FINANCIAL INSTITUTIONS INC
Form 10-K/A
March 19, 2004

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

FORM 10-K/A

Amendment No.1

|X| ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the fiscal year ended December 31, 2003

|_| TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

Commission File Number 0-26481

[LOGO] Financial Institutions, Inc.

(Exact Name of Registrant as specified in its charter)

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

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

Securities Registered Pursuant to Section 12(b) of the Act:
NONE

Securities Registered Pursuant to Section 12(g) of the Act: Title of Class:
COMMON STOCK, PAR VALUE $.01 PER SHARE

Indicate by check mark whether the Registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding twelve months (or for such shorter period that the Registrant was required to file such reports) and (2) has been subject to such filing requirements for the past 90 days.

YES |X| NO |_|

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of Registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendments to 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 |X| NO |_|

Aggregate market value of common stock held by non-affiliates of the registrant, computed by reference to the closing price as of close of business on June 30, 2003 was $181,724,967.

As of March 1, 2004 there were issued and outstanding, exclusive of treasury shares, 11,172,673 shares of the Registrant's Common Stock.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the Registrant's proxy statement to be filed with the Securities and Exchange Commission in connection with the 2004 Annual Meeting of Shareholders are incorporated by reference in Part III of this Annual Report on Form 10-K.

Explanatory Note

This Form 10-K/A is being filed solely to correct typographical errors generated during the edgarization process in Item 8 of Financial Institutions Inc.'s Annual Report on Form 10-K for the year ended December 31, 2003, filed with the Securities and Exchange Commission on March 12, 2004. Specifically, in the Consolidated Statements of Changes in Shareholders' Equity and Comprehensive Income on page 53, data in the line items associated with the purchase of preferred stock in 2001 and 2003 were inadvertently shifted to the wrong column.

The amendment conforms the Form 10-K as filed to the version that was certified by Financial Institution Inc.'s Chief Executive Officer and Chief Financial Officer, pursuant to Rules 13a-14(a) and 13a-14(b) under the Securities Exchange Act of 1934, as amended (Exchange Act). No other changes are being made by means of this filing.

FINANCIAL INSTITUTIONS, INC.

2003 ANNUAL REPORT ON FORM 10-K

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PART I

Item I. Business

Forward Looking Statements

This Annual Report on Form 10-K contains forward-looking statements, which can be identified by the use of such words as estimate, project, believe, intend, anticipate, plan, seek, expect and similar expressions. These statements are intended to identify "forward-looking statements" within the meaning of the Private Securities Litigation Reform Act of 1995 and may include:

- statements regarding our business plans, and prospects;
- statements of our goals, intentions and expectations;
- statements regarding our growth and operating strategies;
- statements regarding the quality of our loan and investment portfolios; and
- estimates of our risks and future costs and benefits.

The Private Securities Litigation Reform Act of 1995 provides a safe harbor for forward-looking statements. In order to comply with the terms of the safe harbor, the Company notes that a variety of factors could cause the Company's actual results and experience to differ materially from the anticipated results or other expectations expressed in the Company's forward-looking statements. Some of the risks and uncertainties that may affect the operations, performance, development and results of the Company's business, the interest rate sensitivity of its assets and liabilities, and the adequacy of its allowance for loan losses, include but are not limited to the following:

- significantly increased competition among depository and other financial institutions;
- changes in the interest rate environment that reduces our margins or the fair value of financial instruments;
- general economic conditions, either nationally or in our market areas, that are worse than expected;
- declines in the value of real estate, equipment, livestock and other assets serving as collateral for our loans outstanding;
- legislative or regulatory changes that adversely affect our business;
- changes in consumer spending, borrowing and savings habits; and
- changes in accounting policies and practices, as generally accepted in the United States of America.

The Company cautions readers not to place undue reliance on any forward-looking statements, which speak only as of the date made, and advises readers that various factors, including those described above, could affect the Company's financial performance and could cause the Company's actual results or circumstances for future periods to differ materially from those anticipated or projected.

Except as required by law, the Company does not undertake, and specifically disclaims any obligation, to publicly release any revisions to any forward-looking statements to reflect the occurrence of anticipated or unanticipated events or circumstances after the date of such statements.

General

Financial Institutions, Inc. (the "Company" or "FII") is a bank holding company headquartered in Warsaw, New York, which is located 45 miles southwest of Rochester and 45 miles southeast of Buffalo. The Company operates a super-community bank holding company - a bank holding company that owns multiple community banks that are separately managed.

The Company owns four commercial banks that provide consumer, commercial and agricultural banking services in Western and Central New York State: Wyoming County Bank ("WCB"), National Bank of Geneva ("NBG"), First Tier Bank & Trust ("FTB") and Bath National Bank ("BNB"), collectively referred to as the "Banks". During 2002, the Company completed a geographic realignment of the subsidiary banks, which involved the merger of the subsidiary formerly known as The Pavilion State Bank ("PSB") into NBG and transfer of other branch offices between subsidiary banks. In September 2003 the Boards of Directors of the Company's two national bank subsidiaries, NBG and BNB entered into formal agreements with their primary regulator, the Office of the Comptroller of the Currency ("OCC"). Under the terms of the agreements, NBG and BNB, without admitting any violations agreed to take various actions to reduce the level of credit risk in the banks, including reviewing loan policies, charge-off policies for nonaccrual loans, real property appraisal standards, insider lending and overdraft policies and affiliate transactions, and adopting capital plans to ensure levels of risk-based capital at higher than minimum levels. Pursuant to these agreements, the banks have taken actions required by the agreements to ensure that their operations are in accordance with applicable laws and regulations.

The Company formerly qualified as financial holding company under the Gramm-Leach-Bliley Act (see discussion beginning on page 19), which allowed FII to expand business operations to include financial services businesses. The Company currently has two financial services subsidiaries: The FI Group, Inc. ("FIGI") and Burke Group, Inc. ("BGI"), collectively referred to as the "Financial Services Group" ("FSG"). FIGI is a brokerage subsidiary that commenced operations as a start-up company in March 2000. BGI is an employee benefits and compensation consulting firm acquired by the Company in October 2001. During 2003, the Company terminated its financial holding company status and now operates as a bank holding company. The change in status did not affect the non-financial subsidiaries or activities being conducted by the Company, although future acquisitions or expansions of non-financial activities may require prior Federal Reserve Board approval and will be limited to those that are permissible for bank holding companies.

In February 2001, the Company formed FISI Statutory Trust I ("FISI" or "Trust") (100% owned) and capitalized the trust with a $502,000 investment in FISI's common securities. The Trust was formed to accommodate the private placement of $16.2 million in capital securities ("trust preferred securities"), the proceeds of which were utilized to partially fund the acquisition of BNB. Effective December 31, 2003, the provisions of FASB Interpretation No. 46, "Consolidation of Variable Interest Entities," resulted in the deconsolidation of the Company's wholly-owned Trust. The deconsolidation resulted in the derecognition of the $16.2 million in trust preferred securities and the recognition of $16.7 million in junior subordinated debentures and a $502,000 investment in the subsidiary trust recorded in other assets in the Company's 2003 consolidated statement of financial position.

As a super-community bank holding company, the Company's strategy has been to manage its bank subsidiaries on a decentralized basis. This strategy provides the Banks the flexibility to efficiently serve their markets and respond to local customer needs. While generally operating on a decentralized basis, the Company has consolidated selected lines of business, operations and support functions in order to achieve economies of scale, greater efficiency and operational consistency. In furtherance of this objective, in September 2002, the Company added a Credit Administration Department at the holding company to review company-wide credit policies and strengthen overall credit administration.

Available Information

This annual report, including the exhibits and schedules filed as part of the annual report, may be inspected at the public reference facility maintained by the Securities and Exchange Commission ("SEC") at its public reference room at 450 Fifth Street, NW, Washington, DC 20549 and copies of all or any part thereof may be obtained from that office upon payment of the prescribed fees. You may call the SEC at 1-800-SEC-0330 for further information on the operation of the public reference room and you can request copies of the documents upon payment of a duplicating fee, by writing to the SEC. In addition, the SEC maintains a website that contains reports, proxy and information statements and other information regarding registrants, including us, that file electronically with the SEC which can be accessed at www.sec.gov.

The Company also makes available, free of charge through its website at www.fiiwarsaw.com, all reports filed with the SEC, including our Annual Report on Form 10-K, Quarterly Reports on Form 10-Q and Current Reports on Form 8-K, as well as any amendments to those reports, as soon as reasonably practicable after those documents are filed with, or furnished to, the SEC. Information available on our website is not a part of, and should not be incorporated into, this annual report on Form 10-K.

Market Area and Competition

The Company provides a wide range of consumer and commercial banking and financial services to individuals, municipalities and businesses through a network of 48 branches and 69 ATMs in fifteen contiguous counties of Western and Central New York State: Allegany, Cattaraugus, Cayuga, Chautauqua, Chemung, Erie, Genesee, Livingston, Monroe, Ontario, Schuyler, Seneca, Steuben, Wyoming and Yates Counties.

The Company's market area is geographically and economically diversified in that it serves both rural markets and, increasingly, the larger more affluent markets of suburban Rochester and suburban Buffalo. Rochester and Buffalo are the two largest cities in New York State outside of New York City, with combined metropolitan area populations of over two million people. The Company anticipates increasing its presence in the markets around these two cities.

The Company faces significant competition in both making loans and attracting deposits, as Western and Central New York have a high density of financial institutions. The Company's competition for loans comes principally from commercial banks, savings banks, savings and loan associations, mortgage banking companies, credit unions, insurance companies and other financial service companies. Its most direct competition for deposits has historically come from savings and loan associations, savings banks, commercial banks and credit unions. The Company faces additional competition for deposits from non-depository competitors such as the mutual fund industry, securities and brokerage firms and insurance companies.

Operating Segments

The relative asset size, profitability and average number of full-time equivalent employees ("FTEs") of the Company's operating segments as of or for the year ended December 31, 2003, are depicted in the following table:

(Dollars in thousands)

Subsidiary	Assets	Percent of Total	Net Income (Loss)	Percent of Total	Average FTEs	Perc of T
Wyoming County Bank	$ 754,639	35%	$ 9,042	63%	168	
National Bank of Geneva	721,374	33	151	1	190	
Bath National Bank	462,113	21	4,108	29	133	
First Tier Bank & Trust	225,080	11	2,117	15	67	
Financial Services Group	5,135	--	(115)	(1)	50	
Parent and eliminations, net	5,391		(1,056)	(7)	106	
Total	$2,173,732	100%	$ 14,247	100%	714	

Mergers and Acquisitions

On December 13, 2002, BNB acquired two Chemung County branch offices of BSB Bank & Trust Company of Binghamton, New York. The two offices purchased, located in Elmira and Elmira Heights, had deposit liabilities totaling $44.2 million at the time of acquisition. The acquisition was accounted for as a business combination using the purchase method of accounting, and accordingly, the excess of the purchase price over the fair value of identifiable tangible and intangible assets acquired, less liabilities assumed, of approximately $1.5 million has been recorded as goodwill. In accordance with Statement of Financial Accounting Standard (SFAS) No. 142, "Goodwill and Other Intangible Assets," the Company is not required to amortize goodwill recognized in this acquisition. The Company also recorded a $2.0 million intangible asset attributable to core deposits, which is being amortized using the straight-line method over seven years.

On May 1, 2002, FII acquired all of the common stock of the Bank of Avoca ("BOA") in exchange for 47,036 shares of FII common stock. BOA was a community bank with its main office located in Avoca, New York, as well as a branch office in Cohocton, New York. Subsequent to the acquisition, BOA was merged with BNB.

The acquisition was accounted for as a business combination using the purchase method of accounting, and accordingly, the excess of the purchase price ($1.5 million) over the fair value of identifiable tangible and intangible assets acquired ($18.4 million), less liabilities assumed ($17.3 million), of approximately $0.4 million has been recorded as goodwill. In accordance with SFAS No. 142, the Company is not required to amortize goodwill recognized in this acquisition. The Company recorded a $146,000 core deposit intangible asset, which is being amortized using the straight-line method over seven years. The results of operations for BOA are included in the income statements from the date of acquisition (May 1, 2002).

On October 22, 2001, the Company acquired the Burke Group, Inc. ("BGI"); an employee benefits administration and compensation consulting firm, with offices in Honeoye Falls and Syracuse, New York. BGI's expertise includes design and consulting for retirement and employee welfare plans, administrative services for defined contribution and benefit plans, actuarial services and post employment benefits. Under the terms of the agreement, BGI shareholders received primarily common stock as consideration for their ownership in BGI. The acquisition was accounted for as a business combination using the purchase method of accounting, and accordingly, the excess of the purchase price ($3.3 million including earned amounts and contingent amounts to date, see Note 2 of the notes to consolidated financial statements for additional discussion regarding the merger consideration) over the fair value of identifiable tangible and intangible assets acquired ($1.7 million), less liabilities assumed ($1.7 million), of approximately $3.3 million has been recorded as goodwill. In accordance with SFAS No. 142, the Company is not required to amortize goodwill recognized in this acquisition. The Company also recorded a $500,000 intangible asset for a customer list that is being amortized using the straight-line method over five years. The results of operations for BGI are included in the income statements from the date of acquisition (October 22, 2001).

On May 1, 2001, FII acquired all of the common stock of BNC, and its wholly owned subsidiary bank, BNB. BNB is a full service community bank headquartered in Bath, New York, which had 9 branch locations in Steuben, Yates, Ontario and Schuyler Counties. The Company paid $48.00 per share in cash for each of the outstanding shares of BNC common stock with an aggregate purchase price of approximately $62.6 million. The acquisition was accounted for under the purchase method of accounting, and accordingly, the excess of the purchase price ($62.6 million) over the fair value of identifiable tangible and intangible assets acquired ($295.4 million), less liabilities assumed ($269.9 million), of approximately $37.1 million has been recorded as goodwill. Goodwill was amortized in 2001 using the straight-line method over 15 years, since the transaction was consummated prior to June 30, 2001, the effective date of SFAS No. 142. However, in accordance with SFAS No. 142, the Company ceased goodwill amortization on January 1, 2002. The results of operations for BNB are included in the income statements from the date of acquisition (May 1, 2001).

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Lending Activities

General. The Company, through its banking subsidiaries, offers a broad range of loans including commercial and agricultural working capital and revolving lines of credit, commercial and agricultural mortgages, equipment loans, crop and livestock loans, residential mortgage loans and home equity lines of credit, home improvement loans, student loans, automobile loans, personal loans and credit cards. Under the Company's decentralized management philosophy, each of the banks determines individually which loans are sold and which are retained for the portfolio. However, most newly originated fixed rate residential mortgage loans are sold in the secondary market. The Company retains the servicing rights on most mortgage loans it sells and realizes monthly service fee income.

Underwriting Standards. During 2003, the Company expanded the role of the position formerly known as Chief Credit Officer to Chief Risk Officer in an effort to better manage overall corporate risk. The Credit Administration Department, which falls under the supervision of the Chief Risk Officer, was given the responsibility of reviewing company-wide credit policies with the goal of developing and implementing stronger and more standardized underwriting and credit administration policies. This process included a thorough evaluation and update of the Company's loan policy and the adoption of enhanced risk rating guidelines company-wide. The revisions to the loan policy included a focus on the Company's lending philosophy and credit objectives.

The key elements of the Company's lending philosophy include the following:

- to ensure consistent underwriting, all employees must share a common view of the risks inherent in lending to businesses as well as the standards to be applied in underwriting and managing specific credit exposures;
- pricing of credit products should be risk-based;
- the loan portfolio must be diversified to limit the potential impact of negative events; and
- careful, timely exposure monitoring through dynamic use of our risk rating system, is required to provide early warning and assure proactive management of potential problems.

The Company's credit objectives are as follows:

- service the legitimate credit needs of small businesses within target markets of our subsidiary banks;
- compete effectively as a high volume producer of credit to commercial and agricultural business within our markets;
- maintain our banks' reputations for superior quality and timely delivery of products and services to our customers;
- continue to provide competitive pricing that reflects the entire relationship and is commensurate with the risk profiles of our borrowers;
- retain, develop and acquire profitable, multi-product, value added relationships with high quality businesses;
- continue the focus on government guaranteed lending and establish a specialization in this area to meet the needs of the small businesses in our communities; and
- comply with the relevant laws and regulations.

The loan policy establishes the lending authority of individual loan officers as well as the loan authority of the banks' loan committees. The policy limits exposure to any one borrower or affiliated group of borrowers to a limit of $8,000,000 unless the amount above that number has liquid collateral pledged as security or has a U.S. Government agency guarantee. The Senior Loan Administrators and Commercial Team Leaders can approve loans up to $500,000 jointly. The subsidiary bank CEOs and Senior Loan Administrators can approve loans up to $1,000,000 jointly. Each bank has an External Loan Committee that consists of up to three lending officers and at least two outside bank directors. The External Loan Committee may approve loans up to $2,000,000. Loans of $2,000,000 and over require the approval of

the Company's Executive Loan Committee. The Executive Loan Committee consists of the Company's CEO, the FII Chief Risk Officer (non-voting), the FII Risk Manager, the FII Loan Administration Manager, each subsidiary bank CEO, and each subsidiary bank Senior Loan Administrator.

Commercial Loans. The Company, through its banking subsidiaries, originates commercial loans in its primary market areas and underwrites them based on the borrower's ability to service the loan from operating income. The Company, through its banking subsidiaries, offers a broad range of commercial lending products, including term loans and lines of credit. Short and medium-term commercial loans, primarily collateralized, are made available to businesses for working capital (including inventory and receivables), business expansion (including acquisition of real estate, expansion and improvements) and the purchase of equipment. As a general practice, a collateral lien is placed on any available real estate, equipment or other assets owned by the borrower and a personal guarantee of the borrower is obtained. At December 31, 2003, $32 million, or 12.9%, of the aggregate commercial loan portfolio was at fixed rates while $216 million, or 87.1%, was at variable rates. The Company also utilizes government loan guarantee programs offered by the Small Business Administration (or "SBA") and Rural Economic and Community Development (or "RECD") when appropriate. See "Government Guarantee Programs" below.

Commercial Real Estate Loans. In addition to commercial loans secured by real estate, the Company, through its banking subsidiaries, makes commercial real estate loans to finance the purchase of real property which generally consists of real estate with completed structures. Commercial real estate loans are secured by first liens on the real estate, typically have variable interest rates and are amortized over a 10 to 20 year period. The underwriting analysis includes credit verification, appraisals and a review of the borrower's financial condition. At December 31, 2003, $46 million, or 12.5%, of the aggregate commercial real estate loan portfolio was at fixed rates while $324 million, or 87.5%, was at variable rates.

Agricultural Loans. Agricultural loans are offered for short-term crop production, farm equipment and livestock financing and agricultural real estate financing, including term loans and lines of credit. Short and medium-term agricultural loans, primarily collateralized, are made available for working capital (crops and livestock), business expansion (including acquisition of real estate, expansion and improvement) and the purchase of equipment. The Banks also closely monitor commodity prices and inventory build-up in various commodity categories to better anticipate price changes in key agricultural products that could adversely affect the borrowers' ability to repay their loans. At December 31, 2003 the Company had $119 million in loans to the dairy industry, which represents 8.9% of the total loan portfolio. The dairy industry is under stress from an extended period of low milk prices. The Company routinely evaluates the effect of those price changes on the cash flow of borrowers and the values of collateral supporting those loans. Borrower cash flows in the dairy industry have recently improved due to some stabilization and upward movement in milk prices. At December 31, 2003, $21 million, or 9.1%, of the agricultural loan portfolio was at fixed rates while $214 million, or 90.9%, was at variable rates. The Banks utilize government loan guarantee programs offered by the SBA and the Farm Service Agency (or "FSA") of the United States Department of Agriculture where available and appropriate. See "Government Guarantee Programs" below.

Residential Real Estate Loans. The Banks originate fixed and variable rate one-to-four family residential real estate loans collateralized by owner-occupied properties located in its market areas. A variety of real estate loan products, which generally are amortized over five to 30 years, are offered. Loans collateralized by one-to-four family residential real estate generally have been originated in amounts of no more than 80% of appraised value or have mortgage insurance. Mortgage title insurance and hazard insurance are normally required. The Company sells most newly originated fixed rate one-to-four family residential mortgages on the secondary mortgage market and retains the rights to service the mortgages. To assure maximum salability of the residential loan products for possible resale, the Company has formally adopted the underwriting, appraisal, and servicing guidelines of the Federal Home Loan Mortgage Corporation ("Freddie Mac") as part of its standard loan policy. At December 31, 2003, the residential mortgage servicing portfolio totaled $386 million, the majority of which have been sold to Freddie Mac. At December 31, 2003, $197 million, or 78.5%, of residential real estate loans retained in portfolio were at fixed rates while $54 million, or 21.5%, were at variable rates.

Consumer and Home Equity Loans. The Banks originate direct and indirect credit automobile loans, recreational vehicle loans, boat loans, home improvement loans, fixed and open-ended home equity loans, personal loans (collateralized and uncollateralized), student loans and deposit account collateralized loans. Visa cards that provide consumer credit lines are also issued. The terms of these loans typically range from 12 to 120 months and vary based upon the nature of the collateral and the size of loan. The majority of the consumer lending program is underwritten on a secured basis using the customer's home or the financed automobile, mobile home, boat or recreational vehicle as collateral. At December 31, 2003, $139 million, or 57.7%, of consumer and home equity loans were at fixed rates while $102 million, or 42.3%, were at variable rates.

Government Guarantee Programs. The Banks participate in government loan guarantee programs offered by the SBA, RECD and FSA. At December 31, 2003, the Banks had loans with an aggregate principal balance of $45.9 million that were covered by guarantees under these programs. The guarantees only cover a certain percentage of these loans. By participating in these programs, the Banks are able to broaden their base of borrowers while minimizing credit risk.

Delinquencies and Nonperforming Assets. The Banks have several procedures in place to assist in maintaining the overall quality of the Company's loan portfolio. Standardized underwriting guidelines have been established for subsidiary bank lending officers. The Company requires each bank subsidiary to report delinquencies on a monthly basis, and the Chief Risk Officer monitors these levels to identify adverse trends.

Loans are generally placed on nonaccrual status and cease accruing interest when the payment of principal or interest is delinquent for 90 days, or earlier in some cases, unless the loan is in the process of collection and the underlying collateral further supports the carrying value of the loan.

Classification of Assets. As previously indicated, the Company adopted enhanced risk rating guidelines company-wide during 2003. Risk ratings are assigned to loans in the commercial, commercial real estate and agricultural portfolios. The risk ratings are specifically used as follows:

- profile banks' risk and exposure in the loan portfolio and identify developing trends and relative levels of risk;

- guide polices which control individual exposure with regard to degree of risk;
- identify deteriorating credits which may become criticized according to regulatory definitions; and
- reflect the probability that a given customer may default on its obligations to pay in a timely fashion.

Through the underwriting and loan review process, the Banks maintain internally classified loan lists which, along with delinquency reporting, helps management assess the overall quality of the loan portfolio and the allowance for loan losses.

Loans classified as "watch" are basically satisfactory, but a higher degree of risk is evident. Loans classified as "warning" or "special mention" have potential weaknesses that may, if not corrected, weaken the loan or inadequately protect the banks' credit position.

"Substandard" loans are those with clear and well-defined weaknesses such as a higher leveraged position, unfavorable financial ratios, uncertain repayment sources or poor financial condition, which may jeopardize the full collection of the debt. Substandard loans may be placed on nonaccrual status and may have specific loss allowances assigned. Once a loan is identified as substandard, the credit relationship is assigned to the Credit Administration Department's Loan Workout Group. The Loan Workout Group performs a detailed analysis of each substandard credit, which includes evaluating the borrower's paying capacity and assessing the collateral supporting the loans outstanding. Various forms of collateral including receivables, inventory, livestock, equipment, real property and other assets, secure the majority of the substandard credits. The Loan Workout Group also quantifies credit loss exposure by determining specific loss allowances where appropriate.

Loans classified as "doubtful" have characteristics similar to substandard with the added characteristic that the weaknesses make collection or liquidation in full, on the basis of currently existing facts, conditions, and values, highly questionable and improbable. Due to the high probability of loss, nonaccrual accounting treatment is required for all assets listed as doubtful.

Assets are classified as "loss" when considered to be uncollectible and of such little value that their continuance as bankable assets is not warranted. This classification does not mean that the asset has absolutely no recovery or salvage value, but rather, that it is not practical or desirable to defer write-off even though partial recovery may be achieved in the future.

Allowance for Loan Losses. The allowance for loan losses is established through charges to earnings in the form of a provision for loan losses. The allowance reflects management's estimate of the amount of probable loan losses in the portfolio, based on the following factors:

- historical charge-off experience;
- the evaluation of the loan portfolio by the loan review function;
- levels and trends in delinquencies and non-accruals;
- trends in volume and terms;

- collateral values;
- effects of changes in lending policy;
- experience, ability and depth of management;
- national and local economic trends and conditions; and
- concentration of credit.

Subsidiary Bank management presents a quarterly review of the allowance for loan losses to each subsidiary Bank's Board of Directors as well as to the Company's Board of Directors, indicating any change in the allowance since the last review and any recommendations as to adjustments in the allowance. In order to determine the allowance for loan losses, the risk classification and delinquency status of loans and other factors are considered, such as collateral value, government guarantees, portfolio composition, trends in economic conditions and the financial strength of borrowers. Specific allowances for loans, which have been individually evaluated for impairment, are established when required. An allowance is also established for groups of loans with similar risk characteristics, based upon average historical charge-off experience taking into account levels and trends in delinquencies, loan volumes, economic and industry trends and concentrations of credit.

Investment Activities

General. The Company's investment securities policy is contained within the overall Asset-Liability Management and Investment Policy. This policy dictates that investment decisions will be made based on the safety of the investment, liquidity requirements, potential returns, cash flow targets, need for collateral and desired risk parameters. In pursuing these objectives, the Company considers the ability of an investment to provide earnings consistent with factors of quality, maturity, marketability and risk diversification. The Board of each subsidiary bank adopts an asset/liability policy containing an investment securities policy within the parameters of the Company's overall asset/liability policy. The FII Treasurer, guided by the separate ALCO Committees of each subsidiary bank, is responsible for securities portfolio decisions within the established policies.

The Company's investment securities strategy centers on providing liquidity to meet loan demand and redeeming liabilities, meeting pledging requirements, managing overall interest rate risk and maximizing portfolio yield. The Company policy generally limits security purchases to the following:

- U.S. treasury securities;
- U.S. government agency and government sponsored agency securities;
- mortgage-backed pass-through securities and collateralized mortgage obligations ("CMOs") issued by the Federal National Mortgage Association ("FNMA"), the Government National Mortgage Association ("GNMA") and Federal Home Loan Mortgage Corporation ("Freddie Mac");
- investment grade municipal securities, including tax, revenue and bond anticipation notes and general obligation and revenue notes and bonds;
- certain creditworthy un-rated securities issued by municipalities;

and investment grade corporate debt.

Additionally, the Company's investment policy limits investments in corporate bonds to no more than 10% of total investments and to bonds rated as Baa or better by Moody's Investor Services, Inc. or BBB or better by Standard & Poor's Ratings Services at the time of purchase.

Sources of Funds

General. Deposits and borrowed funds are the primary sources of the Company's funds for use in lending, investing and for other general purposes. In addition, repayments on loans, proceeds from sales of loans and securities, and cash flows from operations provide additional sources of funds.

Deposits. The Company, through its banking subsidiaries, offers a variety of deposit account products with a range of interest rates and terms. The deposit accounts consist of savings, interest-bearing checking accounts, checking accounts, money market accounts, savings, club accounts and certificates of deposit. The Company offers certificates of deposit with balances in excess of $100,000 at preferential rates (jumbo certificates) to local municipalities, businesses, and individuals as well as Individual Retirement Accounts ("IRAs") and other qualified plan accounts. To enhance its deposit product offerings, the Company provides commercial checking accounts for small to moderately sized commercial businesses, as well as a low-cost checking account service for low-income customers. The flow of deposits is influenced significantly by general economic conditions, changes in money market rates, prevailing interest rates and competition. The Banks' deposits are obtained predominantly from the areas in which the Banks' branch offices are located. The Banks rely primarily on competitive pricing of their deposit products, customer service and long-standing relationships with customers to attract and retain these deposits. On a secondary basis, the Company utilizes time deposit sales in the national brokered market ("brokered deposits") as a wholesale funding source.

Borrowed Funds. Borrowings consist mainly of advances entered into with the Federal Home Loan Bank ("FHLB"), a debt agreement with a commercial bank and sweep repurchase agreements.

Junior Subordinated Debentures Issued to Unconsolidated Subsidiary Trust. The Company formed a trust in February 2001 to accommodate the private placement of capital securities, the proceeds of which were utilized to partially fund the acquisition of BNC.

Risk Factors

Asset Quality. A significant source of risk for the Company arises from the possibility that losses will be sustained because borrowers, guarantors and related parties may fail to perform in accordance with the terms of their loans. Most loans originated by the Company are secured, but loans may be unsecured depending on the nature of the loan. With respect to secured loans, the collateral securing the repayment of these loans includes a wide variety of diverse real and personal property that may be insufficient to cover the obligations owed under such loans. Collateral values may be adversely affected by changes in prevailing economic, environmental and other conditions, including declines in the value of real estate, changes in interest rates, changes in monetary and fiscal policies of the federal government, wide-spread

disease, terrorist activity, environmental contamination and other external events. In addition, collateral appraisals that are out of date or that do not meet M.A.I. or other recognized standards may create the impression that a loan is adequately collateralized when in fact it is not. The Company has adopted underwriting and credit monitoring procedures and policies, including the establishment and review of the allowance for loan losses and regular review of appraisals and borrower financial statements, that management believes are appropriate to mitigate the risk of loss by assessing the likelihood of nonperformance and the value of available collateral, monitoring loan performance and diversifying the Company's credit portfolio. Such policies and procedures, however, may not prevent unexpected losses that could have a material adverse effect on the Company's business, financial condition, results of operations or liquidity. See "Lending Activities" for further discussion on underwriting standards.

Interest Rate Risk. The bank industry earnings depend largely on the relationship between the yield on earning assets, primarily loans and investments, and the cost of funds, primarily deposits and borrowings. This relationship, known as the interest rate spread, is subject to fluctuation and is affected by economic and competitive factors which influence interest rates, the volume and mix of interest earning assets and interest bearing liabilities and the level of non-performing assets. Fluctuations in interest rates affect the demand of customers for the Company's products and services. The Company is subject to interest rate risk to the degree that its interest bearing liabilities reprice or mature more slowly or more rapidly or on a different basis than its interest earning assets. Significant fluctuations in interest rates could have a material adverse effect on the Company's business, financial condition, results of operations or liquidity. For additional information regarding interest rate risk, see Part II, Item 7A, "Quantitative and Qualitative Disclosures About Market Risk."

Changes in the Value of Goodwill and Other Intangible Assets. The Company had goodwill of $40.6 million and other intangible assets of $2.7 million as of December 31, 2003. Under current accounting standards, the Company is not required to amortize goodwill but rather must evaluate goodwill for impairment at least annually. If deemed impaired at any point in the future, an impairment charge representing all or a portion of goodwill will be recorded to current earnings in the period in which the impairment occurred. The capitalized value of other intangible assets is amortized to earnings over their estimated lives. Other intangible assets are also subject to periodic impairment reviews. If these assets are deemed impaired at any point in the future, an impairment charge will be recorded to current earnings in the period in which the impairment occurred. For additional information regarding goodwill and other intangible assets, see Note 6 of the notes to consolidated financial statements.

Breach of Information Security and Technology Dependence. The Company depends upon data processing, software, communication and information exchange on a variety of computing platforms and networks and over the internet. Despite instituted safeguards, the Company cannot be certain that all of its systems are entirely free from vulnerability to attack or other technological difficulties or failures. The Company relies on the services of a variety of vendors to meet its data processing and communication needs. If information security is breached or other technology difficulties or failures occur, information may be lost or misappropriated, services and operations may be interrupted and the Company could be exposed to claims from customers. Any of these results could have a material adverse effect on the Company's business, financial condition, results of operations or liquidity.

Economic Conditions, Limited Geographic Diversification. The Company's banking operations are located in Western and Central New York State. Because of the geographic concentration of its operations, the Company's results depend largely upon economic conditions in this area, which include depressed wholesale milk prices, losses of manufacturing jobs in Rochester and Buffalo, and minimal population growth throughout the region. Further deterioration in economic conditions could adversely affect the quality of the Company's loan portfolio and the demand for its products and services, and accordingly, could have a material adverse effect on the Company's business, financial condition, results of operations or liquidity. See also "Market Area and Competition."

Ability of the Company to Execute Its Business Strategy. The financial performance and profitability of the Company will depend on its ability to execute its strategic plan and manage its future growth. Although the Company believes that it has substantially integrated recently acquired banks into the

Company's operations, there can be no assurance that unforeseen issues relating to the assimilation or prior operations of these banks, including the emergence of any material undisclosed liabilities, will not materially adversely affect the Company. In addition, the effect of the formal agreements entered into by NBG and BNB has been to increase the capital needs at those banks, and to increase staffing and loan administration expense. It is unlikely that either of these banks will be able to grow significantly through loan growth or acquisitions while the formal agreements remain in place. The Company has incurred, and may continue to incur, additional operating costs in connection with compliance with the formal agreements including, among others, incremental staff and continued higher legal, accounting and consulting expenses. Further, the reputational risk created by the formal agreements could have an impact on such matters as business generation and retention, the ability to attract and retain management at the banks, liquidity and funding. The Company's financial performance will also depend on the Company's ability to maintain profitable operations through implementing its strategic plan. Moreover, the Company's future performance is subject to a number of factors beyond its control, including when the formal agreements are lifted at BNB and NBG, pending and future federal and state banking legislation, regulatory changes, unforeseen litigation outcomes, inflation, lending and deposit rate changes, interest rate fluctuations, increased competition and economic conditions. Accordingly, these issues could have a material adverse effect on the Company's business, financial condition, results of operations or liquidity.

Dependence on Key Personnel. The Company's success depends to a significant extent on the management skills of its existing executive officers and directors, many of whom have held officer and director positions with the Company for many years. The loss or unavailability of any of its key executives or directors, including Peter G. Humphrey, Chairman of the Board of Directors, President and Chief Executive Officer, Ronald M. Miller, Senior Vice President and Chief Financial Officer, or Thomas D. Grover, Senior Vice President and Chief Risk Officer, could have a material adverse effect on the Company's business, financial condition, results of operations or liquidity. See also Part III, Item 10, "Directors and Executive Officers of Registrant."

Competition. National competitors are much larger in total assets and capitalization, have greater access to capital markets and offer a broader array of financial services than the Company. There can be no assurance that the Company will be able to compete effectively in its markets. Furthermore, developments increasing the nature or level of competition could have a material adverse effect on the Company's business, financial condition, results of operations or liquidity. See also "Market Area and Competition" and "Supervision and Regulation."

Government Regulation and Monetary Policy. The Company and the banking industry are subject to extensive regulation and supervision under federal and state laws and regulations. The restrictions imposed by such laws and regulations limit the manner in which the Company conducts its banking business, undertakes new investments and activities and obtains financing. These regulations are designed primarily for the protection of the deposit insurance funds and consumers and not to benefit holders of the Company's securities. Financial institution regulation has been the subject of significant legislation in recent years and may be the subject of further significant legislation in the future, none of which is in the control of the Company. Significant new laws or changes in, or repeals of, existing laws could have a material adverse effect on the Company's business, financial condition, results of operations or liquidity. Further, federal monetary policy, particularly as implemented through the Federal Reserve System, significantly affects credit conditions for the Company, and any unfavorable change in these conditions could have a material adverse effect on the Company's business, financial condition, results of operations or liquidity. See also "Supervision and Regulation."

Supervision and Regulation

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

The following description summarizes some of the laws to which the Company and its subsidiaries are subject. References to applicable statutes and regulations are brief summaries and do not claim to be complete. They are qualified in their entirety by reference to such statutes and regulations. Management believes the Company is in compliance in all material respects with these laws and regulations. Changes in the laws, regulations or policies that impact the Company cannot necessarily be predicted, but they may have a material effect on the business and earnings of the Company.

The Company

The Company is a bank holding company registered under the Bank Holding Company Act of 1956, as amended, and is subject to supervision, regulation and examination by the Federal Reserve Board. During 2003, the Company terminated its financial holding company status and now operates as a bank holding company. The change in status did not affect any non-financial subsidiaries or activities being conducted by the Company, although future acquisitions or expansions of non-financial activities may require prior Federal Reserve Board approval and will be limited to those that are permissible for bank holding companies. The Bank Holding Company Act and other federal laws subject bank holding companies to particular restrictions on the types of activities in which they may engage, and to a range of supervisory requirements and activities, including regulatory enforcement actions for violations of laws and regulations.

Regulatory Restrictions on Dividends; Source of Strength. It is the policy of the Federal Reserve Board that bank holding companies should pay cash dividends on common stock only out of income available over the past year, and only if prospective earnings retention is consistent with the holding company's expected future needs and financial condition. The policy provides that bank holding companies should not maintain a level of cash dividends that undermines the bank holding company's ability to serve as a source of strength to its banking subsidiaries.

Under Federal Reserve Board policy, a bank holding company is expected to act as a source of financial strength to each of its banking subsidiaries and commit resources to their support. Such support may be required at times when, absent this Federal Reserve Board policy, a holding company may not be inclined to provide it. As discussed below, a bank holding company in certain circumstances could be required to guarantee the capital plan of an undercapitalized banking subsidiary.

Safe and Sound Banking Practices. Bank holding companies are not permitted to engage in unsafe and unsound banking practices. The Federal Reserve Board's Regulation Y, for example, generally requires a holding company to give the Federal Reserve Board prior notice of any redemption or repurchase of its own equity securities, if the consideration to be paid, together with the consideration paid for any repurchases or redemptions in the preceding year, is equal to 10% or more of the company's consolidated net worth. The Federal Reserve Board may oppose the transaction if it believes that the transaction would constitute an unsafe or unsound practice or would violate any law or regulation. Depending upon the circumstances, the Federal Reserve Board could take the position that paying a dividend would constitute an unsafe or unsound banking practice.

The Federal Reserve Board has broad authority to prohibit activities of bank holding companies and their non-banking subsidiaries which represent unsafe and unsound banking practices or which constitute violations of laws or regulations, and can assess civil money penalties for certain activities conducted on a knowing and reckless basis, if those activities caused a substantial loss to a depository institution. The penalties can be as high as $1,000,000 for each day the activity continues.

Anti-Tying Restrictions. Bank holding companies and their affiliates are prohibited from tying the provision of certain services, such as extensions of credit, to other services offered by a holding company or its affiliates. In late 2002, the Federal Reserve Board adopted Regulation W, a comprehensive synthesis of prior opinions and interpretations under Sections 23A and 23B of the Federal Reserve Act. Regulation W contains an extensive discussion of tying arrangements, which could impact the way banks and bank holding companies transact business with affiliates.

Capital Adequacy Requirements. The Federal Reserve Board has adopted a system using risk-based capital guidelines to evaluate the capital adequacy of bank holding companies. Under the guidelines, specific categories of assets are assigned different risk weights, based generally on the perceived credit risk of the asset. These risk weights are multiplied by corresponding asset balances to determine a "risk-weighted" asset base. The guidelines require a minimum total risk-based capital ratio of 8.0% (of which at least 4.0% is required to consist of Tier 1 capital elements). Total capital is the sum of Tier 1 and Tier 2 capital. As of December 31, 2003, the Company's ratio of Tier 1 capital to total risk-weighted assets was 10.18% and the ratio of total capital to total risk-weighted assets was 11.44%. See "Management's Discussion and Analysis of Financial Condition and Results of Operations-Financial Condition-Capital Resources."

In addition to the risk-based capital guidelines, the Federal Reserve Board uses a leverage ratio as an additional tool to evaluate the capital adequacy of bank holding companies. The leverage ratio is a company's Tier 1 capital divided by three-month average consolidated assets. Certain highly rated bank holding companies may maintain a minimum leverage ratio of 3.0%, but other bank holding companies may be required to maintain a leverage ratio of up to 200 basis points above the regulatory minimum. As of December 31, 2003, the Company's leverage ratio was 7.03%.

The federal banking agencies' risk-based and leverage ratios are minimum supervisory ratios generally applicable to banking organizations that meet certain specified criteria, assuming that they have the highest regulatory rating. Banking organizations not meeting these criteria are expected to operate with capital positions well above the minimum ratios. The federal bank regulatory agencies may set capital requirements for a particular banking organization that are higher than the minimum ratios when circumstances warrant. Federal Reserve Board guidelines also provide that banking organizations experiencing internal growth or making acquisitions will be expected to maintain strong capital positions substantially above the minimum supervisory levels, without significant reliance on intangible assets.

Imposition of Liability for Undercapitalized Subsidiaries. Bank regulators are required to take "prompt corrective action" to resolve problems associated with insured depository institutions whose capital declines below certain levels. In the event an institution becomes "undercapitalized," it must submit a capital restoration plan. The capital restoration plan will not be accepted by the regulators unless each company having control of the undercapitalized institution guarantees the subsidiary's compliance with the capital restoration plan up to a certain specified amount. Any such guarantee from a depository institutions holding company is entitled to a priority of payment in bankruptcy.

The aggregate liability of the holding company of an undercapitalized bank is limited to the lesser of 5% of the institution's assets at the time it became undercapitalized or the amount necessary to cause the institution to be "adequately capitalized." The bank regulators have greater power in situations where an institution becomes "significantly" or "critically" undercapitalized or fails to submit a capital restoration plan. For example, a bank holding company controlling such an institution can be required to obtain prior Federal Reserve Board approval of proposed dividends, or might be required to consent to a consolidation or to divest the troubled institution or other affiliates.

Acquisitions by Bank Holding Companies. The Bank Holding Company Act requires every bank holding company to obtain the prior approval of the Federal Reserve Board before it may acquire all or substantially all of the assets of any bank, or ownership or control of any voting shares of any bank, if after such acquisition it would own or control, directly or indirectly, more than 5% of the voting shares of such bank. In approving bank acquisitions by bank holding companies, the Federal Reserve Board is required to consider the financial and managerial resources and future prospects of the bank holding company and the banks concerned, the convenience and needs of the communities to be served, and various competitive factors.

Control Acquisitions. The Change in Bank Control Act prohibits a person or group of persons from acquiring "control" of a bank holding company unless the Federal Reserve Board has been notified and has not objected to the transaction. Under a rebuttable presumption established by the Federal Reserve Board, the acquisition of 10% or more of a class of voting stock of a bank holding company with a class of

securities registered under Section 12 of the Exchange Act, would, under the circumstances set forth in the presumption, constitute acquisition of control of the Company.

In addition, any entity is required to obtain the approval of the Federal

Reserve Board under the Bank Holding Company Act before acquiring 25% (5% in the case of an acquirer that is a bank holding company) or more of the Company's outstanding common stock, or otherwise obtaining control or a "controlling influence" over the Company.

The Banks

Wyoming County Bank ("WCB") and First Tier Bank & Trust ("FTB") are New York State-chartered banks. National Bank of Geneva ("NBG") and Bath National Bank ("BNB") are national banks chartered by the Office of the Comptroller of Currency. The FDIC through the Bank Insurance Fund insures all of the deposits of the four subsidiary banks. FTB is a member of the Federal Reserve System. The Banks are subject to supervision and regulation that subject them to special restrictions, requirements, potential enforcement actions and periodic examination by the FDIC, the Federal Reserve Board and the New York State Banking Department (in the case of the state-chartered banks) and the Office of the Comptroller of Currency (in the case of the national banks). Because the Federal Reserve Board regulates the bank holding company parent of the Banks, the Federal Reserve Board also has supervisory authority, which directly affects the banks.

Restrictions on Transactions with Affiliates and Insiders. Transactions between the holding company and its subsidiaries, including the Banks, are subject to Section 23A of the Federal Reserve Act, and to the requirements of Regulation W. In general, Section 23A imposes limits on the amount of such transactions, and also requires certain levels of collateral for loans to affiliated parties. It also limits the amount of advances to third parties, which are collateralized by the securities, or obligations of the Company or its subsidiaries.

Affiliate transactions are also subject to Section 23B of the Federal Reserve Act, and to the requirements of Regulation W which generally requires that certain transactions between the holding company and its affiliates be on terms substantially the same, or at least as favorable to the banks, as those prevailing at the time for comparable transactions with or involving other nonaffiliated persons.

The restrictions on loans to directors, executive officers, principal shareholders and their related interests (collectively referred to herein as "insiders") contained in the Federal Reserve Act and Regulation O apply to all insured institutions and their subsidiaries and holding companies. These restrictions include limits on loans to one borrower and conditions that must be met before such a loan can be made. There is also an aggregate limitation on all loans to insiders and their related interests. These loans cannot exceed the institution's total unimpaired capital and surplus, and the FDIC may determine that a lesser amount is appropriate. Insiders are subject to enforcement actions for knowingly accepting loans in violation of applicable restrictions.

Restrictions on Distribution of Subsidiary Bank Dividends and Assets. Dividends paid by the Banks have provided a substantial part of the Company's operating funds and, for the foreseeable future, it is anticipated that dividends paid by the Banks will continue to be its principal source of operating funds. Capital adequacy requirements serve to limit the amount of dividends that may be paid by the subsidiaries. Under federal law, the subsidiaries cannot pay a dividend if, after paying the dividend, a particular subsidiary will be "undercapitalized." The FDIC may declare a dividend payment to be unsafe and unsound even though the bank would continue to meet its capital requirements after the dividend. Neither of the formal agreements entered into by NBG or BNB restrict the ability of the banks to pay dividends to the Company, provided the minimum capital requirements set forth in the agreements are met.

Because the Company is a legal entity separate and distinct from its subsidiaries, the Company's right to participate in the distribution of assets of any subsidiary upon the subsidiary's liquidation or reorganization will be subject to the prior claims of the subsidiary's creditors. In the event of a liquidation or other resolution of an insured depository institution, the claims of depositors and other general or subordinated

creditors are entitled to a priority of payment over the claims of holders of any obligation of the institution to its shareholders, including any depository bank holding company (such as the Company) or any shareholder or creditor thereof.

Examinations. The New York State Banking Department (in the case of WCB and FTB), the Office of the Comptroller of the Currency (in the case of NBG and BNB), the Federal Reserve Board and the FDIC periodically examine and evaluate the Banks. Based upon such examinations, the appropriate regulator may revalue the assets of the institution and require that it establish specific reserves to compensate for the difference between what the regulator determines the value to be and the book value of such assets.

Audit Reports. Insured institutions with total assets of $500 million or more at the beginning of a fiscal year must submit annual audit reports prepared by independent auditors to federal and state regulators. In some instances, the audit report of the institution's holding company can be used to satisfy this requirement. Auditors must receive examination reports, supervisory agreements and reports of enforcement actions. In addition, financial statements prepared in accordance with generally accepted accounting principles, management's certifications concerning responsibility for the financial statements, internal controls and compliance with legal requirements designated by the FDIC, and an attestation by the auditor regarding the statements of management relating to the internal controls must be submitted. The FDIC Improvement Act of 1991 requires that independent audit committees be formed, consisting of outside directors only. The committees of institutions with assets of more than $3 billion must include members with experience in banking or financial management must have access to outside counsel and must not include representatives of large customers.

Capital Adequacy Requirements. The FDIC has adopted regulations establishing minimum requirements for the capital adequacy of insured institutions. The FDIC may establish higher minimum requirements if, for example, a bank has previously received special attention or has a high susceptibility to interest rate risk.

The FDIC's risk-based capital guidelines generally require banks to have a minimum ratio of Tier 1 capital to total risk-weighted assets of 4.0% and a ratio of total capital to total risk-weighted assets of 8.0%. The capital categories have the same definitions for the Company. As of December 31, 2003, the ratio of Tier 1 capital to total risk-weighted assets for the Banks was 8.91% for WCB, 11.15% for NBG, 13.69% for BNB, and 10.90% for FTB, and the ratio of total capital to total risk-weighted assets was 10.16% for WCB, 12.41% for NBG, 14.94% for BNB, and 12.16% for FTB. See "Management's Discussion and Analysis of Financial Condition and Results of Operations--Liquidity and Capital Resources."

The FDIC's leverage guidelines require banks to maintain Tier 1 capital of no less than 4.0% of average total assets, except in the case of certain highly rated banks for which the requirement is 3.0% of average total assets. As of December 31, 2003, the ratio of Tier 1 capital to average total assets (leverage ratio) was 6.71% for WCB, 8.04% for NBG, 8.02% for BNB, and 6.09% for FTB. See "Management's Discussion and Analysis of Financial Condition and Results of Operations--Liquidity and Capital Resources."

As part of the agreements in place with their primary regulator, NBG and BNB were required to develop capital plans enabling them to achieve, by March 31, 2004, Tier 1 leverage capital equal to 8% of risk-weighted assets, Tier 1 risk-based capital equal to 10% of risk-weighted assets, and total risk-based capital of 12% of risk-weighted assets. Each of the banks meets the required levels at December 31, 2003.

Corrective Measures for Capital Deficiencies. The federal banking regulators are required to take "prompt corrective action" with respect to capital-deficient institutions. Agency regulations define, for each capital category, the levels at which institutions are "well-capitalized," "adequately capitalized," "undercapitalized," "significantly undercapitalized" and "critically undercapitalized." A "well-capitalized" bank has a total risk-based capital ratio of 10.0% or higher; a Tier 1 risk-based capital ratio of 6.0% or higher; a leverage ratio of 5.0% or higher; and is not subject to any written agreement, order or directive requiring it to maintain a specific capital level for any capital measure. An "adequately capitalized" bank

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has a total risk-based capital ratio of 8.0% or higher; a Tier 1 risk-based capital ratio of 4.0% or higher; a leverage ratio of 4.0% or higher (3.0% or higher if the bank was rated a composite 1 in its most recent examination report and is not experiencing significant growth); and does not meet the criteria for a well-capitalized bank. A bank is "undercapitalized" if it fails to meet any one of the "adequately capitalized" ratios.

In addition to requiring undercapitalized institutions to submit a capital restoration plan, agency regulations contain broad restrictions on certain activities of undercapitalized institutions including asset growth, acquisitions, branch establishment and expansion into new lines of business. With certain exceptions, an insured depository institution is prohibited from making capital distributions, including dividends, and is prohibited from paying management fees to control persons if the institution would be undercapitalized after any such distribution or payment.

As an institution's capital decreases, the FDIC's enforcement powers become more severe. A significantly undercapitalized institution is subject to mandated capital raising activities, restrictions on interest rates paid and transactions with affiliates, removal of management and other restrictions. The FDIC has only very limited discretion in dealing with a critically undercapitalized institution and is virtually required to appoint a receiver or conservator.

Banks with risk-based capital and leverage ratios below the required minimums may also be subject to certain administrative actions, including the termination of deposit insurance upon notice and hearing, or a temporary suspension of insurance without a hearing in the event the institution has no tangible capital.

Deposit Insurance Assessments. The bank subsidiaries must pay assessments to the FDIC for federal deposit insurance protection. The FDIC has adopted a risk-based assessment system as required by the FDIC Improvement Act. Under this system, FDIC-insured depository institutions pay insurance premiums at rates based on their risk classification. Institutions assigned to higher risk classifications (that is, institutions that pose a greater risk of loss to their respective deposit insurance funds) pay assessments at higher rates than institutions that pose a lower risk. An institution's risk classification is assigned based on its capital levels and the level of supervisory concern the institution poses to the regulators. In addition, the FDIC can impose special assessments in certain instances.

The FDIC maintains a process for raising or lowering all rates for insured institutions semi-annually if conditions warrant a change. Under this system, the FDIC has the flexibility to adjust the assessment rate schedule twice a year without seeking prior public comment, but only within a range of five cents per $100 above or below the premium schedule adopted. The FDIC can make changes in the rate schedule outside the five-cent range above or below the current schedule only after a full rulemaking with opportunity for public comment.

The Deposit Insurance Fund Act of 1996 contained a comprehensive approach to recapitalizing the Savings Association Insurance Fund and to assuring the payment of the Financing Corporation's bond obligations. Under this law, banks insured under the Bank Insurance Fund are required to pay a portion of the interest due on bonds that were issued by the Financing Corporation in 1987 to help shore up the ailing Federal Savings and Loan Insurance Corporation.

Enforcement Powers. The FDIC and the other federal banking agencies have broad enforcement powers, including the power to terminate deposit insurance, impose substantial fines and other civil and criminal penalties and appoint a conservator or receiver. Failure to comply with applicable laws, regulations and supervisory agreements could subject the Company or its banking subsidiaries, as well as the officers, directors and other institution-affiliated parties of these organizations, to administrative sanctions and potentially substantial civil money penalties.

Brokered Deposit Restrictions. Adequately capitalized institutions cannot accept, renew or roll over brokered deposits except with a waiver from the FDIC, and are subject to restrictions on the interest rates that can be paid on such deposits. Undercapitalized institutions may not accept, renew or roll over

brokered deposits. The Company's NBG and BNB subsidiaries for purposes of brokered deposit restrictions are deemed to be adequately capitalized institutions.

Cross-Guarantee Provisions. The Financial Institutions Reform, Recovery and Enforcement Act of 1989 ("FIRREA") contains a "cross-guarantee" provision which generally makes commonly controlled insured depository institutions liable to the FDIC for any losses incurred in connection with the failure of a commonly controlled depository institution.

Community Reinvestment Act. The Community Reinvestment Act of 1977 ("CRA") and the regulations issued hereunder are intended to encourage banks to help meet the credit needs of their service area, including low and moderate income neighborhoods, consistent with the safe and sound operations of the banks. These regulations also provide for regulatory assessment of a bank's record in meeting the needs of its service area when considering applications regarding establishing branches, mergers or other bank or branch acquisitions. FIRREA requires federal banking agencies to make public a rating of a bank's performance under the CRA. In the case of a bank holding company, the CRA performance record of the banks involved in the transaction are reviewed in connection with the filing of an application to acquire ownership or control of shares or assets of a bank or to merge with any other bank holding company. An unsatisfactory record can substantially delay or block the transaction.

Consumer Laws and Regulations. In addition to the laws and regulations discussed herein, the subsidiary banks are also subject to certain consumer laws and regulations that are designed to protect consumers in transactions with banks.

While the list set forth herein is not exhaustive, these laws and regulations include, among others, the Truth in Lending Act, the Truth in Savings Act, the Electronic Funds Transfer Act, the Expedited Funds Availability Act, the Equal Credit Opportunity Act, the Fair Housing Act, the Home Mortgage Disclosure Act, the Real Estate Settlement Procedures Act, and the "Check 21" Act. These laws and regulations mandate certain disclosure requirements and regulate the manner in which financial institutions must deal with customers when taking deposits or making loans to such customers. The Banks must comply with the applicable provisions of these consumer protection laws and regulations as part of their ongoing customer relations.

Changing Regulatory Structure

Gramm-Leach-Bliley Act

The Gramm-Leach-Bliley Act ("Gramm-Leach") was signed into law on November 12, 1999. Gramm-Leach permits, subject to certain conditions, combinations among banks, securities firms and insurance companies beginning March 11, 2000. Under Gramm-Leach, bank holding companies are permitted to offer their customers virtually any type of financial service including banking, securities underwriting, insurance (both underwriting and agency), and merchant banking. In order to engage in these additional financial activities, a bank holding company must qualify and register with the Board of Governors of the Federal Reserve System as a "financial holding company" by demonstrating that each of its bank subsidiaries is "well capitalized," "well managed," and has at least a "satisfactory" rating under the CRA. On May 12, 2000 the Company received approval from the Federal Reserve Bank of New York to become a financial holding company resulting in the eventual formation of FIGI and acquisition of BGI as previously discussed. During 2003, the Company terminated its financial holding company status and now operates as a bank holding company. The change in status did not affect the non-financial subsidiaries or activities being conducted by the Company, although future acquisitions or expansions of non-financial activities may require prior Federal Reserve Board approval and will be limited to those that are permissible for bank holding companies. Gramm-Leach establishes that the federal banking agencies will regulate the banking activities of financial holding companies and banks' financial subsidiaries, the U.S. Securities and Exchange Commission will regulate their securities activities and state insurance regulators will regulate their insurance activities. Gramm-Leach also provides new protections against the transfer and use by financial institutions of consumers' nonpublic, personal information.

The major provisions of Gramm-Leach are:

Financial Holding Companies and Financial Activities. Title I establishes a comprehensive framework to permit affiliations among commercial banks, insurance companies, securities firms, and other financial service providers by revising and expanding the Bank Holding Company Act framework to permit a holding company system to engage in a full range of financial activities through qualification as a new entity known as a financial holding company. A bank holding company that qualifies as a financial holding company can expand into a wide variety of services that are financial in nature, if its subsidiary depository institutions are well-managed, well-capitalized and have received at least a "satisfactory" rating on their last CRA examination. Services that have been deemed to be financial in nature include securities underwriting, dealing and market making, sponsoring mutual funds and investment companies, insurance underwriting and agency activities and merchant banking.

Title I also required the FDIC to adopt regulations implementing Section 121 of

Title I, regarding permissible activities and investments of insured state banks. Final regulations adopted by the FDIC in January 2001, in the form of amendments to Part 362 of the FDIC rules and regulations, provide the framework for subsidiaries of state nonmember banks to engage in financial activities that Gramm-Leach permits national banks to conduct through a financial subsidiary. The regulations require that prior to commencing such financial activities, a state nonmember bank must notify the FDIC of its intent to do so, and must certify that it is well-managed and that it and all of its subsidiary insured depository institutions are well-capitalized after deducting its investment in the new subsidiary. Furthermore, the regulations require that the notifying bank must, and must continue to, (i) disclose the capital deduction in published financial statements, and (ii) comply with sections 23A and 23B of the Federal Reserve Act and (iii) comply with all required financial and operational safeguards.

Activities permissible for financial subsidiaries of national banks, and, pursuant to Section 362 of the FDIC rules and regulations, also permissible for financial subsidiaries of state nonmember banks, include, but are not limited to, the following: (a) Lending, exchanging, transferring, investing for others, or safeguarding money or securities; (b) Insuring, guaranteeing, or indemnifying against loss, harm, damage, illness, disability, or death, or providing and issuing annuities, and acting as principal, agent, or broker for purposes of the foregoing, in any State; (c) Providing financial, investment, or economic advisory services, including advising an investment company; (d) Issuing or selling instruments representing interests in pools of assets permissible for a bank to hold directly; and (e) Underwriting, dealing in, or making a market in securities.

Securities Activities. Title II narrows the exemptions from the securities laws previously enjoyed by banks, requires the Federal Reserve Board and the SEC to work together to draft rules governing certain securities activities of banks and creates a new, voluntary investment bank holding company.

Insurance Activities. Title III restates the proposition that the states are the functional regulators for all insurance activities, including the insurance activities of federally-chartered banks, and bars the states from prohibiting insurance activities by depository institutions. The law encourages the states to develop uniform or reciprocal rules for the licensing of insurance agents.

Privacy. Under Title V, federal banking regulators were required to adopt rules that have limited the ability of banks and other financial institutions to disclose non-public information about consumers to nonaffiliated third parties. These limitations require disclosure of privacy policies to consumers and, in some circumstances, allow consumers to prevent disclosure of certain personal information to a nonaffiliated third party. Federal banking regulators issued final rules on May 10, 2000 to implement the privacy provisions of Title V. Under the rules, financial institutions must provide:

- initial notices to customers about their privacy policies, describing the conditions under which they may disclose nonpublic personal information to nonaffiliated third parties and affiliates;

- annual notices of their privacy policies to current customers; and

- a reasonable method for customers to "opt out" of disclosures to nonaffiliated third parties.

Compliance with the rules is mandatory after July 1, 2001. The Company and the banks were in full compliance with the rules as of or prior to their respective effective dates.

Safeguarding Confidential Customer Information. Under Title V, federal banking regulators are required to adopt rules requiring financial institutions to implement a program to protect confidential customer information. In January 2000, the federal banking agencies adopted guidelines requiring financial institutions to establish an information security program to:

- identify and assess the risks that may threaten customer information;
- develop a written plan containing policies and procedures to manage and control these risks;
- implement and test the plan; and
- adjust the plan on a continuing basis to account for changes in technology, the sensitivity of customer information and internal or external threats to information security.

The Banks' approved security programs appropriate to their size and complexity and the nature and scope of their operations prior to the July 1, 2001 effective date of the regulatory guidelines. The implementation of the programs is an ongoing process.

Community Reinvestment Act Sunshine Requirements. In February 2001, the federal banking agencies adopted final regulations implementing Section 711 of Title VII, the CRA Sunshine Requirements. The regulations require nongovernmental entities or persons and insured depository institutions and affiliates that are parties to written agreements made in connection with the fulfillment of the institution's CRA obligations to make available to the public and the federal banking agencies a copy of each agreement. The regulations impose annual reporting requirements concerning the disbursement, receipt and use of funds or other resources under these agreements. The effective date of the regulations was April 1, 2001. Neither the Company nor the banks is a party to any agreement that would be the subject of reporting pursuant to the CRA Sunshine Requirements.

The Company continues to evaluate the strategic opportunities presented by the broad powers granted to bank holding companies that elect to be treated as financial holding companies. In the event that the Company determines that access to the broader powers of a financial holding company is in the best interests of the Company, its shareholders and the banks, the Company will file the appropriate election with the Federal Reserve Board.

USA Patriot Act

As part of the Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001 ("USA Patriot Act"), signed into law on October 26, 2001, Congress adopted the International Money Laundering Abatement and Financial Anti-Terrorism Act of 2001 ("IMLAFATA"). IMLAFATA authorizes the Secretary of the Treasury, in consultation with the heads of other government agencies, to adopt special measures applicable to banks, bank holding companies, or other financial institutions. During 2002, the Department of Treasury issued a number of regulations relating to enhanced recordkeeping and reporting requirements for certain financial transactions that are of primary money laundering concern, due diligence requirements concerning the beneficial ownership of certain types of accounts, and restrictions or prohibitions on certain types of accounts with foreign financial institutions. Covered financial institutions also are barred from dealing with foreign "shell" banks. In addition, IMLAFATA expands the circumstances under which funds in a bank account may be forfeited and requires covered financial institutions to respond under certain circumstances to requests for information from federal banking agencies within 120 hours.

Regulations were also adopted during 2002 to implement minimum standards to verify customer identity, to encourage cooperation among financial institutions, federal banking agencies, and law enforcement authorities regarding possible money laundering or terrorist activities, to prohibit the anonymous use of "concentration accounts," and to require all covered financial institutions to have in place a Bank Secrecy Act compliance program. IMLAFATA also amends the Bank Holding Company Act and the Bank Merger Act to require the federal banking agencies to consider the effectiveness of a financial institution's anti-money laundering activities when reviewing an application under these acts.

The Banks have in place a Bank Secrecy Act compliance program, and they engage in very few transactions of any kind with foreign financial institutions or foreign persons.

Sarbanes-Oxley Act

On July 30, 2002, the President signed into law the Sarbanes-Oxley Act of 2002 (the "Act") implementing legislative reforms intended to address corporate and accounting fraud. In addition to the establishment of a new accounting oversight board that enforces auditing, quality control and independence standards and is funded by fees from all publicly traded companies, the law restricts provision of both auditing and consulting services by accounting firms. To ensure auditor independence, any non-audit services being provided to an audit client requires pre-approval by the issuer's audit committee members. In addition, the audit partners must be rotated. The Act requires chief executive officers and chief financial officers, or their equivalent, to certify to the accuracy of periodic reports filed with the SEC, subject to civil and criminal penalties if they knowingly or willfully violate this certification requirement. In addition, under the Act, legal counsel is required to report evidence of a material violation of the securities laws or a breach of fiduciary duty by a company to its chief executive officer or its chief legal officer, and, if such officer does not appropriately respond, to report such evidence to the audit committee or other similar committee of the board of directors or the board itself.

Longer prison terms and increased penalties are also applied to corporate executives who violate federal securities laws, the period during which certain types of suits can be brought against a company or its officers has been extended, and bonuses issued to top executives prior to restatement of a company's financial statements are subject to disgorgement if such restatement was due to corporate misconduct. Executives are also prohibited from insider trading during retirement plan "blackout" periods, and loans to company executives are restricted. The Act accelerates the time frame for disclosures by public companies, as they must immediately disclose any material changes in their financial condition or operations. Directors and executive officers must also provide information for most changes in ownership in a company's securities within two business days of the change.

The Act also prohibits any officer or director of a company or any other person acting under their direction from taking any action to fraudulently influence, coerce, manipulate or mislead any independent public or certified accountant engaged in the audit of the company's financial statements for the purpose of rendering the financial statement's materially misleading. The Act also requires the SEC to prescribe rules requiring inclusion of an internal control report and assessment by management in the annual report to stockholders. In addition, the

Act requires that each financial report required to be prepared in accordance with (or reconciled to) accounting principles generally accepted in the United States of America and filed with the SEC reflect all material correcting adjustments that are identified by a "registered public accounting firm" in accordance with accounting principles generally accepted in the United States of America and the rules and regulations of the SEC.

Effective August 29, 2002, as directed by Section 302(a) of the Act, the Company's chief executive officer and chief financial officer are each required to certify that the Company's quarterly and annual reports do not contain any untrue statement of a material fact. The Act imposes several requirements, including having these officers certify that: they are responsible for establishing, maintaining and regularly evaluating the effectiveness of the Company's internal controls; they have made certain disclosures to the Company's auditors and the audit committee of the Board of Directors about the Company's internal controls; and they have included information in the Company's quarterly and annual reports about their evaluation and whether there have been significant changes in the Company's internal controls or in other factors that could significantly affect internal controls during the last quarter.

Fair Credit Reporting Act

In 1970, the U. S. Congress enacted the Fair Credit Reporting Act (the "FCRA") in order to ensure the confidentiality, accuracy, relevancy and proper utilization of consumer credit report information. Under the framework of the FCRA, the United States has developed a highly advanced and efficient credit reporting system. The information contained in that broad system is used by financial institutions, retailers and other creditors of every size in making a wide variety of decisions regarding financial transactions. Employers, and law enforcement agencies have also made wide use of the information

collected and maintained in databases made possible by the FCRA. The FCRA affirmatively preempts state law in a number of areas, including the ability of entities affiliated by common ownership to share and exchange information freely, the requirements on credit bureaus to reinvestigate the contents of reports in response to consumer complaints, among others. By its terms, the preemption provisions of the FCRA were to terminate as of December 31, 2003. With the enactment of the Fair and Accurate Transactions Act (FACT Act) in late 2003, the preemption provisions of FCRA were extended, although the FACT Act imposes additional requirements on entities that gather and share consumer credit information. The FACT Act requires the Federal Reserve Board and the Federal Trade Commission to issue final regulations within nine months of the effective date of the Act. The provisions of these implementing regulations, and their effect on the Company's banks, cannot be determined at this time.

Expanding Enforcement Authority

The Federal Reserve Board, the Office of the Comptroller of Currency, the New York State Superintendent of Banks and the FDIC possess extensive authority to police unsafe or unsound practices and violations of applicable laws and regulations by depository institutions and their holding companies. For example, the FDIC may terminate the deposit insurance of any institution, which it determines has engaged in an unsafe or unsound practice. The agencies can also assess civil money penalties, issue cease and desist or removal orders, seek injunctions, and publicly disclose such actions. The OCC has indicated, in the case of NBG, that it is considering whether civil money penalties should be imposed for certain of the violations of law identified in its Report of Examination for the period ended September 30, 2002.

Effect On Economic Environment

The policies of regulatory authorities, including the monetary policy of the Federal Reserve Board, have a significant effect on the operating results of bank holding companies and their subsidiaries. Among the means available to the Federal Reserve Board to affect the money supply are open market operations in U.S. Government securities, changes in the discount rate on member bank borrowings and changes in reserve requirements against member bank deposits. These means are used in varying combinations to influence overall growth and distribution of bank loans, investments and deposits, and their use may affect interest rates charged on loans or paid for deposits. Federal Reserve Board monetary policies have materially affected the operating results of commercial banks in the past and are expected to continue to do so in the future.

2003 Regulatory Developments

On September 4, 2003, the boards of NBG and BNB entered into formal agreements with their primary regulator, the OCC. Under the terms of the agreements, NBG and BNB, without admitting any violations, agreed to take certain actions designed to assure that their operations are in accordance with applicable laws and regulations. The agreements require them, among other things, to: appoint a Compliance Committee of the Board; develop, implement and ensure compliance with a written plan outlining actions to be taken to address regulatory recommendations set forth in the reports of examination, review and assess the capabilities of management; develop various policies and programs to reduce credit risk and identify problem loans and to adopt policies that will permit them to declare dividends only when they are in compliance with their approved capital plans and applicable laws, and upon prior written notice to (but not with the consent of) the OCC. The boards of both banks have taken, or are in the process of taking, the actions required by the agreements, and the Company has implemented a compliance monitoring program to track and monitor compliance within each bank of each requirement in the formal agreements.

Both banks were required to develop capital plans that will enable them to achieve, by March 31, 2004, Tier 1 leverage capital equal to 8% of risk-weighted assets, Tier 1 risk-based capital equal to 10% of risk-weighted assets, and total risk-based capital of 12% of risk-weighted assets. Interim levels, to be achieved by December 31, 2003, were also established, at 6.25%, 9.0% and 11.0%, respectively, for Bath, and 7.0%, 9.0% and 10.5%, respectively, for NBG. Following the closing of the credit facility with M&T Bank in December 2003, loan proceeds were downstreamed to NBG and BNB so that the capital levels required to be achieved by March 31, 2004 were met by December 31, 2003.

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The NBG agreement also requires its board of directors to adopt, implement and ensure adherence to a written policy on extensions of overdraft credit and limit the circumstances under which NBG will be permitted to extend credit to its affiliates, and requires the bank to engage an independent appraiser to provide updated real estate appraisals where required.

The BNB agreement also requires its board of directors to adopt, implement and ensure adherence to a written action plan outlining proposed corrective action addressing issues in the pre-existing Matters Requiring Attention pertaining to interest rate risk measurement and monitoring systems.

Also on September 4, 2003, in a letter to the Federal Reserve Bank of New York, the Company's primary regulator, the Company terminated its financial holding company status and began operating instead as a bank holding company. The change in status will not affect any non-financial subsidiaries or activities currently being conducted by the Company, although it will mean that future acquisitions or expansions of non-financial activities may require prior Federal Reserve Board approval and will be limited to those that are permissible for bank holding companies.

The Company believes that it has made substantial progress to date in enhancing its risk management and governance practices while working with management and Boards of NBG and BNB to address the various requirements set forth in the formal agreements. There can be no assurance, however, as to the precise timing for determining that all required corrective actions have been taken to the appropriate satisfaction of the OCC. The Board and senior management team are committed to the goal of establishing and maintaining "best practices" at both the Company and the bank level in the areas of governance, corporate conduct, risk management and regulatory compliance, and to meeting all of the banks' commitments to their regulators. While the Company believes that substantial progress has been made in this pursuit to date, the Company also recognizes that this remains an important ongoing effort requiring dedication and a commitment of resources at all levels of the holding company and the banks.

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Item 2. Properties

The Company's headquarters and operations center is located in Warsaw, New York. This facility is leased for a nominal rent from the Wyoming County Industrial Development Agency for local tax reasons and the Company has the right to purchase it for nominal consideration beginning in November 2006. The following table lists the properties of each of the Company's subsidiaries:

ENTITY \ LOCATION	TYPE OF FACILITY	LEASED OR OWNED	EXPIRATIO OF LEASE
Wyoming County Bank			
Warsaw............................	Main Office	Own	--
Attica............................	Branch	Own	--
Batavia...........................	Branch	Lease	September 2
Batavia (In-Store)................	Branch	Lease	August 20
Dansville.........................	Branch	Lease	March 201
East Aurora.......................	Branch	Lease	March 201
Geneseo...........................	Branch	Own	--
Lakeville.........................	Branch	Own	--
Mount Morris......................	Branch	Own	--
North Java........................	Branch	Own	--
North Warsaw......................	Branch	Own	--
Orchard Park......................	Branch	Ground Lease	January 20
Pavilion..........................	Branch	Own	--
Strykersville.....................	Branch	Own	--
Williamsville.....................	Branch	Lease	May 2005
Wyoming...........................	Branch	Own	--
Yorkshire.........................	Branch	Lease	November 2
National Bank of Geneva			
Geneva............................	Main Office	Own	--
Geneva............................	Drive-up Branch	Own	--
Geneva (Plaza)....................	Branch	Ground Lease	January 20
Caledonia.........................	Branch	Lease	April 200

Canandaigua........................	Branch	Own	--
Honeoye Falls......................	Branch	Lease	September 2
Leroy..............................	Branch	Own	--
North Chili........................	Branch	Own	--
Ovid...............................	Branch	Own	--
Penn Yan...........................	Branch	Own	--
Victor.............................	Branch	Own	--
Waterloo...........................	Branch	Own	--
Bath National Bank			
Bath...............................	Main Office	Own	--
Bath...............................	Drive-up Branch	Own	--
Avoca..............................	Branch	Own	--
Avoca..............................	Drive-up Branch	Lease	September 2
Cohocton...........................	Closed Branch	Lease	August 20
Dundee.............................	Branch	Own	--
Elmira.............................	Branch	Own	--
Elmira Heights.....................	Branch	Lease	August 20
Erwin..............................	Branch	Lease	August 20
Hammondsport.......................	Branch	Own	--
Hornell............................	Branch	Own	--
Horseheads.........................	Branch	Lease	October 20
Naples.............................	Branch	Own	--
Wayland............................	Branch	Own	--
First Tier Bank & Trust			
Olean..............................	Main Office	Own	--
Olean..............................	Drive-up Branch	Own	--
Allegany...........................	Branch	Own	--
Cuba...............................	Branch	Own	--
Ellicottville......................	Branch	Own	--
Lakewood...........................	Branch	Own	--
Salamanca..........................	Branch	Own	--
Burke Group			
Honeoye Falls......................	Main Office	Lease	December 2
Syracuse...........................	Branch	Lease	April 200

Item 3. Legal Proceedings

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

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

No matters were submitted during the fourth quarter of the year ended December 31, 2003 to a vote of security holders.

PART II

Item 5. Market for Registrant's Common Stock and Related Stockholder Matters

The common stock of the Company is traded under the symbol of FISI on the Nasdaq

National Market. At March 1, 2004, the Company had 11,172,673 shares of common stock outstanding (exclusive of treasury shares) and approximately 2,400 shareholders of record. The following chart lists prices of actual sales transactions as reported by Nasdaq, as well as the Company's cash dividends declared.

	Sales Price			Cash Dividends
	High	Low	Close	Declared
2003				
First Quarter	$ 29.75	$ 19.05	$ 19.82	$ 0.16
Second Quarter	27.23	18.94	23.53	0.16
Third Quarter	27.20	21.80	21.92	0.16
Fourth Quarter	29.40	22.00	28.23	0.16
2002				
First Quarter	$ 30.00	$ 23.33	$ 29.11	$ 0.13
Second Quarter	38.85	28.74	37.86	0.14
Third Quarter	38.25	24.35	27.15	0.15
Fourth Quarter	32.04	25.05	29.36	0.16

The Company pays regular quarterly cash dividends on its common stock, and the Board of Directors presently intends to continue the payment of regular quarterly cash dividends, subject to the need for those funds for debt service and other purposes. However, because substantially all of the funds available for the payment of dividends are derived from the Banks, future dividends will depend upon the earnings of the Banks', their financial condition and need for funds. Furthermore, there are a number of federal banking policies and regulations that restrict the Company's ability to pay dividends. For further discussion on dividend restrictions, please refer to page 14, as these restrictions may have the effect of reducing the amount of dividends that the Company can declare to its shareholders.

Item 6. Selected Financial Data

(Dollars in thousands)	December 31				
	2003	2002	2001	2000	1999
Selected Financial Condition Data					
Total assets	$2,173,732	$2,105,034	$1,794,296	$1,289,327	$1,136,46
Loans	1,345,347	1,321,892	1,166,050	887,145	763,74
Allowance for loan losses	29,064	21,660	19,074	13,883	11,42
Securities available for sale	604,964	596,862	428,423	257,823	197,13
Securities held to maturity	47,131	47,125	61,281	76,947	81,35
Deposits	1,818,891	1,708,523	1,433,658	1,078,111	949,53
Borrowed funds	154,247	195,479	190,389	62,384	56,33
Shareholders' equity	183,103	178,294	149,187	131,618	117,53

(Dollars in thousands)	For the years ended December 31				
	2003	2002	2001	2000	1999

Selected Results of Operations Data					
Interest income	$ 111,450	$ 118,439	$ 114,468	$ 96,467	$ 78,69
Interest expense	35,949	42,585	49,694	43,605	31,88
Net interest income	75,501	75,854	64,774	52,862	46,80
Provision for loan losses	22,526	6,119	4,958	4,211	3,06
Net interest income after Provision for loan loss	52,975	69,735	59,816	48,651	43,74
Noninterest income	26,072	22,189	15,782	9,409	8,05
Noninterest expense (3)	60,823	53,049	43,352	30,156	27,03
Income before income taxes	18,224	38,875	32,246	27,904	24,77
Income taxes	3,977	12,419	11,033	9,804	8,81
Net income	$ 14,247	$ 26,456	$ 21,213	$ 18,100	$ 15,95

	At or for the years ended December 31				
	2003	2002	2001	2000	
Per Common Share Data					
Net income - basic	$ 1.14	$ 2.26	$ 1.79	$ 1.51	$
Net income - diluted	1.13	2.23	1.77	1.51	
Cash dividends declared on common stock	0.64	0.58	0.48	0.42	
Book value	14.81	14.46	11.93	10.36	
Market value	28.23	29.36	23.40	13.61	
Selected Financial Ratios and Other Data					
Performance Ratios:					
Return on common equity	7.65%	17.01%	15.84%	15.78%	
Return on assets	0.66	1.35	1.34	1.51	
Common dividend payout	56.14	25.66	26.82	27.81	
Net interest rate spread	3.62	3.96	3.96	3.98	
Net interest margin (1)	3.95	4.37	4.62	4.87	
Efficiency ratio	55.73	50.62	48.49	45.19	
Noninterest income to average total assets (2)	1.16	1.11	0.96	0.76	
Noninterest expenses to average total assets	2.82	2.70	2.73	2.52	
Average interest-earning assets to average interest bearing liabilities	118.62	117.82	119.67	123.25	1
Asset Quality Ratios:					
Non-performing loans to total loans	3.82%	2.81%	0.86%	0.80%	
Non-performing assets to total loans and other real estate	3.87	2.90	0.94	0.91	
Allowance for loan losses to non-performing loans	56	58	190	195	
Allowance for loan losses to total loans	2.16	1.64	1.64	1.56	
Net charge-offs during the period to average loans outstanding during the year	1.11	0.30	0.23	0.21	
Capital ratios:					
Equity to total assets	8.42%	8.47%	8.31%	10.21%	
Average common equity to average assets	7.74	7.47	7.84	8.78	
Other Data:					

Number of full-service offices	48	47	41	32	
Loans serviced for others (in millions)	$439.5	$356.4	$302.3	$205.2	$
Full time equivalent employees	744	685	608	441	

(1) Net interest income divided by average interest earning assets. A tax-equivalent adjustment to interest earned from tax-exempt securities has been computed using a federal tax rate of 35%.

(2) Noninterest income excludes net gain (loss) on sale of securities available for sale.

(3) Noninterest expense includes goodwill amortization, which amounted to $1,653,000 for 2001 compared to zero in all other years presented.

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(Dollars in thousands)	First Quarter	Second Quarter	T Qu
Selected Quarterly Financial Information			
2003			
Results of operations data:			
Interest income	$28,527	$28,764	
Interest expense	9,686	9,571	
Net interest income	18,841	19,193	
Provision for loan losses	3,298	5,311	
Net interest income after provision for loan losses	15,543	13,882	
Noninterest income	6,102	6,160	
Noninterest expense	15,576	14,947	
Income before income taxes	6,069	5,095	
Income taxes	1,773	1,445	
Net income	4,296	3,650	
Per common share data:			
Net income - basic	$0.35	$0.29	
Net income - diluted	0.35	0.29	
Cash dividends declared	0.16	0.16	
Book value	14.57	15.11	
Market value	19.82	23.53	

	First Quarter	Second Quarter	T Qu
2002			
Results of operations data:			
Interest income	$28,560	$29,927	
Interest expense	10,483	10,941	
Net interest income	18,077	18,986	
Provision for loan losses	1,007	1,181	
Net interest income after provision for loan losses	17,070	17,805	
Noninterest income	4,937	5,157	

Noninterest expense	12,100	13,093
Income before income taxes	9,907	9,869
Income taxes	3,250	3,225
Net income	6,657	6,644
Per common share data:		
Net income - basic	$0.57	$0.57
Net income - diluted	0.56	0.56
Cash dividends declared	0.13	0.14
Book value	12.26	13.23
Market value	29.11	37.86

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

GENERAL

The principal objective of this discussion is to provide an overview of the financial condition and results of operations of the Company during the year ended December 31, 2003 and the preceding two years. This discussion and tabular presentations should be read in conjunction with the accompanying consolidated financial statements and accompanying notes.

Income. The Company's results of operations are dependent primarily on net interest income, which is the difference between the income earned on loans and securities and the cost of funds, consisting of the interest paid on deposits and borrowings. Results of operations are also affected by the provision for loan losses, service charges on deposits, financial services group fees and commissions, mortgage banking activities, gain or loss on the sale or call of investment securities and other miscellaneous income.

Expenses. The Company's expenses primarily consist of salaries and employee benefits, occupancy and equipment, supplies and postage, amortization of intangible assets, computer and data processing, professional fees, other miscellaneous expense and income tax expense. Results of operations are also significantly affected by general economic and competitive conditions, particularly changes in interest rates, government policies and the actions of regulatory authorities.

OVERVIEW

Net income was $14.2 million, $26.5 million and $21.2 million for 2003, 2002 and 2001, respectively. Diluted earnings per share for the year ended December 31, 2003 was $1.13, compared to $2.23 in 2002 and $1.77 in 2001. The return on average common equity in 2003 was 7.65%, compared to 17.01% in 2002 and 15.84% in 2001. The return on average assets in 2003 was 0.66%, compared to 1.35% in 2002 and 1.34% in 2001.

Net interest income, the principal source of the Company's earnings, was $75.5 million in 2003 comparable to $75.9 million in 2002. Net interest margin was 3.95% for the year ended December 31, 2003, a drop of 42 basis points from the 4.37% level for last year.

The most significant item affecting 2003 financial results was the provision for loan losses, which totaled $22.5 million in 2003, an increase of $16.4 million over the $6.1 million provision for loan losses in 2002. Credit quality issues made 2003 a challenging year for the Company. High levels of nonperforming loans with associated charge-offs and increases to the allowance for loan losses significantly impacted financial results. Nonperforming assets increased to $52 million at December 31, 2003 compared to $38 million at December 31, 2002. Nonperforming agricultural credits, principally dairy farms, have increased $10 million since December 31, 2002. Total nonperforming agricultural loans were $22 million at December 31, 2003 or 9.40% of total agricultural loans. Borrower cash flows in the dairy industry have recently improved due to some stabilization and upward movement in milk prices. Net loan charge-offs were $15 million, or 1.11% of average loans, for the year ended December 31, 2003 compared to $4 million, or 0.30% of average loans for 2002. Commercial and commercial mortgage loans represented $11 million of net charge-offs in 2003.

During 2003, increased regulatory oversight was put in place in the form of formal agreements at the two national banks, NBG and BNB. In addition, the Company's management placed a renewed focus on risk management, from both a corporate and credit perspective. This included expansion of the position formerly known as Chief Credit Officer to Chief Risk Officer. The Company has committed substantial resources to credit administration and underwriting functions with the goal of increasing consistency among subsidiary banks in reporting and grading loans, and strengthening the review and oversight of subsidiary bank lending and credit administration at the holding company level.

The Company's future challenges include managing existing credit quality issues as well as continuing to strengthen and standardize the current loan underwriting process. Significant resources have been invested in building an infrastructure necessary to manage the current credit issues and to support future

growth. Management is now faced with the challenge of leveraging that infrastructure to grow revenues by investing in quality assets.

CRITICAL ACCOUNTING POLICIES

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

The Company has numerous accounting policies, of which the most significant are presented in Note 1 of the notes to consolidated financial statements. These policies, along with the disclosures presented in the other financial statement notes and in this discussion, provide information on how significant assets, liabilities, revenues and expenses are reported in the consolidated financial statements and how those reported amounts are determined. Based on the sensitivity of financial statement amounts to the methods, assumptions, and estimates underlying those amounts, Management has determined that the accounting policies with respect to the allowance for loan losses and goodwill require particularly subjective or complex judgments important to the Company's financial position and results of operations, and, as such, are considered to be critical accounting policies as discussed below.

Allowance for Loan Losses: The allowance for loan lrrent strategic plans or other events will not

Excluding purchases of marketable investment securities of $16.7 million, we used

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$617,000 during the three-month period ended March 31, 2005 for operating activities. The major uses of cash for operating activities during the three-month period ended March 31, 2005 was to fund the Company s clinical development programs and administrative costs of approximately $1.6 million and to prepay the majority of the Company s annual insurance policies. Cash used in investing activities was $24,000 in the three-month period ended March 31, 2005, primarily for investments in technology rights related to our Progenta and Androxal patent portfolios. Cash provided by financing activities was approximately $18.3 million in the three-month period ended March 31, 2005, relating to the follow-on public offering which was completed in February 2005 and the exercise of 26,700 stock options in the three-month period ended March 31, 2005. As of March 31, 2005, in addition to general operating obligations, the Company also had non-cancelable purchase orders primarily relating to the clinical development of both Progenta and Androxal in the amounts of $837,800 and $624,000, respectively.

As of March 31, 2005, we had an accumulated deficit of $88.3 million. The Company has incurred losses since its inception and expects to continue to incur losses for the foreseeable future. Inception to date losses have resulted principally from costs incurred in conducting clinical trials for VASOMAX, our previous lead product candidate for the oral treatment of male erectile dysfunction, in research and development activities related to efforts to develop our products and from the associated administrative costs required to support those efforts. We do not intend to commit any additional resources toward the development of VASOMAX. We have financed our operations primarily with proceeds from public offerings and private placements of equity securities, funds received under collaborative agreements and SBIR grants. We will require substantial additional capital to further develop Progenta as our oral treatment for uterine fibroids and endometriosis and Androxal for the oral treatment of testosterone deficiency.

Our capital requirements will depend on many factors, including the costs and timing of seeking regulatory approvals of the Company s products; the problems, delays, expenses and complications frequently encountered by development stage companies; the progress of the Company s preclinical and clinical activities; the costs associated with any future collaborative research, manufacturing, marketing or other funding arrangements; the Company s ability to obtain regulatory approvals; the success of the Company s potential future sales and marketing programs; the cost of filing, prosecuting and defending and enforcing any patent claims and other intellectual property rights; changes in economic, regulatory or competitive conditions of the Company s planned business; and additional costs associated with being a publicly-traded company. Estimates about the adequacy of funding for the Company s activities are based on certain assumptions, including the assumption that the development and regulatory approval of the Company s products can be completed at projected costs and that product approvals and introductions will be timely and successful. There can be no assurance that changes in the Company s research and development plans, acquisitions or other events will not result in accelerated or unexpected expenditures. To satisfy its capital requirements, the Company may seek to raise additional funds in the public or private capital markets. The Company may seek additional funding through corporate collaborations and other financing vehicles. There can be no assurance that any such funding will be available to the Company on favorable terms or at all. If the Company is successful in obtaining additional financing, the terms of such financing may have the effect of diluting or adversely affecting the holdings or the rights of the holders of the

Company s common stock.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

Interest Rate Risk. Cash, cash equivalents and investments were approximately $23.2 million at March 31, 2005. These assets were primarily invested in investment grade corporate bonds and commercial paper with maturities of less than 18 months, which are classified as Trading Securities. We do not invest in derivative securities. Although our portfolio is subject to fluctuations in interest rates and market conditions, no significant gain or loss on any security is expected to be recognized in earnings due to the expected short holding period.

Item 4. Controls and Procedures

Based on their evaluation as of the end of the period covered by this Quarterly Report on Form 10-Q, the Company s Chief Executive Officer and Chief Financial Officer have concluded that the Company s disclosure controls and procedures (as defined in Rule 13a-15(e) under the Securities Exchange Act of 1934, as amended (the Exchange Act)) are effective in insuring that the information required to be disclosed by the Company in the reports that it files or submits under the Exchange Act is recorded, processed, summarized and reported within the required time periods.

In connection with the evaluation described above, the Company identified no change in internal control over financial reporting that occurred during the fiscal quarter ended March 31, 2005 that has materially affected, or is reasonably likely to materially affect, the Company s internal control over financial reporting.

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PART II OTHER INFORMATION

Item 1. Legal Proceedings

We are not currently a party to any material legal proceedings.

Item 5. Other Information

None

Item 6. Exhibits

31.1 Certification pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 (Chief Executive Officer).

31.2 Certification pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 (Chief Financial Officer).

32.1 Certification furnished pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 (Chief Executive Officer).

32.2 Certification furnished pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 (Chief Financial Officer).

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SIGNATURES

In accordance with the requirements of the Exchange Act, the registrant caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

ZONAGEN, INC.

Date: May 9, 2005

By: /s/ Joseph S. Podolski

Joseph S. Podolski
President, Chief Executive Officer and Director
(Principal Executive Officer)

Date: May 9, 2005

By: /s/ Louis Ploth, Jr.

Louis Ploth, Jr.
Vice President Business Development, Chief Financial Officer, Director and Secretary
(Principal Financial and Accounting Officer)

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EXHIBIT INDEX

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