Time deposits	911,805	3,645	1.62%	1,126,324	5,688	2.05%
Borrowings	830,454	8,758	4.28%	856,662	9,167	4.34%
Total interest-bearing liabilities	4,065,440	14,764	1.47%	4,078,755	17,770	1.77%
Noninterest-bearing liabilities:						
Noninterest checking deposits	739,515			716,172		
Other liabilities	70,104			57,071		
Shareholders' equity	612,559			573,047		
Total liabilities and shareholders' equity	\$5,487,618			\$5,425,045		
Net interest earnings		\$49,492			\$46,994	
Net interest spread			3.83%			3.64%
Net interest margin on interest-earning assets			4.08%			3.93%
Fully tax-equivalent adjustment		\$3,969			\$3,712	

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

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

As discussed above and disclosed in Table 3 below, the quarterly change in net interest income (fully tax-equivalent basis) may be analyzed by segregating the volume and rate components of the changes in interest income and interest expense for each underlying category.

Table 3: Rate/Volume

(000's omitted)	1st Quarter 2011 Compared to 1st Quarter 2010 Increase (Decrease) Due to Change in(1) Net		
	Volume	Rate	Change
<b>Interest earned on:</b>			
Cash equivalents	(\$17)	\$0	(\$17)
Taxable investment securities	1,228	211	1,439
Nontaxable investment securities	758	(390)	368
Loans (net of unearned discount)	(1,010)	(1,288)	(2,298)
<b>Total interest-earning assets (2)</b>	<b>854</b>	<b>(1,362)</b>	<b>(508)</b>
<b>Interest paid on:</b>			
Interest checking, savings and money market deposits	292	(846)	(554)
Time deposits	(976)	(1,067)	(2,043)
Borrowings	(277)	(132)	(409)
<b>Total interest-bearing liabilities (2)</b>	<b>(58)</b>	<b>(2,948)</b>	<b>(3,006)</b>
<b>Net interest earnings (2)</b>	<b>631</b>	<b>1,867</b>	<b>2,498</b>

(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 such change in each component.

(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 Community Bank, N.A. ("CBNA") and First Liberty Bank and Trust); 2) employee benefit trust, administration, actuarial and consulting services (performed by Benefit Plans Administrative Services, Inc. ("BPAS")); and 3) wealth management services, comprised of trust services (performed by the trust unit within CBNA),

investment and insurance products (performed by Community Investment Services, Inc. and CBNA Insurance Agency, Inc.) and asset management (performed by Nottingham Advisors, Inc. or “Nottingham”). Additionally, the Company has periodic transactions, most often net gains or losses from the sale of investment securities and prepayment of debt instruments.

Table 4: Noninterest Income

(000's omitted)	Three Months Ended March 31,	
	2011	2010
Deposit service charges and fees	\$9,685	\$10,519
Benefit trust, administration, consulting and actuarial fees	8,183	7,899
Wealth management services	2,180	2,376
Other banking services	398	440
Mortgage banking	396	483
Total noninterest income	\$20,842	\$21,717
Noninterest income/operating income (FTE)	29.6%	31.6%

As displayed in Table 4, noninterest income was \$20.8 million in the first quarter of 2011, a decrease of \$0.9 million, or 4.0%, for the quarter in comparison to 2010. General recurring banking fees of \$10.1 million for the first quarter were down \$0.9 million or 8.0%, as compared to the prior year period, reflective of lower product utilization due to economic conditions and regulatory 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. Although the majority of customers who have responded have consented to protecting their accounts from electronic transaction rejection, lower utilization of these products has been experienced. Partially offsetting this decline are increased electronic banking activity and expanded debit-card usage.

Residential mortgage banking revenue decreased \$0.1 million for the quarter in comparison to the prior year period. Residential mortgage banking income totaled \$0.4 million for the first quarter of 2011 as compared to \$0.5 million in the first quarter of 2010. 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 the first quarter mortgage banking income is \$0.1 million of unrealized gains on residential mortgage loans held for sale and the related commitments. Also included in the first quarter of 2011 is a \$0.1 million impairment charge 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 \$21.0 million in the first quarter of 2011 as compared to \$11.9 million for the comparable 2010 period. Residential mortgage loans held for sale and recorded at fair value at March 31, 2011 totaled \$0.3 million. Realization of the unrealized gains on mortgage loans held for sale and the related commitments, as well as future revenue generation from mortgage banking activities, will be dependent on market conditions and long-term interest rate trends.

Benefit trust, administration, consulting and actuarial fees increased \$0.3 million for the three months ended March 31, 2011 as compared to the prior year period, driven by a combination of new client generation, expanded service offerings and increased customer asset-based revenue. Wealth management services revenue decreased \$0.2 million, or 8.2%, for the first quarter as compared to the first quarter of 2010, due to lower production levels for broker advisory services, principally related to some systems conversion issues, partially offset by a 13% increase in wealth management revenues.

The ratio of noninterest income to total income (FTE basis) was 29.6% for the quarter versus 31.6% for the comparable period of 2010. The decrease in the quarter is a function of the lower level of deposit service fees combined with higher net interest income.

### Operating Expenses

Table 5 below sets forth the quarterly results of the major operating expense categories for the current and prior year, as well as efficiency ratios (defined below), a standard measure of expense utilization effectiveness commonly used in the banking industry.

Table 5: Operating Expenses

(000's omitted)	Three Months Ended March 31,	
	2011	2010
	\$23,111	\$22,936

Salaries and employee benefits		
Occupancy and equipment	6,057	6,225
Data processing and communications	4,771	5,114
Amortization of intangible assets	901	1,859
Legal and professional fees	1,339	1,300
Office supplies and postage	1,196	1,249
Business development and marketing	1,254	1,014
FDIC insurance premiums	1,361	1,572
Acquisition expenses	691	0
Other	2,635	2,924
Total operating expenses	\$43,316	\$44,193
Operating expenses/average assets	3.08%	3.30%
Efficiency ratio	59.3%	61.6%

As shown in Table 5, first quarter 2011 operating expenses were \$43.3 million, a decrease of \$0.9 million or 2.0% from the prior year level. Implementation of several expense reduction initiatives allowed the Company to report lower total operating expenses despite year-over-year increases in merit-based compensation, and higher business development costs. During the first quarter the Company incurred \$0.7 million of acquisition costs related to its acquisition of Wilber, which was completed in the second quarter of 2011.

Salary expense increased \$0.3 million from the first quarter of 2010, partially offset by a \$0.1 million decrease in employee benefit costs for the three months ended March 31, 2011, as compared to the prior year period. This was primarily due to modifications made to the Company's defined benefit pension plan. As of January 1, 2010, the Company's defined benefit pension plan was modified to a new plan design, which combines service credits in the Company's Cash Balance Plan with additional contributions made to the 401(k) Plan.

Additional changes to operating expenses can be attributable to lower amortization of intangible assets (\$1.0 million), property related write downs (\$0.4 million), data processing and communications costs (\$0.3 million), FDIC insurance premiums (\$0.2 million), and lower occupancy and equipment costs (\$0.2 million), partially offset by higher acquisition related expenses (\$0.7 million) and business development and marketing expenses (\$0.2 million). Amortization of intangibles decreased \$1.0 million in the first quarter as a result of no new acquisitions, accelerated amortization methodologies employed and the core deposit intangible from a 2001 branch acquisition which became fully amortized during 2010.

The Company's efficiency ratio (recurring operating expenses excluding intangible amortization and acquisition expenses divided by the sum of net interest income (FTE) and recurring noninterest income) was 59.3% for the first quarter, 2.3 percentage points favorable to the comparable quarter of 2010. This resulted from operating expenses (as described above) decreasing 1.4%, while recurring operating income increased 2.4%, driven by a 5.3% increase in net interest income. Operating expenses, excluding intangible amortization and acquisition expenses, as a percentage of average assets decreased 22 basis points in comparison to the same quarter last year. Operating expenses (as defined above) decreased 1.4% for the quarter, while average assets increased 1.2% for the same time period.

#### Income Taxes

The first quarter effective income tax rate was 26.5%, up slightly from the 26.3% effective tax rate for the comparable period of 2010. The higher effective tax rate for 2011 was principally a result of a higher proportion of income being generated from fully taxable sources.

#### Investments

As reflected in Table 6 below, the carrying value of investments (including unrealized gains on available-for-sale securities) was \$1.79 billion at the end of the first quarter, an increase of \$49.9 million from December 31, 2010 and an increase of \$45.7 million from March 31, 2010. The book value (excluding unrealized gains) of investments increased \$40.9 million from December 31, 2010 and \$43.9 million from March 31, 2010. Throughout 2010 and the first quarter of 2011 cash equivalents remained above historical levels, as the Company maintained the liquidity from organic deposit growth in anticipation of improved investment opportunities in future periods. The overall mix of securities within the portfolio over the last year has changed, with an increase in the proportion of U.S. Treasury Notes and obligations of state and political subdivisions and a decrease in the proportion of mortgage-backed securities. The change in the carrying value of investments is impacted by the amount of net unrealized gains in the available-for-sale portfolio at a point in time. At March 31, 2011, the portfolio had an \$18.9 million net unrealized gain, an increase of \$9.0 million from the unrealized gain at December 31, 2010 and up \$1.8 million from the unrealized gain at March 31, 2010. This increase in the unrealized gain is indicative of favorable interest rate movements during the respective time periods and 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 \$19.9 million of net unrealized gains as of March 31, 2011.

Table 6: Investment Securities

	March 31, 2011		December 31, 2010		March 31, 2010	
	Amortized Cost/Book Value	Fair Value	Amortized Cost/Book Value	Fair Value	Amortized Cost/Book Value	Fair Value
(000's omitted)						
<b>Held-to-Maturity Portfolio:</b>						
U.S. Treasury and agency securities	\$478,190	\$496,042	\$478,100	\$499,642	\$463,303	\$464,725
Government agency mortgage-backed securities	48,489	50,854	56,891	59,644	91,988	94,655
Obligations of state and political subdivisions	66,599	66,315	67,864	66,450	69,858	71,018
Other securities	47	47	53	53	69	69
Total held-to-maturity portfolio	593,325	613,258	602,908	625,789	625,218	630,467
<b>Available-for-Sale Portfolio:</b>						
U.S. Treasury and agency securities	323,545	345,288	281,826	304,057	289,063	310,742
Obligations of state and political subdivisions	534,421	542,278	518,216	522,218	452,654	464,529
Government agency mortgage-backed securities	165,374	173,626	170,673	179,716	190,703	196,772
Pooled trust preferred securities	69,164	48,172	69,508	41,993	70,653	46,021
Corporate debt securities	24,016	25,589	25,523	27,157	35,552	37,126
Government agency collateralized mortgage obligations	9,665	10,075	9,904	10,395	10,603	11,178
Marketable equity securities	380	447	380	427	380	339
Available-for-sale portfolio	1,126,565	1,145,475	1,076,030	1,085,963	1,049,608	1,066,707
Net unrealized gain on available-for-sale portfolio	18,910	0	9,933	0	17,099	0
Total available-for-sale portfolio	1,145,475	1,145,475	1,085,963	1,085,963	1,066,707	1,066,707
<b>Other Securities:</b>						
Federal Home Loan Bank common stock	37,299	37,299	37,301	37,301	38,402	38,402
Federal Reserve Bank common stock	12,378	12,378	12,378	12,378	12,378	12,378
Other equity securities	3,769	3,769	3,774	3,774	3,860	3,860
Total other securities	53,446	53,446	53,453	53,453	54,640	54,640
Total investments	\$1,792,246	\$1,812,179	\$1,742,324	\$1,765,205	\$1,746,565	\$1,751,814

Included in the available-for-sale portfolio, as detailed in Table 7, are pooled trust preferred, class A-1 securities with a current par value of \$70.8 million and unrealized losses of \$21.0 million at March 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. As of March 31, 2011, an additional 31% - 38% of the underlying collateral would have to be in deferral or default concurrently to result in the potential non-receipt of contractual cash flows. The market for these securities at March 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 for the quarter ended March 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. Based on the analysis performed, the Company determined an other-than-temporary impairment did not exist at March 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. These securities represent less than 1% of the Company's earning-assets as of March 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 7: Pooled Trust Preferred Securities as of March 31, 2011

(000's omitted)	PreTSL XXVI	PreTSL XXVII	PreTSL XXVIII
Single issuer or pooled	Pooled	Pooled	Pooled
Class	A-1	A-1	A-1
Book value at 3/31/11	\$22,258	\$23,147	\$23,759
Fair value at 3/31/11	14,971	16,391	16,810
Unrealized loss at 3/31/11	\$7,287	\$6,756	\$6,949
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	29.6%	27.1%	21.9%
Excess subordination	28.2%	31.5%	35.8%

## Loans

As shown in Table 8, loans ended the first quarter at \$3.00 billion, down \$25.9 million (0.9%) from year-end 2010 and down \$62.1 million (2.0%) from one year earlier. The loan decline during the first quarter of 2011 was comprised of a reduction in the business lending portfolio (\$17.2 million), the consumer mortgage portfolio (\$2.2 million), the consumer installment portfolio (\$0.6 million) and the home equity portfolio (\$6.0 million).

Table 8: Loans

(000's omitted)	March 31, 2011		December 31, 2010		March 31, 2010	
Business lending	\$1,006,114	33.5%	\$1,023,286	33.8%	\$1,048,841	34.2%
Consumer mortgage	1,055,164	35.2%	1,057,332	34.9%	1,049,399	34.3%
Consumer installment	639,241	21.3%	639,809	21.2%	651,781	21.3%
Home equity	299,925	10.0%	305,936	10.1%	312,502	10.2%
Total loans	\$3,000,444	100.0%	\$3,026,363	100.0%	\$3,062,523	100.0%

The combined total of general-purpose business lending to commercial and industrial customers and mortgages on commercial property is characterized as the Company's business lending activity. The business lending portfolio decreased \$42.7 million versus one year ago. Customer demand has remained soft due primarily to economic conditions. 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 continues to invest in additional personnel, technology and business development resources to further strengthen its capabilities in this key business area.

Consumer mortgages increased \$5.8 million year-over-year. During the first quarter of 2011, the Company originated and sold \$21.0 million of residential mortgages, principally to Fannie Mae, as compared to \$11.9 million in the first

quarter of 2010 and \$119.0 million for the year ended December 31, 2010. Consumer mortgage volume has been relatively strong over the last year due to continued low long-term interest rates and comparatively stable real estate valuations in the Company's primary markets. The consumer real estate portfolio does not include exposure to subprime, Alt-A, or other higher-risk mortgage products. The Company's solid performance during a tumultuous period in the overall industry is a testament to the stable, low-risk profile of its portfolio and its ability to successfully meet customer needs. 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 production.

Consumer installment loans, both those originated directly (such as personal installment and lines of credit), and indirectly (originated predominantly in automobile, marine and recreational vehicle dealerships), declined \$0.6 million in the first quarter of 2011 and decreased \$12.5 million on a year-over-year basis. The origination and utilization of consumer installment has faced somewhat softer demand over the past year due to lower consumer spending and deleveraging activities. The tempered volume of new and used vehicle sales to upper tier credit profile customers in the Company's primary markets has made growing this portfolio more difficult 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. It is expected that continued improvement in the automotive market will create the opportunity for the Company to produce indirect loan growth more in line with its longer-term historical experience.

Home equity loans declined \$12.6 million or 4.0% 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 in 2010 and the first three months of 2011 in the low rate environment. In addition, home equity utilization has been adversely impacted by the heightened level of consumer deleveraging that is occurring in response to the continued weak economic conditions.

#### Asset Quality

Table 9 below exhibits the major components of nonperforming loans and assets and key asset quality metrics for the periods ending March 31, 2011 and 2010 and December 31, 2010.

Table 9: Nonperforming Assets

(000's omitted)	March 31, 2011	December 31, 2010	March 31, 2010
<b>Nonaccrual loans</b>			
Consumer mortgage	\$5,832	\$4,737	\$4,368
Business lending	7,788	9,715	13,159
Consumer installment	0	0	279
Home equity	1,333	926	445
<b>Total nonaccrual loans</b>	<b>14,953</b>	<b>15,378</b>	<b>18,251</b>
<b>Accruing loans 90+ days delinquent</b>			
Consumer mortgage	2,203	2,308	719
Business lending	184	247	118
Consumer installment	114	227	41
Home equity	273	309	52
<b>Total accruing loans 90+ days delinquent</b>	<b>2,774</b>	<b>3,091</b>	<b>930</b>
<b>Nonperforming loans</b>			
Consumer mortgage	8,035	7,045	5,087
Business lending	7,972	9,962	13,277
Consumer installment	114	227	320
Home equity	1,606	1,235	497
<b>Total nonperforming loans</b>	<b>17,727</b>	<b>18,469</b>	<b>19,181</b>
<b>Other real estate (OREO)</b>	<b>1,945</b>	<b>2,011</b>	<b>1,479</b>
<b>Total nonperforming assets</b>	<b>19,672</b>	<b>\$20,480</b>	<b>\$20,660</b>
<b>Allowance for loan losses / total loans</b>	<b>1.40%</b>	<b>1.40%</b>	<b>1.37%</b>
<b>Allowance for loan losses / nonperforming loans</b>	<b>238%</b>	<b>230%</b>	<b>219%</b>
<b>Nonperforming loans / total loans</b>	<b>0.59%</b>	<b>0.61%</b>	<b>0.63%</b>
<b>Nonperforming assets / total loans and other real estate</b>	<b>0.66%</b>	<b>0.68%</b>	<b>0.67%</b>
<b>Delinquent loans (30 days old to nonaccruing) to total loans</b>	<b>1.46%</b>	<b>1.91%</b>	<b>1.43%</b>
<b>Loan loss provision to net charge-offs (quarterly)</b>	<b>74%</b>	<b>95%</b>	<b>111%</b>

As displayed in Table 9, nonperforming assets at March 31, 2011 were \$19.7 million, a \$0.8 million decrease versus the level at the end of 2010 and a decrease of \$1.0 million as compared to the level one year earlier. Other real estate owned (“OREO”) of \$1.9 million decreased \$0.1 million from year-end 2010 and increased \$0.5 million from one-year ago. The Company is managing 23 OREO properties at March 31, 2011 as compared to 22 OREO properties at December 31, 2010 and 20 OREO properties at March 31, 2010. Only one property has a carrying value in excess of \$0.2 million at March 31, 2011. Nonperforming loans were 0.59% of total loans outstanding at the end of the first quarter, two and four basis point lower than the levels at December 31, 2010 and March 31, 2010, respectively.

Approximately 45% of the nonperforming loans at March 31, 2011 are related to the business lending portfolio, which is comprised of business loans broadly diversified by industry type. Despite the relatively weak economic conditions, the Company has successfully reduced the level of nonperforming business loans significantly over the last three quarters. Approximately 45% of nonperforming loans at March 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 encountered. However, the continued soft economic conditions and high unemployment levels have adversely impacted consumers and businesses alike and have resulted in higher mortgage nonperforming levels. The remaining ten 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 238% at the end of the first quarter, compared to 230% at year-end 2010 and 219% at March 31, 2010, reflective of the allowance to total loans ratio increasing from one year ago and nonperforming loans dropping from the March 31, 2010 levels.

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 loans, issuing demand letters or other actions. The Company's larger criticized credits are also reviewed on 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 criticized loan portfolio on a monthly basis.

Delinquent loans (30 days through nonaccruing) as a percent of total loans was 1.46% at the end of the first quarter, 45 basis points below the 1.91% at year-end 2010 and three basis points higher than the 1.43% at March 31, 2010. The commercial loan delinquency ratio at the end of the first quarter decreased in comparison to both December 31, 2010 and March 31, 2010. The delinquency rate for consumer mortgage, consumer installment and home equity loans decreased as compared to December 31, 2010, but increased as compared to March 31, 2010. Delinquency ratios were higher at December 31, 2010 due to certain processing limitations during the core accounting system conversion in late 2010. The Company's success at keeping the non-performing and delinquency ratios at manageable levels despite weak economic conditions has been the result of its continued focus on maintaining strict underwriting standards, as well as effective utilization of its collection and recovery capabilities.

Table 10: Allowance for Loan Losses Activity

(000's omitted)	Three Months Ended March 31,	
	2011	2010
Allowance for loan losses at beginning of period	\$42,510	\$41,910
Charge-offs:		
Business lending	843	1,368
Consumer mortgage	236	88
Consumer installment	1,443	1,475
Home equity	36	0
Total charge-offs	2,558	2,931
Recoveries:		
Business lending	86	285
Consumer mortgage	19	28
Consumer installment	1,033	982
Home equity	7	1
Total recoveries	1,145	1,296

Net charge-offs	1,413	1,635
Provision for loans losses	1,050	1,820
Allowance for loan losses at end of period	\$42,147	\$42,095

Net charge-offs to average loans outstanding:		
Business lending	0.30%	0.42%
Consumer mortgage	0.08%	0.02%
Consumer installment	0.26%	0.30%
Home equity	0.04%	0.00%
Total loans	0.19%	0.22%

As displayed in Table 10, net charge-offs during the first quarter of 2011 were \$1.4 million, \$0.2 million lower than the equivalent 2010 period. The business lending and consumer installment portfolios experienced a lower level of net charge-offs while the consumer mortgage and home equity portfolios experienced increases in the level of net charge-offs as compared to the first quarter of 2010. The net charge-off ratio (net charge-offs as a percentage of average loans outstanding) for the first quarter was 0.19%, eight basis points lower than the linked quarter and three basis points lower than the comparable quarter of 2010. Net charge-offs and the corresponding net charge-off ratios continue to be below average long-term historical levels.

The business lending and consumer installment net charge-off ratios for the first quarter of 0.30% and 0.26%, improved 12 and four basis points, respectively, versus the prior year level. The consumer mortgage portfolio and home equity portfolio experienced a six and four basis point, respectively, increase in net charge-off ratios for the first quarter of 2011 as compared to the first quarter of 2010. As compared to the fourth quarter of 2010, the consumer installment net charge-off ratio improved by 50 basis points, while the business lending, consumer mortgage, and home equity portfolios net-charge off ratios were higher by three, six and four basis points, respectively.

A \$1.1 million loan loss provision was recorded in the first quarter, \$0.8 million below the equivalent prior year period. The first quarter 2011 loan loss provision was \$0.4 million below the level of net charge-offs for the quarter in response to a declining loan portfolio and improving credit ratios. The allowance for loan losses of \$42.1 million as of March 31, 2011 increased \$0.1 million or 0.1% over the last 12 months, while the loan portfolio declined 2.0% during the same time period. Continued weak economic conditions and periodic increases in nonperforming and delinquency levels over the last twelve months contributed to these changes and resulted in the allowance for loan loss to total loans ratio increasing from 1.37% at March 31, 2010 to 1.40% at the end of the current quarter.

## Deposits

As shown in Table 11, average deposits of \$3.97 billion in the first quarter were up \$36.2 million compared to the first quarter 2010 and \$24.5 million versus the fourth quarter of last year. The mix of average deposits changed throughout 2010 and this continued in the first three months of 2011. The weightings of non-time deposits (interest checking, non-interest checking, savings and money markets accounts) have increased from their year-ago levels, while the proportion of time deposits decreased. This change in deposit mix reflects the Company's goal of expanding core account relationships and reducing higher cost time deposit balances, as well as the preference of certain customers to hold more funds in liquid accounts in the low interest rate environment. This shift in mix, combined with the Company's ability to reduce rates due to market conditions, resulted in the quarterly cost of interest-bearing deposits declining from 1.08% in the first quarter of 2010 to 0.75% in the most recent quarter. The Company continues to focus heavily on growing its core (non-time) deposits through its proactive marketing efforts, competitive product offerings and top quality customer service.

Average first quarter non-public fund deposits decreased \$24.3 million, or 0.7%, versus the fourth quarter of 2010 and increased \$18.8 million or 0.5% compared to the year earlier period. Average public fund deposits in the first quarter increased \$48.8 million, or 14%, from fourth quarter 2010 and \$17.5 million, or 4.7%, from the first quarter of 2010 in part due to the lack of attractive, low-risk alternative investment options and the Company's competitively priced products. Public fund deposits as a percentage of total deposits rose from 9.5% in the first quarter 2010 to 9.9% in the current quarter.

Table 11: Quarterly Average Deposits

	March 31, 2011	December 31, 2010	March 31, 2010
(000's omitted)			
Noninterest checking deposits	\$739,515	\$743,698	\$716,172
Interest checking deposits	733,379	720,034	689,513
Regular savings deposits	556,245	543,507	513,705
Money market deposits	1,033,557	1,002,463	892,551
Time deposits	911,805	940,323	1,126,324
Total deposits	\$3,974,501	\$3,950,025	\$3,938,265
IPC Deposits	\$3,582,643	\$3,606,972	\$3,563,892
Public Fund Deposits	391,858	343,053	374,373

Total Deposits    \$3,974,501    \$3,950,025    \$3,938,265

### Borrowings

At the end of the first quarter external borrowings of \$830.4 million were \$0.1 million lower than borrowings at December 31, 2010, and declined \$26.2 million versus the end of the first quarter of 2010. The cost of funds on total borrowings in the first quarter of 4.28% was six basis points below that of the year-earlier period. This decline was mostly attributable to the maturing of \$25 million of higher fixed-rate term borrowings.

### Shareholders' Equity

Total shareholders' equity of \$624.1 million at the end of the first quarter rose \$16.8 million from the balance at December 31, 2010. This increase consisted of net income of \$16.2 million, \$1.3 million from shares issued under the employee stock plan, \$1.2 million from employee stock options earned and a \$6.1 million increase in other comprehensive income, partially offset by dividends declared of \$8.0 million. The change in other comprehensive income/(loss) was comprised of a \$5.5 million increase in the after-tax market value adjustment on the available for sale investment portfolio, a positive \$0.1 million adjustment to the funded status of the Company's retirement plans, and a \$0.5 million increase in the after-tax market value adjustment on the interest rate swap. Over the past 12 months, total shareholders' equity increased by \$45.7 million, as net income, the change in the funded status of the Company's defined benefit pension and other postretirement plans, shares issued under the employee stock plan, and a higher market value adjustment on investments more than offset dividends declared.

The Company's Tier I leverage ratio, a primary measure of regulatory capital for which 5% is the requirement to be "well-capitalized," was 8.42% at the end of the first quarter, up 19 basis points from year-end 2010 and 86 basis points higher than its level one year ago. The increase in the Tier I leverage ratio compared to December 31, 2010 is the result of shareholders' equity excluding intangibles and other comprehensive income items increasing 2.9% while average assets excluding intangibles and the market value adjustment on investments increased at a slower pace of 0.6%. The Tier I leverage ratio increased as compared to the prior year's first quarter as average assets excluding intangibles and the market value adjustment increased 1.5%, while shareholders' equity, excluding intangibles and other comprehensive income increased at a higher 13.1% rate. The tangible equity-to-assets ratio (a non-GAAP measure) of 6.36% increased 22 basis points from December 31, 2010 and increased 93 basis points versus March 31, 2010. The increase in the tangible equity ratio from the prior year was mostly attributable to an increase in the investment market value adjustment, higher retained earnings, lower intangible levels and relatively low growth in all other asset categories.

The dividend payout ratio (dividends declared divided by net income) for the first three months of 2010 was 49.6%, down from 51.9% for the first three months of 2010. The ratio decreased because net income increased 15%, while dividends declared increased 10.4%. The Company's quarterly dividend was raised 9.1% in the first quarter of 2010, from \$0.22 to \$0.24 per share and the number of common shares outstanding increased 1.1% over the last twelve months.

#### Liquidity

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

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, the Federal Home Loan Bank and the Federal Reserve Bank. Other funding alternatives may also be appropriate from time to time, including wholesale and retail repurchase agreements, large certificates of deposit and brokered CD relationships.

The Company's primary sources of liquidity are its liquid assets and unencumbered securities that can be used to obtain additional funding. At March 31, 2011, the Company had \$297 million of cash and cash equivalents, of which \$191 million were interest earning deposits held at the Federal Reserve. The Bank also had \$385 million in additional Federal Home Loan Bank borrowing capacity based on quarter-end collateral levels. Additionally, the Company has \$861 million of unencumbered securities that could be pledged at the Federal Home Loan Bank 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 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 total assets); and second, a projection of subsequent cash availability over an additional 60 days. As of March 31, 2011, this ratio was 19.1% for both time periods, excluding the Bank's capacity to borrow additional funds from the Federal Home Loan Bank and other sources. This compares to the internal policy that requires a minimum of 7.5%.

In addition to the 30 and 90-day basic surplus/deficit model, longer-term liquidity over a minimum of five years is measured and a liquidity analysis projecting sources and uses of funds is prepared. 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.

The Company manages liquidity risk by preparing a sources and uses statement over the next year. The report will show management if there is a potential for a liquidity shortfall within the next year. In addition, stress tests on the cash flows are performed in various scenarios ranging from high probability events with low impact to low probability events with high impact. The results of the stress tests as of March 31, 2011 indicate the Company has sufficient sources of funds for the next year.

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 those actions 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 circumstances have been fully addressed through detailed action plans and the establishment of trigger points for monitoring such events.

#### 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, but not limited to, features, pricing and quality) compared to competing products and services; (6) changes in consumer spending, borrowing and savings habits; (7) technological changes and implementation and cost/financial risks with respect to transitioning to new computer and technology based systems involving large multi-year contracts; (8) any acquisitions or mergers that might be considered or consummated by the Company and the costs and factors associated therewith, including differences in the actual financial results of the acquisition or merger compared to expectations and the realization of anticipated cost savings and revenue enhancements; (9) the ability to maintain and increase market share and control expenses; (10) the nature, timing and effect of changes in banking regulations or other regulatory or legislative requirements affecting the respective businesses of the Company and its subsidiaries, including changes in laws and regulations concerning taxes, accounting, banking, securities and other aspects of the financial services industry, specifically the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010; (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 outcome of pending or future litigation and government proceedings; (13) other risk factors outlined in the Company's filings with the Securities and Exchange Commission from time to time; and (14) the success of the Company at managing the risks of the foregoing.

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



## Item 3. Quantitative and Qualitative Disclosures about Market Risk

Market risk is the risk of loss in a financial instrument arising from adverse changes in market interest rates, prices or credit risk. Credit risk associated with the Company's loan portfolio has been previously discussed in the asset quality section of Management's Discussion and Analysis of Financial Condition and Results of Operations. Management believes that the tax risk of the Company's municipal investments associated with potential future changes in statutory, judicial and regulatory actions is minimal. Other than the pooled trust preferred securities discussed beginning on page 29 the Company has a minimal amount of credit risk in its investment portfolio because essentially all of the fixed-income securities in the portfolio are AA or higher rated. 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 Company's Board of Directors. The Board of Directors delegates responsibility for carrying out the policies to the Asset/Liability Committee ("ALCO"), which meets each month and is made up of the Company's senior management as well as regional and line-of-business managers who oversee specific earning asset classes and various funding sources. As the Company does not believe it is possible to reliably predict future interest rate movements, it has maintained an appropriate process and set of measurement tools, which enables it to identify and quantify sources of interest rate risk in varying rate environments. The primary tool used by the Company in managing interest rate risk is income simulation.

While a wide variety of strategic balance sheet and yield curve scenarios are tested on an ongoing basis, the following reflects the Company's projected net interest income sensitivity over the subsequent twelve months based on:

- Asset and liability levels using March 31, 2011 as a starting point.
- There are assumed to be conservative levels of balance sheet growth-low to mid single digit growth in loans and deposits, while using the cash flows from investment contractual maturities and prepayments to repay short-term capital market borrowings or reinvest into securities or cash equivalents.
- In the +200 basis points scenario the prime rate and federal funds rates are assumed to move up 200 basis points over a 12-month period. In the 0 basis points scenario the prime rate and federal funds rates are unchanged. Both scenarios move the long end of the treasury curve to spreads over federal funds that are more consistent with historical norms. Deposit rates are assumed to move in a manner that reflects the historical relationship between deposit rate movement and changes in the federal funds rate.
- Cash flows are based on contractual maturity, optionality, and amortization schedules along with applicable prepayments derived from internal historical data and external sources.

Net Interest Income Sensitivity Model	
Calculated annualized increase (decrease) in projected net interest income at March 31, 2011	
Change in interest rates	
+200 basis points	\$1,102,000

0 basis points (\$2,152,000)

The modeled net interest income (NII) increases in a rising rate environment from a flat rate scenario. The increase is largely due to the impact from slower investment cash flows and earning assets repricing upward, offset by increased funding liability 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 and it is expected that funding liabilities will rise at a slower rate.

The decrease in NII is largely due to faster investment cash flows and assets repricing to lower rates as corresponding liabilities are held at current levels. The Company continues to show interest rate risk exposure if the yield curve shifts to a normalized level despite fed funds trading at a range of 0 – 25 basis points. In the 0 basis point model (normalized yield curve), longer-term rates are lowered to levels more consistent with historical norms. Despite fed funds trading near 0%, the Company believes intermediate and longer-term treasury rates could potentially fall further, and thus, the 0 basis point model tests the impact of this flattening yield curve 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: the nature and timing of interest rate levels (including yield curve shape), balance growth rates, prepayments on loans and securities, deposit decay rates, pricing decisions on loans and deposits, reinvestment/replacement of asset and liability cash flows, and other factors. While the assumptions are developed based upon current economic and local market conditions, the Company cannot make any assurances as to the predictive nature of these assumptions, including how customer preferences or competitor influences might change. Furthermore, the sensitivity analysis does not reflect actions that ALCO might take in responding to or anticipating changes in interest rates.

#### Item 4. Controls and Procedures

##### 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 (the "Exchange Act"), as amended, designed to ensure information required to be disclosed by the Company in reporting that it files or submits under the Exchange Act is : (i) recorded, processed, summarized, and reported within the time periods specified in the Securities and Exchange Commission's ("SEC") rules and forms, and (ii) accumulated and communicated to management, including the principal executive and principal financial officers, as appropriate, to allow timely decisions regarding required 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 Quarterly Report on Form 10-Q, these disclosure controls and procedures were effective as of March 31, 2011.

##### Changes in Internal Control over Financial Reporting

The Company regularly assesses the adequacy of its internal controls over financial reporting. There were no changes in the Company's internal controls over financial reporting in connection with the evaluation referenced in the paragraph above that occurred during the Company's quarter ended March 31, 2011 that has materially affected, or is reasonably likely to materially affect, the Company's internal control over financial reporting.

#### Part II. Other Information

##### Item 1. Legal Proceedings

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

On March 28, 2011, the Company was granted its motions for summary judgment dismissing two class action lawsuits challenging the Company's merger with Wilber. The first action was commenced on November 3, 2010 and captioned Robert E. Becker v. The Wilber Corporation, et al., Index No. 20101266 (Otsego County). The second action was commenced November 17, 2010, and captioned Richard N. Soules v. The Wilber Corporation, et al., Index No. 20101317 (Otsego County). Both complaints named Wilber, Wilber's directors, and the Company as defendants and alleged that the director defendants breached their fiduciary duties by failing to maximize shareholder value in connection with the merger of the Company and Wilber and alleged that the Company aided and abetted those alleged breaches of fiduciary duty. The complaints sought declaratory and injunctive relief to prevent the consummation of the merger, a constructive trust over any benefits improperly received by defendants, and costs including plaintiffs' attorneys' and experts' fees.

In his decision on March 28, 2011, New York Supreme Court Justice Kevin Dowd held that the Wilber directors fulfilled their fiduciary duties and acted appropriately within the scope of the New York Business Judgment Rule based on evidence presented and that the plaintiffs had produced no evidence of any improper conduct by the Wilber directors or the Company. Accordingly, he granted the motions to dismiss the complaints. He denied the plaintiffs' motions to consolidate, appoint lead class counsel and amend as moot.

##### Item 1A. Risk Factors

There has not been any material change in the risk factors disclosure from that contained in the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2010 filed with the SEC on March 15, 2011.

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

a) Not applicable.

b) Not applicable.

c) 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. No repurchases have been made under the repurchase authorization since it was approved, and the full 1,000,000 shares of common shares remain available to be purchased under the authorization.

Item 3. Defaults Upon Senior Securities

Not applicable.

Item 4. (Removed and Reserved)

Item 5. Other Information

Not applicable.

Item 6. Exhibits

Exhibit No.	Description
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.

\*\*Furnished herewith.

Signatures

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

Community Bank System, Inc.

Date: May 9, 2011

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

Date: May 9, 2011

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

