

Edgar Filing: COMMUNITY BANK SYSTEM INC - Form 10-K/A

COMMUNITY BANK SYSTEM INC
Form 10-K/A
May 13, 2005

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

FORM 10-K/A (Amendment #1)

FOR ANNUAL AND TRANSITIONAL REPORTS PURSUANT TO SECTION 13 OR 15(D) OF THE
SECURITIES EXCHANGE ACT OF 1934

For the fiscal year ended December 31, 2004

Commission file number 001-13695

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

New York Stock Exchange
(Name of Each Exchange on Which Registered)

Delaware
(State or other jurisdiction
of incorporation)

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

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

13214-1883
(Zip Code)

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

Securities registered pursuant to Section 12(b) of the Act:
Common Stock, \$1.00 Par Value
Securities registered pursuant to Section 12(g) of the Act: None

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

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

Indicate by check mark whether the registrant is an accelerated filer (as
defined in Rule 12b-2 of the Act). Yes No .

The aggregate market value of the voting stock held by non-affiliates of the
registrant on June 30, 2004 determined using the closing price per share on that
date of \$22.79, as reported on the New York Stock Exchange was approximately
\$636,000,000.

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

30,312,681 shares of Common Stock, \$1.00 par value, were outstanding on

Edgar Filing: COMMUNITY BANK SYSTEM INC - Form 10-K/A

March 9, 2005.

DOCUMENTS INCORPORATED BY REFERENCE.

List hereunder the following documents if incorporated by reference and the Part of the Form 10-K into which the document is incorporated: (1) any annual report to security holders; (2) any proxy or information statement; and (3) any prospectus filed pursuant to Rule 424(b) or (c) under the Securities Act of 1933.

Portions of Definitive Proxy Statement for Annual Meeting of Shareholders to be held on May 11, 2005 (the "Proxy Statement") is incorporated by reference in Part III of this Annual Report on Form 10-K.

Exhibit Index is located on page 35 of 38

EXPLANATORY NOTE:

This Amendment No. 1 to the Annual Report on Form 10-K of Community Bank System, Inc. for the year ended December 31, 2004 (the "Original Form 10-K"), is being filed for the sole purpose of amending the date of the Management's Report on Internal Control Over Financial Reporting from March 14, 2005 to March 11, 2005.

In accordance with Rule 12b-15 under the Securities and Exchange Act of 1934, as amended (the "Exchange Act"), the complete text of Item 8 (Financial Statements and Supplementary Data) of the Original Form 10-K, which Item contained the Management's Report on Internal Control Over Financial Reporting, has been restated in its entirety in this Amendment No. 1. Under Rule 12b-15, Community Bank System, Inc. must also file updated certifications pursuant to Rule 13a-15(e)/15d-15(e) under the Exchange Act and 18 U.S.C. Section 1350 in connection with this Amendment No. 1. The inclusion of these certifications and the updated consent of PricewaterhouseCoopers LLP as exhibits to this Amendment No. 1 also required the restatement of Item 15 (Exhibits, Financial Statement Schedules and Reports on Form 8-K) of the Original Form 10-K.

The remainder of the Original Form 10-K is unchanged and is not reproduced in this Amendment No. 1. This Amendment No. 1 speaks as of the filing date of the Original Form 10-K and reflects only the changes discussed above. No other information included in the Original Form 10-K has been modified or updated in any way.

2

Item 8. Financial Statements and Supplementary Data

The following consolidated financial statements and independent auditor's reports of Community Bank System, Inc. are contained in this item.

- o Consolidated Statements of Condition,
December 31, 2004 and 2003
- o Consolidated Statements of Income,
Years ended December 31, 2004, 2003, and 2002
- o Consolidated Statements of Changes in Shareholders' Equity,
Years ended December 31, 2004, 2003, and 2002
- o Consolidated Statements of Comprehensive Income,

Edgar Filing: COMMUNITY BANK SYSTEM INC - Form 10-K/A

Years ended December 31, 2004, 2003, and 2002

- o Consolidated Statements of Cash Flows,
Years ended December 31, 2004, 2003, and 2002
- o Notes to Consolidated Financial Statements,
December 31, 2004
- o Management's Report on Internal Control over Financial Reporting
- o Report of Independent Registered Public Accounting Firm
- o Quarterly Selected Data (Unaudited) for 2004 and 2003

3

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

	December 2004
<hr style="border-top: 1px dashed black;"/>	
Cash and due from banks	\$118,
Available-for-sale investment securities	1,446,
Held-to-maturity investment securities	137,
<hr style="border-top: 1px dashed black;"/>	
Total investment securities (fair value of \$1,582,873 and \$1,327,120, respectively)	1,584,
Loans	2,358,
Allowance for loan losses	31,
<hr style="border-top: 1px dashed black;"/>	
Net loans	2,326,
Core deposit intangibles, net	35,
Goodwill	195,
Other intangibles, net	1,
<hr style="border-top: 1px dashed black;"/>	
Intangible assets, net	232,
Premises and equipment, net	63,
Accrued interest receivable	27,
Other assets	40,
<hr style="border-top: 1px dashed black;"/>	
Total assets	\$4,393,
<hr style="border-top: 3px double black;"/>	
Liabilities:	
Non-interest bearing deposits	\$567,
Interest bearing deposits	2,361,
<hr style="border-top: 1px dashed black;"/>	
Total deposits	2,928,
Federal funds purchased	13,
Borrowings	826,
Subordinated debt held by unconsolidated subsidiary trusts	80,
Accrued interest and other liabilities	69,

Edgar Filing: COMMUNITY BANK SYSTEM INC - Form 10-K/A

Total liabilities	3,919,
Commitments and contingencies (See Note N)	
Shareholders' equity:	
Preferred stock \$1.00 par value, 500,000 shares authorized, 0 shares issued	
Common stock, \$1.00 par value, 50,000,000 shares authorized; 32,041,591 and 28,746,612 shares issued in 2004 and 2003, respectively	32,
Additional paid-in capital	190,
Retained earnings	248,
Accumulated other comprehensive income	34,
Treasury stock, at cost (1,400,000 and 416,300 shares, respectively)	(30,
Employee stock plan - unearned	(
Total shareholders' equity	474,
Total liabilities and shareholders' equity	\$4,393,

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

4

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

	Years Ended Dec	
	2004	2003
Interest income:		
Interest and fees on loans	\$137,077	\$125,256
Interest and dividends on taxable investments	52,744	47,047
Interest and dividends on non-taxable investments	22,974	18,826
Total interest income	212,795	191,129
Interest expense:		
Interest on deposits	34,587	38,288
Interest on short-term borrowings	7,242	2,685
Interest on subordinated debt held by unconsolidated subsidiary trusts	5,750	5,632
Interest on long-term borrowings	14,173	12,696
Total interest expense	61,752	59,301
Net interest income	151,043	131,828
Less: provision for loan losses	8,750	11,195
Net interest income after provision for loan losses	142,293	120,633

Edgar Filing: COMMUNITY BANK SYSTEM INC - Form 10-K/A

Non-interest income:		
Deposit service fees	25,201	23,121
Other banking services	2,431	1,906
Trust, investment and asset management fees	7,443	6,682
Benefit plan administration, consulting and actuarial fees	9,298	6,220
Gain (loss) on investment securities & debt extinguishments	72	(2,698)

Total non-interest income	44,445	35,231

Operating expenses:		
Salaries and employee benefits	61,146	53,164
Occupancy	10,177	9,297
Equipment and furniture	8,636	7,828
Amortization of intangible assets	7,414	5,093
Legal and professional fees	4,578	3,183
Data processing	7,737	6,800
Office supplies	2,232	1,996
Acquisition expenses	1,704	498
Other	16,275	14,852

Total operating expenses	119,899	102,711

Income before income taxes	66,839	53,153
Income taxes	16,643	12,773

Net income	\$50,196	\$40,380
=====		
Basic earnings per share	\$1.68	\$1.54
Diluted earnings per share	\$1.64	\$1.49
Dividends declared per share	\$0.68	\$0.61

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

5

COMMUNITY BANK SYSTEM, INC.
CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY
Years ended December 31, 2002, 2003 and 2004
(In Thousands, Except Share Data)

	Common Stock		Additional Paid-In Capital	Retained Earnings	Accumulated Other Comprehensive Income
	Shares Outstanding	Amount Issued			
Balance at December 31, 2001, as previously reported	12,902,812	\$12,903	\$77,710	\$170,472	\$7,281
Two-for-one stock split	12,902,812	12,904	(12,904)		

Balance at December 31, 2001, as restated	25,805,624	25,807	64,806	170,472	7,281

Edgar Filing: COMMUNITY BANK SYSTEM INC - Form 10-K/A

Net income				38,517	
Other comprehensive income, net of tax					31,270
Dividends declared:					
Common, \$0.56 per share				(14,506)	
Common stock issued under employee stock plan, including tax benefits of \$219	151,484	151	1,273		

Balance at December 31, 2002	25,957,108	\$25,958	\$66,079	\$194,483	\$38,551
Net income				40,380	
Other comprehensive loss, net of tax					(2,593)
Dividends declared:					
Common, \$0.61 per share				(16,235)	
Common stock issued under employee stock plan, including tax benefits of \$1,410	495,322	495	5,913		
Stock issued for acquisition	2,294,182	2,294	58,074		
Treasury stock purchased	(416,300)				

Balance at December 31, 2003	28,330,312	\$28,747	\$130,066	\$218,628	\$35,958
Net income				50,196	
Other comprehensive loss, net of tax					(1,758)
Dividends declared:					
Common, \$0.68 per share				(20,529)	
Common stock issued under employee stock plan, including tax benefits of \$3,165	702,766	703	8,576		
Stock and options issued for acquisition	2,592,213	2,592	52,127		
Treasury stock purchased	(983,700)				

Balance at December 31, 2004	30,641,591	\$32,042	\$190,769	\$248,295	\$34,200
=====					

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

6

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

	Years Ended Dec	
	2004	2003

Other comprehensive (loss) income, before tax:		
Change in minimum pension liability adjustment	\$0	\$92
Unrealized (losses) gains on securities:		
Unrealized holding (losses) gains arising during period	(3,031)	(5,727)
Reclassification adjustment for (gains) losses included in net income	(72)	54

Edgar Filing: COMMUNITY BANK SYSTEM INC - Form 10-K/A

Other comprehensive (loss) income, before tax	(3,103)	(5,581)
Income tax benefit (expense) related to other comprehensive (loss) income	1,345	2,988

Other comprehensive (loss) income, net of tax	(1,758)	(2,593)
Net income	50,196	40,380

Comprehensive income	\$48,438	\$37,787
=====		

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

7

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

Operating activities:

Net income
Adjustments to reconcile net income to net cash provided by operating activities
 Depreciation
 Amortization of intangible assets
 Net amortization of premiums and discounts on securities and loans
 Amortization of unearned compensation and discount on subordinated debt
 Provision for loan losses
 Provision for deferred taxes
 (Gain) loss on investment securities and debt extinguishments
 Loss (gain) on loans and other assets
 Proceeds from the sale of loans held for sale
 Origination of loans held for sale
 Change in other operating assets and liabilities

Net cash provided by operating activities

Investing activities:

Proceeds from sales of available-for-sale investment securities
Proceeds from maturities of held-to-maturity investment securities
Proceeds from maturities of available-for-sale investment securities
Purchases of held-to-maturity investment securities
Purchases of available-for-sale investment securities
Net increase in loans outstanding
Cash received (paid) for acquisition, net of cash (paid) acquired of (\$7,023), \$23,986, \$0
Capital expenditures

Net cash used by investing activities

Financing activities:

Net change in demand deposits, NOW accounts, and savings accounts
Net change in time deposits
Net change in federal funds purchased
Net change in short-term borrowings

Edgar Filing: COMMUNITY BANK SYSTEM INC - Form 10-K/A

Change in long-term borrowings (net of payments of \$177, \$30,000 and \$252,000)
Issuance of common stock
Purchase of treasury stock
Cash dividends paid
Other financing activities

Net cash provided by financing activities

Change in cash and cash equivalents
Cash and cash equivalents at beginning of year

Cash and cash equivalents at end of year
=====

Supplemental disclosures of cash flow information:

Cash paid for interest
Cash paid for income taxes

Supplemental disclosures of non-cash financing and investing activities:

Dividends declared and unpaid
Gross change in unrealized gains on available-for-sale investment securities

Acquisitions:

Fair value of assets acquired, excluding acquired cash and intangibles
Fair value of liabilities assumed
Common stock and options issued

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

8

COMMUNITY BANK SYSTEM, INC.

NOTE A: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Nature of Operations

Community Bank System, Inc. is a single bank holding company which wholly-owns four consolidated subsidiaries: Community Bank, N.A. (the Bank), Benefit Plans Administrative Services, Inc. (BPAS), CFSI Closeout Corp. (CFSICC), and First of Jermyn Realty Co. (FJRC). BPAS owns two subsidiaries, Benefit Plans Administrative Services LLC and Harbridge Consulting Group LLC. BPAS provides administration, consulting and actuarial services to sponsors of employee benefit plans. CFSICC and FJRC are inactive companies.

The Bank operates 125 customer facilities throughout 22 counties of Upstate New York and five counties of Northeastern Pennsylvania. The Bank owns the following subsidiaries: Community Investment Services, Inc. (CISI), CBNA Treasury Management Corporation (TMC), CBNA Preferred Funding Corporation (PFC), Elias Asset Management, Inc. (EAM) and First Liberty Service Corp. (FLSC). CISI provides broker-dealer and investment advisory services. TMC operates the cash management, investment, and treasury functions of the Bank. PFC primarily is an investor in residential real estate loans. EAM provides asset management services to individuals, corporate pension and profit sharing plans, and foundations. FLSC provides banking-related services to the Pennsylvania branches of the Bank.

The Company wholly-owns three unconsolidated subsidiary business trusts formed for the purpose of issuing mandatorily redeemable preferred securities which are considered Tier I capital under regulatory capital adequacy guidelines (see Note H).

Edgar Filing: COMMUNITY BANK SYSTEM INC - Form 10-K/A

Principles of Consolidation

The consolidated financial statements include the accounts of the Company and its wholly-owned subsidiaries. All inter-company accounts and transactions have been eliminated in consolidation. Certain prior period amounts have been reclassified to conform with the current period presentation.

Critical Accounting Estimates in the Preparation of Financial Statements

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. Critical accounting estimates include the allowance for loan losses, actuarial assumptions associated with the pension, post-retirement and other employee benefit plans, the provision for income taxes, and the carrying value of goodwill and other intangible assets.

Risk and Uncertainties

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

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

Revenue Recognition

The Company recognizes income on an accrual basis. CISI recognizes fee income when investment and insurance products are sold to customers. EAM provides asset management services to brokerage firms and clients and recognizes income ratably over the contract period during which service is performed. Revenue from BPA's administration and recordkeeping services is recognized ratably over the service contract period. Revenue from consulting and actuarial services is recognized when services are rendered. All inter-company revenue and expense among related entities are eliminated in consolidation.

Cash and Cash Equivalents

For purposes of reporting cash flows, cash and cash equivalents include cash on hand, amounts due from banks and highly liquid investments with original maturities of less than ninety days. The carrying amounts reported in the

Edgar Filing: COMMUNITY BANK SYSTEM INC - Form 10-K/A

balance sheet for cash and cash equivalents approximate those assets' fair values.

Investment Securities

The Company has classified its investments in debt and equity securities as held-to-maturity or available-for-sale. Held-to-maturity securities are those for which the Company has the positive intent and ability to hold to maturity, and are reported at cost, which is adjusted for amortization of premiums and accretion of discounts. Securities not classified as held-to-maturity are classified as available-for-sale and are reported at fair market value with net unrealized gains and losses reflected as a separate component of shareholders' equity, net of applicable income taxes. None of the Company's investment securities has been classified as trading securities. Equity securities are stated at cost and include restricted stock of the Federal Reserve Bank of New York and Federal Home Loan Bank of New York. Investment securities are reviewed regularly for other than temporary impairment. Where there is other than temporary impairment, the carrying value of the investment security is reduced to the estimated fair value, with the impairment loss recognized in the consolidated statements of income as other expense.

The average cost method is used in determining the realized gains and losses on sales of investment securities. Premiums and discounts on securities are amortized and accreted, respectively, on a systematic basis over the period to maturity, estimated life, or earliest call date of the related security.

Fair values for investment securities are based on quoted market prices, where available. If quoted market prices are not available, fair values are based on quoted market prices of comparable instruments.

Loans

Loans are stated at unpaid principal balances, net of unearned income. Mortgage loans held for sale are carried at the lower of cost or fair value and are included in loans as the balance of such loans was not significant. Fair values for variable rate loans that reprice frequently are based on carrying values. Fair values for fixed rate loans are estimated using discounted cash flows and interest rates currently being offered for loans with similar terms to borrowers of similar credit quality. The carrying amount of accrued interest approximates its fair value.

Interest on loans is accrued and credited to operations based upon the principal amount outstanding. Unearned discount on installment loans is recognized as income over the term of the loan, principally by the interest method. Non-refundable loan fees and related direct costs are included in the loan balances and are deferred and amortized over the life of the loan as an adjustment to loan yield using the effective interest method. Premiums and discounts on purchased loans are amortized on an accelerated method over the life of the loans.

Impaired and Other Nonaccrual Loans

The Company places a loan on nonaccrual status when the loan becomes ninety days past due (or sooner, if management concludes collection is doubtful), except when, in the opinion of management, it is well-collateralized and in the process of collection. A loan may be placed on nonaccrual status earlier than ninety days past due if there is deterioration in the financial position of the borrower or if other conditions of the loan so warrant. When a loan is placed on nonaccrual status, uncollected accrued interest is reversed against interest income and the deferral and amortization of non-refundable loan fees and related direct costs is discontinued. Interest income during the period the loan is on nonaccrual status is recorded on a cash basis after recovery of principal is

Edgar Filing: COMMUNITY BANK SYSTEM INC - Form 10-K/A

reasonably assured. Nonaccrual loans are returned to accrual status when management determines that the borrower's performance has improved and that both principal and interest are collectible. This generally requires a sustained period of timely principal and interest payments.

Commercial loans greater than \$500,000 are evaluated individually for impairment in accordance with FASB No. 114, "Accounting by Creditors for Impairment of a Loan." A loan is considered impaired, based on current information and events, if it is probable that the Company will be unable to collect the scheduled payments of principal or interest when due according to the contractual terms of the loan agreement. The measurement of impaired loans is generally based upon the present value of expected future cash flows or the fair value of the collateral, if the loan is collateral-dependent.

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

- o Commercial loans are generally charged-off to the extent outstanding principal exceeds the fair value of estimated proceeds from collection efforts, including liquidation of collateral. The charge-off is recognized when the loss becomes reasonably quantifiable.

10

- o Consumer installment loans are generally charged-off to the extent outstanding principal balance exceeds the fair value of collateral, and are recognized by the end of the month in which the loan becomes 120 days past due.
- o Loans secured by 1-4 family residential real estate are generally charged-off to the extent outstanding principal exceeds the fair value of the property, and are recognized when the loan becomes 180 days past due.

Allowance for Loan Losses

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

The general loan loss allocation is composed of two calculations that are computed on four main loan segments: 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 segments 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 non-accruing status with respect to interest. Specific losses are based on discounted estimated cash flows, including any cash flows resulting from the conversion of collateral.

Edgar Filing: COMMUNITY BANK SYSTEM INC - Form 10-K/A

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

Intangible Assets

Intangible assets include core deposit intangibles, customer relationship intangibles and goodwill arising from acquisitions. Core deposit intangibles and customer relationship intangibles are amortized on either an accelerated or straight-line basis over periods ranging from 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.

Premises and Equipment

Premises and equipment are stated at cost less accumulated depreciation. Computer software costs that are capitalized only include external direct costs of obtaining and installing the software. The annual provision for depreciation is computed using the straight-line method over the assets' estimated useful lives. Maintenance and repairs are charged to expense as incurred.

Long-lived depreciable assets are evaluated periodically for impairment when events or changes in circumstances indicate the carrying amount may not be recoverable. Impairment exists when the expected undiscounted future cash flows of a long-lived asset are less than its carrying value. In that event, the Company recognizes a loss for the difference between the carrying amount and the estimated fair value of the asset based on a quoted market price, if applicable, or a discounted cash flow analysis. Impairment losses are recorded in other expenses on the income statement.

Other Real Estate

Properties acquired through foreclosure, or by deed in lieu of foreclosure, are carried at the lower of the unpaid loan balance or fair value less estimated costs of disposal. Subsequent changes in value are reported as adjustments to the carrying amount, not to exceed the initial carrying value of the asset at the time of transfer. Changes in value subsequent to transfer are recorded in operating expenses on the income statement. Gains or losses not previously recognized resulting from the sale of other real estate are recognized as an expense on the date of sale. At December 31, 2004 and 2003, other real estate, included in other assets, amounted to \$1,645,000 and \$1,077,000, respectively.

Mortgage Servicing Rights

Originated mortgage servicing rights are recorded at their allocated fair value at the time of sale of the underlying loan, and are amortized in proportion to and over the period of estimated net servicing income or loss. The Company uses a valuation model that calculates the present value of future cash flows to determine the fair value of servicing rights. In using this valuation method, the Company incorporates assumptions that market participants would use in estimating future net servicing income, which includes estimates of the

Edgar Filing: COMMUNITY BANK SYSTEM INC - Form 10-K/A

servicing cost per loan, the discount rate, and prepayment speeds. The carrying value of the originated mortgage servicing rights is periodically evaluated for impairment using these same market assumptions.

Deposits

The fair value of deposit obligations are based on current market rates for alternative funding sources, principally the Federal Home Loan Bank of New York. The carrying value of accrued interest approximates fair value.

Borrowings

The carrying amounts of federal funds purchased and short-term borrowings approximate their fair values. Fair values for long-term borrowings are estimated using discounted cash flows and interest rates currently being offered on similar borrowings.

Since the Company considers debt extinguishments to be a component of its interest rate risk management, any related gains or losses are not deemed extraordinary and are presented in the non-interest income section of the consolidated statements of income.

Treasury Stock

On June 9, 2003, the Company announced a twelve-month authorization to repurchase up to 1,400,000 of its outstanding shares in open market or privately negotiated transactions. As of December 31, 2004, the Company has repurchased all of the shares at an aggregate cost of \$30,199,000 or \$21.57 per share. The repurchases were for general corporate purposes, including those related to acquisition and stock plan activities.

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.

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.

Assets Under Management or Administration

Assets held in fiduciary or agency capacities for customers are not included in the accompanying consolidated statements of condition as they are not assets of the Company. Substantially all fees associated with providing asset management services are recorded on an accrual basis of accounting and are included in non-interest income. Assets under management or administration at December 31, 2004 and 2003 were \$2,102,000,000 and \$1,807,000,000, respectively.

Earnings Per Share

Edgar Filing: COMMUNITY BANK SYSTEM INC - Form 10-K/A

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 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 (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.

12

At a special meeting of the shareholders held on March 26, 2004, the shareholders approved an amendment to the certificate of incorporation of the Company to increase the number of authorized shares of common stock to 50 million. This amendment was effected in connection with the previously announced two-for-one stock split of the Company's common stock. The stock split was effected in the form of a 100 percent stock dividend, and was paid on April 12, 2004 to shareholders of record on March 17, 2004. Accordingly, all share, option and per-share amounts have been adjusted in the consolidated financial statements to reflect the stock split.

Stock-Based Compensation

The Company accounts for stock-based awards issued to directors, officers and key employees using the intrinsic value method. This method requires that compensation expense be recognized to the extent that the fair value of the underlying stock exceeds the exercise price of the stock award at the grant date. The Company generally does not recognize compensation expense related to stock awards because the stock awards generally have fixed terms and exercise prices that are equal to or greater than the fair value of the Company's common stock at the grant date.

SFAS 123, "Accounting for Stock-Based Compensation," requires companies that use the "intrinsic value method" to account for stock compensation plans to provide pro forma disclosures of the net income and earnings per share effect of stock options using the "fair value method." Under this method, the fair value of the option on the date of grant is recognized ratably as compensation expense over the vesting period of the option.

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

	2004	2003	2002
Weighted-average expected life (in years)	7.33-7.43	7.55-8.76	6.74
Future dividend yield	3.00%	3.00%	3.00%
Share price volatility	26.88%-27.02%	25.59%-27.58%	27.82%
Weighted average risk-free interest rate	4.02%-4.45%	3.82%-4.03%	3.81%-5.16%

Edgar Filing: COMMUNITY BANK SYSTEM INC - Form 10-K/A

=====
 If these assumptions are not accurate, the estimated fair value used to derive the information presented in the following table also will be inaccurate. Moreover, the model assumes that the estimated fair value of an option is amortized over the option's vesting period and would be included in salaries and employee benefits on the income statement.

The pro forma impact of applying the fair value method of accounting for the periods shown below may not be indicative of the pro forma impact in future years.

(000's omitted except per share amounts)	2004	2003
Net income, as reported	\$50,196	\$40,
Stock-based compensation expense included in net income, as reported	228	
Stock-based compensation expense determined under fair value method, net of tax	(886)	(
Pro forma net income	\$49,538	\$39,
Earnings per share:		
As reported:		
Basic	\$1.68	\$1
Diluted	\$1.64	\$1
Pro forma:		
Basic	\$1.66	\$1
Diluted	\$1.61	\$1

Fair Values of Financial Instruments

The Company determines fair values based on quoted market values where available or on estimates using present values or other valuation techniques. Those techniques are significantly affected by the assumptions used, including the discount rate and estimates of future cash flows. In that regard, the derived fair value estimates cannot be substantiated by comparison to independent markets and, in many cases, could not be realized in immediate settlement of the instrument. SFAS 107, "Disclosures about Fair Value of Financial Instruments," excludes certain financial instruments and all non-financial instruments from its disclosure requirements. Accordingly, the aggregate fair value amounts presented do not represent the underlying value of the Company. The fair values of investment securities, loans, deposits, and borrowings have been disclosed in footnotes C, D, G, and H, respectively.

New Accounting Pronouncements

In December 2004, the Financial Accounting Standards Board revised SFAS No. 123, "Accounting for Stock-Based Compensation." SFAS 123R establishes accounting requirements for share-based compensation to employees and carries forward prior guidance on accounting for awards to non-employees. The provisions of this statement will become effective July 1, 2005 for all equity awards granted after the effective date. SFAS 123R requires an entity to recognize compensation expense based on an estimate of the number of awards expected to actually vest,

Edgar Filing: COMMUNITY BANK SYSTEM INC - Form 10-K/A

exclusive of awards expected to be forfeited. Management does not expect the impact of the adoption of this pronouncement to be materially different from the pro forma impacts disclosed under SFAS No. 123.

NOTE B: ACQUISITIONS

Dansville Branch Acquisition

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

First Heritage Bank

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

Grange National Banc Corp.

On November 24, 2003, the Company acquired Grange National Banc Corp. ("Grange"), a \$280 million-asset bank holding company based in Tunkhannock, Pa. Grange's 12 branches operate as part of First Liberty Bank & Trust, a division of Community Bank, N.A. The Company issued 2,294,182 shares of its common stock to certain of the former shareholders at a cost of \$23.97 per share. The remaining shareholders received \$21.25 in cash or approximately \$20.9 million. In addition, Grange stock options representing \$5.4 million of fair value were exchanged for options of the Company.

Peoples Bankcorp Inc.

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

Harbridge Consulting Group

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

14

Acquisition Expenses

The Company incurred certain expenses in connection with the above acquisitions. The following table shows the components of acquisition expenses that are presented in the consolidated statements of income for the years ended December 31:

(000's omitted)	2004	2003	2002
Severance and employee benefits	\$1,044	\$0	\$97

Edgar Filing: COMMUNITY BANK SYSTEM INC - Form 10-K/A

Legal and professional fees	491	213	455
Data processing	130	191	16
Other	39	94	132

Total	\$1,704	\$498	\$700
=====			

NOTE C: INVESTMENT SECURITIES

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

(000's omitted)	2004				Amortized Cost
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value	

Held-to-Maturity Portfolio:					
U.S. treasury and agency securities	\$127,490	\$356	\$1,940	\$125,906	\$127,635
Obligations of state and political subdivisions	12	21			
Other securities	6,576	120	2	6,694	7,459
	3,578	0	0	3,578	3,558

Total held-to-maturity portfolio	137,644	476	1,942	136,178	138,652

Available-for-Sale Portfolio:					
U.S. treasury and agency securities	630,058	20,917	208	650,767	456,913
Obligations of state and political subdivisions	545,698	27,899	46	573,551	443,930
Corporate securities	40,443	3,460	5	43,898	27,712
Collateralized mortgage obligations	70,986	1,680	222	72,444	89,566
Mortgage-backed securities	50,347	2,351	34	52,664	76,628

Sub-total	1,337,532	56,307	515	1,393,324	1,094,749
Equity securities	53,371	0	0	53,371	37,238

Total available-for-sale portfolio	1,390,903	\$56,307	\$515	\$1,446,695	1,131,987
Net unrealized gain on available-for-sale portfolio	55,792			0	58,895

Total	\$1,584,339			\$1,582,873	\$1,329,534
=====					

A summary of investment securities as of December 31, 2004 that have been in a continuous unrealized loss position for less than or greater than twelve months is as follows:

Less than 12 Months 12 Months or Longer

Edgar Filing: COMMUNITY BANK SYSTEM INC - Form 10-K/A

(000's omitted)	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses
Held-to-Maturity Portfolio:				
U.S. treasury and agency securities	\$0	\$0	\$88,060	(\$1,940)
Obligations of state and political subdivisions	1,567	(2)	0	
Total held-to-maturity portfolio	\$1,567	(\$2)	\$88,060	(\$1,940)
Available-for-Sale Portfolio:				
U.S. treasury and agency securities	\$22,633	(\$208)	\$0	\$0
Obligations of state and political subdivisions	7,731	(46)	0	
Corporate securities	1,061	(5)	0	
Collateralized mortgage obligations	7,915	(222)	0	
Mortgage-backed securities	950	(17)	1,197	(1,197)
Total available-for-sale portfolio	\$40,290	(\$498)	\$1,197	(\$1,197)

Management does not believe any individual unrealized loss as of December 31, 2004 represents an other than temporary impairment. The unrealized losses reported for the agency and mortgage-backed securities relate primarily to securities issued by FHLB, FNMA and FHLMC and are currently rated AAA by Moody's Investor Services and Standards & Poor. The unrealized losses in the portfolios are primarily attributable to changes in interest rates. The Company has both the intent and ability to hold these securities for the time necessary to recover the amortized cost. The unrealized losses of \$3,095,000 as of December 31, 2003 were less than 12 months old.

The amortized cost and estimated fair value of debt securities at December 31, 2004, by contractual maturity, are shown below. Expected maturities will differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

(000's omitted)	Held-to-Maturity		Available-for-Sale	
	Carrying Value	Fair Value	Carrying Value	Fair Value
Due in one year or less	\$4,387	\$4,395	\$5,263	\$5,414
Due after one through five years	1,959	2,044	55,927	57,916
Due after five years through ten years	99,596	98,533	712,168	736,972
Due after ten years	31,702	31,206	442,841	467,914
Sub-total	137,644	136,178	1,216,199	1,268,216
Collateralized mortgage obligations	0	0	70,986	72,444
Mortgage-backed securities	0	0	50,347	52,664
Total	\$137,644	\$136,178	\$1,337,532	\$1,393,324

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

Edgar Filing: COMMUNITY BANK SYSTEM INC - Form 10-K/A

(000's omitted)	2004	2003	2002
Proceeds from the sales of investment securities	\$51,889	\$41,227	\$96,000
Gross gains on sales of investment securities	187	11	2,000
Gross losses on sales of investment securities	115	65	1,000
Proceeds from the sales of mortgage-backed securities and CMO's	3,679	20,823	56,000
Proceeds from the maturities of mortgage-backed securities and CMO's	51,652	204,746	174,000
Purchases of mortgage-backed securities and CMO's	\$10,915	\$27,092	\$25,000

Investment securities with a carrying value of \$699,806,000 and \$563,341,000 at December 31, 2004 and 2003, respectively, were pledged to collateralize certain deposits and borrowings.

16

NOTE D: LOANS

Major classifications of loans at December 31 are summarized as follows:

(000's omitted)	2004	2003
Consumer mortgage	\$801,412	\$739,593
Business lending	831,244	689,436
Consumer direct and indirect	725,885	699,562
Gross loans	2,358,541	2,128,591
Unearned discount	48	82
Net loans	2,358,493	2,128,509
Allowance for loan losses	31,778	29,095
Loans, net of allowance for loan losses	\$2,326,715	\$2,099,414

The estimated fair value of loans at December 31, 2004 and 2003 was \$2.4 billion and \$2.1 billion, respectively. Non-accrual loans of \$11,798,000 and \$11,940,000 and accruing loans ninety days past due of \$1,158,000 and \$1,307,000 at December 31, 2004 and 2003, respectively, are included in net loans.

Changes in loans to directors and officers and other related parties for the years ended December 31 are summarized as follows:

(000's omitted)	2004	2003
Balance at beginning of year	\$14,838	\$15,735
New loans	9,796	3,313
Payments	(1,481)	(4,210)
Balance at end of year	\$23,153	\$14,838

Mortgage loans serviced for others are not included in the accompanying consolidated statements of condition. The unpaid principal balances of mortgage loans serviced for others were \$107,155,000, \$126,324,000, and \$103,663,000 at December 31, 2004, 2003, and 2002, respectively. Custodial escrow balances

Edgar Filing: COMMUNITY BANK SYSTEM INC - Form 10-K/A

maintained in connection with the foregoing loan servicing, and included in demand deposits, were approximately and \$813,000 and \$773,000 at December 31, 2004 and 2003, respectively. At December 31, 2004 and 2003, mortgage servicing rights, included in other assets, amounted to \$459,000 and \$456,000 respectively.

Changes in the allowance for loan losses for the years ended December 31 are summarized as follows:

(000's omitted)	2004	2003	2002
Balance at beginning of year	\$29,095	\$26,331	\$23,901
Provision for loan losses	8,750	11,195	12,222
Reserve on acquired loans	2,357	1,832	0
Charge offs	(11,780)	(13,111)	(12,015)
Recoveries	3,356	2,848	2,223
Balance at end of year	\$31,778	\$29,095	\$26,331

As of December 31, 2004 and 2003, the Company had impaired loans of \$2,271,000 and \$5,682,000, respectively. The specifically allocated allowance for loan loss recognized on these impaired loans was \$900,000 and \$1,825,000 at December 31, 2004 and 2003, respectively. For the years ended December 31, 2004 and 2003 the Company had average impaired loans of \$2,399,000 and \$7,100,000. There was no interest income recognized on these loans in 2004 or 2003.

17

NOTE E: PREMISES AND EQUIPMENT

Premises and equipment consist of the following at December 31:

(000's omitted)	2004	2003
Land and land improvements	\$9,340	\$8,616
Bank premises owned	57,519	53,560
Equipment and construction in progress	46,010	42,146
Premises and equipment, gross	112,869	104,322
Less: Accumulated depreciation	(49,359)	(42,617)
Premises and equipment, net	\$63,510	\$61,705

NOTE F: INTANGIBLE ASSETS

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

(000's omitted)	As of December 31, 2004			As of December 31, 2003	
	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount	Gross Carrying Amount	Accumulated Amortization
Amortizing intangible assets:					

Amortizing intangible assets:

Edgar Filing: COMMUNITY BANK SYSTEM INC - Form 10-K/A

Core deposit intangibles	\$63,691	(\$28,340)	\$35,351	\$55,455	(\$2
Other intangibles	2,750	(764)	1,986	2,750	

Total amortizing intangibles	66,441	(29,104)	37,337	58,205	(2
Non-amortizing intangible assets:					
Goodwill	195,163	0	195,163	159,596	

Total intangible assets, net	\$261,604	(\$29,104)	\$232,500	\$217,801	(\$2
=====					

The increases in the gross carrying amount of core deposit intangibles and goodwill relate to the 2004 acquisition of First Heritage Bank (\$30,946,000 in goodwill), a branch acquisition in Dansville, NY (\$4,191,000 in goodwill) and \$430,000 of goodwill adjustments mainly related to adjusting certain real property from the 2003 acquisitions to fair value. No goodwill impairment adjustments were recognized in 2004 and 2003.

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

2005	\$7,243
2006	6,047
2007	5,657
2008	5,335
2009	4,836
Thereafter	8,219

Total	\$37,337
=====	

NOTE G: DEPOSITS

Deposits consist of the following at December 31:

(000's omitted)	2004	2003
Demand	\$567,106	\$498,195
Interest checking	313,639	294,563
Savings	536,460	470,166
Money market	321,461	288,212
Time	1,190,312	1,174,352

Total deposits	\$2,928,978	\$2,725,488
=====		

The estimated fair value of deposits at December 31, 2004 and 2003 was approximately \$2.7 billion and \$2.5 billion, respectively.

At December 31, 2004 and 2003, time certificates of deposit in denominations of \$100,000 and greater totaled \$179,534,000 and \$168,241,000 respectively. The approximate maturities of time deposits at December 31, 2004 are as follows:

(000's omitted)	Amount
2005	\$920,488
2006	132,051
2007	78,405

Edgar Filing: COMMUNITY BANK SYSTEM INC - Form 10-K/A

2008	30,727
2009	28,053
Thereafter	588

Total	\$1,190,312
=====	

NOTE H: BORROWINGS

Outstanding borrowings at December 31 are as follows:

(000's omitted)	2004	2003

Short-term borrowings:		
Federal funds purchased	\$13,200	\$36,300
Federal Home Loan Bank advances	636,000	361,000
Commercial loans sold with recourse	74	0
Capital lease obligations	0	96

Total short-term borrowings	649,274	397,396
Long-term borrowings:		
Federal Home Loan Bank advances	190,000	190,000
Commercial loans sold with recourse	791	0
Subordinated debt held by unconsolidated subsidiary trusts, net of discount of \$1,463 and \$1,519	80,446	80,390

Total long-term borrowings	271,237	270,390

Total borrowings	\$920,511	\$667,786
=====		

The weighted-average interest rates on short-term borrowings for the years ended December 31, 2004 and 2003 were 1.64% and 1.26%, respectively. Federal Home Loan Bank advances are collateralized by a blanket lien on the Company's residential real estate loan portfolio and various investment securities.

19

Long-term borrowings at December 31, 2004 have maturity dates as follows:

(000's omitted, except rate)	Amount	Weighted Average Rate

October 3, 2007	\$236	3.00%
January 23, 2008 (callable)	10,000	5.44%
January 28, 2008 (callable)	5,000	5.48%
April 14, 2010 (callable)	25,000	6.35%
September 27, 2010 (callable)	50,000	5.88%
October 12, 2010 (callable)	50,000	5.84%
November 1, 2010 (callable)	50,000	5.77%
October 30, 2012	258	3.00%
October 16, 2013	193	3.00%
November 23, 2014	56	2.75%
November 29, 2014	48	3.00%
February 3, 2027 (callable)	30,779	9.75%

Edgar Filing: COMMUNITY BANK SYSTEM INC - Form 10-K/A

July 16, 2031 (callable)	25,110	5.38%
July 31, 2031 (callable)	24,557	5.12%

Total	\$271,237	6.19%
=====		

The estimated fair value of long-term borrowings at December 31, 2004 and 2003 was approximately \$319.0 million and \$314.0 million, respectively.

In December 2003, the Company prepaid \$25.0 million of Federal Home Loan Bank ("FHLB") advances with maturity dates ranging from January 30, 2008 to February 4, 2008 and a weighted-average rate of 5.31%. In December 2002, the Company prepaid \$11.0 million of FHLB advances with maturity dates ranging from December 15, 2003 to December 31, 2004 and a weighted-average rate of 6.17%. As a result of these prepayments, the Company incurred penalties of \$2.6 million in 2003 and \$925,000 in 2002. These penalties have been reflected in the consolidated statements of income as gain (loss) on investment securities and debt extinguishments.

The Company sponsors three business trusts, Community Capital Trust I, Community Capital Trust II, and Community Statutory Trust III, 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 at a rate per annum equal to the interest rate being earned by the trust on the debentures held by that trust. The preferred securities are subject to mandatory redemption, in whole or in part, upon repayment of the debentures. The Company has entered into agreements which, taken collectively, fully and unconditionally guarantee the preferred securities subject to the terms of each of the guarantees. The terms of the preferred securities of each trust are as follows:

	Issuance Date	Amount	Interest Rate	Maturity Date	Call Provision
I	2/3/1997	30,000	9.75%	2/03/2027	10 year beginning 2007
II	7/16/2001	25,000	6 month LIBOR plus 3.75% (5.74%)	7/16/2031	5 year beginning 2006
III	7/31/2001	24,450	3 month LIBOR plus 3.58% (5.74%)	7/31/2031	5 year beginning 2006

In the fourth quarter 2003, as a result of applying the provisions of FIN 46, the Company de-consolidated these subsidiary trusts from its financial statements. The de-consolidation of the net assets and results of operations of the trusts had an immaterial impact on the Company's financial statements. The Company continues to be obligated to repay the debentures held by the trusts and guarantees repayment of the preferred securities issued by the trusts. The preferred securities held by the trusts qualify as Tier I capital for the Company under Federal Reserve Board guidelines.

Edgar Filing: COMMUNITY BANK SYSTEM INC - Form 10-K/A

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

(000's omitted)	2004	2003	2002

Current:			
Federal	\$14,677	\$11,534	\$9,268
State	680	341	161
Deferred:			
Federal	1,229	758	3,764
State	57	140	694

Total income taxes	\$16,643	\$12,773	\$13,887
=====			

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

(000's omitted)	2004	2003

Allowance for loan losses	\$10,644	\$10,537
Employee and director benefits	2,599	2,118
Other	1,478	1,501

Deferred tax asset	14,721	14,156

Investment securities	23,273	24,216
Intangible assets	8,145	4,910
Loan origination costs	3,998	3,324
Depreciation	5,264	3,526
Pension	531	1,586
Mortgage servicing rights	177	178

Deferred tax liability	41,388	37,740

Net deferred tax liability	(\$26,667)	(\$23,584)
=====		

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

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

	2004	2003	2002

Federal statutory income tax rate	35.0%	35.0%	35.0%
Increase (reduction) in taxes resulting from:			
Tax-exempt interest	(11.3%)	(11.2%)	(9.9%)
State income taxes, net of federal benefit	0.6%	0.1%	0.6%
Other	0.6%	0.1%	0.8%

Effective income tax rate	24.9%	24.0%	26.5%
=====			

NOTE J: LIMITS ON DIVIDENDS AND OTHER REVENUE SOURCES

The Company's ability to pay dividends to its shareholders is largely dependent

Edgar Filing: COMMUNITY BANK SYSTEM INC - Form 10-K/A

on the Bank's ability to pay dividends to the Company. In addition to state law requirements and the capital requirements discussed below, the circumstances under which the Bank may pay dividends are limited by federal statutes, regulations, and policies. For example, as a national bank, the Bank must obtain the approval of the Office of the Comptroller of the Currency (OCC) for payments of dividends if the total of all dividends declared in any calendar year would exceed the total of the Bank's net profits, as defined by applicable regulations, for that year, combined with its retained net profits for the preceding two years. Furthermore, the Bank may not pay a dividend in an amount greater than its undivided profits then on hand after deducting its losses and bad debts, as defined by applicable regulations. At December 31, 2004, the Bank had approximately \$27,758,000 in undivided profits legally available for the payments of dividends.

21

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

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

NOTE K: BENEFIT PLANS

Pension and post-retirement plans The Company provides defined benefit pension and other post-retirement health and life insurance benefits to qualified employees and retirees. Using a measurement date of December 31, the following table shows the funded status of the Company's plans reconciled with amounts reported in the Company's consolidated statements of condition:

	Pension Benefits		Post-retirement
(000's omitted)	2004	2003	2004
Change in benefit obligation:			
Benefit obligation at the beginning of year	\$42,739	\$34,864	\$5,083
Service cost	2,557	1,831	311
Interest cost	2,433	2,157	325
Participant contributions	0	0	227
Plan amendment/acquisition	(881)	493	95
Other loss	0	1,218	0
Deferred actuarial loss	2,209	3,521	902
Benefits paid	(1,444)	(1,345)	(573)
Benefit obligation at end of year	47,613	42,739	6,370
Change in plan assets:			
Fair value of plan assets at beginning of year	36,784	29,133	0
Actual return of plan assets	3,907	6,815	0

Edgar Filing: COMMUNITY BANK SYSTEM INC - Form 10-K/A

Participant contributions	0	0	227
Employer contributions	2,500	2,181	346
Benefits paid	(1,444)	(1,345)	(573)

Fair value of plan assets at end of year	41,747	36,784	0

Unfunded status	(5,866)	(5,955)	(6,370)
Unrecognized actuarial loss	14,454	14,057	1,480
Unrecognized prior service (benefit) cost	(783)	899	331
Unrecognized transition liability	0	0	328

Prepaid (accrued) benefit cost	\$7,805	\$9,001	(\$4,231)
=====			

In 2004, the Company amended its defined benefit pension plan to allow for a cash balance option. Participants in the plan as of December 31, 2003 were given an option to continue to have their benefits calculated under the traditional plan formula or have their benefits determined as an account balance under a cash balance formula. All new participants to the plan will automatically participate in the cash balance option. In addition, the plan was amended to provide for the payment of certain benefits formerly accrued and payable under the Deferred Compensation Plan for Certain Executive Employees.

The Company has unfunded supplemental pension plans for certain key executives. The projected benefit obligation and accrued benefit cost included in the preceding table related to these plans was \$3,128,000 and \$2,798,000 for 2004 and \$2,606,000 and \$2,245,000 for 2003, respectively. The accumulated benefit obligation for the defined benefit pension was \$40,659,000 and \$35,025,000 as of December 31, 2004 and 2003, respectively.

22

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

	Pension Benefits		Post-retirement Benefits	
	2004	2003	2004	2003
Discount rate	5.60%	5.90%	5.60%	5.90%
Expected return on plan assets	8.75%	8.75%	0.00%	0.00%
Rate of compensation increase	4.00%	4.00%	0.00%	0.00%
=====				

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

(000's omitted)	Pension Benefits			Post-retir
	2004	2003	2002	2004
Service cost	\$2,557	\$1,831	\$1,415	\$311

Edgar Filing: COMMUNITY BANK SYSTEM INC - Form 10-K/A

Interest cost	2,433	2,157	1,926	325
Expected return on plan assets	(3,160)	(2,567)	(2,268)	0
Net amortization and deferral	1,066	1,142	403	37
Amortization of prior service cost	155	129	131	30
Amortization of transition (asset) obligation	0	(4)	(19)	41
Other expense	0	1,218	0	0
-----	-----	-----	-----	-----
Net periodic benefit cost	\$3,051	\$3,906	\$1,588	\$744
=====	=====	=====	=====	=====

Other expense represents a \$1.2 million adjustment recorded in the fourth quarter of 2003 to reflect the proper actuarial impact of indexing salary levels associated with certain benefits frozen in 1988. The weighted-average assumptions used to determine the net periodic pension cost for the years ended December 31 are as follows:

	Pension Benefits			Post-retirement Benefits		
	2004	2003	2002	2004	2003	2002
Discount rate	5.90%	6.10%	6.75%	5.90%	6.10%	6.75%
Expected return on plan assets	8.75%	9.00%	9.00%	0.00%	0.00%	0.00%
Rate of compensation increase	4.00%	4.00%	4.00%	0.00%	0.00%	0.00%
=====	=====	=====	=====	=====	=====	=====

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

(000's omitted)	Pension Benefits	Post-retirement Benefits
2005	\$2,866	\$289
2006	2,666	308
2007	3,278	332
2008	4,607	350
2009	3,302	383
2010-2014	\$21,541	\$2,577
=====	=====	=====

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

The expected long-term rate of return was estimated by taking into consideration asset allocation, reviewing historical returns on type of assets held and current economic factors. The asset allocation for the defined benefit pension plan as of December 31, by asset category, is as follows:

	2004	2003
Equity securities	69%	70%
Debt securities	19%	20%
Cash	12%	10%
-----	-----	-----
Total	100%	100%
=====	=====	=====

Plan assets include \$2,571,000 (6%) and \$2,230,000 (6%) of Community Bank System, Inc. stock at December 31, 2004 and 2003, respectively.

The investment objective for the defined benefit pension plan is to achieve an average annual total return over a five-year period equal to the assumed rate of return used in the actuarial calculations. At a minimum performance level, the portfolio should earn the return obtainable on high quality intermediate-term bonds. The Company's perspective regarding portfolio assets combines both preservation of capital and moderate risk-taking. Asset allocation favors equities, with a target allocation of approximately 75% equity securities, 20% fixed income securities and 5% cash. No more than 10% of the portfolio can be in stock of the Company. Due to the volatility in the market, the target allocation is not always desirable and asset allocations will fluctuate between acceptable ranges. Prohibited transactions include purchase of securities on margin, uncovered call options, short sale transactions, and use of real estate, unlisted limited partnerships, derivative products or venture capital loans as fixed income investment vehicles.

The Company makes contributions to its funded qualified pension plan as required by government regulation or as deemed appropriate by management after considering the fair value of plan assets, expected return on such assets, and the value of the accumulated benefit obligation. Based upon current information, the Company does not expect to make contributions to the funded qualified pension plan in 2005. The Company funds the payment of benefit obligations for the supplemental pension and post-retirement plans because such plans do not hold assets for investment.

The assumed health care cost trend rate used in the post-retirement health plan at December 31, 2004 was 9.0% for medical costs and 13.0% for prescription drugs. The rate to which the cost trend rate is assumed to decline (the ultimate trend rate) and the year that the rate reaches the ultimate trend rate is 5.0% and 2013, respectively.

Assumed health care cost trend rates have a significant effect on the amounts reported for the health care plan. A one-percentage-point increase in the trend rate would increase the service and interest cost components by \$35,000 and increase the benefit obligation by \$264,000. A one-percentage-point decrease in the trend rate would decrease the service and interest cost components by \$8,000 and decrease the benefit obligation by \$141,000.

401(k) Employee Stock Ownership Plan

The Company has a 401(k) Employee Stock Ownership Plan in which employees can contribute from 1% to 90% of eligible compensation, with up to 6% being eligible for matching contributions in the form of Company common stock. The Plan also permits the Company to distribute a discretionary profit-sharing component in the form of Company common stock to all participants except certain executive employees. The expense recognized under this plan for the years ended December 31, 2004, 2003 and 2002 was \$1,583,000, \$1,309,000 and \$1,026,000, respectively.

Deferred Compensation Plan for Certain Executive Employees

The Company has a Deferred Compensation Plan for Certain Executive Employees in which participants may contribute up to 15% of their eligible compensation less any amounts contributed to the 401(k) Employee Stock Ownership Plan. Any discretionary profit-sharing amounts that the executive receives from the Company must be contributed to the Deferred Compensation Plan in the form of Company common stock. The expense recognized under this plan for the years ended

Edgar Filing: COMMUNITY BANK SYSTEM INC - Form 10-K/A

December 31, 2004, 2003 and 2002 was \$159,000, \$119,000 and \$68,000, respectively.

Other Deferred Compensation Arrangements

In addition to the supplemental pension plans for certain executives, the Company has nonqualified deferred compensation for several former directors, officers, and key employees. All benefits provided under these plans are unfunded and payments to plan participants are made by the Company. At December 31, 2004 and 2003, the Company has recorded a liability of \$5,373,000 and \$3,775,000, respectively. The expense recognized under these plans for the years ended December 31, 2004, 2003, and 2002 was \$1,727,000, \$947,000 and \$398,000, respectively.

Deferred Compensation Plan for Directors

Directors may defer all or a portion of their director fees under the Deferred Compensation Plan for Directors. Under this plan, there is a separate account for each participating director which is credited with the amount of shares which could have been purchased with the director's fees as well as any dividends on such shares. On the distribution date, the director will receive common stock equal to the accumulated share balance in his account. As of December 31, 2004 and 2003, there were 65,090 and 56,901 shares credited to the participants' accounts, for which a liability of \$1,097,000 and \$894,000 was accrued, respectively. The expense recognized under the plan for the years ended December 31, 2004, 2003 and 2002, was \$206,000, \$113,000, and \$106,000, respectively.

Director Stock Balance Plan

The Company has a Stock Balance Plan for non-employee directors who have completed six months of service. The Plan is a nonqualified, noncontributory defined benefit plan. The Plan provides benefits for service prior to January 1, 1996 based on a predetermined formula and benefits for service after January 1, 1996 based on the performance of the Company's common stock. Participants become fully vested after six years of service. The directors can elect to receive offset stock options that

24

may reduce the Company's liability under the Plan. These options vest immediately and expire one year after the date the director retires or two years in the event of death. Benefits are payable in the form of cash and/or Company stock (as elected by the director) on January 1st of the year after the director retires from the Board. As of December 31, 2004 and 2003, the accrued pension liability was \$287,000 and \$251,000, respectively. The expense recognized under this plan for the years ended December 31, 2004, 2003 and 2002, was \$36,000, \$38,000 and \$69,000, respectively. The expense and related liability were calculated using a dividend rate of 3.00%, stock price appreciation of 6.00%, and a discount rate of 5.6% for 2004, 5.9% for 2003, and 6.10% for 2002.

NOTE L: STOCK-BASED COMPENSATION PLANS

The Company has a long-term incentive program for directors, officers, and key employees. Under this program the Company authorized 4,024,000 shares of Company common stock for the grant of incentive stock options, restricted stock awards, nonqualified stock options, retroactive stock appreciation rights, and offset options to its Stock Balance Plan (see Note K). The offset options vest and become exercisable immediately and expire one year after the date the director retires or two years in the event of death. The remaining options have a

Edgar Filing: COMMUNITY BANK SYSTEM INC - Form 10-K/A

ten-year term. They vest and become exercisable on a grant-by-grant basis, ranging from immediate vesting to ratably over a five-year period. Option activity in this plan is as follows:

	Options Outstanding	Weighted Average Exercise Price of Shares Outstanding	Shares Exercisable
December 31, 2001	1,901,488	\$12.67	1,300,700
Granted	413,404	13.20	
Exercised	(173,286)	8.94	
Forfeited	(4,278)	12.62	
December 31, 2002	2,137,328	\$13.07	1,411,006
Granted	843,138	10.89	
Exercised	(545,158)	10.99	
Forfeited	(7,826)	14.22	
December 31, 2003	2,427,482	\$12.78	1,519,893
Granted	669,139	18.37	
Exercised	(685,143)	8.35	
Forfeited	(10,546)	16.13	
December 31, 2004	2,400,932	\$15.59	1,383,369

Approximately 222,000 and 390,000 options were exchanged in 2004 and 2003 in connection with the Heritage and Grange acquisitions, respectively.

25

At December 31, 2004 the range of exercise prices and other information relating to the Company's stock options is as follows:

Range of Exercise Price	Options Outstanding			Options Exercisable	
	Shares	Weighted Average Exercise Price	Weighted Average Remaining Life (years)	Shares	Weighted Average Exercise Price
\$3.65 - \$5.15	76,044	\$4.12	1.7	76,044	\$4.12
\$5.15 - \$7.72	40,716	6.77	0.8	40,716	6.77
\$7.72 - \$10.30	69,516	9.13	3.3	69,516	9.13
\$10.30 - \$12.87	520,454	12.12	5.6	374,419	12.09
\$12.87 - \$15.44	452,121	13.57	6.1	275,261	13.86
\$15.44 - \$18.02	782,979	16.32	7.2	489,283	16.71
\$18.02 - \$20.59	15,000	18.96	8.4	3,000	18.96
\$20.59 - \$23.17	19,008	22.62	9.4	4,008	22.95
\$23.17 - \$24.15	425,094	24.15	9.1	51,122	24.15
Total / Average	2,400,932	\$15.59	6.6	1,383,369	\$13.83

Information concerning the grants of stock options and restricted stock is as follows:

Edgar Filing: COMMUNITY BANK SYSTEM INC - Form 10-K/A

	Awards Granted	Weighted Average Exercise Price	Weighted Average Grant Date Fair Value

2004:			
Option price = fair market value	446,860	\$24.09	\$6.05
Option price <fair market value	222,279	\$6.87	\$13.28
Restricted stock	32,418	\$23.76	\$23.76
2003:			
Option price = fair market value	449,476	\$15.78	\$4.12
Option price <fair market value	393,662	\$5.31	\$13.73
Restricted stock	8,000	\$19.12	\$19.12
2002:			
Option price = fair market value	373,404	\$13.20	\$3.59
Option price <fair market value	40,000	\$13.18	\$4.33
=====			

The Company used the Black-Scholes option-pricing model to estimate the weighted average grant date fair value. The assumptions used in the model are disclosed in Note A - Stock Based Compensation. Compensation expense related to restricted stock recognized in the income statement for the years ended December 31, 2004, 2003, and 2002 was \$372,000, \$105,000 and \$353,000, respectively.

On February 21, 1995, the Company adopted a Stockholder Protection Rights Agreement. Under the Plan, each stockholder received one right, representing the right to purchase one share of common stock for \$42.50 for each share of stock owned. All of the rights expire on February 21, 2005, but the Company may redeem the rights earlier for \$.005 per right, subject to certain limitations. Rights will become exercisable if a person or group acquires 15% or more of the Company's outstanding shares. Until that time, the rights will trade with the common stock; any transfer of common stock will also constitute a transfer of the associated right. If the rights become exercisable, they will begin to trade apart from the common stock. If one of a number of "flip-in events" occurs, each right will entitle the holder to purchase common stock having a market value equivalent of two times the exercise price. In January 2005, the Board of Directors voted to permit the agreement to expire in February 2005.

26

NOTE M: EARNINGS PER SHARE

The following is a reconciliation of basic to diluted earnings per share for the years ended December 31:

(000's omitted, except per share data)	Income	Shares	Per Share Amount

Year Ended December 31, 2004			
Basic EPS	\$50,196	29,916	\$1.68
Stock options		754	
Diluted EPS	\$50,196	30,670	\$1.64
=====			
Year Ended December 31, 2003			
Basic EPS	\$40,380	26,299	\$1.54
Stock options		736	

Edgar Filing: COMMUNITY BANK SYSTEM INC - Form 10-K/A

Diluted EPS	\$40,380	27,035	\$1.49
=====			
Year Ended December 31,2002			
Basic EPS	\$38,517	25,946	\$1.48
Stock options		388	

Diluted EPS	\$38,517	26,334	\$1.46
=====			

There were 424,594, 0 and 469,744 anti-dilutive stock options outstanding for the years ended December 31, 2004, 2003 and 2002, respectively.

NOTE N: COMMITMENTS, CONTINGENT LIABILITIES AND RESTRICTIONS

The Company is a party to financial instruments with off-balance-sheet risk in the normal course of business to meet the financing needs of its customers. These financial instruments consist primarily of commitments to extend credit and standby letters of credit. Commitments to extend credit are agreements to lend to customers, generally having fixed expiration dates or other termination clauses that may require payment of a fee. These commitments consist principally of unused commercial and consumer credit lines. Standby letters of credit generally are contingent upon the failure of the customer to perform according to the terms of an underlying contract with a third party. The credit risks associated with commitments to extend credit and standby letters of credit are essentially the same as that involved with extending loans to customers and are subject to normal credit policies. Collateral may be obtained based on management's assessment of the customer's creditworthiness. The fair value of these commitments is immaterial for disclosure in accordance with FASB Interpretation No. 45, "Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others". The contract amount of commitment and contingencies is as follows:

(000's omitted)	2004	2003
Commitments to extend credit	\$429,751	\$315,898
Standby letters of credit	22,948	19,163

Total	\$452,699	\$335,061
=====		

The fair value of these financial instruments approximates carrying value.

The Company has unused lines of credit of \$47,000,000 at December 31, 2004. The Company has unused borrowing capacity of approximately \$134,492,000 through collateralized transactions with the Federal Home Loan Bank and \$11,325,000 through collateralized transactions with the Federal Reserve Bank.

The Company is required to maintain a reserve balance, as established by the Federal Reserve Bank of New York. The required average total reserve for the 14-day maintenance period of December 23, 2004 through January 5, 2005 was \$58,779,000 of which \$2,000,000 was required to be on deposit with the Federal Reserve Bank of New York. The remaining \$56,779,000 was represented by cash on hand.

NOTE O: LEASES

The Company leases buildings and office space under agreements that expire in

Edgar Filing: COMMUNITY BANK SYSTEM INC - Form 10-K/A

various years. Rental expense included in operating expenses amounted to \$2,486,000, \$1,940,000 and \$1,896,000 in 2004, 2003 and 2002, respectively. The future minimum rental commitments as of December 31, 2004 for all non-cancelable operating leases are as follows:

2005	\$2,204
2006	2,022
2007	1,788
2008	1,280
2009	1,002
Thereafter	4,374

Total	\$12,670
=====	

NOTE P: REGULATORY MATTERS

The Company and the Bank are subject to various regulatory capital requirements administered by the federal banking agencies. Failure to meet minimum capital requirements can initiate certain mandatory and possibly additional discretionary actions by regulators that, if undertaken, could have a direct material effect on the Company's financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the Company and the Bank must meet specific capital guidelines that involve quantitative measures of the Company's and the Bank's assets, liabilities, and certain off-balance sheet items as calculated under regulatory accounting practices. The Company's and the Bank's capital amounts and classification are also subject to qualitative judgments by the regulators about components, risk weightings, and other factors.

Quantitative measures established by regulation to ensure capital adequacy require the Company and Bank to maintain minimum total core capital to risk weighted assets of 8%, and tier I capital to risk weighted assets and tier I capital to average assets of 4%. Management believes, as of December 31, 2004, that the Company and Bank meet all capital adequacy requirements to which they are subject.

As of December 31, 2004 and 2003, the most recent notification from the Office of the Comptroller of the Currency categorized the Company and Bank as "well capitalized" under the regulatory framework for prompt corrective action. To be categorized as "well capitalized," the Company and Bank must maintain minimum total core capital to risk weighted assets of 10%, tier I capital to risk weighted assets of 6% and tier I capital to average assets of 5%. There are no conditions or events since that notification that management believes have changed the institution's category. In addition, there were no significant capital requirements imposed or agreed to during the regulatory approval process of any of our acquisitions.

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

(000's omitted)	2004		2003	
	Company	Bank	Company	Bank
Tier 1 capital to average assets				
Amount	\$284,928	\$276,654	\$249,641	\$245,809
Ratio	6.94%	6.74%	7.26%	7.28%
Minimum required amount	\$164,229	\$164,069	\$137,607	\$134,977

Edgar Filing: COMMUNITY BANK SYSTEM INC - Form 10-K/A

Tier 1 capital to risk weighted assets				
Amount	\$284,928	\$276,654	\$249,641	\$245,809
Ratio	11.93%	11.61%	11.76%	11.63%
Minimum required amount	\$95,536	\$95,337	\$84,916	\$84,576
Total core capital to risk weighted assets				
Amount	\$314,783	\$306,447	\$276,177	\$272,339
Ratio	13.18%	12.86%	13.01%	12.88%
Minimum required amount	\$191,072	\$190,675	\$169,831	\$169,151

28

NOTE Q: PARENT COMPANY STATEMENTS

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

(000's omitted)	2004	2003

Assets:		
Cash	\$11,772	\$24,429
Investment securities	2,885	2,885
Investment in and advances to subsidiaries	548,781	482,407
Other assets	3,562	3,023

Total assets	\$567,000	\$512,744
=====		
Liabilities and shareholders' equity:		
Accrued interest and other liabilities	\$8,926	\$7,526
Borrowings	83,446	100,390
Shareholders' equity	474,628	404,828

Total liabilities and shareholders' equity	\$567,000	\$512,744
=====		

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

(000's omitted)	2004	2003	2002

Revenues:			
Dividends from subsidiaries	\$41,500	\$42,771	\$29,587
Interest on investments	179	6	10
Other income	28	0	0

Total revenues	41,707	42,777	29,597

Expenses:			
Interest on long term notes and debentures	6,061	5,765	6,112
Other expenses	13	84	9

Total expenses	6,074	5,849	6,121

Edgar Filing: COMMUNITY BANK SYSTEM INC - Form 10-K/A

Income before tax benefit and equity in undistributed net income of subsidiaries	35,633	36,928	23,476
Income tax benefit	1,461	1,364	1,572

Income before equity in undistributed net income of subsidiaries	37,094	38,292	25,048
Equity in undistributed net income of subsidiaries	13,102	2,088	13,469

Net income	\$50,196	\$40,380	\$38,517
=====			

29

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

(000's omitted)	2004

Operating activities:	
Net income	\$50,196
Adjustments to reconcile net income to net cash provided by operating activities	
Equity in undistributed net income of subsidiaries	(13,102)
Net change in other assets and other liabilities	3,157

Net cash provided by operating activities	40,251

Investing activities:	
Purchase of investment securities	0
Capital contributions to subsidiaries	0

Net cash used in investing activities	0

Financing activities:	
Net change in borrowings	(17,000)
Issuance of common stock	5,344
Purchase of treasury stock	(21,709)
Cash dividends paid	(19,543)

Net cash (used) provided by financing activities	(52,908)

Change in cash and cash equivalents	(12,657)
Cash and cash equivalents at beginning of year	24,429

Cash and cash equivalents at end of year	\$11,772
=====	
Supplemental disclosures of cash flow information:	
Cash paid for interest	\$5,943
Supplemental disclosures of non-cash financing activities	
Dividends declared and unpaid	\$5,515

30

Edgar Filing: COMMUNITY BANK SYSTEM INC - Form 10-K/A

Management's Report on Internal Control Over Financial Reporting

Our management is responsible for establishing and maintaining adequate internal control over financial reporting, as such term is defined in Exchange Act Rule 13a - 15(f). Under the supervision and with the participation of our management, including our principal executive officer and principal financial officer, we conducted an evaluation of the effectiveness of our internal control over financial reporting based on the framework in Internal Control - Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission. Based on our evaluation under the framework in Internal Control - Integrated Framework, our management concluded that our internal control over financial reporting was effective as of December 31, 2004.

Our management's assessment of the effectiveness of our internal control over financial reporting as of December 31, 2004 has been audited by PricewaterhouseCoopers LLP, an independent registered public accounting firm, as stated in their report which is included herein.

Community Bank System, Inc.

Date: March 11, 2005

/s/ Sanford A. Belden

Sanford A. Belden,
President, Chief Executive Officer and Director

/s/ Scott A. Kingsley

Scott A. Kingsley,
Treasurer and Chief Financial Officer

31

Report of Independent Registered Public Accounting Firm

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

We have completed an integrated audit of Community Bank System, Inc.'s 2004 consolidated financial statements and of its internal control over financial reporting as of December 31, 2004 and audits of its 2003 and 2002 consolidated financial statements in accordance with the standards of the Public Company Accounting Oversight Board (United States). Our opinions, based on our audits, are presented below.

Consolidated financial statements

In our opinion, the consolidated financial statements listed in the accompanying index present fairly, in all material respects, the financial position of Community Bank System, Inc. and its subsidiaries at December 31, 2004 and 2003, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2004 in conformity with accounting principles generally accepted in the United States of America. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits of these statements in accordance with the standards of the Public Company Accounting Oversight Board (United States).

Edgar Filing: COMMUNITY BANK SYSTEM INC - Form 10-K/A

Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit of financial statements includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

Internal control over financial reporting

Also, in our opinion, management's assessment, included in Management's Report on Internal Control Over Financial Reporting appearing under Item 8, that the Company maintained effective internal control over financial reporting as of December 31, 2004 based on criteria established in Internal Control - Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO), is fairly stated, in all material respects, based on those criteria. Furthermore, in our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 2004, based on criteria established in Internal Control - Integrated Framework issued by the COSO. The Company's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express opinions on management's assessment and on the effectiveness of the Company's internal control over financial reporting based on our audit. We conducted our audit of internal control over financial reporting in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. An audit of internal control over financial reporting includes obtaining an understanding of internal control over financial reporting, evaluating management's assessment, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we consider necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinions.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (i) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (ii) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (iii) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

PricewaterhouseCoopers LLP
Syracuse, New York
March 11, 2005

Edgar Filing: COMMUNITY BANK SYSTEM INC - Form 10-K/A

32

TWO YEAR SELECTED QUARTERLY DATA (Unaudited)

2004 Results (000's omitted, except per share data)	4th Quarter	3rd Quarter	2nd Quarter
Net interest income	\$ 38,575	\$ 39,057	\$ 37,457
Provision for loan losses	2,100	2,300	2,300
Net interest income after provision for loan losses	36,475	36,757	35,157
Non-interest income	10,832	12,164	10,919
Operating expenses	30,442	29,926	29,775
Income before income taxes	16,865	18,995	16,301
Income taxes	4,199	4,761	4,160
Net income	\$ 12,666	\$ 14,234	\$ 12,141
Basic earnings per share	\$ 0.41	\$ 0.47	\$ 0.41
Diluted earnings per share	\$ 0.40	\$ 0.45	\$ 0.40

2003 Results (000's omitted, except per share data)	4th Quarter	3rd Quarter	2nd Quarter
Net interest income	\$ 34,703	\$ 32,539	\$ 32,102
Provision for loan losses	3,093	2,029	2,673
Net interest income after provision for loan losses	31,610	30,510	29,429
Non-interest income	7,698	9,779	8,947
Operating expenses	27,879	25,206	25,179
Income before income taxes	11,429	15,083	13,197
Income taxes	2,759	3,354	3,165
Net income	\$ 8,670	\$ 11,729	\$ 10,032
Basic earnings per share	\$ 0.32	\$ 0.45	\$ 0.38
Diluted earnings per share	\$ 0.31	\$ 0.44	\$ 0.38

33

SIGNATURES

Pursuant to the requirements of Section 13 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.

Edgar Filing: COMMUNITY BANK SYSTEM INC - Form 10-K/A

By: /s/ Sanford A. Belden

Sanford A. Belden
President, Chief Executive Officer and Director
May 11, 2005

Pursuant to the requirements of the Securities and Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacities indicated on the 11th day of May 2005.

/s/ James A. Gabriel

James A. Gabriel, Director and
Chairman of the Board of Directors

/s/ Scott A. Kingsley

Scott A. Kingsley
Treasurer and Chief Financial Officer

Directors:

/s/ Brian R. Ace

Brian R. Ace, Director

/s/ John M. Burgess

John M. Burgess, Director

/s/ Paul M. Cantwell, Jr.

Paul M. Cantwell, Jr., Director

/s/ William M. Dempsey

William M. Dempsey, Director

/s/ Nicholas A. DiCerbo

Nicholas A. DiCerbo, Director

/s/ Lee T. Hirschey

Lee T. Hirschey, Director

/s/ Harold S. Kaplan

Harold S. Kaplan, Director

Edgar Filing: COMMUNITY BANK SYSTEM INC - Form 10-K/A

/s/ Saul Kaplan

Saul Kaplan, Director

/s/ Charles E. Parente

Charles E. Parente, Director

/s/ David C. Patterson

David C. Patterson, Director

/s/ Peter A. Sabia

Peter A. Sabia, Director

/s/ Sally A. Steele

Sally A. Steele, Director

34

Part IV

Item 15. Exhibits, Financial Statement Schedules and Reports on Form 8-K

A. Documents Filed

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

- Consolidated Statements of Condition,
December 31, 2004 and 2003
- Consolidated Statements of Income,
Years ended December 31, 2004, 2003, and 2002
- Consolidated Statements of Changes in Shareholders' Equity,
Years ended December 31, 2004, 2003, and 2002
- Consolidated Statements of Comprehensive Income,
Years ended December 31, 2004, 2003, and 2002
- Consolidated Statement of Cash Flows,
Years ended December 31, 2004, 2003, and 2002
- Notes to Consolidated Financial Statements,
December 31, 2004
- Report of Independent Registered Public Accounting Firm
- Quarterly selected data,
Years ended December 31, 2004 and 2003 (unaudited)

2. Schedules are omitted since the required information is either not applicable or shown elsewhere in the financial statements.

Edgar Filing: COMMUNITY BANK SYSTEM INC - Form 10-K/A

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

2.1 Agreement and Plan of Merger, dated January 6, 2004 and amended March 11, 2004, by and among Community Bank System, Inc., Community Bank, N.A., and First Heritage Bank. Incorporated by reference to Annex A to the proxy statement/prospectus included in Registration Statement on Form S-4 filed on March 12, 2004, as amended (Registration No. 333-113581).

2.2 Amended and Restated Agreement and Plan of Merger, dated June 7, 2003, by and between Community Bank System, Inc. and Grange National Banc Corp. Incorporated by reference to Annex A to the proxy statement/prospectus included in the Registration Statement on Form S-4 filed on August 20, 2003, as amended (Registration No. 333-107949).

2.3 Agreement and Plan of Merger, dated May 6, 2003, by and among the Registrant, PB Acquisition Corp. and Peoples Bankcorp, Inc. Incorporated by reference to Exhibit 2.1 to the Current Report on Form 8-K of the Registrant filed on May 8, 2003 (Registration No. 001-13695).

2.4 Agreement and Plan of Merger, dated November 29, 2000, by and between Community Bank System, Inc. and First Liberty Bank Corp. Incorporated by reference to Exhibit No. 2.1 to the Current Report on Form 8-K filed on December 20, 2000 (Registration No. 001-13695).

2.5 Agreement regarding the Agreement and Plan of Merger, dated September 26, 2000, by and between Community Bank, N.A. and The Citizens National Bank of Malone. Incorporated by reference to Exhibit No. 10.1 to the Registration Statement on Form S-4 filed on October 20, 2000 (Registration No. 333-48374).

35

2.6 Purchase and Assumption Agreement, dated December 6, 1994, by and between Community Bank System, Inc. and The Chase Manhattan Bank, N.A. Incorporated by reference to Exhibit No. 10.01 to the Registration Statement on Form S-2 filed on April 11, 1995 (Registration No. 033-58539).

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

3.2 Bylaws of Community Bank System, Inc., as amended. Incorporated by reference to Exhibit No. 3.2 to the Registration Statement on Form S-4 filed on October 20, 2000 (Registration No. 333-48374).

4.1 Junior Subordinated Deferrable Interest Debentures, dated as February 3, 1997, by and between Community Bank System, Inc. and The Chase Manhattan Bank. Incorporated by reference to Exhibit No. 4.1 to the Registration Statement on Form S-4 filed on June 25, 1997 (Registration No. 333-30045).

4.2 Amended and Restated Declaration of Trust of Community Capital Trust I, dated as February 3, 1997, by and between Community Bank

Edgar Filing: COMMUNITY BANK SYSTEM INC - Form 10-K/A

System, Inc. and The Chase Manhattan Bank. Incorporated by reference to Exhibit No. 4.5 to the Registration Statement on Form S-4 filed on June 25, 1997 (Registration No. 333-30045).

4.3 Form of Common Stock Certificate. Incorporated by reference to Exhibit No. 4.1 to the Amendment No. 1 to the Registration Statement on Form S-3 filed on October 24, 2001 (Registration No. 333-68866).

10.1 Employment Agreement, effective March 1, 2004, by and between Community Bank System, Inc. and Sanford A. Belden. Incorporated by reference to Exhibit No. 10.1 to the Annual Report on Form 10-K filed on March 12, 2004 (Registration No. 001-13695). **

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

10.3 Pre-2005 Supplemental Retirement Agreement, effective December 31, 2004, by and between Community Bank System, Inc., Community Bank N.A. and Sanford Belden. Incorporated by reference to Exhibit No. 10.2 to the Annual Report on Form 10-K filed on March 15, 2005 (Registration No. 001-13695). **

10.4 Employment Agreement, effective March 8, 2004, by and between Community Bank System, Inc. and Mark E. Tryniski. Incorporated by reference to Exhibit No. 10.4 to the Annual Report on Form 10-K filed on March 12, 2004 (Registration No. 001-13695). **

10.5 Supplemental Retirement Plan Agreement, effective July 1, 2003, by and between Community Bank System Inc. and Mark E. Tryniski. Incorporated by reference to Exhibit No. 10.5 to the Annual Report on Form 10-K filed on March 12, 2004 (Registration No. 001-13695). **

10.6 Employment Agreement, effective August 2, 2004, by and between Community Bank System, Inc., Community Bank, N.A. and Scott A. Kingsley. Incorporated by reference to Exhibit No. 10.3 to the Quarterly Report on Form 10-Q filed on August 4, 2004 (Registration No. 001-13695). **

10.7 Supplemental Retirement Plan Agreement, effective August 2, 2004, by and between Community Bank System Inc. and Scott A. Kingsley. Incorporated by reference to Exhibit No. 10.4 to the Quarterly Report on Form 10-Q filed on August 4, 2004 (Registration No. 001-13695). **

10.8 Agreement dated December 23, 2002, by and between Community Bank System, Inc., Community Bank N.A. and David G. Wallace. Incorporated by reference to Exhibit 10.2 to the Annual Report on Form 10-K filed on March 23, 2003 (Registration No. 001-13695). **

10.9 Employment Agreement, effective August 1, 2004, by and between Community Bank System, Inc., Community Bank, N.A. and Brian D. Donahue. Incorporated by reference to Exhibit No. 10.1 to the Quarterly Report on Form 10-Q filed on November 8, 2004 (Registration No. 001-13695). **

10.10 Employment Agreement, effective March 20, 2003, by and between Community Bank System, Inc. and Michael A. Patton. Incorporated by reference to Exhibit No. 10.8 to the Annual Report on Form 10-K

Edgar Filing: COMMUNITY BANK SYSTEM INC - Form 10-K/A

filed on March 12, 2004 (Registration No. 001-13695). **

36

10.11 Supplemental Retirement Plan Agreement, effective February 1, 2004, by and between Community Bank System Inc. and Michael A. Patton. Incorporated by reference to Exhibit No. 10.9 to the Annual Report on Form 10-K filed on March 12, 2004 (Registration No. 001-13695). **

10.12 Employment Agreement, effective March 20, 2003, by and between Community Bank System, Inc. and James A. Wears. Incorporated by reference to Exhibit No. 10.6 to the Annual Report on Form 10-K filed on March 12, 2004 (Registration No. 001-13695). **

10.13 Supplemental Retirement Plan Agreement, effective February 1, 2004, by and between Community Bank System Inc. and James A. Wears. Incorporated by reference to Exhibit No. 10.7 to the Annual Report on Form 10-K filed on March 12, 2004 (Registration No. 001-13695). **

10.14 Employment Agreement, effective November 21, 2003, by and between Community Bank System, Inc. and Thomas A. McCullough. Incorporated by reference to Exhibit No. 10.10 to the Annual Report on Form 10-K filed on March 12, 2004 (Registration No. 001-13695). **

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

10.16 Employment Agreement, effective May 1, 2004, by and between Community Bank System, Inc., Community Bank N.A. and Steven R. Tokach. Incorporated by reference to Exhibit No. 10.2 to the Quarterly Report on Form 10-Q filed on August 4, 2004 (Registration No. 001-13695). **

10.17 Employment Agreement, effective September 1, 2002, by and between Community Bank System, Inc., Community Bank N.A. and Timothy J. Baker. Incorporated by reference to Exhibit No. 10.2 to the Quarterly Report on Form 10-Q filed on November 8, 2004 (Registration No. 001-13695). **

10.18 Change of Control Agreement, effective November 30, 2001 by and between Community Bank System, Inc., Community Bank N.A. and W. Valen McDaniel. Incorporated by reference to Exhibit No. 10.2 to the Annual Report on Form 10-K filed on March 15, 2005 (Registration No. 001-13695). **

10.19 Employment Agreement, effective September 1, 2002, by and between Community Bank System, Inc., Community Bank N.A. and Joseph J. Lemchak. Incorporated by reference to Exhibit No. 10.4 to the Quarterly Report on Form 10-Q filed on November 8, 2004 (Registration No. 001-13695). **

10.20 Employment Agreement, effective October 1, 2004, by and between Community Bank System, Inc., Community Bank N.A. and J. David Clark. Incorporated by reference to Exhibit No. 10.3 to the

Edgar Filing: COMMUNITY BANK SYSTEM INC - Form 10-K/A

Quarterly Report on Form 10-Q filed on November 8, 2004
(Registration No. 001-13695). **

10.21 Employment Agreement, effective May 15, 2004, by and between Community Bank System, Inc., Community Bank N.A. and Robert P. Matley. Incorporated by reference to Exhibit No. 10.2 to the Annual Report on Form 10-K filed on March 15, 2005 (Registration No. 001-13695). **

10.22 Change of Control Agreement, effective August 20, 2002 by and between Community Bank System, Inc., Community Bank N.A. and J. Michael Wilson. Incorporated by reference to Exhibit No. 10.2 to the Annual Report on Form 10-K filed on March 15, 2005 (Registration No. 001-13695). **

10.23 Employment Agreement, effective April 3, 2000, by and between Community Bank System, Inc. and David J. Elias. Incorporated by reference to Exhibit No. 10.12 to the Annual Report on Form 10-K filed on March 12, 2004 (Registration No. 001-13695). **

10.24 2004 Long-Term Incentive Compensation Program. Incorporated by reference to Appendix A to the Definitive Proxy Statement on Schedule 14A filed on April 15, 2004 (Registration No. 001-13695). **

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

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

10.27 Community Bank System, Inc. Pension Plan Amended and Restated as of January 1, 2004. Incorporated by reference to Exhibit No. 10.2 to the Annual Report on Form 10-K filed on March 15, 2005 (Registration No. 001-13695). **

37

21.1 Subsidiaries of Community Bank System, Inc.

Name	Jurisdiction of Incorporation
----	-----
Community Bank, N.A	New York
Community Capital Trust I	Delaware
Community Capital Trust II	Delaware
Community Statutory Trust III	Connecticut
Community Financial Services, Inc.	New York
Benefit Plans Administrative Services, Inc.	New York
Benefit Plans Administrative Services LLC	New York
Harbridge Consulting Group LLC	New York
CBNA Treasury Management Corporation	New York
Community Investment Services, Inc.	New York
CBNA Preferred Funding Corp.	Delaware
CFSI Close-Out Corp.	New York
Elias Asset Management, Inc.	Delaware
First Liberty Service Corporation	Delaware

Edgar Filing: COMMUNITY BANK SYSTEM INC - Form 10-K/A

First of Jermyn Realty Co.

Delaware

23.1 Consent of PricewaterhouseCoopers LLP. *

31.1 Certification of Sanford A. Belden, 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 A. 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 Sanford A. Belden, 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 A. Kingsley, Treasurer and Chief Financial Officer of the Registrant, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. *

* Filed herewith

**Denotes management contract or compensatory plan or arrangement

B. Reports on Form 8-K

- o Form 8-K related to quarterly earnings press release was filed on January 25, 2005.
- o Form 8-K related to quarterly earnings press release was filed on October 25, 2004.

C. Not applicable