COMMUNITY BANK SYSTEM INC
Form 10-Q
May 08, 2008

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

FORM 10-Q

x QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(D) OF THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended March 31, 2008

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

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

| | |
|---|---|
| Delaware | 16-1213679 |
| (State or other jurisdiction of incorporation or organization) | (I.R.S. Employer Identification No.) |
| 5790 Widewaters Parkway, DeWitt, New York | 13214-1883 |
| (Address of principal executive offices) | (Zip Code) |

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

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

| | | | |
|---|---|---|---|
| Large accelerated filer ¨ | Accelerated filer x | Non-accelerated filer ¨ | Smaller reporting company ¨. |

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

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date. 29,909,066 shares of Common Stock, $1.00 par value, were outstanding on April 30, 2008.

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Part I. Financial Information
Item 1. Financial Statements

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

| | (Unaudited)<br>March 31,<br>2008 | December<br>31,<br>2007 |
|---|---|---|
| Cash and cash equivalents | $ 160,394 | $ 130,823 |
| | | |
| Available-for-sale investment securities, at fair value | 1,171,603 | 1,254,622 |
| Held-to-maturity investment securities | 136,079 | 137,250 |
| Total investment securities (fair value of $1,309,889 and $1,392,281, respectively) | 1,307,682 | 1,391,872 |
| | | |
| Loans | 2,837,786 | 2,821,055 |
| Allowance for loan losses | (36,428) | (36,427) |
| Net loans | 2,801,358 | 2,784,628 |
| | | |
| Core deposit intangibles, net | 18,345 | 19,765 |
| Goodwill | 234,722 | 234,449 |
| Other intangibles, net | 2,044 | 2,002 |
| Intangible assets, net | 255,111 | 256,216 |
| | | |
| Premises and equipment, net | 70,109 | 69,685 |
| Accrued interest receivable | 25,545 | 25,531 |
| Other assets | 38,216 | 38,747 |
| Total assets | $ 4,658,415 | $ 4,697,502 |
| | | |
| Liabilities: | | |
| Noninterest-bearing deposits | $ 563,226 | $ 584,921 |
| Interest-bearing deposits | 2,680,156 | 2,643,543 |
| Total deposits | 3,243,382 | 3,228,464 |
| | | |
| Borrowings | 766,153 | 801,604 |
| Subordinated debt held by unconsolidated subsidiary trusts | 101,956 | 127,724 |
| Accrued interest and other liabilities | 58,256 | 60,926 |
| Total liabilities | 4,169,747 | 4,218,718 |
| | | |
| Commitment and contingencies (See Note H) | | |
| | | |
| Shareholders' equity: | | |
| Preferred stock $1.00 par value, 500,000 shares authorized, 0 shares issued | 0 | 0 |
| Common stock, $1.00 par value, 50,000,000 shares authorized; 33,256,871 and 32,999,544 shares issued in 2008 and 2007, respectively | 33,257 | 33,000 |
| Additional paid-in capital | 212,713 | 208,429 |

| | | |
|---|---|---|
| Retained earnings | 314,927 | 310,281 |
| Accumulated other comprehensive income | 1,399 | 702 |
| Treasury stock, at cost (3,364,811 and 3,364,811 shares, respectively) | (73,628) | (73,628) |
| Total shareholders' equity | 488,668 | 478,784 |
| | | |
| Total liabilities and shareholders' equity | $ 4,658,415 | $ 4,697,502 |

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

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

| | Three Months Ended March 31, | |
|---|---|---|
| | 2008 | 2007 |
| Interest income: | | |
| Interest and fees on loans | $ 46,515 | $ 44,935 |
| Interest and dividends on taxable investments | 10,714 | 11,103 |
| Interest and dividends on nontaxable investments | 5,922 | 5,520 |
| Total interest income | 63,151 | 61,558 |
| | | |
| Interest expense: | | |
| Interest on deposits | 17,694 | 18,120 |
| Interest on borrowings | 8,041 | 7,505 |
| Interest on subordinated debt held by unconsolidated subsidiary trusts | 1,818 | 2,566 |
| Total interest expense | 27,553 | 28,191 |
| | | |
| Net interest income | 35,598 | 33,367 |
| Less: provision for loan losses | 780 | 200 |
| Net interest income after provision for loan losses | 34,818 | 33,167 |
| | | |
| Noninterest income: | | |
| Deposit service fees | 8,261 | 6,977 |
| Other banking services | 595 | 670 |
| Benefit plan administration, consulting and actuarial fees | 6,312 | 3,972 |
| Wealth management services | 2,163 | 1,860 |
| Gain on sales of investment securities | 287 | 0 |
| Total noninterest income | 17,618 | 13,479 |
| | | |
| Operating expenses: | | |
| Salaries and employee benefits | 20,386 | 18,286 |
| Occupancy and equipment | 5,573 | 4,666 |
| Data processing and communications | 3,985 | 3,565 |
| Amortization of intangible assets | 1,531 | 1,515 |
| Legal and professional fees | 1,298 | 1,187 |
| Office supplies and postage | 1,278 | 1,046 |
| Business development and marketing | 1,322 | 950 |
| Other | 3,001 | 2,704 |
| Total operating expenses | 38,374 | 33,919 |
| | | |
| Income before income taxes | 14,062 | 12,727 |
| Income taxes | 3,164 | 3,071 |
| Net income | $ 10,898 | $ 9,656 |
| | | |
| Basic earnings per share | $ 0.37 | $ 0.32 |
| Diluted earnings per share | $ 0.36 | $ 0.32 |

| | | | | |
|---|---|---|---|---|
| Dividends declared per share | $ | 0.21 | $ | 0.20 |

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

COMMUNITY BANK SYSTEM, INC.
CONSOLIDATED STATEMENT OF CHANGES IN SHAREHOLDERS' EQUITY (Unaudited)
Three Months Ended March 31, 2008
(In Thousands, Except Share Data)

| | Common Stock | | | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | Shares Outstanding | | Amount Issued | | Additional Paid-In Capital | | Retained Earnings | | Accumulated Other Comprehensive Income | | Treasury Stock | | Total |
| Balance at December 31, 2007 | 29,634,733 | $ | 33,000 | $ | 208,429 | $ | 310,281 | $ | 702 | $ | (73,628) | $ | 478,784 |
| Net income | | | | | | | 10,898 | | | | | | 10,898 |
| Other comprehensive gain, net of tax | | | | | | | | | 697 | | | | 697 |
| Dividends declared: | | | | | | | | | | | | | |
| Common, $0.21 per share | | | | | | | (6,252) | | | | | | (6,252) |
| Common stock issued under Stock plan, including tax benefits of $294 | 257,327 | | 257 | | 3,632 | | | | | | | | 3,889 |
| Stock options earned | | | | | 652 | | | | | | | | 652 |
| Balance at March 31, 2008 | 29,892,060 | $ | 33,257 | $ | 212,713 | $ | 314,927 | $ | 1,399 | $ | (73,628) | $ | 488,668 |

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

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

| | Three Months Ended March 31, | |
|---|---|---|
| | 2008 | 2007 |
| Other comprehensive income (loss), before tax: | | |
| Change in pension liability | $ (146) | $ (50) |
| Change in unrealized loss on derivative instruments used in cash flow hedging relationship | (2,758) | (423) |
| Unrealized gain (loss) on securities: | | |
| Unrealized holding gain arising during period | 4,280 | 1,413 |
| Reclassification adjustment for gains included in net income | (287) | 0 |
| Other comprehensive income (loss), before tax: | 1,089 | 940 |
| Income tax expense related to other comprehensive income | (392) | (237) |
| Other comprehensive income, net of tax: | 697 | 703 |
| Net income | 10,898 | 9,656 |
| Comprehensive income | $ 11,595 | $ 10,359 |

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

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

| | Three Months Ended March 31, | |
|---|---|---|
| | 2008 | 2007 |
| Operating activities: | | |
| Net income | $ 10,898 | $ 9,656 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Depreciation | 2,332 | 2,267 |
| Amortization of intangible assets | 1,531 | 1,515 |
| Net (accretion) amortization of premiums and discounts on securities and loans | (470) | (405) |
| Amortization of unearned compensation and discount on subordinated debt | 128 | 100 |
| Provision for loan losses | 780 | 200 |
| Gain on investment securities and debt extinguishments | (287) | 0 |
| Loss (Gain) on sale of loans and other assets | 39 | (34) |
| Proceeds from the sale of loans held for sale | 438 | 3,889 |
| Origination of loans held for sale | (440) | (3,863) |
| Excess tax benefits from share-based payment arrangements | (287) | (106) |
| Change in other operating assets and liabilities | (5,591) | (3,691) |
| Net cash provided by operating activities | 9,071 | 9,528 |
| Investing activities: | | |
| Proceeds from sales of available-for-sale investment securities | 24,974 | 3,023 |
| Proceeds from maturities of held-to-maturity investment securities | 1,645 | 8,095 |
| Proceeds from maturities of available-for-sale investment securities | 187,092 | 56,610 |
| Purchases of held-to-maturity investment securities | (510) | (785) |
| Purchases of available-for-sale investment securities | (124,262) | (153,413) |
| Net increase in loans outstanding | (17,509) | 18,704 |
| Cash paid for acquisition (net of cash acquired of $0) | (304) | 0 |
| Capital expenditures | (2,786) | (2,271) |
| Net cash provided by (used in) investing activities | 68,340 | (70,037) |
| Financing activities: | | |
| Net change in non-interest checking, interest checking and savings accounts | 27,531 | 42,636 |
| Net change in time deposits | (12,613) | 67,533 |
| Net change in short-term borrowings | (45,254) | (20,394) |
| Change in long-term borrowings (net of payments of $197 and $322) | 9,803 | (322) |
| Payment on subordinated debt held by unconsolidated subsidiary trusts | (25,774) | (30,928) |
| Issuance of common stock | 4,419 | 2,004 |
| Purchase of treasury stock | 0 | (1,252) |
| Cash dividends paid | (6,239) | (5,989) |
| Tax benefits from share-based payment arrangements | 287 | 106 |
| Net cash (used in) provided by financing activities | (47,840) | 53,394 |
| Change in cash and cash equivalents | 29,571 | (7,115) |
| Cash and cash equivalents at beginning of period | 130,823 | 232,032 |
| Cash and cash equivalents at end of period | $ 160,394 | $ 224,917 |
| Supplemental disclosures of cash flow information: | | |
| Cash paid for interest | $ 28,316 | $ 29,475 |

| | | |
|---|---|---|
| Cash paid for income taxes | 75 | 0 |
| Supplemental disclosures of noncash financing and investing activities: | | |
| Dividends declared and unpaid | 6,252 | 6,027 |
| Gross change in unrealized gain on available-for-sale investment securities | 3,993 | 1,413 |

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

COMMUNITY BANK SYSTEM, INC.
NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)
March 31, 2008

## NOTE A: BASIS OF PRESENTATION

The interim financial data as of March 31, 2008 and for the three months ended March 31, 2008 and 2007 is unaudited; however, in the opinion of the Company, the interim data includes all adjustments, consisting only of normal recurring adjustments, necessary for a fair statement of the results for the interim periods. The results of operations for the interim periods are not necessarily indicative of the results that may be expected for the full year or any other interim period.

## NOTE B: ACQUISITION AND OTHER MATTERS

### Hand Benefits & Trust, Inc.

On May 18, 2007, Benefit Plans Administrative Services, Inc. (BPAS), a wholly owned subsidiary of the Company, completed its acquisition of Hand Benefits & Trust, Inc. (HBT) in an all cash transaction. HBT is a Houston, Texas based provider of employee benefit plan administration and trust services. The results of HBT's operations have been included in the consolidated financial statements since that date.

### TLNB Financial Corporation

On June 1, 2007, the Company completed its acquisition of TLNB Financial Corporation, parent company of Tupper Lake National Bank (TLNB), in an all-cash transaction valued at approximately $17.8 million. Based in Tupper Lake, NY, TLNB operated five branches in the northeastern New York State cities of Tupper Lake, Plattsburgh and Saranac Lake, as well as an insurance subsidiary, TLNB Insurance Agency, Inc. The results of TLNB's operations have been included in the consolidated financial statements since that date.

The estimated purchase price allocation of the assets acquired and liabilities assumed in the purchase of HBT and TLNB, collectively, including capitalized acquisition costs, is as follows:

| (000's omitted) | | |
|---|---|---|
| Cash and due from banks | $ | 9,374 |
| Available-for-sale investment securities | | 28,830 |
| Loans net of allowance for loan losses of $747 | | 54,768 |
| Premises and equipment, net | | 3,034 |
| Other assets | | 1,286 |
| Core deposit & customer list intangibles | | 2,190 |
| Goodwill | | 14,289 |
| Total assets acquired | | 113,771 |
| Deposits | | 84,120 |
| Borrowings | | 4,288 |
| Other liabilities | | 3,490 |
| Total liabilities assumed | | 91,898 |
| Net assets acquired | $ | 21,873 |

Stock Repurchase Program

On April 20, 2005, the Company announced a twenty-month authorization to repurchase up to 1,500,000 of its outstanding shares. On December 20, 2006, the Company extended the program through December 31, 2008 and announced an additional two-year authorization to repurchase up to 900,000 of its shares in open market or privately negotiated transactions. Through March 31, 2008, the Company has repurchased, pursuant to the program, 1,464,811 shares at an aggregate cost of $31.5 million and an average price per share of $21.51. The repurchased shares will be used for general corporate purposes, including those related to stock plan activities.

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## NOTE C: ACCOUNTING POLICIES

### Critical Accounting Policies

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

The general loan loss allocation is composed of two calculations that are computed on four main loan categories: commercial, consumer direct, consumer indirect and residential real estate. The first calculation determines an allowance level based on the latest three years of historical net charge-off data for each loan category (commercial loans exclude balances with specific loan loss allocations). The second calculation is qualitative and takes into consideration five major factors affecting the level of loan loss risk: portfolio risk migration patterns (internal credit quality trends); the growth of the categories of the loan portfolio; economic and business environment trends in the Company's markets (includes review of bankruptcy, unemployment, population, consumer spending and regulatory trends); industry, geographical and product concentrations in the portfolio; and the perceived effectiveness of managerial resources and lending practices and policies. These two calculations are added together to determine the general loan loss allocation. The specific loan loss allocation relates to individual commercial loans that are both greater than $0.5 million and in a nonaccruing status with respect to interest. Specific losses are based on discounted estimated cash flows, including any cash flows resulting from the conversion of collateral.

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

Income Taxes
Provisions for income taxes are based on taxes currently payable or refundable, and deferred taxes which are based on temporary differences between the tax basis of assets and liabilities and their reported amounts in the financial statements. Deferred tax assets and liabilities are reported in the financial statements at currently enacted income tax rates applicable to the period in which the deferred tax assets and liabilities are expected to be realized or settled.

Intangible Assets
Intangible assets include core deposit intangibles, customer relationship intangibles and goodwill arising from acquisitions. Core deposit intangibles and customer relationship intangibles are amortized on either an accelerated or straight-line basis over periods ranging from 7 to 20 years. Goodwill is evaluated at least annually for impairment. 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 use of a discount rate that reflects the current return requirements of the market in relation to present risk-free interest rates, required equity market premiums, and company-specific risk indicators.

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

on plan assets.

New Accounting Pronouncements

SFAS No. 141(R)
In December 2007, the FASB issued SFAS No. 141(R), Business Combinations.  This statement provides new accounting guidance and disclosure requirements for business combinations.  The Company will be required to apply SFAS No. 141(R) to all business combinations completed on or after January 1, 2009.

SFAS No. 160
In December 2007, the FASB issued SFAS No. 160, Noncontrolling Interests in Consolidated Financial Statements – an amendment of ARB No. 51.  This statement provides new accounting guidance and disclosure and presentation requirements for noncontrolling interests in a subsidiary.  SFAS No. 160 is effective for fiscal years beginning on or after December 15, 2008.  The Company is currently assessing the effect of SFAS No. 160 on its financial statements.

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SFAS No. 161

In March 2008, the FASB issued SFAS No. 161, Disclosures About Derivative Instruments and Hedging Activities – an amendment of FASB Statement No. 133. This statement expands quarterly disclosure requirements in SFAS No. 133 about an entity's derivative instruments and hedging activities. SFAS No. 161 is effective for fiscal years beginning on or after November 15, 2008. The Company is currently assessing the effect of SFAS No. 161 on its financial statements.

NOTE D: EARNINGS PER SHARE

Basic earnings per share are computed based on the weighted-average common shares outstanding for the period. Diluted earnings per share are based on the weighted-average shares outstanding adjusted for the dilutive effect of restricted stock and the assumed exercise of stock options during the year. The dilutive effect of options is calculated using the treasury stock method of accounting. The treasury stock method determines the number of common shares that would be outstanding if all the dilutive options (those where the average market price is greater than the exercise price) were exercised and the proceeds were used to repurchase common shares in the open market at the average market price for the applicable time period. There were approximately 1.6 million anti-dilutive stock options outstanding at March 31, 2008 compared to approximately 1.7 million weighted-average anti-dilutive stock options outstanding at March 31, 2007 that were not included in the computation below. The following is a reconciliation of basic to diluted earnings per share for the three months ended March 31, 2008 and 2007.

| (000's omitted, except per share data) | Income | Shares | Per Share Amount |
|---|---|---|---|
| Three Months Ended March 31, 2008 | | | |
| Basic EPS | $ 10,898 | 29,720 | $ 0.37 |
| Stock options and restricted stock | | 316 | |
| Diluted EPS | $ 10,898 | 30,036 | $ 0.36 |
| | | | |
| Three Months Ended March 31, 2007 | | | |
| Basic EPS | $ 9,656 | 30,192 | $ 0.32 |
| Stock options and restricted stock | | 355 | |
| Diluted EPS | $ 9,656 | 30,547 | $ 0.32 |

NOTE E: INTANGIBLE ASSETS

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

| | As of March 31, 2008 | | | As of December 31, 2007 | | |
|---|---|---|---|---|---|---|
| (000's omitted) | Gross Carrying Amount | Accumulated Amortization | Net Carrying Amount | Gross Carrying Amount | Accumulated Amortization | Net Carrying Amount |
| Amortizing intangible assets: | | | | | | |
| Core deposit intangibles | $ 66,368 | $ (48,023) | $ 18,345 | $ 66,368 | $ (46,603) | $ 19,765 |
| Other intangibles | 4,076 | (2,032) | 2,044 | 3,923 | (1,921) | 2,002 |
| Total amortizing intangibles | 70,444 | (50,055) | 20,389 | 70,291 | (48,524) | 21,767 |

| | | | | | | |
|---|---|---|---|---|---|---|
| Non-amortizing intangible assets: | | | | | | |
| Goodwill | 234,722 | 0 | 234,722 | 234,449 | 0 | 234,449 |
| Total intangible assets, net | $ 305,166 | $ (50,055) | $ 255,111 | $ 304,740 | $ (48,524) | $ 256,216 |

No goodwill impairment adjustments were recognized in 2008 or 2007. The estimated aggregate amortization expense for each of the succeeding fiscal years ended December 31 is as follows:

| (000's omitted) | Amount |
|---|---|
| Apr-Dec 2008 | $ 4,561 |
| 2009 | 5,499 |
| 2010 | 3,579 |
| 2011 | 1,481 |
| 2012 | 1,221 |
| Thereafter | 4,048 |
| Total | $ 20,389 |

NOTE F:  MANDATORILY REDEEMABLE PREFERRED SECURITIES

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

| | Issuance Date | Par Amount | Interest Rate | Maturity Date | Call Provision | Call Price |
|---|---|---|---|---|---|---|
| III | 7/31/2001 | $24.5 million | 3 month LIBOR plus 3.58% (6.82%) | 7/31/2031 | 5 year beginning 2006 | 107.5000% declining to par in 2011 |
| IV | 12/8/2006 | $75 million | 3 month LIBOR plus 1.65% (4.45%) | 12/15/2036 | 5 year beginning 2012 | Par |

The Company also entered into an interest rate swap agreement to convert Trust IV's variable rate trust preferred securities into a fixed rate security for a term of five years at a fixed rate of 6.43%.  A net gain of $37,000 was recognized for the interest rate swap agreement for the three months ended March 31, 2008 and was used to offset the interest expense for the trust preferred securities.

NOTE G:  BENEFIT PLANS

The Company provides defined benefit pension benefits and post-retirement health and life insurance benefits to eligible employees. The Company also provides supplemental pension retirement benefits for several current and former key employees.  No contributions in 2008 are required for regulatory purposes.  The Company accrues for the estimated cost of these benefits through charges to expense during the years that employees earn these benefits.  The net periodic benefit cost for the three months ended March 31 is as follows:

| | Pension Benefits Three Months Ended March 31, | | Post-retirement Benefits Three Months Ended March 31, | |
|---|---|---|---|---|
| (000's omitted) | 2008 | 2007 | 2008 | 2007 |
| Service cost | $ 779 | $ 763 | $ 175 | $ 148 |
| Interest cost | 819 | 678 | 150 | 131 |
| Expected return on plan assets | (1,117) | (1,024) | 0 | 0 |
| Net amortization and deferral | 165 | 247 | 25 | 29 |
| Amortization of prior service cost | (28) | (23) | 27 | 28 |
| Amortization of transition obligation | 0 | 0 | 10 | 10 |
| Net periodic benefit cost | $ 618 | $ 641 | $ 387 | $ 346 |

NOTE H:  COMMITMENTS, CONTINGENT LIABILITIES AND RESTRICTIONS

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

The contract amount of commitment and contingencies are as follows:

| (000's omitted) | March 31, 2008 | December 31, 2007 |
|---|---|---|
| Commitments to extend credit | $ 481,598 | $ 482,517 |
| Standby letters of credit | 10,296 | 10,121 |
| Total | $ 491,894 | $ 492,638 |

## NOTE I: FAIR VALUE

Effective January 1, 2008 the Company adopted SFAS No. 157, Fair Value Measurements (SFAS 157) and SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities (SFAS 159). SFAS 159 allows entities an irrevocable option to measure certain financial assets and financial liabilities at fair value. Unrealized gains and losses on items for which the fair value option has been elected are reported in earnings. The implementation of this standard did not have a material impact on the Company's consolidated financial position or results of operations.

SFAS 157 establishes a common definition for fair value to be applied to generally accepted accounting principals requiring the use of fair value, establishes a framework for measuring fair value and expands disclosure about such fair value instruments. It defines fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date (exit price). It also classifies the inputs used to measure fair value into the following hierarchy:

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

A financial instrument's categorization within the valuation hierarchy is based upon the lowest level of input that is significant to the fair value measurement. The following tables set forth the Company's financial assets and liabilities that were accounted for at fair value on a recurring basis as of March 31, 2008:

| (000's omitted) | Level 1 | Level 2 | Level 3 | Total Fair Value |
|---|---|---|---|---|
| Available-for-sale investment securities | $ 1,062 | $ 1,052,200 | $ 69,584 | $ 1,122,846 |
| Derivative assets/(liabilities), net | 0 | (5,003) | 0 | (5,003) |
| Total | $ 1,062 | $ 1,047,197 | $ 69,584 | $ 1,117,843 |

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

- Available for sale investment securities – The fair value of available for sale investment securities is based upon quoted prices, if available. If quoted prices are not available, fair values are measured using quoted market prices for similar securities or model-based valuation techniques. Level 1 securities include U.S. Treasury securities that are traded by dealers or brokers in active over-the-counter markets. Level 2 securities include mortgage-backed securities issued by government sponsored entities, municipal securities and corporate debt securities. Securities classified as Level 3 include asset-backed securities in less liquid markets. The value of these instruments is determined using pricing models or similar techniques as well as significant judgment or estimation.
- Derivative assets and liabilities – The fair value of derivative instruments traded in over-the-counter markets where quoted market prices are not readily available, are measured using models that primarily use market observable inputs, such as yield curves and option volatilities.

Certain other assets are measured at fair value on a nonrecurring basis. These adjustments to fair value usually result from application of lower or cost or fair value accounting or write-downs of individual assets due to impairment. Examples of these nonrecurring assets includes mortgage servicing rights and impaired loans for which the level of impairment is determined based upon the fair value of the underlying collateral of the loan. At March 31, 2008, the Company had no assets measured at fair value on a nonrecurring basis.

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

| (000's omitted) | | AFS investments |
|---|---|---|
| Balance at December 31, 2007 | $ | 73,442 |
| Total gains (losses) included in earnings (a) | | 6 |
| Total gains (losses) included in other comprehensive income | | (3,796) |
| Purchases | | 0 |
| Sales/calls | | (68) |
| Transfers | | 0 |
| Balance at March 31, 2008 | $ | 69,584 |

(a) Included in Gain on sales of investment securities.

## NOTE J: SEGMENT INFORMATION

Statement of Financial Accounting Standards No. 131 (SFAS 131), Disclosures about Segments of an Enterprise and Related Information has established standards for public companies relating to the reporting of financial and descriptive information about their operating segments in financial statements. Operating segments are components of an enterprise, which are evaluated regularly by the chief operating decision maker in deciding how to allocate resources and assess performance. The Company's chief operating decision maker is the President and Chief Executive Officer of the Company.

The Company has identified "Banking" as its reportable operating business segment. The Banking segment provides full-service banking to consumers, businesses and governmental units in northern, central and western New York as well as Northeastern Pennsylvania.

Immaterial operating segments of the Company's operations, which do not have similar characteristics to the banking segment and do not meet the quantitative thresholds requiring disclosure, are included in the "Other" category. Revenues derived from these segments includes administration, consulting and actuarial services provided to sponsors of employee benefit plans, broker-dealer and investment advisory services, asset management services to individuals, corporate pension and profit sharing plans, trust services and insurance commissions from various insurance related products and services. The accounting policies used in the disclosure of business segments are the same as those described in the summary of significant accounting policies (See Note A, Summary of Significant Accounting Policies of the most recent Form 10-K for the year ended December 31, 2007).

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

| (000's omitted) | Banking | Other | Consolidated Total |
|---|---|---|---|
| For the Three Months Ended March 31, 2008 | | | |
| Net interest income | $ 35,515 | $ 83 | $ 35,598 |
| Provision for loan losses | 780 | 0 | 780 |
| Noninterest income excluding gain (loss) on investment securities and debt extinguishments | 8,467 | 8,864 | 17,331 |
| Gain on investment securities | 287 | 0 | 287 |
| Amortization of intangible assets | 1,421 | 110 | 1,531 |
| Other operating expenses | 29,870 | 6,973 | 36,843 |
| Income before income taxes | $ 12,198 | $ 1,864 | $ 14,062 |
| Assets | $ 4,622,569 | $ 35,846 | $ 4,658,415 |
| Goodwill | $ 221,315 | $ 13,407 | $ 234,722 |
| | | | |
| For the Three Months Ended March 31, 2007 | | | |
| Net interest income | $ 33,240 | $ 127 | $ 33,367 |
| Provision for loan losses | 200 | 0 | 200 |
| Noninterest income excluding gain (loss) on investment securities and debt extinguishments | 7,168 | 6,311 | 13,479 |
| Amortization of intangible assets | 1,445 | 70 | 1,515 |
| Other operating expenses | 27,470 | 4,934 | 32,404 |
| Income before income taxes | $ 11,293 | $ 1,434 | $ 12,727 |
| Assets | $ 4,528,735 | $ 30,153 | $ 4,558,888 |
| Goodwill | $ 208,932 | $ 11,336 | $ 220,268 |

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

### Introduction

This Management's Discussion and Analysis of Financial Condition and Results of Operations (MD&A) primarily reviews the financial condition and results of operations of Community Bank System, Inc. (the Company or CBSI) as of and for the three months ended March 31, 2008 and 2007, although in some circumstances the fourth quarter of 2007 is also discussed in order to more fully explain recent trends. The following discussion and analysis should be read in conjunction with the Company's Consolidated Financial Statements and related notes that appear on pages 3 through 13. All references in the discussion to the financial condition and results of operations are to those of the Company and its subsidiaries taken as a whole.

Unless otherwise noted, the term "this year" refers to results in calendar year 2008, "first quarter" refers to the quarter ended March 31, 2008, earnings per share (EPS) figures refer to diluted EPS, and net interest income and net interest margin are presented on a fully tax-equivalent (FTE) basis.

This MD&A contains certain forward-looking statements with respect to the financial condition, results of operations and business of the Company. These forward-looking statements involve certain risks and uncertainties. Factors that may cause actual results to differ materially from those proposed by such forward-looking statements are set herein under the caption, "Forward-Looking Statements," on page 27.

### Critical Accounting Policies

As a result of the complex and dynamic nature of the Company's business, management must exercise judgment in selecting and applying the most appropriate accounting policies for its various areas of operations. The policy decision process not only ensures compliance with the latest generally accepted accounting principles, 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 critical accounting estimates include:

- Allowance for loan losses - The allowance for loan losses reflects management's best estimate of probable losses inherent in the loan portfolio. Determination of the allowance 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.

- 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.

- 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 use of a discount rate that reflects the current return requirements of the market in relation to present risk-free interest rates, required equity market premiums, and company-specific risk indicators.

A summary of the accounting policies used by management is disclosed in Note A, "Summary of Significant Accounting Policies" on pages 46-51 of the most recent Form 10-K (fiscal year ended December 31, 2007) filed with the Securities and Exchange Commission on March 13, 2008.

Executive Summary

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

The Company's core operating objectives are: (i) grow the branch network, primarily through a disciplined acquisition strategy, and certain selective de novo expansions, (ii) build high-quality, profitable loan and deposit portfolios using both organic and acquisition strategies, (iii) increase the noninterest income component of total revenues through development of banking-related fee income, growth in existing financial services business units, and the acquisition of additional financial services and banking businesses, and (iv) utilize technology to deliver customer-responsive products and services and 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, noninterest income, operating expenses, asset quality, loan and deposit growth, capital management, performance of individual banking and financial services units, liquidity and interest rate sensitivity, enhancements to customer products and services, technology enhancements, market share, peer comparisons, and the performance of acquisition and integration activities.

On June 1, 2007, the Company completed its acquisition of TLNB Financial Corporation, parent company of Tupper Lake National Bank (TLNB), in an all-cash transaction valued at approximately $17.8 million.  Based in Tupper Lake, NY, TLNB operated five branches in the northeastern New York State cities of Tupper Lake, Plattsburgh and Saranac Lake, as well as an insurance subsidiary, TLNB Insurance Agency, Inc.  On a consolidated basis, TLNB had approximately $100 million in assets and $87 million of deposits.

On May 18, 2007, the Company's subsidiary, Benefit Plans Administrative Services, Inc. (BPAS), completed its acquisition of Hand Benefits & Trust, Inc. (HBT) in an all cash transaction.  HBT is a Houston, Texas based provider of employee benefit plan administration and trust services.

First quarter net income of $10.9 million, or $0.36 per share was up 13% or $0.04 over the $0.32 per share reported in the first quarter of 2007.  The increase was driven by higher interest income generated from solid loan growth, continued expansion of non-interest income sources, improved net interest margin and favorable asset quality results.  These were partially offset by a higher provision for loan loss and increased operating expenses.  Cash earnings per share (which excludes the after-tax effect of the amortization of intangibles assets and acquisition-related market value adjustments) were $0.41 versus $0.36 for the prior year's first quarter.

Asset quality in the first quarter of 2008 remained strong in comparison to the same period last year, with reductions in nonperforming loan and total delinquent loan ratios.  Net charge-offs increased, but remained well below average quarterly charge-offs in the last few years.  The Company experienced year-over-year loan growth in all portfolios: consumer installment, consumer mortgage and business lending, due to organic growth and the acquisition of TLNB.  The investment portfolio decreased as compared to both the first quarter of 2007 and December 31, 2007.  Average deposits increased in the first quarter of 2008 as compared to the first quarter of 2007 and declined slightly from the fourth quarter of 2007.  External borrowings decreased from the end of December 2007 due to the redemption of $25 million of variable-rate trust preferred securities in the beginning of the first quarter of 2008.  Additionally, in December 2007, the Company restructured $150 million of its fixed rate Federal Home Loan Bank (FHLB) advances, replacing them with lower cost instruments with similar remaining duration.  These restructuring strategies had a positive impact on the Company's net interest margin in the first quarter of 2008.

Net Income and Profitability

As shown in Table 1, net income for the quarter of $10.9 million was up 12.9% over the first quarter of 2007. Earnings per share for the first quarter of $0.36 was $0.04 higher than the EPS generated in the same period of last year. First quarter net interest income of $35.6 million was up $2.2 million or 6.7% from the comparable prior year period. The current quarter's provision for loan losses increased $0.6 million as compared to the first quarter of 2007 and decreased $0.1 million from the fourth quarter of 2007. First quarter noninterest income, excluding securities gains and losses, was $17.3 million, up $3.9 million or 29% from the first quarter of 2007. Operating expenses of $38.4 million for the quarter were up $4.5 million or 13% from the comparable prior year period, a significant portion of the increase was attributable to the acquisitions of TLNB and HBT during the second quarter of 2007.

In addition to the earnings results presented above in accordance with generally accepted accounting principles (GAAP), the Company provides cash earnings per share, which excludes the after-tax effect of the amortization of intangible assets and acquisition-related market value adjustments. Management believes that this information helps investors better understand the effect of acquisition activity in reported results. Cash earnings per share for the first quarter of 2008 was $0.41, up 14% from the $0.36 earned in the comparable period of 2007.

As reflected in Table 1, the primary reasons for higher earnings were higher noninterest income and net interest income, partially offset by higher operating expenses and loan loss provision. Net interest income for the first quarter of 2008 increased as compared to both the first and the fourth quarters of 2007 as a result of higher net interest margins as well as acquired and organic loan growth. Excluding security gains and losses, noninterest income increased due to a strong performance by the Company's employee benefits consulting and plan administration business, as a result of significant organic growth and the acquisition of HBT, as well as higher banking service fees, including higher account fees and debit card related revenues. Higher net charge-offs and an increase in total loans were the primary reasons for the increase in loan loss provision, which remained below the average provision for the prior eight quarters. Operating expenses increased for the quarter as compared to the prior year, primarily due to costs associated with the two acquisitions in the last year, as well as higher business development and volume-based processing costs, increased facility-based utilities and maintenance costs, and higher personnel expenses.

A condensed income statement and a reconciliation of GAAP-based earnings results to cash-based earnings results are as follows:

Table 1: Summary Income Statements

| | Three Months Ended March 31, | |
|---|---|---|
| (000's omitted, except per share data) | 2008 | 2007 |
| Net interest income | $ 35,598 | $ 33,367 |
| Provision for loan losses | 780 | 200 |
| Noninterest income excluding security losses | 17,331 | 13,479 |
| Gain on sales of investment securities | 287 | 0 |
| Operating expenses | 38,374 | 33,919 |
| Income before taxes | 14,062 | 12,727 |
| Income taxes | 3,164 | 3,071 |
| Net income | $ 10,898 | $ 9,656 |
| | | |
| Diluted earnings per share | $ 0.36 | $ 0.32 |

Table 2: Reconciliation of GAAP Net Income to Cash Net Income (Non-GAAP measure)

| | Three Months Ended March 31, | |
|---|---|---|
| (000's omitted) | 2008 | 2007 |
| Net income | $ 10,898 | $ 9,656 |
| After-tax cash adjustments: | | |
| Amortization of market value adjustments on net assets acquired in mergers | 156 | 179 |
| Amortization of intangible assets | 1,187 | 1,150 |
| Net income – cash | $ 12,241 | $ 10,985 |
| | | |
| Diluted earnings per share – cash | $ 0.41 | $ 0.36 |

Net Interest Income

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

As shown in Table 3, net interest income (with nontaxable income converted to a fully tax-equivalent basis) for the first quarter of 2008 was $39.5 million, a $2.3 million increase from the same period last year and a $0.8 million increase from the fourth quarter of 2008. A $143 million increase in first quarter interest-earning assets and a seven basis point increase in the net interest margin versus the prior year offset a $147 million increase in average interest-bearing liabilities. As reflected in Table 4, the volume and rate increases from interest bearing assets had a $1.7 million favorable impact on net interest income, while the volume and rate increases from interest bearing liabilities had a $0.6 million favorable impact on net interest income. The increase in interest bearing assets and the decrease in the cost of funding had a favorable impact on net interest margin, which was partially offset by the increase in the interest bearing liabilities and the lower yields on interest bearing assets.

Higher first quarter average loan balances were attributable to $82 million of organic loan growth since the first quarter of 2007, driven by growth in the consumer mortgage and consumer installment portfolios.  The remaining contribution to the increase in the average first quarter loan balance was the $56 million of loans acquired in the TLNB acquisitions.  Average investments and cash equivalents for the first quarter period were $5.8 million higher than the respective period of 2007.  In comparison to the prior year, total average deposits were up $41 million or 1.3% for the quarter as a result of the acquisition of TLNB.  Quarterly average deposits from acquisitions were $70 million.  On an organic basis, average deposits for the first quarter decreased $29 million from the first quarter of 2007, as a result of the Company's objective of lowering its overall funding costs by reducing higher cost time deposits.  Quarterly average borrowings increased $110 million as compared to the first quarter of 2007 due to the all-cash acquisitions of TLNB and HBT, partially offset by the redemption of $25 million of fixed rate trust preferred securities in the first quarter of 2008.

The net interest margin of 3.81% for the first quarter increased seven basis points versus the same period in the prior year.  The improvement was primarily attributable to a 20 basis point decrease in the cost of funds, due primarily to a 10 basis point drop in the cost of deposit funding and the restructuring of  $175 million of external borrowings that were replaced with lower cost instruments in late 2007 and early 2008.  Partially offsetting these improvements was a 12 basis point decline in earning assets yields for the quarter as compared to the first quarter of 2007.  The change in the earning-asset yield was driven by a 16 basis point decrease in loan yields for the quarter and a four basis point decline in the investment yields for the quarter, mostly as a result of variable and adjustable-rate assets repricing downward due to the decline in short-term fed funds rates.

The first quarter cost of funds decreased 20 basis points versus the prior year quarter due to a 79 basis point decrease in the average interest rate paid on external borrowings and a 12 basis point decrease on interest-bearing deposits rates.  The decrease in the external borrowing rate is due to the restructuring of $150 million of FHLB advances in December 2007 and the redemption of $25 million of variable rate, trust-preferred securities in January 2008.  Additionally, the long-term rate was impacted by the approximately 200 basis point decrease in the three month LIBOR (London Interbank Offered Rates) over the last twelve months, from which the interest rate on $25 million of the mandatorily redeemable preferred securities is based.  Interest rates on selected categories of deposit accounts were lowered throughout the second half of 2007 and the first quarter of 2008 in response to market conditions.  Additionally, the proportion of customer deposits in higher cost time deposits has declined 1.4 percentage points over the last twelve months, while the percentage of deposits in lower cost checking and savings accounts has increased.

Table 3 below sets forth information related to average interest-earning assets and interest-bearing liabilities and their associated yields and rates for the periods indicated. Interest income and yields are on a fully tax-equivalent basis using marginal income tax rates of 38.49% in 2008 and 38.75% in 2007. Average balances are computed by accumulating the daily ending balances in a period and dividing by the number of days in that period. Loan yields and amounts earned include loan fees. Average loan balances include nonaccrual loans and loans held for sale.

Table 3: Quarterly Average Balance Sheet

| (000's omitted except yields and rates) | Three Months Ended March 31, 2008 | | | Three Months Ended March 31, 2007 | | |
|---|---|---|---|---|---|---|
| | Average Balance | Interest | Avg. Yield/Rate Paid | Average Balance | Interest | Avg. Yield/Rate Paid |
| Interest-earning assets: | | | | | | |
| Cash equivalents | $ 44,728 | $ 318 | 2.86% | $ 102,553 | $ 1,329 | 5.26% |
| Taxable investment securities (1) | 764,234 | 10,717 | 5.64% | 741,304 | 10,280 | 5.62% |
| Nontaxable investment securities (1) | 540,993 | 9,334 | 6.94% | 500,273 | 8,639 | 7.00% |
| Loans (net of unearned discount) | 2,822,100 | 46,672 | 6.65% | 2,684,566 | 45,106 | 6.81% |
| Total interest-earning assets | 4,172,055 | 67,041 | 6.46% | 4,028,696 | 65,354 | 6.58% |
| Noninterest-earning assets | 469,964 | | | 440,548 | | |
| Total assets | $ 4,642,019 | | | $ 4,469,244 | | |
| | | | | | | |
| Interest-bearing liabilities: | | | | | | |
| Interest checking, savings and money market deposits | $ 1,260,934 | 2,714 | 0.87% | $ 1,198,183 | 3,340 | 1.13% |
| Time deposits | 1,398,650 | 14,980 | 4.31% | 1,424,289 | 14,780 | 4.21% |
| Short-term borrowings | 426,116 | 4,419 | 4.17% | 159,444 | 1,637 | 4.16% |
| Long-term borrowings | 457,177 | 5,440 | 4.79% | 613,624 | 8,434 | 5.57% |
| Total interest-bearing liabilities | 3,542,877 | 27,553 | 3.13% | 3,395,540 | 28,191 | 3.37% |
| Noninterest-bearing liabilities: | | | | | | |
| Demand deposits | 555,927 | | | 552,087 | | |
| Other liabilities | 60,465 | | | 56,994 | | |
| Shareholders' equity | 482,750 | | | 464,623 | | |
| Total liabilities and shareholders' equity | $ 4,642,019 | | | $ 4,469,244 | | |
| | | | | | | |
| Net interest earnings | | $ 39,488 | | | $ 37,163 | |
| Net interest spread | | | 3.33% | | | 3.21% |
| Net interest margin on interest-earnings assets | | | 3.81% | | | 3.74% |
| | | | | | | |
| Fully tax-equivalent adjustment | | $ 3,890 | | | $ 3,796 | |

(1)

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

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As discussed above and disclosed in Table 4 below, the quarterly change in net interest income (fully tax-equivalent basis) may be analyzed by segregating the volume and rate components of the changes in interest income and interest expense for each underlying category.

Table 4: Rate/Volume

| | 1st Quarter 2008 versus 1st Quarter 2007<br>Increase (Decrease) Due to Change in (1) | | |
|---|---|---|---|
| | Volume | Rate | Net Change |
| (000's omitted) | | | |
| Interest earned on: | | | |
| Cash equivalents | $ (562) | $ (449) | $ (1,011) |
| Taxable investment securities | 321 | 116 | 437 |
| Nontaxable investment securities | 703 | (8) | 695 |
| Loans (net of unearned discount) | 2,283 | (717) | 1,566 |
| Total interest-earning assets (2) | 2,309 | (622) | 1,687 |
| | | | |
| Interest paid on: | | | |
| Interest checking, savings and money market deposits | 168 | (794) | (626) |
| Time deposits | (269) | 469 | 200 |
| Short-term borrowings | 2,766 | 16 | 2,782 |
| Long-term borrowings | (1,961) | (1,033) | (2,994) |
| Total interest-bearing liabilities (2) | 1,192 | (1,830) | (638) |
| | | | |
| Net interest earnings (2) | $ 1,343 | $ 982 | $ 2,325 |

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

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

Noninterest Income

The Company's sources of noninterest income are of three primary types: 1) general banking services related to loans, deposits and other core customer activities typically provided through the branch network and electronic banking channels; 2) employee benefit plan administration, actuarial and consulting services (performed by BPA-Harbridge and HBT); and 3) wealth management services, comprised of trust services (performed by the trust unit within CBNA), investment and insurance products (performed by Community Investment Services, Inc. or CISI and CBNA Insurance Agency, Inc.) and asset management (performed by Nottingham Advisors or Nottingham). Additionally, the Company has periodic transactions, most often net gains (losses) from the sale of investment securities and prepayment of debt instruments.

Table 5: Noninterest Income

| | Three Months Ended March 31, | |
|---|---|---|
| (000's omitted) | 2008 | 2007 |
| Deposit service charges and fees | $ 8,261 | $ 6,977 |
| Benefit plan administration, consulting and actuarial fees | 6,312 | 3,972 |
| Wealth management services | 2,163 | 1,860 |
| Other banking services | 373 | 413 |
| Mortgage banking | 222 | 257 |
| Subtotal | 17,331 | 13,479 |
| Gain on sales of investment securities | 287 | 0 |
| Total noninterest income | $ 17,618 | $ 13,479 |
| | | |
| Noninterest income/total income (FTE) | 30.5% | 26.6% |

As displayed in Table 5, noninterest income (excluding securities gains) was $17.3 million in the first quarter, an increase of $3.8 million or 29% from the prior year level. A significant portion of the growth was attributable to growth in benefit plan administration, consulting and actuarial fees, primarily due to the acquisition of HBT in mid May 2007 which generated approximately $1.7 million of revenue growth in the quarter. The remainder of the increase was due to organic growth generated from new clients along with enhanced product offerings to both new and existing customers and a strong quarter from the unit's actuarial consulting practice. First quarter wealth management services revenue increased $0.3 million or 16%, primarily attributable to the acquisition of TLNB's Insurance Agency business. General recurring banking fees of $8.9 million for the first quarter were up $1.2 million or 15.8%, as compared to the prior year period, driven by organic core deposit account growth, higher electronic banking related revenues, and incremental income generated from the acquired TLNB branches.

The ratio of noninterest income to total income (FTE basis) was 30.5% for the quarter versus 26.6% for the comparable period in 2007. This improvement is a function of increased noninterest banking and financial services income (excluding net security gains), combined with proportionally smaller increases in net interest income.

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Operating Expenses

Table 6 below sets forth the quarterly results of the major operating expense categories for the current and prior year, as well as efficiency ratios (defined below), a standard measure of expense utilization effectiveness used in the banking industry.

Table 6: Operating Expenses

| | Three Months Ended March 31, | |
|---|---|---|
| (000's omitted) | 2008 | 2007 |
| Salaries and employee benefits | $ 20,386 | $ 18,286 |
| Occupancy and equipment | 5,573 | 4,666 |
| Data processing and communications | 3,985 | 3,565 |
| Amortization of intangible assets | 1,531 | 1,515 |
| Legal and professional fees | 1,298 | 1,187 |
| Office supplies and postage | 1,278 | 1,046 |
| Business development and marketing | 1,322 | 950 |
| Other | 3,001 | 2,704 |
| Total operating expenses | $ 38,374 | $ 33,919 |
| | | |
| Operating expenses/average assets | 3.32% | 3.08% |
| Efficiency ratio | 64.8% | 63.8% |

As shown in Table 6, first quarter 2008 operating expenses were $38.4 million, up $4.5 million or 13.1% from the prior year level.  The majority of the increase was attributable to incremental operating expenses related to the TLNB and HBT acquisitions.  Additionally, the increase in operating expenses can be attributable to annual merit and other personnel related costs ($0.9 million), higher facility-based utility and maintenance costs ($0.7 million), higher volume-based data processing and communication costs ($0.3 million), and an increased level of business development and marketing expense ($0.4 million).  A portion of the increase in data processing and communications costs, as well as the increase in business development and marketing expenses, reflects the Company's continued investments in strategic technology and business development initiatives to grow and enhance our service offerings.

The Company's efficiency ratio (recurring operating expenses excluding intangible amortization and acquisition expenses divided by the sum of net interest income (FTE) and recurring noninterest income) was 64.8% for the first quarter, 1.0 percentage point above the comparable quarter of 2007.  This resulted from operating expenses (as described above) increasing 14% primarily due to the acquisitions in the last year, while recurring operating income increased at a slower rate of 12.3% due to a $3.9 million or 29% increase in noninterest income excluding security gains and a $2.4 million or 6.4% increase in net interest income quarter over quarter.  In both periods, the efficiency ratios were adversely affected by the growing proportion of financial services activities which, due to the differing nature of their business, carry high efficiency ratios.  Operating expenses as a percentage of average assets increased 24 basis points for the quarter as operating expenses increased 13.1%, while average assets increased 3.9% during the same time period.  This ratio was impacted by the comparatively higher growth rates of the financial services businesses, which are less asset-intensive and have higher efficiency ratio attributes.

Income Taxes

The first quarter effective income tax rate was 22.5%, compared to the 24.1% effective tax rate in the first quarter of 2007.   The lower effective tax rate for 2008 was principally a result of a higher proportion of income being generated from tax-exempt securities and loans.

Investments

As reflected in Table 7 below, the carrying value of investments (including unrealized gains on available-for-sale securities) was $1.31 billion at the end of the first quarter, a decrease of $84.2 million and $9.9 million from December 31, 2007 and March 31, 2007, respectively.  The book value (excluding unrealized gains) of investments decreased $88.2 million and $21.9 million from December 31, 2007 and March 31, 2007, respectively.  The short-term agency securities purchased during the third quarter of 2007 matured during the fourth quarter of 2007 and the first quarter of 2008.  Cash flows from these securities provided an opportunity to invest in municipal and certain mortgage-backed securities that improved the Company's interest rate sensitivity position. The overall mix of securities within the portfolio over the last year has changed, with an increase in the proportion of obligations of state and political subdivisions and mortgage-backed securities, the addition of asset-backed securities and a decrease in U.S. Treasury and Agency securities.  The change in the carrying value of investments is impacted by the amount of net unrealized gains in the available for sale portfolio at a point in time.  At March 31, 2008, the portfolio had a $21.2 million net unrealized gain, an increase of $4.0 million from the unrealized gain at December 31, 2007 and an improvement of $12.0 million from the unrealized gain at March 31, 2007.  This fluctuation is indicative of the interest rate movements during the respective time periods and the changes in the size and composition of the portfolio.

Included in the available for sale portfolio are asset-backed securities with a book value of $73.0 million and unrealized losses of $4.6 million at March 31, 2008.  The underlying collateral of these assets are trust-preferred securities of community banks.  The Company has the intent and ability to hold these securities to recovery and does not consider these investments to be other-than temporarily impaired as of March 31, 2008.

Table 7: Investments

| | March 31, 2008 | | December 31, 2007 | | March 31, 2007 | |
|---|---|---|---|---|---|---|
| (000's omitted) | Amortized Cost/Book Value | Fair Value | Amortized Cost/Book Value | Fair Value | Amortized Cost/Book Value | Fair Value |
| Held-to-Maturity Portfolio: | | | | | | |
| U.S. Treasury and Agency securities | $ 127,019 | $ 129,117 | $ 127,055 | $ 127,382 | $ 127,164 | $ 124,538 |
| Obligations of state and political subdivisions | 5,850 | 5,959 | 6,207 | 6,289 | 7,345 | 7,373 |
| Other securities | 3,210 | 3,210 | 3,988 | 3,988 | 4,004 | 4,004 |
| Total held-to-maturity portfolio | 136,079 | 138,286 | 137,250 | 137,659 | 138,513 | 135,915 |
| | | | | | | |
| Available-for-Sale Portfolio: | | | | | | |
| U.S. Treasury and Agency securities | 251,006 | 260,473 | 432,832 | 438,526 | 484,354 | 483,805 |
| Obligations of state and political subdivisions | 534,985 | 547,991 | 532,431 | 543,963 | 491,172 | 502,447 |
| Corporate securities | 37,259 | 37,626 | 40,457 | 40,270 | 35,568 | 35,209 |
| Collateralized mortgage obligations | 32,340 | 32,722 | 34,451 | 34,512 | 41,005 | 40,592 |
| Asset-backed securities | 73,038 | 68,454 | 73,089 | 72,300 | 0 | 0 |
| Mortgage-backed securities | 171,882 | 174,418 | 72,655 | 73,525 | 74,067 | 73,308 |
| Subtotal | 1,100,510 | 1,121,684 | 1,185,915 | 1,203,096 | 1,126,166 | 1,135,361 |
| Equity securities | 49,919 | 49,919 | 51,526 | 51,526 | 43,680 | 43,680 |
| | 1,150,429 | 1,171,603 | 1,237,441 | 1,254,622 | 1,169,846 | 1,179,041 |

| | | | | | | |
|---|---|---|---|---|---|---|
| Total available-for-sale portfolio | | | | | | |
| | | | | | | |
| Net unrealized gain on available-for-sale portfolio | 21,174 | 0 | 17,181 | 0 | 9,195 | 0 |
| Total | $ 1,307,682 | $ 1,309,889 | $ 1,391,872 | $ 1,392,281 | $ 1,317,554 | $ 1,314,956 |

Loans

As shown in Table 8, loans ended the first quarter at $2.84 billion, up $16.7 million (0.6%) from year-end 2007 and up $155.6 million (5.8%) versus one year earlier.  The TLNB acquisition added approximately $56 million of loans to the loan portfolio as of March 31, 2008.  Excluding the impact of the TLNB acquisition, loans increased $99.6 million or 3.7% from the first quarter of 2007 with organic growth in all portfolios; consumer mortgage, consumer installment and business lending.  During the first quarter loan growth was driven by increases in the business lending portfolio ($13.7 million) and the consumer mortgage portfolio ($10.2 million), partially offset by a decrease in the consumer installment portfolio ($7.2 million).

Table 8: Loans

| (000's omitted) | March 31, 2008 | | December 31, 2007 | | March 31, 2007 | |
|---|---|---|---|---|---|---|
| Business lending | $ 998,443 | 35.2% | $ 984,780 | 34.9% | $ 957,853 | 35.7% |
| Consumer mortgage | 987,807 | 34.8% | 977,553 | 34.7% | 914,909 | 34.1% |
| Consumer installment | 851,536 | 30.0% | 858,722 | 30.4% | 809,472 | 30.2% |
| Total loans | $ 2,837,786 | 100.0% | $ 2,821,055 | 100.0% | $ 2,682,234 | 100.0% |

Business lending increased $13.7 million in the first three months of 2008 and increased $40.6 million versus one year ago. Excluding the impact of the TLNB acquisition, business lending increased $11.9 million over the last three months and $9.9 million over the last year. The Company continues to face competitive conditions in most of its markets and it maintains its commitment to generating growth in its business portfolio in a manner that adheres to its twin goals of maintaining strong asset quality and producing profitable margins. The Company has recently invested in additional personnel, technology and business development resources to further strengthen its capabilities in this key business segment.

Consumer mortgages increased $72.9 million, year-over-year, and $10.3 million in the first three months of 2008, despite the sale of a portion of longer-term, fixed-rate new mortgage originations in the secondary market. Excluding the impact of the TLNB acquisition, consumer mortgages increased $9.9 million and $52.0 million for the past three and twelve month periods, respectively. Consumer mortgage growth has been strong over the last few quarters despite softening demand in the overall market. The consumer real estate portfolio does not include exposure to subprime, Alt-A, or other higher-risk mortgage products. The Company's solid performance during a tumultuous period in the overall industry is a testament to the stable, low-risk profile of its portfolio and its ability to successfully meet customer needs at a time when some national mortgage lenders are restricting their lending activities in many of our markets.

Consumer installment loans, including borrowings originated in automobile, marine and recreational vehicle dealerships, as well as branch originated home equity and installment loans, decreased $7.2 million in the first three months of 2008 and increased $42.1 million on a year-over-year basis. Excluding the impact of the TLNB acquisition, consumer installment lending decreased $7.1 million for the first three months of 2008 and increased $37.7 million for the year-over-year period. Declines in manufacturer production and industry sale projections indicate continued weakness in the new vehicle market which has created a demand in late model used and program car inventories. Aggressive business development efforts have created opportunities to strategically expand the Company's share of the market, helping drive productive growth in this portfolio. The origination of consumer installment loans demonstrates definite seasonal patterns and is traditionally slower in the first quarter.

Asset Quality

Table 9 below exhibits the major components of nonperforming loans and assets and key asset quality metrics for the periods ending March 31, 2008 and 2007 and December 31, 2007.

Table 9: Nonperforming Assets

| (000's omitted) | March 31, 2008 | December 31, 2007 | March 31, 2007 |
|---|---|---|---|
| Nonaccrual loans | $ 7,662 | $ 7,140 | $ 9,451 |

| | | | |
|---|---|---|---|
| Accruing loans 90+ days delinquent | 392 | 622 | 1,914 |
| Restructured loans | 1,095 | 1,126 | 1,246 |
| Total nonperforming loans | 9,149 | 8,888 | 12,611 |
| Other real estate (OREO) | 1,027 | 1,007 | 1,916 |
| Total nonperforming assets | $ 10,176 | $ 9,895 | $ 14,527 |
| | | | |
| Allowance for loan losses to total loans | 1.28% | 1.29% | 1.34% |
| Allowance for loan losses to nonperforming loans | 398% | 410% | 285% |
| Nonperforming loans to total loans | 0.32% | 0.32% | 0.47% |
| Nonperforming assets to total loans and other real estate | 0.36% | 0.35% | 0.54% |
| Delinquent loans (30 days old to nonaccruing) to total loans | 0.99% | 1.10% | 1.02% |
| Net charge-offs to average loans outstanding (quarterly) | 0.11% | 0.13% | 0.09% |
| Loan loss provision to net charge-offs (quarterly) | 100% | 98% | 32% |

As displayed in Table 9, nonperforming assets at March 31, 2008 were $10.2 million, a decrease of $4.4 million versus one year earlier and a $0.3 million increase as compared to the level at the end of 2007. Nonperforming loan ratios remain at the lowest level in over three years, reflective of disciplined credit management and a relatively stable economic condition in our markets over the past few years. Other real estate decreased $0.9 million from one-year ago and increased slightly from year-end 2007, a result of the Company managing 12 OREO properties at March 31, 2008 as compared to 22 OREO properties at March 31, 2007. No single property has a carrying value in excess of $300,000.

Nonperforming loans were 0.32% of total loans outstanding at the end of the first quarter, consistent with the level at December 31, 2007 and significantly below the 0.47% at March 31, 2007. The allowance for loan losses to nonperforming loans ratio, a general measure of coverage adequacy, was 398% at the end of the first quarter compared to 410% at year-end 2007 and 285% at March 31, 2007, reflective of the low level of nonperforming loans.

Delinquent loans (30 days through nonaccruing) as a percent of total loans was 0.99% at the end of the first quarter, substantially below the 1.10% at year-end 2007 and lower than the 1.02% at March 31, 2007. The commercial loan delinquency ratio at the end of the first quarter increased slightly in comparison to December 31, 2007 and declined as compared to March 31, 2007. The delinquency rate for installment loans and real estate loans decreased as compared to the December 31, 2007 and increased as compared to March 31, 2007. The delinquency level at the end of the current quarter was 15 basis points below the Company's average of 1.14% over the previous eight quarters.

Table 10: Allowance for Loan Losses Activity

| | Three Months Ended March 31, | |
|---|---|---|
| (000's omitted) | 2008 | 2007 |
| Allowance for loan losses at beginning of period | $ 36,427 | $ 36,313 |
| Charge-offs: | | |
| Business lending | 277 | 240 |
| Consumer mortgage | 52 | 235 |
| Consumer installment | 1,348 | 1,161 |
| Total charge-offs | 1,677 | 1,636 |
| Recoveries: | | |
| Business lending | 173 | 257 |
| Consumer mortgage | 46 | 1 |
| Consumer installment | 679 | 756 |
| Total recoveries | 898 | 1,014 |
| | | |
| Net charge-offs | 779 | 622 |
| Provision for loans losses | 780 | 200 |
| Allowance for loan losses at end of period | $ 36,428 | $ 35,891 |
| | | |
| Net charge-offs to average loans outstanding: | | |
| Business lending | 0.04% | -0.01% |
| Consumer mortgage | 0.00% | 0.10% |
| Consumer installment | 0.31% | 0.20% |
| Total loans | 0.11% | 0.09% |

As displayed in Table 10, net charge-offs during the first quarter were $0.8 million, $0.2 million higher than the equivalent 2007 period. The consumer installment and business lending portfolios experienced small increases in the level of charge-offs, while the consumer mortgage portfolio charge-offs declined as compared to the first quarter of 2007. The net charge-off ratio (net charge-offs as a percentage of average loans outstanding) for the first quarter was 0.11%, two basis points higher than the comparable quarter of 2007 and six basis points below the average charge-off ratio for the previous eight quarters. Net charge-offs and the corresponding net charge-off ratios continue to be significantly below the average net charge-off levels of the past several years.

The consumer mortgage portfolio experienced a net charge-off ratio of zero for the quarter, while the consumer installment and business lending net charge-off ratios for the first quarter of 0.31% and 0.04%, respectively, increased 11 basis points and five basis points versus prior year levels. As compared to the fourth quarter of 2007, the business lending portfolio and consumer mortgage portfolio charge-off ratios improved five basis points and two basis points, respectively, while the consumer installment charge-off ratio was higher by two basis points, but was at a level below the average for the previous eight quarters.

A loan loss allowance of $36.4 million was determined as of March 31, 2008, necessitating a $0.8 million loan loss provision for the quarter, compared to $0.2 million one year earlier. The first quarter 2008 loan loss provision was consistent with the level of net charge-offs, despite an increase in the total loan portfolio. The allowance for loan losses rose $0.5 million or 1.5% over the last 12 months, less than the 5.8% growth in the loan portfolio. Contributing to the changes was the favorable charge-off, nonperforming and delinquency trends experienced over the last twelve months. This contributed to the ratio of allowance for loan loss to loans outstanding decreasing six basis points to 1.28% for the first quarter, as compared to the levels at March 31, 2007 and declining one basis point from the level at December 31, 2007. The decrease was also slightly impacted by the increased proportion of low-risk consumer mortgage and home equity loans in the overall loan portfolio, as a result of both organic and acquired growth.

Deposits

As shown in Table 11, average deposits of $3.2 billion in the first quarter were up $41.0 million compared to first quarter 2007 and decreased $26.6 million versus the fourth quarter of last year. Excluding the impact of the TLNB acquisition, average deposits decreased $23.0 million as compared to the fourth quarter of 2007 and decreased $29.0 million as compared to the first quarter of the prior year. The mix of average deposits changed slightly since the first quarter of 2007. The weightings of interest checking deposits increased from their year-ago levels, while time deposits, demand, savings and money market deposit weightings decreased. As a component of the Company's strategy to reduce its overall cost of funding, time deposits balances have been actively managed lower. Interest checking account balances are above the prior year levels primarily as a result of the continued success of new product initiatives that commenced in the second quarter of 2006. This shift in mix, combined with the Company's ability to reduce rates due to market conditions, resulted in the quarterly cost of interest-bearing deposits declining from 2.80% in the first quarter of 2007 to 2.68% in the most recent quarter.

Average first quarter non-public fund deposits were up $46.0 million or 1.6% compared to the year earlier period and decreased $50.8 million or 1.7% versus the fourth quarter of 2007. Average public funds have increased $24.2 million or 12.3% from the fourth quarter of 2007 and decreased $5.0 million or 2.2% from the first quarter of 2007. The Company continues to focus heavily on growing its core deposits through enhanced marketing and training programs and new product offerings introduced during the past two years.

Table 11: Quarterly Average Deposits

| (000's omitted) | March 31, 2008 | December 31, 2007 | March 31, 2007 |
|---|---|---|---|
| Demand deposits | $ 555,927 | $ 574,266 | $ 552,087 |
| Interest checking deposits | 473,805 | 464,996 | 408,573 |
| Savings deposits | 452,929 | 451,148 | 457,177 |
| Money market deposits | 334,200 | 329,566 | 332,433 |
| Time deposits | 1,398,650 | 1,422,159 | 1,424,289 |
| Total deposits | $ 3,215,511 | $ 3,242,135 | $ 3,174,559 |
| | | | |
| Non-public fund deposits | $ 2,995,201 | $ 3,046,018 | $ 2,949,201 |
| | 220,310 | 196,117 | 225,358 |

| | | | | | | |
|---|---|---|---|---|---|---|
| Public fund deposits | | | | | | |
| Total deposits | $ | 3,215,511 | $ | 3,242,135 | $ | 3,174,559 |

Borrowings

At the end of the first quarter, borrowings of $868.1 million decreased $61.2 million from December 31, 2007 and were up $114.2 million versus the end of the first quarter of 2007 as a result of the acquisitions of HBT and TLNB, which were both 100% cash transactions, partially offset by the early redemption of $25 million of its variable rate, trust-preferred securities in January 2008. In December 2007, the Company restructured $150 million of its fixed rate FHLB advances, replacing them with lower cost instruments with similar remaining duration. These restructuring strategies helped reduce the Company's interest expense on external borrowings and consequently improved its net interest margin in the first quarter of 2008.

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Shareholders' Equity

On April 20, 2005, the Company announced a twenty-month authorization to repurchase up to 1.5 million of its outstanding shares in open market or privately negotiated transactions.  On December 20, 2006, the Company extended the program through December 31, 2008 and announced an additional two-year authorization to repurchase up to 900,000 of its outstanding shares in open market or privately negotiated transactions.  All reacquired shares will become treasury shares and will be used for general corporate purposes, including those related to employee and director stock plan activities.  Through March 31, 2008, the Company had repurchased 1,464,811 shares at an aggregate cost of $31.5 million under this program.

Total shareholders' equity of $488.7 million at the end of the first quarter increased $9.9 million from the balance at December 31, 2007.  This change consisted of net income of $10.9 million, $3.9 million from shares issued under the employee stock plan,  $0.7 million from employee stock options earned, and a $0.7 million increase in other comprehensive income, partially offset by dividends declared of $6.3 million.  The other comprehensive gain is comprised of $2.5 million increase in the after-tax market value adjustment on the available for sale investment portfolio, partially offset by a $1.7 million decrease in the after-tax market value adjustment on the interest rate swap and a $0.1 million adjustment to the funded status of the Company's retirement plans. Over the past 12 months total shareholders' equity increased by $21.8 million, as net income, positive contributions from shares issued under the employee stock plan, and a higher market value adjustment more than offset dividends declared, treasury stock purchases, and the funded status of the company's  defined benefit pension and other postretirement plans.

The Company's Tier I leverage ratio, a primary measure of regulatory capital for which 5% is the requirement to be "well-capitalized," was 7.59% at the end of the first quarter, down 18 basis points from year-end 2007 and 70 basis points lower than its level one year ago.  The decrease in the Tier I leverage ratio compared to December 31, 2007 is primarily the result of the early call of $25 million of variable-rate trust preferred securities in the first quarter.  The decrease in Tier I, as compared to the prior year first quarter, is the result of a 5.3% decrease in shareholders equity, excluding intangibles and the market value adjustment, combined with a 3.5% increase in average assets excluding intangibles and the market value adjustment.  The primary drivers of the year-over-year changes were treasury share purchases, the redemption of trust-preferred securities and two acquisitions that increased both asset and intangible levels.  The tangible equity-to-assets ratio of 5.30% increased 29 basis points versus December 31, 2007 and increased 15 basis points versus March 31, 2007, due to shareholders equity excluding intangible assets growing at a faster pace than assets excluding intangibles.

The dividend payout ratio (dividends declared divided by net income) for the first three months of 2008 was 57.4%, down from 62.4% for the first three months of 2007.  The ratio decreased because net income increased 12.9% while dividends declared increased at a lesser 3.7%.  The Company's quarterly dividend was raised 5.0% in August 2007, from $0.20 to $0.21, but shares outstanding declined by 1.0% resulting in dividends declared growth trailing the dividend per share increase.  On a cash earnings basis, the dividend payout ratio was 51.1% for the first three months of 2008 as compared to 54.9% for the first three months of 2007.

Liquidity

Management of the Company's liquidity is critical due to the potential for unexpected fluctuations in deposits and loans.  Adequate sources of both on and off-balance sheet funding are in place to effectively respond to such unexpected fluctuations.

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); and second, a projection of subsequent cash availability over an additional 60 days.  The minimum policy level of liquidity under the Basic Surplus/Deficit approach is 7.5% of total assets for both the 30 and 90-day time horizons.  As of March 31, 2008, this ratio was 12.2% for 30 days and 12.0% for 90 days, excluding the Company's capacity to borrow additional funds from the FHLB.

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

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Forward-Looking Statements

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

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

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

Market risk is the risk of loss in a financial instrument arising from adverse changes in market rates, prices or credit risk. Credit risk associated with the Company's loan portfolio has been previously discussed in the asset quality section of Management's Discussion and Analysis of Financial Condition and Results of Operations. Management believes that the tax risk of the Company's municipal investments associated with potential future changes in statutory, judicial and regulatory actions is minimal. The Company has an insignificant amount of credit risk in its investment portfolio because essentially all of the fixed-income securities in the portfolio are AAA-rated (highest possible rating). Therefore, almost all the market risk in the investment portfolio is related to interest rates.

The ongoing monitoring and management of both interest rate risk and liquidity, in the short and long term time horizons is an important component of the Company's asset/liability management process, which is governed by limits established in the policies reviewed and approved annually by the Board of Directors. The Board of Directors delegates responsibility for carrying out the policies to the Asset/Liability Committee (ALCO) which meets each month and is made up of the Company's senior management as well as regional and line-of-business managers who oversee specific earning asset classes and various funding sources. As the Company does not believe it is possible to reliably predict future interest rate movements, it has maintained an appropriate process and set of measurement tools, which enable it to identify and quantify sources of interest rate risk in varying rate environments. The primary tool used by the Company in managing interest rate risk is income simulation.

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

- Asset and liability levels using March 31, 2008 as a starting point.

- There are assumed to be conservative levels of balance sheet growth—low to mid single digit growth in loans and deposits, while using the cashflows from investment contractual maturities and prepayments to repay short-term capital market borrowings.

- The prime rate and federal funds rates are assumed to move up 200 basis points and down 100 basis points over a 12-month period while moving the long end of the treasury curve to spreads over federal funds that are more consistent with historical norms. Deposit rates are assumed to move in a manner that reflects the historical relationship between deposit rate movement and changes in the federal funds rate.

- Cash flows are based on contractual maturity, optionality and amortization schedules along with applicable prepayments derived from internal historical data and external sources.

Net Interest Income Sensitivity Model

| Change in interest rates | Calculated annualized increase (decrease) in projected net interest income at March 31, 2008 |
|---|---|

| | |
|---|---|
| + 200 basis points | 0.4% |
| - 100 basis points | (2.6%) |

The modeled net interest income (NII) reflects an increase in a rising rate environment from a flat rate scenario and a decrease if rates were to fall.  The increase in a rising rate environment is largely due to slower investment cash flows, the repricing of assets and liabilities to higher rates. The decrease in a falling rate environment is largely due to faster investment cash flows and assets repricing to lower rates than corresponding liabilities.  Over a longer time period the growth in NII improves significantly in a rising rate environment as lower yielding assets mature and are replaced at higher rates.

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

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## Item 4. Controls and Procedures

The Company maintains disclosure controls and procedures, as defined in Rule 13a – 15(e) under the Securities Exchange Act of 1934, designed to: (i) record, process, summarize, and report within the time periods specified in the Securities and Exchange Commission's (SEC) rules and forms, and (ii) accumulate and communicate to management, including the principal executive and principal financial officers, as appropriate, to allow timely decisions regarding disclosure. Based on management's evaluation of the Company's disclosure controls and procedures, with the participation of the Chief Executive Officer and the Chief Financial Officer, it has concluded that, as of the end of the period covered by this Quarterly Report on Form 10-Q, these disclosure controls and procedures were effective as of March 31, 2008.

There have been no changes in the Company's internal controls over financial reporting in connection with the evaluation referenced in the paragraph above that occurred during the Company's last fiscal quarter that has materially affected, or is reasonably likely to materially affect, the Company's internal control over financial reporting.

## Part II. Other Information

## Item 1. Legal Proceedings

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

## Item 1A. Risk Factors

There has not been any material change in the risk factors disclosure from that contained in the Company's 2007 Form 10-K for the fiscal year ended December 31, 2007 (filed with the SEC on March 13, 2008).

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

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. On December 20, 2006, the Company extended the program through December 31, 2008 and announced an additional two-year authorization to repurchase up to 900,000 of its shares in open market or privately negotiated transactions. These repurchases will be for general corporate purposes, including those related to stock plan activities. The following table shows treasury stock purchases during the first quarter of 2008.

| | Number of Shares Purchased | Average Price Paid Per share | Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs | Maximum Number of Shares That May Yet Be Purchased Under the Plans or Programs |
|---|---|---|---|---|
| January 2008 | 0 | $ 0 | 1,464,811 | 935,189 |
| February 2008 | 0 | 0 | 1,464,811 | 935,189 |
| March 2008 | 0 | 0 | 1,464,811 | 935,189 |

| | | |
|---|---|---|
| Total | 0 | $ 0 |

Item 3. Defaults Upon Senior Securities

Not applicable.

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 ending March 31, 2008.

Item 5. Other Information

Not applicable.

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Item 6. Exhibits

| Exhibit No. | Description |
|---|---|
| 10.1 | Employment Agreement dated January 1, 2008, by and among Community Bank System, Inc., Community Bank, N.A. and George J. Getman. |
| 10.2 | Employment Agreement dated April 4, 2008, by and among Community Bank System, Inc., Community Bank, N.A. and Scott Kingsley. Incorporated by reference to Exhibit 10.1 to the Form 8-K filed on April 9, 2008 (Registration No. 001-13695). |
| 31.1 | Certification of Mark E. Tryniski, President and Chief Executive Officer of the Registrant, pursuant to Rule 13a-15(e) or Rule 15d-15(e) under the Securities Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002. |
| 31.2 | Certification of Scott Kingsley, Treasurer and Chief Financial Officer of the Registrant, pursuant to Rule 13a-15(e) or Rule 15d-15(e) under the Securities Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002. |
| 32.1 | Certification of Mark E. Tryniski, President and Chief Executive Officer of the Registrant, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. |
| 32.2 | Certification of Scott Kingsley, Treasurer and Chief Financial Officer of the Registrant, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 |

## Signatures

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

Community Bank System, Inc.

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| Date: May 8, 2008 | /s/ Mark E. Tryniski<br>Mark E. Tryniski, President and Chief Executive Officer |
| Date: May 8, 2008 | /s/ Scott Kingsley<br>Scott Kingsley, Treasurer and Chief Financial Officer |