

Strength  
in Numbers

 Community Bank System, Inc.  
2003 | Annual Report

When you walk into one of **Community Bank System's** branches, you won't be overwhelmed by its grandeur. In most cases, the architecture won't impress you either. Neither will its furnishings. And that's all been done by design.

You see, the appeal of this little branch is not what it is by itself, but of the greater network—the team—of which it is a part. We've found there is **Strength in Numbers.**

You might be thinking, "That's certainly not a new concept." And you're right. It's been present in nature since the beginning of time. Flocks of geese fly across continents in their well-known V-formations. They take turns braving the head winds, making it a little easier on the rest. Tiny ants **work together** as a colony to lift objects weighing several times their own weight. Zebras travel in herds because predators get confused by all the stripes moving at once. And a family of beavers can alter the flow of the mightiest of rivers.

Alone they could only get so far. But as a team, they're able to go the distance.

So no, it's not unique at all...but relative to our industry and markets, the concept has proven to be quite novel. The critical mass we've achieved over the last decade has positioned CBU extremely well for continued **growth.** In fact, we have never had more opportunities available to us than we do right now.

That's what allows a single CBU branch to provide quick lending decisions made right on-site. And offer a thorough variety of **banking and investment products.** And implement technology-driven, customer-convenient solutions. And provide insightful service and guidance to customers, even in rural settings.

By itself, our little branch couldn't accomplish much. But by ensuring that all 129 of our customer facilities work together with our other CBU subsidiaries—as you'll see throughout the next few pages—what we've **accomplished** is remarkable.

## Company Profile

Community Bank System, Inc. is a registered bank holding company based in DeWitt, N.Y. Upon completion of its recently announced acquisition of First Heritage Bank in Wilkes-Barre, Pa., CBU's wholly-owned banking subsidiary, Community Bank, N.A. will have approximately \$4.1 billion of assets, 129 customer facilities and 98 ATMs across Upstate New York and Northeastern Pennsylvania (where it operates as First Liberty Bank & Trust).

CBU is located in smaller urban markets where superior service is valued and customer loyalty can be earned. The company ranks first or second in deposit market share in over 70% of the towns in which it does business, serving approximately 213,000 households.

Other subsidiaries within the CBU family are:

- Elias Asset Management, Inc., an investment management and advisory firm based in Williamsville, N.Y.
- Community Investment Services, Inc., a broker-dealer delivering financial products, including mutual funds, annuities, individual stocks and bonds, and insurance products from various locations throughout Community Bank System's branch network.
- Benefit Plans Administrative Services, Inc., an employee benefits company which includes BPA, a retirement plan administration firm located in Utica, N.Y., and Harbridge Consulting Group, an actuarial and consulting firm based in Syracuse, N.Y.

## A Decade of Adding Numbers...and Strength

- **April 1994** Began offering select financial services products through a third-party partner.
- **June 1994** Began our acquisition campaign, buying 3 Central New York branches from the Resolution Trust Company.
- **October 1994** Acquired 1 branch in Cato, N.Y. from Chase Manhattan Bank.
- **July 1995** Completed \$27 million secondary stock offering and acquired 15 branches from Chase Manhattan Bank in New York's Finger Lakes and Northern regions.
  - **July 1996** Acquired Benefit Plans Administrators, Inc. (BPA), pension administration and recordkeeping business based in Utica, N.Y.
  - **June 1997** Acquired 8 Western New York branches from Key Bank.
    - **July 1997** Acquired 12 Northern New York branches from Fleet Bank.
    - **January 1998** Opened a de novo branch in Owego, N.Y.
    - **February 1998** Opened a de novo branch in Houghton, N.Y.
    - **June 1998** Established a stand-alone insurance agency (since incorporated into CISI, see below).
    - **September 1998** Opened a de novo branch in Jamestown, N.Y.
    - **March 1999** Created Community Investment Services Inc. (CISI), based in Olean, N.Y., giving us our own broker-dealer.

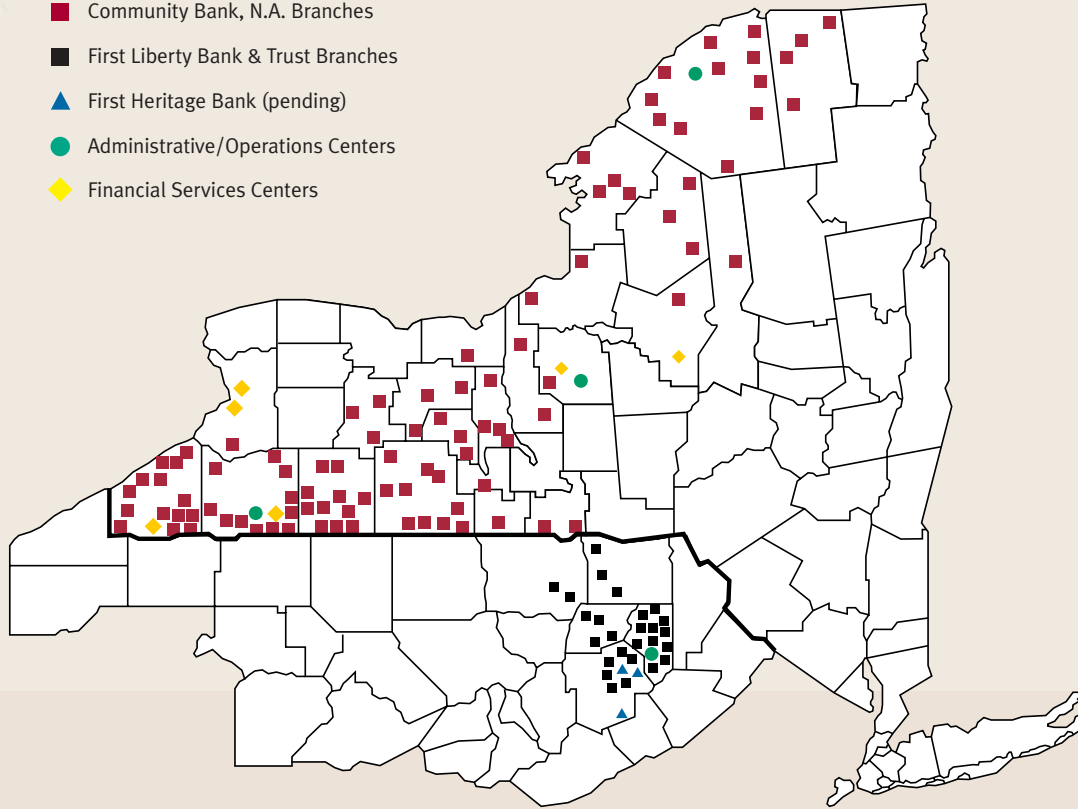






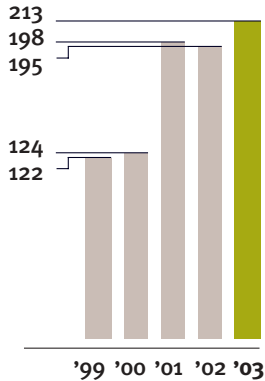
## CommunityBankSystem Locations

- Community Bank, N.A. Branches
- First Liberty Bank & Trust Branches
- ▲ First Heritage Bank (pending)
- Administrative/Operations Centers
- ◆ Financial Services Centers



### Households Served

(in thousands)



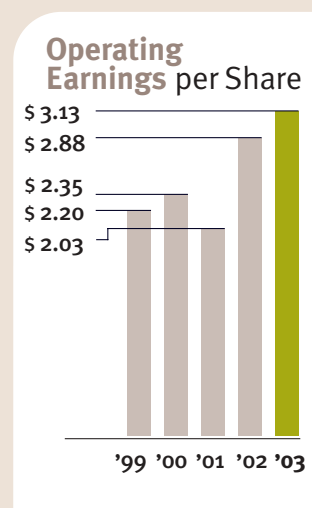
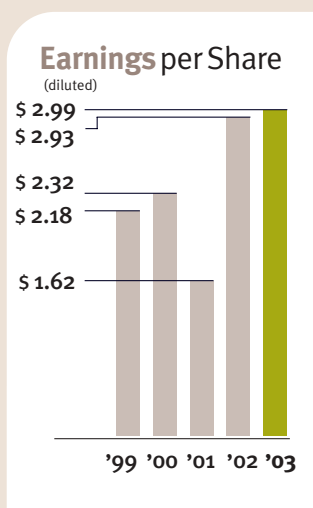
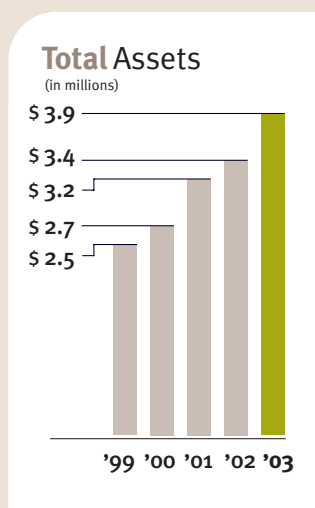
- **February 2000** Opened a de novo branch in Falconer, N.Y.
- **April 2000** Acquired Elias Asset Management, a nationally recognized investment advisory firm.
- **January 2001** Acquired Citizens' National Bank of Malone, adding 5 branches in Northern New York.
- **May 2001** Acquired Scranton, Pa.-based First Liberty Bank Corp., and its wholly owned, 13-branch subsidiary, First Liberty Bank & Trust—our first transaction outside of New York.
- **November 2001** Acquired 36 branches in Western and Central New York from FleetBoston.
- **July 2003** Acquired Harbridge Consulting Group, an actuarial and pension consultant based in Syracuse, N.Y. that complements the services offered by BPA.
- **September 2003** Acquired Peoples Bankcorp., which added one branch in Ogdensburg, N.Y.
- **November 2003** Acquired Grange National Banc Corp., adding 12 branches to our Northeastern Pennsylvanian First Liberty Bank & Trust franchise.
- **January 2004** Announced our agreement to acquire First Heritage Bank, in Wilkes-Barre, Pa., to further enhance our First Liberty franchise.

# Financial Highlights

	2003	2002	Percent Change	2001	2000	1999	5-Year CAGR
<b>Income Statement Data</b> (in thousands)							
Net interest income	\$ 131,828	\$ 127,850	3.1 %	\$ 96,655	\$ 90,433	\$ 88,000	9.4%
Non interest income (excludes securities gains/losses)	37,679	30,133	25.0	26,092	23,284	18,153	17.5
Net income	40,380	38,517	4.8	19,129	24,899	23,662	15.4
Net income – operating*	\$ 42,332	\$ 37,926	11.6	\$ 24,052	\$ 25,230	\$ 23,906	17.1
Average diluted common shares outstanding	13,517	13,167	2.7%	11,825	10,737	10,861	3.7%
<b>Common Per Share Data</b> (diluted)							
Net income	\$ 2.99	\$ 2.93	2.0%	\$ 1.62	\$ 2.32	\$ 2.18	11.3%
Net income – operating*	3.13	2.88	8.7	2.03	2.35	2.20	13.0
Cash dividend declared	1.22	1.12	8.9	1.08	1.04	0.96	7.2
Common stock price	49.00	31.35	56.3	26.20	24.75	23.13	10.8
Period-end book value – stated	28.58	25.04	14.1	20.77	19.11	15.55	11.6
Period-end book value – tangible	\$ 14.73	\$ 14.66	0.5%	\$ 9.74	\$ 13.88	\$ 10.47	6.0%
<b>End of Period Balance Sheet Data</b> (in millions)							
Total assets	\$ 3,855	\$ 3,437	12.2%	\$ 3,213	\$ 2,652	\$ 2,495	10.9%
Loans	2,129	1,807	17.8	1,733	1,516	1,426	10.5
Deposits	2,725	2,505	8.8	2,546	1,949	1,845	7.8
Assets under fiduciary management	1,807	1,364	32.5	1,385	1,282	583	39.9
CBU equity market value	\$ 694	\$ 407	70.5%	\$ 338	\$ 261	\$ 247	26.5%

\* Operating earnings exclude the effects of certain items the company considers to be non-operating, including acquisition expenses, securities gains & losses, and debt restructuring transactions. See Table 1 in “Management’s Discussion and Analysis of Financial Condition and Results of Operations” (“MD&A,” page 30) for a reconciliation of GAAP-based earnings results to operating-based earnings results.

In accordance with Generally Accepted Accounting Principles (GAAP), all historical results throughout this Annual Report for periods prior to 2001 have been restated to include the 2001 acquisition of First Liberty Bank Corp. (FLIB) on a pooling-of-interest basis.



## Table of Contents

Letter to Shareholders ..... 2  
 Review of Operations ..... 6  
 Board of Directors ..... 16

Form 10-K ..... 17  
 Administration and Lenders ..... 92  
 Financial Services & Subsidiaries .. 93

Branch Offices ..... 94  
 Glossary of Banking Terms ..... 96  
 Shareholder Information ..... 97

## Letter to Shareholders

We built substantial value at Community Bank System during 2003. Our total return to shareholders, including reinvestment of dividends, was 61% over the course of the year — well ahead of both peer group and overall market performances. Such stellar stock price improvement, coupled with additional shares issued in the November Grange acquisition, produced a market capitalization value of \$694 million at the end of the year — up nearly 71% over last year's closing level. This figure will soon be further enhanced by the all-stock acquisition of First Heritage Bank, announced in January of this year and expected to be completed in May. We anticipate that our recently announced stock split will enhance liquidity and facilitate even greater retail and institutional investor interest.

Our team enhanced our franchise value in a number of ways in 2003. In July, we acquired the pension and health benefits consulting practice of PricewaterhouseCoopers in Syracuse and renamed it Harbridge Consulting Group. Harbridge has a deep pool of talented actuaries and consultants with a thriving practice throughout the Northeast. We have linked them with Benefit Plans Administrative Services from a technology, marketing and organizational perspective to form a complete and powerful set of employee benefit consulting and administrative services for our clients.

In September, we consummated the acquisition of Peoples Bankcorp., deepening our market share and enhancing our delivery structure in this important Northern New York market.

Our major acquisition focus on the banking side of the business recently has been to build our presence and franchise value in Pennsylvania, following our highly successful strategy and business model geared to decentralized decision making in non-metropolitan markets. Acquiring Grange National Bank in November provided us with a significantly expanded presence in Pennsylvania markets similar to the smaller markets in which we have been so successful in New York. Grange was a premier bank in Northeastern Pennsylvania and had been so for a long time under the very able leadership of Thomas McCullough, who is now leading our Pennsylvania team as President of Pennsylvania Banking.

*From left: Sanford Belden, Mark Tryniski, Michael Patton, Steven Tokach, James Wears, Brian Donahue, Valen McDaniel, Thomas McCullough, Timothy Baker.*



In early 2004 we announced the acquisition of First Heritage Bank, one of the other premier banks in Northeastern Pennsylvania. First Heritage deepens our market presence in Luzerne County, brings a successful team of commercial lenders with a strong portfolio, offers substantial opportunity to grow non-interest income within their customer base, and rounds out our Pennsylvania management team with Robert Matley, who will be Chief Lending Officer and Executive Vice President of Pennsylvania Banking. We are delighted that Sally Steele and Brian Ace have joined our Board from Grange, and look forward to Charles Parente joining us as a result of the First Heritage transaction after its anticipated May completion.

Operating earnings per share at \$3.13 represent an all-time record for Community Bank System and a continuation of the strong earnings trend built off our successful 2001 acquisitions (see Table 1 in the “Managements Discussion and Analysis,” page 30). Aided by the strong earnings performance, capital levels continue to build and position us for future internal investment and additional constructive acquisitions.

Other operating highlights include:

- Consistent improvements throughout the year in asset quality metrics, including the delinquency, charge-off and non-performing loan ratios;
- Robust loan growth in the face of moderate growth in the New York and Pennsylvania economies;
- Continued development of our internal technology infrastructure, and;
- Provision of additional electronic banking capabilities to our customers, such as electronic statements, an enhanced commercial cash management product and an upgraded Web site.

### Total Return to Shareholders

	<b>CBU (a) (b)</b>	Russell 2000	S&P Small Cap Bank Index (c)
<b>One Year</b>	<b>61.1 %</b>	47.3 %	34.0 %
<b>Three Years</b>	<b>29.3</b>	6.3	18.0
<b>Five Years</b>	<b>14.7</b>	7.2 %	14.9 %
<b>Ten Years</b>	<b>17.3 %</b>	N/A	N/A

(a) CBU share price of \$49.00 at 12/31/03

(b) Assumes reinvestment of all dividends

(c) Index of 23 commercial banks nationwide with market capitalization between \$400 million and \$1.8 billion

However, above all of these accomplishments, the most important building block we laid for future success was the deepening and strengthening of our Senior Management team, starting with the addition in June of Mark Tryniski as Executive Vice President and Chief Financial Officer. We followed that development with the promotion of Brian Donahue (Chief Credit Officer), Tim Baker (Head of Operations and Technology) and Val McDaniel (Chief Risk Officer) to the Senior Management Committee and the addition of Tom McCullough (President, Pennsylvania Banking) as a result of our Grange transaction. As always, our current and future success is attributable to the consistent and responsible leadership of the Board of Directors and the commitment to excellence in execution of our strategy by our tremendous team of approximately 1,200 employees.

During last year's annual report we outlined a number of near- and long-term objectives. We're pleased to report we accomplished all our near-term goals. Specifically, we have:

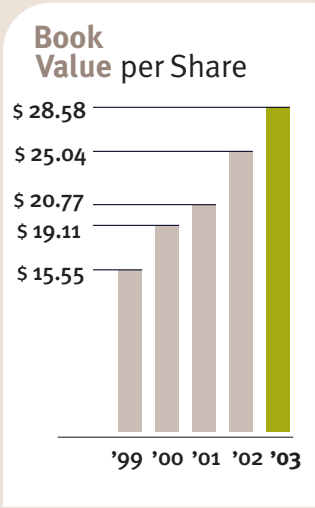
- Strengthened our management team in exactly the manner we intended, as you've just read;
- Successfully expanded our franchise, both within our New York and Pennsylvania banking markets, as well as our Financial Services Group;
- Improved our asset quality, as indicated above; and
- Taken a number of steps designed to improve the return on revenue of our Financial Services Group in the near future.

Furthermore, we have made significant progress toward — and in one case, have already exceeded — the long-term objectives we set as well. For instance:

4

- Last year, our total assets stood at \$3.4 billion. Currently they are \$3.9 billion. Upon May's completion of the First Heritage merger, we will jump to \$4.1 billion. This puts us half-way to the \$5.0 billion goal we set to reach before the close of 2005.
- At the close of 2002, noninterest income comprised 18% of our total operating income. One year later, that figure has climbed to 20.7%, putting us closer to reaching our long-term goal of having noninterest income comprise 40% of our total operating income.
- Our Grange and pending First Heritage acquisitions have clearly addressed the third objective we established of expanding our presence in the Northeastern Pennsylvania market. Nonetheless, we continue to remain focused on this market for continued growth opportunities.
- Lastly, as stated at the onset, our market capitalization stood at \$694 million at year end — more than 39% higher than the goal we set for ourselves to reach by the end of 2005! And that figure is expected to be further enhanced with the completion of our all-stock First Heritage merger.





In short, we added numerous strengths to CBU during 2003, while adding to our strong numbers as well. But as you've seen if you've followed us for any length of time, the decisions we make are seldom for the sake of the short term. Indeed, the choices we made in 2003 will have their biggest impact on CBU several years from now, just as those we made throughout the 1990's and early part of this decade have come together to carry us to the successes we enjoyed this past year. If you have not shared in our successes to date, we invite you to join us as a new investor. And if you have, we hope you will continue to trust in our team, while we work hard to ensure you remain a very satisfied CBU shareholder.

Sincerely,

Sanford A. Belden  
 President & Chief Executive Officer

James A. Gabriel  
 Chairman of the Board





6

## The CBU Growth Strategy

*Developing Our Instincts*

Whether it's instinct or learned behavior, whenever you witness an impressive team-based accomplishment, you can be sure there is some type of strategic plan in place that's been the guiding force.

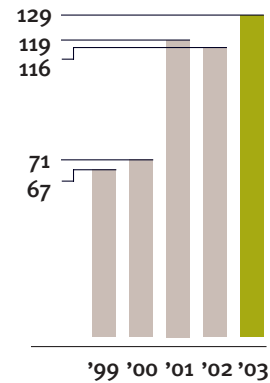
It's been no different at Community Bank System (CBU) since 1993 when we first formulated our simplified, four-step strategy for growth. Every major decision we've made since then has been held up against this plan, to ensure it addresses at least one of the four elements we've established as keys to our success:

- Create a dominant branch system with decentralized decision-making.
- Diversify our revenue and earnings streams through noninterest income.
- Build profitable loan volume.
- Utilize technology to enhance customer service and productivity.

Those four short guidelines may not seem like much, but they've allowed us to more than quintuple (5X) the size of our company over the last ten years — both in terms of total assets (from \$713 million to \$3.9 billion), and branches (from 23 to 125). That's translated to the bottom line as well, in the form of a tripling of our net income, and a total return to shareholders of 17.3% annually, including dividend reinvestment, over that ten-year span.

With results like this, it's worth understanding these four growth elements in a little more detail.

### Growth in Customer Facilities



## Growth Element 1 Sticking With What's Second Nature

While most banks fled markets like ours throughout the e-banking and consolidation craze of the 1990's, we did the opposite and stayed true to our roots. We understood that our banking model worked best in smaller towns and villages where service was still highly valued and loyalty could be earned. Therefore, we played to our strengths. We stayed put — but didn't stand pat.

So while others abandoned our markets, we took a more involved role, raising our levels of service as well as our commitment to and support of our communities. We reinforced our belief in empowering our associates at the local level to be key decision makers, resulting in faster, more responsive service to our customers—without sacrificing accuracy or compromising our strong credit standards. Our efforts did not go unnoticed, as we quickly gained trust and market share.

It didn't take long for us to realize that if this approach worked in the markets we were in, it could work in similar markets where we did not have a presence. And although our bank would open a number of de novo (newly built) branches during the decade, we knew that to achieve a true system of community banks, we would need to accomplish this via acquisitions.

We started off slowly... a small, three-branch acquisition in June 1994... another branch four months later... transactions so small, they probably didn't even make the local papers. But a year later we acquired 15 branches from a major money center bank, and suddenly we were gaining confidence, capital... and competence.

Nine years, 11 acquisitions and eighty-seven branches later, we can safely claim a certain amount of expertise in this process. Our efforts have resulted in the dominant network we sought, with 125 branches and four stand-alone financial services subsidiaries serving 27 counties across Upstate New York and Northeastern Pennsylvania. Moreover, we rank first or second in deposit market share in roughly three—quarters of the places we do business. We're not just a bank in these communities — we're an important part of the community.

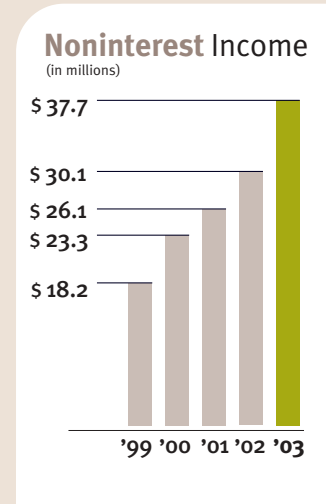




## Growth Element 2 Our Interest in Noninterest Income

We also recognized a need to diversify our revenue streams during our plan's development. With the rapid changes occurring in the banking and financial services regulatory landscape, it became clear that noninterest income should become a primary focus for CBU, because it mitigates the effect of interest income volatility that can occur with changing economic conditions.

We've invested significantly in obtaining the know-how and products that our customer base needs and will buy, and that investment has produced strong returns time after time. In 1994, our noninterest income was just \$5.6 million. Today it's \$37.7 million – a more than 573% jump. More importantly, its relative impact on our organization is far greater. In 1994, it comprised 12.0% of all our revenue. Five years later, it had climbed to 16.2%. And today it stands at 20.7%, moving ever closer to our long-term goal of having 40% of our total revenue coming from noninterest income.



Thus, it's easy to see why the potential for noninterest income growth has been among the foremost considerations when evaluating all our acquisitions. We've actively sought franchises and markets whose customers did not have access to certain products and services that we offer, to maximize the impact we can have on that new region. For example, our pending First Heritage acquisition's ratio of noninterest income to total income is under 10%, compared to CBU's 20.7%. The component of noninterest income that we believe has the most potential upside is the financial services arena, a major focus of ours that we will discuss in greater detail in the coming pages.

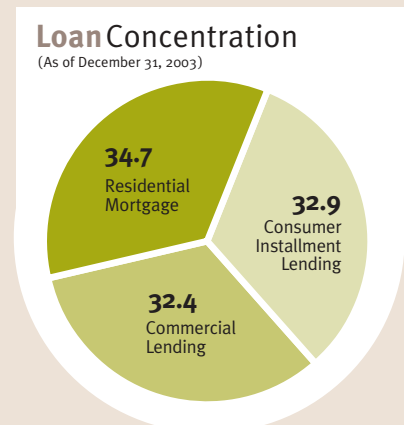
## Growth Element 3 Lending and Learning

8

Any discussion of growth in community banking has to focus on the challenges of lending. As we've stated, we utilize a process of responsive, localized decision-making, focused on customer needs. We've continued to hire very good lenders that have experience within our marketplace, including Northeastern Pa., and we've empowered them to make loan decisions. This method has worked well for us, positioning us to compete successfully for high quality loan business.

In fact, through the end of 2003, our portfolio has grown at a compounded average of 10.5% per year over the last five years and 17.7% per year since the inception of our acquisition program ten years ago. More importantly, this growth has not been achieved at the expense of asset quality, which has remained consistently strong.

Our loan portfolio's present mix is approximately one-third residential mortgages, one-third consumer installment lending and one-third commercial lending—a nicely balanced ratio that has benefited from the favorable mortgage and refinancing environment of the last two years. We continue, however, to remain focused on increasing the relative size of the commercial lending portion of our portfolio, as First Heritage's 80% business loan weighting indicates.

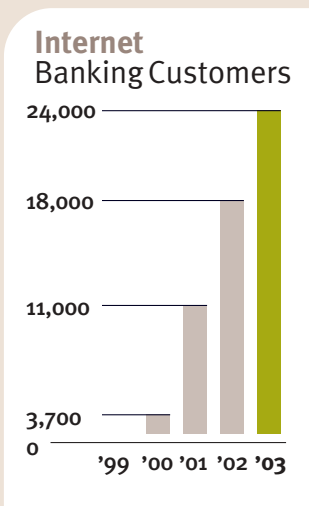


## Growth Element 4 Raising Our Tech. Without Losing Our Touch.

While it's true we don't jump on every technology trend that comes along (an approach that drove far too many banks' strategies during the 1990's), we continually use and invest in technology when it is prudent. In fact, we've made sizable investments in technology, both in the areas of customer products and services, as well as our own back-office operations. However, to our way of thinking, it is paramount that technology serve only as an enhancement to our customers' interactions with their CBU personnel — not as a substitute for them.

For instance, we've committed to working with a technology partner to ensure that our systems remain current. We believe our long-term alliance with Fiserv has provided a more economical and effective solution to our technology needs, allowing us to offer expanded products and services to our customers in a shorter time frame, while staying focused on our core competency: customer service. We've also successfully introduced Internet banking to our retail and commercial customers, with some 24,000 of them using it presently.

During 2003, we made many technology investments and enhanced our customers' capabilities, convenience and cost-efficiency. Several of these investments were designed to further strengthen our existing web-based banking platform, which has been in place for several years. We rolled out "E-statement", a service that enables customers to have their account statements delivered to them via the internet, and we added cash management and other account management functionality for our business banking customers. We upgraded our web site ([communitybankna.com](http://communitybankna.com)) to allow for improved navigation and access to our on-line banking products, as well as providing enhanced data and graphics to the investor relation's section of our site.



2004 is expected to bring even further enhancements to our technology platform, including on-line check image access capabilities, enhanced customer service technology in our branches, standardized loan processing systems, and continuation of the 4 year plan begun in 2001 to replace all our ATM's with improved customer convenience and security features.

So you see, technology has a valuable and critical place within our banking model. In many ways it has leveled the playing field for us, allowing us to link our many locations together despite their somewhat non-urban geographies. It lets us offer the kinds of products and service that used to be found only among the big-city banks. And it has provided clear operational efficiencies as well. However, we remain fully aware that there's merit to the phrase "too much of a good thing," and shall be vigilant in ensuring that our "high tech" never replaces our "high touch."





## The Pennsylvania Market

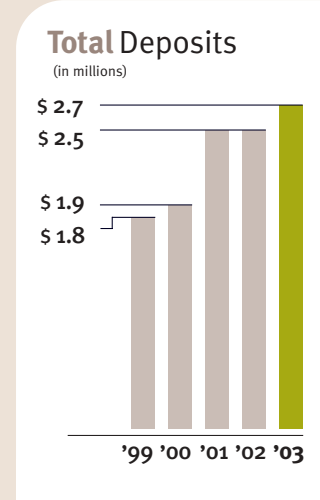
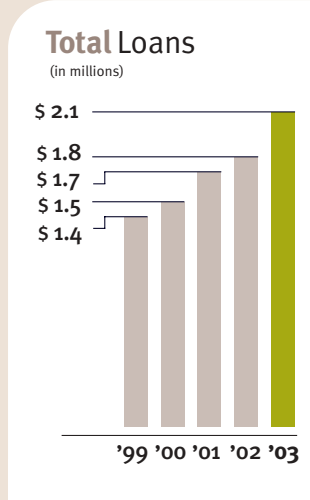
### *Our Southern Migration*

In May of 2001 we officially entered the Pennsylvania banking industry with our purchase of First Liberty Bank & Trust. This Scranton-area, 13-branch entity immediately added an entirely new set of markets to our system, and also gave us a strong and established brand name to go along with the nearly \$650 million in assets we acquired. First Liberty allowed us to enter a new market with an immediate and significant presence.

After two years of developing this market and surveying additional opportunities in the region, we made another significant transaction in 2003, adding \$280-million-asset Grange National Banc Corp. This 12-branch, whole-bank purchase marked the first step of our growth and consolidation strategy in Northeastern Pa., built upon our First Liberty franchise.

Grange is mainly in small towns and villages, like the bulk of our New York franchise. In addition to combining two offices in Scranton and converting all Grange locations to the First Liberty brand name, all of Grange's back-office and administrative functions were quickly and seamlessly merged into either our First Liberty or New York-based operations.

Grange not only added numbers to our branch network in this region, it also added valuable depth in terms of our management structure, with the addition of Thomas A. McCullough. Having served as Chief Executive Officer of Grange since 1990, his 35 years of banking experience make him ideally suited to take responsibility for all our Pennsylvania banking business. While with Grange, Tom created a peer-leading track record of earnings growth, loan generation and consistently superior asset quality, making Grange a highly respectable and desirable franchise.



If it wasn't clear that the Pennsylvania market has become a significant focus for CBU by the end of 2003, we underscored the point shortly after the new year. On January 6 we announced our intent to purchase First Heritage Bank, a closely-held, \$275 million-asset bank with branches in Wilkes-Barre, Hazleton and Kingston, Pa. First Heritage will significantly enhance CBU's presence in Northeastern Pennsylvania, specifically in Luzerne County where it will raise CBU's deposit market share to seventh from eleventh. It also provides an opportunity to expand CBU's commercial lending business, as 80% of First Heritage's loan portfolio is comprised of commercial loans. First Heritage is expected to be accretive to earnings within the first full year of combined operations.

Upon its completion during the second quarter of 2004, First Heritage will also operate as part of First Liberty Bank & Trust, adding a portfolio and a personnel skill set that significantly enhances our commercial banking expertise in the region. And like Grange, we'll acquire a key individual talent via this transaction as well in the form of Robert Matley, First Heritage's current President and Chief Operating Officer. Bob will join our senior management team as Senior Lending Officer and Executive Vice President for Pennsylvania Banking. With 30 years of banking and lending experience of his own, Bob is tremendously capable of taking responsibility for all our Pennsylvania lending business. Jim O'Brien, CEO of First Heritage, will remain with us for a time on a consulting basis as well.

In less than three years, we will have acquired three franchises, 50,000 customers and more than \$1.2 billion in assets in Northeastern Pennsylvania. More importantly, these transactions have all brought good growth potential with them too, because as you'll see in our next section, our acquired customers all had another characteristic in common: they all shared a need we could fill.







## Financial Services

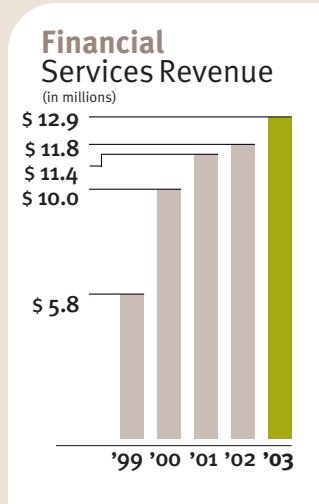
*Our Second Stream of Revenue*



As we stated earlier, one of CBU's four key growth elements is a heightened focus on non-interest income. And although it currently only accounts for one-third of all our noninterest income, we intend for our financial services group to soon be the driving force for growth in this area.

Leading up to 1999, once it had become clear that U.S. regulations would be altered to permit banks like ours to begin offering such products and services, we stepped up our efforts to mature and evolve our financial services portfolio. Currently it includes:

- Our long-standing personal trust department;
- Our broker-dealer, which provides mutual funds and insurance products through our branches and independent offices;
- Our asset management subsidiary, which provides wealth management services to individuals, corporations, and not-for-profits; and
- Our benefit plans subsidiary, which provides actuarial, administration, consulting and daily valuation recordkeeping services to sponsors of retirement plans in 27 states and Puerto Rico.



Together, they combined to generate \$12.9 million of revenue for CBU in 2003—approximately 2.2 times the level generated just five years ago. Similarly, our total client assets under management stood at \$1.8 billion at year end, an extremely noteworthy compound annual growth rate (CAGR) of 39.9% over the last five years, to go along with the similarly impressive five-year CAGR of our full financial services group of 22.2%.

### An Acquired Taste

How did we achieve this growth? We began in 1994 by offering the limited range of services that we legally could: personal trust services, including living, testamentary and charitable trusts, as well as estate settlement services, conservatorships and investment management services. Today, 10 years later, this business contributes \$1.5 million to our total non-interest income stream.

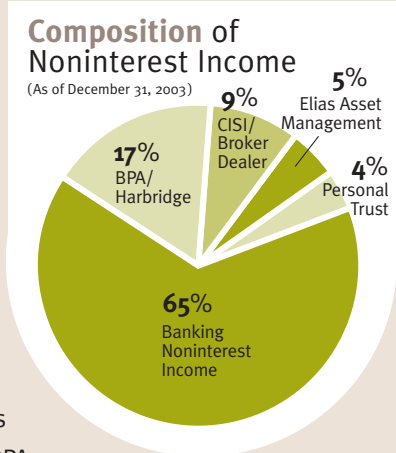
However, like our strategy for growth in banking, acquisitions would play a tremendous role and enable us to quickly build scale and proficiency for our financial services area. We began in 1996 by purchasing Benefit Plans Administrators (BPA), a stand-alone pension administrator and consultant based in Utica, N.Y. BPA represented a completely new and somewhat unrelated revenue stream for CBU, immediately providing a source of income that was not subject to the cyclical nature of traditional banking net interest income.

Then in 1999 we eliminated third-party stock brokers from our financial service distribution process by creating our own in-house capability. Community Investment Services Inc. (CISI) has grown significantly since then, now operating from numerous branches throughout our network, in addition to a stand-alone office. CISI reached \$3.3 million in 2003—163% higher than its first year's contribution four years ago—while the total assets CISI manages now exceed \$327 million.

A year later we acquired Elias Asset Management (EAM), a highly respected investment advisory and management firm based in Williamsville, N.Y. Its founder, David Elias, has written two investment advice books in addition to appearing as a frequent guest on CNBC and CNN, and being interviewed by such publications as the *Wall Street Journal* and *Forbes*. EAM currently contributes \$1.9 million of revenue to our financial services group, and comprises 15% of its total.

Most recently, we added Syracuse-based Harbridge Consulting Group during 2003. Formerly the pension and health benefits consulting practice of PricewaterhouseCoopers, Harbridge wonderfully complements BPA's products and services, and we expect it will only enhance the already lively momentum and performance of BPA, which in 2003 climbed to a record-best \$4.7 million in revenue. This is a significant 318% rise from the \$1.1 million BPA generated when first joining CBU seven years ago.

Equally importantly, we have not only made it a point to acquire businesses with financial service expertise—we've made certain we acquire customers with financial service needs. In fact, every branch or whole-bank acquisition we've made since 2001, including all three of our Pennsylvania purchases, has featured a customer base that could benefit greatly from a large portion—if not all—of our financial service products. This is yet another example of how we've kept our growth strategy at the forefront of all of our decisions.





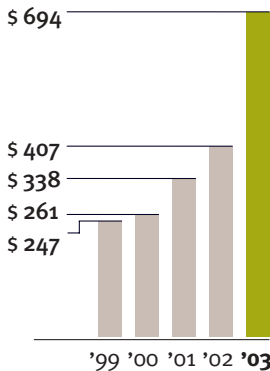


## Performance

### *The Numbers All Add Up.*

#### Market Capitalization

(in millions)



As we've said — and as you've seen — despite the “little” size of our components we've found strength in numbers. More importantly, so have our shareholders. Almost everywhere we turned in 2003, we watched our various teams generate one company-record performance after another. It all translated into a company-best share price in December 2003 of \$50.95, and a year-end closing price of \$49.00, giving CBU a market capitalization of \$694 million as of December 31. That's more than 39% higher than the \$500 million goal we hoped to reach — by 2005 — as stated in our shareholders' letter objectives within last year's annual report!

Moreover, our total return to shareholders consistently exceeded that of most banking industry indices, including the Russell 2000 and the S&P Small Cap Bank Index, throughout the last five years. In 2003 alone, CBU generated a total return to shareholders (including reinvestment of dividends) of more than 61%.



Here are a few more of 2003's highlights:

- Reached a record \$3.13 of operating earnings per share, an 8.7% increase from last year's previous record high of \$2.88.
- Completed three acquisitions. The two whole-bank transactions added 13 branches (net) and \$309 million in assets to our company, while the addition of Harbridge Consulting Group to our financial services team roughly doubled the revenue CBU has within its benefit plan consulting and administration subsidiary.
- Grew net interest income to a company-best \$131.8 million in 2003. Net interest margin improved from 4.62% in 2002 to 4.69% in 2003.
- Established a new high for noninterest income, as both our non-interest banking income and our financial services income each reached record levels, up 36% and 9%, respectively.
- Improved our asset quality over 2002's levels. Our ratio of non-performing loans to total loans decreased from 0.64% to 0.62%, while our delinquencies dropped to 1.76% of total loans from 1.88%.
- Experienced a company-record 6.7 million shares of trading volume, one million more shares than the record level reached just one year earlier.

And although it's nice to have strong year-over-year performance metrics, we're far more proud of the longer-term accomplishments we've generated for our customers and shareholders over the last five years, including:

- Generating an 11.3% compound annual growth rate (CAGR) for earnings per share since 1998.
- Increasing CBU's total assets by a CAGR of 10.9% since 1998.
- Completing seven successful M&A transactions since 1998 (13 since 1994), raising the number of counties we serve by 50% from 18 to 27 — and the number of households by 86% from 113,000 to 210,000 — during that span.
- Generating a 17.5% CAGR for noninterest income since 1998, while more than doubling it — and increasing its percentage of our total revenue from 16.7% to 20.7% — during that span.
- Vaulting CBU's total client assets under management to \$1.8 billion, more than 436% higher than the level we managed in 1998, a CAGR of 39.9% over the last five years.
- Growing our loan portfolio at a 10.5% CAGR since 1998.
- Achieving a book value per share of \$28.58, a CAGR of 11.6% since 1998.
- Raising our annualized dividend payment by more than 10% in 2003, our fourth increase over the last five years.
- Increasing our market capitalization by a CAGR of 16.9% since 1998.

Not bad for a bunch of "little" banks, serving in "little" towns. However, we indicated at the close of last year's annual report that, while we had enjoyed a very good year, we had no intention of resting on our laurels. And although 2003 proved to be even better than contemplated, we still have aggressive growth and profitability targets ahead of us that our team is fully intent on achieving. We're confident you'll agree that what we've accomplished thus far is impressive ...and to some, perhaps surprising. But it's not in the least bit surprising to all of us at CBU. We've always been confident in our abilities — despite our size — and remain as focused and assured as ever. We hope that you now share our confidence, enough to add your own strengths to our numbers.



## Board of Directors

**James A. Gabriel** was named Chairman of the Board on January 1, 1999. He has served as a Director since 1984. He is owner of the law firm of Franklin & Gabriel, located in Ovid, N.Y.



left to right, Mr. Gabriel, Ms. Steele, Mr. Patterson

**Brian R. Ace** has served as a Director since 2003, following the acquisition of Grange National Banc Corp. A member of the Loan & Compensation Committees. He served on the Board of Grange National Banc Corp. from 1992 to 2003, and was Vice Chairman from 2001 to 2003. He is owner of Laceyville Hardware in Laceyville, Pa. and Chairman of the Laceyville Revitalization Project.

**Sanford A. Belden** has served as a Director since 1992, when he was also named President and Chief Executive Officer. Mr. Belden was formerly Manager, Eastern Region, Rabobank Nederland, New York, N.Y. from 1990–1992 and prior thereto served as President, Community Banking, for First Bank System, Minneapolis, Mn., a multi-state bank holding company.

**John M. Burgess** has served as a Director since 1991. He is a retired president of Kinney Drugs, Inc., a drug and retail chain with stores primarily located throughout Upstate New York. He is Chairman of the Investment and Operations /Technology Committees, and a member of Audit/Compliance/Risk/Management, Loan & Nominating Committees.

**Paul M. Cantwell Jr.** is the former Chairman and President of the Citizens National Bank of Malone, which was acquired in 2001, at which time he became a Director. He is Owner of the Cantwell & Cantwell Law Offices in Malone, N.Y., Chairman of the Trust Committee and a member of the Investment and Operations/Technology Committees.



Mr. Belden and Mr. Burgess

**William M. Dempsey** is retired from the Rochester Institute of Technology (RIT), where he was VP, Finance & Administration, and President of the American College of Management & Technology (an RIT affiliate), in Dubrovnik, Croatia. A Director since 1984, he is Chairman of the Audit/Compliance/Risk/Management and Nominating Committees and a member of the Investment and Operations/ Technology Committees.



Mr. Cantwell, Mr. Ace, Mr. H. Kaplan

**Nicholas A. DiCerbo** is a partner of the law firm of DiCerbo & Palumbo of Olean, N.Y. He has been a Director since 1984. He is Chairman of the Strategic/Executive Committee and a member of the Investment, Loan and Trust Committees.

**Lee T. Hirschey** has been a Director since 1991. He currently serves as President and Chief Executive Officer of Climax Manufacturing Company in Castorland, N.Y. He is a member of the Audit /Compliance /Risk Management, Compensation, Nominating and Strategic/Executive Committees.

**Harold S. Kaplan** has served as a Director since 2001, following the merger of First Liberty Bank Corp. He is a Co-owner of M.C.F., Inc. and a Partner at D&T Real Estate, both of Scranton, Pa. He serves on the Investment, Operations/Technology and Trust Committees.

**Saul Kaplan** is a former President of NBO National Bank, which merged into First National Bank of Jermyn in 1999, and then into First Liberty Bank Corp. Mr. Kaplan has served as a Director since 2001, following the acquisition of First Liberty Bank Corp. He is Co-owner M.C.F., Inc. and Partner, D&T Real Estate, Scranton, Pa.



Mr. S. Kaplan, Mr. Sabia, Mr. DiCerbo

**David C. Patterson** is President and owner of Wight and Patterson, Inc., a manufacturer and seller of livestock feed located in Canton, N.Y. He has served as a Director since 1991. He is Chairman of the Loan Committee and a member of the Compensation, Nominating and Strategic/Executive Committees.

**Peter A. Sabia** is owner of Valley Dodge Truck Center, Dunmore, Pa. He has served as a Director since 2001, following the merger of First Liberty Bank Corp. Mr. Sabia is a member of the Compensation, Loan, Operations/Technology and Trust Committees.

**William N. Sloan** has served as a Director since 1991. He is Vice President for Administration Emeritus with The State University of New York College at Potsdam, where he also served as Associate Professor of Mathematics prior to 1997. He is Chairman of the Compensation Committee and a member of the Audit/Compliance/Risk Management, Operations/Technology and Strategic/Executive Committees.

**Sally A. Steele** has served as a Director since 2003, following the acquisition of Grange National Banc Corp. She is a member of the Trust and Operations/Technology committees. Ms. Steele operates her own law practice in Tunkhannock, Pa.



Mr. Hirschey, Mr. Sloan, Mr. Dempsey

## Glossary of Banking Terms

The following terms are particular to our industry and appear throughout this Annual Report. A more detailed explanation of certain terms is found in the Notes to the company's financial statements contained on Form 10-K within this Annual Report.

**Consumer direct lending:** Direct lending to consumers through the bank's branches, largely on an installment basis, for the purchase of automobiles and durable (long lasting) goods for the home, and for educational and general purposes. Also includes loans secured by the equity in a borrower's home.

**Consumer indirect lending:** Loans originated through applications taken on the premises of automobile, boat, and other dealers selling substantially priced goods, electronically submitted to the bank, and approved within a very short time period while the consumer remains on premises.

**Core deposits:** The total of checking, interest checking, savings and money market deposits, and certificates of deposit less than \$100,000. Generally considered a bank's most stable and affordable source of funds.

**Coverage ratio:** The ratio of loan loss allowance to nonperforming loans (loans for which payment is delinquent 90 days or more and loans for which interest is not being accrued) or nonperforming assets (additionally includes collateral acquired by a bank after a loan has defaulted). Considered an indicator of the strength of a financial institution's allowance for loan losses.

**Diluted shares (or fully diluted):** A calculation which includes those shares issued and outstanding or issuable upon the exercise of in-the-money stock options held by employees or Directors, offset by the number of shares which the company could repurchase on the open market with the cash received upon exercise. Shares held in treasury are excluded.

**Efficiency Ratio:** Measure of a bank's productivity, derived by dividing overhead expense by revenues (net interest income (FTE) plus noninterest income), excluding the effect of gains or losses on the sale of securities or the extinguishment of debt, amortization of intangibles, and acquisition-related expenses. The lower the ratio, the better the efficiency.

**Full-tax equivalent (FTE):** Restatement of tax-exempt interest income as if it were fully taxable. Enables tax-exempt interest income to be compared to taxable interest income on a consistent basis.

**IPC deposits:** Deposits from individuals, partnerships and corporations (i.e., all consumer and commercial deposits). Excludes deposits from local governments/municipalities. Constitutes the major component of core deposits (see above).

**Interest rate spread:** The difference between the yield on a bank's earning assets and the rate it pays on its combined interest-bearing funds (deposits plus borrowings). It's considered a basic measure of sensitivity of a bank's net interest earnings to changes in interest rates, excluding funding from noninterest-bearing sources.

**Loan loss provision:** The charge against earnings to increase the allowance for loan losses (net of current period charge-offs) sufficient to absorb probable future charge-offs.

**Net income – operating:** Excludes the effects of certain items the company considers to be non-operating, including acquisition expenses, securities gains & losses, and debt restructuring transactions.

**Net interest income:** Banking revenues generated from standard lending and investment activities, equaling the difference between interest income on loans and investments and interest expense on deposits and borrowings. It's the primary source of earnings before expenses for most banks.

**Net interest margin:** A performance measure or ratio which is calculated by dividing net interest income by average interest-earning assets. It's the most basic indicator of the relative return on loan and investing activities before overhead and loan loss provision. Interest rate spread is a component of the net interest margin.

**Noninterest income:** Revenues generated from fee-based depositor and borrowing services (including ATMs and overdrafts), and the sale of financial services products. As reported by the company, it may exclude gains or losses from the sale of securities and extinguishment of debt and the impact of the disposal of branch properties, if indicated.

**Nonperforming assets:** Represent loans delinquent as to interest or principal for a period of 90 days or more, loans for which interest is not being accrued (no payments expected), restructured loans, and real estate acquired through foreclosure.

**Tangible equity/assets:** Shareholders' equity net of goodwill and intangible assets divided by the assets of the bank, net of goodwill and intangible assets.

**Tier 1 Capital:** Shareholders' equity, adjusted for the unrealized gain or loss on securities held for sale and for certain assets such as goodwill and other intangibles. It's the primary measure of a bank's capital as defined by various bank regulatory agencies.

# Shareholder Information

## Corporate Headquarters

Community Bank System, Inc.  
5790 Widewaters Parkway  
DeWitt, NY 13214-1883  
800-724-2262  
Phone: 315-445-2282, Fax: 315-445-7347  
www.communitybankna.com

## Stock Listing

The common stock of Community Bank System, Inc. is listed on the New York Stock Exchange (NYSE) under the symbol CBU.

Its trust preferred securities are traded over the counter under the symbol CBSIP. Newspaper listing for common stock: CmntyBkSys

## Annual Meeting

Wednesday, May 19, 2004 at 1:00 p.m.  
Wyndham Hotel—Syracuse  
6301 Route 298  
East Syracuse, NY 13057  
315-432-0200

## Transfer Agent and Registrar of Stock

American Stock Transfer & Trust Company  
59 Maiden Lane  
New York, NY 10038  
800-937-5449

## Analyst Coverage

The following analysts published research about Community Bank System in 2003:

Firm and Analyst	Phone/e-mail
Advest	
David J. Chiaverini .....	212-484-3827 david.chiaverini@advest.com
Cohen Bros. & Company	
Wilson Smith .....	215-861-7852 wsmith@cohen-bros.com
FTN Midwest Research	
Anthony Polini .....	212-418-6722 anthony.polini@midwestresearch.com
Janney Montgomery Scott	
Claire Percarpio .....	215-665-4559 cpercario@jmsonline.com
Keefe, Bruyette & Woods	
Jared Shaw .....	860-246-7209 jshaw@kbw.com
McConnell, Budd & Romano	
William McCrystal .....	973-538-7800 wmcrcrystal@mcbd.com

## Investor Information

www.communitybankna.com  
Investor and shareholder information regarding Community Bank System, Inc., including all filings with the Securities and Exchange Commission, is available through the company's web site.

Copies may also be obtained without charge upon written request to:

Ms. JosephineAnne E. Rurka  
Investor Relations Department  
Community Bank System, Inc.  
5790 Widewaters Parkway  
DeWitt, NY 13214-1883  
315-445-7300  
josie.rurka@communitybankna.com

## Investor's Choice Program

CBSI's Investor's Choice Program offers a variety of convenient, low-cost services for investors who wish to build their share ownership.

For information, contact:

Ms. Donna J. Drengel  
Shareholder Relations Department  
Community Bank System, Inc.  
5790 Widewaters Parkway  
DeWitt, NY 13214-1883  
315-445-7313  
donna.drengel@communitybankna.com  
or

American Stock Transfer & Trust Co.  
59 Maiden Lane  
New York, NY 10038  
800-278-4353  
www.investpower.com

## Independent Auditors

The Board of Directors has appointed the firm of PricewaterhouseCoopers LLP, as auditor for the company.

The Community Bank System, Inc. Annual Report contains forward-looking statements, within the provisions of the Private Security Litigation Reform Act of 1995, that are based on current expectations, estimates, and projections about the industry, markets and economic environment in which the company operates. Such statements involve risks and uncertainties that could cause actual results to differ materially from the results discussed in these statements. These risks are detailed in the company's periodic reports filed with the Securities and Exchange Commission.



**Community Bank System, Inc.**

5790 Widewaters Parkway | DeWitt, New York 13214-1883 | 800.724.2262 | Fax 315.445.7347 | [communitybankna.com](http://communitybankna.com)