COMMUNITY BANK SYSTEM INC
Form 10-K
March 16, 2006

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

FORM 10-K

|X| ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(D) OF THE SECURITIES EXCHANGE ACT OF 1934

For the fiscal year ended December 31, 2005

|_| 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

Securities registered pursuant of Section 12(b) of the Act:

Title of each class	Name of each exchange on which registered
Common Stock, Par Value $1.00	New York Stock Exchange

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

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes |_| No |X|.

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes |_| No |X|.

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

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of "accelerated filer and large accelerated filer" in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer |_| Accelerated filer |X| Non-accelerated filer |_|

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

State the aggregate market value of the voting and non-voting common equity held by non-affiliates computed by reference to the price at which the common equity was last sold, or the average bid and ask price of such common equity, as of the last business day of the registrant's most recently completed second fiscal quarter $698,546,000.

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

29,908,003 shares of Common Stock, $1.00 par value, were outstanding on February 23, 2006.

DOCUMENTS INCORPORATED BY REFERENCE.

Portions of Definitive Proxy Statement for Annual Meeting of Shareholders to be held on May 16, 2006 (the "Proxy Statement") is incorporated by reference in Part III of this Annual Report on Form 10-K.

Exhibit Index is located on page 71 of 81

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Part I

This Annual Report on Form 10-K contains certain forward-looking statements with respect to the financial condition, results of operations and business of Community Bank System, Inc. These forward-looking statements involve certain risks and uncertainties. Factors that may cause actual results to differ materially from those contemplated by such forward-looking statements are set forth herein under the caption "Forward-Looking Statements." The share and per-share information in this document has been adjusted to give effect to a two-for-one stock split of the Company's common stock effected as of April 12, 2004.

Item 1. Business

Community Bank System, Inc. ("the Company") was incorporated on April 15, 1983, under the Delaware General Corporation Law. Its principal office is located at 5790 Widewaters Parkway, DeWitt, New York 13214. The Company maintains a web-site at communitybankna.com and firstlibertybank.com. Annual reports on Form 10-K, quarterly reports on Form 10-Q and current reports on Form 8-K, and amendments to those reports, are available on the Company's web-site free of charge as soon as reasonably practicable after such reports or amendments are electronically filed with or furnished to the Securities and Exchange Commission. The information on the web-site is not part of this filing. Copies of all documents filed with the SEC can also be obtained by visiting the SEC's Public Reference Room at 450 Fifth Street, NW, Washington, DC 20549, by calling the SEC at 1-800-SEC-0330 or by accessing the SEC's website at http://www.sec.gov.

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.

Community Bank System, Inc. is a single bank holding company which wholly-owns four subsidiaries: Community Bank, N.A. ("the Bank"), Benefit Plans

Administrative Services, Inc. ("BPAS"), CFSI Closeout Corp. ("CFSICC"), and First of Jermyn Realty Co. ("FJRC"). BPAS owns two subsidiaries, Benefit Plans Administrative Services LLC ("BPA") and Harbridge Consulting Group LLC. BPAS provides administration, consulting and actuarial services to sponsors of employee benefit plans. CFSICC and FJRC are inactive companies. The Company also wholly-owns three unconsolidated subsidiary business trusts formed for the purpose of issuing mandatorily redeemable preferred securities which are considered Tier I capital under regulatory capital adequacy guidelines.

The Bank operates 124 customer facilities throughout twenty-two counties of Upstate New York and five counties of Northeastern Pennsylvania offering a range of commercial and retail banking services. The Bank owns the following subsidiaries: Community Investment Services, Inc. ("CISI"), CBNA Treasury Management Corporation ("TMC"), CBNA Preferred Funding Corporation ("PFC"), Elias Asset Management, Inc. ("EAM") and First Liberty Service Corp. ("FLSC"). CISI provides broker-dealer and investment advisory services. TMC provides the cash management, investment, and treasury services to the Bank. PFC primarily is an investor in residential real estate loans. EAM provides asset management services to individuals, corporate pension and profit sharing plans, and foundations. FLSC provides banking-related services to the Pennsylvania branches of the Bank.

Acquisition History (2001-2005)

Dansville Branch Acquisition

On December 3, 2004, the Company completed the purchase of a branch office in Dansville, N.Y. ("Dansville") from HSBC Bank USA, N.A with deposits of $32.6 million and loans of $5.6 million.

First Heritage Bank

On May 14, 2004, the Company acquired First Heritage Bank ("First Heritage"), a closely held bank headquartered in Wilkes-Barre, PA with three branches in Luzerne County, Pennsylvania. First Heritage's three branches operate as part of First Liberty Bank & Trust, a division of Community Bank, N.A. Consideration included 2,592,213 shares of common stock with a fair value of $52 million, employee stock options with a fair value of $3.0 million, and $7.0 million of cash (including capitalized acquisition costs of $1.0 million).

Grange National Banc Corp.

On November 24, 2003, the Company acquired Grange National Banc Corp. ("Grange"), a $280 million-asset bank holding company based in Tunkhannock, Pa. Grange's 12 branches operate as part of First Liberty Bank & Trust, a division of Community Bank, N.A. The Company issued approximately 2,294,000 shares of its common stock to certain of the former shareholders with a fair value of $55 million. The remaining shareholders received $21.25 per share in cash or approximately $20.9 million. In addition, Grange stock options representing $5.4 million of fair value were exchanged for options to purchase shares in the Company.

Peoples Bankcorp Inc.

On September 5, 2003, the Company acquired Peoples Bankcorp, Inc. ("Peoples"), a $29-million-asset savings and loan holding company based in Ogdensburg, New York. Peoples' single branch is being operated as a branch of the Bank's network of branches in Northern New York.

Harbridge Consulting Group

On July 31, 2003, the Company acquired PricewaterhouseCoopers' Upstate New York Global Human Resource Solutions consulting group. This practice has been renamed Harbridge Consulting Group ("Harbridge") and is a leading provider of retirement and employee benefits consulting services throughout Upstate New York, and is complementary to BPA, the Company's employee benefits plan administration subsidiary.

FleetBoston Financial Corporation branches

On November 16, 2001, the Company acquired 36 branches from FleetBoston Financial Corporation with $470 million in deposits and $177 million in loans. The branches are located in the Southwestern and Finger Lakes Regions of New York State.

First Liberty Bank Corp.

On May 11, 2001, the Company completed its acquisition of the $648-million-asset First Liberty Bank Corp. ("First Liberty"). Pursuant to the terms of the merger, each share of First Liberty stock was exchanged for 1.12 shares of the Company's common stock, which amounted to approximately 7.2 million shares. The merger constituted a tax-free reorganization and was accounted for as a pooling of interests under APB Opinion 16.

Citizens National Bank of Malone

On January 26, 2001, the Company acquired the $111-million-asset Citizens National Bank of Malone, a commercial bank with five branches throughout Franklin and St. Lawrence counties in New York State. The Company issued 1,904,000 shares of its common stock to the former shareholders at a cost of $13.25 per share. All of the 1,296,200 shares then held in the Company's treasury were issued in this transaction as part of the total 1,904,000 shares.

Services

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

Competition

The financial services business is highly competitive. The Company competes actively with national and state banks, thrift institutions, credit unions, retail brokerage firms, mortgage bankers, finance companies, insurance companies, and other regulated and unregulated providers of financial services.

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

	County	State	Deposits as of 6/30/2005 (000's omitted) (1)	Market Share	Facilities	ATM's
1.	Allegany	NY	$ 190,535	48.4%	10	8
2.	Lewis	NY	76,777	37.3%	4	1
3.	Seneca	NY	117,724	32.4%	4	3
4.	Yates	NY	77,740	30.6%	3	2
5.	Cattaraugus	NY	260,354	29.1%	10	7
6.	St. Lawrence	NY	364,468	27.7%	13	7
7.	Wyoming	PA	96,095	26.2%	4	1
8.	Franklin	NY	82,554	16.6%	5	3
9.	Chautauqua	NY	190,893	13.1%	12	10
10.	Schuyler	NY	17,744	12.9%	1	1
11.	Livingston	NY	78,346	12.3%	3	3
12.	Jefferson	NY	139,928	12.1%	5	5
13.	Steuben	NY	171,386	11.4%	9	6
14.	Lackawanna	PA	455,359	10.5%	12	13
15.	Tioga	NY	32,842	8.9%	2	2
16.	Herkimer	NY	30,705	5.8%	1	1
17.	Ontario	NY	79,011	5.6%	3	4
18.	Wayne	NY	45,409	5.0%	1	1
19.	Luzerne	PA	269,877	4.4%	9	8
20.	Susquehanna	PA	22,650	4.4%	2	1
21.	Oswego	NY	42,404	4.1%	2	2
22.	Cayuga	NY	28,703	3.5%	2	1
23.	Bradford	PA	17,490	2.1%	2	2
	Subtotal		2,888,994	11.1%	119	92
24.	Chemung	NY	18,333	1.4%	1	1
25.	Oneida	NY	55,660	1.2%	2	1
26.	Erie	NY	26,893	0.1%	1	1
27.	Onondaga	NY	11,342	0.1%	1	1
	Total		$3,001,222	4.7%	124	96

(1) Deposit market share data as of June 30, 2005, the most recent information available, calculated by Sheshunoff Information Services, Inc.

Employees

As of December 31, 2005 the Company employed 1,299 full-time equivalent employees. The Company offers a variety of employment benefits and considers its relationship with its employees to be good.

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Supervision and Regulation

Bank holding companies and national banks are regulated by state and federal law. The following is a summary of certain laws and regulations that govern the Company and the Bank. To the extent that the following information describes statutory or regulatory provisions, it is qualified in its entirety by reference to the actual statutes and regulations thereunder.

Federal Bank Holding Company Regulation

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

Federal Reserve System

The Company is required by the Board of Governors of the Federal Reserve System to maintain cash reserves against its deposits. After exhausting other sources of funds, the Company may seek borrowings from the Federal Reserve for such purposes. Bank holding companies registered with the FRB are, among other things, restricted from making direct investments in real estate. Both the Company and the Bank are subject to extensive supervision and regulation, which focus on, among other things, the protection of depositors' funds.

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

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

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

Office of Comptroller of the Currency

The Bank is supervised and regularly examined by the Office of the Comptroller of the Currency ("the OCC"). The various laws and regulations administered by the OCC affect corporate practices such as payment of dividends, incurring debt, and acquisition of financial institutions and other companies. It also affects business practices, such as payment of interest on deposits, the charging of interest on loans, types of business conducted and location of offices. There are no regulatory orders or outstanding issues resulting from regulatory examinations of the Bank.

Sarbanes-Oxley Act of 2002

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

Item 1A. Risk Factors

Investment in Community Bank System, Inc. common stock involves risk. The market price of the Company's common stock may fluctuate significantly in response to a number of factors including, but not limited to:

- Changes in securities analysts' expectations of financial performance
- Volatility of stock market prices and volumes
- Incorrect information or speculation
- Changes in industry valuations
- Interest rate changes
- Variations in operating results from general expectations
- Actions taken against the Company by various regulatory agencies
- Changes in authoritative accounting guidance by Financial Accounting Standards Board or other regulatory agencies
- Changes in general domestic economic conditions such as inflation rates, tax rates, unemployment rates, higher labor and healthcare costs, recessions, and changing government policies, laws and

regulations

The Company's main markets are located in the states of New York and Pennsylvania. A prolonged economic downturn in these markets could negatively impact the Company.

The Company's income and cash flow depends to a great extent on the difference between the interest earned on loans and investment securities, and the interest paid on deposits and other borrowings. Interest rates are beyond the Company's control, and they fluctuate in response to general economic conditions and the policies of various governmental and regulatory agencies, in particular, the Federal Reserve Board. Changes in monetary policy, including changes in interest rates, will influence the origination of loans, the purchase of investments, the generation of deposits and the rates received on loans and investment securities and paid on deposits.

The Company and its subsidiaries are subject to extensive state and federal regulation, supervision and legislation that govern nearly every aspect of its operations. Changes to these laws could affect the Company's ability to deliver or expand its services and diminish the value of its business.

The business strategy of the Company includes growth through acquisition. Any future acquisitions will be accompanied by the risks commonly encountered in acquisitions. These risks include among other things; the difficulty of integrating the operations and personnel of acquired banks and branches, the potential disruption of our ongoing business, the inability of our management to maximize our financial and strategic position, and the inability to maintain uniform standards, controls, procedures and policies and the impairment of relationships with employees and customers as a result of changes in management.

The Company relies on communication, information, operating and financial control systems from third-party service providers. Any failure or interruption or breach in security of these systems could result in failures or interruptions in our customer relationship management, general ledger, deposit, servicing and/or loan origination systems.

Readers are cautioned that it is not possible to predict or identify all of the risks, uncertainties and other factors that may affect future results and that the above list should not be considered to be a complete list.

Item 1B. Unresolved Staff Comments

None

Item 2. Properties

The Company's primary headquarters is located at 5790 Widewaters Parkway, Dewitt, New York, which is leased. In addition, the Company has 135 properties, 92 are owned and 43 are located in long-term leased premises. Real property and related banking facilities owned by the Company at December 31, 2005 had a net book value of $48.3 million and none of the properties was subject to any material encumbrances. For the year ended December 31, 2005, rental fees of $2.7 million were paid on facilities leased by the Company for its operations. We believe that our facilities are suitable and adequate for the Company's current operations.

Item 3. Legal Proceedings

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

Item 4. Submission of Matters to a Vote of Security Holders

There were no matters submitted to a vote of the shareholders during the quarter ended December 31, 2005.

Item 4A. Executive Officers of the Registrant

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

Name	Age	Position
Sanford A. Belden	63	Director, President and Chief Executive Officer of the Com held this position since he joined the Company in October
Mark E. Tryniski	45	Executive Vice President and Chief Operating Officer of th Company in June 2003 as the Treasurer and Chief Financial his current position. He previously served as a partner in PricewaterhouseCoopers LLP, with eighteen years of experie banking and other industries.
Scott A. Kingsley	41	Treasurer of the Company, and Executive Vice President and Bank. Mr. Kingsley joined the Company in August 2004 in hi Vice President and Chief Financial Officer of Carlisle Eng subsidiary of the Carlisle Companies, Inc., from 1997 unti
Brian D. Donahue	49	Executive Vice President and Chief Banking Officer. Mr. Do in August 2004. He served as the Bank's Chief Credit Offic and as the Senior Lending Officer for the Southern Region 2004.
Thomas A. McCullough	59	President, Pennsylvania Banking. Mr. McCullough joined the current position. He was previously the President and Chie National Banc Corp. from 1989 until they merged with the C
Steven R. Tokach	59	Senior Vice President and Chief Credit Administrator. Mr. Administrator position in March 2003. He was previously th franchise since May 2001, when the Company acquired First Vice President of First Liberty Bank Corp. and First Liber
Timothy J. Baker	54	Senior Vice President and Director of Special Projects. Mr position in August 2004. He was previously the Senior Oper responsible for bank operations, special projects and tech 2004.
W. Valen McDaniel	59	Senior Vice President and Chief Risk Officer. Mr. McDaniel January 2004. He served as the Company's corporate auditor Company in June 1991. He is responsible for the insurance compliance, loan review, facilities, and security of the b
Joseph J. Lemchak	44	Senior Vice President and Chief Investment Officer. Mr. Le and since May 1991 he has served in the duel capacity of C

Asset/Liability Manager for the Bank.

Name	Age	Position
J. David Clark	51	Senior Vice President and Chief Credit Officer. Mr. Clark October 2004. He was previously the Commercial Market Mana market since April 1993.
Robert P. Matley	54	Executive Vice President and Senior Lending Officer, PA Ba Company in 2004. He was previously employed by First Herit organization in 1994 as Executive Vice President and Senio to President and Chief Operating Officer in 2003 and serve with the Company in 2004.
Bernadette R. Barber	44	Senior Vice President and Chief Human Resources Officer. M February 2005 in her current position. She has served sinc Resources and Administration for The Penn Traffic Company.
Harold M. Wentworth	41	Senior Vice President and Director of Sales and Marketing. position in January 2005. He was previously a manager in t was responsible for asset liability management and product
J. Michael Wilson	35	Senior Vice President and Chief Technology Officer. Mr. Wi 2002 as Vice President of Information Technology and assum 2004. He previously held the position of Director of Techn Ohio.

Part II

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

The Company's common stock has been trading on the New York Stock Exchange under the symbol "CBU" since December 31, 1997. Prior to that, the common stock traded over-the-counter on the NASDAQ National Market under the symbol "CBSI" beginning on September 16, 1986. There were 29,956,850 shares of common stock outstanding on December 31, 2005, held by approximately 3,702 registered shareholders of record. The following table sets forth the high and low prices for the common stock, and the cash dividends declared with respect thereto, for the periods indicated. The prices do not include retail mark-ups, mark-downs or commissions. The information below has been adjusted to reflect the two-for-one stock split of the Company's common stock effected on April 12, 2004.

Year / Qtr	High Price	Low Price	Quarterly Dividend
2005			
4th	$24.68	$21.60	$0.19
3rd	$26.12	$21.63	$0.19
2nd	$24.87	$21.40	$0.18
1st	$28.30	$22.41	$0.18
2004			

4th	$28.66	$25.06	$0.18
3rd	$26.00	$20.87	$0.18
2nd	$23.85	$18.86	$0.16
1st	$25.39	$21.76	$0.16

The Company has historically paid regular quarterly cash dividends on its common stock, and declared a cash dividend of $0.19 per share for the first quarter of 2006. The Board of Directors of the Company presently intends to continue the payment of regular quarterly cash dividends on the common stock, as well as to make payment of regularly scheduled dividends on the trust preferred stock when due, subject to the Company's need for those funds. However, because substantially all of the funds available for the payment of dividends by the Company are derived from the Bank, future dividends will depend upon the earnings of the Bank, its financial condition, its need for funds and applicable governmental policies and regulations.

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The following table provides information as of December 31, 2005 with respect to shares of common stock that may be issued under the Company's existing equity compensation plans:

Plan Category	Number of Securities to be Issued upon Exercise of Outstanding Options, Warrants and Rights (1)	W Exe on Optio a
Equity compensation plans approved by security holders:		
1994 Long Term Incentive Plan	1,973,273	
2004 Long Term Incentive Plan	593,511	
Equity compensation plans not approved by security holders:		
Citizens Advisory Council Plan (2)	0	
Total	2,566,784	

(1) The number of securities includes unvested restricted stock issued of 21,094.

(2) In connection with the acquisition of Citizens National Bank, the Company formed an advisory council comprised of the former directors of Citizens National Bank for the purpose of advising the Bank on banking activities in Citizens National Bank's market area, the transition of business relationships after the merger, and the continued development of business relationships throughout Northern New York State. In consideration for serving on this council, the members have been granted shares of restricted stock that vest over two years.

The following table shows treasury stock purchases during the fourth quarter 2005.

	Number of Shares Purchased	Average Price Paid Per share	Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs
October 1-31, 2005 (1)	0	$ 0.00	521,611
November 1-30,2005 (1)	0	0.00	521,611
December 1-31, 2005 (1)	72,100	22.99	593,711
Total	72,100	$22.99	593,711

(1) All shares were repurchased through the Company's publicly announced share repurchase program. On April 20, 2005, the Company announced a twenty-month authorization to repurchase up to 1,500,000 of its outstanding shares in open market or privately negotiated transactions. These repurchases will be for general corporate purposes, including those related to stock plan activities.

Item 6. Selected Financial Data

The following table sets forth selected consolidated historical financial data of the Company as of and for each of the years in the five-year period ended December 31, 2005. The historical information set forth under the captions "Income Statement Data" and "Balance Sheet Data" is derived from the audited financial statements while the information under the captions "Average Balance Sheet Data", "Capital and Related Ratios", "Selected Performance Ratios" and "Asset Quality Ratios" for all periods is unaudited. All financial information in this table should be read in conjunction with the information contained in "Management's Discussion and Analysis of Financial Condition and Results of Operations" and with the Consolidated Financial Statements and the related notes thereto included elsewhere in this Annual Report on Form 10-K.

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SELECTED CONSOLIDATED FINANCIAL INFORMATION

	Years Ended D		
(In thousands except per share data)	2005	2004	2003
Income Statement Data:			
Loan interest income	$ 147,608	$ 137,077	$ 125,25
Investment interest income	71,586	75,718	65,87
Interest expense	75,572	61,752	59,30
Net interest income	143,622	151,043	131,82
Provision for loan losses	8,534	8,750	11,19
Other noninterest income	48,651	44,373	37,92
Gain (loss) on investment securities & early retirement of long-term borrowings	12,195	72	(2,69
Special charges/acquisition expenses	2,943	1,704	49
Other noninterest expenses	124,446	118,195	102,21
Income before income taxes	68,545	66,839	53,15
Net income	50,805	50,196	40,38
Diluted earnings per share (1)	1.65	1.64	1.4
Diluted earnings per share - cash (3)	1.84	1.81	1.6

Balance Sheet Data:			
Investment securities	$1,303,090	$1,584,339	$1,329,53
Loans, net of unearned discount	2,411,817	2,358,493	2,128,50
Allowance for loan losses	(32,581)	(31,778)	(29,09
Intangible assets	224,878	232,500	196,11
Total assets	4,152,734	4,393,831	3,855,39
Deposits	2,984,768	2,928,978	2,725,48
Borrowings	653,090	920,511	667,78
Shareholders' equity	457,595	474,628	404,82
Capital and Related Ratios:			
Cash dividend declared per share (1)	$ 0.74	$ 0.68	$ 0.6
Book value per share (1)	15.28	15.49	14.2
Tangible book value per share (1)	7.77	7.90	7.3
Market capitalization (in millions)	676	866	69
Tier 1 leverage ratio	7.57%	6.94%	7.2
Total risk-based capital to risk-adjusted assets	13.64%	13.18%	13.0
Tangible equity to tangible assets	5.92%	5.82%	5.7
Dividend payout ratio	43.9%	40.9%	40.
Period end common shares outstanding (1)	29,957	30,642	28,33
Diluted weighted average shares outstanding (1)	30,838	30,670	27,03
Selected Performance Ratios:			
Return on assets	1.19%	1.20%	1.1
Return on equity	10.89%	11.39%	11.7
Net interest margin	4.17%	4.45%	4.6
Noninterest income/operating income (FTE)	27.8%	21.2%	19.
Efficiency ratio(2)	56.8%	52.8%	53.
Asset Quality Ratios:			
Allowance for loan loss/loans outstanding	1.35%	1.35%	1.3
Nonperforming loans/loans outstanding	0.55%	0.55%	0.6
Allowance for loan loss/nonperforming loans	245%	245%	21
Net charge-offs/average loans	0.33%	0.37%	0.5
Loan loss provision/net charge-offs	110%	104%	10

(1) All share and share-based amounts reflect the two-for-one stock split effected as a 100% stock dividend on April 12, 2004.

(2) Efficiency ratio excludes intangible amortization, gain (loss) on investment securities & debt extinguishments and special charges/acquisition expenses.

(3) Cash earnings are reconciled to GAAP net income in Table 1.

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

This Management's Discussion and Analysis of Financial Condition and Results of Operations ("MD&A") primarily reviews the financial condition and results of operations of Community Bank System, Inc. ("the Company") for the past two years, although in some circumstances a period longer than two years is covered in order to comply with Securities and Exchange Commission disclosure requirements or to more fully explain long-term trends. The following discussion and analysis should be read in conjunction with the Selected Consolidated Financial Information on page 11 and the Company's Consolidated Financial

Statements and related notes that appear on pages 44 through 66. All references in the discussion to the financial condition and results of operations are to the consolidated position and results of the Company and its subsidiaries taken as a whole.

All financial results reflect the 2001 acquisition of First Liberty in accordance with the pooling of interests method of accounting. Unless otherwise noted, all earnings per share ("EPS") figures disclosed in the MD&A refer to diluted EPS; interest income, net interest income and net interest margin are presented on a fully tax-equivalent ("FTE") basis. The term "this year" and equivalent terms refer to results in calendar year 2005, "last year" and equivalent terms refer to calendar year 2004, and all references to income statement results correspond to full-year activity unless otherwise noted. Lastly, all references to "peer banks" pertain to a group of 89 bank holding companies nationwide having $3 billion to $10 billion in assets and their associated composite financial results for the nine months ending September 30, 2005 (the most recently available disclosure), as provided by the Federal Reserve Board's Division of Banking Supervision and Regulation in the Bank Holding Company Performance Report. All share and share-based amounts reflect the two-for-one stock split effected as a 100% stock dividend on April 12, 2004.

This Management's Discussion and Analysis of Financial Condition and Results of Operations contains certain forward-looking statements with respect to the financial condition, results of operations and business of Community Bank System, Inc. These forward-looking statements involve certain risks and uncertainties. Factors that may cause actual results to differ materially from those contemplated by such forward-looking statements are set herein under the caption "Forward-Looking Statements" on page 34.

Critical Accounting Policies

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

- Actuarial assumptions associated with pension, post-retirement and other employee benefit plans - These assumptions include discount rate, rate of future compensation increases and expected return on plan assets. Specific discussion of the assumptions used by management is discussed in Note K on pages 58 through 61.

- Provision for income taxes - The Company is subject to examinations from various taxing authorities. Such examinations may result in challenges to the tax return treatment applied by the Company to specific transactions. Management believes that the assumptions and judgements used to record tax-related assets or liabilities have been appropriate. Should tax laws change or the taxing authorities determine that management's assumptions were inappropriate, an adjustment may be required which could have a material effect on the Company's results of operations.

o Carrying value of goodwill and other intangible assets - The carrying value of goodwill and other intangible assets is based upon discounted cash flow modeling techniques that require management to make estimates regarding the amount and timing of expected future cash flows. It also requires 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.

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A summary of the accounting policies used by management is disclosed in Note A, Summary of Significant Accounting Policies, starting on page 44.

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 portfolios using both organic and acquisition strategies, (iii) increase the non-interest income component of total revenues through development of banking-related fee income, growth in existing financial services business units, and the acquisition of additional financial services and banking businesses, and (iv) utilize technology to deliver customer-responsive products and services and to reduce operating costs.

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

In 2005, the Company reported record earnings as a result of higher non-interest income including securities gains, improved asset quality and organic loan and deposit growth offset by higher operating expenses, including special charges, an increased cost of funds, lower investment income and a higher effective tax rate. Capital levels remained strong with both the Tier 1 leverage ratio and tangible equity ratio improving from 2004. Non-interest income, including securities gains, increased 37% over 2004 as a result of $12 million of gains on the sale of investments, as well as strong growth from banking sources and the Company's employee benefits administration and consulting businesses. Operating expense in the fourth quarter of 2005 included a one-time, $2.9 million charge related to certain early retirement actions.

Asset quality remained strong in 2005, with a reduction in the loan charge-off ratios and consistent delinquency and non-performing loan ratios versus 2004. The Company produced loan growth in the consumer mortgage and consumer installment lending portfolios, while outstanding business lending balances declined. On a geographical basis, the Company's New York markets reported strong growth in consumer mortgage and consumer installment loans, with slight declines in business lending. The Pennsylvania markets reported growth in the consumer installment portfolio with declines in the business lending and mortgage portfolios. Total deposits increased 1.9% over 2004.

Net Income and Profitability

Net income for 2005 was $50.8 million, up $0.6 million or 1.2% from the prior year. Earnings per share of $1.65 in 2005 were 0.6% higher than 2004's results. The growth rate of EPS was below that of net income due to higher weighted average diluted shares outstanding driven by the 2.6 million shares of common stock issued in conjunction with the acquisition of First Heritage in May 2004 and the exercise of options under the employee stock plan. In 2005, the Company made significant progress on its objective of shortening the average life of its investment portfolio, generating a $0.29 per share after-tax gain through the sale of securities that had optimized their total return and interest-rate sensitivity characteristics. The 2005 results were also impacted by a $2.9 million, or $0.07 per share non-recurring charge related to the early retirement of certain executives. Earnings in 2004 included $1.7 million of non-recurring acquisition related expenses.

In addition to the earnings results presented above in accordance with GAAP, the Company provides cash earnings per share, which excludes the after-tax effect of the amortization of intangible assets and the market value adjustments on net assets acquired in mergers. Management believes that this information helps investors understand the effect of acquisition activity in reported results. Cash earnings per share for 2005 were $1.84, up 1.7% from $1.81 for the year ended December 31, 2004.

Net income and earnings per share for 2004 were $50.2 million and $1.64, up 24% and 10.1%, respectively, from 2003 results. The growth rate of EPS was below that of net income due to higher weighted average diluted shares outstanding. The increase in diluted shares was primarily driven by the 2.6 million and 2.3 million shares of common stock issued in conjunction with the acquisition of First Heritage in May 2004 and Grange in November 2003, respectively, an increased level of option grants and exercises, and a higher average common share price (refer to the "Earnings per Share" section of Note A on page 48 for information regarding the impact of share price on diluted shares).

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Table 1: Reconciliation of GAAP Net Income To Cash Net Income

	Years Ended December 31,			
(000's omitted)	2005	2004	2003	2002
Net income	$50,805	$50,196	$40,380	$38,517
After-tax adjustments:				
Net amortization of market value adjustments on net assets acquired in mergers	655	(126)	72	--

Amortization of intangible assets	5,281	5,568	3,869	4,375
Net income - cash	$56,741	$55,638	$44,321	$42,892

Table 2: Condensed Income Statements

	Years Ended December 31,		
(000's omitted, except per share data)	2005	2004	2003
Net interest income	$143,622	$151,043	$131,828
Loan loss provision	8,534	8,750	11,195
Noninterest income	60,846	44,445	35,231
Operating expenses	127,389	119,899	102,711
Income before taxes	68,545	66,839	53,153
Income taxes	17,740	16,643	12,773
Net income	$ 50,805	$ 50,196	$ 40,380
Diluted earnings per share	$ 1.65	$ 1.64	$ 1.49
Diluted earnings per share-cash(1)	$ 1.84	$ 1.81	$ 1.64

(1) Cash earnings are reconciled to GAAP net income in Table 1.

The primary factors explaining 2005 performance are discussed in detail in the remaining sections of this document and are summarized as follows:

- As shown in Table 2 above, net interest income decreased 4.9% or $7.4 million due to a 28 basis point decrease in the net interest margin, partially offset by a $69 million increase in average earning assets. Average loans grew $110 million or 4.9%, primarily due to strong consumer installment growth as well as the addition of First Heritage in May 2004. Average investments decreased $41.0 million or 2.8% in 2005 primarily as a result of the sales made throughout 2005. The growth in earning assets was funded by $103 million or 3.6% higher average deposits. Cash flows from the investment sales were used to pay down external borrowings throughout 2005, resulting in $63 million lower average borrowings in 2005 as compared to 2004.

- The loan loss provision of $8.5 million decreased $0.2 million, or 2.5%, from the prior year level. Net charge-offs of $7.7 million decreased by $0.7 million from 2004, reducing the net charge-off ratio (net charge-offs / total average loans) to 0.33% for the year. Asset quality in 2005 remained stable and favorable as evidenced by consistent standard metrics such as non-performing loans as a percentage of total loans, non-performing assets as a percentage of loans and other real estate owned and delinquent loans (30+ days through non-accruing) as a percentage of total loans. Additional information on trends and policy related to asset quality is provided in the asset quality section on pages 26 through 29.

- Non-interest income for 2005 of $60.8 million increased by $16.4 million or 36.9% from 2004's level, the twelfth consecutive year of growth. Banking services were up 9.1% and accounted for $2.5 million of the improvement, primarily due to the acquisitions in 2004 as well as several revenue enhancement initiatives implemented this year. Financial services revenue was $1.8 million or 10.5% higher, mostly as a result of strong growth at the Company's benefit plan administration and consulting business. Gains on the sale of investment securities increased $12.1 million as the Company took advantage of market conditions to sell certain securities in order to shorten the average length of the portfolio and maximize their expected total return.

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- Total operating expenses rose $7.5 million or 6.2% in 2005 to $127.4 million. Excluding special charges/acquisition expenses in both years, 2005 operating expenses rose $6.3 million or 5.3%. A majority of the increase was due to increased personnel expenses associated with the acquisitions in 2004, as well as merit increases and higher costs in employee health and welfare programs. In addition, higher business development costs associated with a more robust marketing strategy were incurred. Net occupancy expenses also increased because of a larger number of facilities due to acquisitions, current and prior year renovations and maintenance, and slightly higher property tax and utility rates. Operating expenses for 2005 include a $2.9 million non-recurring charge related to the early retirement of certain executives.

- The Company's combined effective federal and state income tax rate increased 1.0 percentage points in 2005 to 25.9%, primarily as a result of a higher proportion of income being generated from fully taxable sources (loans and investments).

Selected Profitability and Other Measures

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

Table 3: Selected Ratios

	2005	2004	2003
Return on average assets	1.19%	1.20%	1.16%
Return on average equity	10.89%	11.39%	11.78%
Dividend payout ratio	43.9%	40.9%	40.2%
Average equity to average assets	10.93%	10.50%	9.87%

As displayed in Table 3 above, the return on average assets decreased slightly in 2005 as compared to 2004, but was above the 2003 level. This was primarily a result of higher expenses due to the special charge taken in the fourth quarter of 2005 related to certain early retirements. Reported return on equity in 2005 was down slightly from 2004's level. This was mainly a result of equity capital increasing at a faster pace than net income due to the impact of the First Heritage acquisition and the enhancement of the Company's capital position through the retention of net profits. Return on equity in 2004 was down slightly from 2003's level. Likewise this was mainly a result of the buildup of equity capital from the retention of net profits in 2004 as well as the common shares issued in conjunction with the acquisitions of First Heritage in May 2004 and Grange in November 2003. The strengthening of the Company's equity capital position over the past two years is reflected in the 43 and 63 basis-point increases in the average equity to average total assets ratios in 2005 and 2004, respectively.

The dividend payout ratio for 2005 was above 2004's level based on reported net income mostly due to the 12.5% and 5.6% increase in the quarterly dividend in the third quarters of 2004 and 2005, respectively.

Net Interest Income

Net interest income is the amount that interest and fees on earning assets (loans and investments) exceeds 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 disclosed in Table 4, net interest income (with non-taxable income converted to a fully tax-equivalent basis) totaled $158.0 million in 2005, down $7.6 million or 4.6% from the prior year. A $7.3 million increase in average interest-bearing liabilities and a 28 basis point decrease in the net interest margin more than offset a $69 million increase in average earning-assets. As reflected in Table 5, the volume changes mentioned above increased net interest income by $3.0 million, while the lower net interest margin had a $10.6 million negative impact.

The net interest margin declined 28 basis points from 4.45% in 2004 to 4.17% in 2005. This decline was primarily attributable to the eight rate hikes (25 basis points each) by the Federal Reserve to the overnight federal funds rates since last December having a greater impact on funding costs (up 35 basis points) than earning-asset yields (up six basis points). The rising short-term market rates resulted in steady increases to rates throughout the year on interest-bearing deposits rates (up 30 basis points) and total external borrowings (up 101 basis points). Conversely, the yield on loans remained relatively stable for the first three quarters of 2005 and increased 25 basis points in the fourth quarter as compared to the third quarter. The yield on investments declined during the year from 6.18% for 2004 to 6.05% for 2005, as a result of the sale of higher yielding securities.

The net interest margin also declined in each of the quarters of 2004, from 4.67% for the first quarter to 4.32% in the fourth quarter. This trend was mostly attributable to the changes in market interest rates during 2004 as well as the Federal Reserve

beginning to raise the overnight federal funds rate in June 2004. Falling market rates early in the year allowed the Company to reduce or hold steady rates on interest-bearing deposit accounts in the first three quarters of 2004. The fourth quarter of 2004 saw interest rates on money market and time deposit accounts rise slightly in response to increasing market rates. Similarly, the yield on loans decreased throughout the first three quarters of the year. The decline in loan yields had a greater negative impact on the margin in 2004 ($12.1 million) than the benefit derived from deposit rate reductions ($7.2 million). Yields on investments declined 35 basis points during 2004 from 6.53% to 6.18% as investment purchases were at generally lower rates. Lastly, the average interest rate paid on borrowings decreased 83 basis points from 4.13% for 2003 to 3.30% for 2004.

As shown in Table 4, total interest income increased by $6.2 million or 2.7% in 2005. Table 5 shows that higher average earning assets contributed a positive $4.2 million variance and higher yields contributed $2.0 million. Average loans grew a total of $110 million in 2005, the majority as a result of the addition of $204 million of loans through the acquisition of First Heritage in May 2004 and $5.6 million from the November 2004 acquisition of the Dansville branch as well as organic growth in the consumer installment and consumer mortgage portfolios. Interest and fees on loans increased $10.6 million or 7.7%. The increase was attributable to higher average loan balances (positive $6.8 million) as well as a 17-basis point increase in loan yields (positive $3.8 million) due to the rising rate environment. Average loans grew $379 million in 2004, the majority being the result of the First Heritage acquisition as well as the $186 million of loans acquired in the Peoples and Grange acquisition in late 2003. Interest and fees on loans increased $11.6 million or 9.2% in 2004 as compared to 2003. The increase was attributable to higher average loan balances (positive $23.7 million), partially offset by a 60-basis point drop in loan yields (negative $12.1 million) due to falling capital market rates.

A leveraging strategy was employed beginning in late 2003 through mid-2004, which increased average investment balances by $268.3 million for 2004 versus the year-earlier period. In 2005, the Company decided to sell certain securities and not fully reinvest cash flows from maturing securities in the current flat yield environment, to take advantage of market conditions to shorten the average life of the portfolio, improve its interest-rate sensitivity profile in a rising-rate environment, and maximize the expected total return. As a result, average investments for 2005 decreased $41 million and the expected life-to-maturity of the portfolio was reduced from 5.9 years at December 31, 2004 to 5.3 years at December 31, 2005. Refer to the "Investments" section of the MD&A on pages 32 through 34 for further information.

Investment interest income in 2005 of $85.5 million was $4.4 million or 4.9% lower than the prior year as a result of a smaller portfolio (negative $2.1 million impact) as well as a decrease in the average investment yield from 6.18% to 6.05% (negative $2.3 million impact). The decrease in the yield was principally driven by the sale and maturity of higher-yielding securities. The performance of the investment portfolio in 2005 remained strong despite the interest rate environment. The Company was able to maintain its yields to a great extent primarily because of two important strategies: the addition of a substantial amount of call-protected securities in 2001 and first half of 2002 when rates were higher, and foregoing security purchases in the late-2002 to mid-2003 period as rates were falling significantly. The success of these actions was evident in the Company's 97th percentile ranking within its peer group for tax-equivalent investment yield for the nine months ended September 2005. Investment interest income in 2004 of $89.8 million was $12.5 million or 16% higher than the prior year as a result of a larger portfolio (positive $16.9 million impact), partially offset by a decrease in the average investment yield from 6.53% to 6.18% (negative $4.5 million impact). The decrease in the yield was principally driven by significant declines in market interest rates from early 2001 through mid-2003. Consequently, the Company was unable to replace the run-off of longer-term higher-yielding securities with equivalent-rate investments. The Company also purchased securities in the relatively low-interest rate environment in the second half of 2003 and 2004, which resulted in an overall decline in yields, but offered at attractive net spread due to the low cost of the borrowings used to fund the purchase.

The average earning asset yield grew six basis points to 6.17% in 2005 because of the previously mentioned increase in loan yields, partially offset by the declines in the investment yields. In 2003 the yield on the loan portfolio was 14 basis points higher than the yield on investments. In 2004 investment yields were 11 basis points above those produced by loans. During 2005, changes in market interest rates combined with the strategic investment portfolio actions previously discussed resulted in the yield on the loan portfolio again being higher than the investment portfolio by 19 basis points.

Total average funding (deposits and borrowings) grew by $39.8 million in 2005. Deposits increased $102.9 million, attributable to the acquisitions of First Heritage, Dansville and organic growth. Average external borrowings declined $63.0 million in 2005 as compared to the prior year as cash flows from the securities sales were used to reduce short-term borrowings. In 2004 total average funding increased by $626.5 million, with $310.9 million of the increase coming from deposits, mostly attributable to the acquisitions of First Heritage, Grange and Peoples. External borrowings increased $315.6 in 2004 to fund organic loan growth and investment purchases.

The cost of funding increased throughout 2005 reflective of the eight 25 basis point increases to short-term rates by the Federal Reserve since December of 2004. Interest rates on deposit accounts were raised throughout the year, with increases in almost all product offerings. The primary drivers of the increase in deposit cost of funds were maturing time deposits

rolled over at higher interest rates and customers transferring funds from lower rate interest bearing accounts to a new higher yielding money market product. This is demonstrated by the percentage of average deposits that were in time deposit accounts and regular savings dropping from 41.3% and 18.1% in 2004 to 40.9% and 17.1% in 2005, while money market deposits increased from 10.7% in 2004 to 11.7% in 2005. The flattening yield curve also resulted in decreasing the interest rate differential between short and long-term debt.

Total interest expense increased by $13.8 million to $75.6 million in 2005. As shown in Table 5, higher interest rates on deposits and external borrowings resulted in $13.7 million of this increase, while the higher deposit and borrowings balances accounted for just $0.1 million of the increase in interest expense. Interest expense as a percentage of earning assets increased by 33 basis points to 1.99%. The rate on interest bearing deposits increased 30 basis points to 1.79%, due largely to increases in money market and time deposit rates throughout 2005. The rate on external borrowings increased 101 basis points to 4.31% because of the previously mentioned increase in short-term market rates. Total interest expense increased by $2.5 million to $61.8 million in 2004 as compared to 2003. A higher level of deposits and borrowings, partially offset by lower interest rates accounted for the increase. The rate on interest bearing deposits fell 34 basis points to 1.49% and the rate on external borrowings declined 83 basis points to 3.30% in 2004.

The following table sets forth information related to average interest-earning assets and interest-bearing liabilities and their associated yields and rates for the years ended December 31, 2005, 2004 and 2003. Interest income and yields are on a fully tax-equivalent basis using marginal income tax rates of 38.6% in 2005, 38.7% in 2004, and 38.9% in 2003. Average balances are computed by totaling the daily ending balances in a period and dividing by the number of days in that period. Loan yields and amounts earned include loan fees. Average loan balances include non-accrual loans and loans held for sale.

Table 4: Average Balance Sheet

(000's omitted except yields and rates)	Year Ended December 31, 2005			Year Ended December 31, 2004		
	Average Balance	Interest	Avg. Yield/Rate Paid	Average Balance	Interest	Avg. Yield/Ra Paid

Interest-earning assets:						
Time deposits in other banks	$ 935	$ 31	3.32%	$ 868	$ 22	2.53%
Taxable investment securities (1)	881,712	49,739	5.64%	940,744	54,205	5.76%
Non-taxable investment securities (1)	530,639	35,704	6.73%	512,666	35,626	6.95%
Loans (net of unearned discount)	2,374,893	148,075	6.24%	2,264,857	137,450	6.07%
Total interest-earning assets	3,788,179	233,549	6.17%	3,719,135	227,303	6.11%
Noninterest-earning assets	479,325			477,686		
Total assets	$4,267,504			$4,196,821		
Interest-bearing liabilities:						
Interest checking, savings and money market deposits	$1,172,333	8,959	0.76%	$1,128,071	6,368	0.56%
Time deposits	1,214,719	33,793	2.78%	1,188,625	28,219	2.37%
Short-term borrowings	366,775	11,249	3.07%	442,287	7,242	1.64%
Long-term borrowings	394,195	21,571	5.47%	381,716	19,923	5.22%
Total interest-bearing liabilities	3,148,022	75,572	2.40%	3,140,699	61,752	1.97%
Noninterest-bearing liabilities:						
Demand deposits	591,061			558,552		
Other liabilities	61,845			56,943		
Shareholders' equity	466,576			440,627		
Total liabilities and shareholders' equity	$4,267,504			$4,196,821		
Net interest earnings		$157,977			$165,551	
Net interest spread			3.77%			4.14%
Net interest margin on interest-earning assets			4.17%			4.45%
Fully tax-equivalent adjustment		$ 14,355			$ 14,508	

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

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

Table 5: Rate/Volume

(000's omitted)	2005 Compared to 2004 Increase (Decrease) Due to Change in (1) Volume	Rate	Net Change	Increa Volume
Interest earned on:				
Time deposits in other banks	$ 2	$ 7	$ 9	$ 1
Taxable investment securities	(3,348)	(1,118)	(4,466)	9,48
Non-taxable investment securities	1,228	(1,150)	78	7,43
Loans (net of unearned discount)	6,795	3,830	10,625	23,73
Total interest-earning assets (2)	4,245	2,001	6,246	40,47
Interest paid on:				
Interest checking, savings and money market deposits	259	2,332	2,591	80
Time deposits	632	4,942	5,574	2,66
Short-term borrowings	(1,413)	5,420	4,007	3,57
Long-term borrowings	664	984	1,648	4,77
Total interest-bearing liabilities (2)	144	13,676	13,820	11,32
Net interest earnings (2)	3,029	(10,603)	(7,574)	29,13

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

(2) Changes due to volume and rate are computed from the respective changes in average balances and rates of the totals; they are not a summation of the changes of the components.

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Non-interest Income

The Company's sources of non-interest income are of three primary types: general banking services related to loans, deposits and other core customer activities typically provided through the branch network; financial services, comprised of employee benefit plan administration, actuarial and consulting services (BPA-Harbridge), trust services, investment and insurance products (Community Investment Services, Inc. or CISI) and asset management (Elias Asset Management or EAM); and periodic transactions, most often net gains (losses) from the sale of investments and prepayment of term debt.

Table 6: Non-interest Income

(000's omitted)	Years Ended 2005	200
Deposit service charges and fees	$21,961	$20,3
Benefit plan administration, consulting and actuarial fees	11,193	9,1

Trust, investment and asset management fees	7,307	7,5
Commissions and other	4,839	4,1
Electronic banking	2,829	2,5
Mortgage banking	522	5
Subtotal	48,651	44,3
Gain (loss) on investment securities & debt prepayment	12,195	
Total noninterest income	$60,846	$44,4
Noninterest income/operating income (FTE)	27.8%	21.

As displayed in Table 6, non-interest income, excluding security gains, increased by 9.6% to $48.7 million, largely as a result of recurring bank fees and growth in benefit plan administration, consulting and actuarial fees. Gain on the sale of investment securities increased $12.1 million as the Company took advantage of market conditions to sell certain securities in order to shorten the average length of the portfolio and maximize their expected total return. Refer to the "Investments" section of the MD&A on pages 32 through 34 for further information. Total non-interest income for 2004 increased by 26.2% over 2003 to $44.4 million, largely as a result of higher bank fees, driven by four bank acquisitions in 2003 and 2004, the acquisition of Harbridge, growth at BPA and CISI, and the absence of debt repayment charges.

Non-interest income as a percent of operating income (FTE basis) was 27.8% in 2005, up 6.6 percentage points from the prior year, an all-time high for the Company. Excluding the gain (loss) on investment securities & debt prepayment, non-interest income as a percent of operating income (FTE basis) was 23.5% in 2005, a 2.4 percentage point increase from 21.1% for 2004. This increase was primarily driven by the aforementioned strong growth in recurring bank fees and benefit plan administration, consulting and actuarial fees and declining net interest income. This ratio is considered an important measure for determining the progress the Company is making on one of its primary long-term strategies, expansion of non-interest income in order to diversify its revenue sources and reduce reliance on net interest margins that may be strongly impacted by general interest rate and other market conditions.

The largest portion of the Company's recurring non-interest income is the wide variety of fees earned from general banking services, which reached $30.2 million in 2005, up 9.1% from the prior year. A large portion of the income growth was attributable to overdraft fees, up $1.2 million (7.8%) over 2004's level, due in large part to the incremental transaction volume generated from the accounts added through the First Heritage and Dansville acquisitions, as well as several revenue enhancement initiatives implemented this year. Commissions and other increased $0.7 million, due to higher New York Bankers Association dividends and transaction fees. In addition, the increase in electronic banking is directly attributable to a concerted effort to increase the penetration of debit cards as well as the introduction of a business debit card program. Fees from general banking services were $27.6 million in 2004, up $2.6 million or 10.4% from 2003 primarily driven by growth in overdraft fees and commissions, a majority derived from the First Heritage and Grange acquisitions.

As disclosed in Table 6, non-interest income from financial services rose $1.8 million or 10.5% in 2005 to $18.5 million. Financial services revenue now comprises 38% of total non-interest income, excluding net gains (losses) on the sale of investment securities and retirement of debt. Revenue growth at BPA-Harbridge (up $2.0 million or 22%) was driven by enhanced service offerings to both new and existing clients, a portion of which relates to new actuarial determinations required by certain state and federal healthcare programs. These two businesses operate collaboratively to offer their clients a full array of employee benefits, recordkeeping and consulting services, on a national basis. BPA-Harbridge revenue of $9.2 million in 2004 was $3.1 million higher than prior year results, driven by seven more months of revenue from Harbridge,

which was acquired at the end of July 2003, a significant number of new plans under administration and growth in the market value of client assets.

Personal trust generated revenue growth of $154,000 (8.3%) in 2005, achieved through new client relationships and the investment of additional assets by established clients. In 2005, CISI and Elias were negatively impacted by the challenging retail investment market conditions. Revenues in 2005 were down $323,000 (17.6%) and $106,000 (2.7%) at Elias and CISI, respectively as compared to 2004. In 2004 CISI and personal trust had positive revenue growth of $568,000 (17%) and $275,000 (18%), respectively, as improving market conditions positively impacted both businesses. In addition, in 2004 CISI experienced an increased volume of annuity sales in response to higher interest rates and additional client relationships developed in the new markets opened up by the Company's acquisitions.

Assets under management and administration at the Company's financial services businesses rose considerably over the last two years reaching $2.5 billion at the end of 2005, compared to $2.2 billion at year-end 2004 and $1.8 billion at year-end 2003. Market-driven gains in equity-based assets were augmented by attraction of new client assets. BPA in particular was very successful at growing its asset base, as demonstrated by a $358 million or 35% increase in its assets under administration during 2005.

Excluding non-recurring retirement charges, the total financial services group contributed $2.9 million (excluding allocation of indirect corporate expense) or 4.1% of the Company's pre-tax income in 2005, reflecting nearly a 15% operating margin. In 2004, financial services' contribution was $2.1 million or 3.1% of total pre-tax income, with a margin of 12%. The higher earnings were the result of new client business at BPA and personal trust. The increase in percentage contribution was primarily due to growth in the financial services businesses in 2005, combined with the decline in net interest income.

There was a total net gain on security transactions of $12.2 million in 2005 as compared to $72,000 in 2004, as the Company took advantage of market conditions to sell certain securities in order to shorten the average length of the portfolio and maximize their expected total return. Securities sold included $173.2 million of U.S. Treasury and Agency securities, $46.1 million of AAA-rated obligations of state and political subdivisions, and $24.4 million of investment grade corporate bonds. The corresponding gains recognized on these sales were $7.0 million, $2.2 million and $3.0 million respectively.

The net gain on security and debt transactions of $72,000 in 2004 compared to a net loss of $2.7 million in 2003. The loss in 2003 was primarily composed of $2.6 million of charges associated with the early retirement of $25 million of longer-term FHLB borrowings that were replaced with lower rate, short-term borrowings, which were expected to provide a long-term earnings benefit as well as reduce interest rate risk. The security and debt gains and losses taken over the last three years are illustrative of the Company's active management of its investment portfolio and external borrowings to achieve a desirable total return through the combination of net interest income, transaction gains/losses and changes in market value across financial market cycles, as well as achieving an appropriate interest-rate sensitivity profile in changing rate environments.

Operating Expenses

As shown in Table 7, operating expenses rose $7.5 million or 6.2% in 2005 to $127.4 million. Excluding special charges/acquisition expenses, operating expenses were up $6.3 million or 5.3% in 2005, primarily attributable to increases in salaries and benefits costs, utility costs and business development expenses. This year's operating expenses as a percent of average assets were 2.99%, up from 2.86% in 2004 and 2.96% in 2003. The increase in this ratio for 2005 was principally due to the reduction in the size of the investment portfolio, the special charge related to certain early retirement actions as well as more active business development and marketing programs. The decrease in this ratio for 2004 was principally due to an investment leverage strategy executed in the first two quarters of 2004 and the acquisitions in late 2003 and the first half of 2004 (Grange and First Heritage), whereby average assets increased significantly (21%), while operating expenses only increased 17%.

The efficiency ratio, a performance measurement tool widely used by banks, is defined by the Company as operating expenses (excluding special charges/acquisition expenses and intangible amortization) divided by operating income (fully tax-equivalent net interest income plus non-interest income, excluding net securities and debt gains and losses). Lower ratios are often correlated to higher efficiency. In 2005 the efficiency ratio increased 4.0 percentage points to 56.8% due to higher operating expenses and a decline in net interest income. The efficiency ratio for 2004 was 0.6 percentage points lower than the 53.4% ratio for 2003 due primarily to increased net investment interest income.

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Table 7: Operating Expenses

	Years Ended December 31,		
(000's omitted)	2005	2004	20
Salaries and employee benefits	$ 65,059	$ 61,146	$
Occupancy and equipment	20,094	18,813	
Data processing and communications	8,240	8,945	
Amortization of intangible assets	7,125	7,414	
Legal and professional fees	4,540	4,566	
Office supplies and postage	4,097	3,970	
Business development and marketing	2,771	2,003	
Foreclosed property	1,312	994	
Special charges/acquisition expenses	2,943	1,704	
Other	11,208	10,344	
Total operating expenses	$127,389	$119,899	$
Operating expenses/average assets	2.99%	2.86%	
Efficiency ratio	56.8%	52.8%	

Higher personnel expenses accounted for 52% of 2005's increase in operating costs, primarily the result of the First Heritage and Dansville acquisitions in 2004. The remainder of the increase in personnel expense reflects higher benefit costs and merit increases. Personnel expenses in 2004 were up $8.0 million from

2003's level mostly due to the four acquisitions made between July 2003 and May 2004. Total full-time equivalent staff at the end of 2005 was 1,299 compared to 1,301 at December 31, 2004 and 1,259 at then end of 2003.

Medical expenses were up in 2005 due to a general rise in the cost of medical care, administration and insurance, as well as a greater number of insured employees. Qualified and non-qualified pension expenses increased in 2005 principally due to the special charge related to certain early retirement actions and a lower discount rate. In 2004 the qualified and non-qualified pension expense decreased slightly due to a change in the Company's defined benefit pension plan from a standard annuity paid benefit, to a cash balance design, offset by a reduction of the discount rate applied to future payments from 6.1% to 5.9% (increases current expenses in present value terms) and additional obligations for employees added through acquisition and organic growth. The three assumptions that have the largest impact on the calculation of annual pension expense are the aforementioned discount rate, the rate applied to future compensation increases and the expected rate of return on plan assets. See Note K to the financial statements for further information concerning the pension plan.

Total non-personnel expense increased $3.6 million or 6.1% in 2005. Excluding special charges/acquisition expense, non-personal expenses were up $2.3 million or 4.1% from 2004's level. As displayed in Table 7, this was largely caused by higher occupancy and equipment expense (up $1.3 million), business development and marketing (up $0.8 million), foreclosed property (up $0.3 million) and other expenses (up $0.9 million), partially offset by decreases in data processing and communication expense (down $0.7 million) and amortization of intangible assets (down $0.3 million). The increase in occupancy and equipment in 2005 was mainly due to incremental costs from recently acquired facilities, expenses arising from renovations and repairs, the effect of higher rates and severe weather on maintenance and utilities expenses, and the general increase in property taxes in many of the locations we do business in. Business development and marketing costs were up due to a more robust marketing strategy in 2005. The majority of the increase in other expenses relates to higher overdraft charge-offs as a result of higher transaction volume and certain fixed asset write-downs. Data processing and communications costs have decreased due to certain contract renegotiations, the assimilation of the 2004 acquisitions, and other vendor management programs.

Total non-personnel expenses increased $9.2 million or 19% in 2004 from 2003. Excluding acquisition-related expenses, non-personnel expenses were up $8.0 million or 16% from 2003's level. This increase was largely caused by higher occupancy and equipment expense ($1.7 million), legal and professional fees ($1.3 million), data processing and communication expense ($.9 million), amortization of intangible assets ($2.3 million), business development and marketing expense ($0.5 million) and other expenses ($0.7 million). The increase in occupancy and equipment expenses in 2004 was mainly due to incremental costs from recently acquired facilities. The increase in legal and professional fees over the prior year was caused, in most part, by the additional responsibilities associated with complying with new governance and regulatory requirements. Data processing and other expenses were up primarily due to incremental recurring operating expense associated with the five acquisitions completed from July 2003 to December 2004. Intangible amortization in 2004

was up versus the prior year due to the amortization of additional core deposit and customer relationship intangibles arising from the 2003 and 2004 acquisitions.

Special charges/acquisition expenses totaled $2.9 million in 2005, up from $1.7 million in 2004. The 2005 special charge relates to the early retirement of certain long-service executives and includes severance and certain benefit plan enhancements. Acquisition expenses totaled $1.7 million in 2004, up from $498,000 in 2003, comprised of severance and employee benefits of $1.0 million and legal, consulting and system conversion costs of $0.7 million.

Income Taxes

The Company estimates its tax expense based on the amount it expects to owe the respective tax authorities, plus the impact of deferred tax items. Taxes are discussed in more detail in Note I of the Consolidated Financial Statements on page 57. Accrued taxes represent the net estimated amount due or to be received from taxing authorities. In estimating accrued taxes, management assesses the relative merits and risks of the appropriate tax treatment of transactions taking into account statutory, judicial and regulatory guidance in the context of the Company's tax position. If the final resolution of taxes payable differs from its estimates due to regulatory determination or legislative or judicial actions, adjustments to tax expense may be required.

The effective tax rate for 2005 increased by 1.0 percentage point to 25.9%. This increase was primarily due to a larger proportion of income from fully taxable sources versus the prior year period. The effective tax rate for 2004 increased by 0.9 percentage points over 2003 to 24.9%, for similar reasons.

Capital

Shareholders' equity ended 2005 at $457.6 million, down $17.0 million or 3.6% from one year earlier. This decrease reflects treasury share purchases of $25.9 million, a $25.8 million decline in the market value adjustment ("MVA", represents the after-tax, unrealized change in value of available-for-sale securities in the Company's investment portfolio), and common stock dividends declared of $22.3 million. These decreases were partially offset by net income of $50.8 million and $6.1 million from the issuance of shares through employee stock plans. Excluding accumulated other comprehensive income in both 2005 and 2004, capital rose by $8.7 million or 2.0%. Shares outstanding declined by 685,000 during the year, comprised of 0.4 million added through employee stock plans, offset by the purchase of 1.1 million treasury shares.

The Company's ratio of Tier 1 capital to assets (or tier 1 leverage ratio), the basic measure for which regulators have established a 5% minimum for an institution to be considered "well-capitalized," increased 63 basis points in 2005 to 7.57%. This was due to the capital-building contribution from retained earnings (net income less dividends declared) and the decline in average assets, primarily resulting from the sale of certain investments. The tangible equity/tangible assets ratio was 5.92% at the end of 2005 versus 5.82% one year earlier. The Company manages organic and acquired growth in a manner that enables it to continue to build upon its strong capital base, and maintain the Company's ability to take advantage of future strategic growth opportunities.

Cash dividends declared on common stock in 2005 of $22.3 million represented an increase of 8.6% over the prior year. This growth was mostly a result of dividends per share of $0.74 for 2005 increasing from $0.68 in 2004 due to quarterly dividends per share being raised from $0.18 to $0.19 (+5.6%) in the third quarter of 2005 and from $0.16 to $0.18 (+12.5%) in the third quarter of 2004. The increase in dollar amount of dividends declared was partially offset by a slight decrease in the number of shares outstanding during the year, primarily a result of treasury stock purchases in 2005. The dividend payout ratio for this year was 43.9% compared to 40.9% in 2004, and 40.2% in 2003.

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 must be capable of meeting all obligations to its customers at any time and, therefore, the active management of its liquidity position is critical. 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 cashflows, liquidity must be supplemented with additional sources such as credit lines from correspondent banks, the Federal Home Loan Bank, and 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 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 December 31, 2005, this ratio was 15.4% and 15.2% for the respective time periods, excluding the Company's capacity to borrow additional funds from the Federal Home Loan Bank and other sources. There is currently $317 million in additional Federal Home Loan Bank borrowing capacity based on the Company's year-end collateral levels. Additionally, the Company has $11 million in unused capacity at the Federal Reserve Bank and $50 million in unused capacity from unsecured lines of credit with other correspondent banks.

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 growth over the next five years.

Though remote, the possibility of a funding crisis exists at all financial institutions and therefore must be planned for. 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.

Intangible Assets

Intangible assets at the end of 2005 of $224.9 million decreased $7.6 million from the prior year-end due primarily to $7.1 million of amortization during the year.

Intangible assets consist of goodwill, core deposit value and customer relationships arising from acquisitions. Goodwill represents the excess cost of an acquisition over the fair value of the net assets acquired. Goodwill at December 31, 2005 amounted to $195 million, comprised of $184 million related to banking acquisitions and $11 million arising from the acquisition of financial services businesses. Goodwill is subjected to periodic impairment analysis to determine whether the carrying value of the acquired net assets exceeds their fair value, which would necessitate a write-down of the goodwill. The Company completed its goodwill impairment analyses during 2005 and 2004 and no adjustments were necessary. The impairment analysis was based upon discounted cash flow modeling techniques that require management to make estimates regarding the amount and timing of expected future cash flows. It also requires 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. Management believes that there is a low probability of future impairment with regard to the goodwill associated with whole-bank and branch acquisitions. The performance of Elias Asset Management (EAM) weakened subsequent to its acquisition in 2000 as a result of adverse market conditions, however, its performance stabilized in 2004 as market conditions improved. As a result of margin compression and no asset growth, operating revenues continued to decline in 2005. Certain organizational and structural changes were made late in 2005 that will decrease operating expenses going forward. The Company expects these changes will result in improved operating performance for EAM in the future. However, additional declines in EAM's operating results may cause impairment to its recorded goodwill of $7.3 million.

Core deposit intangibles represent the premium the Company has paid for deposits acquired in excess of the cost that would have been incurred had the funds been purchased in the capital markets. Core deposit intangibles are amortized on either an accelerated or straight-line basis over periods ranging from seven to twenty years. The recognition of a customer relationship intangible arose due to the acquisition of Harbridge. This asset was determined based on a methodology that calculates the present value of the projected future revenue derived from the acquired customer base. This asset is being amortized over eleven years on an accelerated basis.

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Loans

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

Table 8: Loans Outstanding

(000's omitted)	2005	2004	2003
Consumer mortgage	$ 815,795	$ 801,412	$ 739,593
Business lending	819,605	831,244	689,436
Consumer installment	776,445	725,885	699,562
Gross loans	2,411,845	2,358,541	2,128,591
Less: unearned discount	28	48	82
Net loans	2,411,817	2,358,493	2,128,509
Allowance for loans	(32,581)	(31,778)	(29,095
Loans, net of allowance for loan losses	$ 2,379,236	$ 2,326,715	$ 2,099,414

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As disclosed in Table 8 above, gross loans outstanding reached a record level of $2.41 billion as of year-end 2005, up $53.3 million or 2.3% compared to twelve months earlier. The loan growth was produced in the consumer mortgage and installment lines of business, with declines experienced in business lending. Loan growth was attributable to the New York market, with the Pennsylvania market experiencing a net decline in loans outstanding.

The compounded annual growth rate ("CAGR") for the Company's total loan portfolio between 2001 and 2005 was 8.6% comprised of approximately 4% organic growth, with the remainder coming from whole bank and branch acquisitions. The greatest overall expansion occurred in the consumer mortgage segment, which grew at a 16% CAGR (including the impact of acquisitions) over that time frame. The consumer mortgage growth was primarily driven by record mortgage refinancing volumes over the last five years, as well as the acquisition of consumer-oriented banks and branches in that time period. As a consequence, the consumer mortgages segment accounted for 34% of the total loan portfolio at year-end 2005 versus 26% at the end of 2001. Indirect consumer installment loans, largely borrowings originated in automobile, marine and recreational vehicle dealerships experienced a compounded annual growth rate of 13.5% over the last 5 years. Business lending grew at a compounded annual growth rate of 6% from 2001 to 2005.

The weighting of retail lending in the Company's loan portfolio enables it to be highly diversified. Approximately 66% of loans outstanding at the end of 2005 were made to consumers borrowing on an installment and residential mortgage loan basis. The commercial portfolio is also broadly diversified by industry type as demonstrated by the following distributions at year-end 2005: real estate development (19%), healthcare (10%), general services (10%), motor vehicle and parts dealers (8%), construction (6%), agriculture (7%), restaurant & lodging (7%), retail trade (8%), manufacturing (6%) and wholesale trade (5%). A variety of other industries with less than a 3% share of the total portfolio comprise the remaining 14%. Since May 2004, the mix of loans has become more weighted towards business lending due to the high proportion of commercial loans in First Heritage's portfolio.

The consumer mortgage segment of the Company's loan portfolio is comprised of fixed (96%) and adjustable rate (4%) residential lending. Consumer mortgages increased $14.4 million or 1.8% in 2005. During the last several years, record levels of refinancing activity were driven by mortgage rates that were at or near 40-year lows. Consumer mortgage growth slowed in 2005 compared to the past two years, as the pace of refinancing slowed after an extended period of elevated demand in the low-rate environment. The 2005 growth was derived principally from activity in the New York markets.

The combined total of general-purpose business lending, dealer floor plans, mortgages on commercial property, and farm loans is characterized as the Company's business lending activity. The business lending portfolio decreased $11.6 million or 1.4% in 2005. The declines were concentrated in the Pennsylvania market, while the New York market experienced modest growth. Lending efforts in First Liberty's traditional markets continue to be challenged by a modest economic recovery, diminished capital spending levels in the commercial sector, an extremely competitive pricing environment and the Company's dedication to maintaining strong credit quality standards. Management has worked aggressively to address the loan generation challenges in Pennsylvania by adding enhanced management, lending and credit administration resources, and strong business relationships over the last two years via the acquisition of First Heritage in 2004 and Grange in 2003. The enhanced scale and coverage of the Pennsylvania business combined with a commitment to business development efforts, positions the Company to fully take advantage of growth opportunities in this key market as economic conditions continue to improve and increased capital spending leads to expanded borrowing activity in the commercial sector.

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Consumer installment loans, both those originated directly (such as personal loans and home equity loans and lines of credit), and indirectly (originated predominantly in automobile, marine and recreational vehicle dealerships), rose $50.6 million or 7.0% from one year ago. Continued moderate interest rates by historical standards, aggressive dealer and manufacturer incentives on new vehicles, and enhanced business development efforts have helped drive strong growth in this segment over the last two years. Consumer installment loans increased in both the New York and Pennsylvania markets during the last twelve months.

The following table shows the maturities and type of interest rates for business and construction loans as of December 31, 2005:

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

(000's omitted)	Maturing in One Year or Less	Maturing After One but Within Five Years
Commercial, financial and agricultural	$291,213	$404,514
Real estate - construction	14,503	0