FINANCIAL INSTITUTIONS INC
Form 10-Q
May 08, 2007

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UNITED STATES SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
FORM 10-Q

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

FOR THE QUARTERLY PERIOD ENDED March 31, 2007

Commission File Number 0-26481

(Exact Name of Registrant as specified in its charter)

NEW YORK	16-0816610
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification Number)
220 Liberty Street Warsaw, NY	14569
(Address of Principal Executive Offices)	(Zip Code)

Registrant s Telephone Number Including Area Code:
(585) 786-1100

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 twelve months (or for such shorter period that the Registrant was required to file reports) and (2) has been subject to such requirements for at least the past 90 days. YES þ NO o

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

Large Accelerated filer o Accelerated filer þ Non-accelerated filer o

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). YES o NO þ

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

CLASS	OUTSTANDING AT MAY 1, 2007
Common Stock, $0.01 par value	11,204,266 shares

FINANCIAL INSTITUTIONS, INC.
FORM 10-Q
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Item 1. Financial Statements (Unaudited)

FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF FINANCIAL CONDITION
(Unaudited)

(Dollars in thousands, except per share amounts)	March 31, 2007	December 31, 2006
Assets		
Cash and due from banks	$ 40,647	$ 47,166
Federal funds sold and interest-bearing deposits in other banks	92,432	62,606
Securities available for sale, at fair value	761,252	735,148
Securities held to maturity, at amortized cost (fair value of $44,902 and $40,421 at March 31, 2007 and December 31, 2006, respectively)	44,848	40,388
Loans held for sale	1,078	992
Loans	929,250	926,482
Less: Allowance for loan losses	16,914	17,048
Loans, net	912,336	909,434
Premises and equipment, net	34,341	34,562
Goodwill	37,369	37,369
Other assets	38,445	39,887
Total assets	$ 1,962,748	$ 1,907,552
Liabilities And Shareholders Equity		
Liabilities:		
Deposits:		
Noninterest-bearing demand	$ 260,068	$ 273,783
Interest-bearing demand, savings and money market	723,343	674,224
Certificates of deposit	688,351	669,688
Total deposits	1,671,762	1,617,695
Short-term borrowings	24,860	32,310
Long-term borrowings	38,173	38,187
Junior subordinated debentures issued to unconsolidated subsidiary trust (Junior subordinated debentures)	16,702	16,702
Other liabilities	26,721	20,270
Total liabilities	1,778,218	1,725,164

Shareholders equity:		
3% cumulative preferred stock, $100 par value, authorized 10,000 shares, issued and outstanding 1,586 shares at March 31, 2007 and December 31, 2006	159	159
8.48% cumulative preferred stock, $100 par value, authorized 200,000 shares, issued and outstanding 174,639 shares at March 31, 2007 and December 31, 2006	17,464	17,464
Common stock, $0.01 par value, authorized 50,000,000 shares, issued 11,348,122 shares at March 31, 2007 and December 31, 2006	113	113
Additional paid-in capital	24,554	24,439
Retained earnings	150,865	148,730
Accumulated other comprehensive loss	(7,026)	(8,404)
Treasury stock, at cost 76,446 and 5,351 shares at March 31, 2007 and December 31, 2006, respectively	(1,599)	(113)
Total shareholders equity	184,530	182,388
Total liabilities and shareholders equity	$ 1,962,748	$ 1,907,552

See Accompanying Notes to Unaudited Consolidated Financial Statements.

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FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF INCOME
(Unaudited)

	Three Months Ended March 31,	
(Dollars in thousands, except per share amounts)	2007	2006
Interest income:		
Interest and fees on loans	$ 16,627	$ 16,632
Interest and dividends on securities	8,427	8,352
Other interest income	752	291
Total interest income	25,806	25,275
Interest expense:		
Deposits	10,763	8,221
Short-term borrowings	169	112
Long-term borrowings	486	1,031
Junior subordinated debentures	432	432
Total interest expense	11,850	9,796
Net interest income	13,956	15,479
Provision for loan losses		250
Net interest income after provision for loan losses	13,956	15,229
Noninterest income:		
Service charges on deposits	2,569	2,672
ATM and debit card income	620	534
Broker-dealer fees and commissions	383	431
Trust fees		194
Mortgage banking income	254	308
Income from corporate owned life insurance	20	20
Net gain on sale of student loans held for sale	112	147
Net gain on sale of commercial-related loans held for sale		82
Net gain on sale and disposal of other assets	57	98
Net gain on sale of trust relationships	13	
Other	710	470
Total noninterest income	4,738	4,956
Noninterest expense:		

Salaries and employee benefits	8,354	8,758
Occupancy and equipment	2,448	2,362
Supplies and postage	438	559
Amortization of other intangible assets	77	108
Computer and data processing	457	405
Professional fees and services	495	673
Other	1,659	2,410
Total noninterest expense	13,928	15,275
Income before income taxes	4,766	4,910
Income tax expense	1,151	1,171
Net income	$ 3,615	$ 3,739
Earnings per common share (note 3):		
Basic	$ 0.29	$ 0.30
Diluted	$ 0.29	$ 0.30

See Accompanying Notes to Unaudited Consolidated Financial Statements.

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FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENT OF CHANGES IN
SHAREHOLDERS EQUITY AND COMPREHENSIVE INCOME
(Unaudited)

(Dollars in thousands, except per share amounts)	3% Preferred Stock	8.48% Preferred Stock	Common Stock	Additional Paid-in Capital	Retained Earnings	Accumulated Other Comprehensive Loss	Treasury Stock	Total Shareholders Equity
Balance December 31, 2006	$ 159	$ 17,464	$ 113	$ 24,439	$ 148,730	$ (8,404)	$ (113)	$ 182,388
Purchase 77,595 shares of common stock							(1,625)	(1,625)
Issue 6,500 shares of common stock exercised stock options, net of tax				(2)			139	137
Excess tax benefit from stock options exercised				3				3
Amortization of unvested stock options				114				114
Amortization of unvested restricted stock awards					24			24
Comprehensive income:								
Net income					3,615			3,615
Net unrealized gain on securities available for sale (net of tax of $878)						1,376		1,376
Defined benefit pension plan, net of tax of $4)						7		7
Postretirement benefit plan, net of tax of $(3))						(5)		(5)
Other comprehensive income								1,378
Total comprehensive income								4,993

Cash dividends declared:								
3% Preferred $0.75 per share					(1)			(1)
8.48% Preferred $2.12 per share					(370)			(370)
Common $0.10 per share					(1,133)			(1,133)
Balance March 31, 2007	$ 159	$ 17,464	$ 113	$ 24,554	$ 150,865	$ (7,026)	$ (1,599)	$ 184,530

See Accompanying Notes to Unaudited Consolidated Financial Statements.

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FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS
(Unaudited)

(Dollars in thousands)	Three Months Ended March 31, 2007	2006
Cash flows from operating activities:		
Net income	$ 3,615	$ 3,739
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	971	1,063
Net amortization of premiums and discounts on securities	140	222
Provision for loan losses		250
Amortization of unvested stock options	114	181
Amortization of unvested restricted stock awards	24	
Tax benefit from stock options exercised	3	
Deferred income tax expense	137	404
Proceeds from sale of loans held for sale	11,720	31,537
Originations of loans held for sale	(11,644)	(31,695)
Net gain on sale of loans held for sale	(161)	(226)
Net gain on sale of commercial-related loans held for sale		(82)
Net gain on sale and disposal of other assets	(57)	(98)
Net gain on sale of trust relationships	(13)	
Decrease (increase) in other assets	448	(1,465)
Increase (decrease) in other liabilities	6,338	(808)
Net cash provided by operating activities	11,635	3,022
Cash flows from investing activities:		
Purchase of securities:		
Available for sale	(59,257)	(13,210)
Held to maturity	(6,241)	(5,306)
Proceeds from maturity, call and principal pay-down of securities:		
Available for sale	35,267	26,337
Held to maturity	1,781	4,861
Net loan (increase) decrease	(3,373)	25,932
Net proceeds from sale of commercial-related loans		970
Proceeds from sales of other assets	428	36
Proceeds from sale of trust relationships	13	
Purchase of premises and equipment	(672)	(394)
Net cash (used in) provided by investing activities	(32,054)	39,226
Cash flows from financing activities:		
Net increase (decrease) in deposits	54,067	(39,103)
Net (decrease) increase in short-term borrowings	(7,450)	2,130
Repayment of long-term borrowings	(14)	(3,016)
Purchase of common shares	(1,625)	(211)
Stock options exercised	137	2

Excess tax benefit from stock options exercised	3	
Dividends paid	(1,392)	(1,278)
Net cash provided by (used in) financing activities	43,726	(41,476)
Net increase in cash and cash equivalents	23,307	772
Cash and cash equivalents at the beginning of the period	109,772	91,940
Cash and cash equivalents at the end of the period	$ 133,079	$ 92,712
Supplemental disclosure of cash flow information:		
Cash paid during period for:		
Interest	$ 10,734	$ 10,221
Income taxes paid	1	
Noncash investing and financing activities:		
Real estate and other assets acquired in settlement of loans	$ 470	$ 544

See Accompanying Notes to Unaudited Consolidated Financial Statements.

FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES
NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS
(1) Basis of Presentation

Financial Institutions, Inc. (FII), a bank holding company organized under the laws of New York State, and its subsidiaries (collectively the Company) provide deposit, lending and other financial services to individuals and businesses in Central and Western New York State. The Company is subject to regulation by certain federal and state agencies.

FII s primary subsidiary is its New York State-chartered Five Star Bank (100% owned) (FSB or the Bank). In addition, FII formerly qualified as a financial holding company under the Gramm-Leach-Bliley Act, which allowed the expansion of business operations to include a broker-dealer subsidiary, namely, Five Star Investment Services, Inc. (100% owned) (FSIS) (formerly known as The FI Group, Inc. (FIGI). During 2003, FII terminated its financial holding company status and now operates as a bank holding company. The change in status did not affect the broker-dealer subsidiary or activities being conducted by the Company, although future acquisition or expansion of non-financial activities may require prior Federal Reserve Bank (FRB) approval and will be limited to those that are permissible for bank holding companies.

In February 2001, the Company formed FISI Statutory Trust I (100% owned) (FISI or the Trust) and capitalized the entity with a $502,000 investment in the Trust s common securities. The Trust was formed to facilitate the private placement of $16.2 million in capital securities (trust preferred securities). Effective December 31, 2003, the provisions of Financial Accounting Standards Board (FASB) Interpretation No. 46, Consolidation of Variable Interest Entities, resulted in the deconsolidation of the Trust. The deconsolidation resulted in the derecognition of the $16.2 million in trust preferred securities and the recognition of $16.7 million in junior subordinated debentures and a $502,000 investment in the Trust recorded in other assets in the Company s consolidated statements of financial condition.

In management s opinion, the interim consolidated financial statements reflect all adjustments necessary for a fair presentation. The results of operations for the interim periods are not necessarily indicative of the results of operations to be expected for the full year ended December 31, 2007. The interim consolidated financial statements should be read in conjunction with the Company s 2006 Annual Report on Form 10-K. The consolidated financial information included herein combines the results of operations, the assets, liabilities and shareholders equity of FII and its subsidiaries. All significant inter-company transactions and balances have been eliminated in consolidation. Certain amounts in the prior periods consolidated financial statements are reclassified when necessary to conform to the current period s presentation.

The interim consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America and prevailing practices in the banking industry. In preparing the financial statements, management is required to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities, and the reported revenues and expenses for the period. Actual results could differ from those estimates. A material estimate that is particularly susceptible to near-term change is the allowance for loan losses.

For purposes of the consolidated statements of cash flows, cash and due from banks, federal funds sold, interest-bearing deposits in other banks and commercial paper due in less than 90 days are considered cash and cash equivalents.

(2) Recent Accounting Pronouncements

In February 2006, the Financial Accounting Standards Board (FASB) issued SFAS No. 155, Accounting for Certain Hybrid Financial Instruments. SFAS No. 155 amends SFAS No. 133 and SFAS No. 140, and improves the financial reporting of certain hybrid financial instruments by requiring more consistent accounting that eliminates exemptions and provides a means to simplify the accounting for these instruments. Specifically, SFAS No. 155 allows financial instruments that have embedded derivatives to be accounted for as a whole (eliminating the need to bifurcate the derivative from its host) if the holder elects to account for the whole instrument on a fair value basis. SFAS No. 155 is effective for all financial instruments acquired or issued in fiscal years beginning after September 15, 2006. The Company adopted this statement effective January 1, 2007 and adoption did not have an effect on its consolidated financial position, consolidated results of operations, or liquidity.

In March 2006, the FASB issued SFAS No. 156, Accounting for Servicing of Financial Assets, an amendment of SFAS No. 140, which requires that all separately recognized servicing assets and servicing liabilities be initially

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measured at fair value, if practicable and permits the entities to elect either fair value measurement with changes in fair value reflected in earnings or the amortization and impairment requirements of SFAS No. 140 for subsequent measurement. SFAS No. 156 is effective for fiscal years beginning after September 15, 2006. The Company adopted this statement effective January 1, 2007 and elected to continue using the amortization and impairment requirements of SFAS No. 140 for subsequent measurement of servicing assets, therefore adoption did not have an effect on its consolidated financial position, consolidated results of operations, or liquidity.

In June 2006, the FASB issued FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes an interpretation of FASB Statement No. 109 (FIN 48). FIN 48 prescribes a recognition threshold and measurement attribute for financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return, and also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure, and transition. FIN 48 is effective for fiscal years beginning after December 15, 2006. The Company adopted this statement effective January 1, 2007 and the required disclosures are included in Note 9. The adoption of FIN 48 did not have a material effect on the Company s consolidated financial position, consolidated results of operations, or liquidity.

In September 2006, the FASB issued SFAS No. 157, Fair Value Measurements. SFAS No. 157 defines fair value, establishes a framework for measuring fair value under generally accepted accounting principles, and expands disclosures about fair value measurements. SFAS No. 157 emphasizes that fair value is a market-based measurement, not an entity-specific measurement, and states that a fair value measurement should be determined based on assumptions that market participants would use in pricing the asset or liability. The Company is required to adopt SFAS No. 157 for its fiscal year beginning after November 15, 2007. The Company plans to adopt this statement on January 1, 2008 and is currently assessing the impact that the adoption will have on its consolidated financial position, consolidated results of operations, or liquidity.

In September 2006, the FASB issued SFAS No. 158, Employers Accounting for Defined Benefit Pension and Other Postretirement Plans an amendment of FASB Statements No. 87, 88, 106, and 132(R). SFAS No. 158 requires companies to recognize the over-funded or under-funded status of a defined benefit postretirement plan (other than a multi-employer plan) as an asset or liability in its balance sheet and to recognize changes in that funded status in the year in which the changes occur through comprehensive income. The Company adopted this provision of SFAS No. 158 for the year ended December 31, 2006 and the required disclosures were included in Note 13 of the annual report on Form 10-K as filed on March 13, 2007. SFAS No. 158 also requires companies to measure the funded status of a plan as of the date of the company s fiscal year-end, with limited exceptions. The Company is required and plans to adopt this provision for the fiscal year ending December 31, 2008 and does not expect adoption to have a material effect on its consolidated financial position, consolidated results of operations, or liquidity.

In September 2006, the Emerging Issues Task Force (EITF) reached a final consensus on Issue 06-04, Accounting for Deferred Compensation and Postretirement Benefit Aspects of Endorsement Split Dollar Life Insurance Arrangements. In accordance with the EITF consensus, an agreement by an employer to share a portion of the proceeds of a life insurance policy with an employee during the postretirement period is a postretirement benefit arrangement required to be accounted for in accordance with SFAS No. 106 or Accounting Principles Board Opinion (APB) No. 12, Omnibus Opinion 1967. Furthermore, the purchase of a split dollar life insurance policy does not constitute a settlement under SFAS No. 106 and, therefore, a liability for the postretirement obligation must be recognized under SFAS No. 106 if the benefit is offered under an arrangement that constitutes a plan or under APB No. 12 if it is not part of a plan. The provisions of EITF Issue 06-04 are to be applied through either a cumulative-effect adjustment to retained earnings as of the beginning of the year of adoption or retrospective application. The Company is required to adopt this statement in its fiscal year beginning after December 15, 2007, with early adoption permitted. The Company plans to adopt this statement on January 1, 2008 and is currently assessing the impact that the adoption will have on its consolidated financial position, consolidated results of operations, or liquidity.

In February 2007, the FASB issued SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities, including an amendment of FASB Statement No. 115. SFAS No. 159 allows entities to irrevocably elect fair value as the initial and subsequent measurement attribute for certain financial assets and financial liabilities that are not otherwise required to be measured at fair value, with changes in fair value recognized in earnings as they occur. SFAS No. 159 also requires entities to report those financial assets and financial liabilities measured at fair value in a manner that separates those reported fair values from the carrying amounts of similar assets and liabilities measured using another measurement attribute on the face of the statement of financial condition. Lastly, SFAS No. 159 establishes presentation and disclosure requirements designed to improve comparability between entities that

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elect different measurement attributes for similar assets and liabilities. The Company is required to adopt SFAS No. 159 for its fiscal year beginning after November 15, 2007, with early adoption permitted if an entity also early adopts the provisions of SFAS No. 157. The Company plans to adopt this statement on January 1, 2008 and is currently assessing the impact the adoption will have on its consolidated financial position, consolidated results of operations, or liquidity.

(3) Earnings Per Common Share

Basic earnings per common share, after giving effect to preferred stock dividends, has been computed using weighted average common shares outstanding. Diluted earnings per share reflect the effects, if any, of incremental common shares issuable upon exercise of dilutive stock options.

Earnings per common share have been computed based on the following:

	Three Months Ended March 31,	
(Dollars and shares in thousands, except per share amounts)	2007	2006
Net income	$ 3,615	$ 3,739
Less: Preferred stock dividends	371	372
Net income available to common shareholders	$ 3,244	$ 3,367
Weighted average number of common shares outstanding used to calculate basic earnings per common share	11,317	11,328
Add: Effect of common stock equivalents	43	44
Weighted average number of common shares used to calculate diluted earnings per common share	11,360	11,372
Earnings per common share:		
Basic	$ 0.29	$ 0.30
Diluted	$ 0.29	$ 0.30

There were approximately 270,132 and 284,000 weighted average common stock equivalents from outstanding stock options for the three months ended March 31, 2007 and 2006, respectively, that were not considered in the calculation of diluted earnings per share since their effect would have been anti-dilutive.

(4) Stock Compensation Plans

The Company has a Management Stock Incentive Plan and a Director s Stock Incentive Plan (the Plans). Under the Plans, the Company may grant stock options to purchase shares of common stock, shares of restricted stock or stock appreciation rights to its directors and key employees. Grants under the Plans may be made up to 10% of the number of shares of common stock issued, including treasury shares. The exercise price of each option equals the market price of the Company s stock on the date of the grant. The maximum term of each option is ten years and the vesting period generally ranges between three and five years. There were no stock options or restricted stock awards granted during the three months ended March 31, 2007.

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Effective January 1, 2006, the Company adopted Statement of Financial Accounting Standards (SFAS) No. 123(R), Share-Based Payments , requiring the Company to recognize expense related to the fair value of the stock-based compensation awards. The following table presents the expense associated with the amortization of unvested stock compensation included in the consolidated statements of income (unaudited) for the periods indicated.

	Three Months Ended March 31,	
(Dollars in thousands)	2007	2006
Stock options:		
Management Stock Incentive Plan (1)	$ 93	$ 143
Director Stock Incentive Plan (2)	21	38
Total amortization of unvested stock options	114	181
Restricted stock awards:		
Management Stock Incentive Plan (1)	24	
Total amortization of unvested restricted stock awards	24	
Total amortization of unvested restricted stock compensation	$ 138	$ 181

(1) Included in salaries and employee benefits in the consolidated statements of income (unaudited).

(2) Included in other noninterest expense in the consolidated statements of income (unaudited).

(5) Loans

Loans outstanding, including net unearned income and net deferred fees and costs of $4.5 million at March 31, 2007 and December 31, 2006, are summarized as follows:

(Dollars in thousands)	March 31, 2007	December 31, 2006
Commercial	$ 115,211	$ 105,806
Commercial real estate	249,179	243,966

Agricultural	54,273	56,808
Residential real estate	162,846	163,243
Consumer indirect	107,729	106,391
Consumer direct and home equity	240,012	250,268
Total loans	929,250	926,482
Allowance for loan losses	(16,914)	(17,048)
Loans, net	$ 912,336	$ 909,434

The Company has reclassified its residential real estate and consumer loan portfolios for all periods presented to more consistently reflect management of the loan portfolio. Consumer indirect loans, primarily automobile loans, are shown on a separate line from the consumer direct and home equity category. Consumer indirect loans totaled $107.7 million and $106.4 million at March 31, 2007 and December 31, 2006, respectively. Closed-end home equity loans, formerly included in the residential real estate category, are presented in the consumer direct and home equity category. Closed-end home equity loans totaled $103.5 million and $105.2 million at March 31, 2007 and December 31, 2006, respectively.

The Company s significant concentrations of credit risk in the loan portfolio relates to a geographic concentration in the communities that the Company serves.

(6) Retirement and Postretirement Benefit Plans

The Company adopted SFAS No. 158 effective December 31, 2006, which required the over-funded or under-funded status of its defined benefit pension and postretirement benefit plans to be recognized as an asset or liability in the consolidated statements of financial condition. Future changes in the funded status of the defined benefit and postretirement plans will be recognized in the year in which the changes occur on a net of tax basis through comprehensive income or loss.

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Defined Benefit Pension Plan

The Company participates in The New York State Bankers Retirement System, which is a defined benefit pension plan covering substantially all employees. The benefits are based on years of service and the employee s highest average compensation during five consecutive years of employment.

The defined benefit plan was closed to new participants effective December 31, 2006. Only employees hired on or before December 31, 2006 and who meet participation requirements on or before January 1, 2008 shall be eligible to receive benefits.

Net periodic pension cost consists of the following components:

	Three Months Ended March 31,	
(Dollars in thousands)	2007	2006
Service cost	$ 375	$ 431
Interest cost on projected benefit obligation	368	335
Expected return on plan assets	(477)	(466)
Amortization of net transition asset		(7)
Amortization of unrecognized loss	8	56
Amortization of unrecognized prior service cost	3	4
Net periodic pension cost	$ 277	$ 353

The Company s funding policy is to contribute, at a minimum, an actuarially determined amount that will satisfy the minimum funding requirements determined under the appropriate sections of Internal Revenue Code. The minimum required contribution is zero for the year ended December 31, 2007, however the Company is considering making a discretionary contribution to the pension plan during 2007.

Postretirement Benefit Plan

Prior to December 31, 2001, an entity acquired by the Company provided health and dental care benefits to certain retired employees who met specified age and service requirements through a postretirement health and dental care plan in which both the acquired entity and the retiree shared the cost. The plan was amended in 2001 to curtail eligible benefit payments to only retired employees and active participants who were fully vested under the plan.

(7) Commitments and Contingencies

In the normal course of business there are outstanding commitments to extend credit not reflected in the accompanying consolidated financial statements. These commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. The Company uses the same credit policy to make such commitments as it uses for on-balance-sheet items. Unused lines of credit and loan commitments totaling $246.4 million and $258.6 million were contractually available at March 31, 2007 and December 31, 2006, respectively, and are not reflected in the consolidated statements of financial condition (unaudited). Since commitments to extend credit and unused lines of credit may expire without being fully drawn upon, the amount does not necessarily represent future cash commitments.

The Company guarantees the obligations or performance of customers by issuing stand-by letters of credit to third parties. The risk involved in issuing stand-by letters of credit is essentially the same as the credit risk involved in extending loan facilities to customers, and they are subject to the same credit origination, portfolio maintenance and management procedures in effect to monitor other credit and off-balance-sheet products. Typically, these instruments have terms of five years or less and expire unused; therefore, the amount does not necessarily represent future cash requirements. Stand-by letters of credit totaled $5.6 million and $5.8 million at March 31, 2007 and December 31, 2006, respectively. As of March 31, 2007, the fair value of the stand-by letters of credit was not material to the Company s consolidated financial statements.

From time to time the Company is a party to or otherwise involved in legal proceedings arising in the normal course of business. Management does not believe that there is any pending or threatened proceeding against the Company, which, if determined adversely, would have a material adverse effect on the Company s business, results of operations or financial condition.

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(8) Supervision and Regulation

The supervision and regulation of financial and bank holding companies and their subsidiaries is intended primarily for the protection of depositors, the deposit insurance funds regulated by the FDIC and the banking system as a whole, and not for the protection of shareholders or creditors of bank holding companies. The various bank regulatory agencies have broad enforcement power over bank holding companies and banks, including the power to impose substantial fines, operational restrictions and other penalties for violations of laws and regulations. In addition, payments of dividends by FSB to FII are limited or restricted in certain circumstances under banking regulations.

The Company is also subject to varying regulatory capital requirements administered by the federal banking agencies. Failure to meet minimum capital requirements can initiate certain mandatory, and possibly additional discretionary, actions by regulators that, if undertaken, could have a direct material impact on the Company s consolidated financial statements.

For evaluating regulatory capital adequacy, companies are required to determine capital and assets under regulatory accounting practices. Quantitative measures established by regulation to ensure capital adequacy require the Company to maintain minimum amounts and ratios. The leverage ratio requirement is based on period-end capital to average adjusted total assets during the previous three months. Compliance with risk-based capital requirements is determined by dividing regulatory capital by the sum of a company s weighted asset values. Risk weightings are established by the regulators for each asset category according to the perceived degree of risk. As of March 31, 2007 and December 31, 2006, the Company and FSB met all capital adequacy requirements to which they are subject.

(9) Income Taxes

The Company adopted the provisions of FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes (FIN 48) effective January 1, 2007. There was no cumulative effect adjustment related to the adoption of FIN 48. As of January 1, 2007, the Company s unrecognized tax benefits totaled $50,000, of which $32,000 would impact the Company s effective tax rate, if recognized or reversed. The Company is currently under examination by New York State and expects to conclude the examination during 2007 at which point the uncertain tax position would be settled. The tax years that remain subject to examination by major tax jurisdictions are as follows:

Federal	2003 - 2005
New York	2002 - 2005

The Company accounts for interest and penalties related to uncertain tax positions as part of its provision for federal and state income taxes. As of January 1, 2007, the Company had accrued $17,000 of interest related to uncertain tax positions. As of March 31, 2007, the total amount of accrued interest was $19,000.

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

FORWARD-LOOKING STATEMENTS

This report contains certain forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended (the Securities Act), and Section 21E of the Securities Exchange Act of 1934, as amended (the Exchange Act), that involve substantial risks and uncertainties. When used in this report, or in the documents incorporated by reference herein, the words anticipate , believe , estimate , expect , intend , may , project , pl similar expressions identify such forward-looking statements. Actual results, performance or achievements could differ materially from those contemplated, expressed or implied by the forward-looking statements contained herein. There are a number of important factors that could affect the Company s forward-looking statements which include the quality of collateral associated with nonperforming loans, the ability of customers to continue to make payments on criticized or substandard loans, the impact of rising interest rates on customer cash flows, the speed or cost of resolving bad loans, the ability to hire and train personnel, the economic conditions in the area in which the Company operates, customer preferences, competition and other factors discussed in the Company s filings with the Securities and Exchange Commission. Many of these factors are beyond the Company s control.

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GENERAL

The principal objective of this discussion is to provide an overview of the financial condition and results of operations of the Company for the periods covered in this quarterly report. This discussion and tabular presentations should be read in conjunction with the accompanying consolidated financial statements and accompanying notes.

The Company s revenues are dependent primarily on net interest income, which is the difference between the income earned on loans and securities and the interest paid on deposits and borrowings. Revenues are also affected by service charges on deposits, ATM and debit card income, broker-dealer fees and commissions, mortgage banking income, gain or loss on the sale of securities, gain or loss on sale of loans held for sale, gain or loss on the sale and disposal of other assets and other miscellaneous noninterest income.

The Company s expenses primarily consist of the provision (credit) for loan losses, salaries and employee benefits, occupancy and equipment, supplies and postage, amortization of other intangible assets, computer and data processing, professional fees and services, other miscellaneous noninterest expense and income tax expense (benefit). Results of operations are also affected by the general economic and competitive conditions, particularly changes in interest rates, government policies and the actions of regulatory authorities.

OVERVIEW

Net income for the quarter was $3.6 million, or $0.29 per diluted share, compared with $3.7 million, or $0.30 per diluted share, for the first quarter of 2006. The decline in net income was primarily the result of a decline in net interest income, which was $14.0 million for the first quarter of 2007, down $1.5 million from $15.5 million in the first quarter of 2006. Net interest margin declined 26 basis points, to 3.38%, for the first quarter of 2007 compared with the same period last year. The flat-to-inverted interest rate yield curve, which prevailed throughout much of 2006 and continues in 2007, negatively affected net interest margin and net interest income, as did changes in the mix of deposits that increased cost of funds.

The decline in net interest income was partially offset by a reduction of $1.4 million, or 9%, in noninterest expense in the first quarter of 2007 to $13.9 million compared with $15.3 million for the first quarter of 2006. The lower expense levels reflect operational efficiencies gained from the consolidation of administrative and operational functions, improved asset quality and lower advertising costs.

The Company also experienced an increase of $2.8 million in loans to $929.3 million at March 31, 2007 compared to $926.5 million at December 31, 2006. Commercial loans increased $12.1 million over December 31, 2006, as our commercial business development programs over the past year delivered results during the first quarter of 2007.

Asset quality continued to improve, as the Company s provision for loan losses for the first quarter of 2007 was zero, compared with $250,000 for the first quarter of 2006. Net loan charge-offs of $134,000 for the first quarter represented 6 basis points of average loans (annualized) and compared with $190,000 and 8 basis points for the first quarter of 2006. Nonperforming assets totaled $17.0 million at March 31, 2007, unchanged from December 31, 2006, but the overall level of criticized and classified loans declined $3.8 million during the first quarter of 2007. The allowance for loan losses was $16.9 million at March 31, 2007 or 1.82% of loans, comparable to $17.0 million and 1.84% at December 31, 2006.

CRITICAL ACCOUNTING POLICIES

The Company s consolidated financial statements are prepared in accordance with accounting principles generally accepted in the United States of America and are consistent with predominant practices in the financial services industry. Application of critical accounting policies, which are those policies that management believes are the most important to the Company s financial position and results, requires management to make estimates, assumptions, and judgments that affect the amounts reported in the consolidated financial statements and accompanying notes and are based on information available as of the date of the financial statements. Future changes in information may affect these estimates, assumptions and judgments, which, in turn, may affect amounts reported in the financial statements.

The Company has numerous accounting policies, of which the most significant are presented in Note 1 of the notes to consolidated financial statements included in the Company s Annual Report on Form 10-K as of December 31, 2006, dated March 13, 2007, as filed with the Securities and Exchange Commission. These policies, along with the disclosures presented in the other financial statement notes and in this discussion, provide information on how

significant assets, liabilities, revenues and expenses are reported in the consolidated financial statements and how those reported amounts are determined. Based on the sensitivity of financial statement amounts to the methods, assumptions, and estimates underlying those amounts, management has determined that the accounting policies with respect to the allowance for loan losses, goodwill and defined benefit pension plan require particularly subjective or complex judgments important to the Company s consolidated financial statements, results of operations, and, as such, are considered to be critical accounting policies as discussed below.

Allowance for Loan Losses: The allowance for loan losses represents management s estimate of probable credit losses inherent in the loan portfolio. Determining the amount of the allowance for loan losses is considered a critical accounting estimate because it requires significant judgment and the use of subjective measurements including management s assessment of the internal risk classifications of loans, changes in the nature of the loan portfolio, industry concentrations and the impact of current local, regional and national economic factors on the quality of the loan portfolio. Changes in these estimates and assumptions are reasonably possible and may have a material impact on the Company s consolidated financial statements, results of operations or liquidity.

A loan is considered impaired when, based on current information and events, it is probable that a creditor will be unable to collect all amounts of principal and interest under the original terms of the agreement or the loan is restructured in a troubled debt restructuring. Accordingly, the Company evaluates impaired commercial and agricultural loans individually based on the present value of future cash flows discounted at the loan s effective interest rate, or at the loan s observable market price or the net realizable value of the collateral if the loan is collateral dependent. The majority of the Company s loans are secured.

Loans, including impaired loans, are generally classified as nonaccruing if they are past due as to maturity or payment of principal or interest for a period of more than 90 days (120 days for consumer loans), unless such loans are well-collateralized and in the process of collection. Loans that are on a current payment status or past due less than 90 days may also be classified as nonaccrual if repayment in full of principal and/or interest is uncertain.

For additional discussion related to the Company s accounting policies for the allowance for loan losses, see the section titled Analysis of the Allowance for Loan Losses.

Goodwill: Statement of Financial Accounting Standards (SFAS) No. 142, Goodwill and Other Intangible Assets prescribes the accounting for goodwill and intangible assets subsequent to initial recognition. The provisions of SFAS No. 142 discontinue the amortization of goodwill and intangible assets with indefinite lives. Instead, these assets are subject to at least an annual impairment review, and more frequently if certain impairment indicators are in evidence. Changes in the estimates and assumptions are reasonably possible and may have a material impact on the Company s consolidated financial statements, results of operations or liquidity. During the fourth quarter of 2006, the Company evaluated goodwill for impairment using a discounted cash flow analysis and determined no impairment existed. There were no material events or transactions that occurred subsequent to that evaluation that indicates any impairment at the current period end.

Defined Benefit Pension Plan: Management is required to make various assumptions in valuing its defined benefit pension plan assets and liabilities. These assumptions include, but are not limited to, the expected long-term rate of return on plan assets, the weighted average discount rate used to value certain liabilities and the rate of compensation increase. The Company uses a third-party specialist to assist in making these estimates and assumptions. Changes in these estimates and assumptions are reasonably possible and may have a material impact on the Company s consolidated financial statements, results of operations or liquidity.

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SELECTED FINANCIAL DATA

The following tables present certain information and ratios that management of the Company considers important in evaluating performance:

	At or For the Three Months Ended March 31,	
(Dollars in thousands, except per share amounts)	2007	2006
Per common share data:		
Net income basic	$ 0.29	$ 0.30
Net income diluted	$ 0.29	$ 0.30
Cash dividends declared	$ 0.10	$ 0.08
Book value	$ 14.81	$ 13.55
Tangible book value	$ 11.42	$ 10.14
Common shares outstanding:		
Weighted average shares basic	11,316,811	11,328,404
Weighted average shares diluted	11,360,202	11,372,253
Period end	11,271,676	11,320,000
Performance ratios (annualized) and data:		
Return on average assets	0.77%	0.77%
Return on average common equity	7.96%	8.82%
Return on average tangible common equity	10.35%	11.75%
Common dividend payout ratio	34.48%	26.67%
Net interest margin (tax-equivalent)	3.38%	3.64%
Efficiency ratio (1)	69.53%	69.99%
Full-time equivalent employees	634	661
Asset quality data:		
Loans past due 90 days or more	$ 7	$ 35
Nonaccrual loans	15,778	18,561
Total nonperforming loans	15,785	18,596
Other real estate owned (ORE) and repossessed assets (repos)	1,216	879
Total nonperforming assets	$ 17,001	$ 19,475
Gross loan charge-offs	$ 692	$ 1,304
Net loan charge-offs	$ 134	$ 190
Allowance for loan losses	$ 16,914	$ 20,291
Asset quality ratios:		
Nonperforming loans to total loans	1.70%	1.93%
Nonperforming assets to total loans, ORE and repos	1.83%	2.02%
Nonperforming assets to total assets	0.87%	0.98%
Allowance for loan losses to total loans	1.82%	2.10%
Allowance for loan losses to nonperforming loans	107%	109%
Net loan charge-offs to average loans (annualized)	0.06%	0.08%
Capital ratios:		
Period-end common equity to total assets	8.50%	7.74%
Period-end tangible common equity to total tangible assets	6.69%	5.91%
Leverage ratio	8.99%	8.11%
Tier 1 risk-based capital ratio	15.58%	14.07%
Total risk-based capital ratio	16.83%	15.32%

(1) The efficiency ratio represents noninterest expense less other real estate expense and amortization of intangibles divided by net interest income (tax-equivalent) plus other noninterest income less gain on sale of trust relationships and net gain on sale of commercial-related loans held for sale calculated using the following detail:

Noninterest expense	$	13,928	$	15,275
Less: Other real estate expense		88		71
Amortization of other intangible assets		77		108
Net expense (numerator)	$	13,763	$	15,096
Net interest income	$	13,956	$	15,479
Plus: Tax-equivalent adjustment		1,114		1,217
Net interest income (tax-equivalent)		15,070		16,696
Plus: Noninterest income		4,738		4,956
Less: Net gain on sale of commercial-related loans held for sale				82
Less: Net gain on sale of trust relationships		13		
Net revenue (denominator)	$	19,795	$	21,570

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NET INCOME ANALYSIS

Average Balance Sheets

The following table presents the average annualized yields and rates on interest-earning assets and interest-bearing liabilities on a fully tax-equivalent basis for the periods indicated. All average balances are average daily balances.

	For the Three Months Ended March 31,					
	2007			2006		
(Dollars in thousands)	Average Outstanding Balance	Interest Earned/ Paid	Annualized Yield/ Rate	Average Outstanding Balance	Interest Earned/ Paid	Annualized Yield/ Rate
Interest-earning assets:						
Federal funds sold and interest-bearing deposits	$ 57,405	$ 752	5.32%	$ 16,400	$ 185	4.59%
Commercial paper due in less than 90 days			%	9,276	106	4.63%
Investment securities (1):						
Taxable	570,139	6,264	4.40%	578,268	6,092	4.21%
Non-taxable	239,855	3,277	5.46%	262,537	3,477	5.30%
Total investment securities	809,994	9,541	4.71%	840,805	9,569	4.55%
Loans held for sale	400	8	8.47%	657	12	7.45%
Loans (2):						
Commercial and agricultural	409,290	7,785	7.71%	446,049	8,104	7.37%
Residential real estate	163,046	2,643	6.48%	166,288	2,675	6.43%
Consumer indirect	105,856	1,755	6.72%	85,692	1,256	5.94%
Consumer direct and home equity	243,435	4,436	7.39%	277,537	4,585	6.70%
Total loans	921,627	16,619	7.30%	975,566	16,620	6.89%
Total interest-earning assets	1,789,426	$ 26,920	6.06%	1,842,704	$ 26,492	5.79%
Allowance for loans losses	(17,159)			(20,528)		
Other noninterest-earning assets (3)	142,326			155,657		
Total assets	$ 1,914,593			$ 1,977,833		
Interest-bearing liabilities:						
Savings and money market	$ 334,455	$ 1,370	1.66%	$ 349,492	$ 927	1.08%
Interest-bearing demand	355,785	1,593	1.82%	397,066	1,560	1.59%
Certificates of deposit	683,361	7,800	4.63%	667,273	5,734	3.48%
Short-term borrowings	29,052	169	2.36%	21,778	112	2.08%
Long-term borrowings	38,177	486	5.17%	76,614	1,031	5.46%
Junior subordinated debentures and trust preferred securities	16,702	432	10.35%	16,702	432	10.35%

Total interest-bearing liabilities	1,457,532	11,850	3.30%	1,528,925	9,796	2.60%
Noninterest-bearing demand deposits	254,274			259,050		
Other noninterest-bearing liabilities	19,834			17,335		
Total liabilities	1,731,640			1,805,310		
Shareholders equity (3)	182,953			172,523		
Total liabilities and shareholders equity	$ 1,914,593			$ 1,977,833		
Net interest income tax-equivalent		15,070			16,696	
Less: tax equivalent adjustment		1,114			1,217	
Net interest income		$ 13,956			$ 15,479	
Net interest rate spread			2.76%			3.19%
Net earning assets	$ 331,894			$ 313,779		
Net interest income as a percentage of average interest-earning assets (net interest margin)			3.38%			3.64%
Ratio of average interest-earning assets to average interest-bearing liabilities			122.77%			120.52%

(1) Amounts shown are amortized cost for both held to maturity and available for sale securities. In order to make resultant yields

on non-taxable securities comparable to taxable securities and loans, the non-taxable interest earned is presented on a tax-equivalent basis.

(2) Includes net unearned income and net deferred loan fees and costs. Nonaccruing loans are included in the average loan totals and payments on nonaccruing loans have been recognized as disclosed in Note 1 of the notes to consolidated financial statements.

(3) Includes unrealized losses on securities available for sale, net of related taxes.

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Net Interest Income

For the three months ended March 31, 2007, net interest income was $14.0 million, down $1.5 million in comparison with $15.5 million for the same period last year. Net interest margin was 3.38% for the three months ended March 31, 2007, a 26 basis point decline from 3.64% for the same period last year. The yield on interest-earning assets increased 27 basis points, to 6.06%, for the quarter ended March 31, 2007, compared to the same quarter a year ago. The Company s cost of funds increased 53 basis points, to 2.68%, for the first quarter of 2007, versus the same quarter last year. The Company s funding sources are more heavily influenced by the short-end of the interest rate yield curve, so the flat-to-inverted yield curve has led to a more rapid increase in the cost of funds versus the yield on interest-earning assets. In addition, the cost of funds was adversely impacted by a change in the mix of funding sources as customers shifted deposits to higher cost certificates of deposit from lower cost interest-bearing demand, savings and money market accounts. Average earning assets were $1.789 billion for the first quarter of 2007, down 3% from $1.843 billion for the first quarter of 2006. The reduction in average earning assets reflects lower deposit levels as a result of managing overall liquidity needs consistent with spread opportunities and the overall cost of funding.

Rate/Volume Analysis

The following table presents the extent to which changes in interest rates and changes in the volume of interest-earning assets and interest-bearing liabilities have affected the Company s interest income and interest expense during the periods indicated. Information is provided in each category with respect to: (i) changes attributable to changes in volume (changes in volume multiplied by current year rate); (ii) changes attributable to changes in rate (changes in rate multiplied by prior volume); and (iii) the net change. The changes attributable to the combined impact of volume and rate have been allocated proportionately to the changes due to volume and the changes due to rate.

	Three Months ended March 31, 2007 vs. 2006		
	Increase/(Decrease) Due To		Total Increase/
(Dollars in thousands)	Volume	Rate	(Decrease)
Interest-earning assets:			
Federal funds sold and interest-bearing deposits	$ 537	$ 30	$ 567
Commercial paper due in less than 90 days	(106)		(106)
Investment securities (1):			
Taxable	(82)	254	172
Non-taxable	(302)	102	(200)
Total investment securities	(384)	356	(28)