CHARTER COMMUNICATIONS INC /MO/
Form S-1
January 06, 2006

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As filed with the Securities and Exchange Commission on January 6, 2006

Registration No. 333-

UNITED STATES SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

Form S-1

REGISTRATION STATEMENT

UNDER
THE SECURITIES ACT OF 1933

Charter Communications, Inc.

(Exact name of registrant as specified in its Charter)

Delaware	**4841**	**43-1857213**
(State or other jurisdiction of incorporation or organization)	*(Primary Standard Industrial Classification Code Number)*	*(I.R.S. Employer Identification Number)*

12405 POWERSCOURT DRIVE

ST. LOUIS, MISSOURI 63131
(314) 965-0555
(Address, including zip code, and telephone number, including area code, of registrant principal executive offices)

Grier C. Raclin

Executive Vice President, General Counsel and Corporate Secretary
12405 Powerscourt Drive
St. Louis, Missouri 63131
(314) 965-0555
(Name, address, including zip code, and telephone number, including area code, of agent for service)

Copies to:

Dennis J. Friedman	**Jeremy W. Dickens**
Jeffrey L. Kochian	**Brian A. Haskel**
Gibson, Dunn & Crutcher LLP	**Weil, Gotshal & Manges LLP**
200 Park Avenue	**767 Fifth Avenue**
New York, NY 10166	**New York, NY 10153**
(212) 351-4000	**(212) 310-8000**

Approximate date of commencement of proposed sale to the public: As soon as practicable after this Registration Statement becomes effective.

If any of the securities being registered on this form are to be offered on a delayed or continuous basis pursuant to Rule 415 under the Securities Act of 1933, check the following box. o

If this form is filed to register additional securities for an offering pursuant to Rule 462(b) under the Securities Act, please check the following box and list the Securities Act registration statement number of the earlier effective registration statement for the same offering. o

If this form is a post-effective amendment filed pursuant to Rule 462(c) under the Securities Act, check the following box and list the Securities Act registration statement number of the earlier effective registration statement for the same offering. o

If this form is a post-effective amendment filed pursuant to Rule 462(d) under the Securities Act, check the following box and list the Securities Act registration statement number of the earlier effective registration statement for the same offering. o

If delivery of the prospectus is expected to be made pursuant to Rule 434, please check the following box. o

CALCULATION OF REGISTRATION FEE

Title of Each Class of Securities to be Registered	**Amount to be Registered**	**Proposed Maximum Offering Price Per Unit**	**Proposed Maximum Aggregate Offering Price**	**Amount of Registration Fee(1)**
Class A Common Stock	55,088,700	$1.20	$65,830,996.50	$7,043.92

(1) Calculated pursuant to Rule 457(c) under the Securities Act solely for the purpose of calculating the registration fee on the basis of the average of the high and low prices of the Class A Common Stock as reported on the NASDAQ National Market on January 5, 2006.

The Registrant hereby amends this Registration Statement on such date or dates as may be necessary to delay its effective date until the Registrant shall file a further amendment which specifically states that this Registration Statement shall thereafter become effective in accordance with Section 8(a) of the Securities Act of 1933, as amended, or until this Registration Statement shall become effective on such date as the Commission, acting pursuant to said Section 8(a), may determine.

The information in this prospectus is not complete and may be changed. This prospectus is not an offer to sell these securities and it is not soliciting an offer to buy these securities in any state or jurisdiction where the offer or sale is not permitted.

SUBJECT TO COMPLETION, DATED JANUARY 6, 2006

PROSPECTUS

55,088,700 Shares

Charter Communications, Inc.

Class A Common Stock

$ per share

The shares of our Class A common stock offered hereby are shares that we will loan to Citigroup Global Markets Limited, as borrower, through Citigroup Global Markets Inc., as agent, pursuant to a share lending agreement.

Our Class A common stock is quoted on the Nasdaq National Market under the symbol CHTR. The last reported sale price of our Class A common stock on the Nasdaq National Market on January 5, 2006 was $1.19 per share.

Investing in our Class A common stock involves risks. See Risk Factors beginning on page 12.

Neither the Securities and Exchange Commission nor any state securities commission has approved or disapproved of these securities or determined if this prospectus is truthful or complete. Any representation to the contrary is a criminal offense.

	Per Share	Total
Public Offering Price	$	$

Under the share lending agreement, we will receive a loan fee of $.001 for each share that we lend. We have been advised by Citigroup Global Markets Limited that it, or its affiliates, intend(s) to use the short sales of the shares of our Class A common stock offered pursuant to this prospectus to facilitate transactions by which investors in our 5.875% convertible senior notes due 2009 issued on November 22, 2004 will hedge their investments in the 5.875% convertible senior notes. See Share Lending Agreement and Underwriting on pages 186 and 191, respectively, of this prospectus. We will not receive any of the proceeds from the sale of the shares of Class A common stock in this offering.

THE SHARES OFFERED HEREBY ARE NOT BEING OFFERED TO, AND MAY NOT BE PURCHASED BY, ANY PERSON WHO HOLDS AN OPEN SHORT POSITION IN OUR CLASS A COMMON STOCK, ANY PERSON WHO IS PURCHASING THE SHARES ON BEHALF OF OR FOR THE ACCOUNT OF SUCH A PERSON OR ANY PERSON WHO HAS AN ARRANGEMENT OR UNDERSTANDING TO RESELL, LEND OR OTHERWISE TRANSFER (DIRECTLY OR INDIRECTLY) THE SHARES TO SUCH A PERSON. PURCHASERS IN THIS OFFERING WILL BE REQUIRED TO CERTIFY THE FOREGOING IN WRITING. SEE NOTICE TO INVESTORS ON PAGE ii OF THIS PROSPECTUS.

The shares of our Class A common stock are being offered on a best efforts basis. Best efforts means that Citigroup Global Markets Limited is not under any obligation to borrow and sell any of the shares offered hereby. Citigroup Global Markets Limited has informed us that it will use its best efforts to sell the shares offered pursuant to this prospectus, provided that it intends to borrow and sell the shares offered hereby only to the extent there is interest by investors in the 5.875% convertible senior notes in establishing hedge positions and there is corresponding demand by purchasers for the shares. Accordingly, there is no assurance that all or any portion of the shares offered hereby will be sold.

The offering will be at a fixed price and will not be conducted on a continuous or delayed basis. The offering will terminate on or before , 2006, and the underwriter expects to deliver the shares to purchasers on or about , 2006.

Citigroup

, 2006

You should rely only on the information contained in this prospectus. We have not authorized anyone to provide you with information that is different from that contained in this prospectus. We are offering to sell shares of our common stock only in jurisdictions where offers and sales are permitted. The information in this prospectus is complete and accurate only as of the date of this prospectus, regardless of the time of delivery of this prospectus or of any sale of shares.

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DISCLOSURE REGARDING FORWARD-LOOKING STATEMENTS

This prospectus includes forward-looking statements within the meaning of Section 27A of the Securities Act and Section 21E of the Exchange Act, regarding, among other things, our plans, strategies and prospects, both business and financial. Although we believe that our plans, intentions and expectations reflected in or suggested by these forward-looking statements are reasonable, we cannot assure you that we will achieve or realize these plans, intentions or expectations. Forward-looking statements are inherently subject to risks, uncertainties and assumptions. Many of the forward-looking statements contained in this prospectus may be identified by the use of forward-looking words such as believe, expect, anticipate, should, planned, will, may, intend, estimated and potential, among others. Important factors tha results to differ materially from the forward-looking statements we make in

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this prospectus are set forth in this prospectus and in other reports or documents that we file from time to time with the Securities and Exchange Commission, or SEC, and include, but are not limited to:

- the availability, in general, of funds to meet interest payment obligations under our debt and to fund our operations and necessary capital expenditures, either through cash flows from operating activities, further borrowings or other sources and, in particular, our ability to be able to provide under applicable debt instruments, such funds (by dividend, investment or otherwise) to the applicable obligor of such debt;
- our ability to sustain and grow revenues and cash flows from operating activities by offering video, high-speed Internet, telephone and other services and to maintain and grow a stable customer base, particularly in the face of increasingly aggressive competition from other service providers;
- our ability to comply with all covenants in our indentures, bridge loan and credit facilities, any violation of which would result in a violation of the applicable facility or indenture and could trigger a default of other obligations under cross-default provisions;
- our ability to pay or refinance debt prior to or when it becomes due and/or to take advantage of market opportunities and market windows to refinance that debt in the capital markets, through new issuances, exchange offers or otherwise, including restructuring our balance sheet and leverage position;
- our ability to obtain programming at reasonable prices or to pass programming cost increases on to our customers;
- general business conditions, economic uncertainty or slowdown; and
- the effects of governmental regulation, including but not limited to local franchise authorities, on our business.

All forward-looking statements attributable to us or any person acting on our behalf are expressly qualified in their entirety by this cautionary statement.

ADDITIONAL INFORMATION

We have filed with the SEC a registration statement on Form S-1 to register the sale of the securities covered by this prospectus. This prospectus, which forms part of that registration statement, does not contain all the information included in the registration statement. For further information about us and the securities described in this prospectus, you should refer to the registration statement and its exhibits.

Our Class A common stock is quoted on the Nasdaq National Market under the symbol CHTR. We file annual, quarterly and special reports, proxy statements and other information with the SEC. You may read and copy at prescribed rates any document we file at the SEC s public reference room at 100 F. Street, N.E., Washington, D.C. 20549. Please call the SEC at 1-800-SEC-0330 for further information on the public reference room. Our SEC filings are also available to the public at the SEC s website at www.sec.gov.

NOTICE TO INVESTORS

The shares offered hereby are not being offered to, and may not be purchased by, any person who has an open short position in Charter s Class A common stock at the time of the sale, any person who is purchasing the shares on behalf of or for the account of such a person or any person who has an arrangement or understanding to resell, lend or otherwise transfer (directly or indirectly) the shares to such a person.

Each purchaser of Charter s Class A common stock in this offering must execute and deliver the Investor Acknowledgement set forth on Annex A hereto to Citigroup by facsimile to (646) 843-3922.

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SUMMARY

This summary contains a general discussion of our business, and summary financial information. It does not contain all the information that you should consider before making an investment decision regarding our Class A common stock. For a more complete understanding of an investment in our Class A common stock, you should read this entire prospectus. Unless otherwise noted, all business data in this summary is as of September 30, 2005.

Unless otherwise stated, the discussion in this prospectus of our business and operations includes the business and operations of Charter Communications, Inc. and its subsidiaries. Unless the context otherwise requires, the terms we, us and our refer to Charter Communications, Inc. and its direct and indirect subsidiaries on a consolidated basis. The term Charter refers to the issuer, Charter Communications, Inc.

Our Business

We are a broadband communications company operating in the United States, with approximately 6.17 million customers at September 30, 2005. Through our broadband network of coaxial and fiber optic cable, we offer our customers traditional cable video programming (analog and digital, which we refer to as video service), high-speed cable Internet access, advanced broadband cable services (such as video on demand (VOD), high definition television service, and interactive television) and, in some of our markets, we offer telephone service. See Business Products and Services for further description of these terms, including customers.

At September 30, 2005, we served approximately 5.91 million analog video customers, of which approximately 2.75 million were also digital video customers. We also served approximately 2.12 million high-speed Internet customers (including approximately 244,000 who received only high-speed Internet services). We also provided telephone service to approximately 89,900 customers as of that date.

Our principal executive offices are located at Charter Plaza, 12405 Powerscourt Drive, St. Louis, Missouri 63131. Our telephone number is (314) 965-0555 and we have a website accessible at www.charter.com. The information posted or linked on our website is not part of this prospectus and you should rely solely on the information contained in this prospectus and the related documents to which we refer herein when deciding to make an investment in our Class A common stock.

Strategy

Our principal financial goal is to maximize our return on invested capital. To do so, we will focus on increasing revenues, growing our customer base, improving customer retention and enhancing customer satisfaction by providing reliable, high-quality service offerings, superior customer service and attractive bundled offerings.

Specifically, in the near term, we are focusing on:

- improving the overall value to our customers of our service offerings, relative to pricing;
- developing more sophisticated customer care capabilities through investment in our customer care and marketing infrastructure, including targeted marketing capabilities;
- executing growth strategies for new services, including digital simulcast, VOD, telephone, and digital video recorder service (DVR);
- managing our operating costs by exercising discipline in capital and operational spending; and
- identifying opportunities to continue to improve our balance sheet and liquidity.

We have begun an internal operational improvement initiative aimed at helping us gain new customers and retain existing customers, which is focused on customer care, technical operations and sales. We intend to continue efforts to focus management attention on instilling a customer service oriented culture throughout the company and to give those areas of our operations priority of resources for staffing levels, training budgets and financial incentives for employee performance in those areas.

We believe that our high-speed Internet service will continue to provide a substantial portion of our revenue growth in the near future. We also plan to continue to expand our marketing of high-speed Internet service to the business community, which we believe has shown an increasing interest in high-speed Internet service and private network services. Additionally, we plan to continue to prepare additional markets for telephone launches in 2006.

We believe we offer our customers an excellent choice of services through a variety of bundled packages, particularly with respect to our digital video and high-speed Internet services, as well as telephone in certain markets. Our digital platform enables us to offer a significant number and variety of channels, and we offer customers the opportunity to choose among groups of channel offerings, including premium channels, and to combine selected programming with other services such as high-speed Internet, high definition television (in selected markets) and VOD (in selected markets).

We continue to pursue opportunities to improve our liquidity. Our efforts in this regard resulted in the completion of a number of transactions in 2004 and 2005, as follows:

the October 2005, entry by CCO Holdings, LLC (CCO Holdings) and CCO Holdings Capital Corp., as guarantor thereunder, into a $600 million senior bridge loan agreement with various lenders;

the September 2005 exchange by Charter Communications Holdings, LLC (Charter Holdings), CCH I, LLC (CCH I) and CCH I Holdings, LLC (CIH) of approximately $6.8 billion in total principal amount of outstanding debt securities of Charter Holdings in a private placement for new debt securities;

the August 2005 sale by, our subsidiaries, CCO Holdings and CCO Holdings Capital Corp. of $300 million of 8 3/4% senior notes due 2013;

the March and June 2005 issuance of $333 million of Charter Communications Operating, LLC (Charter Operating) notes in exchange for $346 million of Charter Holdings notes;

the March and June 2005 repurchase of $131 million of our 4.75% convertible senior notes due 2006 leaving $25 million in principal amount outstanding;

the March 2005 redemption of all of CC V Holdings, LLC s outstanding 11.875% senior discount notes due 2008 at a total cost of $122 million;

the December 2004 sale by our subsidiaries, CCO Holdings and CCO Holdings Capital Corp. of $550 million of senior floating rate notes due 2010;

the November 2004 sale of the $862.5 million of 5.875% convertible senior notes due 2009 and the December 2004 redemption of all of our outstanding 5.75% convertible senior notes due 2005 ($588 million principal amount);

the April 2004 sale of $1.5 billion of senior second lien notes by our subsidiary, Charter Operating, together with the concurrent refinancing of its credit facilities; and

the sale in the first half of 2004 of non-core cable systems for a total of $735 million, the proceeds of which were used to reduce indebtedness.

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Recent Events

CC VIII Settlement

As of October 31, 2005, acting through a Special Committee of Charter s Board of Directors, we settled our dispute with Paul G. Allen, Charter s controlling stockholder and Chairman of the Board, related to the ownership of a Charter subsidiary, CC VIII, LLC (CC VIII).

Under the terms of the settlement, Charter Investment, Inc. (CII), 100% owned by Mr. Allen, will retain 30% of the Class A preferred equity interests it previously held in CC VIII, subject to certain rights and restrictions concerning transfer. Of the other 70% of the CC VIII preferred interests, 7.4% has been transferred by CII to CCHC, LLC, (CCHC) a newly formed direct, wholly owned subsidiary of Charter Communications Holding Company, LLC (Charter Holdco) and the new direct parent of Charter Holdings in exchange for a subordinated exchangeable note issued to CII and the remaining 62.6% has been transferred by CII to Charter Holdco, in accordance with the terms of the settlement, for no additional monetary consideration. Charter Holdco contributed the 62.6% interest to CCHC. The note has an initial accreted value of $48.2 million accreting at 14%, compounded quarterly, with a 15-year maturity.

Also as part of the settlement, CC VIII issued approximately 49 million additional Class B units to CC V Holdings, LLC, the direct parent of CC VIII, in consideration for prior capital contributions to CC VIII by CC V Holdings, LLC in connection with a transaction that was unrelated to the dispute with CII. As a result of these transfers and issuances, Mr. Allen s pro rata share of the profits and losses of CC VIII is approximately 5.6%. See Certain Relationships and Related Transactions Transactions Arising Out of Our Organizational Structure and Mr. Allen s Investment in Charter and Its Subsidiaries Equity Put Rights CC VIII.

Repurchase of Convertible Redeemable Preferred Stock

In November 2005, Charter repurchased 508,546 shares of its Series A Convertible Redeemable Preferred Stock for an aggregate purchase price of approximately $31 million (or $60 per share). The shares had liquidation preference of approximately $51 million and had accrued but unpaid dividends of approximately $3 million resulting in a gain of approximately $23 million. Following the repurchase, 36,713 shares of preferred stock remained outstanding.

In connection with the repurchase, the holders of Preferred Stock consented to an amendment to the Certificate of Designation governing the Preferred Stock that will eliminate the quarterly dividends on all of the outstanding Preferred Stock and will provide that the liquidation preference for the remaining shares outstanding will be $105.4063 per share, which amount shall accrete from September 30, 2005 at an annual rate of 7.75%, compounded quarterly. Certain holders of Preferred Stock also released Charter from various threatened claims relating to their acquisition and ownership of the Preferred Stock, including threatened claims for breach of contract.

CCO Holdings Bridge Loan

In October 2005, CCO Holdings entered into a senior bridge loan agreement with JPMorgan Chase Bank, N.A., Credit Suisse, Cayman Islands Branch and Deutsche Bank AG Cayman Islands Branch (the Lenders) whereby the Lenders have committed to make loans to CCO Holdings in an aggregate amount of $600 million. CCO Holdings may, subject to the satisfaction of certain conditions, including the satisfaction of certain of the conditions to borrowing under the Charter Operating credit facilities, draw upon the facility between January 2, 2006 and September 29, 2006 and the loans will mature on the sixth anniversary of the first borrowing under the bridge loan. The failure to satisfy the conditions to borrowing under the bridge loan would prevent any borrowing thereunder, which could materially adversely affect our ability to operate our business and to make payments under our debt instruments. See Description of Certain Indebtedness CCO Holdings, LLC Notes and Bridge Loan.

Charter Holdings, CCH I and CIH Exchange Offer

On September 28, 2005, Charter Holdings and its wholly owned subsidiaries, CCH I and CIH, completed the exchange of approximately $6.8 billion in total principal amount of outstanding debt securities of Charter Holdings in a private placement for new debt securities. Holders of Charter Holdings notes due in 2009 and 2010 exchanged $3.4 billion principal amount of notes for $2.9 billion principal amount of new 11% CCH I senior secured notes due 2015. Holders of Charter Holdings notes due 2011 and 2012 exchanged $845 million principal amount of notes for $662 million principal amount of 11% CCH I senior secured notes due 2015. In addition, holders of Charter Holdings notes due 2011 and 2012 exchanged $2.5 billion principal amount of notes for $2.5 billion principal amount of various series of new CIH notes. Each series of new CIH notes has the same stated interest rate and provisions for payment of cash interest as the series of old Charter Holdings notes for which such CIH notes were exchanged. In addition, the maturities for each series were extended three years.

Consummation of Prior Share Borrow Transaction

On November 28, 2005, we issued 67,741,300 shares of Class A common stock in a public offering (the prior share borrow transaction). As with the shares offered hereby, the shares were issued pursuant to the share lending agreement described herein under Share Lending Agreement, pursuant to which we had previously agreed to loan up to 150 million shares to Citigroup Global Markets Limited (CGML). To date, 94,911,300 shares were sold in the two prior share borrow transactions. Because less than the full 150 million shares covered by the share lending agreement were sold in the prior share borrow transactions, we remain obligated to issue, at CGML s request, up to an additional 55,088,700 additional loaned shares in up to two additional subsequent registered public offerings pursuant to the share lending agreement. Those remaining shares constitute the shares offered hereby.

As with this offering, the prior share borrow transaction was conducted to facilitate transactions by which investors in Charter s 5.875% convertible senior notes due 2009 issued on November 22, 2004, hedged their investments in those convertible senior notes. Charter did not receive any of the proceeds from the sale of shares in the prior share borrow transaction. However, under the share lending agreement, Charter received a loan fee of $.001 for each share that it lent to CGML.

The Offering

Total shares of Class A common stock offered by us hereby	55,088,700 shares
Approximate number of shares of Class A common stock to be outstanding after the offering	471.4 million shares (including the shares offered hereby and 94.9 million shares issued in July and November 2005 pursuant to the share lending agreement
Nasdaq National Market Symbol	CHTR

The shares of our Class A common stock offered hereby are shares that we will loan to Citigroup Global Markets Limited pursuant to a share lending agreement, dated as of November 22, 2004, which we refer to as the share lending agreement. Under the share lending agreement, we will receive a loan fee of $.001 per share. We will not receive any proceeds from this offering. See Share Lending Agreement and Underwriting.

THE SHARES OFFERED HEREBY ARE NOT BEING OFFERED TO, AND MAY NOT BE PURCHASED BY, ANY PERSON WHO HOLDS AN OPEN SHORT POSITION IN OUR CLASS A COMMON STOCK, ANY PERSON WHO IS PURCHASING THE SHARES ON BEHALF OF OR FOR THE ACCOUNT OF SUCH A PERSON OR ANY PERSON WHO HAS AN ARRANGEMENT OR UNDERSTANDING TO RESELL, LEND OR OTHERWISE TRANSFER (DIRECTLY OR INDIRECTLY) THE SHARES TO SUCH A PERSON.

PURCHASERS IN THE OFFERING WILL BE REQUIRED TO CERTIFY THE FOREGOING IN WRITING. SEE NOTICE TO INVESTORS ON PAGE ii AND FORM OF INVESTOR ACKNOWLEDGMENT ON PAGE A-1.

Risk Factors

Investing in our Class A common stock involves substantial risk. See the Risk Factors section of this prospectus for a description of certain of the risks you should consider before investing in our Class A common stock.

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Organizational Structure

The chart below sets forth the organizational structure of Charter and its principal direct and indirect subsidiaries. The equity ownership, voting percentages and indebtedness amounts shown below are approximations as of September 30, 2005 giving effect to the issuance of the shares offered hereby, the 67.7 million shares issued on November 28, 2005, the creation of CCHC and the settlement of the CC VIII dispute and do not give effect to any exercise, conversion or exchange of then outstanding options, preferred stock, convertible notes and other convertible or exchangeable securities.

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(1) Charter acts as the sole manager of Charter Holdco and its direct and indirect limited liability company subsidiaries. Charter s certificate of incorporation requires that its principal assets be securities of Charter Holdco, the terms of which mirror the terms of securities issued by Charter. See Description of Capital Stock and Membership Units.

(2) These membership units are held by Charter Investment, Inc. and Vulcan Cable III Inc., each of which is 100% owned by Paul G. Allen, our Chairman and controlling shareholder. They are exchangeable at any time on a one-for-one basis for shares of Charter Class A common stock.

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(3) The percentages shown in this table reflect the issuance of the 55.1 million shares of Class A common stock offered hereby as well as the 94.9 million shares of Class A common stock issued in July and November 2005 and the corresponding issuance of an equal number of mirror membership units by Charter Holdco to Charter. However, for accounting purposes, Charter s common equity interest in Charter Holdco is 48%, and Paul G. Allen s ownership of Charter Holdco is 52%. These percentages exclude the 150 million mirror membership units issued or to be issued to Charter due to the required return of the issued mirror units upon return of the shares offered hereby pursuant to the share lending agreement. See Share Lending Agreement.

(4) Represents preferred membership interests in CC VIII a subsidiary of CC V Holdings, LLC and a subordinated accreting note issued by CCHC related to the settlement of the CC VIII dispute. See Certain Relationships and Related Transactions Transactions Arising out of Our Organizational Structure and Mr. Allen s Investment in Charter Communications, Inc. and Its Subsidiaries Equity Put Rights CC VIII.

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Summary Consolidated Financial Data

Charter is a holding company whose principal assets are a controlling common equity interest in Charter Holdco and mirror notes that are payable by Charter Holdco to Charter which have the same principal amount and terms as those of Charter s convertible senior notes. Charter Holdco is a holding company whose primary assets are equity interests in our cable operating subsidiaries and intercompany loan receivables. Charter consolidates Charter Holdco on the basis of voting control. Charter Holdco s limited liability agreement provides that so long as Charter s Class B common stock retains its special voting rights, Charter will maintain 100% voting interest in Charter Holdco. Voting control gives Charter full authority and control over the operations of Charter Holdco.

The following table presents summary financial and other data for Charter and its subsidiaries and has been derived from the audited consolidated financial statements of Charter and its subsidiaries for the three years ended December 31, 2004 and the unaudited consolidated financial statements of Charter and its subsidiaries for the nine months ended September 30, 2005 and 2004. The consolidated financial statements of Charter and its subsidiaries for the years ended December 31, 2002 to 2004 have been audited by KPMG LLP, an independent registered public accounting firm. The pro forma data set forth below represent our unaudited pro forma consolidated financial statements after giving effect to the following transactions as if they occurred on January 1 of the respective period for the statement of operations data and other financial data and as of the last day of the respective period for the operating data:

(1) the disposition of certain assets in March and April 2004 for total proceeds of $735 million and the use of such proceeds in each case to pay down credit facilities;

(2) the issuance and sale of $550 million of CCO Holdings senior floating rate notes in December 2004 and $1.5 billion of Charter Operating senior second lien notes in April 2004;

(3) an increase in amounts outstanding under the Charter Operating credit facilities in April 2004 and the use of such funds, together with the proceeds from the sale of the Charter Operating senior second lien notes, to refinance amounts outstanding under the credit facilities of our subsidiaries, CC VI Operating Company, LLC, CC VIII Operating, LLC and Falcon Cable Communications, LLC;

(4) the issuance and sale of $863 million of 5.875% convertible senior notes in November 2004 with proceeds used for (i) the purchase of certain U.S. government securities pledged as security to fund the first six interest payments thereon, (ii) redemption of the outstanding 5.75% convertible senior notes due 2005 and (iii) general corporate purposes;

(5) the repayment of $530 million of borrowings under the Charter Operating revolving credit facility with net proceeds from the issuance and sale of the CCO Holdings senior floating rate notes in December 2004, which were included in our cash balance at December 31, 2004;

(6) the redemption of all of CC V Holdings, LLC s outstanding 11.875% senior discount notes due 2008 with cash on hand;

(7) the issuance and sale of $300 million of 8 3/4% CCO Holdings senior notes in August 2005 and the use of a portion of such proceeds to pay financing costs and accrued interest in the exchange transaction referenced below;

(8) the exchange of $3.4 billion principal amount of Charter Holdings notes scheduled to mature in 2009 and 2010 for CCH I notes and the exchange of $3.4 billion principal amount of Charter Holdings notes scheduled to mature in 2011 and 2012 for CIH notes and CCH I notes; and

(9) the issuance of 67.7 million shares in November 2005 and the shares offered hereby pursuant to the share lending agreement, the sole effect of which is to increase common shares issued and outstanding. See Share Lending Agreement.

The following information should be read in conjunction with Selected Historical Consolidated Financial Data, Capitalization, Unaudited Pro Forma Consolidated Financial Statements, Manage-

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ment s Discussion and Analysis of Financial Condition and Results of Operations, Share Lending Agreement and the historical consolidated financial statements and related notes included elsewhere in this prospectus.

	Year Ended December 31,				Nine Months Ended September 30,	
	2002 Actual	2003 Actual	2004 Actual	2004 Pro Forma(a)	2004 Pro Forma(a)	2005 Pro Forma(a)
	(Dollars in millions, except per share, share and customer data)					
Statement of Operations Data:						
Revenues:						
Video	$ 3,420	$ 3,461	$ 3,373	$ 3,352	$ 2,513	$ 2,551
High-speed Internet	337	556	741	738	535	671
Advertising sales	302	263	289	288	204	214
Commercial	161	204	238	236	173	205
Other	346	335	336	334	247	271
Total revenues	4,566	4,819	4,977	4,948(b)	3,672	3,912
Costs and Expenses:						
Operating (excluding depreciation and amortization)	1,807	1,952	2,080	2,068	1,540	1,714
Selling, general and administrative	963	940	971	967	731	762
Depreciation and amortization	1,436	1,453	1,495	1,489	1,099	1,134
Impairment of franchises	4,638		2,433	2,433	2,433	
Asset impairment charges						39
(Gain) loss on sale of assets, net	3	5	(86)	20	2	5
Option compensation expense, net	5	4	31	31	34	11
Hurricane asset retirement loss						19
Special charges, net	36	21	104	104	100	4
Unfavorable contracts and other settlements		(72)	(5)	(5)		
Total costs and expenses	8,888	4,303	7,023	7,107	5,939	3,688
Income (loss) from operations	(4,322)	516	(2,046)	(2,159)	(2,267)	224
Interest expense, net	(1,503)	(1,557)	(1,670)	(1,679)	(1,249)	(1,301)
Gain (loss) on derivative instruments and hedging activities, net	(115)	65	69	69	48	43
Loss on debt to equity conversions			(23)	(23)	(23)	
Gain (loss) on extinguishment of debt		267	(31)			13

Other, net	(4)	(16)	3	3		21
Loss before minority interest, income taxes and cumulative effect of accounting change	(5,944)	(725)	(3,698)	(3,789)	(3,491)	(1,000)
Minority interest(d)	3,176	377	19	19	24	(9)
Loss before income taxes and cumulative effect of accounting change	(2,768)	(348)	(3,679)	(3,770)	(3,467)	(1,009)
Income tax benefit (expense)	460	110	103	118	131	(75)
Loss before cumulative effect of accounting change, net of tax	$ (2,308)	$ (238)	$ (3,576)	$ (3,652)	$ (3,336)	$ (1,084)
Loss per common share, basic and diluted(e)	$ (7.85)	$ (0.82)	$ (11.92)	$ (12.16)	$ (13.71)	$ (3.53)
Weighted-average common shares outstanding, basic and diluted	294,440,261	294,597,519	300,291,877	300,291,877	299,411,053	307,761,930
Other Financial Data:						
Capital expenditures	$ 2,167	$ 854	$ 924	$ 922	$ 637	$ 815
Deficiencies of earnings to cover fixed charges(f)	$ 5,944	$ 725	$ 3,698	$ 3,789	$ 3,491	$ 1,000

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	December 31,			September 30,	
	2003 Actual	2003 Pro Forma	2004 Actual	2004 Actual	2005 Actual
Operating Data (end of period)(g):					
Analog video customers	6,431,300	6,200,500	5,991,500	6,074,600	5,906,300
Digital video customers	2,671,900	2,588,600	2,674,700	2,688,900	2,749,400
Residential high-speed Internet customers	1,565,600	1,527,800	1,884,400	1,819,900	2,120,000
Telephone customers	24,900	24,900	45,400	40,200	89,900

	Actual As of September 30, 2005
	(Dollars in millions)
Balance Sheet Data (end of period):	
Cash and cash equivalents	$ 22
Total assets	16,524
Accounts payable and accrued expenses	1,172
Long-term debt(c)	19,120
Other long-term liabilities	504
Minority interest(d)	665
Shareholders deficit	(5,006)

(a) Actual revenues exceeded pro forma revenues for the year ended December 31, 2004 and the nine months ended September 30, 2004 and 2005 by $29 million, $29 million and $0, respectively. Pro forma loss before cumulative effect of accounting change, net of tax exceeded actual loss before cumulative effect of accounting change, net of tax by $76 million, $99 million and $453 million for the year ended December 31, 2004 and the nine months ended September 30, 2004 and 2005 respectively. The unaudited pro forma financial information required allocation of certain revenues and expenses and such information has been presented for comparative purposes and is not intended to provide any indication of what our results of operations would have been had the transactions described above been completed on the dates indicated or to project our results of operations for any future date.

(b) Pro forma 2004 revenue by quarter is as follows:

	2004 Pro Forma Revenue
	(In millions)
1st Quarter	$1,185
2nd Quarter	1,239
3rd Quarter	1,248
4th Quarter	1,276
Total pro forma revenue	$4,948

(c) The CIH notes and CCH I notes issued in exchange for Charter Holdings notes are recorded in accordance with generally accepted accounting principles (GAAP). GAAP requires that the CIH notes issued in exchange for Charter Holdings notes and the CCH I notes issued in exchange for the 8.625% Charter Holdings notes due 2009 be recorded at the historical book values of the Charter Holdings notes as opposed to the current accreted value for legal purposes and notes indenture purposes (which, for both purposes, is the amount that would become payable if the debt becomes immediately due). As of September 30, 2005, the accreted value of our long-term debt for legal purposes and notes indenture purposes is $18.6 billion.

(d) Minority interest represents the percentage of Charter Holdco not owned by Charter, plus preferred membership interests in CC VIII. Reported losses allocated to minority interest on the statement of operations are limited to the extent of any remaining minority interest on the balance sheet related to Charter Holdco. Because minority interest in Charter Holdco was substantially eliminated at December 31, 2003, beginning in 2004, Charter absorbs substantially all losses before income taxes that otherwise would have been allocated to minority interest. This resulted in an approximate additional $2.0 billion and $535 million of losses before cumulative effect of accounting change for the year ended December 31, 2004 and the pro forma nine months ended September 30, 2005, respectively. Under our existing capital structure, Charter will absorb all future losses. Paul G. Allen indirectly held the preferred membership units in CC VIII as a result of the exercise of a put right originally granted in connection with the Bresnan transaction in 2000. There was an issue regarding the ultimate ownership of the CC VIII membership interests following the consummation of the Bresnan put transaction on June 6, 2003. Effective January 1, 2005, Charter ceased recognizing minority interest in earnings or losses of CC VIII for financial reporting purposes until such time as the resolution of the issue was determinable or certain other events occured. This dispute was settled October 31, 2005. We are currently determining the accounting impact of the settlement. Subsequent to recording the impact of the settlement in the fourth quarter of 2005, approximately 6% of CC VIII s income will be allocated to minority interest. See Certain Relationships and Related Transactions Transactions Arising Out of Our Organizational Structure and Mr. Allen s Investment in Charter and Its Subsidiaries Equity Put Rights CC VIII.

(e) Loss per common share, basic and diluted, assumes none of the membership units of Charter Holdco are exchanged for Charter common stock and none of the outstanding options to purchase membership units of Charter Holdco that are automatically exchanged for Charter common stock are exercised. Basic loss per share equals loss before cumulative effect of accounting change less dividends on preferred stock-redeemable divided by weighted average shares outstanding. If the membership units were exchanged or options exercised, the effects would be antidilutive. Therefore, basic and diluted loss per common share is the same.

(f) Earnings include net loss plus fixed charges. Fixed charges consist of interest expense and an estimated interest component of rent expense.

(g) See Business Products and Services for definitions of the terms contained in this section.

RISK FACTORS

An investment in our Class A common stock entails the following risks. You should carefully consider these risk factors, as well as the other information contained in this prospectus, before making a decision to invest in our Class A common stock.

Risks Related to Significant Indebtedness of Us and Our Subsidiaries

We may not generate (or, in general, have available to the applicable obligor) sufficient cash flow or access to additional external liquidity sources to fund our capital expenditures, ongoing operations and debt obligations.

Our ability to service our debt and to fund our planned capital expenditures and ongoing operations will depend on both our ability to generate cash flow and our access to additional external liquidity sources, and in general our ability to provide (by dividend or otherwise), such funds to the applicable issuer of the debt obligation. Our ability to generate cash flow is dependent on many factors, including:

- our future operating performance;
- the demand for our products and services;
- general economic conditions and conditions affecting customer and advertiser spending;
- competition and our ability to stabilize customer losses; and
- legal and regulatory factors affecting our business.

Some of these factors are beyond our control. If we are unable to generate sufficient cash flow and/or access additional external liquidity sources, we may not be able to service and repay our debt, operate our business, respond to competitive challenges or fund our other liquidity and capital needs. We believe that cash flows from operating activities and amounts available under our credit facilities and bridge loan will not be sufficient to fund our operations and satisfy our interest payment and principal repayment obligations in 2007 and beyond. See Management s Discussion and Analysis of Financial Condition and Results of Operations Liquidity and Capital Resources.

Additionally, franchise valuations performed in accordance with the requirements of Statement of Financial Accounting Standards (SFAS) No. 142, *Goodwill and Other Intangible Assets*, are based on the projected cash flows derived by selling products and services to new customers in future periods. Declines in future cash flows could result in lower valuations which in turn may result in impairments to the franchise assets in our financial statements.

Charter Operating may not be able to access funds under its credit facilities if it fails to satisfy the covenant restrictions in its credit facilities, which could adversely affect our financial condition and our ability to conduct our business.

Our subsidiaries have historically relied on access to credit facilities in order to fund operations and to service parent company debt, and we expect such reliance to continue in the future. Our total potential borrowing availability under the Charter Operating credit facilities was $786 million as of September 30, 2005, however, the actual availability is limited by financial covenant restrictions. At September 30, 2005, actual availability as a result of these restrictions was only $648 million. These financial covenant restrictions will be likely to further limit the availability of funds for the foreseeable future. Although beginning January 2, 2006, we have additional borrowing availability of $600 million under the bridge loan, availability of borrowings under the bridge loan is subject to the satisfaction of certain conditions, including the satisfaction of certain of the conditions to borrowing under the credit facilities.

An event of default under the credit facilities, bridge loan or indentures, if not waived, could result in the acceleration of those debt obligations and, consequently, other debt obligations. Such acceleration could result in the exercise of remedies by our creditors and could force us to seek the protection of the bankruptcy laws, which could materially adversely impact our ability to operate our business and to make payments under our debt instruments. In addition, an event of default under the credit facilities, such as the failure to maintain the applicable required financial ratios, would prevent additional borrowing under our subsidiary credit facilities and bridge loan, which could materially adversely affect our ability to

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operate our business and to make payments under our debt instruments. Likewise, the failure to satisfy the conditions to borrowing under the bridge loan would prevent any borrowing thereunder, which could materially adversely affect our ability to operate our business and to make payments under our debt instruments.

We and our subsidiaries have a significant amount of existing debt and may incur significant additional debt, including secured debt, in the future, which could adversely affect our financial health and our ability to react to changes in our business.

Charter and its subsidiaries have a significant amount of debt and may (subject to applicable restrictions in their debt instruments) incur additional debt in the future. As of September 30, 2005, our total debt was approximately $19.1 billion, our shareholders deficit was approximately $5.0 billion and the deficiency of earnings to cover fixed charges for the nine month period ended September 30, 2005 was $547 million. The maturities of these obligations are set forth in Description of Certain Indebtedness.

We will need to raise additional capital and/or receive distributions or payments from our subsidiaries in order to satisfy our debt obligations. However, because of our significant indebtedness, our ability to raise additional capital at reasonable rates or at all is uncertain, and the ability of our subsidiaries to make distributions or payments to us is subject to availability of funds and restrictions under our and our subsidiaries applicable debt instruments as more fully described in Description of Certain Indebtedness. If we were to raise capital through the issuance of additional equity or to engage in a recapitalization or other similar transaction, our shareholders could suffer significant dilution.

Our significant amount of debt could have other important consequences to you. For example, the debt will or could:

- require us to dedicate a significant portion of our cash flow from operating activities to payments on our debt, which will reduce our funds available for working capital, capital expenditures and other general corporate expenses;
- limit our flexibility in planning for, or reacting to, changes in our business, the cable and telecommunications industries and the economy at large;
- place us at a disadvantage as compared to our competitors that have proportionately less debt;
- make us vulnerable to interest rate increases, because a significant amount of our borrowings are, and will continue to be, at variable rates of interest;
- expose us to increased interest expense as we refinance our existing lower interest rate instruments;
- adversely affect our relationship with customers and suppliers;
- limit our ability to borrow additional funds in the future, if we need them, due to applicable financial and restrictive covenants in our debt; and
- make it more difficult for us to satisfy our obligations to the holders of our notes and for our subsidiaries to satisfy their obligations to their lenders under their credit facilities and to their noteholders.

A default by one of our subsidiaries under its debt obligations could result in the acceleration of those obligations, the obligations of our other subsidiaries and our obligations under our convertible notes. We and our subsidiaries may incur substantial additional debt in the future. If current debt levels increase, the related risks that we and you now face will intensify.

The agreements and instruments governing our debt and the debt of our subsidiaries contain restrictions and limitations that could significantly affect our ability to operate our business, as well as significantly affect our liquidity, and adversely affect you, as a shareholder.

The Charter Operating credit facilities, bridge loan and the indentures governing our and our subsidiaries public debt contain a number of significant covenants that could adversely affect our ability to operate our business, as well as significantly affect our liquidity, and therefore could adversely affect our results of operations and the price of our Class A common stock. These covenants restrict our and our subsidiaries ability to:

- incur additional debt;
- repurchase or redeem equity interests and debt;
- issue equity;
- make certain investments or acquisitions;
- pay dividends or make other distributions;
- receive distributions from our subsidiaries;
- dispose of assets or merge;
- enter into related party transactions;
- grant liens; and
- pledge assets.

Furthermore, Charter Operating s credit facilities require our subsidiaries to, among other things, maintain specified financial ratios, meet specified financial tests and provide audited financial statements, with an unqualified opinion from our independent auditors. See Description of Certain Indebtedness for a summary of our outstanding indebtedness and a description of our credit facilities and other indebtedness and for details on our debt covenants and future liquidity. Charter Operating s ability to comply with these provisions may be affected by events beyond our control.

The breach of any covenants or obligations in the foregoing indentures, bridge loan or credit facilities, not otherwise waived or amended, could result in a default under the applicable debt agreement or instrument and could trigger acceleration of the related debt, which in turn could trigger defaults under other agreements governing our long-term indebtedness. See Management s Discussion and Analysis of Financial Condition and Results of Operations Liquidity and Capital Resources. In addition, the secured lenders under the Charter Operating credit facilities and the holders of the Charter Operating senior second-lien notes could foreclose on their collateral, which includes equity interests in our subsidiaries, and exercise other rights of secured creditors. Any default under those credit facilities, the bridge loan, the indentures governing our convertible notes or our subsidiaries debt could adversely affect our growth, our financial condition and our results of operations and our ability to make payments on our notes, the bridge loan, and Charter Operating s credit facilities and other debt of our subsidiaries. See Description of Certain Indebtedness for a summary of outstanding indebtedness and a description of credit facilities and other indebtedness.

All of our and our subsidiaries outstanding debt is subject to change of control provisions. We may not have the ability to raise the funds necessary to fulfill our obligations under our indebtedness following a change of control, which would place us in default under the applicable debt instruments.

We may not have the ability to raise the funds necessary to fulfill our obligations under our convertible senior notes and our subsidiaries senior notes, senior discount notes, senior floating rate notes, the bridge loan, and credit facilities following a change of control. Under the indentures governing our convertible senior notes, upon the occurrence of specified change of control events, we are required to offer to repurchase all of our outstanding convertible senior notes. However, Charter may not have sufficient funds at the time of the change of control event to make the required repurchase of its convertible senior notes, and our subsidiaries are limited in their ability to make distributions or other payments to us to fund any required repurchase. In addition, a change of control under our subsidiaries credit facilities, bridge loan and indentures governing our subsidiaries notes could result in a default under those credit facilities and bridge loan and a required repayment of the notes under those indentures. Because such credit facilities, bridge loan and notes are obligations of our subsidiaries, the credit facilities, bridge loan and our subsidiaries notes would have to be repaid by our subsidiaries before their assets could be available to us to repurchase our convertible senior notes. Additionally, our subsidiaries may not have sufficient funds at the time of the change of control to make the required repurchases or repayments. Our failure to make or complete a change of control offer would place us in default under our convertible senior notes. The failure

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of our subsidiaries to make a change of control offer or repay the amounts accelerated under their credit facilities and bridge loan would place them in default under these agreements and could result in a default under the indentures governing our convertible senior notes and our subsidiaries credit facilities and notes.

Paul G. Allen and his affiliates are not obligated to purchase equity from, contribute to or loan funds to us or any of our subsidiaries.

Paul G. Allen and his affiliates are not obligated to purchase equity from, contribute to or loan funds to us or any of our subsidiaries.

Risks Related to Our Business

We operate in a very competitive business environment, which affects our ability to attract and retain customers and can adversely affect our business and operations. We have lost a significant number of customers to direct broadcast satellite competition and further loss of customers could have a material negative impact on our business.

The industry in which we operate is highly competitive and has become more so in recent years. In some instances, we compete against companies with fewer regulatory burdens, easier access to financing, greater personnel resources, greater brand name recognition and long-established relationships with regulatory authorities and customers. Increasing consolidation in the cable industry and the repeal of certain ownership rules may provide additional benefits to certain of our competitors, either through access to financing, resources or efficiencies of scale.

Our principal competitor for video services throughout our territory is direct broadcast satellite television services, also known as DBS. Competition from DBS, including intensive marketing efforts and aggressive pricing has had an adverse impact on our ability to retain customers. DBS has grown rapidly over the last several years and continues to do so. The cable industry, including us, has lost a significant number of subscribers to DBS competition, and we face serious challenges in this area in the future. We believe that competition from DBS service providers may present greater challenges in areas of lower population density, and that our systems service a higher concentration of such areas than those of other major cable service providers.

Local telephone companies and electric utilities can offer video and other services in competition with us and they increasingly may do so in the future. Certain telephone companies have begun more extensive deployment of fiber in their networks that will enable them to begin providing video services, as well as telephone and high bandwidth Internet access services, to residential and business customers and they are now offering such service in limited areas. Some of these telephone companies have obtained, and are now seeking, franchises or operating authorizations that are less burdensome than existing Charter franchises. The subscription television industry also faces competition from free broadcast television and from other communications and entertainment media. Further loss of customers to DBS or other alternative video and Internet services could have a material negative impact on the value of our business and its performance.

With respect to our Internet access services, we face competition, including intensive marketing efforts and aggressive pricing, from telephone companies and other providers of dial-up and digital subscriber line technology, also known as DSL. DSL service is competitive with high-speed Internet service over cable systems. In addition, DBS providers have entered into joint marketing arrangements with Internet access providers to offer bundled video and Internet service, which competes with our ability to provide bundled services to our customers. Moreover, as we expand our telephone offerings, we will face considerable competition from established telephone companies and other carriers, including other Voice Over Internet Protocol (VOIP) providers.

In order to attract new customers, from time to time we make promotional offers, including offers of temporarily reduced-price or free service. These promotional programs result in significant advertising, programming and operating expenses, and also require us to make capital expenditures to acquire additional digital set-top terminals. Customers who subscribe to our services as a result of these offerings may not remain customers for any significant period of time following the end of the promotional period.

A failure to retain existing customers and customers added through promotional offerings or to collect the amounts they owe us could have a material adverse effect on our business and financial results.

Mergers, joint ventures and alliances among franchised, wireless or private cable operators, satellite television providers, local exchange carriers and others, may provide additional benefits to some of our competitors, either through access to financing, resources or efficiencies of scale, or the ability to provide multiple services in direct competition with us.

We cannot assure you that our cable systems will allow us to compete effectively. Additionally, as we expand our offerings to include other telecommunications services, and to introduce new and enhanced services, we will be subject to competition from other providers of the services we offer. We cannot predict the extent to which competition may affect our business and operations in the future. See Business Competition.

We are currently the subject of certain lawsuits and other legal matters, the unfavorable outcome of which could adversely affect our business and financial condition.

We are a party to, or otherwise involved in, lawsuits, claims, proceedings and legal matters that have arisen in the ordinary course of conducting our business, certain of which are described in Business Legal Proceedings. In addition, our restatement of our 2000, 2001 and 2002 financial statements could lead to additional or expanded claims or investigations.

We cannot predict with certainty the ultimate outcome of any of the lawsuits, claims, proceedings and other legal matters to which we are a party, or in which we are otherwise involved, due to, among other things, (i) the inherent uncertainties of litigation and legal matters generally, (ii) the remaining conditions to the finalization of certain litigation and other settlements and resolutions to which we are parties, (iii) the outcome of appeals and (iv) the need for us to comply with, and/or otherwise implement, certain covenants, conditions, undertakings, procedures and other obligations that would be, or have been, imposed under the terms of settlements and resolutions of legal matters we have entered into.

An unfavorable outcome in any of the lawsuits pending against us, or in any other legal matter, or our failure to comply with or properly implement the terms of the settlements and resolutions of legal matters we have entered into, could result in substantial potential liabilities and otherwise have a material adverse effect on our business, consolidated financial condition and results of operations, in our liquidity, our operations, and/or our ability to comply with any debt covenants. Further, these legal matters, and our actions in response to them, could result in substantial potential liabilities, additional defense and other costs, increase our indemnification obligations, divert management s attention, and/or adversely affect our ability to execute our business and financial strategies.

See Business Legal Proceedings for additional information concerning these and other litigation matters.

We have a history of net losses and expect to continue to experience net losses. Consequently, we may not have the ability to finance future operations.

We have had a history of net losses and expect to continue to report net losses for the foreseeable future. Our net losses are principally attributable to insufficient revenue to cover the interest costs on our debt, the depreciation expenses that we incur resulting from the capital investments we have made in our cable properties, and the amortization and impairment of our franchise intangibles. We expect that these expenses (other than amortization and impairment of franchises) will remain significant, and we expect to continue to report net losses for the foreseeable future. We reported losses before cumulative effect of accounting change of \$2.3 billion for 2002, \$238 million for 2003 and \$3.6 billion for 2004 and \$3.2 billion and \$631 million for the nine months ended September 30, 2004 and 2005, respectively. Continued losses would reduce our cash available from operations to service our indebtedness, as well as limit our ability to finance our operations.

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We may not have the ability to pass our increasing programming costs on to our customers, which would adversely affect our cash flow and operating margins.

Programming has been, and is expected to continue to be, our largest operating expense item. In recent years, the cable industry has experienced a rapid escalation in the cost of programming, particularly sports programming. We expect programming costs to continue to increase because of a variety of factors, including inflationary or negotiated annual increases, additional programming being provided to customers and increased costs to purchase programming. The inability to fully pass these programming cost increases on to our customers would have an adverse impact on our cash flow and operating margins. As measured by programming costs, and excluding premium services (substantially all of which were renegotiated and renewed in 2003), as of December 31, 2005, approximately 15% of our current programming contracts were expired, and approximately another 4% were scheduled to expire at or before the end of 2006. There can be no assurance that these agreements will be renewed on favorable or comparable terms. Our programming costs increased by approximately 6% in 2004 and we expect our programming costs in 2005 to increase at a higher rate than in 2004. To the extent that we are unable to reach agreement with certain programmers on terms that we believe are reasonable we may be forced to remove such programming channels from our line-up, which could result in a further loss of customers.

If our required capital expenditures exceed our projections, we may not have sufficient funding, which could adversely affect our growth, financial condition and results of operations.

During the nine months ended September 30, 2005, we spent approximately $815 million on capital expenditures. During 2005, we expect capital expenditures to be approximately $1 billion to $1.1 billion. The actual amount of our capital expenditures depends on the level of growth in high-speed Internet customers and in the delivery of other advanced services, as well as the cost of introducing any new services. We may need additional capital if there is accelerated growth in high-speed Internet customers or in the delivery of other advanced services. If we cannot obtain such capital from increases in our cash flow from operating activities, additional borrowings or other sources, our growth, financial condition and results of operations could suffer materially.

Our inability to respond to technological developments and meet customer demand for new products and services could limit our ability to compete effectively.

Our business is characterized by rapid technological change and the introduction of new products and services. We cannot assure you that we will be able to fund the capital expenditures necessary to keep pace with unanticipated technological developments, or that we will successfully anticipate the demand of our customers for products and services requiring new technology. Our inability to maintain and expand our upgraded systems and provide advanced services in a timely manner, or to anticipate the demands of the marketplace, could materially adversely affect our ability to attract and retain customers. Consequently, our growth, financial condition and results of operations could suffer materially.

We may not be able to carry out our strategy to improve operating results by standardizing and streamlining operations and procedures.

In prior years, we experienced rapid growth through acquisitions of a number of cable operators and the rapid rebuild and rollout of advanced services. Our future success will depend in part on our ability to standardize and streamline our operations. The failure to implement a consistent corporate culture and management, operating or financial systems or procedures necessary to standardize and streamline our operations and effectively operate our enterprise could have a material adverse effect on our business, results of operations and financial condition.

Recent management changes could disrupt operations.

Since August 2004, we have experienced a number of changes in our senior management, including changes in our Chief Executive Officer, Chief Financial Officer, Chief Operating Officer, Executive Vice

President of Finance and Strategy and Interim co-Chief Financial Officer and our Executive Vice President, General Counsel and Corporate Secretary. The individual currently serving as Chief Financial Officer is serving in an interim capacity. In addition, Neil Smit assumed the positions of President and Chief Executive Officer effective August 22, 2005, and Grier Raclin became the Executive Vice President, General Counsel and Corporate Secretary effective October 10, 2005. These senior management changes could disrupt our ability to manage our business as we transition to and integrate a new management team, and any such disruption could adversely affect our operations, growth, financial condition and results of operations.

Malicious and abusive Internet practices could impair our high-speed Internet services.

Our high-speed Internet customers utilize our network to access the Internet and, as a consequence, we or they may become victim to common malicious and abusive Internet activities, such as unsolicited mass advertising (i.e., spam) and dissemination of viruses, worms and other destructive or disruptive software. These activities could have adverse consequences on our network and our customers, including degradation of service, excessive call volume to call centers and damage to our or our customers equipment and data. Significant incidents could lead to customer dissatisfaction and, ultimately, loss of customers or revenue, in addition to increased costs to us to service our customers and protect our network. Any significant loss of high-speed Internet customers or revenue or significant increase in costs of serving those customers could adversely affect our growth, financial condition and results of operations.

We could be deemed an investment company under the Investment Company Act of 1940. This would impose significant restrictions on us and would be likely to have a material adverse impact on our growth, financial condition and results of operation.

Our principal assets are our equity interests in Charter Holdco and certain indebtedness of Charter Holdco. If our membership interest in Charter Holdco were to constitute less than 50% of the voting securities issued by Charter Holdco, then our interest in Charter Holdco could be deemed an investment security for purposes of the Investment Company Act. This may occur, for example, if a court determines that the Class B common stock is no longer entitled to special voting rights and, in accordance with the terms of the Charter Holdco limited liability company agreement, our membership units in Charter Holdco were to lose their special voting privileges. A determination that such interest was an investment security could cause us to be deemed to be an investment company under the Investment Company Act, unless an exemption from registration were available or we were to obtain an order of the Securities and Exchange Commission excluding or exempting us from registration under the Investment Company Act.

If anything were to happen which would cause us to be deemed an investment company, the Investment Company Act would impose significant restrictions on us, including severe limitations on our ability to borrow money, to issue additional capital stock and to transact business with affiliates. In addition, because our operations are very different from those of the typical registered investment company, regulation under the Investment Company Act could affect us in other ways that are extremely difficult to predict. In sum, if we were deemed to be an investment company it could become impractical for us to continue our business as currently conducted and our growth, our financial condition and our results of operations could suffer materially.

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If a court determines that the Class B common stock is no longer entitled to special voting rights, we would lose our rights to manage Charter Holdco. In addition to the investment company risks discussed above, this could materially impact the value of the Class A common stock.

If a court determines that the Class B common stock is no longer entitled to special voting rights, Charter would no longer have a controlling voting interest in, and would lose its right to manage, Charter Holdco. If this were to occur:

- we would retain our proportional equity interest in Charter Holdco but would lose all of our powers to direct the management and affairs of Charter Holdco and its subsidiaries; and

- we would become strictly a passive investment vehicle and would be treated under the Investment Company Act as an investment company.

This result, as well as the impact of being treated under the Investment Company Act as an investment company, could materially adversely impact:

- the liquidity of the Class A common stock;

- how the Class A common stock trades in the marketplace;

- the price that purchasers would be willing to pay for the Class A common stock in a change of control transaction or otherwise; and

- the market price of the Class A common stock.

Uncertainties that may arise with respect to the nature of our management role and voting power and organizational documents as a result of any challenge to the special voting rights of the Class B common stock, including legal actions or proceedings relating thereto, may also materially adversely impact the value of the Class A common stock.

Risks Related to Mr. Allen s Controlling Position

The failure by Mr. Allen to maintain a minimum voting and economic interest in us could trigger a change of control default under our subsidiary s credit facilities.

The Charter Operating credit facilities provide that the failure by Mr. Allen to maintain a 35% direct or indirect voting interest in the applicable borrower would result in a change of control default. Such a default could result in the acceleration of repayment of our and our subsidiaries indebtedness, including borrowings under the Charter Operating credit facilities.

Mr. Allen controls our stockholder voting and may have interests that conflict with your interests.

Mr. Allen has the ability to control us. Through his control as of November 30, 2005 of approximately 90% of the voting power of our capital stock prior to completion of this offering, Mr. Allen is entitled to elect all but one of our board members and effectively has the voting power to elect the remaining board member as well. Mr. Allen thus has the ability to control fundamental corporate transactions requiring equity holder approval, including, but not limited to, the election of all of our directors, approval of merger transactions involving us and the sale of all or substantially all of our assets.

Mr. Allen is not restricted from investing in, and has invested and engaged in, other businesses involving or related to the operation of cable television systems, video programming, high-speed Internet service, telephone or business and financial transactions conducted through broadband interactivity and Internet services. Mr. Allen may also engage in other businesses that compete or may in the future compete with us.

Mr. Allen s control over our management and affairs could create conflicts of interest if he is faced with decisions that could have different implications for him, us and the holders of our Class A common stock. Further, Mr. Allen could effectively cause us to enter into contracts with another entity in which he owns an interest or to decline a transaction into which he (or another entity in which he owns an interest) ultimately enters.

Current and future agreements between us and either Mr. Allen or his affiliates may not be the result of arm s-length negotiations. Consequently, such agreements may be less favorable to us than agreements that we could otherwise have entered into with unaffiliated third parties. See Certain Relationships and Related Transactions.

We are not permitted to engage in any business activity other than the cable transmission of video, audio and data unless Mr. Allen authorizes us to pursue that particular business activity, which could adversely affect our ability to offer new products and services outside of the cable transmission business and to enter into new businesses, and could adversely affect our growth, financial condition and results of operations.

Our certificate of incorporation and Charter Holdco s limited liability company agreement provide that Charter and Charter Holdco and our subsidiaries, cannot engage in any business activity outside the cable transmission business except for specified businesses. This will be the case unless we first offer the opportunity to pursue the particular business activity to Mr. Allen, he decides not to pursue it and he consents to our engaging in the business activity. The cable transmission business means the business of transmitting video, audio (including telephone services), and data over cable television systems owned, operated or managed by us from time to time. These provisions may limit our ability to take advantage of attractive business opportunities.

The loss of Mr. Allen s services could adversely affect our ability to manage our business.

Mr. Allen is Chairman of our board of directors and provides strategic guidance and other services to us. If we were to lose his services, our growth, financial condition and results of operations could be adversely impacted.

The special tax allocation provisions of the Charter Holdco limited liability company agreement may cause us in some circumstances to pay more taxes than if the special tax allocation provisions were not in effect.

Charter Holdco s limited liability company agreement provided that through the end of 2003, net tax losses of Charter Holdco that would otherwise have been allocated to us based generally on our percentage ownership of outstanding common membership units of Charter Holdco would instead be allocated to the membership units held by Vulcan Cable III Inc. (Vulcan Cable) and Charter Investment, Inc. (CII) The purpose of these special tax allocation provisions was to allow Mr. Allen to take advantage for tax purposes of the losses generated by Charter Holdco. However, beginning in 2002, due to tax capital account limitations, certain net tax losses of Charter Holdco that were to be allocated to Vulcan Cable and CII were instead allocated to us and have continued to be so allocated since that time. The limited liability company agreement further provides that beginning at the time that Charter Holdco generates net tax profits (as determined under the applicable federal income tax rules for determining capital accounts), the net tax profits that would otherwise have been allocated to us based generally on our percentage of outstanding common membership units of Charter Holdco will instead generally be allocated to membership units held by Vulcan Cable and CII. In some situations, the special tax allocation provisions could result in our having to pay taxes in an amount that is more or less than if Charter Holdco had allocated net tax losses and net tax profits to its members based generally on the percentage of outstanding common membership units owned by such members from the time of the completion of the offering. See Description of Capital Stock and Membership Units Special Tax Allocation Provisions. For further discussion on the details of the tax allocation provisions see Management s Discussion and Analysis of Financial Condition and Results of Operations Critical Accounting Policies and Estimates Income Taxes.

The issuance of our Class A common stock offered hereby pursuant to the share lending agreement, as well as possible future conversions of our convertible notes, significantly increase the risk that we will experience an ownership change in the future for tax purposes, resulting in a material limitation on the use of a substantial amount of our existing net operating loss carryforwards.

As of September 30, 2005, Charter had approximately $5.5 billion of tax net operating losses (resulting in a gross deferred tax asset of approximately $2.2 billion) expiring in the years 2010 through 2025. Due to uncertainties in projected future taxable income, valuation allowances have been established against the gross deferred tax assets for book accounting purposes except for deferred benefits available to offset certain deferred tax liabilities. Currently, such tax net operating losses can accumulate and be used to offset any future taxable income of Charter. An ownership change as defined in Section 382 of the Internal Revenue Code of 1986, as amended, would place significant limitations, on an annual basis, on the use of such net operating losses to offset any future taxable income we may generate. Such limitations, in conjunction with the net operating loss expiration provisions, could effectively eliminate our ability to use a substantial portion of our net operating losses to offset future taxable income. The shares issued hereby are being issued pursuant to a share lending agreement. See Share Lending Agreement. While the tax treatment of the issuance of shares offered hereby pursuant to a borrowing transaction under the share lending agreement is uncertain, we do not believe that this issuance would result in our experiencing an ownership change. However, future transactions and the timing of such transactions could cause an ownership change. Such transactions include additional issuances of common stock by us (including but not limited to issuances upon future conversion of our 5.875% convertible senior notes or as contemplated in the proposed settlement of derivative class action litigation), reacquisitions of the borrowed shares by us, or acquisitions or sales of shares by certain holders of our shares, including persons who have held, currently hold, or accumulate in the future five percent or more of our outstanding stock (including upon an exchange by Paul Allen or his affiliates, directly or indirectly, of membership units of Charter Holdco into our Class A common stock). Many of the foregoing transactions are beyond our control.

Risks Related to Regulatory and Legislative Matters

Our business is subject to extensive governmental legislation and regulation, which could adversely affect our business.

Regulation of the cable industry has increased cable operators administrative and operational expenses and limited their revenues. Cable operators are subject to, among other things:

- rules governing the provision of cable equipment and compatibility with new digital technologies;
- rules and regulations relating to subscriber privacy;
- limited rate regulation;
- requirements governing when a cable system must carry a particular broadcast station and when it must first obtain consent to carry a broadcast station;
- rules for franchise renewals and transfers; and
- other requirements covering a variety of operational areas such as equal employment opportunity, technical standards and customer service requirements.

Additionally, many aspects of these regulations are currently the subject of judicial proceedings and administrative or legislative proposals. There are also ongoing efforts to amend or expand the federal, state and local regulation of some of our cable systems, which may compound the regulatory risks we already face. Certain states and localities are considering new telecommunications taxes that could increase operating expenses.

Our cable systems are operated under franchises that are subject to non-renewal or termination. The failure to renew a franchise in one or more key markets could adversely affect our business.

Our cable systems generally operate pursuant to franchises, permits and similar authorizations issued by a state or local governmental authority controlling the public rights-of-way. Many franchises establish comprehensive facilities and service requirements, as well as specific customer service standards and monetary penalties for non-compliance. In many cases, franchises are terminable if the franchisee fails to comply with significant provisions set forth in the franchise agreement governing system operations. Franchises are generally granted for fixed terms and must be periodically renewed. Local franchising authorities may resist granting a renewal if either past performance or the prospective operating proposal is considered inadequate. Franchise authorities often demand concessions or other commitments as a condition to renewal. In some instances, franchises have not been renewed at expiration, and we have operated and are operating under either temporary operating agreements or without a license while negotiating renewal terms with the local franchising authorities. Approximately 11% of our franchises, covering approximately 10% of our video customers, were expired as of September 30, 2005. Approximately 2% of additional franchises, covering approximately an additional 4% of our video customers, will expire on or before December 31, 2005, if not renewed prior to expiration.

We cannot assure you that we will be able to comply with all significant provisions of our franchise agreements and certain of our franchisors have from time to time alleged that we have not complied with these agreements. Additionally, although historically we have renewed our franchises without incurring significant costs, we cannot assure you that we will be able to renew, or to renew as favorably, our franchises in the future. A termination of or a sustained failure to renew a franchise in one or more key markets could adversely affect our business in the affected geographic area.

Our cable systems are operated under franchises that are non-exclusive. Accordingly, local franchising authorities can grant additional franchises and create competition in market areas where none existed previously, resulting in overbuilds, which could adversely affect results of operations.

Our cable systems are operated under non-exclusive franchises granted by local franchising authorities. Consequently, local franchising authorities can grant additional franchises to competitors in the same geographic area or operate their own cable systems. In addition, certain telephone companies are seeking authority to operate in local communities without first obtaining a local franchise. As a result, competing operators may build systems in areas in which we hold franchises. In some cases municipal utilities may legally compete with us without obtaining a franchise from the local franchising authority.

Different legislative proposals have been introduced in the United States Congress and in some state legislatures that would greatly streamline cable franchising. This legislation is intended to facilitate entry by new competitors, particularly local telephone companies. Such legislation has already passed in at least one state but is now subject to court challenge. Although various legislative proposals provide some regulatory relief for incumbent cable operators, these proposals are generally viewed as being more favorable to new entrants. The FCC recently initiated a proceeding to determine whether local franchising authorities are impeding the deployment of competitive cable services through unreasonable franchising requirements and whether such impediments should be preempted. At this time, we are not able to determine what impact such proceeding may have on us.

The existence of more than one cable system operating in the same territory is referred to as an overbuild. These overbuilds could adversely affect our growth, financial condition and results of operations by creating or increasing competition. As of September 30, 2005, we are aware of overbuild situations impacting approximately 5% of our estimated homes passed, and potential overbuild situations in areas servicing approximately 2% of our estimated homes passed. Additional overbuild situations may occur in other systems.

Local franchise authorities have the ability to impose additional regulatory constraints on our business, which could further increase our expenses.

In addition to the franchise agreement, cable authorities in some jurisdictions have adopted cable regulatory ordinances that further regulate the operation of cable systems. This additional regulation increases the cost of operating our business. We cannot assure you that the local franchising authorities will not impose new and more restrictive requirements. Local franchising authorities also have the power to reduce rates and order refunds on the rates charged for basic services.

Further regulation of the cable industry could cause us to delay or cancel service or programming enhancements or impair our ability to raise rates to cover our increasing costs, resulting in increased losses.

Currently, rate regulation is strictly limited to the basic service tier and associated equipment and installation activities. However, the Federal Communications Commission (FCC) and the U.S. Congress continue to be concerned that cable rate increases are exceeding inflation. It is possible that either the FCC or the U.S. Congress will again restrict the ability of cable system operators to implement rate increases. Should this occur, it would impede our ability to raise our rates. If we are unable to raise our rates in response to increasing costs, our losses would increase.

There has been considerable legislative interest in requiring cable operators to offer historically bundled programming services on an á la carte basis or to at least offer a separately available child-friendly Family Tier. It is possible that new marketing restrictions could be adopted in the future. Such restrictions could adversely affect our operations.

Actions by pole owners might subject us to significantly increased pole attachment costs.

Pole attachments are cable wires that are attached to poles. Cable system attachments to public utility poles historically have been regulated at the federal or state level, generally resulting in favorable pole attachment rates for attachments used to provide cable service. The FCC clarified that a cable operator s favorable pole rates are not endangered by the provision of Internet access, and that approach ultimately was upheld by the Supreme Court of the United States. Despite the existing regulatory regime, utility pole owners in many areas are attempting to raise pole attachment fees and impose additional costs on cable operators and others. In addition, the favorable pole attachment rates afforded cable operators under federal law can be increased by utility companies if the operator provides telecommunications services, as well as cable service, over cable wires attached to utility poles. Any significant increased costs could have a material adverse impact on our profitability and discourage system upgrades and the introduction of new products and services.

We may be required to provide access to our networks to other Internet service providers, which could significantly increase our competition and adversely affect our ability to provide new products and services.

A number of companies, including independent Internet service providers, or ISPs, have requested local authorities and the FCC to require cable operators to provide non-discriminatory access to cable s broadband infrastructure, so that these companies may deliver Internet services directly to customers over cable facilities. In a June 2005 ruling, commonly referred to as *Brand X*, the Supreme Court upheld an FCC decision (and overruled a conflicting Ninth Circuit opinion) making it much less likely that any non-discriminatory open access requirements (which are generally associated with common carrier regulation of telecommunications services) will be imposed on the cable industry by local, state or federal authorities. The Supreme Court held that the FCC was correct in classifying cable provided Internet service as an information service, rather than a telecommunications service. This favorable regulatory classification limits the ability of various governmental authorities to impose open access requirements on cable-provided Internet service. Given how recently *Brand X* was decided, however, the nature of any legislative or regulatory response remains uncertain. The imposition of open access requirements could materially affect our business.

If we were required to allocate a portion of our bandwidth capacity to other Internet service providers, we believe that it would impair our ability to use our bandwidth in ways that would generate maximum revenues.

Changes in channel carriage regulations could impose significant additional costs on us.

Cable operators also face significant regulation of their channel carriage. They currently can be required to devote substantial capacity to the carriage of programming that they would not carry voluntarily, including certain local broadcast signals, local public, educational and government access programming, and unaffiliated commercial leased access programming. This carriage burden could increase in the future, particularly if cable systems were required to carry both the analog and digital versions of local broadcast signals (dual carriage) or to carry multiple program streams included with a single digital broadcast transmission (multicast carriage). Additional government-mandated broadcast carriage obligations could disrupt existing programming commitments, interfere with our preferred use of limited channel capacity and limit our ability to offer services that would maximize customer appeal and revenue potential. Although the FCC issued a decision in February 2005, confirming an earlier ruling against mandating either dual carriage or multicast carriage, that decision has been appealed. In addition, the FCC could reverse its own ruling or Congress could legislate additional carriage obligations.

Offering voice communications service may subject us to additional regulatory burdens, causing us to incur additional costs.

In 2002, we began to offer voice communications services on a limited basis over our broadband network. We continue to explore development and deployment of Voice over Internet Protocol or VoIP services. The regulatory requirements applicable to VoIP service are unclear although the FCC has declared that certain VoIP services are not subject to traditional state public utility regulation. The full extent of the FCC preemption of VoIP services is not yet clear. Expanding our offering of these services may require us to obtain certain authorizations, including federal, state and local licenses. We may not be able to obtain such authorizations in a timely manner, or conditions could be imposed upon such licenses or authorizations that may not be favorable to us. Furthermore, telecommunications companies generally are subject to significant regulation, including payments to the Federal Universal Service Fund and the intercarrier compensation regime, and it may be difficult or costly for us to comply with such regulations, were it to be determined that they applied to VoIP offerings such as ours. The FCC has already determined that VoIP providers must comply with traditional 911 emergency service obligations (E911) and has imposed a specific timeframe for VoIP providers to accommodate law enforcement wiretaps. Based on a recent FCC release, we are now seeking subscriber acknowledgement of E911 limitations so as to minimize the risk of potential sanctions. In addition, pole attachment rates are higher for providers of telecommunications services than for providers of cable service. If there were to be a final legal determination by the FCC, a state Public Utility Commission, or appropriate court that VoIP services are subject to these higher rates, our pole attachment costs could increase significantly, which could adversely affect our financial condition and results of operations.

Additional Risks Related to this Offering

The market price of our Class A common stock may be volatile, which could cause the value of your investment to decline.

It is impossible to predict whether the price of our Class A common stock will rise or fall. Trading prices of our Class A common stock will be influenced by our operating results and prospects and by economic, financial, regulatory and other factors. In addition, general market conditions, including the level of, and fluctuations in, the trading prices of stocks generally, and sales of substantial amounts of our Class A common stock by us in the market after this offering, or the perception that such sales may occur, could affect the price of our Class A common stock.

The price of our Class A common stock also could be affected by any sales of our Class A common stock by investors who view our recently issued 5.875% convertible senior notes as a more attractive means of equity participation in our company. Some investors in our Class A common stock may decide to sell some or all of their shares and purchase our 5.875% convertible senior notes instead. Such sales of our Class A common stock could cause the trading price to decline. The hedging or arbitrage trading activity that has developed and could further develop with respect to our Class A common stock as a result of the November 2004 issuance of our 5.875% convertible senior notes could also cause a decline or retard any increase in the trading price of our Class A common stock since investors in the convertible senior notes may sell short our Class A common stock in order to establish initial hedge positions, and may increase those positions, particularly as the trading price of our Class A common stock increases, in order to hedge their 5.875% convertible senior notes. See Share Lending Agreement.

In addition to the hedging transactions that were facilitated by the prior share borrow transaction, we understand that many holders of our 5.875% convertible senior notes have also been able to borrow shares of our Class A common stock for the purpose of establishing short positions in the stock. To the extent that those same holders seek to establish short positions with Citigroup through private hedging transactions in connection with this offering, we believe such holders are likely to seek to close out their existing share borrow arrangements using shares purchased in the open market. Such purchases could cause extreme volatility in the trading price of our Class A common stock, including temporary increases in the price as short term demand increases.

The market price of our Class A common stock could be adversely affected by the large number of additional shares of Class A common stock eligible for issuance in the future.

As of November 30, 2005, 416,433,240 shares of Class A common stock were issued and outstanding, and 50,000 shares of Class B common stock were issued and outstanding. This includes 94,911,300 shares of Class A common stock that were issued in the July and November share borrow transactions. An additional 339,132,031 shares of Class A common stock are issuable upon conversion of outstanding units of Charter Holdco and an additional 24,381,166 shares are issuable as of November 30, 2005 if Mr. Allen were to exchange the CCHC subordinated accreting note that he holds as a result of the settlement of the CC VIII dispute, into Charter Holdco units and exchange Charter Holdco units into Class A shares. See Certain Relationships and Related Transactions Transactions Arising Out of Our Organizational Structure and Mr. Allen s Investment in Charter Communications Inc. and Its Subsidiaries Equity Put Rights CC VIII . Also 29,221,352 shares were issuable upon the exercise of outstanding options under our option plans and approximately 356 million shares are now issuable upon conversion of our recently issued 5.875% convertible senior notes due 2009. All of the 363,513,197 shares of Class A common stock issuable upon exchange of Charter Holdco membership units and all shares of the Class A common stock issuable upon conversion of shares of our Class B common stock will have demand and/or piggyback registration rights attached to them. All of the 356 million shares issuable upon conversion of the 5.875% convertible senior notes are eligible for resale pursuant to a shelf registration statement. If less than all of the remaining 55,088,700 shares of Class A common stock covered by the share lending agreement are sold in this offering, Citigroup will have the right under the share lending agreement to borrow the unsold portion of those shares in the future, and a registration rights agreement will obligate Charter to file, at Citigroup s request, up to two additional registration statements with respect to these unsold shares until November 16, 2006. The sale of a substantial number of shares of Class A common stock or the perception that such sales could occur could adversely affect the market price for the Class A common stock because the sale could cause the amount of the Class A common stock available for sale in the market to exceed the demand for the Class A common stock and could also make it more difficult for us to sell equity securities or equity-related securities in the future at a time and price that we deem appropriate. This could adversely affect our ability to fund our current and future obligations. See Shares Eligible for Future Sale.

The failure to maintain a minimum share price of $1.00 per share of Class A common stock could result in delisting of our shares on the Nasdaq National Market, which would harm the market price of our Class A common stock.

In order to retain our listing on the Nasdaq National Market we are required to maintain a minimum bid price of $1.00 per share. Although, as of January 5, 2006, the trading price of our Class A common stock was $1.19 per share, our stock has traded below this $1.00 minimum in the recent past. If the bid price falls below the $1.00 minimum for more than 30 consecutive trading days, we will have 180 days to satisfy the $1.00 minimum bid price for a period of at least 10 trading days. If we are unable to take action to increase the bid price per share (either by reverse stock split or otherwise), we could be subject to delisting from the Nasdaq National Market.

The failure to maintain our listing on the Nasdaq National Market would harm the liquidity of our Class A common stock and would have adverse effect on the market price of our common stock. If the stock were to trade it would likely trade on the OTC pink sheets, which provide significantly less liquidity than does Nasdaq. As a result, the liquidity of our common stock would be impaired, not only in the number of shares which could be bought and sold, but also through delays in the timing of transactions, reduction in security analysts and news media s coverage and lower prices for our common stock than might otherwise be attained. In addition, our common stock would become subject to the lowpriced security or so-called penny stock rules that impose additional sales practice requirements on broker-dealers who sell such securities.

The effect of the issuance of our shares of Class A common stock pursuant to the share lending agreement and upon conversion of our 5.875% convertible notes, including sales of our Class A common stock in short sale transactions by the holders of the 5.875% convertible notes, may have a negative effect on the market price of our Class A common stock.

We have agreed pursuant to a share lending agreement to lend to Citigroup Global Markets Limited up to 150 million shares of our common stock, including the 55.1 million shares that are being offered pursuant to this prospectus and the 94.9 million shares issued in July and November 2005. In addition, in November 2004, we sold $862.5 million original aggregate principal amount of 5.875% convertible senior notes due 2009, which are currently convertible into approximately 356 million shares of our Class A common stock. We have been advised by Citigroup Global Markets Limited that it or an affiliate intends to facilitate the establishment by holders of those convertible notes of hedged positions in the convertible notes. While issuance of shares upon the conversion of the convertible notes may result in a reduction of an equal number in the outstanding borrowed shares under the share lending agreement, the increase in the number of shares of our Class A common stock issued or issuable pursuant to the share lending agreement or upon conversion of the 5.875% convertible senior notes could have a negative effect on the market price of our Class A common stock. Since there will be more shares sold or available for sale, the market price of our Class A common stock may decline or not increase as much as it might have without the availability of such shares. The market price of our Class A common stock also could decline as a result of other short sales of our Class A common stock by the purchasers of the 5.875% convertible senior notes to hedge their investment in the convertible notes. In addition to the hedging transactions facilitated by the prior share borrow transaction, we understand that many investors in our 5.875% convertible senior notes have also already hedged their investment by selling additional shares of our Class A common stock short in order to establish initial hedge positions. This offering may result in establishment of hedged positions by other holders or in replacement of existing hedged position by those holders who are already hedged. We expect that all such hedged parties may increase those positions as the market price of the Class A common stock increases, since such price increases will increase the likelihood that such holders will convert their 5.875% convertible senior notes and receive Class A common stock. Therefore, such short sales could retard any increase in the market price of our Class A common stock or cause a decline. See Business Legal Proceedings, Share Lending Agreement and Underwriting.

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USE OF PROCEEDS

None of the proceeds from the sale of our Class A common stock offered by this prospectus will be received by us. However, pursuant to the share lending agreement, we will receive a loan fee of $0.001 for each share that we lend to Citigroup Global Markets Limited, which will be used for general corporate purposes. See Share Lending Agreement.

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PRICE RANGE OF COMMON STOCK AND DIVIDEND POLICY

Our Class A common stock is quoted on the Nasdaq National Market under the symbol CHTR. The following table sets forth, for the periods indicated, the range of high and low last reported sale price per share of Class A common stock on the Nasdaq National Market. There is no established trading market for our Class B common stock.

2006	High	Low
First Quarter through January 5	$1.21	$1.18

2005	High	Low
First Quarter	$2.30	$1.35
Second Quarter	$1.53	$0.90
Third Quarter	$1.71	$1.14
Fourth Quarter	$1.50	$1.12

2004	High	Low
First Quarter	$5.43	$3.99
Second Quarter	$4.70	$3.61
Third Quarter	$3.90	$2.61
Fourth Quarter	$3.01	$2.03

As of November 30, 2005, there were 4,549 holders of record of our Class A common stock, one holder of our Class B common stock, and 4 holders of record of our Series A Convertible Redeemable Preferred Stock.

The last reported sale price of our Class A common stock on the Nasdaq National Market on January 5, 2006 was $1.19 per share.

We have never paid and do not expect to pay any cash dividends on our Class A common stock in the foreseeable future. Charter Holdco is required under certain circumstances to pay distributions pro rata to all its common members to the extent necessary for any common member to pay taxes incurred with respect to its share of taxable income attributed to Charter Holdco. Covenants in the indentures and credit agreements governing the debt of our subsidiaries restrict their ability to make distributions to us and, accordingly, limit our ability to declare or pay cash dividends. We intend to cause Charter Holdco and its subsidiaries to retain future earnings, if any, to finance the operation of the business of Charter Holdco and its subsidiaries.

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CAPITALIZATION

The following table sets forth our capitalization as of September 30, 2005, on a consolidated basis:

The following information should be read in conjunction with Selected Historical Consolidated Financial Data, Management s Discussion and Analysis of Financial Condition and Results of Operations and the historical consolidated financial statements and related notes included elsewhere in this prospectus.

	As of September 30, 2005
	(Dollars in millions)
Cash and cash equivalents	$ 22
Long-term debt:	
Charter Communications, Inc.:	
5.875% convertible senior notes due 2009(a)	$ 841
4.75% convertible senior notes due 2006	25
Charter Holdings:	
Senior and senior discount notes(b)	1,736
CIH:	
Senior and senior discount notes(c)(d)	2,426
CCH I:	
11.00% senior notes due 2015(d)	3,686
CCH II:	
10.250% senior notes due 2010	1,601
CCO Holdings:	
8 3/4% senior notes due 2013	794
Senior floating rate notes due 2010	550
Charter Operating:	
8.000% senior second lien notes due 2012	1,100
8 3/8% senior second lien notes due 2014	733
Renaissance:	
10.00% senior discount notes due 2008	115
Credit facilities:	
Charter Operating(e)	5,513
Total long-term debt	19,120
Preferred stock redeemable(f)	55
Minority interest(g)	665
Shareholders deficit:	
Class A common stock; $.001 par value; 1.75 billion shares authorized; 348,576,466 shares issued and outstanding(h)	
Class B common stock; $.001 par value; 750 million shares authorized; 50,000 shares issued and outstanding	
Preferred stock; $.001 par value; 250 million shares authorized; no non-redeemable shares issued and outstanding	
Additional paid-in-capital	4,821
Accumulated deficit	(9,830)
Accumulated other comprehensive income	3
Total shareholders deficit	(5,006)

Total capitalization	$ 14,834

(a) Represents $863 million of 5.875% convertible senior notes of which $30 million, related to certain provisions of the 5.875% convertible senior notes that for accounting purposes were derivatives which required bifurcation, was recorded as accounts payable and accrued expenses and other long-term liabilities with the resulting long-term debt of $832 million. The debt has accreted to $841 million at September 30, 2005 and will accrete to the $863 million face value over three years, the duration of our pledged securities.

		As of September 30, 2005
		(Dollars in millions)
(b)	Represents the following Charter Holdings notes:	
	8.250% senior notes due 2007	$ 105
	8.625% senior notes due 2009	292
	9.920% senior discount notes due 2011	198
	10.000% senior notes due 2009	154
	10.250% senior notes due 2010	49
	11.750% senior discount notes due 2010	43
	10.750% senior notes due 2009	131
	11.125% senior notes due 2011	217
	13.500% senior discount notes due 2011	91
	9.625% senior notes due 2009	107
	10.000% senior notes due 2011	136
	11.750% senior discount notes due 2011	116
	12.125% senior discount notes due 2012	97
	Total	$1,736

		As of September 30, 2005
		(Dollars in millions)
(c)	Represents the following CIH notes:	
	11.125% senior notes due 2014	$ 151
	9.920% senior discount notes due 2014	471
	10.000% senior notes due 2014	299
	11.750% senior discount notes due 2014	759
	13.500% senior discount notes due 2014	559
	12.125% senior discount notes due 2015	187
	Total	$2,426

(d) The CIH notes and CCH I notes issued in exchange for Charter Holdings notes are recorded in accordance with GAAP. GAAP requires that the CIH notes issued in exchange for Charter Holdings notes and the CCH I notes issued in exchange for the 8.625% Charter Holdings notes due 2009 be recorded at the historical book values of the Charter Holdings notes as opposed to the current accreted value for legal purposes and notes indenture purposes (which, for both purposes, is the amount that would become payable if the debt becomes immediately due). As of September 30, 2005, the accreted value of our total long-term debt for legal purposes and notes indenture purposes is $18.6 billion.

(e) Total potential borrowing availability under our credit facilities was $786 million as of September 30, 2005, although the actual availability at that time was only $648 million because of limits imposed by covenant restrictions.

(f) In connection with Charter s acquisition of Cable USA, Inc. and certain cable system assets from affiliates of Cable USA, Inc., Charter issued 545,259 shares of Series A Convertible Redeemable Preferred Stock valued at and with a liquidation preference of $55 million. Holders of the preferred stock have no voting rights but are entitled to receive cumulative cash dividends at an annual rate of 5.75%, payable quarterly or 7.75% if not paid but accrued. Beginning January 1, 2005 and through September 30, 2005, Charter accrued the dividend on its Series A Convertible Redeemable Preferred Stock. The preferred stock is redeemable by Charter at its option on or after August 31, 2004 and must be redeemed by Charter at any time upon a change of control, or if not previously redeemed or converted, on August 31, 2008. In November 2005, we repurchased 508,546 shares of the preferred stock. See Summary Recent Events Repurchase of

Convertible Redeemable Preferred Stock.

The preferred stock is convertible, in whole or in part, at the option of the holders from April 1, 2002 through August 31, 2008, into shares of Class A common stock at an initial conversion rate equal to a conversion price of $24.71 per share of Class A common stock, subject to certain customary adjustments.

(g) Minority interest consists of preferred membership interests in CC VIII. Paul G. Allen indirectly held preferred membership units in CC VIII as a result of the exercise of put rights originally granted in connection with the Bresnan transaction in 2000. There was an issue regarding the ultimate ownership of the CC VIII membership interests following the consummation of the Bresnan put transaction on June 6, 2003. This dispute was settled October 31, 2005. See Certain Relationships and Related Transactions Transactions Arising Out of Our Organizational Structure and Mr. Allen s Investment in Charter and its Subsidiaries Equity Put Rights CC VIII.

(h) Although the shares offered by this prospectus and issued in July and November 2005 will be considered issued and outstanding, we do not expect they will impact our earnings per share under current accounting literature. See Share Lending Agreement for further discussion related to the accounting of the share lending agreement. Pro forma for the issuance of the shares offered hereby and the shares issued in November 2005, at September 30, 2005, there were 471,406,466 shares issued and outstanding.

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UNAUDITED PRO FORMA CONSOLIDATED FINANCIAL STATEMENTS

The following unaudited pro forma consolidated financial statements are based on the historical consolidated financial statements of Charter, adjusted on a pro forma basis to reflect the following transactions as if they had occurred on January 1, 2004 for the unaudited pro forma consolidated statement of operations:

(1) the disposition of certain assets in March and April 2004 for total proceeds of $735 million and the use of such proceeds in each case to pay down credit facilities;

(2) the issuance and sale of $550 million of CCO Holdings senior floating rate notes in December 2004 and $1.5 billion of Charter Operating senior second lien notes in April 2004;

(3) an increase in amounts outstanding under the Charter Operating credit facilities in April 2004 and the use of such funds, together with the proceeds from the sale of the Charter Operating senior second lien notes, to refinance amounts outstanding under the credit facilities of our subsidiaries, CC VI Operating Company, LLC, CC VIII Operating, LLC and Falcon Cable Communications, LLC;

(4) the issuance and sale of $863 million of 5.875% convertible senior notes in November 2004 with proceeds used for (i) the purchase of certain U.S. government securities pledged as security to fund the first six interest payments thereon, (ii) redemption of outstanding 5.75% convertible senior notes due 2005 and (iii) general corporate purposes;

(5) the repayment of $530 million of borrowings under the Charter Operating revolving credit facility with net proceeds from the issuance and sale of the CCO Holdings senior floating rate notes in December 2004, which were included in our cash balance at December 31, 2004;

(6) the redemption of all of CC V Holdings, LLC s outstanding 11.875% senior discount notes due 2008 with cash on hand;

(7) the issuance and sale of $300 million of 8 3/4% CCO Holdings senior notes in August 2005 and the use of a portion of such proceeds to pay financing costs and accrued interest in the exchange transaction referenced below;

(8) the exchange of $3.4 billion principal amount of Charter Holdings notes scheduled to mature in 2009 and 2010 for CCH I notes and the exchange of $3.4 billion principal amount of Charter Holdings notes scheduled to mature in 2011 and 2012 for CIH notes and CCH I notes; and

(9) the issuance of 67.7 million shares in November 2005 and the shares offered hereby pursuant to a share lending agreement, the sole effect of which is to increase common shares issued and outstanding. See Share Lending Agreement.

The unaudited pro forma adjustments are based on information available to us as of the date of this prospectus and certain assumptions that we believe are reasonable under the circumstances. The Unaudited Pro Forma Consolidated Financial Statements required allocation of certain revenues and expenses and such information has been presented for comparative purposes and is not intended to provide any indication of what our actual financial position or results of operations would have been had the transactions described above been completed on the dates indicated or to project our results of operations for any future date.

The unaudited pro forma balance sheet as of September 30, 2005 is not provided as pro forma adjustments are not significant for that period.

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CHARTER COMMUNICATIONS, INC.

UNAUDITED PRO FORMA CONSOLIDATED STATEMENT OF OPERATIONS

For the Nine Months Ended September 30, 2004

	Historical	Asset Dispositions(a)	Financing Transactions(b)	Pro Forma
	(Dollars in millions, except per share and share amounts)			
Revenues				
Video	$ 2,534	$ (21)	$	$ 2,513
High-speed Internet	538	(3)		535
Advertising sales	205	(1)		204
Commercial	175	(2)		173
Other	249	(2)		247
Total	3,701	(29)		3,672
Costs and Expenses				
Operating (excluding depreciation and amortization)	1,552	(12)		1,540
Selling, general and administrative	735	(4)		731
Depreciation and amortization	1,105	(6)		1,099
Impairment of franchises	2,433			2,433
(Gain) loss on sale of assets, net	(104)	106		2
Option compensation expense, net	34			34
Special charges, net	100			100
	5,855	84		5,939
Loss from operations	(2,154)	(113)		(2,267)
Interest expense, net	(1,227)	4	(26)	(1,249)
Gain on derivative instruments and hedging activities, net	48			48
Loss on debt to equity conversions	(23)			(23)
Loss on extinguishment of debt	(21)		21	
	(1,223)	4	(5)	(1,224)
Loss before minority interest, income taxes, and cumulative effect of accounting change	(3,377)	(109)	(5)	(3,491)
Minority interest	24			24
Loss before income taxes and cumulative effect of accounting change	(3,353)	(109)	(5)	(3,467)
Income tax benefit	116	15		131
Loss before cumulative effect of accounting change	(3,237)	$ (94)	$ (5)	$ (3,336)
Loss per common share, basic and diluted	$ (13.38)			$ (13.71)
Weighted average common shares outstanding, basic and diluted(c)	299,411,053			299,411,053

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(a) Represents the elimination of operating results related to the disposition of certain assets in March and April 2004 and a reduction of interest expense related to the use of the net proceeds from such sales to repay a portion of our subsidiaries credit facilities.

(b) Represents adjustment to interest expense associated with the completion of the financing transactions discussed in pro forma assumptions two through eight (in millions):

Interest on the Charter Operating senior second lien notes issued in April 2004 and the amended and restated Charter Operating credit facilities	$ 114	
Amortization of deferred financing costs	8	
Less Historical interest expense for Charter Operating credit facilities and on subsidiary credit facilities repaid	(83)	
		39
Interest on $863 million of 5.875% convertible senior notes issued in November 2004	38	
Amortization of deferred financing costs	3	
Less Interest from $144 million of securities pledged for interest payments on convertible notes	(2)	
Historical interest expense on $588 million of 5.75% convertible senior notes retired with proceeds	(28)	
		11
Interest on $550 million of CCO Holdings senior floating rate notes issued in December 2004	27	
Amortization of deferred financing costs	2	
Less Historical interest expense for Charter Operating s revolving credit facility repaid with cash on hand in February 2005	(20)	
Historical interest expense for the CC V Holdings, LLC 11.875% senior discount notes repaid with cash on hand in March 2005	(10)	
		(1)
Interest on $300 million of CCO Holdings 8 3/4% senior notes issued in August 2005		20
Interest on new CCH I notes issued in September 2005 in exchange for CCH notes	279	
Amortization of deferred financing costs	5	
Less Historical interest expense on CCH notes exchanged for CCH I notes	(327)	
		(43)
Net increase in interest expense		$ 26

Adjustment to loss on extinguishment of debt represents the elimination of the write-off of deferred financing fees and third party costs related to the Charter Operating refinancing in April 2004.

(c) Loss per common share, basic and diluted assumes none of the membership units of Charter Holdco are exchanged for Charter common stock and none of the outstanding options to purchase membership units of Charter Holdco that are automatically exchanged for Charter common stock are exercised. Basic loss per share equals loss before cumulative effect of accounting change less dividends on preferred stock-redeemable divided by weighted average shares outstanding. If the membership units were exchanged or options exercised, the effects would be antidilutive. Therefore, basic and diluted loss per common share is the same. Although the shares offered by this prospectus will be considered issued and outstanding, we do not expect they will impact our earnings per share under current accounting literature. See Share Lending Agreement for further discussion related to the accounting of the share lending agreement.

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CHARTER COMMUNICATIONS, INC.

UNAUDITED PRO FORMA CONSOLIDATED STATEMENT OF OPERATIONS

For the Year Ended December 31, 2004

	Historical	Asset Dispositions(a)	Financing Transactions(b)	Pro Forma
	(Dollars in millions, except per share and share amounts)			
Revenues				
Video	$ 3,373	$ (21)	$	$ 3,352
High-speed Internet	741	(3)		738
Advertising sales	289	(1)		288
Commercial	238	(2)		236
Other	336	(2)		334
Total	4,977	(29)		4,948
Costs and Expenses				
Operating (excluding depreciation and amortization)	2,080	(12)		2,068
Selling, general and administrative	971	(4)		967
Depreciation and amortization	1,495	(6)		1,489
Impairment of franchises	2,433			2,433
(Gain) loss on sale of assets, net	(86)	106		20
Option compensation expense, net	31			31
Special charges, net	104			104
Unfavorable contracts and other settlements	(5)			(5)
	7,023	84		7,107
Loss from operations	(2,046)	(113)		(2,159)
Interest expense, net	(1,670)	4	(13)	(1,679)
Gain on derivative instruments and hedging activities, net	69			69
Loss on debt to equity conversions	(23)			(23)
Loss on extinguishment of debt	(31)		31	
Other, net	3			3
	(1,652)	4	18	(1,630)
Loss before minority interest, income taxes, and cumulative effect of accounting change	(3,698)	(109)	18	(3,789)
Minority interest	19			19
Loss before income taxes and cumulative effect of accounting change	(3,679)	(109)	18	(3,770)
Income tax benefit	103	15		118
Loss before cumulative effect of accounting change	$ (3,576)	$ (94)	$ 18	$ (3,652)
Loss per common share, basic and diluted	$ (11.92)			$ (12.16)
	300,291,877			300,291,877

Weighted average common shares outstanding, basic and diluted(c)		

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(a) Represents the elimination of operating results related to the disposition of certain assets in March and April 2004 and a reduction of interest expense related to the use of the net proceeds from such sales to repay a portion of our subsidiaries credit facilities.

(b) Represents adjustment to interest expense associated with the completion of the financing transactions discussed in pro forma assumptions two through eight (in millions):

Interest on the Charter Operating senior second lien notes issued in April 2004 and the amended and restated Charter Operating credit facilities	$ 114	
Amortization of deferred financing costs	8	
Less Historical interest expense for Charter Operating credit facilities and on subsidiary credit facilities repaid	(83)	
		39
Interest on $863 million of 5.875% convertible senior notes issued in November 2004	45	
Amortization of deferred financing costs	4	
Less Interest from $144 million of securities pledged for interest payments on convertible notes	(2)	
Historical interest expense on $588 million of 5.75% convertible senior notes retired with proceeds	(37)	
		10
Interest on $550 million of CCO Holdings senior floating rate notes issued in December 2004	35	
Amortization of deferred financing costs	2	
Less Historical interest expense for Charter Operating s revolving credit facility repaid with cash on hand in February 2005	(30)	
Historical interest expense for the CC V Holdings, LLC 11.875% senior discount notes repaid with cash on hand in March 2005	(13)	
		(6)
Interest on $300 million of CCO Holdings 8 3/4% senior notes issued in August 2005		27
Interest on new CCH I notes issued in September 2005 in exchange for CCH notes	372	
Amortization of deferred financing costs	6	
Less Historical interest expense on CCH notes exchanged for CCH I notes	(435)	
		(57)
Net increase in interest expense		$ 13

Adjustment to loss on extinguishment of debt represents the elimination of the write-off of deferred financing fees and third party costs related to the Charter Operating refinancing in April 2004 and the elimination of the premium paid to retire the 5.75% convertible senior notes and the write-off of the related deferred financing fees.

(c) Loss per common share, basic and diluted assumes none of the membership units of Charter Holdco are exchanged for Charter common stock and none of the outstanding options to purchase membership units of Charter Holdco that are automatically exchanged for Charter common stock are exercised. Basic loss per share equals loss before cumulative effect of accounting change less dividends on preferred stock-redeemable divided by weighted average shares outstanding. If the membership units were exchanged or options exercised, the effects would be antidilutive. Therefore, basic and diluted loss per common share is the same. Although the shares offered by this prospectus will be considered issued and outstanding, we do not expect they will impact our earnings per share under current accounting literature. See Share Lending Agreement for further discussion related to the accounting of the share lending agreement.

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CHARTER COMMUNICATIONS, INC.

UNAUDITED PRO FORMA CONSOLIDATED STATEMENT OF OPERATIONS

For the Nine Months Ended September 30, 2005

	Historical	Financing Transactions(a)	Pro Forma
	(Dollars in millions, except per share and share amounts)		
Revenues			
Video	$ 2,551	$	$ 2,551
High-speed Internet	671		671
Advertising sales	214		214
Commercial	205		205
Other	271		271
Total revenues	3,912		3,912
Costs and Expenses			
Operating (excluding depreciation and amortization)	1,714		1,714
Selling, general and administrative	762		762
Depreciation and amortization	1,134		1,134
Asset impairment charges	39		39
Loss on sale of assets, net	5		5
Option compensation expense, net	11		11
Hurricane asset retirement loss	19		19
Special charges, net	4		4
	3,688		3,688
Income from operations	224		224
Interest expense, net	(1,333)	32	(1,301)
Gain on derivative instruments and hedging activities, net	43		43
Gain on extinguishment of debt	498	(485)	13
Other, net	21		21
	(771)	(453)	(1,224)
Loss before minority interest and income taxes	(547)	(453)	(1,000)
Minority interest	(9)		(9)
Loss before income taxes	(556)	(453)	(1,009)
Income tax expense	(75)		(75)
Loss before cumulative effect of accounting change	$ (631)	$ (453)	$ (1,084)
Loss per common share, basic and diluted	$ (2.06)		$ (3.53)
Weighted average common shares outstanding, basic and diluted(b)	307,761,930		307,761,930

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(a) Represents adjustment to interest expense associated with the completion of the financing transactions discussed in pro forma assumptions five through eight (in millions):

Less Historical interest expense for Charter Operating s revolving credit facility repaid with cash on hand in February 2005	$ (3)	
Historical interest expense for the CC V Holdings, LLC 11.875% senior discount notes repaid with cash on hand in March 2005	(3)	
		(6)
Interest on $300 million of CCO Holdings 8 3/4% senior notes issued in August 2005		17
Interest on new CCH I notes issued in September 2005 in exchange for CCH notes	279	
Amortization of deferred financing costs	5	
Less Historical interest expense on CCH notes exchanged for CCH I notes	(327)	
		(43)
Net decrease in interest expense		$ (32)

Adjustment to loss on extinguishment of debt represents the elimination of losses related to the redemption of CC V Holdings, LLC 11.875% notes due 2008 of $5 million and the elimination of the gain related to the exchange of Charter Holdings notes for CIH and CCH I notes of $490 million.

(b) Loss per common share, basic and diluted assumes none of the membership units of Charter Holdco are exchanged for Charter common stock and none of the outstanding options to purchase membership units of Charter Holdco that are automatically exchanged for Charter common stock are exercised. Basic loss per share equals loss before cumulative effect of accounting change less dividends on preferred stock-redeemable divided by weighted average shares outstanding. If the membership units were exchanged or options exercised, the effects would be antidilutive. Therefore, basic and diluted loss per common share is the same. Although the shares offered by this prospectus will be considered issued and outstanding, we do not expect they will impact our earnings per share under current accounting literature. See Share Lending Agreement for further discussion related to the accounting of the share lending agreement.

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SELECTED HISTORICAL CONSOLIDATED FINANCIAL DATA

The following table presents summary financial and other data for Charter and its subsidiaries, and has been derived from (i) the audited consolidated financial statements of Charter and its subsidiaries for the five years ended December 31, 2004 and (ii) the unaudited consolidated financial statements of Charter and its subsidiaries for the nine months ended September 30, 2004 and 2005. The consolidated financial statements of Charter and its subsidiaries for each of the years ended December 31, 2000 to 2004 have been audited by KPMG LLP, an independent registered public accounting firm. The following information should be read in conjunction with Management s Discussion and Analysis of Financial Condition and Results of Operations and the historical consolidated financial statements and related notes included elsewhere in this prospectus.

	Year Ended December 31,					Nine Months Ended September 30,	
	2000	2001	2002	2003	2004	2004	2005
	(Dollars in millions, except share and per share amounts)						
Statement of Operations Data:							
Revenues	$ 3,141	$ 3,807	$ 4,566	$ 4,819	$ 4,977	$ 3,701	$ 3,912
Costs and Expenses:							
Operating (excluding depreciation and amortization)	1,187	1,486	1,807	1,952	2,080	1,552	1,714
Selling, general and administrative	606	826	963	940	971	735	762
Depreciation and amortization	2,398	2,683	1,436	1,453	1,495	1,105	1,134
Impairment of franchises			4,638		2,433	2,433	
Asset impairment charges							39
(Gain) loss on sale of assets, net		10	3	5	(86)	(104)	5
Option compensation expense (income), net	38	(5)	5	4	31	34	11
Hurricane asset retirement loss							19
Special charges, net		18	36	21	104	100	4
Unfavorable contracts and other settlements				(72)	(5)		
	4,229	5,018	8,888	4,303	7,023	5,855	3,688
Income (loss) from operations	(1,088)	(1,211)	(4,322)	516	(2,046)	(2,154)	224
Interest expense, net	(1,040)	(1,310)	(1,503)	(1,557)	(1,670)	(1,227)	(1,333)
Gain (loss) on derivative instruments and hedging activities, net		(50)	(115)	65	69	48	43
Loss on debt to equity conversions					(23)	(23)	
Gain (loss) on extinguishment of debt				267	(31)	(21)	498
Other, net	(20)	(59)	(4)	(16)	3		21
Loss before minority interest, income taxes and cumulative effect of accounting change	(2,148)	(2,630)	(5,944)	(725)	(3,698)	(3,377)	(547)
Minority interest(a)	1,280	1,461	3,176	377	19	24	(9)
Loss before income taxes and cumulative effect of accounting change	(868)	(1,169)	(2,768)	(348)	(3,679)	(3,353)	(556)
Income tax benefit (expense)	10	12	460	110	103	116	(75)
Loss before cumulative effect of accounting change	(858)	(1,157)	(2,308)	(238)	(3,576)	(3,237)	(631)
		(10)	(206)		(765)	(765)	

Cumulative effect of accounting change, net of tax							
Net loss	(858)	(1,167)	(2,514)	(238)	(4,341)	(4,002)	(631)
Dividends on preferred stock redeemable		(1)	(3)	(4)	(4)	(3)	(3)
Net loss applicable to common stock	$ (858)	$ (1,168)	$ (2,517)	$ (242)	$ (4,345)	$ (4,005)	$ (634)
Loss per common share, basic and diluted	$ (3.80)	$ (4.33)	$ (8.55)	$ (0.82)	$ (14.47)	$ (13.38)	$ (2.06)

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	Year Ended December 31,					Nine Months Ended September 30,	
	2000	2001	2002	2003	2004	2004	2005
	(Dollars in millions, except share and per share amounts)						
Weighted-average common shares outstanding, basic and diluted	225,697,775	269,594,386	294,440,261	294,597,519	300,291,877	299,411,053	307,761,930
Other Data:							
Deficiencies of earnings to cover fixed charges(b)	$ 2,148	$ 2,630	$ 5,944	$ 725	$ 3,698	$ 3,377	$ 547
Balance Sheet Data (end of period):							
Total assets	$ 24,352	$ 26,463	$ 22,384	$ 21,364	$ 17,673	$ 17,084	$ 16,524
Long-term debt	13,061	16,343	18,671	18,647	19,464	18,484	19,120
Minority interest(a)	4,571	4,434	1,050	689	648	637	665
Redeemable securities	1,104						
Preferred stock redeemable		51	51	55	55	55	55
Shareholders equity (deficit)	2,767	2,585	41	(175)	(4,406)	(4,082)	(5,006)

(a) Minority interest represents the percentage of Charter Holdco not owned by Charter, plus preferred membership interests in CC VIII. Reported losses allocated to minority interest on the statement of operations are limited to the extent of any remaining minority interest on the balance sheet related to Charter Holdco. Because minority interest in Charter Holdco was substantially eliminated at December 31, 2003, beginning in 2004, Charter began to absorb substantially all losses before income taxes that otherwise would have been allocated to minority interest. As a result of negative equity at Charter Holdco, during the year ended December 31, 2004 and the nine months ended September 30, 2005, no additional losses were allocated to minority interest, resulting in an approximate additional $2.4 billion and $301 million of net losses, respectively. Under our existing capital structure, Charter will absorb all future losses. Paul G. Allen indirectly held the preferred membership units in CC VIII, as a result of the exercise of a put right originally granted in connection with the Bresnan transaction in 2000. There was an issue regarding the ultimate ownership of the CC VIII membership interest following the consummation of the Bresnan put transaction on June 6, 2003. Effective January 1, 2005, Charter ceased recognizing minority interest in earnings and losses of CC VIII for financial reporting purposes until such time as the resolution of the issue was determinable or other events occured. This dispute was settled October 31, 2005. We are currently determining the accounting impact of the settlement. Subsequent to recording the impact of the settlement in the fourth quarter of 2005, approximately 6% of CC VIII s income will be allocated to minority interest. See Certain Relationships and Related Transactions Transactions Arising Out of Our Organizational Structure and Mr. Allen s Investment in Charter and Its Subsidiaries Equity Put Rights CC VIII.

(b) Earnings include net loss plus fixed charges. Fixed charges consist of interest expense and an estimated interest component of rent expense.

SUPPLEMENTARY QUARTERLY FINANCIAL DATA

The following tables present quarterly financial data for the periods presented on the consolidated statements of operations (Dollars in millions, except share and per share amounts):

	Three Months Ended March 31, 2005	Three Months Ended June 30, 2005	Three Months Ended September 30, 2005
Revenues	$ 1,271	$ 1,323	$ 1,318
Income from operations	51	110	63
Income (loss) before minority interest and income taxes	(334)	(321)	108
Net income (loss) applicable to common stock	(353)	(356)	75
Basic income (loss) per common share	(1.16)	(1.18)	0.24
Diluted income (loss) per common share	(1.16)	(1.18)	0.09
Weighted-average shares outstanding, basic	303,308,880	303,620,347	316,214,740
Weighted-average shares outstanding, diluted	303,308,880	303,620,347	1,012,591,842

	Year Ended December 31, 2004			
	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
Revenues	$ 1,214	$ 1,239	$ 1,248	$ 1,276
Income (loss) from operations	175	15	(2,344)	108
Loss before minority interest, income taxes and cumulative effect of accounting change	(235)	(366)	(2,776)	(321)
Net loss applicable to common stock	(294)	(416)	(3,295)	(340)
Basic and diluted loss per common share before cumulative effect of accounting change	(1.00)	(1.39)	(8.36)	(1.12)
Basic and diluted loss per common share	(1.00)	(1.39)	(10.89)	(1.12)
Weighted-average shares outstanding	295,106,077	300,522,815	302,604,978	302,934,348

	Year Ended December 31, 2003			
	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
Revenues	$ 1,178	$ 1,217	$ 1,207	$ 1,217
Income from operations	77	112	117	210
Income (loss) before minority interest and income taxes	(301)	(286)	23	(161)
Net income (loss) applicable to common stock	(182)	(38)	36	(58)
Basic income (loss) per common share	(0.62)	(0.13)	0.12	(0.20)
Diluted income (loss) per common share	(0.62)	(0.13)	0.07	(0.20)
Weighted-average shares outstanding, basic	294,466,137	294,474,596	294,566,878	294,875,504
Weighted-average shares outstanding, diluted	294,466,137	294,474,596	637,822,843	294,875,504

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MANAGEMENT S DISCUSSION AND ANALYSIS

OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Reference is made to Disclosure Regarding Forward-Looking Statements, which describes important factors that could cause actual results to differ from expectations and non-historical information contained herein. In addition, the following discussion should be read in conjunction with the audited consolidated financial statements of Charter Communications, Inc. and subsidiaries as of and for the years ended December 31, 2004, 2003 and 2002 and the unaudited consolidated financial statements of Charter Communications, Inc. and subsidiaries as of and for the nine months ended September 30, 2005.

Introduction

In 2004 and 2005, we completed several transactions that improved our liquidity. Our efforts in this regard resulted in the completion of a number of transactions in 2004 and 2005, as follows:

- the October 2005 entry by CCO Holdings and CCO Holdings Capital Corp., as guarantor thereunder, into a $600 million senior bridge loan agreement with various lenders;
- the September 2005 exchange by Charter Holdings, CCH I and CIH of approximately $6.8 billion in total principal amount of outstanding debt securities of Charter Holdings in a private placement for new debt securities;
- the August 2005 sale by our subsidiaries, CCO Holdings and CCO Holdings Capital Corp., of $300 million of 8 3/4% senior notes due 2013;
- the March and June 2005 issuance of $333 million of Charter Operating notes in exchange for $346 million of Charter Holdings notes;
- the March and June 2005 repurchase of $131 million of our 4.75% convertible senior notes due 2006 leaving $25 million in principal amount outstanding;
- the March 2005 redemption of all of CC V Holdings, LLC s outstanding 11.875% senior discount notes due 2008 at a total cost of $122 million;
- the December 2004 sale by our subsidiaries, CCO Holdings and CCO Holdings Capital Corp., of $550 million of senior floating rate notes due 2010;
- the November 2004 sale of $862.5 million of 5.875% convertible senior notes due 2009 and the December 2004 redemption of all of our outstanding 5.75% convertible senior notes due 2005 ($588 million principal amount);
- the April 2004 sale of $1.5 billion of senior second-lien notes by our subsidiary, Charter Operating, together with the concurrent refinancing of its credit facilities; and
- the sale in the first half of 2004 of non-core cable systems for a total of $735 million, the proceeds of which were used to reduce indebtedness.

During the years 1999 through 2001, we grew significantly, principally through acquisitions of other cable businesses financed by debt and, to a lesser extent, equity. We have no current plans to pursue any significant acquisitions. However, we may pursue exchanges of non-strategic assets or divestitures, such as the sale of cable systems to Atlantic Broadband Finance, LLC discussed under Liquidity and Capital Resources Sale of Assets, below. We therefore do not believe that our historical growth rates are accurate indicators of future growth.

The industry s and our most significant operational challenges include competition from DBS providers and DSL service providers. See Business Competition. We believe that competition from DBS has resulted in net analog video customer losses and decreased growth rates for digital video customers. Competition from DSL providers combined with limited opportunities to expand our customer base now that approximately 32% of our analog video customers subscribe to our high-speed Internet services has resulted in decreased growth rates for high-speed Internet customers. In the recent past, we have grown revenues by offsetting video customer losses with price increases and sales of incremental advanced services such as high-speed Internet, video on demand, digital video recorders and high definition television. We expect to

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continue to grow revenues through continued growth in high-speed Internet and incremental new services including telephone, high definition television, VOD and DVR service.

Historically, our ability to fund operations and investing activities has depended on our continued access to credit under our credit facilities. We expect we will continue to borrow under our credit facilities from time to time to fund cash needs. The occurrence of an event of default under our credit facilities could result in borrowings from these facilities being unavailable to us and could, in the event of a payment default or acceleration, trigger events of default under the indentures governing our outstanding notes and would have a material adverse effect on us. Approximately $30 million of indebtedness under our credit facilities is scheduled to mature during 2006. We expect to fund payment of such indebtedness through borrowings under our revolving credit facility. See Liquidity and Capital Resources.

Acquisitions

The following table sets forth information regarding our significant acquisitions from January 1, 2000 to December 31, 2002 (none in 2003, 2004 or 2005):

		Purchase Price				
	Acquisition Date	**Cash Paid**	**Assumed Debt**	**Securities Issued/Other Consideration**	**Total Price**	**Acquired Customers (approx)**
		(Dollars in millions)				
Interlake	1/00	$ 13	$	$	$ 13	6,000
Bresnan	2/00	1,100	963	1,014(a)	3,077	695,800
Capital Cable	4/00	60			60	23,200
Farmington	4/00	15			15	5,700
Kalamazoo	9/00			171(b)	171	50,700
Total 2000 Acquisitions		$1,188	$963	$1,185	$3,336	781,400
AT&T Systems	6/01	$1,711	$	$ 25	$1,736(c)	551,100
Cable USA	8/01	45		55(d)	100	30,600
Total 2001 Acquisitions		$1,756	$	$ 80	$1,836	581,700
High Speed Access Corp.	2/02	78			78	N/A
Enstar Limited Partnership Systems	4/02	48			48	21,600
Enstar Income Program II-1, L.P.	9/02	15			15	6,400
Total 2002 Acquisitions		$ 141	$	$	$ 141	28,000
Total 2000-2002 Acquisitions		$3,085	$963	$1,265	$5,313	1,391,100

(a) Comprised of $385 million in equity in Charter Holdco and $629 million of equity in CC VIII.

(b) In connection with this transaction, we acquired all of the outstanding stock of Cablevision of Michigan in exchange for 11,173,376 shares of Charter Class A common stock.

(c) Comprised of approximately $1.7 billion, as adjusted, in cash and a cable system located in Florida valued at approximately $25 million, as adjusted.

(d) In connection with this transaction, at the closing we and Charter Holdco acquired all of the outstanding stock of Cable USA and the assets of related affiliates in exchange for cash and 505,664 shares of Charter Series A convertible redeemable preferred stock. In the first quarter of 2003, an additional $0.34 million in cash was paid and 39,595 additional shares of Charter Series A convertible redeemable preferred stock were issued to certain sellers.

All acquisitions were accounted for under the purchase method of accounting and results of operations were included in our consolidated financial statements from their respective dates of acquisition.

We have no current plans to pursue any significant acquisitions. However, we will continue to evaluate opportunities to consolidate our operations through the sale of cable systems to, or exchange of like-kind assets with, other cable operators as such opportunities arise, and on a very limited basis, consider strategic new acquisitions. Our primary criteria in considering these opportunities are the rationalization of our operations into geographic clusters and the potential financial benefits we expect to ultimately realize as a result of the sale, exchange, or acquisition.

Overview of Operations

Approximately 86% of our revenues for both the nine months ended September 30, 2005 and for the year ended December 31, 2004, respectively, are attributable to monthly subscription fees charged to customers for our video, high-speed Internet, telephone and commercial services provided by our cable systems. Generally, these customer subscriptions may be discontinued by the customer at any time. The remaining 14% of revenue is derived primarily from advertising revenues, franchise fee revenues, which are collected by us but then paid to local franchising authorities, pay-per-view and VOD programming where users are charged a fee for individual programs viewed, installation or reconnection fees charged to customers to commence or reinstate service, and commissions related to the sale of merchandise by home shopping services. We have increased revenues during the past three years, primarily through the sale of digital video and high-speed Internet services to new and existing customers and price increases on video services offset in part by dispositions of systems. Going forward, our goal is to increase revenues by stabilizing our analog video customer base, implementing price increases on certain services and packages and increasing the number of our customers who purchase high-speed Internet services, digital video and new products and services such as telephone, VOD, high definition television and DVR service. To accomplish this, we are increasing prices for certain services and we are offering new bundling of services combining digital video and our advanced services (such as high-speed Internet service and high definition television) at what we believe are attractive price points. See Business Sales and Marketing for more details.

Our success in our efforts to grow revenues and improve margins will be impacted by our ability to compete against companies with often fewer regulatory burdens, easier access to financing, greater personnel resources, greater brand name recognition and long-established relationships with regulatory authorities and customers. Additionally, controlling our cost of operations is critical, particularly cable programming costs, which have historically increased at rates in excess of inflation and are expected to continue to increase. See Business Programming for more details. We are attempting to control our costs of operations by maintaining strict controls on expenses. More specifically, we are focused on managing our cost structure by renegotiating programming agreements to reduce the rate of historical increases in programming cost, managing our workforce to control increases and improve productivity, and leveraging our size in purchasing activities.

Our expenses primarily consist of operating costs, selling, general and administrative expenses, depreciation and amortization expense and interest expense. Operating costs primarily include programming costs, the cost of our workforce, cable service related expenses, advertising sales costs, franchise fees and expenses related to customer billings. For the nine months ended September 30, 2005, our income from operations, which includes depreciation and amortization expense and asset impairment charges but excludes interest expense, was $224 million. For the nine months ended September 30, 2004, our loss from operations was $2.2 billion. We had a positive operating margin (defined as income (loss) from operations divided by revenues) of 6% for the nine months ended September 30, 2005, and a negative operating margin of 58% for the nine months ended September 30, 2004. The increase in income from operations and operating margin for the nine months ended September 30, 2005 compared to 2004 was principally due to impairment of franchises of $2.4 billion recorded in 2004 which did not recur in 2005. For the years ended December 31, 2004 and 2002, loss from operations was $2.0 billion and $4.3 billion, respectively. For the year ended December 31, 2003, income from operations was $516 million. Operating margin was

11% for the year ended December 31, 2003, whereas for the years ending December 31, 2004 and 2002, we had negative operating margin of 41% and 95%, respectively. The improvement in income from operations and operating margin from 2002 to 2003 was principally due to a $4.6 billion franchise impairment charge in the fourth quarter of 2002 which did not recur in 2003 and the recognition of gains in 2003 of $93 million related to unfavorable contracts and other settlements and gain on sale of systems. Although we do not expect charges for impairment in the future of comparable magnitude, potential charges could occur due to changes in market conditions.

We have a history of net losses. Further, we expect to continue to report net losses for the foreseeable future. Our net losses are principally attributable to insufficient revenue to cover the interest costs on our high level of debt, the depreciation expenses that we incur resulting from the capital investments we have made in our cable properties and the amortization and impairment of our franchise intangibles. We expect that these expenses (other than impairment of franchises) will remain significant, and we therefore expect to continue to report net losses for the foreseeable future. Additionally, because minority interest in Charter Holdco was substantially eliminated at December 31, 2003, beginning in the first quarter of 2004, we began to absorb substantially all future losses before income taxes that otherwise would have been allocated to minority interest. This resulted in an additional $2.4 billion of net loss for the year ended December 31, 2004. Under our existing capital structure, future losses will continue to be absorbed by Charter. Effective January 1, 2005, we ceased recognizing minority interest in earnings or losses of CC VIII for financial reporting purposes until the dispute between Charter and Mr. Allen regarding the preferred membership interests in CC VIII was determinable or other events occurred. This dispute was settled October 31, 2005. We are currently determining the accounting impact of the settlement. Subsequent to recording the impact of the settlement in the fourth quarter of 2005, approximately 6% of CC VIII s income will be allocated to minority interest. See Note 7 to condensed consolidated financial statements.

Critical Accounting Policies and Estimates

Certain of our accounting policies require our management to make difficult, subjective or complex judgments. Management has discussed these policies with the Audit Committee of Charter s board of directors and the Audit Committee has reviewed the following disclosure. We consider the following policies to be the most critical in understanding the estimates, assumptions and judgments that are involved in preparing our financial statements and the uncertainties that could affect our results of operations, financial condition and cash flows:

- Capitalization of labor and overhead costs;
- Useful lives of property, plant and equipment;
- Impairment of property, plant, and equipment, franchises, and goodwill;
- Income taxes; and
- Litigation.

In addition, there are other items within our financial statements that require estimates or judgment but are not deemed critical, such as the allowance for doubtful accounts, but changes in judgment, or estimates in these other items could also have a material impact on our financial statements.

Capitalization of labor and overhead costs. The cable industry is capital intensive, and a large portion of our resources are spent on capital activities associated with extending, rebuilding, and upgrading our cable network. As of September 30, 2005 and December 31, 2004 and 2003, the net carrying amount of our property, plant and equipment (consisting primarily of cable network assets) was approximately $5.9 billion (representing 36% of total assets), $6.3 billion (representing 36% of total assets) and $7.0 billion (representing 33% of total assets), respectively. Total capital expenditures for the nine months ended September 30, 2005 and the years ended December 31, 2004, 2003 and 2002 were approximately $815 million, $924 million, $854 million and $2.2 billion, respectively.

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Costs associated with network construction, initial customer installations, installation refurbishments and the addition of network equipment necessary to provide advanced services are capitalized. Costs capitalized as part of initial customer installations include materials, direct labor, and certain indirect costs. These indirect costs are associated with the activities of personnel who assist in connecting and activating the new service and consist of compensation and overhead costs associated with these support functions. The costs of disconnecting service at a customer s dwelling or reconnecting service to a previously installed dwelling are charged to operating expense in the period incurred. Costs for repairs and maintenance are charged to operating expense as incurred, while equipment replacement and betterments, including replacement of cable drops from the pole to the dwelling, are capitalized.

We make judgments regarding the installation and construction activities to be capitalized. We capitalize direct labor and certain indirect costs (overhead) using standards developed from actual costs and applicable operational data. We calculate standards for items such as the labor rates, overhead rates and the actual amount of time required to perform a capitalizable activity. For example, the standard amounts of time required to perform capitalizable activities are based on studies of the time required to perform such activities. Overhead rates are established based on an analysis of the nature of costs incurred in support of capitalizable activities and a determination of the portion of costs that is directly attributable to capitalizable activities. The impact of changes that resulted from these studies were not significant in the periods presented.

Labor costs directly associated with capital projects are capitalized. We capitalize direct labor costs associated with personnel based upon the specific time devoted to network construction and customer installation activities. Capitalizable activities performed in connection with customer installations include such activities as:

Scheduling a truck roll to the customer s dwelling for service connection;

Verification of serviceability to the customer s dwelling (i.e., determining whether the customer s dwelling is capable of receiving service by our cable network and/or receiving advanced or Internet services);

Customer premise activities performed by in-house field technicians and third-party contractors in connection with customer installations, installation of network equipment in connection with the installation of expanded services and equipment replacement and betterment; and

Verifying the integrity of the customer s network connection by initiating test signals downstream from the headend to the customer s digital set-top terminal.

Judgment is required to determine the extent to which overhead is incurred as a result of specific capital activities, and therefore should be capitalized. The primary costs that are included in the determination of the overhead rate are (i) employee benefits and payroll taxes associated with capitalized direct labor, (ii) direct variable costs associated with capitalizable activities, consisting primarily of installation and construction vehicle costs, (iii) the cost of support personnel, such as dispatch, that directly assist with capitalizable installation activities, and (iv) indirect costs directly attributable to capitalizable activities.

While we believe our existing capitalization policies are appropriate, a significant change in the nature or extent of our system activities could affect management s judgment about the extent to which we should capitalize direct labor or overhead in the future. We monitor the appropriateness of our capitalization policies, and perform updates to our internal studies on an ongoing basis to determine whether facts or circumstances warrant a change to our capitalization policies. We capitalized direct labor and overhead of $139 million, $164 million, $174 million and $335 million for the nine months ended September 30, 2005 and the years ended December 31, 2004, 2003 and 2002, respectively. Capitalized internal direct labor and overhead costs have increased in 2005 as a result of the use of more internal labor for capitalizable installations rather than third-party contractors. Capitalized internal direct labor and overhead costs significantly decreased in 2004 and 2003 compared to 2002 primarily due to the substantial completion of the upgrade of our systems and a decrease in the amount of capitalizable installation costs.

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Useful lives of property, plant and equipment. We evaluate the appropriateness of estimated useful lives assigned to our property, plant and equipment, based on annual studies of such useful lives, and revise such lives to the extent warranted by changing facts and circumstances. Any changes in estimated useful lives as a result of these studies, which were not significant in the periods presented, will be reflected prospectively beginning in the period in which the study is completed. The effect of a one-year decrease in the weighted average remaining useful life of our property, plant and equipment would be an increase in depreciation expense for the year ended December 31, 2004 of approximately $296 million. The effect of a one-year increase in the weighted average useful life of our property, plant and equipment would be a decrease in depreciation expense for the year ended December 31, 2004 of approximately $198 million.

Depreciation expense related to property, plant and equipment totaled $1.1 billion, $1.5 billion, $1.5 billion and $1.4 billion, representing approximately 31%, 21%, 34% and 16% of costs and expenses, for the nine months ended September 30, 2005 and for the years ended December 31, 2004, 2003 and 2002, respectively. Depreciation is recorded using the straight-line composite method over management s estimate of the estimated useful lives of the related assets as listed below:

Cable distribution systems	7-20 years
Customer equipment and installations	3-5 years
Vehicles and equipment	1-5 years
Buildings and leasehold improvements	5-15 years
Furniture and fixtures	5 years

Impairment of property, plant and equipment, franchises and goodwill. As discussed above, the net carrying value of our property, plant and equipment is significant. We also have recorded a significant amount of cost related to franchises, pursuant to which we are granted the right to operate our cable distribution network throughout our service areas. The net carrying value of franchises as of September 30, 2005, December 31, 2004 and 2003 was approximately $9.8 billion (representing 59% of total assets), $9.9 billion (representing 56% of total assets) and $13.7 billion (representing 64% of total assets), respectively. Furthermore, our noncurrent assets included approximately $52 million of goodwill.

We adopted SFAS No. 142 on January 1, 2002. SFAS No. 142 requires that franchise intangible assets that meet specified indefinite-life criteria no longer be amortized against earnings, but instead must be tested for impairment annually based on valuations, or more frequently as warranted by events or changes in circumstances. In determining whether our franchises have an indefinite-life, we considered the exclusivity of the franchise, the expected costs of franchise renewals, and the technological state of the associated cable systems with a view to whether or not we are in compliance with any technology upgrading requirements. We have concluded that as of September 30, 2005, December 31, 2004, 2003 and 2002 more than 99% of our franchises qualify for indefinite-life treatment under SFAS No. 142, and that less than one percent of our franchises do not qualify for indefinite-life treatment due to technological or operational factors that limit their lives. Costs of finite-lived franchises, along with costs associated with franchise renewals, are amortized on a straight-line basis over 10 years, which represents management s best estimate of the average remaining useful lives of such franchises. Franchise amortization expense was $3 million and $4 million for the nine months ended September 30, 2005 and for the year ended December 31, 2004, respectively, and $9 million for each of the years ended December 31, 2003 and 2002. We expect that amortization expense on franchise assets will be approximately $3 million annually for each of the next five years. Actual amortization expense in future periods could differ from these estimates as a result of new intangible asset acquisitions or divestitures, changes in useful lives and other relevant factors. Our goodwill is also deemed to have an indefinite life under SFAS No. 142.

SFAS No. 144, *Accounting for Impairment or Disposal of Long-Lived Assets*, requires that we evaluate the recoverability of our property, plant and equipment and franchise assets which did not qualify for indefinite-life treatment under SFAS No. 142 upon the occurrence of events or changes in circumstances which indicate that the carrying amount of an asset may not be recoverable. Such events or changes in circumstances could include such factors as the impairment of our indefinite life franchises under SFAS No. 142, changes in technological advances, fluctuations in the fair value of such assets, adverse changes in relationships with local franchise authorities, adverse changes in market conditions or poor operating results. Under SFAS No. 144, a long-lived asset is deemed impaired when the carrying amount of the asset exceeds the projected undiscounted future cash flows associated with the asset. During the nine months ended September 30, 2005, certain cable systems to be sold met the criteria for assets held for sale. As such, the assets were written down to fair value less estimated costs to sell resulting in asset impairment charges during the nine months ended September 30, 2005 of approximately $39 million. No impairments of long-lived assets were recorded in the years ended December 31, 2004, 2003 or 2002. We were also required to evaluate the recoverability of our indefinite-life franchises, as well as goodwill, as of January 1, 2002 upon adoption of SFAS No. 142, and on an annual basis or more frequently as deemed necessary.

Under both SFAS No. 144 and SFAS No. 142, if an asset is determined to be impaired, it is required to be written down to its estimated fair market value. We determine fair market value based on estimated discounted future cash flows, using reasonable and appropriate assumptions that are consistent with internal forecasts. Our assumptions include these and other factors: penetration rates for analog and digital video and high-speed Internet, revenue growth rates, expected operating margins and capital expenditures. Considerable management judgment is necessary to estimate future cash flows, and such estimates include inherent uncertainties, including those relating to the timing and amount of future cash flows and the discount rate used in the calculation.

Based on the guidance prescribed in Emerging Issues Task Force (EITF) Issue No. 02-7, *Unit of Accounting for Testing of Impairment of Indefinite-Lived Intangible Assets*, franchises were aggregated into essentially inseparable asset groups to conduct the valuations. The asset groups generally represent geographic clustering of our cable systems into groups by which such systems are managed. Management believes such groupings represent the highest and best use of those assets. We determined that our franchises were impaired upon adoption of SFAS No. 142 on January 1, 2002 and as a result recorded the cumulative effect of a change in accounting principle of $206 million (approximately $572 million before minority interest effects of $306 million and tax effects of $60 million). As required by SFAS No. 142, the standard has not been retroactively applied to results for the period prior to adoption.

Our valuations, which are based on the present value of projected after tax cash flows, result in a value of property, plant and equipment, franchises, customer relationships and our total entity value. The value of goodwill is the difference between the total entity value and amounts assigned to the other assets. The use of different valuation assumptions or definitions of franchises or customer relationships, such as our inclusion of the value of selling additional services to our current customers within customer relationships versus franchises, could significantly impact our valuations and any resulting impairment.

Franchises, for valuation purposes, are defined as the future economic benefits of the right to solicit and service potential customers (customer marketing rights), and the right to deploy and market new services such as interactivity and telephone to the potential customers (service marketing rights). Fair value is determined based on estimated discounted future cash flows using assumptions consistent with internal forecasts. The franchise after-tax cash flow is calculated as the after-tax cash flow generated by the potential customers obtained and the new services added to those customers in future periods. The sum of the present value of the franchises after-tax cash flow in years 1 through 10 and the continuing value of the after-tax cash flow beyond year 10 yields the fair value of the franchise. Prior to the adoption of EITF Topic D-108, *Use of the Residual Method to Value Acquired Assets Other than Goodwill*, discussed below, we followed a residual method of valuing our franchise assets, which had the effect of including goodwill with the franchise assets.

We follow the guidance of EITF Issue 02-17, *Recognition of Customer Relationship Intangible Assets Acquired in a Business Combination*, in valuing customer relationships. Customer relationships, for valuation purposes, represent the value of the business relationship with our existing customers and are calculated by projecting future after-tax cash flows from these customers including the right to deploy and market additional services such as interactivity and telephone to these customers. The present value of these after-tax cash flows yields the fair value of the customer relationships. Substantially all our acquisitions occurred prior to January 1, 2002. We did not record any value associated with the customer relationship intangibles related to those acquisitions. For acquisitions subsequent to January 1, 2002, we did assign a value to the customer relationship intangible, which is amortized over its estimated useful life.

In September 2004, EITF Topic D-108, *Use of the Residual Method to Value Acquired Assets Other than Goodwill,* was issued, which requires the direct method of separately valuing all intangible assets and does not permit goodwill to be included in franchise assets. We performed an impairment assessment as of September 30, 2004, and adopted Topic D-108 in that assessment resulting in a total franchise impairment of approximately $3.3 billion. We recorded a cumulative effect of accounting change of $765 million (approximately $875 million before tax effects of $91 million and minority interest effects of $19 million) for the year ended December 31, 2004 representing the portion of our total franchise impairment attributable to no longer including goodwill with franchise assets. The effect of the adoption was to increase net loss and loss per share by $765 million and $2.55 for the year ended December 31, 2004. The remaining $2.4 billion of the total franchise impairment was attributable to the use of lower projected growth rates and the resulting revised estimates of future cash flows in our valuation and was recorded as impairment of franchises in our consolidated statements of operations for the year ended December 31, 2004. Sustained analog video customer losses by us and our industry peers in the third quarter of 2004 primarily as a result of increased competition from DBS providers and decreased growth rates in our and our industry peers high speed Internet customers in the third quarter of 2004, in part as a result of increased competition from DSL providers, led us to lower our projected growth rates and accordingly revise our estimates of future cash flows from those used at October 1, 2003. See Business Competition.

The valuation completed at October 1, 2003 showed franchise values in excess of book value and thus resulted in no impairment. Our annual impairment assessment as of October 1, 2002, based on revised estimates from January 1, 2002 of future cash flows and projected long-term growth rates in our valuation, led to the recognition of a $4.6 billion impairment charge in the fourth quarter of 2002.

The valuations used in our impairment assessments involve numerous assumptions as noted above. While economic conditions, applicable at the time of the valuation, indicate the combination of assumptions utilized in the valuations are reasonable, as market conditions change so will the assumptions with a resulting impact on the valuation and consequently the potential impairment charge.

The October 1, 2005 annual impairment test will be finalized in the fourth quarter of 2005 and any impairment resulting from such test will be recorded in the fourth quarter.

Sensitivity Analysis. The effect on the impairment charge recognized in the third quarter of 2004 of the indicated increase/decrease in the selected assumptions is shown below:

Assumption	**Percentage/ Percentage Point Change**	**Impairment Charge Increase/(Decrease)**
		(Dollars in millions)
Annual Operating Cash Flow(1)	+/- 5%	$ (890)/$921
Long-Term Growth Rate(2)	+/- 1 pts(3)	(1,579)/1,232
Discount Rate	+/- 0.5 pts(3)	1,336/(1,528)

(1) Operating Cash Flow is defined as revenues less operating expenses and selling general and administrative expenses.

(2) Long-Term Growth Rate is the rate of cash flow growth beyond year ten.

(3) A percentage point change of one point equates to 100 basis points.

Income Taxes. All operations are held through Charter Holdco and its direct and indirect subsidiaries. Charter Holdco and the majority of its subsidiaries are not subject to income tax. However, certain of these subsidiaries are corporations and are subject to income tax. All of the taxable income, gains, losses, deductions and credits of Charter Holdco are passed through to its members: Charter,

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Charter Investment, Inc. and Vulcan Cable III Inc. Charter is responsible for its share of taxable income or loss of Charter Holdco allocated to it in accordance with the Charter Holdco limited liability company agreement (LLC Agreement) and partnership tax rules and regulations.

The LLC Agreement provided for certain special allocations of net tax profits and net tax losses (such net tax profits and net tax losses being determined under the applicable federal income tax rules for determining capital accounts). Under the LLC Agreement, through the end of 2003, net tax losses of Charter Holdco that would otherwise have been allocated to Charter based generally on its percentage ownership of outstanding common units were allocated instead to membership units held by Vulcan Cable III Inc. and Charter Investment, Inc. (the Special Loss Allocations) to the extent of their respective capital account balances. After 2003, under the LLC Agreement, net tax losses of Charter Holdco are allocated to Charter, Vulcan Cable III Inc. and Charter Investment, Inc. based generally on their respective percentage ownership of outstanding common units to the extent of their respective capital account balances. The LLC Agreement further provides that, beginning at the time Charter Holdco generates net tax profits, the net tax profits that would otherwise have been allocated to Charter based generally on its percentage ownership of outstanding common membership units will instead generally be allocated to Vulcan Cable III Inc. and Charter Investment, Inc. (the Special Profit Allocations). The Special Profit Allocations to Vulcan Cable III Inc. and Charter Investment, Inc. will generally continue until the cumulative amount of the Special Profit Allocations offsets the cumulative amount of the Special Loss Allocations. The amount and timing of the Special Profit Allocations are subject to the potential application of, and interaction with, the Curative Allocation Provisions described in the following paragraph. The LLC Agreement generally provides that any additional net tax profits are to be allocated among the members of Charter Holdco based generally on their respective percentage ownership of Charter Holdco common membership units.

Because the respective capital account balance of each of Vulcan Cable III Inc. and Charter Investment, Inc. was reduced to zero by December 31, 2002, certain net tax losses of Charter Holdco that were to be allocated for 2002, 2003, 2004 and possibly later years, to Vulcan Cable III Inc. and Charter Investment, Inc. instead have been and will be allocated to Charter (the Regulatory Allocations). The LLC Agreement further provides that, to the extent possible, the effect of the Regulatory Allocations is to be offset over time pursuant to certain curative allocation provisions (the Curative Allocation Provisions) so that, after certain offsetting adjustments are made, each member s capital account balance is equal to the capital account balance such member would have had if the Regulatory Allocations had not been part of the LLC Agreement. The cumulative amount of the actual tax losses allocated to Charter as a result of the Regulatory Allocations through the year ended December 31, 2004 is approximately $4.0 billion.

As a result of the Special Loss Allocations and the Regulatory Allocations referred to above, the cumulative amount of losses of Charter Holdco allocated to Vulcan Cable III Inc. and Charter Investment, Inc. is in excess of the amount that would have been allocated to such entities if the losses of Charter Holdco had been allocated among its members in proportion to their respective percentage ownership of Charter Holdco common membership units. The cumulative amount of such excess losses was approximately $2.1 billion through December 31, 2003 and $1.0 billion through December 31, 2004.

In certain situations, the Special Loss Allocations, Special Profit Allocations, Regulatory Allocations and Curative Allocation Provisions described above could result in Charter paying taxes in an amount that is more or less than if Charter Holdco had allocated net tax profits and net tax losses among its members based generally on the number of common membership units owned by such members. This could occur due to differences in (i) the character of the allocated income (e.g., ordinary versus capital), (ii) the allocated amount and timing of tax depreciation and tax amortization expense due to the application of section 704(c) under the Internal Revenue Code, (iii) the potential interaction between the Special Profit Allocations and the Curative Allocation Provisions, (iv) the amount and timing of alternative minimum taxes paid by Charter, if any, (v) the apportionment of the allocated income or loss among the states in which Charter Holdco does business, and (vi) future federal and state tax laws. Further, in the event of new capital contributions to Charter Holdco, it is possible that the tax effects of the Special Profit

Allocations, Special Loss Allocations, Regulatory Allocations and Curative Allocation Provisions will change significantly pursuant to the provisions of the income tax regulations or the terms of a contribution agreement with respect to such contributions. Such change could defer the actual tax benefits to be derived by Charter with respect to the net tax losses allocated to it or accelerate the actual taxable income to Charter with respect to the net tax profits allocated to it. As a result, it is possible under certain circumstances, that Charter could receive future allocations of taxable income in excess of its currently allocated tax deductions and available tax loss carryforwards. The ability to utilize net operating loss carryforwards is potentially subject to certain limitations as discussed below.

In addition, under their exchange agreement with Charter, Vulcan Cable III Inc. and Charter Investment, Inc. may exchange some or all of their membership units in Charter Holdco for Charter s Class B common stock, be merged with Charter, or be acquired by Charter in a non-taxable reorganization. If such an exchange were to take place prior to the date that the Special Profit Allocation provisions had fully offset the Special Loss Allocations, Vulcan Cable III Inc. and Charter Investment, Inc. could elect to cause Charter Holdco to make the remaining Special Profit Allocations to Vulcan Cable III Inc. and Charter Investment, Inc. immediately prior to the consummation of the exchange. In the event Vulcan Cable III Inc. and Charter Investment, Inc. choose not to make such election or to the extent such allocations are not possible, Charter would then be allocated tax profits attributable to the membership units received in such exchange pursuant to the Special Profit Allocation provisions. Mr. Allen has generally agreed to reimburse Charter for any incremental income taxes that Charter would owe as a result of such an exchange and any resulting future Special Profit Allocations to Charter. The ability of Charter to utilize net operating loss carryforwards is potentially subject to certain limitations (see Risk Factors Risks Related to Mr. Allen s Controlling Position). If Charter were to become subject to such limitations (whether as a result of an exchange described above or otherwise), and as a result were to owe taxes resulting from the Special Profit Allocations, then Mr. Allen may not be obligated to reimburse Charter for such income taxes.

As of September 30, 2005 and December 31, 2004 and 2003, we have recorded net deferred income tax liabilities of $287 million, $216 million and $417 million, respectively. Additionally, as of September 30, 2005, December 31, 2004 and 2003, we have deferred tax assets of $3.7 billion, $3.5 billion and $1.7 billion, respectively, which primarily relate to financial and tax losses allocated to Charter from Charter Holdco. We are required to record a valuation allowance when it is more likely than not that some portion or all of the deferred income tax assets will not be realized. Given the uncertainty surrounding our ability to utilize our deferred tax assets, these items have been offset with a corresponding valuation allowance of $3.4 billion, $3.2 billion and $1.3 billion at September 30, 2005, December 31, 2004 and 2003, respectively.

Charter Holdco is currently under examination by the Internal Revenue Service for the tax years ending December 31, 2002 and 2003. Our results (excluding Charter and our indirect corporate subsidiaries) for these years are subject to this examination. Management does not expect the results of this examination to have a material adverse effect on our consolidated financial condition, results of operations or our liquidity, including our ability to comply with our debt covenants.

Litigation. Legal contingencies have a high degree of uncertainty. When a loss from a contingency becomes estimable and probable, a reserve is established. The reserve reflects management s best estimate of the probable cost of ultimate resolution of the matter and is revised accordingly as facts and circumstances change and, ultimately when the matter is brought to closure. We have established reserves for certain matters including those described in Business Legal Proceedings. If any of the litigation matters pending against us, including those described in Business Legal Proceedings is resolved unfavorably resulting in payment obligations in excess of management s best estimate of the outcome, such resolution could have a material adverse effect on our consolidated financial condition, results of operations or our liquidity.

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Results of Operations

Nine Months Ended September 30, 2005 Compared to Nine Months Ended September 30, 2004

The following table sets forth the percentages of revenues that items in the accompanying consolidated statements of operations constituted for the periods presented (dollars in millions, except per share and share data):

	Nine Months Ended September 30,			
	2005		2004	
Revenues	$ 3,912	100%	$ 3,701	100%
Costs and expenses:				
Operating (excluding depreciation and amortization)	1,714	44%	1,552	42%
Selling, general and administrative	762	19%	735	20%
Depreciation and amortization	1,134	29%	1,105	30%
Impairment of franchises			2,433	66%
Asset impairment charges	39	1%		
(Gain) loss on sale of assets, net	5		(104)	(3)%
Option compensation expense, net	11		34	1%
Hurricane asset retirement loss	19	1%		
Special charges, net	4		100	2%
	3,688	94%	5,855	158%
Income (loss) from operations	224	6%	(2,154)	(58)%
Interest expense, net	(1,333)		(1,227)	
Gain on derivative instruments and hedging activities, net	43		48	
Loss on debt to equity conversions			(23)	
Gain (loss) on extinguishment of debt	498		(21)	
Gain on investments	21			
	(771)		(1,223)	
Loss before minority interest, income taxes and cumulative effect of accounting change	(547)		(3,377)	
Minority interest	(9)		24	
Loss before income taxes and cumulative effect of accounting change	(556)		(3,353)	
Income tax benefit (expense)	(75)		116	
Loss before cumulative effect of accounting change	(631)		(3,237)	
Cumulative effect of accounting change, net of tax			(765)	
Net loss	(631)		(4,002)	
Dividends on preferred stock redeemable	(3)		(3)	
Net loss applicable to common stock	$ (634)		$ (4,005)	

Loss per common share, basic and diluted	$ (2.06)	$ (13.38)
Weighted average common shares outstanding, basic and diluted	307,761,930	299,411,053

Revenues. Revenues increased by $211 million, or 6%, from $3.7 billion for the nine months ended September 30, 2004 to $3.9 billion for the nine months ended September 30, 2005. This increase is principally the result of an increase of 300,100 and 60,500 high-speed Internet and digital video customers, respectively, as well as price increases for video and high-speed Internet services, and is offset partially by a decrease of 168,300 analog video customers and $6 million of credits issued to hurricane Katrina impacted customers related to service outages. Through September and October, we have been restoring service to our impacted customers and, as of the date of this report, substantially all of our customers service has been restored. Included in the reduction in analog video customers and reducing the increase in digital video and high-speed Internet customers are 26,800 analog video customers, 12,000 digital video customers and 600 high-speed Internet customers sold in the cable system sales in Texas and West Virginia, which closed in July 2005. The cable system sales to Atlantic Broadband Finance, LLC, which closed in March and April 2004, and the cable system sales in Texas and West Virginia, which closed in July 2005 (referred to in this section as the System Sales) reduced the increase in revenues by approximately $33 million. Our goal is to increase revenues by improving customer service, which we believe will stabilize our analog video customer base, implementing price increases on certain services and packages and increasing the number of customers who purchase high-speed Internet services, digital video and advanced products and services such as telephone, VOD, high definition television and digital video recorder service.

Average monthly revenue per analog video customer increased to $72.97 for the nine months ended September 30, 2005 from $66.24 for the nine months ended September 30, 2004 primarily as a result of incremental revenues from advanced services and price increases. Average monthly revenue per analog video customer represents total revenue for the nine months ended during the respective period, divided by nine, divided by the average number of analog video customers during the respective period.

Revenues by service offering were as follows (dollars in millions):

	Nine Months Ended September 30,					
	2005		2004		2005 over 2004	
	Revenues	% of Revenues	Revenues	% of Revenues	Change	% Change
Video	$2,551	65%	$2,534	68%	$ 17	1%
High-speed Internet	671	17%	538	14%	133	25%
Advertising sales	214	6%	205	6%	9	4%
Commercial	205	5%	175	5%	30	17%
Other	271	7%	249	7%	22	9%
	$3,912	100%	$3,701	100%	$211	6%

Video revenues consist primarily of revenues from analog and digital video services provided to our non-commercial customers. Video revenues increased by $17 million for the nine months ended September 30, 2005 compared to the nine months ended September 30, 2004. Approximately $102 million of the increase was the result of price increases and incremental video revenues from existing customers and approximately $11 million resulted from an increase in digital video customers. The increases were offset by decreases of approximately $66 million related to a decrease in analog video customers, approximately $25 million resulting from the System Sales and approximately $5 million of credits issued to hurricanes Katrina and Rita impacted customers related to service outages.

Revenues from high-speed Internet services provided to our non-commercial customers increased $133 million, or 25%, from $538 million for the nine months ended September 30, 2004 to $671 million for the nine months ended September 30, 2005. Approximately $101 million of the increase related to the increase in the average number of customers receiving high-speed Internet services, whereas approximately $36 million related to the increase in average price of the service. The increase in high-speed Internet revenues was reduced by approximately $3 million as a result of the System Sales and $1 million of credits issued to hurricanes Katrina and Rita impacted customers related to service outages.

Advertising sales revenues consist primarily of revenues from commercial advertising customers, programmers and other vendors. Advertising sales increased $9 million, or 4%, from $205 million for the nine months ended September 30, 2004 to $214 million for the nine months ended September 30, 2005, primarily as a result of an increase in local advertising sales and an increase of $3 million in advertising sales revenues from vendors offset by a decline in national advertising sales. In addition, the increase was offset by a decrease of $1 million as a result of the System Sales. For the nine months ended September 30, 2005 and 2004, we received $12 million and $9 million, respectively, in advertising sales revenues from vendors.

Commercial revenues consist primarily of revenues from cable video and high-speed Internet services to our commercial customers. Commercial revenues increased $30 million, or 17%, from $175 million for the nine months ended September 30, 2004 to $205 million for the nine months ended September 30, 2005, primarily as a result of an increase in commercial high-speed Internet revenues. The increase was reduced by approximately $3 million as a result of the System Sales.

Other revenues consist of revenues from franchise fees, telephone revenue, equipment rental, customer installations, home shopping, dial-up Internet service, late payment fees, wire maintenance fees and other miscellaneous revenues. Other revenues increased $22 million, or 9%, from $249 million for the nine months ended September 30, 2004 to $271 million for the nine months ended September 30, 2005. The increase was primarily the result of an increase in telephone revenue of $11 million, franchise fees of $11 million and installation revenue of $7 million and was partially offset by approximately $2 million as a result of the System Sales.

Operating Expenses. Operating expenses increased $162 million, or 10%, from $1.6 billion for the nine months ended September 30, 2004 to $1.7 billion for the nine months ended September 30, 2005. The increase in operating expenses was reduced by $13 million as a result of the System Sales. Programming costs included in the accompanying condensed consolidated statements of operations were $1.1 billion and $991 million, representing 29% and 17% of total costs and expenses for the nine months ended September 30, 2005 and 2004, respectively. Key expense components as a percentage of revenues were as follows (dollars in millions):

	Nine Months Ended September 30,					
	2005		2004		2005 over 2004	
	Expenses	% of Revenues	Expenses	% of Revenues	Change	% Change
Programming	$1,066	27%	$ 991	27%	$ 75	8%
Service	572	15%	489	13%	83	17%
Advertising sales	76	2%	72	2%	4	6%
	$1,714	44%	$1,552	42%	$162	10%

Programming costs consist primarily of costs paid to programmers for analog, premium, digital channels, VOD and pay-per-view programming. The increase in programming costs of $75 million, or 8%, for the nine months ended September 30, 2005 over the nine months ended September 30, 2004 was a result of price increases, particularly in sports programming, partially offset by decreases in analog video customers. Additionally, the increase in programming costs was reduced by $10 million as a result of the System Sales. Programming costs were offset by the amortization of payments received from programmers in support of launches of new channels of $27 million and $43 million for the nine months ended September 30, 2005 and 2004, respectively. Programming costs for the nine months ended September 30, 2004 also include a $5 million reduction related to the settlement of a dispute with TechTV, Inc. See Note 20 to the condensed consolidated financial statements.

Our cable programming costs have increased in every year we have operated in excess of U.S. inflation and cost-of-living increases, and we expect them to continue to increase because of a variety of factors, including inflationary or negotiated annual increases, additional programming being provided to customers and increased costs to purchase programming. In 2005, programming costs have increased and we expect will continue to increase at a higher rate than in 2004. These costs will be determined in part on the outcome of programming negotiations in 2005 and will likely be subject to offsetting events or otherwise affected by factors similar to the ones mentioned in the preceding paragraph. Our increasing programming costs will result in declining operating margins for our video services to the extent we are unable to pass on cost increases to our customers. We expect to partially offset any resulting margin compression from our traditional video services with revenue from advanced video services, increased high-speed Internet revenues, advertising revenues and commercial service revenues.

Service costs consist primarily of service personnel salaries and benefits, franchise fees, system utilities, costs of providing high-speed Internet service, maintenance and pole rent expense. The increase in service costs of $83 million, or 17%, resulted primarily from increased labor and maintenance costs to support improved service levels and our advanced products, higher fuel prices and pole rent expense. The increase in service costs was reduced by $3 million as a result of the System Sales. Advertising sales expenses consist of costs related to traditional advertising services provided to advertising customers, including salaries, benefits and commissions. Advertising sales expenses increased $4 million, or 6%, primarily as a result of increased salary, benefit and commission costs.

Selling, General and Administrative Expenses. Selling, general and administrative expenses increased by $27 million, or 4%, from $735 million for the nine months ended September 30, 2004 to $762 million for the nine months ended September 30, 2005. The increase in selling, general and administrative expenses was reduced by $5 million as a result of the System Sales. Key components of expense as a percentage of revenues were as follows (dollars in millions):

	Nine Months Ended September 30,					
	2005		2004		2005 over 2004	
	Expenses	% of Revenues	Expenses	% of Revenues	Change	% Change
General and administrative	$658	17%	$636	17%	$ 22	3%
Marketing	104	2%	99	3%	5	5%
	$762	19%	$735	20%	$ 27	4%

General and administrative expenses consist primarily of salaries and benefits, rent expense, billing costs, call center costs, internal network costs, bad debt expense and property taxes. The increase in general and administrative expenses of $22 million, or 3%, resulted primarily from increases in professional fees associated with consulting services of $28 million and a rise in salaries and benefits of $21 million related to increased emphasis on improved service levels and operational efficiencies, offset by decreases in bad debt expense of $13 million, property and casualty insurance of $7 million and the System Sales of $5 million.

Marketing expenses increased $5 million, or 5%, as a result of an increased investment in targeted marketing campaigns.

Depreciation and Amortization. Depreciation and amortization expense increased by $29 million, or 3%, as a result of an increase in capital expenditures.

Impairment of Franchises. We performed an impairment assessment during the third quarter of 2004 using an independent third-party appraiser. The use of lower projected growth rates and the resulting revised estimates of future cash flows in our valuation, primarily as a result of increased competition, led to the recognition of a $2.4 billion impairment charge for the nine months ended September 30, 2004.

Asset Impairment Charges. Asset impairment charges for the nine months ended September 30, 2005 represent the write-down of assets related to pending cable asset sales to fair value less costs to sell. See Note 3 to the condensed consolidated financial statements.

(Gain) Loss on Sale of Assets, Net. Loss on sale of assets of $5 million for the nine months ended September 30, 2005 primarily represents the loss recognized on the disposition of plant and equipment.

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Gain on sale of assets of $104 million for the nine months ended September 30, 2004 primarily represents the pretax gain realized on the sale of systems to Atlantic Broadband Finance, LLC which closed on March 1 and April 30, 2004.

Option Compensation Expense, Net. Option compensation expense of $11 million for the nine months ended September 30, 2005 primarily represents options expensed in accordance with SFAS No. 123. Option compensation expense of $34 million for the nine months ended September 30, 2004 primarily represents the expense of approximately $9 million related to a stock option exchange program under which our employees were offered the right to exchange all stock options (vested and unvested) issued under the 1999 Charter Communications Option Plan and 2001 Stock Incentive Plan that had an exercise price over $10 per share for shares of restricted Charter Class A common stock or, in some instances, cash. The exchange offer closed in February 2004. Additionally, during the nine months ended September 30, 2004, we recognized approximately $8 million related to the performance shares granted under the Charter Long-Term Incentive Program and approximately $17 million related to options granted following the adoption of SFAS No. 123.

Hurricane Asset Retirement Loss. Hurricane asset retirement loss represents the loss associated with the write-off of the net book value of assets destroyed by hurricanes Katrina and Rita in the third quarter of 2005.

Special Charges, Net. Special charges of $4 million for the nine months ended September 30, 2005 represents $5 million of severance and related costs of our management realignment and $1 million related to legal settlements offset by approximately $2 million related to an agreed upon cash discount on settlement of the consolidated Federal Class Action and Federal Derivative Action. See Legal Proceedings. Special charges of $100 million for the nine months ended September 30, 2004 represents approximately $85 million as part of the terms set forth in memoranda of understanding regarding settlement of the consolidated Federal Class Action and Federal Derivative Action and approximately $9 million of litigation costs related to the tentative settlement of the South Carolina national class action suit, which were approved by the respective courts and approximately $9 million of severance and related costs of our workforce reduction. For the nine months ended September 30, 2004, the severance costs were offset by $3 million received from a third party in settlement of a dispute.

Interest Expense, Net. Net interest expense increased by $106 million, or 9%, from $1.2 billion for the nine months ended September 30, 2004 to $1.3 billion for the nine months ended September 30, 2005. The increase in net interest expense was a result of an increase of $757 million in average debt outstanding from $18.4 billion for the nine months ended September 30, 2004 compared to $19.2 billion for the nine months ended September 30, 2005 and an increase in our average borrowing rate from 8.61% in the nine months ended September 30, 2004 to 8.95% in the nine months ended September 30, 2005 combined with approximately $11 million of liquidated damages on our 5.875% convertible senior notes. This was offset partially by $26 million in gains related to embedded derivatives in Charter s 5.875% convertible senior notes issued in November 2004. See Note 10 to the condensed consolidated financial statements.

Gain on Derivative Instruments and Hedging Activities, Net. Net gain on derivative instruments and hedging activities decreased $5 million from $48 million for the nine months ended September 30, 2004 to $43 million for the nine months ended September 30, 2005. The decrease is primarily a result of a decrease in gains on interest rate agreements that do not qualify for hedge accounting under SFAS No. 133, which decreased from $45 million for the nine months ended September 30, 2004 to $41 million for the nine months ended September 30, 2005.

Loss on debt to equity conversions. Loss on debt to equity conversions of $23 million for the nine months ended September 30, 2004 represents the loss recognized from privately negotiated exchanges in the aggregate of $30 million principal amount of Charter s 5.75% convertible senior notes held by two unrelated parties for shares of Charter Class A common stock, which resulted in the issuance of more shares in the exchange transaction than would have been issued under the original terms of the convertible senior notes.

Gain (loss) on extinguishment of debt. Gain on extinguishment of debt of $498 million for the nine months ended September 30, 2005 primarily represents approximately $490 million related to the exchange of approximately $6.8 billion total principal amount of outstanding debt securities of Charter Holdings in a private placement for new debt securities, approximately $10 million related to the issuance of Charter Communications Operating, LLC (Charter Operating) notes in exchange for Charter Holdings notes and approximately $4 million related to the repurchase of $131 million principal amount of our 4.75% convertible senior notes due 2006. These gains were offset by approximately $5 million of losses related to the redemption of our subsidiary s, CC V Holdings, LLC, 11.875% notes due 2008. See Note 6 to the condensed consolidated financial statements. Loss on extinguishment of debt of $21 million for the nine months ended September 30, 2004 represents the write-off of deferred financing fees and third party costs related to the Charter Operating refinancing in April 2004.

Gain on investments. Gain on investments of $21 million for the nine months ended September 30, 2005 primarily represents a gain realized on an exchange of our interest in an equity investee for an investment in a larger enterprise.

Minority Interest. Minority interest represents the 2% accretion of the preferred membership interests in our indirect subsidiary, CC VIII, and in 2004, the pro rata share of the profits and losses of CC VIII. Effective January 1, 2005, we ceased recognizing minority interest in earnings or losses of CC VIII for financial reporting purposes until the dispute between Charter and Mr. Allen regarding the preferred membership interests in CC VIII was resolved. This dispute was settled October 31, 2005. See Note 7 to the condensed consolidated financial statements. Additionally, reported losses allocated to minority interest on the statement of operations are limited to the extent of any remaining minority interest on the balance sheet related to Charter Holdco. Because minority interest in Charter Holdco is eliminated, Charter absorbs all losses before income taxes that otherwise would be allocated to minority interest. Subject to any changes in Charter Holdco s capital structure, future losses will continue to be substantially absorbed by Charter.

Income Tax Benefit (Expense). Income tax expense of $75 million and income tax benefit of $116 million was recognized for the nine months ended September 30, 2005 and 2004, respectively. The income tax expense is recognized through increases in deferred tax liabilities related to our investment in Charter Holdco, as well as through current federal and state income tax expense and increases in the deferred tax liabilities of certain of our indirect corporate subsidiaries. The income tax benefit was realized as a result of decreases in certain deferred tax liabilities related to our investment in Charter Holdco as well as decreases in the deferred tax liabilities of certain of our indirect corporate subsidiaries.

The income tax benefit recognized in the nine months ended September 30, 2004 was directly related to the impairment of franchises as discussed above. We do not expect to recognize a similar benefit associated with the impairment of franchises in future periods. However, the actual tax provision calculations in future periods will be the result of current and future temporary differences, as well as future operating results.

Net Loss. Net loss decreased by $3.4 billion, from $4.0 billion for the nine months ended September 30, 2004 to $631 million for the nine months ended September 30, 2005 as a result of the factors described above.

Preferred stock dividends. On August 31, 2001, Charter issued 505,664 shares (and on February 28, 2003 issued an additional 39,595 shares) of Series A Convertible Redeemable Preferred Stock in connection with the Cable USA acquisition, on which Charter pays a quarterly cumulative cash dividends at an annual rate of 5.75% if paid or 7.75% if accrued on a liquidation preference of $100 per share. Beginning January 1, 2005, Charter is accruing the dividend on its Series A Convertible Redeemable Preferred Stock.

Loss Per Common Share. The loss per common share decreased by $11.32, from $13.38 per common share for the nine months ended September 30, 2004 to $2.06 per common share for the nine months ended September 30, 2005 as a result of the factors described above.

Year Ended December 31, 2004, December 31, 2003 and December 31, 2002

The following table sets forth the percentages of revenues that items in the accompanying consolidated statements of operations constitute for the indicated periods (dollars in millions, except per share and share data):

	Year Ended December 31,					
	2004		2003		2002	
Revenues	$ 4,977	100%	$ 4,819	100%	$ 4,566	100%
Costs and Expenses:						
Operating (excluding depreciation and amortization)	2,080	42%	1,952	40%	1,807	40%
Selling, general and administrative	971	19%	940	20%	963	21%
Depreciation and amortization	1,495	30%	1,453	30%	1,436	31%
Impairment of franchises	2,433	49%			4,638	102%
(Gain) loss on sale of assets, net	(86)	(2)%	5		3	
Option compensation expense, net	31	1%	4		5	
Special charges, net	104	2%	21		36	1%
Unfavorable contracts and other settlements	(5)		(72)	(1)%		
	7,023	141%	4,303	89%	8,888	195%
Income (loss) from operations	(2,046)	(41)%	516	11%	(4,322)	(95)%
Interest expense, net	(1,670)		(1,557)		(1,503)	
Gain (loss) on derivative instruments and hedging activities, net	69		65		(115)	
Loss on debt to equity conversions	(23)					
Gain (loss) on extinguishment of debt	(31)		267			
Other, net	3		(16)		(4)	
Loss before minority interest, income taxes and cumulative effect of accounting change	(3,698)		(725)		(5,944)	
Minority interest	19		377		3,176	
Loss before income taxes and cumulative effect of accounting change	(3,679)		(348)		(2,768)	
Income tax benefit	103		110		460	
Loss before cumulative effect of accounting change	(3,576)		(238)		(2,308)	
Cumulative effect of accounting change, net of tax	(765)				(206)	
Net loss	(4,341)		(238)		(2,514)	
Dividends on preferred stock redeemable	(4)		(4)		(3)	
Net loss applicable to common stock	$ (4,345)		$ (242)		$ (2,517)	
Loss per common share, basic and diluted	$ (14.47)		$ (0.82)		$ (8.55)	

Weighted average common shares outstanding	300,291,877	294,597,519	294,440,261

Year Ended December 31, 2004 Compared to Year Ended December 31, 2003

Revenues. Revenues increased by $158 million, or 3%, from $4.8 billion for the year ended December 31, 2003 to $5.0 billion for the year ended December 31, 2004. This increase is principally the result of an increase of 318,800 and 2,800 high-speed Internet customers and digital video customers, respectively, as well as price increases for video and high-speed Internet services, and is offset partially by a decrease of 439,800 analog video customers. Included in the reduction in analog video customers and reducing the increase in digital video and high-speed Internet customers are 230,800 analog video customers, 83,300 digital video customers and 37,800 high-speed Internet customers sold in the cable system sales to Atlantic Broadband Finance, LLC, which closed in March and April 2004 (collectively, with the cable system sale to WaveDivision Holdings, LLC in October 2003, referred to in this section as the System Sales). The System Sales reduced the increase in revenues by $160 million.

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Average monthly revenue per analog video customer increased from $61.92 for the year ended December 31, 2003 to $68.02 for the year ended December 31, 2004 primarily as a result of price increases and incremental revenues from advanced services. Average monthly revenue per analog video customer represents total annual revenue, divided by twelve, divided by the average number of analog video customers during the respective period.

Revenues by service offering were as follows (dollars in millions):

	Year Ended December 31,					
	2004		2003		2004 over 2003	
	Revenues	% of Revenues	Revenues	% of Revenues	Change	% Change
Video	$3,373	68%	$3,461	72%	$ (88)	(3)%
High-speed Internet	741	15%	556	12%	185	33%
Advertising sales	289	6%	263	5%	26	10%
Commercial	238	4%	204	4%	34	17%
Other	336	7%	335	7%	1	
	$4,977	100%	$4,819	100%	$158	3%

Video revenues consist primarily of revenues from analog and digital video services provided to our non-commercial customers. Video revenues decreased by $88 million, or 3%, from $3.5 billion for the year ended December 31, 2003 to $3.4 billion for the year ended December 31, 2004. Approximately $116 million of the decrease was the result of the System Sales and approximately an additional $65 million related to a decline in analog video customers. These decreases were offset by increases of approximately $66 million resulting from price increases and incremental video revenues from existing customers and approximately $27 million resulting from an increase in digital video customers.

Revenues from high-speed Internet services provided to our non-commercial customers increased $185 million, or 33%, from $556 million for the year ended December 31, 2003 to $741 million for the year ended December 31, 2004. Approximately $163 million of the increase related to the increase in the average number of customers receiving high-speed Internet services, whereas approximately $35 million related to the increase in average price of the service. The increase in high-speed Internet revenues was reduced by approximately $12 million as a result of the System Sales.

Advertising sales revenues consist primarily of revenues from commercial advertising customers, programmers and other vendors. Advertising sales increased $26 million, or 10%, from $263 million for the year ended December 31, 2003 to $289 million for the year ended December 31, 2004 primarily as a result of an increase in national advertising campaigns and election related advertising. The increase was offset by a decrease of $7 million as a result of the System Sales. For the years ended December 31, 2004 and 2003, we received $16 million and $15 million, respectively, in advertising revenue from vendors.

Commercial revenues consist primarily of revenues from cable video and high-speed Internet services to our commercial customers. Commercial revenues increased $34 million, or 17%, from $204 million for the year ended December 31, 2003, to $238 million for the year ended December 31, 2004, primarily as a result of an increase in commercial high-speed Internet revenues. The increase was reduced by approximately $14 million as a result of the System Sales.

Other revenues consist of revenues from franchise fees, telephone revenue, equipment rental, customer installations, home shopping, dial-up Internet service, late payment fees, wire maintenance fees and other miscellaneous revenues. For the year ended December 31, 2004 and 2003, franchise fees represented approximately 49% and 48%, respectively, of total other revenues. Other revenues increased $1 million from $335 million for the year ended December 31, 2003 to $336 million for the year ended December 31, 2004. The increase was primarily the result of an increase in home shopping and infomercial revenue and was partially offset by approximately $11 million as a result of the System Sales.

Operating expenses. Operating expenses increased $128 million, or 7%, from $2.0 billion for the year ended December 31, 2003 to $2.1 billion for the year ended December 31, 2004. The increase in operating expenses was reduced by approximately $59 million as a result of the System Sales. Programming costs included in the accompanying consolidated statements of operations were $1.3 billion and $1.2 billion, representing 63% and 64% of total operating expenses for the years ended December 31, 2004 and 2003, respectively. Key expense components as a percentage of revenues were as follows (dollars in millions):

	Year Ended December 31,					
	2004		2003		2004 over 2003	
	Expenses	% of Revenues	Expenses	% of Revenues	Change	% Change
Programming	$1,319	27%	$1,249	26%	$ 70	6%
Advertising sales	98	2%	88	2%	10	11%
Service	663	13%	615	12%	48	8%
	$2,080	42%	$1,952	40%	$128	7%

Programming costs consist primarily of costs paid to programmers for analog, premium and digital channels and pay-per-view programming. The increase in programming costs of $70 million, or 6%, for the year ended December 31, 2004 over the year ended December 31, 2003 was a result of price increases, particularly in sports programming, an increased number of channels carried on our systems, and an increase in digital video customers, partially offset by a decrease in analog video customers. Additionally, the increase in programming costs was reduced by $42 million as a result of the System Sales. Programming costs were offset by the amortization of payments received from programmers in support of launches of new channels of $59 million and $62 million for the years ended December 31, 2004 and 2003, respectively. Programming costs for the year ended December 31, 2004 also include a $5 million reduction related to the settlement of a dispute with TechTV, Inc., a related party. See Note 22 to the consolidated financial statements included elsewhere in this prospectus.

Advertising sales expenses consist of costs related to traditional advertising services provided to advertising customers, including salaries, benefits and commissions. Advertising sales expenses increased $10 million, or 11%, primarily as a result of increased salary, benefit and commission costs. The increase in advertising sales expenses was reduced by $2 million as a result of the System Sales. Service costs consist primarily of service personnel salaries and benefits, franchise fees, system utilities, Internet service provider fees, maintenance and pole rental expense. The increase in service costs of $48 million, or 8%, resulted primarily from additional activity associated with ongoing infrastructure maintenance. The increase in service costs was reduced by $15 million as a result of the System Sales.

Selling, general and administrative expenses. Selling, general and administrative expenses increased by $31 million, or 3%, from $940 million for the year ended December 31, 2003 to $971 million for the year ended December 31, 2004. The increase in selling, general and administrative expenses was reduced by $22 million as a result of the System Sales. Key components of expense as a percentage of revenues were as follows (dollars in millions):

	Year Ended December 31,					
	2004		2003		2004 over 2003	
	Expenses	% of Revenues	Expenses	% of Revenues	Change	% Change
General and administrative	$849	17%	$833	18%	$ 16	2%
Marketing	122	2%	107	2%	15	14%
	$971	19%	$940	20%	$ 31	3%

General and administrative expenses consist primarily of salaries and benefits, rent expense, billing costs, call center costs, internal network costs, bad debt expense and property taxes. The increase in general and administrative expenses of $16 million, or 2%, resulted primarily from increases in costs

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associated with our commercial business of $21 million, third party call center costs resulting from increased emphasis on customer service of $10 million and bad debt expense of $10 million offset by decreases in costs associated with salaries and benefits of $21 million and rent expense of $3 million.

Marketing expenses increased $15 million, or 14%, as a result of an increased investment in marketing and branding campaigns.

Depreciation and amortization. Depreciation and amortization expense increased by $42 million, or 3%, to $1.5 billion in 2004. The increase in depreciation related to an increase in capital expenditures, which was partially offset by lower depreciation as the result of the System Sales.

Impairment of franchises. We performed an impairment assessment during the third quarter of 2004. The use of lower projected growth rates and the resulting revised estimates of future cash flows in our valuation, primarily as a result of increased competition, led to the recognition of a $2.4 billion impairment charge for the year ended December 31, 2004.

(Gain) loss on sale of assets, net. Gain on sale of assets of $86 million for the year ended December 31, 2004 primarily represents the pretax gain of $106 million realized on the sale of systems to Atlantic Broadband Finance, LLC which closed in March and April 2004 offset by losses recognized on the disposition of plant and equipment. Loss on sale of assets of $5 million for the year ended December 31, 2003 represents the loss recognized on the disposition of plant and equipment offset by a gain of $21 million recognized on the sale of cable systems in Port Orchard, Washington which closed on October 1, 2003.

Option compensation expense, net. Option compensation expense of $31 million for the year ended December 31, 2004 primarily represents $22 million related to options granted and expensed in accordance with SFAS No. 123, *Accounting for Stock-Based Compensation*. Additionally, during the year ended December 31, 2004, we expensed approximately $8 million related to a stock option exchange program, under which our employees were offered the right to exchange all stock options (vested and unvested) issued under the 1999 Charter Communications Option Plan and 2001 Stock Incentive Plan that had an exercise price over $10 per share for shares of restricted Charter Class A common stock or, in some instances, cash. The exchange offer closed in February 2004. Option compensation expense of $4 million for the year ended December 31, 2003 primarily represents options expensed in accordance with SFAS No. 123, *Accounting for Stock-Based Compensation*. See Note 19 to our consolidated financial statements included elsewhere in this prospectus for more information regarding our option compensation plans.

Special charges, net. Special charges of $104 million for the year ended December 31, 2004 represents approximately $85 million of aggregate value of the Charter Class A common stock and warrants to purchase Charter Class A common stock contemplated to be issued as part of a settlement of the consolidated federal class actions, state derivative actions and federal derivative action lawsuits, approximately $10 million of litigation costs related to the tentative settlement of a South Carolina national class action suit, all of which settlements are subject to final documentation and court approval and approximately $12 million of severance and related costs of our workforce reduction and realignment. Special charges for the year ended December 31, 2004 were offset by $3 million received from a third party in settlement of a dispute. Special charges of $21 million for the year ended December 31, 2003 represents approximately $26 million of severance and related costs of our workforce reduction partially offset by a $5 million credit from a settlement from the Internet service provider Excite@Home related to the conversion of about 145,000 high-speed Internet customers to our Charter Pipeline service in 2001.

Unfavorable contracts and other settlements. Unfavorable contracts and other settlements of $5 million for the year ended December 31, 2004 relates to changes in estimated legal reserves established in connection with prior business combinations, which based on an evaluation of current facts and circumstances, are no longer required.

Unfavorable contracts and other settlements of $72 million for the year ended December 31, 2003 represents the settlement of estimated liabilities recorded in connection with prior business combinations.

The majority of this benefit (approximately $52 million) is due to the renegotiation in 2003 of a major programming contract, for which a liability had been recorded for the above market portion of that agreement in connection with a 1999 and a 2000 acquisition. The remaining benefit relates to the reversal of previously recorded liabilities, which are no longer required.

Interest expense, net. Net interest expense increased by $113 million, or 7%, from $1.6 billion for the year ended December 31, 2003 to $1.7 billion for the year ended December 31, 2004. The increase in net interest expense was a result of an increase in our average borrowing rate from 7.99% in the year ended December 31, 2003 to 8.66% in the year ended December 31, 2004 partially offset by a decrease of $306 million in average debt outstanding from $18.9 billion in 2003 to $18.6 billion in 2004.

Gain (loss) on derivative instruments and hedging activities, net. Net gain on derivative instruments and hedging activities increased $4 million from a gain of $65 million for the year ended December 31, 2003 to a gain of $69 million for the year ended December 31, 2004. The increase is primarily the result of an increase in gains on interest rate agreements that do not qualify for hedge accounting under SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities*, which increased from a gain of $57 million for the year ended December 31, 2003 to a gain of $65 million for the year ended December 31, 2004. This was coupled with a decrease in gains on interest rate agreements, as a result of hedge ineffectiveness on designated hedges, which decreased from $8 million for the year ended December 31, 2003 to $4 million for the year ended December 31, 2004.

Loss on debt to equity conversions. Loss on debt to equity conversions of $23 million for the year ended December 31, 2004 represents the loss recognized from privately negotiated exchanges of a total of $30 million principal amount of Charter s 5.75% convertible senior notes held by two unrelated parties for shares of Charter Class A common stock. The exchange resulted in the issuance of more shares in the exchange transaction than would have been issuable under the original terms of the convertible senior notes.

Gain (loss) on extinguishment of debt. Loss on extinguishment of debt of $31 million for the year ended December 31, 2004 represents the write-off of deferred financing fees and third party costs related to the Charter Communications Operating refinancing in April 2004 and the redemption of our 5.75% convertible senior notes due 2005 in December 2004. Gain on extinguishment of debt of $267 million for the year ended December 31, 2003 represents the gain realized on the purchase of an aggregate $609 million principal amount of our outstanding convertible senior notes and $1.3 billion principal amount of Charter Holdings senior notes and senior discount notes in consideration for an aggregate of $1.6 billion principal amount of 10.25% notes due 2010 issued by our indirect subsidiary, CCH II. The gain is net of the write-off of deferred financing costs associated with the retired debt of $27 million.

Other, net. Net other expense decreased by $19 million from $16 million in 2003 to income of $3 million in 2004. Other expense in 2003 included $11 million associated with amending a revolving credit facility of our subsidiaries and costs associated with terminated debt transactions that did not recur in 2004. In addition, gains on equity investments increased $7 million in 2004 over 2003.

Minority interest. Minority interest represents the 2% accretion of the preferred membership interests in our indirect subsidiary, CC VIII, and since June 6, 2003, the pro rata share of the profits and losses of CC VIII. See Certain Relationships and Related Transactions Transactions Arising out of Our Organizational Structure and Mr. Allen s Investment in Charter Communications, Inc. and Its Subsidiaries Equity Put Rights CC VIII. Reported losses allocated to minority interest on the statement of operations are limited to the extent of any remaining minority interest on the balance sheet related to Charter Holdco. Because minority interest in Charter Holdco was substantially eliminated at December 31, 2003, beginning in the first quarter of 2004, Charter began to absorb substantially all future losses before income taxes that otherwise would have been allocated to minority interest. For the year ended December 31, 2003, 53.5% of our losses were allocated to minority interest. As a result of negative equity at Charter Holdco during the year ended December 31, 2004, no additional losses were allocated to minority interest, resulting in an additional $2.4 billion of net losses. Under our existing capital structure, future losses will be substantially absorbed by Charter.

Income tax benefit. Income tax benefit of $103 million and $110 million was recognized for the years ended December 31, 2004 and 2003, respectively. The income tax benefits were realized as a result of decreases in certain deferred tax liabilities related to our investment in Charter Holdco as well as decreases in the deferred tax liabilities of certain of our indirect corporate subsidiaries.

The income tax benefit recognized in the year ended December 31, 2004 was directly related to the impairment of franchises as discussed above. The deferred tax liabilities decreased as a result of the write-down of franchise assets for financial statement purposes, but not for tax purposes. We do not expect to recognize a similar benefit associated with the impairment of franchises in future periods. However, the actual tax provision calculations in future periods will be the result of current and future temporary differences, as well as future operating results.

The income tax benefit recognized in the year ended December 31, 2003 was directly related to the tax losses allocated to Charter from Charter Holdco. In the second quarter of 2003, Charter started receiving tax loss allocations from Charter Holdco. Previously, the tax losses had been allocated to Vulcan Cable III Inc. and Charter Investment, Inc. in accordance with the Special Loss Allocations provided under the Charter Holdco limited liability company agreement. We do not expect to recognize a similar benefit related to our investment in Charter Holdco after 2003 related to tax loss allocations received from Charter Holdco, due to limitations associated with our ability to offset future tax benefits against the remaining deferred tax liabilities. However, the actual tax provision calculations in future periods will be the result of current and future temporary differences, as well as future operating results.

Cumulative effect of accounting change, net of tax. Cumulative effect of accounting change of $765 million (net of minority interest effects of $19 million and tax effects of $91 million) in 2004 represents the impairment charge recorded as a result of our adoption of EITF Topic D-108.

Net loss. Net loss increased by $4.1 billion from $238 million in 2003 to $4.3 billion in 2004 as a result of the factors described above. The impact to net loss in 2004 of the impairment of franchises, cumulative effect of accounting change and the reduction in losses allocated to minority interest was to increase net loss by approximately $3.7 billion. The impact to net loss in 2003 of the gain on the sale of systems, unfavorable contracts and settlements and gain on debt exchange, net of income tax impact, was to decrease net loss by $168 million.

Preferred stock dividends. On August 31, 2001, in connection with the Cable USA acquisition, Charter issued 505,664 shares (and on February 28, 2003 issued an additional 39,595 shares) of Series A Convertible Redeemable Preferred Stock, on which it pays or accrues a quarterly cumulative cash dividend at an annual rate of 5.75% if paid or 7.75% if accrued on a liquidation preference of $100 per share.

Loss per common share. The loss per common share increased by $13.65, from $0.82 per common share for the year ended December 31, 2003 to $14.47 per common share for the year ended December 31, 2004 as a result of the factors described above.

Year Ended December 31, 2003 Compared to Year Ended December 31, 2002

Revenues. Revenues increased by $253 million, or 6%, from $4.6 billion for the year ended December 31, 2002 to $4.8 billion for the year ended December 31, 2003. This increase is principally the result of an increase of 427,500 high-speed Internet customers, as well as price increases for video and high-speed Internet services, and is offset partially by a decrease of 147,500 and 10,900 in analog and digital video customers, respectively. Included within the decrease of analog and digital video customers and reducing the increase of high-speed Internet customers are 25,500 analog video customers, 12,500 digital video customers and 12,200 high-speed Internet customers sold in the Port Orchard, Washington sale on October 1, 2003.

Average monthly revenue per analog video customer increased from $56.91 for the year ended December 31, 2002 to $61.92 for the year ended December 31, 2003 primarily as a result of price increases and incremental revenues from advanced services. Average monthly revenue per analog video customer represents total annual revenue, divided by twelve, divided by the average number of analog video customers during the respective period.

Revenues by service offering were as follows (dollars in millions):

	Year Ended December 31,					
	2003		2002		2003 over 2002	
	Revenues	% of Revenues	Revenues	% of Revenues	Change	% Change
Video	$3,461	72%	$3,420	75%	$ 41	1%
High-speed Internet	556	12%	337	7%	219	65%
Advertising sales	263	5%	302	7%	(39)	(13)%
Commercial	204	4%	161	3%	43	27%
Other	335	7%	346	8%	(11)	(3)%
	$4,819	100%	$4,566	100%	$253	6%

Video revenues consist primarily of revenues from analog and digital video services provided to our non-commercial customers. Video revenues increased by $41 million, or 1%, for the year ended December 31, 2003 compared to the year ended December 31, 2002. Video revenues increased approximately $65 million due to price increases and incremental video revenues from existing customers and $82 million as a result of increases in the average number of digital video customers, which were partially offset by a decrease of approximately $106 million as a result of a decline in analog video customers.

Revenues from high-speed Internet services provided to our non-commercial customers increased $219 million, or 65%, from $337 million for the year ended December 31, 2002 to $556 million for the year ended December 31, 2003. Approximately $206 million of the increase related to the increase in the average number of customers, whereas approximately $13 million related to the increase in the average price of the service. The increase in customers was primarily due to the addition of high-speed Internet customers in our existing service areas. We were also able to offer this service to more of our customers, as the estimated percentage of homes passed that could receive high-speed Internet service increased from 82% as of December 31, 2002 to 87% as of December 31, 2003 as a result of our system upgrades.

Advertising sales revenues consist primarily of revenues from commercial advertising customers, programmers and other vendors. Advertising sales decreased $39 million, or 13%, from $302 million for the year ended December 31, 2002, to $263 million for the year ended December 31, 2003, primarily as a result of a decrease in advertising from vendors of approximately $64 million offset partially by an increase in local advertising sales revenues of approximately $25 million. For the years ended December 31, 2003 and 2002, we received $15 million and $79 million, respectively, in advertising revenue from vendors.

Commercial revenues consist primarily of revenues from video and high-speed Internet services to our commercial customers. Commercial revenues increased $43 million, or 27%, from $161 million for the year ended December 31, 2002, to $204 million for the year ended December 31, 2003, primarily due to an increase in commercial high-speed Internet revenues.

Other revenues consist of revenues from franchise fees, equipment rental, customer installations, home shopping, dial-up Internet service, late payment fees, wire maintenance fees and other miscellaneous revenues. For the years ended December 31, 2003 and 2002, franchise fees represented approximately 48% and 46%, respectively, of total other revenues. Other revenues decreased $11 million, or 3%, from $346 million for the year ended December 31, 2002 to $335 million for the year ended December 31, 2003. The decrease was due primarily to a decrease in franchise fees after an FCC ruling in March 2002, no longer requiring the collection of franchise fees for high-speed Internet services. Franchise fee revenues are collected from customers and remitted to franchise authorities.

The decrease in accounts receivable of 27% compared to the increase in revenues of 6% is primarily due to the timing of collection of receivables from programmers for fees associated with the launching of their networks coupled with our tightened credit and collections policy. These fees from programmers are not recorded as revenue but, rather, are recorded as reductions of programming expense on a straight-line basis over the term of the contract. Programmer receivables decreased $40 million, or 57%, from $70 million as of December 31, 2002 to $30 million as of December 31, 2003.

Operating expenses. Operating expenses increased $145 million, or 8%, from $1.8 billion for the year ended December 31, 2002 to $2.0 billion for the year ended December 31, 2003. Programming costs included in the accompanying consolidated statements of operations were $1.2 billion and $1.2 billion, representing 64% and 65% of total operating expenses for the years ended December 31, 2003 and 2002, respectively. Key expense components as a percentage of revenues were as follows (dollars in millions):

	Year Ended December 31,					
	2003		2002		2003 over 2002	
	Expenses	% of Revenues	Expenses	% of Revenues	Change	% Change
Programming	$ 1,249	26%	$ 1,166	26%	$ 83	7%
Advertising sales	88	2%	87	2%	1	1%
Service	615	12%	554	12%	61	11%
	$ 1,952	40%	$Amount	Percent	Amount	Percent
Noninterest-bearing demand	$ 501,514	22.2%	$ 393,421	20.3%	$ 350,877	18.6%
Interest-bearing demand	449,744	19.9	362,555	18.8	374,900	19.9
Savings and money market	655,598	28.9	474,947	24.6	417,359	22.2
Certificates of deposit < $100,000	432,506	19.2	486,496	25.2	555,840	29.5
Certificates of deposit of $100,000 or more	222,432	9.8	214,180	11.1	183,914	9.8
Total deposits	$ 2,261,794	100.0%	$ 1,931,599	100.0%	$ 1,882,890	100.0%

We offer a variety of deposit products designed to attract and retain customers, with the primary focus on building and expanding long-term relationships. At December 31, 2012, total deposits were $2.262 billion, representing an increase of $330.2 million for the year. The increase is largely attributable to $286.8 million in nonpublic (retail) deposits assumed from the branch acquisitions. Certificates of deposit were approximately 29% and 36% of total deposits at December 31, 2012 and 2011, respectively. Depositors remain hesitant to invest in certificates of deposit for long periods due to the low interest rate environment. This has resulted in lower amounts being placed in time deposits for generally shorter terms.

Nonpublic deposits, the largest component of our funding sources, represented 80% of total deposits and totaled $1.789 billion and $1.541 billion as of December 31, 2012 and 2011, respectively. We have managed this segment of funding through a strategy of competitive pricing that minimizes the number of customer relationships that have only a single service high cost deposit account.

We had no traditional brokered deposits at December 31, 2012 or 2011, however, we do participate in the Certificate of Deposit Account Registry Service (CDARS) and Insured Cash Sweep (ICS) programs, which enables depositors to receive FDIC insurance coverage for deposits otherwise exceeding the maximum insurable amount. Through these programs, deposits in excess of the maximum insurable amount are placed with multiple participating financial institutions. Reciprocal CDARS deposits totaled $61.0 million and $46.5 million at December 31, 2012 and 2011, respectively. ICS deposits totaled $18.1 million at December 31, 2012. There were non ICS deposits outstanding at December 31, 2011.

As an additional source of funding, we offer a variety of public (municipal) deposit products to the many towns, villages, counties and school districts within our market. Public deposits generally range from 20% to 25% of our total deposits. There is a high degree of seasonality in this component of funding, because the level of deposits varies with the seasonal cash flows for these public customers. We maintain the necessary levels of short-term liquid assets to accommodate the seasonality associated with public deposits. Total public deposits were $454.2 million and $390.2 million, as of December 31, 2012 and 2011, respectively, and represented 20% of total deposits as of the end of each period. In general, the number of public relationships remained stable in comparison to the prior year.

Borrowings

There were no long-term borrowings outstanding as of December 31, 2012 and 2011. Outstanding short-term borrowings are summarized as follows as of December 31 (in thousands):

	2012	2011
Short-term borrowings:		
Federal funds purchased	$	$ 11,597
Repurchase agreements	40,806	36,301
Short-term FHLB borrowings	139,000	102,800
Total short-term borrowings	$ 179,806	$ 150,698

We classify borrowings as short-term or long-term in accordance with the original terms of the agreement.

We have credit capacity with the FHLB and can borrow through facilities that include amortizing and term advances or repurchase agreements. We had approximately $5 million of immediate credit capacity with FHLB as of December 31, 2012. We had approximately $452 million in secured borrowing capacity at the Federal Reserve Bank (FRB) Discount Window, none of which was outstanding at December 31, 2012. The FHLB and FRB credit capacity are collateralized by securities from our investment portfolio and certain qualifying loans. We had approximately $120 million of credit available under unsecured federal funds purchased lines with various banks as of December 31, 2012. Additionally, we had approximately $150 million of unencumbered liquid securities available for pledging.

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Federal funds purchased are short-term borrowings that typically mature within one to ninety days. Short-term repurchase agreements are secured overnight borrowings with customers. Short-term FHLB borrowings have original maturities of less than one year and include overnight borrowings which the Company typically utilizes to address short term funding needs as they arise. Short-term FHLB borrowings at December 31, 2012 consisted of $99.0 million in overnight borrowings and $40.0 million in short-term advances. Short-term FHLB borrowings at December 31, 2011 consisted of $65.0 million in overnight borrowings and $37.8 million in short-term advances.

The following table summarizes information relating to our short-term borrowings (dollars in thousands).

	At or for the Year Ended December 31,		
	2012	2011	2010
Year-end balance	$ 179,806	$ 150,698	$ 77,110
Year-end weighted average interest rate	0.54%	0.39%	0.21%
Maximum outstanding at any month-end	$ 229,598	$ 188,355	$ 77,110
Average balance during the year	$ 121,735	$ 99,122	$ 49,104
Average interest rate for the year	0.48%	0.50%	0.74%

There were no long-term borrowings outstanding at December 31, 2012 and 2011. In August 2011, the Company redeemed all of the 10.20% junior subordinated debentures at a redemption price equaling 105.1% of the principal amount redeemed, plus all accrued and unpaid interest. As a result of the redemption, the Company recognized a loss on extinguishment of debt of $1.1 million, consisting of the redemption premium of $852 thousand and the write-off of the remaining unamortized issuance costs of $231 thousand.

Shareholders Equity

Total shareholders equity was $253.9 million at December 31, 2012, an increase of $16.7 million from $237.2 million at December 31, 2011. Net income for the year increased shareholders equity by $23.4 million, which was partially offset by common and preferred stock dividends declared of $9.3 million. Accumulated other comprehensive income included in shareholders equity increased $2.3 million during the year due primarily to higher net unrealized gains on securities available for sale. For detailed information on shareholders equity, see Note 12, Shareholders Equity, of the notes to consolidated financial statements.

The Company and Bank are subject to various regulatory capital requirements. At December 31, 2012, both the Company and the Bank exceeded all regulatory requirements. For detailed information on regulatory capital, see Note 11, Regulatory Matters, of the notes to consolidated financial statements.

GOODWILL AND OTHER INTANGIBLE ASSETS

The carrying value of goodwill totaled $49.0 million and $37.4 million as of December 31, 2012 and 2011, respectively. We performed a qualitative assessment of goodwill at the reporting unit level, Five Star Bank, to determine if it was more likely than not that the fair value of the reporting unit is less than its carrying value. In performing a qualitative analysis, factors considered include, but are not limited to, business strategy, financial performance and market and regulatory dynamics. The results of the qualitative assessment for 2012 indicated that it was not more likely than not that the fair value of the reporting unit is less than its carrying value. Consequently, no additional quantitative two-step impairment test was required, and no impairment was recorded in 2012.

The change in the balance for goodwill during the years ended December 31 was as follows (in thousands):

	2012	2011
Goodwill, beginning of year	$ 37,369	$ 37,369
Branch acquisitions	11,599	
Impairment		

Goodwill, end of year	$ 48,968	$ 37,369

Declines in the market value of our publicly traded stock price or declines in our ability to generate future cash flows may increase the potential that goodwill recorded on our consolidated statements of financial condition be designated as impaired and that we may incur a goodwill write-down in the future.

The Company s other intangible assets consisted entirely of a core deposit intangible asset. The gross carrying amount and accumulated amortization for the core deposit intangible asset was $2.0 million and $190 thousand, respectively, at December 31, 2012. The Company had no other intangible assets as of December 31, 2011. Core deposit intangible amortization expense, included in other noninterest expense on the consolidated statements of income, was $190 thousand for the year ended December 31, 2012. There was no core deposit intangible amortization expense for the years ended December 31, 2011 and 2010. For further discussion, see Note 1, Summary of Significant Accounting Policies, and Note 7, Goodwill and Other Intangible Assets, to the Consolidated Financial Statements included in Item 8 of this Annual Report on Form 10-K.

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LIQUIDITY AND CAPITAL RESOURCES

The objective of maintaining adequate liquidity is to assure that we meet our financial obligations. These obligations include the withdrawal of deposits on demand or at their contractual maturity, the repayment of matured borrowings, the ability to fund new and existing loan commitments and the ability to take advantage of new business opportunities. We achieve liquidity by maintaining a strong base of core customer funds, maturing short-term assets, our ability to sell or pledge securities, lines-of-credit, and access to the financial and capital markets.

Liquidity for the Bank is managed through the monitoring of anticipated changes in loans, the investment portfolio, core deposits and wholesale funds. The strength of the Bank s liquidity position is a result of its base of core customer deposits. These core deposits are supplemented by wholesale funding sources that include credit lines with the other banking institutions, the FHLB and the FRB.

The primary sources of liquidity for FII are dividends from the Bank and access to financial and capital markets. Dividends from the Bank are limited by various regulatory requirements related to capital adequacy and earnings trends. The Bank relies on cash flows from operations, core deposits, borrowings and short-term liquid assets. FSIS relies on cash flows from operations and funds from FII when necessary.

Our cash and cash equivalents were $60.4 million as of December 31, 2012, up $2.8 million from $57.6 million as of December 31, 2011. Our net cash provided by operating activities totaled $38.7 million and the principal source of operating activity cash flow was net income adjusted for noncash income and expense items. Net cash used in investing activities totaled $99.1 million, which included outflows of $151.3 million for net loan originations and $138.4 million from net investment securities transactions, substantially offset by $195.8 million in cash received through the branch acquisitions. Net cash provided by financing activities of $63.2 million was attributed to a $43.4 million increase in deposits and a $29.1 million increase in short-term borrowings, partly offset by $8.9 million in dividend payments.

Contractual Obligations and Other Commitments

The following table summarizes the maturities of various contractual obligations and other commitments (in thousands):

	At December 31, 2012				
	Within 1 year	Over 1 to 3 years	Over 3 to 5 Years	Over 5 years	Total
On-Balance sheet:					
Certificates of deposit [1]	$ 495,423	$ 127,045	$ 31,721	$ 749	$ 654,938
Supplemental executive retirement plans	159	506	618	1,402	2,685
Off-Balance sheet:					
Limited partnership investments [2]	$ 402	$ 804	$ 402	$	$ 1,608
Commitments to extend credit [3]	435,948				435,948
Standby letters of credit [3]	4,161	4,996	66		9,223
Operating leases	1,433	2,689	2,023	4,347	10,492

(1) Includes the maturity of certificates of deposit amounting to $100 thousand or more as follows: $58.7 million in three months or less; $39.5 million between three months and six months; $79.5 million between six months and one year; and $44.7 million over one year.

(2) We have committed to capital investments in several limited partnerships of up to $6.3 million, of which we have contributed $4.7 million as of December 31, 2012, including $951 thousand during 2012.

(3) We do not expect all of the commitments to extend credit and standby letters of credit to be funded. Thus, the total commitment amounts do not necessarily represent our future cash requirements.

Off-Balance Sheet Arrangements

With the exception of obligations in connection with our irrevocable loan commitments, operating leases and limited partnership investments, we had no other off-balance sheet arrangements that have or are reasonably likely to have a current or future effect on our financial condition, changes in financial condition, revenues or expenses, results of operations, liquidity, capital expenditures or capital resources that is material to investors. For additional information on off-balance sheet arrangements, see Note 1, Summary of Significant Accounting Policies and Note 10, Commitments and Contingencies, in the notes to the accompanying consolidated financial statements.

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Security Yields and Maturities Schedule

The following table sets forth certain information regarding the amortized cost (Cost), weighted average yields (Yield) and contractual maturities of our debt securities portfolio as of December 31, 2012. Mortgage-backed securities are included in maturity categories based on their stated maturity date. Actual maturities may differ from the contractual maturities presented because borrowers may have the right to call or prepay certain investments. We have stopped accruing interest on our asset-backed securities. No tax-equivalent adjustments were made to the weighted average yields (in thousands).

	Due in one year or less		Due from one to five years		Due after five years through ten years		Due after ten years		Total	
	Cost	Yield	Cost	Yield	Cost	Yield	Cost	Yield	Cost	Yield
Available for sale debt securities:										
U.S. Government agencies and government-sponsored enterprises	$ 18,557	1.89%	$ 23,973	2.20%	$ 72,633	1.77%	$ 12,934	0.87%	$ 128,097	1.78%
State and political subdivisions	10,064	3.64	68,677	2.21	110,256	2.06			188,997	2.20
Mortgage-backed securities	346	3.76	1,829	3.65	135,235	1.82	342,576	2.33	479,986	2.19
Asset-backed securities							121		121	
	28,967	2.52	94,479	2.24	318,124	1.89	355,631	2.27	797,201	2.13
Held to maturity debt securities:										
State and political subdivisions	12,886	2.24	4,164	3.69	768	4.78	87	5.53	17,905	2.70
	$ 41,853	2.43%	$ 98,643	2.30%	$ 318,892	1.90%	$ 355,718	2.28%	$ 815,106	2.14%

Contractual Loan Maturity Schedule

The following table summarizes the contractual maturities of our loan portfolio at December 31, 2012. Loans, net of deferred loan origination costs, include principal amortization and non-accruing loans. Demand loans having no stated schedule of repayment or maturity and overdrafts are reported as due in one year or less (in thousands).

	Due in less than one year	Due from one to five years	Due after five years	Total
Commercial business	$ 158,620	$ 87,051	$ 13,004	$ 258,675
Commercial mortgage	134,797	212,004	66,523	413,324
Residential mortgage	28,496	64,013	41,011	133,520
Home equity	49,190	129,284	108,175	286,649
Consumer indirect	204,831	362,478	19,485	586,794
Other consumer	10,647	13,874	2,243	26,764
Total loans	$ 586,581	$ 868,704	$ 250,441	$ 1,705,726
Loans maturing after one year:				
With a predetermined interest rate		$ 249,428	$ 131,385	$ 380,813
With a floating or adjustable rate		619,276	119,056	738,332
Total loans maturing after one year		$ 868,704	$ 250,441	$ 1,119,145

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Capital Resources

The FRB has adopted a system using risk-based capital guidelines to evaluate the capital adequacy of bank holding companies on a consolidated basis. The guidelines require a minimum Tier 1 leverage ratio of 4.00%, a minimum Tier 1 capital ratio of 4.00% and a minimum total risk-based capital ratio of 8.00%. The following table reflects the ratios and their components (in thousands):

	2012	2011
Total shareholders equity	$ 253,897	$ 237,194
Less: Unrealized gain on securities available for sale, net of tax	16,060	13,570
Unrecognized net periodic pension & postretirement benefits (costs), net of tax	(12,807)	(12,625)
Disallowed goodwill and other intangible assets	50,820	37,369
Disallowed deferred tax assets		1,794
Tier 1 capital	$ 199,824	$ 197,086
Adjusted average total assets (for leverage capital purposes)	$ 2,595,691	$ 2,282,755
Tier 1 leverage ratio (Tier 1 capital to adjusted average total assets)	7.70%	8.63%
Total Tier 1 capital	$ 199,824	$ 197,086
Plus: Qualifying allowance for loan losses	23,352	20,239
Total risk-based capital	$ 223,176	$ 217,325
Net risk-weighted assets	$ 1,866,764	$ 1,616,119
Tier 1 capital ratio (Tier 1 capital to net risk-weighted assets)	10.70%	12.20%
Total risk-based capital ratio (Total risk-based capital to net risk-weighted assets)	11.96%	13.45%

CRITICAL ACCOUNTING ESTIMATES

Our consolidated financial statements are prepared in accordance with GAAP 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 our 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.

We have numerous accounting policies, of which the most significant are presented in Note 1, Summary of Significant Accounting Policies, 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, valuation of goodwill and deferred tax assets, the valuation of securities and determination of OTTI, and accounting for defined benefit plans require particularly subjective or complex judgments important to our financial position and results of operations, and, as such, are considered to be critical accounting policies as discussed below. These estimates and assumptions are based on management s best estimates and judgment and are evaluated on an ongoing basis using historical experience and other factors, including the current economic environment. We adjust these estimates and assumptions when facts and circumstances dictate. Illiquid credit markets and volatile equity have combined with declines in consumer spending to increase the uncertainty inherent in these estimates and assumptions. As future events cannot be determined with precision, actual results could differ significantly from our estimates.

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MANAGEMENT S DISCUSSION AND ANALYSIS

Adequacy of the Allowance for Loan Losses

The allowance for loan losses represents management s estimate of probable credit losses inherent in the loan portfolio. Determining the amount of the allowance for loan losses is considered a critical accounting estimate because it requires significant judgment and the use of subjective measurements including management s assessment of the internal risk classifications of loans, changes in the nature of the loan portfolio, industry concentrations, existing economic conditions, the fair value of underlying collateral, and other qualitative and quantitative factors which could affect probable credit losses. Because current economic conditions can change and future events are inherently difficult to predict, the anticipated amount of estimated loan losses, and therefore the appropriateness of the allowance for loan losses, could change significantly. As an integral part of their examination process, various regulatory agencies also review the allowance for loan losses. Such agencies may require additions to the allowance for loan losses or may require that certain loan balances be charged off or downgraded into criticized loan categories when their credit evaluations differ from those of management, based on their judgments about information available to them at the time of their examination. We believe the level of the allowance for loan losses is appropriate as recorded in the consolidated financial statements.

For additional discussion related to our accounting policies for the allowance for loan losses, see the sections titled Allowance for Loan Losses in Part II, Item 7, Management s Discussion and Analysis of Financial Condition and Results of Operations and Note 1, Summary of Significant Accounting Policies, of the notes to consolidated financial statements.

Valuation of Goodwill

Goodwill represents the excess of the purchase price over the fair value of net assets acquired in accordance with the purchase method of accounting for business combinations. Goodwill has an indefinite useful life and is not amortized, but is tested for impairment. GAAP requires goodwill to be tested for impairment at our reporting unit level on an annual basis, which for us is September 30th, and more frequently if events or circumstances indicate that there may be impairment. Currently, our goodwill is evaluated at the entity level as there is only one reporting unit.

Impairment exists when a reporting unit s carrying value of goodwill exceeds its implied fair value. In testing goodwill for impairment, GAAP permits us to first assess qualitative factors to determine whether it is more likely than not that the fair value of a reporting unit is less than its carrying value. If, after assessing the totality of events and circumstances, we determine it is not more likely than not that the fair value of a reporting unit is less than its carrying value, then performing the two-step impairment test would be unnecessary. However, if we conclude otherwise, we would then be required to perform the first step (Step 1) of the goodwill impairment test, and continue to the second step (Step 2), if necessary. Step 1 compares the fair value of a reporting unit with its carrying value, including goodwill. If the carrying value of the reporting unit exceeds its fair value, Step 2 of the goodwill impairment test is performed to measure the value of impairment loss, if any.

Valuation of Deferred Tax Assets

The determination of deferred tax expense or benefit is based on changes in the carrying amounts of assets and liabilities that generate temporary differences. The carrying value of our net deferred tax assets assumes that we will be able to generate sufficient future taxable income based on estimates and assumptions (after consideration of historical taxable income as well as tax planning strategies). If these estimates and related assumptions change, we may be required to record valuation allowances against our deferred tax assets resulting in additional income tax expense in the consolidated statements of income. Management evaluates deferred tax assets on a quarterly basis and assesses the need for a valuation allowance, if any. A valuation allowance is established when management believes that it is more likely than not that some portion of its deferred tax assets will not be realized. Changes in valuation allowance from period to period are included in our tax provision in the period of change. For additional discussion related to our accounting policy for income taxes see Note 15, Income Taxes, of the notes to consolidated financial statements.

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MANAGEMENT S DISCUSSION AND ANALYSIS

Valuation and Other Than Temporary Impairment of Securities

We record all of our securities that are classified as available for sale at fair value. The fair value of equity securities are determined using public quotations, when available. Where quoted market prices are not available, fair values are estimated based on dealer quotes, pricing models, discounted cash flow methodologies, or similar techniques for which the determination of fair value may require significant judgment or estimation. Fair values of public bonds and those private securities that are actively traded in the secondary market have been determined through the use of third-party pricing services using market observable inputs. Private placement securities and other corporate fixed maturities for which we do not receive a public quotation are valued using a variety of acceptable valuation methods. Market rates used are applicable to the yield, credit quality and average maturity of each security. Private equity securities may also utilize internal valuation methodologies appropriate for the specific asset. Fair values might also be determined using broker quotes or through the use of internal models or analysis.

Securities are evaluated quarterly to determine whether a decline in their fair value is other than temporary. Management utilizes criteria such as, the current intent or requirement to hold or sell the security, the magnitude and duration of the decline and, when appropriate, consideration of negative changes in expected cash flows, creditworthiness, near term prospects of issuers, the level of credit subordination, estimated loss severity, and delinquencies, to determine whether a loss in value is other than temporary. The term other than temporary is not intended to indicate that the decline is permanent, but indicates that the prospect for a near-term recovery of value is not necessarily favorable. Declines in the fair value of investment securities below their cost that are deemed to be other than temporary are reflected in earnings as realized losses to the extent the impairment is related to credit issues or concerns, or the security is intended to be sold. The amount of impairment related to non-credit related factors on securities not intended to be sold is recognized in other comprehensive income.

Defined Benefit Pension Plan

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

RECENT ACCOUNTING PRONOUNCEMENTS

See Note 1, Summary of Significant Accounting Policies Recent Accounting Pronouncements, in the notes to consolidated financial statements for a discussion of recent accounting pronouncements.

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ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Asset-Liability Management

The principal objective of our interest rate risk management is to evaluate the interest rate risk inherent in assets and liabilities, determine the appropriate level of risk to us given our business strategy, operating environment, capital and liquidity requirements and performance objectives, and manage the risk consistent with the guidelines approved by our Board of Directors. Management is responsible for reviewing with the Board of Directors our activities and strategies, the effect of those strategies on the net interest income, the fair value of the portfolio and the effect that changes in interest rates will have on the portfolio and exposure limits. Management has developed an Asset-Liability Policy that meets the strategic objectives and regularly reviews the activities of the Bank.

Portfolio Composition

Our balance sheet assets are a mix of fixed and variable rate assets with consumer indirect loans, commercial loans, and MBSs comprising a significant portion of our assets. Our consumer indirect loan portfolio comprised 21% of assets and is primarily fixed rate loans with relatively short durations. Our commercial loan portfolio totaled 24% of assets and is a combination of fixed and variable rate loans, lines and mortgages. The MBS portfolio, including collateralized mortgages obligations, totaled 18% of assets with durations averaging three to five years.

Our liabilities are made up primarily of deposits, which account for approximately 90% of total liabilities. Of these deposits, the majority, or 53%, is in nonpublic variable rate and noninterest bearing products including demand (both noninterest and interest- bearing), savings and money market accounts. In addition, fixed rate nonpublic certificate of deposit products make up 27% of total deposits. The bank also has a significant amount of public deposits, which represented 20% of total deposits as of December 31, 2012.

Net Interest Income at Risk

A primary tool used to manage interest rate risk is rate shock simulation to measure the rate sensitivity. Rate shock simulation is a modeling technique used to estimate the impact of changes in rates on net interest income as well as economic value of equity. At December 31, 2012, the Company is generally asset sensitive, meaning that, in most cases, net interest income tends to rise as interest rates rise and decline as interest rates fall. The following table sets forth the results of the modeling analysis as of December 31, 2012 (dollars in thousands):

	Changes in Interest Rate			
	-100 bp	+100 bp	+200 bp	+300 bp
Change in net interest income	$ (106)	$ 2,611	$ 5,492	$ 6,565
% Change	(0.12)%	2.85%	5.99%	7.16%

Net interest income at risk is measured by estimating the changes in net interest income resulting from instantaneous and sustained parallel shifts in interest rates of different magnitudes over a period of 12 months. As of December 31, 2012, a 300 basis point increase in rates would increase net interest income by $6.6 million, or 7.2%, over the following twelve-month period. A 100 basis point decrease in rates would decrease net interest income by $106 thousand, or 0.1%, over the following twelve-month period.

In addition to the changes in interest rate scenarios listed above, other scenarios are typically modeled to measure interest rate risk. These scenarios vary depending on the economic and interest rate environment.

The simulations referenced above are based on management s assumption as to the effect of interest rate changes on assets and liabilities and assumes a parallel shift of the yield curve. It also includes certain assumptions about the future pricing of loans and deposits in response to changes in interest rates. Further, it assumes that delinquency rates would not change as a result of changes in interest rates, although there can be no assurance that this will be the case. While this simulation is a useful measure as to net interest income at risk due to a change in interest rates, it is not a forecast of the future results and is based on many assumptions that, if changed, could cause a different outcome.

Economic Value of Equity At Risk

The economic (or fair) value of financial instruments on our balance sheet will also vary under the interest rate scenarios previously discussed. This is measured by simulating changes in our economic value of equity (EVE), which is calculated by subtracting the estimated fair value of liabilities from the estimated fair value of assets. Fair values for financial instruments are estimated by discounting projected cash flows (principal and interest) at current replacement rates for each account type, while fair values of non-financial assets and liabilities are assumed to equal book value and do not vary with interest rate fluctuations. An economic value simulation is a static measure for balance sheet accounts at a given point in time, but this measurement can change substantially over time as the characteristics of our balance sheet evolve and as interest rate and yield curve assumptions are updated.

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The amount of change in economic value under different interest rate scenarios depends on the characteristics of each class of financial instrument, including the stated interest rate or spread relative to current market rates or spreads, the likelihood of prepayment, whether the rate is fixed or floating, and the maturity date of the instrument. As a general rule, fixed-rate financial assets become more valuable in declining rate scenarios and less valuable in rising rate scenarios, while fixed-rate financial liabilities gain in value as interest rates rise and lose value as interest rates decline. The longer the duration of the financial instrument, the greater the impact a rate change will have on its value. In our economic value simulations, estimated prepayments are factored in for financial instruments with stated maturity dates, and decay rates for non-maturity deposits are projected based historical data (back-testing).

The table below shows estimated changes in our EVE under different interest rate scenarios relative to a base case of current interest rates.

	Changes in Interest Rate			
	-100 bp	**+100 bp**	**+200 bp**	**+300 bp**
Change in EVE	$ 27,739	$ 3,684	$ 172	$ (15,721)
% Change	7.06%	0.94%	0.04%	(4.00)%

As of December 31, 2012, a 300 basis point increase in rates would decrease the economic value of equity by $15.7 million, or 4.0%. A 100 basis point decrease in rates would increase the economic value of equity by $27.7 million, or 7.0%. Embedded options within the current balance sheet such as caps, floors, and calls as well as changes in prepayment speeds and a decompression of deposit rates in rising interest rate scenarios are affecting the results, particularly as market rates begin to rise with rates increasing 100 and 200 basis points. Embedded optionality sometimes outweighs impacts of the movement in the direction of interest rates. This is evidenced in the results under the plus 100 and plus 200 basis point scenarios.

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Interest Rate Sensitivity Gap

The following table presents an analysis of our interest rate sensitivity gap position at December 31, 2012. All interest-earning assets and interest-bearing liabilities are shown based on the earlier of their contractual maturity or re-pricing date. The expected maturities are presented on a contractual basis or, if more relevant, based on projected call dates. Investment securities are at amortized cost for both securities available for sale and securities held to maturity. Loans, net of deferred loan origination costs, include principal amortization adjusted for estimated prepayments (principal payments in excess of contractual amounts) and non-accruing loans. Because the interest rate sensitivity levels shown in the table could be changed by external factors such as loan prepayments and liability decay rates or by factors controllable by us, such as asset sales, it is not an absolute reflection of our potential interest rate risk profile (in thousands).

	At December 31, 2012				
	Three Months or Less	**Over Three Months Through One Year**	**Over One Year Through Five Years**	**Over Five Years**	**Total**
INTEREST-EARNING ASSETS:					
Federal funds sold and interest-earning deposits in other banks	$	$ 94	$	$	$ 94
Investment securities	98,857	137,633	344,016	234,600	815,106
Loans	521,041	306,079	749,167	130,957	1,707,244
Total interest-earning assets	$ 619,898	$ 443,806	$ 1,093,183	$ 365,557	2,522,444
Cash and due from banks					60,342
Other assets [1]					181,248
Total assets					$ 2,764,034
INTEREST-BEARING LIABILITIES:					
Interest-bearing demand, savings and money market	$ 1,105,342	$	$	$	$ 1,105,342
Certificates of deposit	154,826	340,379	158,984	749	654,938
Borrowings	139,806	40,000			179,806
Total interest-bearing liabilities	$ 1,399,974	$ 380,379	$ 158,984	$ 749	1,940,086
Noninterest-bearing deposits					501,514
Other liabilities					68,537
Total liabilities					2,510,137
Shareholders equity					253,897
Total liabilities and shareholders equity					$ 2,764,034
Interest sensitivity gap	$ (780,076)	$ 63,427	$ 934,199	$ 364,808	$ 582,358
Cumulative gap	$ (780,076)	$ (716,649)	$ 217,550	$ 582,358	
Cumulative gap ratio [2]	44.3%	59.7%	111.2%	130.0%	
Cumulative gap as a percentage of total assets	(28.2)%	(25.9)%	7.9%	21.1%	

(1) Includes net unrealized gain on securities available for sale and allowance for loan losses.
(2) Cumulative total interest-earning assets divided by cumulative total interest-bearing liabilities.

For purposes of interest rate risk management, we direct more attention on simulation modeling, such as net interest income at risk as previously discussed, rather than gap analysis. The net interest income at risk simulation modeling is considered by management to be more informative in forecasting future income at risk.

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ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

Index to Consolidated Financial Statements

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Management s Report on Internal Control over Financial Reporting

Management is responsible for establishing and maintaining adequate internal control over financial reporting for Financial Institutions, Inc. and its subsidiaries (the Company), as such term is defined in Exchange Act Rules 13a-15(f). The Company s system of internal control over financial reporting has been designed to provide reasonable assurance to the Company s management and board of directors regarding the reliability of financial reporting and the preparation and fair presentation of financial statements for external purposes in accordance with U.S. generally accepted accounting principles.

Any system of internal control over financial reporting, no matter how well designed, has inherent limitations, including the possibility that a control can be circumvented or overridden and misstatements due to error or fraud may occur and not be detected. Also, because of changes in conditions, internal control effectiveness may vary over time. Accordingly, even an effective system of internal control will provide only reasonable assurance with respect to financial statement preparation and presentation.

The Company s management has assessed the effectiveness of the Company s internal control over financial reporting as of December 31, 2012. To make this assessment, we used the criteria for effective internal control over financial reporting described in *Internal Control Integrated Framework*, issued by the Committee of Sponsoring Organizations of the Treadway Commission. Based on our assessment and based on such criteria, we believe that, as of December 31, 2012, the Company s internal control over financial reporting was effective.

The Company s independent registered public accounting firm that audited the Company s consolidated financial statements has issued an attestation report on internal control over financial reporting as of December 31, 2012. That report appears herein.

/s/ Martin K. Birmingham
President and Chief Executive Officer
March 18, 2013

/s/ Karl F. Krebs
Executive Vice President and Chief Financial Officer
March 18, 2013

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Report of Independent Registered Public Accounting Firm

The Board of Directors and Shareholders

Financial Institutions, Inc.:

We have audited Financial Institutions, Inc. and subsidiaries (the Company) internal control over financial reporting as of December 31, 2012, based on criteria established in *Internal Control Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). The Company s management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying Management s Report on Internal Control over Financial Reporting. Our responsibility is to express an opinion on the Company s internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audit also includes performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company s internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company s internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company s assets that could have a material effect on the financial statements.

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

In our opinion, Financial Institutions, Inc. and subsidiaries maintained, in all material respects, effective internal control over financial reporting as of December 31, 2012, based on criteria established in *Internal Control Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated statements of financial condition of Financial Institutions, Inc. and subsidiaries as of December 31, 2012 and 2011, and the related consolidated statements of income, comprehensive income, changes in shareholders equity, and cash flows for each of the years in the three-year period ended December 31, 2012, and our report dated March 18, 2013 expressed an unqualified opinion on those consolidated financial statements.

/s/ KPMG LLP

Rochester, New York

March 18, 2013

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Report of Independent Registered Public Accounting Firm

The Board of Directors and Shareholders

Financial Institutions, Inc.:

We have audited the accompanying consolidated statements of financial condition of Financial Institutions, Inc. and subsidiaries (the Company) as of December 31, 2012 and 2011, and the related consolidated statements of income, comprehensive income, changes in shareholders equity, and cash flows for each of the years in the three-year period ended December 31, 2012. These consolidated financial statements are the responsibility of the Company s management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of Financial Institutions, Inc. and subsidiaries as of December 31, 2012 and 2011, and the results of their operations and their cash flows for each of the years in the three-year period ended December 31, 2012, in conformity with U.S. generally accepted accounting principles.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the Company s internal control over financial reporting as of December 31, 2012, based on criteria established in *Internal Control Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO), and our report dated March 18, 2013 expressed an unqualified opinion on the effectiveness of the Company s internal control over financial reporting.

/s/ KPMG LLP

Rochester, New York

March 18, 2013

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FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

Consolidated Statements of Financial Condition

(Dollars in thousands, except share and per share data)	December 31, 2012	December 31, 2011
ASSETS		
Cash and cash equivalents:		
Cash and due from banks	$ 60,342	$ 57,489
Federal funds sold and interest-bearing deposits in other banks	94	94
Total cash and cash equivalents	60,436	57,583
Securities available for sale, at fair value	823,796	627,518
Securities held to maturity, at amortized cost (fair value of $18,478 and $23,964, respectively)	17,905	23,297
Loans held for sale	1,518	2,410
Loans (net of allowance for loan losses of $24,714 and $23,260, respectively)	1,681,012	1,461,516
Company owned life insurance	47,386	45,556
Premises and equipment, net	36,618	33,085
Goodwill and other intangible assets, net	50,820	37,369
Other assets	44,543	48,019
Total assets	$ 2,764,034	$ 2,336,353
LIABILITIES AND SHAREHOLDERS EQUITY		
Deposits:		
Noninterest-bearing demand	$ 501,514	$ 393,421
Interest-bearing demand	449,744	362,555
Savings and money market	655,598	474,947
Certificates of deposit	654,938	700,676
Total deposits	2,261,794	1,931,599
Short-term borrowings	179,806	150,698
Other liabilities	68,537	16,862
Total liabilities	2,510,137	2,099,159
Commitments and contingencies (Note 10)		
Shareholders equity:		
Series A 3% preferred stock, $100 par value; 1,533 shares authorized; 1,499 and 1,500 shares issued, respectively	150	150
Series B-1 8.48% preferred stock, $100 par value, 200,000 shares authorized; 173,210 and 173,235 shares issued, respectively	17,321	17,323
Total preferred equity	17,471	17,473
Common stock, $0.01 par value, 50,000,000 shares authorized and 14,161,597 shares issued	142	142
Additional paid-in capital	67,710	67,247
Retained earnings	172,244	158,079
Accumulated other comprehensive income	3,253	945
Treasury stock, at cost 373,888 and 358,481 shares, respectively	(6,923)	(6,692)
Total shareholders equity	253,897	237,194
Total liabilities and shareholders equity	$ 2,764,034	$ 2,336,353

See accompanying notes to the consolidated financial statements.

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FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

Consolidated Statements of Income

(Dollars in thousands, except per share amounts)	Years ended December 31, 2012	2011	2010
Interest income:			
Interest and fees on loans	$ 81,123	$ 77,105	$ 75,877
Interest and dividends on investment securities	16,444	18,013	20,622
Other interest income			10
Total interest income	97,567	95,118	96,509
Interest expense:			
Deposits	8,462	11,434	14,853
Short-term borrowings	589	500	365
Long-term borrowings		1,321	2,502
Total interest expense	9,051	13,255	17,720
Net interest income	88,516	81,863	78,789
Provision for loan losses	7,128	7,780	6,687
Net interest income after provision for loan losses	81,388	74,083	72,102
Noninterest income:			
Service charges on deposits	8,627	8,679	9,585
ATM and debit card	4,716	4,359	3,995
Broker-dealer fees and commissions	2,104	1,829	1,283
Company owned life insurance	1,751	1,424	1,107
Loan servicing	617	835	1,124
Net gain on sale of loans held for sale	1,421	880	650
Net gain on disposal of investment securities	2,651	3,003	169
Impairment charges on investment securities	(91)	(18)	(594)
Net (loss) gain on sale and disposal of other assets	(381)	67	(203)
Other	3,362	2,867	2,338
Total noninterest income	24,777	23,925	19,454
Noninterest expense:			
Salaries and employee benefits	40,127	35,743	32,844
Occupancy and equipment	11,419	10,868	10,818
Professional services	4,133	2,617	2,197
Computer and data processing	3,271	2,437	2,487
Supplies and postage	2,497	1,778	1,772
FDIC assessments	1,300	1,513	2,507
Advertising and promotions	929	1,259	1,121
Loss on extinguishment of debt		1,083	
Other	7,721	6,496	7,171
Total noninterest expense	71,397	63,794	60,917
Income before income taxes	34,768	34,214	30,639

Income tax expense	11,319	11,415	9,352
Net income	$ 23,449	$ 22,799	$ 21,287
Preferred stock dividends	1,474	1,877	3,358
Accretion of discount on Series A preferred stock		1,305	367
Net income available to common shareholders	$ 21,975	$ 19,617	$ 17,562
Earnings per common share (Note 16):			
Basic	$ 1.60	$ 1.50	$ 1.62
Diluted	$ 1.60	$ 1.49	$ 1.61
Cash dividends declared per common share	$ 0.57	$ 0.47	$ 0.40
Weighted average common shares outstanding:			
Basic	13,696	13,067	10,767
Diluted	13,751	13,157	10,845

See accompanying notes to the consolidated financial statements.

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FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

Consolidated Statements of Comprehensive Income

	Years ended December 31,		
(Dollars in thousands)	**2012**	**2011**	**2010**
Net income	$ 23,449	$ 22,799	$ 21,287
Other comprehensive income:			
Unrealized gains on securities:			
Change in net unrealized securities gains arising during period	6,682	22,350	(16)
Deferred tax expense	(2,646)	(8,855)	(19)
Reclassification adjustment for gains included in income before income taxes	(2,560)	(2,985)	425
Related tax expense (benefit)	1,014	1,183	(168)
Change in net unrealized gains on securities, net of tax	2,490	11,693	222
Change in pension and post-retirement obligations:			
Change in net actuarial gain\loss	(300)	(9,979)	(2,192)
Related tax expense	118	3,953	950
Change in pension and post-retirement obligations, net of tax	(182)	(6,026)	(1,242)
Other comprehensive income (loss)	2,308	5,667	(1,020)
Comprehensive income	$ 25,757	$ 28,466	$ 20,267

See accompanying notes to the consolidated financial statements.

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FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

Consolidated Statements of Changes in Shareholders Equity

Years ended December 31, 2012, 2011 and 2010

(Dollars in thousands, except per share data)	**Preferred Equity**	**Common Stock**	**Additional Paid-in Capital**	**Retained Earnings**	**Accumulated Other Comprehensive Income (Loss)**	**Treasury Stock**	**Total Shareholders Equity**
Balance at January 1, 2010	**$ 53,418**	**$ 113**	**$ 26,940**	**$ 131,371**	**$ (3,702)**	**$ (9,846)**	**$ 198,294**
Comprehensive income:							
Net income				21,287			21,287
Other comprehensive loss, net of tax					(1,020)		(1,020)
Total comprehensive income							20,267
Purchases of common stock for treasury						(69)	(69)
Share-based compensation plans:							
Share-based compensation			1,031				1,031
Stock options exercised			(74)			290	216
Restricted stock awards issued, net			(1,853)			1,853	
Directors retainer			(15)			112	97
Accrued undeclared cumulative dividend on Series A preferred stock, net of accretion	367			(367)			
Cash dividends declared:							
Series A 3% preferred-$3.00 per share				(5)			(5)
Series A preferred-$250.00 per share				(1,876)			(1,876)
Series B-1 8.48% preferred-$8.48 per share				(1,477)			(1,477)
Common-$0.40 per share				(4,334)			(4,334)
Balance at December 31, 2010	**$ 53,785**	**$ 113**	**$ 26,029**	**$ 144,599**	**$ (4,722)**	**$ (7,660)**	**$ 212,144**
Comprehensive income:							
Net income				22,799			22,799
Other comprehensive income, net of tax					5,667		5,667
Total comprehensive income							28,466
Issuance of common stock		29	43,098				43,127
Purchases of common stock for treasury						(215)	(215)
Repurchase of Series A 3% preferred stock	(3)						(3)
Repurchase of warrant issued to U.S. Treasury			(2,080)				(2,080)
Redemption of Series A preferred stock	(37,515)		68				(37,447)
Repurchase of Series B-1 8.48% preferred stock	(99)						(99)
Share-based compensation plans:							
Share-based compensation			1,105				1,105
Stock options exercised			(28)			119	91
Restricted stock awards issued, net			(954)			954	
Excess tax benefit on share-based compensation			21				21
Directors retainer			(12)			110	98
Accretion of discount on Series A preferred stock	1,305			(1,305)			
Cash dividends declared:							
Series A 3% preferred-$3.00 per share				(5)			(5)
Series A preferred-$53.24 per share				(399)			(399)
Series B-1 8.48% preferred-$8.48 per share				(1,473)			(1,473)

Common-$0.47 per share				(6,137)			(6,137)
Balance at December 31, 2011	**$ 17,473**	**$ 142**	**$ 67,247**	**$ 158,079**	**$ 945**	**$ (6,692)**	**$ 237,194**

Continued on next page

See accompanying notes to the consolidated financial statements.

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FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

Consolidated Statements of Changes in Shareholders Equity (Continued)

Years ended December 31, 2012, 2011 and 2010

(Dollars in thousands, except per share data)	Preferred Equity	Common Stock	Additional Paid-in Capital	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Treasury Stock	Total Shareholders Equity
Balance at December 31, 2011	**$ 17,473**	**$ 142**	**$ 67,247**	**$ 158,079**	**$ 945**	**$ (6,692)**	**$ 237,194**
Balance carried forward							
Comprehensive income:							
Net income				23,449			23,449
Other comprehensive income, net of tax					2,308		2,308
Total comprehensive income							25,757
Purchases of common stock for treasury						(557)	(557)
Repurchase of Series B-1 8.48% preferred stock	(2)						(2)
Share-based compensation plans:							
Share-based compensation			526				526
Stock options exercised			(10)			79	69
Restricted stock awards issued, net			(140)			140	
Excess tax benefit on share-based compensation			97				97
Directors retainer			(10)			107	97
Cash dividends declared:							
Series A 3% Preferred-$3.00 per share				(5)			(5)
Series B-1 8.48% Preferred-$8.48 per share				(1,469)			(1,469)
Common-$0.57 per share				(7,810)			(7,810)
Balance at December 31, 2012	**$ 17,471**	**$ 142**	**$ 67,710**	**$ 172,244**	**$ 3,253**	**$ (6,923)**	**$ 253,897**

See accompanying notes to the consolidated financial statements.

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FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

Consolidated Statements of Cash Flows

(Dollars in thousands)	Years ended December 31, 2012	2011	2010
Cash flows from operating activities:			
Net income	$ 23,449	$ 22,799	$ 21,287
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation and amortization	3,828	3,466	3,537
Net amortization of premiums on securities	5,284	5,722	3,005
Provision for loan losses	7,128	7,780	6,687
Share-based compensation	526	1,105	1,031
Deferred income tax expense	6,343	6,510	2,468
Proceeds from sale of loans held for sale	55,067	32,839	42,195
Originations of loans held for sale	(52,754)	(31,231)	(44,262)
Increase in company owned life insurance	(1,751)	(1,424)	(1,107)
Net gain on sale of loans held for sale	(1,421)	(880)	(650)
Net gain on disposal of investment securities	(2,651)	(3,003)	(169)
Impairment charges on investment securities	91	18	594
Net loss (gain) on sale and disposal of other assets	381	(67)	203
Contributions to defined benefit pension plan	(8,000)	(10,000)	(4,300)
Loss on extinguishment of debt		1,083	
Increase in other assets	(4,249)	(7,756)	(353)
Increase in other liabilities	7,429	5,057	5,261
Net cash provided by operating activities	38,700	32,018	35,427
Cash flows from investing activities:			
Purchases of investment securities:			
Available for sale	(322,191)	(158,013)	(430,952)
Held to maturity	(15,484)	(17,188)	(19,791)
Proceeds from principal payments, maturities and calls on investment securities:			
Available for sale	175,679	168,976	219,974
Held to maturity	20,819	21,986	30,885
Proceeds from sales of securities available for sale	2,823	44,514	122,090
Net increase in loans, excluding sales	(151,311)	(157,110)	(89,507)
Loans sold or participated to others		13,033	
Purchases of company owned life insurance	(79)	(18,079)	(79)
Proceeds from sales of other assets	734	705	611
Purchases of premises and equipment	(5,840)	(3,678)	(2,438)
Net cash received in branch acquisitions	195,778		
Net cash used in investing activities	(99,072)	(104,854)	(169,207)
Cash flows from financing activities:			
Net increase in deposits	43,376	48,709	139,935
Net increase in short-term borrowings	29,108	73,588	17,567
Repayments of long-term borrowings		(26,767)	(20,080)
Proceeds from issuance of common stock, net of issuance costs		43,127	
Purchases of common stock for treasury	(557)	(215)	(69)
Repurchase of preferred stock	(2)	(37,549)	
Repurchase of warrant issued to U.S. Treasury		(2,080)	
Proceeds from stock options exercised	69	91	216

Excess tax benefit on share-based compensation	97	21	
Cash dividends paid to preferred shareholders	(1,474)	(2,118)	(3,358)
Cash dividends paid to common shareholders	(7,392)	(5,446)	(4,332)
Net cash provided by financing activities	63,225	91,361	129,879
Net increase (decrease) in cash and cash equivalents	2,853	18,525	(3,901)
Cash and cash equivalents, beginning of period	57,583	39,058	42,959
Cash and cash equivalents, end of period	$ 60,436	$ 57,583	$ 39,058

See accompanying notes to the consolidated financial statements.

FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2012, 2011 and 2010

(1.) SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Financial Institutions, Inc., a financial holding company organized under the laws of New York State (New York or NYS), and its subsidiaries provide deposit, lending and other financial services to individuals and businesses in Central and Western New York. The Company has also expanded its indirect lending network to include relationships with franchised automobile dealers in the Capital District of New York and Northern Pennsylvania. Financial Institutions, Inc. owns all of the capital stock of Five Star Bank, a New York State chartered bank, and Five Star Investment Services, Inc., a financial services subsidiary offering noninsured investment products and investment advisory services. References to the Company mean the consolidated reporting entities and references to the Bank mean Five Star Bank.

The accounting and reporting policies conform to general practices within the banking industry and to U.S. generally accepted accounting principles (GAAP). Prior years consolidated financial statements are re-classified whenever necessary to conform to the current year s presentation.

The Company has evaluated events and transactions for potential recognition or disclosure through the day the financial statements were issued.

The following is a description of the Company s significant accounting policies.

(a.) Principles of Consolidation

The consolidated financial statements include the accounts of the Company and its subsidiaries. All significant intercompany accounts and transactions have been eliminated in consolidation.

(b.) Use of Estimates

In preparing the consolidated financial statements in conformity with GAAP, management is required to make estimates and assumptions that affect the reported amount of assets and liabilities as of the date of the statement of financial condition and reported amounts of revenue and expenses during the reporting period. Material estimates relate to the determination of the allowance for loan losses, the carrying value of goodwill and deferred tax assets, the valuation and other than temporary impairment (OTTI) considerations related to the securities portfolio, and assumptions used in the defined benefit pension plan accounting. These estimates and assumptions are based on management s best estimates and judgment and are evaluated on an ongoing basis using historical experience and other factors, including the current economic environment. The Company adjusts these estimates and assumptions when facts and circumstances dictate. As future events cannot be determined with precision, actual results could differ significantly from the Company s estimates.

(c.) Cash Flow Reporting

Cash and cash equivalents include cash and due from banks, federal funds sold and interest-bearing deposits in other banks. Net cash flows are reported for loans, deposit transactions and short-term borrowings.

Supplemental cash flow information is summarized as follows for the years ended December 31 (in thousands):

	2012	2011	2010
Cash payments:			
Interest expense	$ 10,438	$ 15,668	$ 17,676
Income taxes	4,014	5,191	6,923
Noncash investing and financing activities:			
Real estate and other assets acquired in settlement of loans	$ 322	$ 305	$ 561
Accrued and declared unpaid dividends	2,562	2,144	1,694

Accretion of preferred stock discount		1,305	367
Increase (decrease) in net unsettled security purchases	51,135	(67)	(317)
Net transfer of portfolio loans to held for sale		13,576	
Assets acquired and liabilities assumed in branch acquisition:			
Loans and other non-cash assets, excluding goodwill and core deposit intangible asset	77,912		
Deposits and other liabilities	287,331		

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FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2012, 2011 and 2010

(1.) SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

(d.) Investment Securities

Investment securities are classified as either available for sale or held to maturity. Debt securities that management has the positive intent and ability to hold to maturity are classified as held to maturity and are recorded at amortized cost. Other investment securities are classified as available for sale and recorded at fair value, with unrealized gains and losses excluded from earnings and reported as a component of comprehensive income and shareholders equity.

Purchase premiums and discounts are recognized in interest income using the interest method over the terms of the securities. Securities are evaluated periodically to determine whether a decline in their fair value is other than temporary. Management utilizes criteria such as, the current intent to hold or sell the security, the magnitude and duration of the decline and, when appropriate, consideration of negative changes in expected cash flows, creditworthiness, near term prospects of issuers, the level of credit subordination, estimated loss severity, and delinquencies, to determine whether a loss in value is other than temporary. The term other than temporary is not intended to indicate that the decline is permanent, but indicates that the prospect for a near-term recovery of value is not necessarily favorable. Declines in the fair value of investment securities below their cost that are deemed to be other than temporary are reflected in earnings as realized losses to the extent the impairment is related to credit issues or concerns, or the security is intended to be sold. The amount of impairment related to non-credit related factors is recognized in other comprehensive income. Gains and losses on the sale of securities are recorded on the trade date and are determined using the specific identification method.

(e.) Loans Held for Sale and Loan Servicing Rights

The Company generally makes the determination of whether to identify a mortgage as held for sale at the time the loan is closed based on the Company s intent and ability to hold the loan. Loans held for sale are recorded at the lower of cost or market computed on the aggregate portfolio basis. The amount, by which cost exceeds market value, if any, is accounted for as a valuation allowance with changes included in the determination of results of operations for the period in which the change occurs. The amount of loan origination cost and fees are deferred at origination of the loans and recognized as part of the gain or loss on sale of the loans, determined using the specific identification method, in the consolidated statements of income.

The Company originates and sells certain residential real estate loans in the secondary market. The Company typically retains the right to service the mortgages upon sale. Mortgage-servicing rights (MSRs) represent the cost of acquiring the contractual rights to service loans for others. MSRs are recorded at their fair value at the time a loan is sold and servicing rights are retained. MSRs are reported in other assets in the consolidated statements of financial position and are amortized to noninterest income in the consolidated statements of income in proportion to and over the period of estimated net servicing income. The Company uses a valuation model that calculates the present value of future cash flows to determine the fair value of servicing rights. In using this valuation method, the Company incorporates assumptions to estimate future net servicing income, which include estimates of the cost to service the loan, the discount rate, an inflation rate and prepayment speeds. On a quarterly basis, the Company evaluates its MSRs for impairment and charges any such impairment to current period earnings. In order to evaluate its MSRs the Company stratifies the related mortgage loans on the basis of their predominant risk characteristics, such as interest rates, year of origination and term, using discounted cash flows and market-based assumptions. Impairment of MSRs is recognized through a valuation allowance, determined by estimating the fair value of each stratum and comparing it to its carrying value. Subsequent increases in fair value are adjusted through the valuation allowance, but only to the extent of the valuation allowance. No impairment loss related to the MSRs was recognized during the years ended December 31, 2012 or 2010. The Company recognized an impairment loss related to the MSRs of $35 thousand during the year ended December 31, 2011.

Mortgage loan servicing includes collecting monthly mortgagor payments, forwarding payments and related accounting reports to investors, collecting escrow deposits for the payment of mortgagor property taxes and insurance, and paying taxes and insurance from escrow funds when due. Loan servicing income (a component of noninterest income in the consolidated statements of income) consists of fees earned for servicing mortgage loans sold to third parties, net of amortization expense and impairment losses associated with capitalized mortgage servicing assets.

FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2012, 2011 and 2010

(1.) SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Automobile loan servicing rights are accounted for using the amortization method. A servicing asset is established at fair value at the time of the sale. The servicing asset is reported in other assets in the consolidated statements of financial position and amortized to noninterest income in the consolidated statements of income in proportion to and over the period of estimated net servicing income. Impairment, if any, is recognized when carrying value exceeds the fair value as determined by calculating the present value of expected net future cash flows. The primary risk characteristic for measuring servicing assets is payoff rates of the underlying loan pools. Valuation calculations rely on the predicted payoff assumption and, if actual payoff is quicker than expected, then future value would be impaired. Management reviewed the servicing asset related to the automobile loan servicing rights for impairment as of December 31, 2012 and determined that no valuation allowance was necessary.

(f.) Loans

Loans are classified as held for investment when management has both the intent and ability to hold the loan for the foreseeable future, or until maturity or payoff. Loans are carried at the principal amount outstanding, net of any unearned income and unamortized deferred fees and costs on originated loans. Loan origination fees and certain direct loan origination costs are deferred, and the net amount is amortized into net interest income over the contractual life of the related loans or over the commitment period as an adjustment of yield. Interest income on loans is based on the principal balance outstanding computed using the effective interest method.

A loan is considered delinquent when a payment has not been received in accordance with the contractual terms. The accrual of interest income for commercial loans is discontinued when there is a clear indication that the borrower s cash flow may not be sufficient to meet payments as they become due, while the accrual of interest income for retail loans is discontinued when loans reach specific delinquency levels. Loans are generally placed on nonaccrual status when contractually past due 90 days or more as to interest or principal payments, unless the loan is well secured and in the process of collection. Additionally, if management becomes aware of facts or circumstances that may adversely impact the collectability of principal or interest on loans, it is management s practice to place such loans on a nonaccrual status immediately, rather than delaying such action until the loans become 90 days past due. When a loan is placed on nonaccrual status, previously accrued and uncollected interest is reversed, amortization of related deferred loan fees or costs is suspended, and income is recorded only to the extent that interest payments are subsequently received in cash and a determination has been made that the principal balance of the loan is collectible. If collectability of the principal is in doubt, payments received are applied to loan principal. A nonaccrual loan may be returned to accrual status when all delinquent principal and interest payments become current in accordance with the terms of the loan agreement, the borrower has demonstrated a period of sustained performance (generally a minimum of six months) and the ultimate collectability of the total contractual principal and interest is no longer in doubt.

The Company s loan policy dictates the guidelines to be followed in determining when a loan is charged-off. All charge offs are approved by the Bank s senior loan officers or loan committees, depending on the amount of the charge off, and are reported in aggregate to the Bank s Board of Directors. Commercial business and commercial mortgage loans are charged-off when a determination is made that the financial condition of the borrower indicates that the loan will not be collectible in the ordinary course of business. Residential mortgage loans and home equities are generally charged-off or written down when the credit becomes severely delinquent and the balance exceeds the fair value of the property less costs to sell. Indirect and other consumer loans, both secured and unsecured, are generally charged-off in full during the month in which the loan becomes 120 days past due, unless the collateral is in the process of repossession in accordance with the Company s policy.

A loan is accounted for as a troubled debt restructuring if the Company, for economic or legal reasons related to the borrower s financial condition, grants a significant concession to the borrower that it would not otherwise consider. A troubled debt restructuring may involve the receipt of assets from the debtor in partial or full satisfaction of the loan, or a modification of terms such as a reduction of the stated interest rate or face amount of the loan, a reduction of accrued interest, an extension of the maturity date at a stated interest rate lower than the current market rate for a new loan with similar risk, or some combination of these concessions. Troubled debt restructurings generally remain on nonaccrual status until there is a sustained period of payment performance (usually six months or longer) and there is a reasonable assurance that the payments will continue. See Allowance for Loan Losses below for further policy discussion and see Note 5 Loans for additional information.

FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2012, 2011 and 2010

(1.) SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

(g.) Off-Balance Sheet Financial Instruments

In the ordinary course of business, the Company enters into off-balance sheet financial instruments consisting of commitments to extend credit, standby letters of credit and financial guarantees. Such financial instruments are recorded in the consolidated financial statements when they are funded or when related fees are incurred or received. The Company periodically evaluates the credit risks inherent in these commitments and establishes loss allowances for such risks if and when these are deemed necessary.

The Company recognizes as liabilities the fair value of the obligations undertaken in issuing the guarantees under the standby letters of credit, net of the related amortization at inception. The fair value approximates the unamortized fees received from the customers for issuing the standby letters of credit. The fees are deferred and recognized on a straight-line basis over the commitment period. Standby letters of credit outstanding at December 31, 2012 had original terms ranging from one to five years.

Fees received for providing loan commitments and letters of credit that result in loans are typically deferred and amortized to interest income over the life of the related loan, beginning with the initial borrowing. Fees on commitments and letters of credit are amortized to other income as banking fees and commissions over the commitment period when funding is not expected.

(h.) Allowance for Loan Losses

The allowance for loan losses is established through charges to earnings in the form of a provision for loan losses. When a loan or portion of a loan is determined to be uncollectible, the portion deemed uncollectible is charged against the allowance and subsequent recoveries, if any, are credited to the allowance.

The allowance for loan losses is evaluated on a regular basis and is based upon periodic review of the collectability of the loans in light of historical experience, the nature and volume of the loan portfolio, adverse situations that may affect the borrower s ability to repay, estimated value of any underlying collateral, and prevailing economic conditions. This evaluation is inherently subjective as it requires estimates that are susceptible to significant revision as more information becomes available.

The allowance consists of specific and general components. Specific allowances are established for impaired loans. Impaired commercial business and commercial mortgage loans are individually evaluated and measured for impairment based on the present value of expected future cash flows discounted at the loan s effective interest rate, a loan s observable market price, or the fair value of the collateral if the loan is collateral dependent. Regardless of the measurement method, impairment is based on the fair value of the collateral when foreclosure is probable. If the recorded investment in impaired loans exceeds the measure of estimated fair value, a specific allowance is established as a component of the allowance for loan losses. Interest payments on impaired loans are typically applied to principal unless collectability of the principal amount is reasonably assured, in which case interest is recognized on a cash basis. Impaired loans, or portions thereof, are charged-off when deemed uncollectible.

A loan is considered impaired when, based on current information and events, it is probable that the Company will be unable to collect the scheduled payments of principal or interest when due according to the contractual terms of the loan agreement. Factors considered in determining impairment include payment status and the probability of collecting scheduled principal and interest payments when due. Loans that experience insignificant payment delays and payment shortfalls generally are not classified as impaired. The Company determines the significance of payment delays and payment shortfalls on a case-by-case basis, taking into consideration all of the circumstances surrounding the loan and the borrower, including the length of the delay, the reasons for the delay, the borrower s prior payment record, and the amount of the shortfall in relation to the principal and interest owed. Impairment is measured on a loan by loan basis by either the present value of expected future cash flows discounted at the loan s effective interest rate, the loans obtainable market price, or the fair value of the collateral if the loan is collateral dependent. Large groups of homogeneous loans are collectively evaluated for impairment. Accordingly, the Company does not separately identify individual consumer and residential loans for impairment disclosures unless the loan has been subject to a troubled debt restructure. At December 31, 2012, there were no commitments to lend additional funds to those borrowers whose loans were classified as impaired.

FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2012, 2011 and 2010

(1.) SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

General allowances are established for loan losses on a portfolio basis for loans that do not meet the definition of impaired. The portfolio is grouped into similar risk characteristics, primarily loan type. The Company applies an estimated loss rate to each loan group. The loss rate is based on historical experience and as a result can differ from actual losses incurred in the future. The historical loss rate is adjusted for qualitative factors such as levels and trends of delinquent and non-accruing loans, trends in volume and terms, effects of changes in lending policy, the experience, ability and depth of management, national and local economic trends and conditions, concentrations of credit risk, interest rates, highly leveraged borrowers, information risk and collateral risk. The qualitative factors are reviewed at least quarterly and adjustments are made as needed.

While management evaluates currently available information in establishing the allowance for loan losses, future adjustments to the allowance may be necessary if conditions differ substantially from the assumptions used in making the evaluations. In addition, various regulatory agencies, as an integral part of their examination process, periodically review a financial institution s allowance for loan losses. Such agencies may require the financial institution to recognize additions to the allowance based on their judgments about information available to them at the time of their examination.

(i.) Other Real Estate Owned

Other real estate owned consists of properties acquired through foreclosure or by acceptance of a deed in lieu of foreclosure. These assets are recorded at the lower of fair value of the asset acquired less estimated costs to sell or cost (defined as the fair value at initial foreclosure). At the time of foreclosure, or when foreclosure occurs in-substance, the excess, if any, of the loan over the fair market value of the assets received, less estimated selling costs, is charged to the allowance for loan losses and any subsequent valuation write-downs are charged to other expense. In connection with the determination of the allowance for loan losses and the valuation of other real estate owned, management obtains appraisals for properties. Operating costs associated with the properties are charged to expense as incurred. Gains on the sale of other real estate owned are included in income when title has passed and the sale has met the minimum down payment requirements prescribed by GAAP. The balance of other real estate owned was $184 thousand and $475 thousand at December 31, 2012 and 2011, respectively.

(j.) Company Owned Life Insurance

The Company holds life insurance policies on certain current and former employees. The Company is the owner and beneficiary of the policies. The cash surrender value of these policies is included as an asset on the consolidated statements of financial condition, and any increase in cash surrender value is recorded as noninterest income on the consolidated statements of income. In the event of the death of an insured individual under these policies, the Company would receive a death benefit which would be recorded as noninterest income.

(k.) Premises and Equipment

Premises and equipment are stated at cost, less accumulated depreciation and amortization. Depreciation is computed on the straight-line method over the estimated useful lives of the assets. The Company generally amortizes buildings and building improvements over a period of 15 to 39 years and software, furniture and equipment over a period of 3 to 10 years. Leasehold improvements are amortized over the shorter of the lease term or the useful life of the improvements. Premises and equipment are periodically reviewed for impairment or when circumstances present indicators of impairment.

(l.) Goodwill and Other Intangible Assets

Goodwill represents the excess of the purchase price over the fair value of net assets acquired in accordance with the purchase method of accounting for business combinations. Goodwill has an indefinite useful life and is not amortized, but is tested for impairment. GAAP requires goodwill to be tested for impairment at the Company s reporting unit level on an annual basis, which for the Company is September 30th, and more frequently if events or circumstances indicate that there may be impairment. Currently, the Company s goodwill is evaluated at the entity level as there is only one reporting unit.

FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2012, 2011 and 2010

(1.) SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Impairment exists when a reporting unit s carrying value of goodwill exceeds its implied fair value. In testing goodwill for impairment, GAAP permits the Company to first assess qualitative factors to determine whether it is more likely than not that the fair value of a reporting unit is less than its carrying value. If, after assessing the totality of events and circumstances, the Company determines it is not more likely than not that the fair value of a reporting unit is less than its carrying value, then performing the two-step impairment test would be unnecessary. However, if the Company concludes otherwise, it would then be required to perform the first step (Step 1) of the goodwill impairment test, and continue to the second step (Step 2), if necessary. Step 1 compares the fair value of a reporting unit with its carrying value, including goodwill. If the carrying value of the reporting unit exceeds its fair value, Step 2 of the goodwill impairment test is performed to measure the amount of impairment loss, if any.

Intangible assets are acquired assets that lack physical substance but can be distinguished from goodwill because of contractual or other legal rights or because the asset is capable of being sold or exchanged either on its own or in combination with a related contract, asset, or liability. The Company s intangible assets relate to core deposits. Intangible assets with definite useful lives are amortized on an accelerated basis over their estimated life of approximately nine and a half years. Intangible assets with indefinite useful lives are not amortized until their lives are determined to be definite. Intangible assets are tested for impairment whenever events or changes in circumstances indicate the carrying amount of the assets may not be recoverable from future undiscounted cash flows. If impaired, the assets are recorded at fair value. See Note 7 Goodwill and Other Intangible Assets.

(m.) Federal Home Loan Bank (FHLB) and Federal Reserve Bank (FRB) Stock

The non-marketable investments in FHLB and FRB stock are included in other assets in the consolidated statements of financial condition at par value or cost and are periodically reviewed for impairment. The dividends received relative to these investments are included in other noninterest income in the consolidated statements of income.

As a member of the FHLB system, the Company is required to maintain a specified investment in FHLB of New York (FHLBNY) stock in proportion to its volume of certain transactions with the FHLB. FHLBNY stock totaled $8.4 million and $6.8 million as of December 31, 2012 and 2011, respectively.

As a member of the FRB system, the Company is required to maintain a specified investment in FRB stock based on a ratio relative to the Company s capital. FRB stock totaled $3.9 million as of December 31, 2012 and 2011.

(n.) Equity Method Investments

The Company has investments in limited partnerships and accounts for these investments under the equity method. These investments are included in other assets in the consolidated statements of financial condition and totaled $4.7 million and $4.0 million as of December 31, 2012 and 2011, respectively.

(o.) Treasury Stock

Acquisitions of treasury stock are recorded at cost. The reissuance of shares in treasury is recorded at weighted-average cost.

(p.) Employee Benefits

The Company participates in a non-contributory defined benefit pension plan for certain employees who previously met participation requirements. The Company also provides post-retirement benefits, principally health and dental care, to employees of a previously acquired entity. The Company has closed the pension and post-retirement plans to new participants. The actuarially determined pension benefit is based on years of service and the employee s highest average compensation during five consecutive years of employment. The Company s policy is to at least fund the minimum amount required by the Employment Retirement Income Security Act of 1974. The cost of the pension and post-retirement plans are based on actuarial computations of current and future benefits for employees, and is charged to noninterest expense in the consolidated statements of income.

The Company recognizes an asset or a liability for a plans overfunded status or underfunded status, respectively, in the consolidated financial statements and reports changes in the funded status as a component of other comprehensive income, net of applicable taxes, in the year in which changes occur.

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FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2012, 2011 and 2010

(1.) SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

(q.) Share-Based Compensation Plans

Compensation expense for stock options and restricted stock awards is based on the fair value of the award on the measurement date, which, for the Company, is the date of grant and is recognized ratably over the service period of the award. The fair value of stock options is estimated using the Black-Scholes option-pricing model. The fair value of restricted stock awards is generally the market price of the Company s stock on the date of grant.

Share-based compensation expense is included in the consolidated statements of income under salaries and employee benefits for awards granted to management and in other noninterest expense for awards granted to directors.

(r.) Income Taxes

Income taxes are accounted for using the asset and liability method. Deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases. Deferred tax assets and liabilities are measured using enacted tax rates in effect for the year in which those temporary differences are expected to be recovered or settled. The effect of a change in tax rates on deferred tax assets and liabilities is recognized in income in the period that includes the enactment date. A valuation allowance is recognized on deferred tax assets if, based upon the weight of available evidence, it is more likely than not that some or all of the assets may not be realized. The Company recognizes interest and/or penalties related to income tax matters in income tax expense.

(s.) Earnings Per Common Share

The Company calculates earnings per common share (EPS) using the two-class method in accordance with Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) Topic 260, Earnings Per Share . The two-class method requires the Company to present EPS as if all of the earnings for the period are distributed to common shareholders and any participating securities, regardless of whether any actual dividends or distributions are made. All outstanding unvested share-based payment awards that contain rights to nonforfeitable dividends are considered participating securities. Certain of the restricted shares issued under the Company s share-based compensation plan are entitled to dividends at the same rate as common stock. The Company has determined that these outstanding non-vested stock awards qualify as participating securities.

Basic EPS is computed by dividing distributed and undistributed earnings available to common shareholders by the weighted average number of common shares outstanding for the period. Distributed and undistributed earnings available to common shareholders represent net income reduced by preferred stock dividends and distributed and undistributed earnings available to participating securities. Common shares outstanding include common stock and vested restricted stock awards. Diluted EPS reflects the assumed conversion of all potential dilutive securities. A reconciliation of the weighted-average shares used in calculating basic earnings per common share and the weighted average common shares used in calculating diluted earnings per common share for the reported periods is provided in Note 16 Earnings Per Common Share.

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FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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(1.) SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

(t.) Recent Accounting Pronouncements

In May 2011, the FASB issued Accounting Standards Update (ASU) No. 2011-04, *Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs.* The provisions of ASU No. 2011-04 provide a consistent definition of fair value and common requirements for the measurement of and disclosure about fair value between U.S. GAAP and International Financial Reporting Standards (IFRS). The changes to U.S. GAAP as a result of ASU No. 2011-04 are as follows: (1) the concepts of highest and best use and valuation premise are only relevant when measuring the fair value of nonfinancial assets (that is, it does not apply to financial assets or any liabilities); (2) extends the prohibition on applying a blockage factor in valuing financial instruments with quoted prices in active markets; (3) creates an exception to the basic fair value measurement principles for an entity that holds a group of financial assets and financial liabilities with offsetting positions in market risks or counterparty credit risk that are managed on the basis of the entity s net exposure to either of those risks by allowing the entity, if certain criteria are met, to measure the fair value of the net asset or liability position in a manner consistent with how market participants would price the net risk position; (4) aligns the fair value measurement of instruments classified within an entity s shareholders equity with the guidance for liabilities; and (5) enhances disclosure requirements for Level 3 fair value measurements to disclose quantitative information about unobservable inputs and assumptions used, to describe the valuation processes used by the entity, and to qualitatively describe the sensitivity of fair value measurements to changes in unobservable inputs and the interrelationships between those inputs. In addition, entities must report the level in the fair value hierarchy of items that are not measured at fair value in the statement of condition but whose fair value must be disclosed. The Company adopted the provisions of ASU No. 2011-04 effective January 1, 2012. The fair value measurement provisions of ASU No. 2011-04 had no material impact on the Company s consolidated financial statements. See Note 18 Fair Value Measurements to the consolidated financial statements for the enhanced disclosures required by ASU No. 2011-04.In June 2011, the FASB issued ASU No. 2011-05, *Presentation of Comprehensive Income.* The provisions of ASU No. 2011-05 allow an entity the option to present the total of comprehensive income, the components of net income, and the components of other comprehensive income either in a single continuous statement of comprehensive income or in two separate but consecutive statements. In both options, an entity is required to present each component of net income along with total net income, each component of other comprehensive income along with a total for other comprehensive income, and a total amount for comprehensive income. Under either method, entities are required to present on the face of the financial statements reclassification adjustments for items that are reclassified from other comprehensive income to net income in the statement(s) where the components of net income and the components of other comprehensive income are presented. ASU No. 2011-05 also eliminates the option to present the components of other comprehensive income as part of the statement of changes in shareholders equity but does not change the items that must be reported in other comprehensive income or when an item of other comprehensive income must be reclassified to net income. ASU No. 2011-05 was effective for the Company s interim reporting period beginning on or after January 1, 2012, with retrospective application required. In December 2011, the FASB issued ASU No. 2011-12, *Deferral of the Effective Date for Amendments to the Presentation of Reclassifications of Items Out of Accumulated Other Comprehensive Income in Accounting Standards Update No. 2011-05.* The provisions of ASU No. 2011-12 defer indefinitely the requirement for entities to present reclassification adjustments out of accumulated other comprehensive income by component in both the statement in which net income is presented and the statement in which other comprehensive income is presented. ASU No. 2011-12, which shares the same effective date as ASU No. 2011-05, does not defer the requirement for entities to present components of comprehensive income in either a single continuous statement of comprehensive income or in two separate but consecutive statements. The Company adopted the provisions of ASU No. 2011-05 and ASU No. 2011-12 which resulted in a new statement of comprehensive income beginning with the interim period ended March 31, 2012. The adoption of ASU No. 2011-05 and ASU No. 2011-12 had no material impact on the Company s statements of income and financial condition.

In September 2011, the FASB issued ASU No. 2011-08 *Testing Goodwill for Impairment.* The provisions of ASU 2011-08 permit an entity the option to first perform a qualitative assessment to determine whether it is more likely than not that the fair value of a reporting unit is less than its carrying amount. If an entity believes, as a result of its qualitative assessment, that it is more likely than not that the fair value of a reporting unit is less than its carrying amount, the quantitative impairment test is required. Otherwise, no further impairment testing is required. ASU No. 2011-08 includes examples of events and circumstances that may indicate that a reporting unit s fair value is less than its carrying amount. The provisions of ASU No. 2011-08 are effective for annual and interim goodwill impairment tests performed beginning in 2012. The adoption of ASU No. 2011-08 did not have a material impact on the Company s consolidated financial statements.

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FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2012, 2011 and 2010

(1.) SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

In July 2012, the FASB issued ASU No. 2012-02, *Testing Indefinite-Lived Intangible Assets for Impairment.* The provisions of ASU No. 2012-02 permit an entity to first assess qualitative factors to determine whether it is more likely than not that an indefinite-lived intangible asset is impaired as a basis for determining whether it is necessary to perform a quantitative impairment test, as is currently required by GAAP. ASU No. 2012-02 is effective for annual and interim impairment tests performed for fiscal years beginning after September 15, 2012. The Company does not have any indefinite-lived intangible assets other than goodwill, therefore the adoption of ASU No. 2012-02 is expected to have no material impact on the Company s consolidated financial statements.

In February 2013, the FASB issued ASU No. 2013-02, *Reporting of Amounts Reclassified Out of Accumulated Other Comprehensive Income*. The Update requires an entity to provide information about the amounts reclassified out of accumulated other comprehensive income by component and to present either on the face of the statement where net income is presented, or in the notes, significant amounts reclassified out of accumulated other comprehensive income by the respective line items of net income, but only if the amount reclassified is required to be reclassified to net income in its entirety in the same reporting period. The amendments are effective for annual and interim reporting periods beginning on or after December 15, 2012. The Company is currently in the process of evaluating the ASU but does not expect it will have a material impact on the Company s consolidated financial statements.

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FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

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(2.) BRANCH ACQUISITIONS

On January 19, 2012, the Bank entered into agreements with First Niagara Bank, National Association (First Niagara) to acquire four First Niagara retail bank branches in Medina, Brockport, Batavia and Waterloo, New York (the First Niagara Branches) and four retail bank branches previously owned by HSBC Bank USA, National Association (HSBC) in Elmira, Elmira Heights, Horseheads and Albion, New York (the HSBC Branches). First Niagara assigned its rights to the HSBC branches in connection with its acquisition of HSBC s Upstate New York banking franchise. Under the terms of the agreements, the Bank assumed all related deposits and purchased the related branch premises and certain performing loans. The transaction to acquire the First Niagara Branches was completed on June 22, 2012 and the transaction to acquire the HSBC Branches was completed on August 17, 2012. The combined assets acquired and deposits assumed in the two transactions were recorded at their estimated fair values as follows:

Cash	$ 195,778
Loans	75,635
Bank premises and equipment	1,938
Goodwill	11,599
Core deposit intangible asset	2,042
Other assets	339
Total assets acquired	$ 287,331
Deposits assumed	$ 286,819
Other liabilities	512
Total liabilities assumed	$ 287,331

The transactions were accounted for using the acquisition method of accounting and accordingly, assets acquired, liabilities assumed and consideration exchanged were recorded at their estimated fair values on the acquisition dates. Fair values are preliminary and in certain cases are subject to refinement for up to one year after the closing date of the acquisition as additional information relative to fair values becomes available.

The operating results of the acquired branches included in the Company s consolidated statement of income for the year ended December 31, 2012 reflect only amounts from the acquisition dates through December 31, 2012. The operating results of the acquired branches prior to the acquisition dates were not material for purposes of supplemental disclosure under the FASB guidance on business combinations.

The Company acquired the loan portfolios at a fair value discount of $824 thousand. The discount represents expected credit losses, net of market interest rate adjustments. The discount on loans receivable will be amortized to interest income over the estimated remaining life of the acquired loans using the level yield method. The core deposit intangible asset will be amortized on an accelerated basis over a period of approximately nine and a half years. The time deposit premium of $335 thousand will be accreted over the estimated remaining life of the related deposits as a reduction of interest expense.

Preliminary goodwill of $11.6 million is calculated as the purchase premium after adjusting for the fair value of net assets acquired and represents the value expected from the synergies created and the economies of scale expected from combining the operations of the acquired branches with those of the Bank. All goodwill and core deposit intangible assets arising from this acquisition are expected to be deductible for tax purposes.

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FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

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December 31, 2012, 2011 and 2010

(3.) INVESTMENT SECURITIES

The amortized cost and estimated fair value of investment securities are summarized below (in thousands).

	Amortized Cost	Unrealized Gains	Unrealized Losses	Fair Value
December 31, 2012				
Securities available for sale:				
U.S. Government agencies and government sponsored enterprises	$ 128,097	$ 3,667	$ 69	$ 131,695
State and political subdivisions	188,997	6,285	72	195,210
Mortgage-backed securities:				
Federal National Mortgage Association	147,946	4,394	188	152,152
Federal Home Loan Mortgage Corporation	65,426	1,430		66,856
Government National Mortgage Association	56,166	3,279		59,445
Collateralized mortgage obligations:				
Federal National Mortgage Association	60,805	1,865	2	62,668
Federal Home Loan Mortgage Corporation	78,581	1,911		80,492
Government National Mortgage Association	70,989	2,168		73,157
Privately issued	73	1,025		1,098
Total collateralized mortgage obligations	210,448	6,969	2	217,415
Total mortgage-backed securities	479,986	16,072	190	495,868
Asset-backed securities	121	902		1,023
Total available for sale securities	$ 797,201	$ 26,926	$ 331	$ 823,796
Securities held to maturity:				
State and political subdivisions	$ 17,905	$ 573	$	$ 18,478
December 31, 2011				
Securities available for sale:				
U.S. Government agencies and government sponsored enterprises	$ 94,947	$ 2,770	$ 5	$ 97,712
State and political subdivisions	119,099	5,336	11	124,424
Mortgage-backed securities:				
Federal National Mortgage Association	98,679	2,944		101,623
Federal Home Loan Mortgage Corporation	63,838	1,017		64,855
Government National Mortgage Association	73,226	3,376		76,602
Collateralized mortgage obligations:				
Federal National Mortgage Association	28,339	581	7	28,913
Federal Home Loan Mortgage Corporation	22,318	675	1	22,992
Government National Mortgage Association	103,975	2,654	18	106,611
Privately issued	327	1,762		2,089
Total collateralized mortgage obligations	154,959	5,672	26	160,605

Total mortgage-backed securities	390,702	13,009	26	403,685
Asset-backed securities	297	1,400		1,697
Total available for sale securities	$ 605,045	$ 22,515	$ 42	$ 627,518
Securities held to maturity:				
State and political subdivisions	$ 23,297	$ 667	$	$ 23,964

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FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2012, 2011 and 2010

(3.) INVESTMENT SECURITIES (Continued)

Interest and dividends on securities for the years ended December 31 are summarized as follows (in thousands):

	2012	2011	2010
Taxable interest and dividends	$ 12,202	$ 14,185	$ 17,101
Tax-exempt interest and dividends	4,242	3,828	3,521
Total interest and dividends on securities	$ 16,444	$ 18,013	$ 20,622

Sales and calls of securities available for sale for the years ended December 31 were as follows (in thousands):

	2012	2011	2010
Proceeds from sales	$ 2,823	$ 44,514	$ 122,090
Gross realized gains	2,651	3,051	173
Gross realized losses		48	4

The scheduled maturities of securities available for sale and securities held to maturity at December 31, 2012 are shown below. Actual expected maturities may differ from contractual maturities because issuers may have the right to call or prepay obligations (in thousands).

	Amortized Cost	Fair Value
Debt securities available for sale:		
Due in one year or less	$ 28,967	$ 29,165
Due from one to five years	94,479	98,341
Due after five years through ten years	318,124	326,802
Due after ten years	355,631	369,488
	$ 797,201	$ 823,796
Debt securities held to maturity:		
Due in one year or less	$ 12,886	$ 12,974
Due from one to five years	4,164	4,455
Due after five years through ten years	768	931
Due after ten years	87	118
	$ 17,905	$ 18,478

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FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2012, 2011 and 2010

(3.) INVESTMENT SECURITIES (Continued)

There were no unrealized losses in held to maturity securities at December 31, 2012 or December 31, 2011. Unrealized losses on investment securities available for sale and the fair value of the related securities, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position as of December 31 are summarized as follows (in thousands):

	Less than 12 months		12 months or longer		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
December 31, 2012						
U.S. Government agencies and government sponsored enterprises	$ 13,265	$ 67	$ 2,967	$ 2	$ 16,232	$ 69
State and political subdivisions	8,471	72			8,471	72
Mortgage-backed securities:						
Federal National Mortgage Association	25,200	188			25,200	188
Collateralized mortgage obligations:						
Federal National Mortgage Association			1,173	2	1,173	2
Total collateralized mortgage obligations			1,173	2	1,173	2
Total mortgage-backed securities	25,200	188	1,173	2	26,373	190
Total temporarily impaired securities	$ 46,936	$ 327	$ 4,140	$ 4	$ 51,076	$ 331
December 31, 2011						
U.S. Government agencies and government sponsored enterprises	$ 2,177	$ 1	$ 5,246	$ 4	$ 7,423	$ 5
State and political subdivisions	452	2	646	9	1,098	11
Mortgage-backed securities:						
Collateralized mortgage obligations:						
Federal National Mortgage Association			1,817	7	1,817	7
Federal Home Loan Mortgage Corporation			388	1	388	1
Government National Mortgage Association	6,138	18			6,138	18
Total collateralized mortgage obligations	6,138	18	2,205	8	8,343	26
Total mortgage-backed securities	6,138	18	2,205	8	8,343	26
Total temporarily impaired securities	$ 8,767	$ 21	$ 8,097	$ 21	$ 16,864	$ 42

The total number of security positions in the investment portfolio in an unrealized loss position at December 31, 2012 was 52 compared to 14 at December 31, 2011. At December 31, 2012, the Company had positions in six investment securities with an amortized cost of $4.1 million and an unrealized loss of $4 thousand that have been in a continuous unrealized loss position for more than 12 months. There were a total of 46 securities positions in the Company s investment portfolio, with an amortized cost of $47.3 million and a total unrealized loss of $327 thousand at December 31, 2012, that have been in a continuous unrealized loss position for less than 12 months. The unrealized loss on these investment securities was predominantly caused by changes in market interest rates, average life or credit spreads subsequent to purchase. The fair value of most of the investment securities in the Company s portfolio fluctuates as market interest rates change.

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FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2012, 2011 and 2010

(3.) INVESTMENT SECURITIES (Continued)

The Company reviews investment securities on an ongoing basis for the presence of other-than-temporary impairment (OTTI) with formal reviews performed quarterly. When evaluating debt securities for OTTI, management considers many factors, including: (1) the length of time and the extent to which the fair value has been less than cost, (2) the financial condition and near-term prospects of the issuer, (3) whether the market decline was affected by macroeconomic conditions, and (4) whether the Company has the intention to sell the debt security or whether it is more likely than not that it will be required to sell the debt security before its anticipated recovery. The assessment of whether OTTI exists involves a high degree of subjectivity and judgment and is based on the information available to management.

The following summarizes the amounts of OTTI recognized during the years ended December 31 by investment category (in thousands).

	2012	2011	2010
Mortgage-backed securities Privately issued whole loan CMOs	$ 91	$ 18	$
Asset-backed securities Trust preferred securities			526
Asset-backed securities Other			68
Total OTTI	$ 91	$ 18	$ 594

Based on management s review and evaluation of the Company s debt securities as of December 31, 2012, the debt securities with unrealized losses were not considered to be OTTI. As of December 31, 2012, the Company does not intend to sell any debt securities which have an unrealized loss, it is unlikely the Company will be required to sell these securities before recovery and the Company expects to recover the entire amortized cost of these impaired securities. Accordingly, as of December 31, 2012, management has concluded that unrealized losses on its investment securities are temporary and no further impairment loss has been realized in the Company s consolidated statements of income.

(4.) LOANS HELD FOR SALE AND LOAN SERVICING RIGHTS

Loans held for sale were entirely comprised of residential real estate mortgages and totaled $1.5 million and $2.4 million as of December 31, 2012 and 2011, respectively.

The Company sells certain qualifying newly originated or refinanced residential real estate mortgages on the secondary market. Residential real estate mortgages serviced for others, which are not included in the consolidated statements of financial condition, amounted to $273.3 million and $297.8 million as of December 31, 2012 and 2011, respectively. In connection with these mortgage-servicing activities, the Company administered escrow and other custodial funds which amounted to approximately $5.6 million and $5.9 million as of December 31, 2012 and 2011, respectively.

The activity in capitalized mortgage servicing assets is summarized as follows for the years ended December 31 (in thousands):

	2012	2011	2010
Mortgage servicing assets, beginning of year	$ 1,609	$ 1,642	$ 1,534
Originations	554	319	408

Amortization	(526)	(352)	(300)
Mortgage servicing assets, end of year	1,637	1,609	1,642
Valuation allowance	(168)	(210)	(175)
Mortgage servicing assets, net, end of year	$ 1,469	$ 1,399	$ 1,467

During 2011, the Company sold $13.0 million of indirect auto loans under a 90%/10% participation agreement, recognizing a gain of $153 thousand. The loans were reclassified from portfolio to loans held for sale during the second quarter of 2011. The loan servicing asset for these loans, included in other assets in the consolidated statements of financial condition, was $250 thousand and $574 thousand as of December 31, 2012 and 2011, respectively. The Company will continue to service the loans for a fee in accordance with the participation agreement.

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FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

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(5.) LOANS

The Company s loan portfolio consisted of the following at December 31 (in thousands):

	Principal Amount Outstanding	Net Deferred Loan (Fees) Costs	Loans, Net
2012			
Commercial business	$ 258,706	$ (31)	$ 258,675
Commercial mortgage	414,282	(958)	413,324
Residential mortgage	133,341	179	133,520
Home equity	282,503	4,146	286,649
Consumer indirect	559,964	26,830	586,794
Other consumer	26,657	107	26,764
Total	$ 1,675,453	$ 30,273	1,705,726
Allowance for loan losses			(24,714)
Total loans, net			$ 1,681,012
2011			
Commercial business	$ 233,727	$ 109	$ 233,836
Commercial mortgage	394,034	(790)	393,244
Residential mortgage	113,865	46	113,911
Home equity	227,853	3,913	231,766
Consumer indirect	465,807	21,906	487,713
Other consumer	24,138	168	24,306
Total	$ 1,459,424	$ 25,352	1,484,776
Allowance for loan losses			(23,260)
Total loans, net			$ 1,461,516

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

Certain executive officers, directors and their business interests are customers of the Company. Transactions with these parties are based on substantially the same terms as similar transactions with unrelated third parties and do not carry more than normal credit risk. Borrowings by these related parties amounted to $292 thousand and $378 thousand at December 31, 2012 and 2011, respectively. During 2012, new borrowings amounted to $50 thousand (including borrowings of executive officers and directors that were outstanding at the time of their election), and repayments and other reductions were $136 thousand.

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FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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(5.) LOANS (Continued)

Past Due Loans Aging

The Company s recorded investment, by loan class, in current and nonaccrual loans, as well as an analysis of accruing delinquent loans is set forth as of December 31 (in thousands):

	30-59 Days Past Due	60-89 Days Past Due	Greater Than 90 Days	Total Past Due	Nonaccrual	Current	Total Loans
2012							
Commercial business	$ 160	$	$	$ 160	$ 3,413	$ 255,133	$ 258,706
Commercial mortgage	331			331	1,799	412,152	414,282
Residential mortgage	376			376	2,040	130,925	133,341
Home equity	675	10		685	939	280,879	282,503
Consumer indirect	1,661	163		1,824	891	557,249	559,964
Other consumer	127	35	18	180	25	26,452	26,657
Total loans, gross	$ 3,330	$ 208	$ 18	$ 3,556	$ 9,107	$ 1,662,790	$ 1,675,453
2011							
Commercial business	$ 35	$	$	$ 35	$ 1,259	$ 232,433	$ 233,727
Commercial mortgage	165			165	2,928	390,941	394,034
Residential mortgage	517			517	1,644	111,704	113,865
Home equity	749	68		817	682	226,354	227,853
Consumer indirect	984	92		1,076	558	464,173	465,807
Other consumer	106	10	5	121		24,017	24,138
Total loans, gross	$ 2,556	$ 170	$ 5	$ 2,731	$ 7,071	$ 1,449,622	$ 1,459,424

There were no loans past due greater than 90 days and still accruing interest as of December 31, 2012 and December 31, 2011. There were $18 thousand and $5 thousand in consumer overdrafts which were past due greater than 90 days as of December 31, 2012 and December 31, 2011, respectively. Consumer overdrafts are overdrawn deposit accounts which have been reclassified as loans but by their terms do not accrue interest.

Interest income on nonaccrual loans, if recognized, is recorded using the cash basis method of accounting. There was no interest income recognized on nonaccrual loans during the years ended December 31, 2012, 2011 and 2010. For the years ended December 31, 2012, 2011 and 2010, estimated interest income of $555 thousand, $438 thousand, and $474 thousand, respectively, would have been recorded if all such loans had been accruing interest according to their original contractual terms.

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FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2012, 2011 and 2010

(5.) LOANS (Continued)

Troubled Debt Restructurings

A modification of a loan constitutes a troubled debt restructuring (TDR) when a borrower is experiencing financial difficulty and the modification constitutes a concession. The Company offers various types of concessions when modifying loans, however, forgiveness of principal is rarely granted. Commercial loans modified in a TDR may involve temporary interest-only payments, term extensions, reducing the interest rate for the remaining term of the loan, extending the maturity date at an interest rate lower than the current market rate for new debt with similar risk, requesting additional collateral, releasing collateral for consideration, or substituting or adding a new borrower or guarantor.

The following presents, by loan class, information related to loans modified in a TDR during the years ended December 31 (in thousands).

	Number of Contracts	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment
2012			
Commercial business	3	$ 536	$ 536
Commercial mortgage	4	648	648
Total	7	$ 1,184	$ 1,184
2011			
Commercial business	6	$ 142	$ 142
Commercial mortgage	1	280	280
Total	7	$ 422	$ 422

All of the loans identified as TDRs by the Company were previously on nonaccrual status and reported as impaired loans prior to restructuring. The modifications primarily related to extending the amortization periods of the loans and releasing collateral in consideration of payment. All loans restructured during the years ended December 31, 2012 and 2011 were on nonaccrual status at the end of those respective years. Nonaccrual loans that are restructured remain on nonaccrual status, but may move to accrual status after they have performed according to the restructured terms for a period of time. The TDR classification did not have a material impact on the Company s determination of the allowance for loan losses because the modified loans were impaired and evaluated for a specific reserve both before and after restructuring.

For purposes of this disclosure, a loan modified as a TDR is considered to have defaulted when the borrower becomes 90 days past due. One commercial business loan restructured during 2012 with a balance of $52 thousand at December 31, 2012 was in default. One commercial real estate loan restructured during 2011 with a balance of $261 thousand at December 31, 2011 was in default. These defaults did not significantly impact the Company s determination of the allowance for loan losses.

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FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

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(5.) LOANS (Continued)

Impaired Loans

Management has determined that specific commercial loans on nonaccrual status and all loans that have had their terms restructured in a troubled debt restructuring are impaired loans. The following table presents data on impaired loans at December 31 (in thousands):

	Recorded Investment[1]	Unpaid Principal Balance[1]	Related Allowance	Average Recorded Investment	Interest Income Recognized
2012					
With no related allowance recorded:					
Commercial business	$ 963	$ 1,425	$	$ 755	$
Commercial mortgage	911	1,002		1,310	
	1,874	2,427		2,065	
With an allowance recorded:					
Commercial business	2,450	2,450	664	2,114	
Commercial mortgage	888	888	310	1,858	
	3,338	3,338	974	3,972	
	$ 5,212	$ 5,765	$ 974	$ 6,037	$
2011					
With no related allowance recorded:					
Commercial business	$ 342	$ 1,266	$	$ 361	$
Commercial mortgage	605	696		583	
	947	1,962		944	
With an allowance recorded:					
Commercial business	917	917	436	1,033	
Commercial mortgage	2,323	2,323	644	2,172	
	3,240	3,240	1,080	3,205	
	$ 4,187	$ 5,202	$ 1,080	$ 4,149	$

(1) Difference between recorded investment and unpaid principal balance represents partial charge-offs.

During the year ended December 31, 2010, the Company s average investment in impaired loans was $4.5 million. There was no interest income recognized on impaired loans during the year ended December 31, 2010.

Credit Quality Indicators

The Company categorizes loans into risk categories based on relevant information about the ability of borrowers to service their debt such as: current financial information, historical payment experience, credit documentation, public information, and current economic trends, among other factors such as the fair value of collateral. The Company analyzes commercial business and commercial mortgage loans individually by classifying the loans as to credit risk. Risk ratings are updated any time the situation warrants. The Company uses the following definitions for risk ratings:

Special Mention: Loans classified as special mention have a potential weakness that deserves management s close attention. If left uncorrected, these potential weaknesses may result in deterioration of the repayment prospects for the loan or of the Company s credit position at some future date.

Substandard: Loans classified as substandard are inadequately protected by the current net worth and paying capacity of the obligor or of the collateral pledged, if any. Loans so classified have a well-defined weakness or weaknesses that jeopardize the liquidation of the debt. They are characterized by the distinct possibility that the Company will sustain some loss if the deficiencies are not corrected.

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FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

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(5.) LOANS (Continued)

Doubtful: Loans classified as doubtful have all the weaknesses inherent in those classified as 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.

Loans not meeting the criteria above that are analyzed individually as part of the process described above are considered Uncriticized or pass-rated loans and are included in groups of homogeneous loans with similar risk and loss characteristics.

The following table sets forth the Company s commercial loan portfolio, categorized by internally assigned asset classification, as of December 31 (in thousands):

	Commercial Business	Commercial Mortgage
2012		
Uncriticized	$ 240,291	$ 400,576
Special mention	6,591	6,495
Substandard	11,824	7,211
Doubtful		
Total	$ 258,706	$ 414,282
2011		
Uncriticized	$ 221,477	$ 383,700
Special mention	7,445	2,388
Substandard	4,805	7,946
Doubtful		
Total	$ 233,727	$ 394,034

The Company utilizes payment status as a means of identifying and reporting problem and potential problem retail loans. The Company considers nonaccrual loans and loans past due greater than 90 days and still accruing interest to be non-performing. The following table sets forth the Company s retail loan portfolio, categorized by payment status, as of December 31 (in thousands):

	Residential Mortgage	Home Equity	Consumer Indirect	Other Consumer
2012				
Performing	$ 131,301	$ 281,564	$ 559,073	$ 26,632
Non-performing	2,040	939	891	25
Total	$ 133,341	$ 282,503	$ 559,964	$ 26,657

2011				
Performing	$ 112,221	$ 227,171	$ 465,249	$ 24,138
Non-performing	1,644	682	558	
Total	$ 113,865	$ 227,853	$ 465,807	$ 24,138

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December 31, 2012, 2011 and 2010

(5.) LOANS (Continued)

Allowance for Loan Losses

The following tables set forth the changes in the allowance for loan losses for the years ended December 31 (in thousands):

	Commercial	Commercial Mortgage	Residential Mortgage	Home Equity	Consumer Indirect	Other Consumer	Total
2012							
Allowance for loan losses:							
Beginning balance	$ 4,036	$ 6,418	$ 858	$ 1,242	$ 10,189	$ 517	$ 23,260
Charge-offs	(729)	(745)	(326)	(305)	(6,589)	(874)	(9,568)
Recoveries	336	261	130	44	2,769	354	3,894
Provision	1,241	647	78	301	4,346	515	7,128
Ending balance	$ 4,884	$ 6,581	$ 740	$ 1,282	$ 10,715	$ 512	$ 24,714
Evaluated for impairment:							
Individually	$ 664	$ 310	$	$	$	$	$ 974
Collectively	$ 4,220	$ 6,271	$ 740	$ 1,282	$ 10,715	$ 512	$ 23,740
Loans:							
Ending balance	$ 258,706	$ 414,282	$ 133,341	$ 282,503	$ 559,964	$ 26,657	$ 1,675,453
Evaluated for impairment:							
Individually	$ 3,413	$ 1,799	$	$	$	$	$ 5,212
Collectively	$ 255,293	$ 412,483	$ 133,341	$ 282,503	$ 559,964	$ 26,657	$ 1,670,241
2011							
Allowance for loan losses:							
Beginning balance	$ 3,712	$ 6,431	$ 1,013	$ 972	$ 7,754	$ 584	$ 20,466
Charge-offs	(1,346)	(751)	(152)	(449)	(4,713)	(877)	(8,288)
Recoveries	401	245	90	44	2,066	456	3,302
Provision (credit)	1,269	493	(93)	675	5,082	354	7,780
Ending balance	$ 4,036	$ 6,418	$ 858	$ 1,242	$ 10,189	$ 517	$ 23,260
Evaluated for impairment:							
Individually	$ 436	$ 644	$	$	$	$	$ 1,080

Collectively	$ 3,600	$ 5,774	$ 858	$ 1,242	$ 10,189	$ 517	$ 22,180
Loans:							
Ending balance	$ 233,727	$ 394,034	$ 113,865	$ 227,853	$ 465,807	$ 24,138	$ 1,459,424
Evaluated for impairment:							
Individually	$ 1,259	$ 2,928	$	$	$	$	$ 4,187
Collectively	$ 232,468	$ 391,106	$ 113,865	$ 227,853	$ 465,807	$ 24,138	$ 1,455,237

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(5.) LOANS (Continued)

	Commercial	Commercial Mortgage	Residential Mortgage	Home Equity	Consumer Indirect	Other Consumer	Total
2010							
Allowance for loan losses:							
Beginning balance	$ 4,407	$ 6,638	$ 1,251	$ 1,043	$ 6,837	$ 565	$ 20,741
Charge-offs	(3,426)	(263)	(290)	(259)	(4,669)	(909)	(9,816)
Recoveries	326	501	21	36	1,485	485	2,854
Provision (credit)	2,405	(445)	31	152	4,101	443	6,687
Ending balance	$ 3,712	$ 6,431	$ 1,013	$ 972	$ 7,754	$ 584	$ 20,466
Evaluated for impairment:							
Individually	$ 149	$ 883	$	$	$	$	$ 1,032
Collectively	$ 3,563	$ 5,548	$ 1,013	$ 972	$ 7,754	$ 584	$ 19,434
Loans:							
Ending balance	$ 210,948	$ 353,537	$ 129,553	$ 205,070	$ 400,221	$ 25,937	$ 1,325,266
Evaluated for impairment:							
Individually	$ 948	$ 3,100	$	$	$	$	$ 4,048
Collectively	$ 210,000	$ 350,437	$ 129,553	$ 205,070	$ 400,221	$ 25,937	$ 1,321,218

Risk Characteristics

Commercial business loans primarily consist of loans to small to mid-sized businesses in our market area in a diverse range of industries. These loans are of higher risk and typically are made on the basis of the borrower s ability to make repayment from the cash flow of the borrower s business. Further, the collateral securing the loans may depreciate over time, may be difficult to appraise and may fluctuate in value. The credit risk related to commercial loans is largely influenced by general economic conditions and the resulting impact on a borrower s operations or on the value of underlying collateral, if any.

Commercial mortgage loans generally have larger balances and involve a greater degree of risk than residential mortgage loans, inferring higher potential losses on an individual customer basis. Loan repayment is often dependent on the successful operation and management of the properties, as well as on the collateral securing the loan. Economic events or conditions in the real estate market could have an adverse impact on the cash flows generated by properties securing the Company s commercial real estate loans and on the value of such properties.

Residential mortgage loans and home equities (comprised of home equity loans and home equity lines) are generally made on the basis of the borrower s ability to make repayment from his or her employment and other income, but are secured by real property whose value tends to be more easily ascertainable. Credit risk for these types of loans is generally influenced by general economic conditions, the characteristics of individual borrowers, and the nature of the loan collateral.

Consumer indirect and other consumer loans may entail greater credit risk than residential mortgage loans and home equities, particularly in the case of other consumer loans which are unsecured or, in the case of indirect consumer loans, secured by depreciable assets, such as automobiles or boats. In such cases, any repossessed collateral for a defaulted consumer loan may not provide an adequate source of repayment of the outstanding loan balance. In addition, consumer loan collections are dependent on the borrower s continuing financial stability, and thus are more likely to be affected by adverse personal circumstances such as job loss, illness or personal bankruptcy. Furthermore, the application of various federal and state laws, including bankruptcy and insolvency laws, may limit the amount which can be recovered on such loans.

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(6.) PREMISES AND EQUIPMENT, NET

Major classes of premises and equipment at December 31 are summarized as follows (in thousands):

	2012	2011
Land and land improvements	$ 4,883	$ 4,330
Buildings and leasehold improvements	43,402	40,590
Furniture, fixtures, equipment and vehicles	24,440	23,414
Premises and equipment	72,725	68,334
Accumulated depreciation and amortization	(36,107)	(35,249)
Premises and equipment, net	$ 36,618	$ 33,085

Depreciation and amortization expense relating to premises and equipment, included in occupancy and equipment expense in the consolidated statements of income, amounted to $3.6 million for the year ended December 31, 2012 and $3.5 million for the years ended December 31, 2011 and 2010.

(7.) GOODWILL AND OTHER INTANGIBLE ASSETS

The change in the balance for goodwill during the years ended December 31, 2012 and 2011 was as follows (in thousands):

	2012	2011
Goodwill, beginning of year	$ 37,369	$ 37,369
Branch acquisitions	11,599	
Impairment		
Goodwill, end of year	$ 48,968	$ 37,369

Pursuant to the adoption of ASU 2011-08 in 2012, the Company first performed a qualitative assessment of goodwill at the reporting unit level, the Bank, to determine if it was more likely than not that the fair value of the reporting unit is less than its carrying value. In performing a qualitative analysis, factors considered include, but are not limited to, business strategy, financial performance and market and regulatory dynamics. The results of the qualitative assessment for 2012 indicated that it was not more likely than not that the fair value of the reporting unit is less than its carrying value. Consequently, no additional quantitative two-step impairment test was required, and no impairment was recorded in 2012. In 2011 and 2010, prior to the adoption of ASU 2011-08, the Company performed a quantitative impairment test that did not result in any impairment.

Declines in the market value of the Company s publicly traded stock price or declines in the Company s ability to generate future cash flows may increase the potential that goodwill recorded on the Company s consolidated statement of financial condition be designated as impaired and that the Company may incur a goodwill write-down in the future.

The amount of goodwill to be deducted for tax purposes was $11.3 million at December 31, 2012.

The Company s other intangible assets consisted entirely of a core deposit intangible asset. The gross carrying amount and accumulated amortization for the core deposit intangible asset was $2.0 million and $190 thousand, respectively, at December 31, 2012. The Company had no other intangible assets as of December 31, 2011. Core deposit intangible amortization expense, included in other noninterest expense on the consolidated statements of income, was $190 thousand for the year ended December 31, 2012. There was no core deposit intangible amortization expense for the years ended December 31, 2011 and 2010.

Estimated core deposit intangible amortization expense for each of the next five years is as follows:

2013	$ 386
2014	341
2015	296
2016	251
2017	205

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(8.) DEPOSITS

A summary of deposits as of December 31 are as follows (in thousands):

	2012	2011
Noninterest-bearing demand	$ 501,514	$ 393,421
Interest-bearing demand	449,744	362,555
Savings and money market	655,598	474,947
Certificates of deposit, due:		
Within one year	495,423	547,874
One to two years	91,052	84,687
Two to three years	35,993	17,974
Three to five years	31,721	50,000
Thereafter	749	141
Total certificates of deposit	654,938	700,676
Total deposits	$ 2,261,794	$ 1,931,599

Certificates of deposit in denominations of $100,000 or more at December 31, 2012 and 2011 amounted to $222.4 million and $214.2 million, respectively.

Interest expense by deposit type for the years ended December 31 is summarized as follows (in thousands):

	2012	2011	2010
Interest-bearing demand	$ 598	$ 614	$ 705
Savings and money market	998	1,056	1,133
Certificates of deposit	6,866	9,764	13,015
Total interest expense on deposits	$ 8,462	$ 11,434	$ 14,853

(9.) BORROWINGS

There were no long-term borrowings outstanding as of December 31, 2012 and 2011. Outstanding short-term borrowings are summarized as follows as of December 31 (in thousands):

	2012	2011
Short-term borrowings:		
Federal funds purchased	$	$ 11,597
Repurchase agreements	40,806	36,301

Short-term FHLB borrowings	139,000	102,800
Total short-term borrowings	$ 179,806	$ 150,698

The Company classifies borrowings as short-term or long-term in accordance with the original terms of the agreement. At December 31, 2012, the Company s short-term borrowings had a weighted average rate of 0.54%.

Short-term Borrowings

Federal funds purchased are short-term borrowings that typically mature within one to ninety days. Short-term repurchase agreements are secured overnight borrowings with customers. Short-term FHLB borrowings have original maturities of less than one year and include overnight borrowings which the Company typically utilizes to address short term funding needs as they arise. Short-term FHLB borrowings at December 31, 2012 consisted of $99.0 million in overnight borrowings and $40.0 million in short-term advances. Short-term FHLB borrowings at December 31, 2011 consisted of $65.0 million in overnight borrowings and $37.8 million in short-term advances.

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FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

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(9.) BORROWINGS (Continued)

Long-term Borrowings

The Company has credit capacity with the FHLB and can borrow through facilities that include an overnight line of credit, amortizing and term advances, and repurchase agreements. The FHLB credit capacity is collateralized by securities from the Company s investment portfolio and certain qualifying loans. The Company may be required to provide additional collateral based on the fair value of the underlying securities. There were no FHLB borrowings outstanding as of December 31, 2012 and 2011.

In February 2001, the Company formed Financial Institutions Statutory Trust I (the Trust) for the sole purpose of issuing trust preferred securities. The Company s $502 thousand investment in the common equity of the Trust was classified in the consolidated statements of financial condition as other assets and $16.7 million of related 10.20% junior subordinated debentures were classified as long-term borrowings. In 2001, the Company incurred costs relating to the issuance of the debentures totaling $487 thousand. These costs, which were included in other assets on the consolidated statements of financial condition, were deferred and were being amortized to interest expense using the straight-line method over a twenty year period.

In August 2011, the Company redeemed all of the 10.20% junior subordinated debentures at a redemption price equaling 105.1% of the principal amount redeemed, plus all accrued and unpaid interest. As a result of the redemption, the Company recognized a loss on extinguishment of debt of $1.1 million, consisting of the redemption premium of $852 thousand and the write-off of the remaining unamortized issuance costs of $231 thousand.

(10.) COMMITMENTS AND CONTINGENCIES

Financial Instruments with Off-Balance Sheet Risk

The Company has financial instruments with off-balance sheet risk established in the normal course of business to meet the financing needs of its customers. These financial instruments include commitments to extend credit and standby letters of credit. These instruments involve, to varying degrees, elements of credit and interest rate risk extending beyond amounts recognized in the financial statements.

The Company s exposure to credit loss in the event of nonperformance by the other party to the financial instrument for commitments to extend credit and standby letters of credit is essentially the same as that involved with extending loans to customers. The Company uses the same credit underwriting policies in making commitments and conditional obligations as for on-balance sheet instruments.

Off-balance sheet commitments as of December 31 consist of the following (in thousands):

	2012	2011
Commitments to extend credit	$ 435,948	$ 374,266
Standby letters of credit	9,223	8,855

Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the agreement. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Commitments may expire without being drawn upon; therefore the total commitment amounts do not necessarily represent future cash requirements. Each customer s creditworthiness is evaluated on a case-by-case basis. The amount of collateral obtained, if any, is based on management s credit evaluation of the borrower. Standby letters of credit are conditional lending commitments issued by the Company to guarantee the performance of a customer to a third party. These standby letters of credit are primarily issued to support private borrowing arrangements. The credit risk involved in issuing standby letters of credit is essentially the same as that involved in extending loan facilities to customers.

The Company also extends rate lock agreements to borrowers related to the origination of residential mortgage loans. To mitigate the interest rate risk inherent in these rate lock agreements when the Company intends to sell the related loan, once originated, as well as closed residential mortgage loans held for sale, the Company enters into forward commitments to sell individual residential mortgages. Rate lock agreements and forward commitments are considered derivatives and are recorded at fair value. Forward sales commitments totaled $1.8 million and $2.9 million at December 31, 2012 and 2011, respectively. In addition, the net change in the fair values of these derivatives was recognized as other noninterest income or other noninterest expense in the consolidated statements of income.

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(10.) COMMITMENTS AND CONTINGENCIES (Continued)

Lease Obligations

The Company is obligated under a number of noncancellable operating lease agreements for land, buildings and equipment. Certain of these leases provide for escalation clauses and contain renewal options calling for increased rentals if the lease is renewed. Future minimum payments by year and in the aggregate, under the noncancellable leases with initial or remaining terms of one year or more, are as follows at December 31, 2012 (in thousands):

2013	$ 1,433
2014	1,384
2015	1,305
2016	1,197
2017	826
Thereafter	4,347
	$ 10,492

Rent expense relating to these operating leases, included in occupancy and equipment expense in the statements of income, was $1.6 million, $1.5 million and $1.4 million in 2012, 2011 and 2010, respectively.

Contingent Liabilities

In the ordinary course of business there are various threatened and pending legal proceedings against the Company. Based on consultation with outside legal counsel, management believes that the aggregate liability, if any, arising from such litigation would not have a material adverse effect on the Company s consolidated financial statements.

(11.) REGULATORY MATTERS

General

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 financial holding companies and banks, including the power to impose substantial fines, operational restrictions and other penalties for violations of laws and regulations and for safety and soundness considerations.

Capital

Banks and financial holding companies are subject to various regulatory capital requirements administered by state and federal banking agencies. Failure to meet minimum capital requirements can initiate certain mandatory and possibly additional discretionary, actions by regulators that, if undertaken, could have a direct material impact on the Company s consolidated financial statements. Capital adequacy guidelines and, additionally for banks, prompt corrective action regulations, involve quantitative measures of assets, liabilities, and certain off-balance sheet items calculated under regulatory accounting practices. Capital amounts and classifications are also subject to qualitative judgments by regulators about components, risk weighting and other factors.

Quantitative measures established by regulation to ensure capital adequacy require the Company and the Bank to maintain minimum amounts and ratios of Total and Tier 1 capital to risk-weighted assets and of Tier 1 capital to average assets (all as defined in the regulations). These minimum amounts and ratios are included in the table below.

The Company s and the Bank s Tier 1 capital consists of shareholders equity excluding unrealized gains and losses on securities available for sale (except for unrealized losses which have been determined to be other than temporary and recognized as expense in the consolidated statements of income), goodwill and other intangible assets and disallowed portions of deferred tax assets. Tier 1 capital for the Company includes, subject to limitation, $17.5 million of preferred stock. The Company and the Bank s total capital are comprised of Tier 1 capital for each entity plus a permissible portion of the allowance for loan losses.

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FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

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(11.) REGULATORY MATTERS (Continued)

The Tier 1 and total risk-based capital ratios are calculated by dividing the respective capital amounts by risk-weighted assets. Risk-weighted assets are calculated based on regulatory requirements and include total assets, excluding goodwill and other intangible assets and disallowed portions of deferred tax assets, allocated by risk weight category and certain off-balance-sheet items (primarily loan commitments). The leverage ratio is calculated by dividing Tier 1 capital by adjusted quarterly average total assets, which exclude goodwill and other intangible assets and disallowed portions of deferred tax assets.

The Company s and the Bank s actual and required regulatory capital ratios were as follows as of December 31 (in thousands):

		Actual		For Capital Adequacy Purposes		Well Capitalized	
		Amount	Ratio	Amount	Ratio	Amount	Ratio
2012							
Tier 1 leverage:	Company	$ 199,824	7.70%	$ 103,828	4.00%	$ 129,785	5.00%
	Bank	191,704	7.40	103,664	4.00	129,580	5.00
Tier 1 capital:	Company	199,824	10.70	74,671	4.00	112,006	6.00
	Bank	191,704	10.29	74,515	4.00	111,773	6.00
Total risk-based capital:	Company	223,176	11.96	149,341	8.00	186,677	10.00
	Bank	215,008	11.54	149,031	8.00	186,289	10.00
2011							
Tier 1 leverage:	Company	$ 197,086	8.63%	$ 91,310	4.00%	$ 114,138	5.00%
	Bank	184,639	8.10	91,192	4.00	113,990	5.00
Tier 1 capital:	Company	197,086	12.20	64,645	4.00	96,967	6.00
	Bank	184,639	11.46	64,445	4.00	96,667	6.00
Total risk-based capital:	Company	217,325	13.45	129,290	8.00	161,612	10.00
	Bank	204,817	12.71	128,890	8.00	161,112	10.00

As of December 31, 2012, the Company and Bank were considered well capitalized under all regulatory capital guidelines. Such determination has been made based on the Tier 1 leverage, Tier 1 capital and total risk-based capital ratios.

Federal Reserve Requirements

The Bank is required to maintain a reserve balance at the FRB of New York. The reserve requirement for the Bank totaled $1.0 million as of December 31, 2012 and 2011.

Dividend Restrictions

In the ordinary course of business, the Company is dependent upon dividends from Five Star Bank to provide funds for the payment of interest expense on the junior subordinated debentures, dividends to shareholders and to provide for other cash requirements. Banking regulations may limit the amount of dividends that may be paid. Approval by regulatory authorities is required if the effect of dividends declared would cause the regulatory capital of the Bank to fall below specified minimum levels. Approval is also required if dividends declared exceed the net profits for that year combined with the retained net profits for the preceding two years. The Company is no longer subject to the limitations prescribed by the terms of the Treasury s TARP Capital Purchase Program. See Note 12 Shareholders Equity.

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FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

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(12.) SHAREHOLDERS EQUITY

The Company s authorized capital stock consists of 50,210,000 shares of capital stock, 50,000,000 of which are common stock, par value $0.01 per share, and 210,000 of which are preferred stock, par value $100 per share, which is designated into two classes, Class A of which 10,000 shares are authorized, and Class B of which 200,000 shares are authorized. There are two series of Class A preferred stock: Series A 3% preferred stock and the Series A preferred stock. There is one series of Class B preferred stock: Series B-1 8.48% preferred stock. There were 174,709 shares and 174,735 shares of preferred stock issued and outstanding as of December 31, 2012 and 2011, respectively.

Common Stock

The following table sets forth the changes in the number of shares of common stock for the years ended December 31:

	Outstanding	Treasury	Issued
2012			
Shares outstanding at beginning of year	13,803,116	358,481	14,161,597
Restricted stock awards issued, net of forfeitures	7,857	(7,857)	
Stock options exercised	4,250	(4,250)	
Treasury stock purchases	(33,330)	33,330	
Directors retainer	5,816	(5,816)	
Shares outstanding at end of year	13,787,709	373,888	14,161,597
2011			
Shares outstanding at beginning of year	10,937,506	410,616	11,348,122
Shares issued in common stock offering	2,813,475		2,813,475
Restricted stock awards issued, net of forfeitures	51,070	(51,070)	
Stock options exercised	6,357	(6,357)	
Treasury stock purchases	(11,181)	11,181	
Directors retainer	5,889	(5,889)	
Shares outstanding at end of year	13,803,116	358,481	14,161,597

Issuance of Common Stock

In March 2011, the Company completed the sale of 2,813,475 shares of its common stock through an underwritten public offering at a price of $16.35 per share. The net proceeds of the offering, after deducting underwriting discounts and commissions and offering expenses, were $43.1 million. A portion of the proceeds from this offering was used to redeem the Company s Series A preferred stock and the 10.20% junior subordinated debentures.

Preferred Stock

Series A 3% Preferred Stock. There were 1,499 shares and 1,500 shares of Series A 3% preferred stock issued and outstanding as of December 31, 2012 and 2011, respectively. Holders of Series A 3% preferred stock are entitled to receive an annual dividend of $3.00 per share, which is cumulative and payable quarterly. Holders of Series A 3% preferred stock have no pre-emptive right in, or right to purchase or subscribe for, any additional shares of the Company s capital stock and have no voting rights. Dividend or dissolution payments to the Class A shareholders must be declared and paid, or set apart for payment, before any dividends or dissolution payments can be declared and paid, or set apart for payment, to the holders of Class B preferred stock or common stock. The Series A 3% preferred stock is not convertible into any other of the Company s securities.

Series B-1 8.48% Preferred Stock. There were 173,210 shares and 173,235 shares of Series B-1 8.48% preferred stock issued and outstanding as of December 31, 2012 and 2011, respectively. Holders of Series B-1 8.48% preferred stock are entitled to receive an annual dividend of $8.48 per share, which is cumulative and payable quarterly. Holders of Series B-1 8.48% preferred stock have no pre-emptive right in, or right to purchase or subscribe for, any additional shares of the Company s common stock and have no voting rights. Accumulated dividends on the Series B-1 8.48% preferred stock do not bear interest, and the Series B-1 8.48% preferred stock is not subject to redemption. Dividend or dissolution payments to the Class B shareholders must be declared and paid, or set apart for payment, before any dividends or dissolution payments are declared and paid, or set apart for payment, to the holders of common stock. The Series B-1 8.48% preferred stock is not convertible into any other of the Company s securities.

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(12.) SHAREHOLDERS EQUITY (Continued)

Redemption of Series A Preferred Stock and Warrant

In December 2008, under the Treasury s TARP Capital Purchase Program, the Company entered into a Securities Purchase Agreement Standard Terms with the Treasury pursuant to which, among other things, the Company sold to the Treasury for an aggregate purchase price of $37.5 million, 7,503 shares of fixed rate cumulative perpetual preferred stock, Series A (Series A preferred stock) and a warrant to purchase up to 378,175 shares of the Company s common stock, par value $0.01 per share, at an exercise price of $14.88 per share (the Warrant), of the Company.

Pursuant to the terms of the Purchase Agreement, the Company s ability to declare or pay dividends on any of its shares was limited. Specifically, the Company was prohibited from paying any dividend with respect to shares of common stock, other junior securities or preferred stock ranking *pari passu* with the Series A preferred stock or repurchasing or redeeming any shares of the Company s common stock, other junior securities or preferred stock ranking *pari passu* with the Series A preferred stock in any quarter unless all accrued and unpaid dividends were paid on the Series A preferred stock for all past dividend periods (including the latest completed dividend period), subject to certain limited exceptions.

The $37.5 million in proceeds was allocated to the Series A preferred stock and the Warrant based on their relative fair values at issuance ($35.5 million was allocated to the Series A preferred stock and $2.0 million to the Warrant). The resulting discount for the Series A preferred stock was to be accreted over five years through retained earnings as a preferred stock dividend. The Warrant was to remain in additional paid-in-capital at its initial book value until it was exercised or expired.

In February 2011, the Company redeemed one-third, or $12.5 million, of the Series A preferred stock. In March 2011, the remaining $25.0 million of the Series A preferred stock was redeemed. The unamortized discount related to the Series A preferred stock was charged to retained earnings upon redemption. The complete redemption of the Series A preferred stock removed the TARP restrictions pertaining to the Company s ability to declare and pay dividends and repurchase its common stock, as well as certain restrictions associated with executive compensation.

In May 2011, the Company repurchased the Warrant issued to the Treasury. The repurchase price of $2.1 million was recorded as a reduction of additional paid-in capital.

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FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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(13.) OTHER COMPREHENSIVE INCOME

Other comprehensive income is reported in the accompanying consolidated statements of comprehensive income and changes in shareholders equity. Information related to other comprehensive income for the years ended December 31 was as follows (in thousands):

	Pre-tax Amount	Tax Expense (Benefit)	Net-of-tax Amount
2012			
Securities available for sale:			
Change in net unrealized gain/loss during the period	$ 6,682	$ 2,646	$ 4,036
Reclassification adjustment for gains included in income	(2,651)	(1,050)	(1,601)
Reclassification adjustment for impairment charges included in income	91	36	55
	4,122	1,632	2,490
Change in net actuarial gain/loss and prior service cost on defined benefit pension and post-retirement plans	(300)	(118)	(182)
Other comprehensive income	$ 3,822	$ 1,514	$ 2,308
2011			
Securities available for sale:			
Change in net unrealized gain/loss during the period	$ 22,350	$ 8,855	$ 13,495
Reclassification adjustment for gains included in income	(3,003)	(1,190)	(1,813)
Reclassification adjustment for impairment charges included in income	18	7	11
	19,365	7,672	11,693
Change in net actuarial gain/loss and prior service cost on defined benefit pension and post-retirement plans	(9,979)	(3,953)	(6,026)
Other comprehensive income	$ 9,386	$ 3,719	$ 5,667
2010			
Securities available for sale:			
Change in net unrealized gain/loss during the period	$ (16)	$ 19	$ (35)
Reclassification adjustment for gains included in income	(169)	(67)	(102)
Reclassification adjustment for impairment charges included in income	594	235	359
	409	187	222
Change in net actuarial gain/loss and prior service cost on defined benefit pension and post-retirement plans	(2,192)	(950)	(1,242)
Other comprehensive loss	$ (1,783)	$ (763)	$ (1,020)

The components of accumulated other comprehensive income (loss), net of tax, as of December 31 were as follows (in thousands):

	2012	2011
Net actuarial loss and prior service cost on defined benefit pension and post-retirement plans	$ (12,807)	$ (12,625)
Net unrealized gain on securities available for sale	16,060	13,570
	$ 3,253	$ 945

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FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

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(14.) SHARE-BASED COMPENSATION

The Company maintains certain stock-based compensation plans, approved by the Company s shareholders that are administered by the Board, or the Management Development and Compensation Committee (the Compensation Committee) of the Board. In May 2009, the shareholders of the Company approved two share-based compensation plans, the 2009 Management Stock Incentive Plan (Management Plan) and the 2009 Directors Stock Incentive Plan (Director s Plan), and collectively with the Management Plan, the Plans . An aggregate of 690,000 shares of the Company s common stock have been reserved for issuance by the Company under the terms of the Management Plan pursuant to the grant of incentive stock options (not to exceed 500,000 shares), non-qualified stock options and restricted stock grants, all which are defined in the plan. An aggregate of 250,000 shares of the Company s common stock have been reserved for issuance by the Company under the terms of the Director s Plan pursuant to the grant of non-qualified stock options and restricted stock grants, all which are defined in the plan. Under both plans, for purposes of calculating the number of shares of common stock available for issuance, each share of common stock granted pursuant to a restricted stock grant shall count as 1.64 shares of common stock. As of December 31, 2012, there were approximately 200,000 and 451,000 shares available for grant under the Director s Plan and Management Plan, respectively, of which 61% were available for issuance as restricted stock grants.

Under the Plans, the Board, in the case of the Director s Plan, or the Compensation Committee, in the case of the Management Plan, may establish and prescribe grant guidelines including various terms and conditions for the granting of stock-based compensation. For stock options, the exercise price of each option equals the market price of the Company s stock on the date of the grant. All options expire after a period of ten years from the date of grant and generally become fully exercisable over a period of 3 to 5 years from the grant date. When option recipients exercise their options, the Company issues shares from treasury stock and records the proceeds as additions to capital. Shares of restricted stock granted to employees generally vest over 2 to 3 years from the grant date. Fifty percent of the shares of restricted stock granted to non-employee directors generally vests on the date of grant and the remaining fifty percent generally vests one year from the grant date. Vesting of the shares may be based on years of service, established performance measures or both. If restricted stock grants are forfeited before they vest, the shares are reacquired into treasury stock.

The share-based compensation plans were established to allow for the granting of compensation awards to attract, motivate and retain employees, executive officers and non-employee directors who contribute to the success and profitability of the Company and to give such persons a proprietary interest in the Company, thereby enhancing their personal interest in the Company s success.

The share-based compensation expense for the years ended December 31 was as follows (in thousands):

	2012	2011	2010
Stock options:			
Management Stock Incentive Plan	$ 12	$ 55	$ 110
Director Stock Incentive Plan		14	43
Total stock options	12	69	153
Restricted stock awards:			
Management Stock Incentive Plan	382	917	761
Director Stock Incentive Plan	132	119	117
Total restricted stock awards	514	1,036	878
Total share-based compensation	$ 526	$ 1,105	$ 1,031

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FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2012, 2011 and 2010

(14.) SHARE-BASED COMPENSATION (Continued)

The Company uses the Black-Scholes valuation method to estimate the fair value of its stock option awards. There were no stock options awarded during 2012, 2011 or 2010. There was no unrecognized compensation expense related to unvested stock options as of December 31, 2012. The following is a summary of stock option activity for the year ended December 31, 2012 (dollars in thousands, except per share amounts):

	Number of Options	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term	Aggregate Intrinsic Value
Outstanding at beginning of year	368,058	$ 20.70		
Granted				
Exercised	(4,250)	15.85		
Forfeited				
Expired	(44,533)	24.55		
Outstanding at end of period	319,275	$ 20.22	2.6 years	$ 71
Exercisable at end of period	319,275	$ 20.22	2.6 years	$ 71

The aggregate intrinsic value (the amount by which the market price of the stock on the date of exercise exceeded the market price of the stock on the date of grant) of option exercises for the years ended December 31, 2012, 2011 and 2010 was $10 thousand, $31 thousand, and $59 thousand, respectively. The total cash received as a result of option exercises under stock compensation plans for the years ended December 31, 2012, 2011 and 2010 was $69 thousand, $91 thousand, and $216 thousand, respectively. The tax benefits realized in connection with these stock option exercises were not significant.

The following is a summary of restricted stock award activity for the year ended December 31, 2012:

	Number of Shares	Weighted Average Market Price at Grant Date
Outstanding at beginning of year	166,654	$ 14.34
Granted	57,541	17.32
Vested	(94,931)	12.79
Forfeited	(49,684)	16.67
Outstanding at end of period	79,580	$ 16.89

As of December 31, 2012, there was $458 thousand of unrecognized compensation expense related to unvested restricted stock awards that is expected to be recognized over a weighted average period of 1.31 years.

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(15.) INCOME TAXES

The income tax expense for the years ended December 31 consisted of the following (in thousands):

	2012	2011	2010
Current tax expense:			
Federal	$ 4,021	$ 3,747	$ 5,781
State	955	1,158	1,103
Total current tax expense	4,976	4,905	6,884
Deferred tax expense (benefit):			
Federal	5,262	5,584	2,852
State	1,081	926	(384)
Total deferred tax expense	6,343	6,510	2,468
Total income tax expense	$ 11,319	$ 11,415	$ 9,352

Income tax expense differed from the statutory federal income tax rate for the years ended December 31 as follows:

	2012	2011	2010
Statutory federal tax rate	35.0%	35.0%	35.0%
Increase (decrease) resulting from:			
Tax exempt interest income	(4.6)	(4.3)	(4.2)
Non-taxable earnings on company owned life insurance	(1.8)	(1.5)	(1.3)
State taxes, net of federal tax benefit	3.8	4.0	1.5
Nondeductible expenses	0.3	0.4	0.6
Other, net	(0.1)	(0.2)	(1.1)
Effective tax rate	32.6%	33.4%	30.5%

Total income tax expense was allocated as follows for the years ended December 31 (in thousands):

	2012	2011	2010
Income tax expense	$ 11,319	$ 11,415	$ 9,352
Shareholder s equity	1,514	3,718	(763)

The Company s net deferred tax asset is included in other assets in the consolidated statements of condition. The tax effects of temporary differences that give rise to the deferred tax assets and deferred tax liabilities are as follows at December 31 (in thousands):

	2012	2011
Deferred tax assets:		
Other than temporary impairment of investment securities	$ 5,283	$ 11,326
Allowance for loan losses	9,791	9,106
Share-based compensation	1,111	1,437
SERP agreements	734	285
Deferred compensation	868	499
Interest on nonaccrual loans	732	716
Accrued pension costs		538
Tax attribute carryforward benefits		463
Other	798	467
Gross deferred tax assets	19,317	24,837
Deferred tax liabilities:		
Net unrealized gain on securities available for sale	10,536	8,903
Depreciation and amortization	1,827	1,741
Prepaid pension costs	1,648	
Loan servicing assets	681	781
Deferred loan origination costs		930
Gross deferred tax liabilities	14,692	12,355
Net deferred tax asset	$ 4,625	$ 12,482

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FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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(15.) INCOME TAXES (Continued)

The Company recognizes deferred income taxes for the estimated future tax effects of differences between the tax and financial statement bases of assets and liabilities considering enacted tax laws. These differences result in deferred tax assets and liabilities, which are included in other assets in the Company s consolidated statements of condition. The Company also assesses the likelihood that deferred tax assets will be realizable based on, among other considerations, future taxable income and establishes, if necessary, a valuation allowance for those deferred tax assets determined to not likely be realizable. A deferred tax asset valuation allowance is recognized if, based on the weight of available evidence (both positive and negative), it is more likely than not that some portion or all of the deferred tax assets will not be realized. The future realization of deferred tax benefits depends upon the existence of sufficient taxable income within the carry-back and carry-forward periods. Management s judgment is required in determining the appropriate recognition of deferred tax assets and liabilities, including projections of future taxable income.

Based upon the Company s historical and projected future levels of pre-tax and taxable income, the scheduled reversals of taxable temporary differences to offset future deductible amounts, and prudent and feasible tax planning strategies, management believes it is more likely than not that the deferred tax assets will be realized. As such, no valuation allowance has been recorded as of December 31, 2012 or 2011.

The Company and its subsidiaries are subject to federal and New York State (NYS) income taxes. The federal income tax years currently open for audits are 2007 through 2012. The NYS income tax years currently open for audits are 2009 through 2012.

At December 31, 2012, the Company had no federal or NYS net operating loss or tax credit carryforwards.

The Company s unrecognized tax benefits and changes in unrecognized tax benefits were not significant as of or for the years ended December 31, 2012 and 2011. There were no interest or penalties recorded in the income statement in income tax expense for the year ended December 31, 2012. As of December 31, 2012, there were no amounts accrued for interest or penalties related to uncertain tax positions.

(16.) EARNINGS PER COMMON SHARE

The following table presents a reconciliation of the earnings and shares used in calculating basic and diluted EPS for each of the years ended December 31 (in thousands, except per share amounts).

	2012	2011	2010
Net income available to common shareholders	$ 21,975	$ 19,617	$ 17,562
Less: Earnings allocated to participating securities	2	38	105
Net income available to common shareholders for EPS	$ 21,973	$ 19,579	$ 17,457
Weighted average common shares outstanding:			
Total shares issued	14,162	13,599	11,348
Unvested restricted stock awards	(107)	(166)	(154)
Treasury shares	(359)	(366)	(427)
Total basic weighted average common shares outstanding	13,696	13,067	10,767
Incremental shares from assumed:			

Exercise of stock options	4	3	6
Vesting of restricted stock awards	51	65	27
Exercise of warrant		22	45
Total diluted weighted average common shares outstanding	13,751	13,157	10,845
Basic earnings per common share	$ 1.60	$ 1.50	$ 1.62
Diluted earnings per common share	$ 1.60	$ 1.49	$ 1.61

For each of the periods presented, average shares subject to the following instruments were excluded from the computation of diluted EPS because the effect would be antidilutive:

Stock options	303	339	353
Restricted stock awards	1		
	304	339	353

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(17.) EMPLOYEE BENEFIT PLANS

Defined Benefit Pension Plan

The Company participates in The New York State Bankers Retirement System (the Plan), a defined benefit pension plan covering substantially all employees, subject to the limitations related to the plan closure effective December 31, 2006. The benefits are based on years of service and the employee s highest average compensation during five consecutive years of employment. The defined benefit plan was closed to new participants effective December 31, 2006. Only employees hired on or before December 31, 2006 and who met participation requirements on or before January 1, 2008 are eligible to receive benefits.

The following table provides a reconciliation of the Company s changes in the plan s benefit obligations, fair value of assets and a statement of the funded status as of and for the year ended December 31 (in thousands):

	2012	**2011**
Change in projected benefit obligation:		
Projected benefit obligation at beginning of period	$ 48,303	$ 38,381
Service cost	2,037	1,756
Interest cost	2,017	2,027
Actuarial loss	3,291	7,939
Benefits paid and plan expenses	(2,023)	(1,800)
Projected benefit obligation at end of period	53,625	48,303
Change in plan assets:		
Fair value of plan assets at beginning of period	46,943	38,731
Actual return on plan assets	4,865	12
Employer contributions	8,000	10,000
Benefits paid and plan expenses	(2,023)	(1,800)
Fair value of plan assets at end of period	57,785	46,943
Funded (unfunded) status at end of period	$ 4,160	$ (1,360)

The accumulated benefit obligation was $48.0 million and $43.3 million at December 31, 2012 and 2011, respectively.

The Company s funding policy is to contribute, at a minimum, an actuarially determined amount that will satisfy the minimum funding requirements determined under the appropriate sections of Internal Revenue Code. The Company had no minimum required contribution for the 2013 fiscal year, but for tax purposes chose to contribute $8.0 million to its pension plan prior to December 31, 2012.

Estimated benefit payments under the pension plan over the next ten years at December 31, 2012 are as follows (in thousands):

2013	$ 1,637

2014	1,724
2015	1,882
2016	2,106
2017	2,284
2018 2022	13,128

Net periodic pension cost consists of the following components for the years ended December 31 (in thousands):

	2012	2011	2010
Service cost	$ 2,037	$ 1,756	$ 1,633
Interest cost on projected benefit obligation	2,017	2,027	1,933
Expected return on plan assets	(3,211)	(2,653)	(2,444)
Amortization of unrecognized loss	1,370	608	458
Amortization of unrecognized prior service cost	20	19	11
Net periodic pension cost	$ 2,233	$ 1,757	$ 1,591

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FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2012, 2011 and 2010

(17.) EMPLOYEE BENEFIT PLANS (Continued)

The actuarial assumptions used to determine the net periodic pension cost were as follows:

	2012	2011	2010
Weighted average discount rate	4.27%	5.38%	5.89%
Rate of compensation increase	3.00%	3.00%	3.50%
Expected long-term rate of return	7.00%	7.00%	7.50%

The actuarial assumptions used to determine the projected benefit obligation were as follows:

	2012	2011	2010
Weighted average discount rate	3.84%	4.27%	5.38%
Rate of compensation increase	3.00%	3.00%	3.00%

The weighted average discount rate was based upon the projected benefit cash flows and the market yields of high grade corporate bonds that are available to pay such cash flows.

The weighted average expected long-term rate of return is estimated based on current trends in the Plan s assets as well as projected future rates of return on those assets and reasonable actuarial assumptions based on the guidance provided by Actuarial Standard of Practice No. 27, Selection of Economic Assumptions for Measuring Pension Obligations , for long term inflation, and the real and nominal rate of investment return for a specific mix of asset classes. The following assumptions were used in determining the long-term rate of return:

Equity securities	Dividend discount model, the smoothed earnings yield model and the equity risk premium model
Fixed income securities	Current yield-to-maturity and forecasts of future yields
Other financial instruments	Comparison of the specific investment s risk to that of fixed income and equity instruments and using judgment

The long term rate of return considers historical returns. Adjustments were made to historical returns in order to reflect expectations of future returns. These adjustments were due to factor forecasts by economists and long-term U.S. Treasury yields to forecast long-term inflation. In addition forecasts by economists and others for long-term GDP growth were factored into the development of assumptions for earnings growth and per capital income.

The Plan s overall investment strategy is to achieve a mix of approximately 97% of investments for long-term growth and 3% for near-term benefit payments with a wide diversification of asset types, fund strategies, and fund managers. The target allocations for Plan assets are shown in the table below. Cash equivalents consist primarily of short term investment funds. Equity securities primarily include investments in common stock and depository receipts. Fixed income securities include corporate bonds, government issues and mortgage backed securities. Other financial instruments primarily include rights and warrants.

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FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

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(17.) EMPLOYEE BENEFIT PLANS (Continued)

Effective September 2011, the Plan revised its investment guidelines. The Plan currently prohibits its investment managers from purchasing any security greater than 5% of the portfolio at the time of purchase or greater than 8% at market value in any one issuer. In addition, the following are prohibited:

Equity securities	Short sales
	Unregistered securities
	Margin purchases
Fixed income securities	Mortgage backed derivatives that have an inverse floating rate coupon or that are interest only securities
	Any ABS that is not issued by the U.S. Government or its agencies or its instrumentalities
	Generally securities of less than Baa2/BBB quality may not be purchased
	Securities of less than A-quality may not in the aggregate exceed 10% of the investment manager s portfolio
Other financial instruments	Unhedged currency exposure in countries not defined as high income economies by the World Bank

Prior to September 2011 investments in emerging countries as defined by the Morgan Stanley Emerging Markets Index and structured notes were prohibited.

All other investments not prohibited by the Plan are permitted. At December 31, 2012 and 2011, the Plan held certain investments which are no longer deemed acceptable to acquire. These positions will be liquidated when the investment managers deem that such liquidation is in the best interest of the Plan.

	2013 Target Allocation		Percentage of Plan Assets at December 31, 2012	Percentage of Plan Assets at December 31, 2011	Weighted Average Expected Long-term Rate of Return
Asset category:					
Cash equivalents	0	20%	12.8%	10.6%	0.38%
Equity securities	40	60	45.5	47.9	3.95
Fixed income securities	40	60	41.7	41.5	1.90
Other financial instruments	0	5			

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FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

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December 31, 2012, 2011 and 2010

(17.) EMPLOYEE BENEFIT PLANS (Continued)

Assets are segregated by the level of the valuation inputs within the fair value hierarchy established by ASC Topic 820 utilized to measure fair value (see Note 18 Fair Value Measurements). There were no assets classified as Level 3 assets during the years ended December 31, 2012 and 2011. The major categories of Plan assets measured at fair value on a recurring basis as of December 31 are presented in the following table (in thousands).

	Level 1 Inputs	Level 2 Inputs	Level 3 Inputs	Total Fair Value
2012				
Cash equivalents:				
Foreign currencies	60			60
Government issues		314		314
Short term investment funds		7,083		7,083
Total cash equivalents	60	7,397		7,457
Equity securities:				
Common stock	25,447			25,447
Depository receipts	569			569
Preferred stock	113			113
Real estate investment fund	113			113
Total equity securities	26,242			26,242
Fixed income securities:				
Auto loan receivable		313		313
Collateralized mortgage obligations		6,262		6,262
Corporate Bonds		5,456		5,456
FHLMC		717		717
FNMA		2,867		2,867
GNMA I		31		31
GNMA II		133		133
Government Issues		8,231		8,231
Municipals		63		63
Other Asset Backed		14		14
Total fixed income securities		24,087		24,087
Total Plan investments	$ 26,302	31,484		57,786

FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2012, 2011 and 2010

(17.) EMPLOYEE BENEFIT PLANS (Continued)

	Level 1 Inputs	Level 2 Inputs	Level 3 Inputs	Total Fair Value
2011				
Cash equivalents:				
Foreign currencies	81			81
Short term investment funds		4,901		4,901
Total cash equivalents	81	4,901		4,982
Equity securities:				
Common stock	21,951			21,951
Depository receipts	473			473
Preferred stock	69			69
Total equity securities	22,493			22,493
Fixed income securities:				
Auto loan receivable		6		6
Collateralized mortgage obligations		4,587		4,587
Corporate Bonds		4,171		4,171
FHLMC		809		809
FNMA		2,500		2,500
GNMA I		34		34
GNMA II		175		175
Government Issues		7,078		7,078
Municipals		55		55
Other Asset Backed		53		53
Total fixed income securities		19,468		19,468
Total Plan investments	$ 22,574	24,369		46,943

At December 31, 2012 the portfolio was managed by two investment firms, with control of the portfolio split approximately 49% and 43% under the control of the investment managers with the remaining 8% under the direct control of the Plan. A portfolio concentration in the State Street Bank & Trust Co. Short Term Investment Fund of 12% and 10% existed at December 31, 2012 and 2011, respectively.

Postretirement Benefit Plan

An entity acquired by the Company provided health and dental care benefits to retired employees who met specified age and service requirements through a postretirement health and dental care plan in which both the acquired entity and the retirees shared the cost. The plan provided for substantially the same medical insurance coverage as for active employees until their death and was integrated with Medicare for those retirees aged 65 or older. In 2001, the plan s eligibility requirements were amended to curtail eligible benefit payments to only retired employees and active employees who had already met the then-applicable age and service requirements under the Plan. In 2003, retirees under age 65 began contributing to health coverage at the same cost-sharing level as that of active employees. Retirees ages 65 or older were offered new Medicare supplemental plans as alternatives to the plan historically offered. The cost sharing of medical coverage was standardized throughout the group of retirees aged 65 or older. In addition, to be consistent with the administration of the Company s dental plan for active employees, all retirees who continued dental coverage began paying the full monthly premium. The accrued liability included in other liabilities in the consolidated statements of financial condition related to this plan amounted to $118 thousand and $122 thousand as of December 31, 2012 and 2011, respectively. The postretirement expense for the plan that was included in salaries and employee benefits in the consolidated statements of income was not significant for the years ended December 31, 2012, 2011 and 2010. The plan is not funded.

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(17.) EMPLOYEE BENEFIT PLANS (Continued)

The components of accumulated other comprehensive loss related to the defined benefit plan and postretirement benefit plan, on a pre-tax basis as of December 31 are summarized below (in thousands):

	2012	2011
Defined benefit plan:		
Net actuarial loss	$ (21,428)	$ (21,160)
Prior service cost	(93)	(113)
	(21,521)	(21,273)
Postretirement benefit plan:		
Net actuarial loss	(195)	(210)
Prior service credit	508	575
	313	365
Total recognized in accumulated other comprehensive loss	$ (21,208)	$ (20,908)

Changes in plan assets and benefit obligations recognized in other comprehensive loss on a pre-tax basis during the years ended December 31 are as follows (in thousands):

	2012	2011
Defined benefit plan:		
Net actuarial loss	$ (1,638)	$ (10,580)
Amortization of net loss	1,370	608
Amortization of prior service cost	20	19
	(248)	(9,953)
Postretirement benefit plan:		
Net actuarial gain	15	42
Amortization of prior service credit	(67)	(68)
	(52)	(26)
Total recognized in other comprehensive loss	$ (300)	$ (9,979)

For the year ending December 31, 2013, the estimated net loss and prior service cost for the plan that will be amortized from accumulated other comprehensive income into net periodic benefit cost is $1.3 million and $20 thousand, respectively.

Defined Contribution Plan

Employees that meet specified eligibility conditions are eligible to participate in the Company sponsored 401(k) plan. Under the plan, participants may make contributions, in the form of salary deferrals, up to the maximum Internal Revenue Code limit. The Company matches a participant s contributions up to 4.5% of compensation, calculated as 100% of the first 3% of compensation and 50% of the next 3% of compensation deferred by the participant. The Company may also make additional discretionary matching contributions, although no such additional discretionary contributions were made in 2012, 2011 or 2010. The expense included in salaries and employee benefits in the consolidated statements of income for this plan amounted to $1.0 million in 2012 and 2011 and $936 thousand in 2010.

Supplemental Executive Retirement Plans

The Company has non-qualified Supplemental Executive Retirement Plans (SERPs) covering four former executives. The unfunded pension liability related to the SERPs was $2.2 million and $1.0 million at December 31, 2012 and 2011, respectively. SERP expense was $1.3 million, $67 thousand, and $262 thousand for 2012, 2011 and 2010, respectively.

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(18.) FAIR VALUE MEASUREMENTS

Determination of Fair Value Assets Measured at Fair Value on a Recurring and Nonrecurring Basis

Valuation Hierarchy

The fair value of an asset or liability is the price that would be received to sell that asset or paid to transfer that liability in an orderly transaction occurring in the principal market (or most advantageous market in the absence of a principal market) for such asset or liability. ASC Topic 820, Fair Value Measurements and Disclosures, establishes a fair value hierarchy for valuation inputs that gives the highest priority to quoted prices in active markets for identical assets or liabilities and the lowest priority to unobservable inputs. The fair value hierarchy is as follows:

Level 1 Unadjusted quoted prices in active markets for identical assets or liabilities that the reporting entity has the ability to access at the measurement date.

Level 2 Inputs other than quoted prices included in Level 1 that are observable for the asset or liability, either directly or indirectly. These might include quoted prices for similar assets or liabilities in active markets, quoted prices for identical or similar assets or liabilities in markets that are not active, inputs other than quoted prices that are observable for the asset or liability (such as interest rates, volatilities, prepayment speeds, credit risks, etc.) or inputs that are derived principally from or corroborated by market data by correlation or other means.

Level 3 Unobservable inputs for determining the fair values of assets or liabilities that reflect an entity s own assumptions about the assumptions that market participants would use in pricing the assets or liabilities.

In general, fair value is based upon quoted market prices, where available. If such quoted market prices are not available, fair value is based upon internally developed models that primarily use, as inputs, observable market-based parameters. Valuation adjustments may be made to ensure that financial instruments are recorded at fair value. These adjustments may include amounts to reflect counterparty credit quality and the company s creditworthiness, among other things, as well as unobservable parameters. Any such valuation adjustments are applied consistently over time. The Company s valuation methodologies may produce a fair value calculation that may not be indicative of net realizable value or reflective of future fair values. While management believes the Company s valuation methodologies are appropriate and consistent with other market participants, the use of different methodologies or assumptions to determine the fair value of certain financial instruments could result in a different estimate of fair value at the reporting date. Furthermore, the reported fair value amounts have not been comprehensively revalued since the presentation dates, and therefore, estimates of fair value after the balance sheet date may differ significantly from the amounts presented herein. A more detailed description of the valuation methodologies used for assets and liabilities measured at fair value, as well as the general classification of such instruments pursuant to the valuation hierarchy, is set forth below.

Securities available for sale: Securities classified as available for sale are reported at fair value utilizing Level 2 inputs. For these securities, the Company obtains fair value measurements from an independent pricing service. The fair value measurements consider observable data that may include dealer quotes, market spreads, cash flows, the U.S. Treasury yield curve, live trading levels, trade execution data, market consensus prepayment speeds, credit information and the bond s terms and conditions, among other things.

Loans held for sale: The fair value of loans held for sale is determined using quoted secondary market prices and investor commitments. Loans held for sale are classified as Level 2 in the fair value hierarchy.

Collateral dependent impaired loans: Fair value of impaired loans with specific allocations of the allowance for loan losses is measured based on the value of the collateral securing these loans and is classified as Level 3 in the fair value hierarchy. Collateral may be real estate and/or business assets including equipment, inventory and/or accounts receivable and collateral value is determined based on appraisals performed by qualified licensed appraisers hired by the Company. These appraisals may utilize a single valuation approach or a combination of approaches including comparable sales and the income approach. Appraised and reported values may be discounted based on management s historical knowledge, changes in market conditions from the time of valuation, and/or management s expertise and knowledge of the client and the client s business. Such discounts are typically significant and result in a Level 3 classification of the inputs for determining fair value. Impaired loans are reviewed and evaluated on at least a quarterly basis for additional impairment and adjusted accordingly, based on the same factors identified above.

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FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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(18.) FAIR VALUE MEASUREMENTS (Continued)

Loan servicing rights: Loan servicing rights do not trade in an active market with readily observable market data. As a result, the Company estimates the fair value of loan servicing rights by using a discounted cash flow model to calculate the present value of estimated future net servicing income. The assumptions used in the discounted cash flow model are those that we believe market participants would use in estimating future net servicing income, including estimates of loan prepayment rates, servicing costs, ancillary income, impound account balances, and discount rates. The significant unobservable inputs used in the fair value measurement of the Company s loan servicing rights are the constant prepayment rates and weighted average discount rate. Significant increases (decreases) in any of those inputs in isolation could result in a significantly lower (higher) fair value measurement. Although the constant prepayment rate and the discount rate are not directly interrelated, they will generally move in opposite directions. Loan servicing rights are classified as Level 3 measurements due to the use of significant unobservable inputs, as well as significant management judgment and estimation.

Other real estate owned (Foreclosed assets): Nonrecurring adjustments to certain commercial and residential real estate properties classified as other real estate owned are measured at the lower of carrying amount or fair value, less costs to sell. Fair values are generally based on third party appraisals of the property, resulting in a Level 3 classification. The appraisals are sometimes further discounted based on management s historical knowledge, changes in market conditions from the time of valuation, and/or management s expertise and knowledge of the client and client s business. Such discounts are typically significant and result in a Level 3 classification of the inputs for determining fair value. In cases where the carrying amount exceeds the fair value, less costs to sell, an impairment loss is recognized.

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FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2012, 2011 and 2010

(18.) FAIR VALUE MEASUREMENTS (Continued)

Assets Measured at Fair Value

The following table presents for each of the fair-value hierarchy levels the Company s assets that are measured at fair value on a recurring and non-recurring basis as of December 31 (in thousands).

	Quoted Prices in Active Markets for Identical Assets or Liabilities (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total
2012				
Measured on a recurring basis:				
Securities available for sale:				
U.S. Government agencies and government sponsored enterprises	$	$ 131,695	$	$ 131,695
State and political subdivisions		195,210		195,210
Mortgage-backed securities		495,868		495,868
Asset-backed securities:				
Trust preferred securities		754		754
Other		269		269
	$	$ 823,796	$	$ 823,796
Measured on a nonrecurring basis:				
Loans:				
Loans held for sale	$	$ 1,518	$	$ 1,518
Collateral dependent impaired loans			2,364	2,364
Other assets:				
Loan servicing rights			1,719	1,719
Other real estate owned			184	184
	$	$ 1,518	$ 4,267	$ 5,785
2011				
Measured on a recurring basis:				
Securities available for sale:				
U.S. Government agencies and government sponsored enterprises	$	$ 97,712	$	$ 97,712
State and political subdivisions		124,424		124,424
Mortgage-backed securities		403,685		403,685
Asset-backed securities:				

Trust preferred securities			1,636	1,636
Other		61		61
	$	$ 625,882	$ 1,636	$ 627,518
Measured on a nonrecurring basis:				
Loans:				
Loans held for sale	$	$ 2,410	$	$ 2,410
Collateral dependent impaired loans			2,160	2,160
Other assets:				
Loan servicing rights			1,973	1,973
Other real estate owned			475	475
	$	$ 2,410	$ 4,608	$ 7,018

There were no transfers between level 1 and 2 during the years ended December 31, 2012 and 2011. There were no liabilities measured at fair value on a recurring or nonrecurring basis during the years ended December 31, 2012 and 2011.

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FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2012, 2011 and 2010

(18.) FAIR VALUE MEASUREMENTS (Continued)

The following table presents additional quantitative information about assets measured at fair value on a recurring and nonrecurring basis for which the Company has utilized Level 3 inputs to determine fair value (dollars in thousands).

Asset	Fair Value	Valuation Technique	Unobservable Input	Unobservable Input Value or Range
Collateral dependent impaired loans	$ 2,364	Appraisal of collateral (1)	Appraisal adjustments (2)	16% 100% discount
		Discounted cash flow	Discount rate	4.9%(3)
			Risk premium rate	10.1%(3)
Loan servicing rights	1,719	Discounted cash flow	Discount rate	4.1%(3)
			Constant prepayment rate	28.9%(3)
Other real estate owned	184	Appraisal of collateral (1)	Appraisal adjustments (2)	20% 55% discount

(1) Fair value is generally determined through independent appraisals of the underlying collateral, which generally include various Level 3 inputs which are not identifiable.
(2) Appraisals may be adjusted by management for qualitative factors such as economic conditions and estimated liquidation expenses.
(3) Weighted averages.

Changes in Level 3 Fair Value Measurements

There were no assets measured at fair value on a recurring basis using significant unobservable inputs (Level 3) as of December 31, 2012. The Company transferred all of the assets classified as Level 3 assets at December 31, 2011 to Level 2 during the three months ended March 31, 2012. The transfers of the $1.5 million of pooled trust preferred securities out of Level 3 was primarily the result of using observable pricing information or a third party pricing quote that appropriately reflects the fair value of those securities, without the need for adjustment based on our own assumptions regarding the characteristics of a specific security or the current liquidity in the market.

The reconciliation for all assets measured at fair value on a recurring basis using significant unobservable inputs (Level 3) for the years ended December 31 is as follows (in thousands):

	2012	2011
Securities available for sale, beginning of period	$ 1,636	$ 572
Sales	(360)	(2,478)
Principal paydowns and other		(53)
Total gains (losses) realized/unrealized:		
Included in earnings	331	2,263
Included in other comprehensive income	(102)	1,332
Transfers from Level 3 to Level 2	(1,505)	

Securities available for sale, end of period	$	$ 1,636

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FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2012, 2011 and 2010

(18.) FAIR VALUE MEASUREMENTS (Continued)

Disclosures about Fair Value of Financial Instruments

The assumptions used below are expected to approximate those that market participants would use in valuing these financial instruments.

Fair value estimates are made at a specific point in time, based on available market information and judgments about the financial instrument, including estimates of timing, amount of expected future cash flows and the credit standing of the issuer. Such estimates do not consider the tax impact of the realization of unrealized gains or losses. In some cases, the fair value estimates cannot be substantiated by comparison to independent markets. In addition, the disclosed fair value may not be realized in the immediate settlement of the financial instrument. Care should be exercised in deriving conclusions about our business, its value or financial position based on the fair value information of financial instruments presented below.

The estimated fair value approximates carrying value for cash and cash equivalents, FHLB and FRB stock, accrued interest receivable, non-maturity deposits, short-term borrowings and accrued interest payable. Fair value estimates for other financial instruments not included elsewhere in this disclosure are discussed below.

Securities held to maturity: The fair value of the Company s investment securities held to maturity is primarily measured using information from a third-party pricing service. The fair value measurements consider observable data that may include dealer quotes, market spreads, cash flows, the U.S. Treasury yield curve, live trading levels, trade execution data, market consensus prepayment speeds, credit information and the bond s terms and conditions, among other things.

Loans: The fair value of the Company s loans was estimated by discounting the expected future cash flows using the current interest rates at which similar loans would be made for the same remaining maturities. Loans were first segregated by type such as commercial, residential mortgage, and consumer, and were then further segmented into fixed and variable rate and loan quality categories. Expected future cash flows were projected based on contractual cash flows, adjusted for estimated prepayments.

Time deposits: The fair value of time deposits was estimated using a discounted cash flow approach that applies prevailing market interest rates for similar maturity instruments. The fair values of the Company s time deposit liabilities do not take into consideration the value of the Company s long-term relationships with depositors, which may have significant value.

The following presents the carrying amount, estimated fair value, and placement in the fair value measurement hierarchy of the Company s financial instruments as of December 31(in thousands):

	Level in Fair Value Measurement Hierarchy	2012 Carrying Amount	2012 Estimated Fair Value	2011 Carrying Amount	2011 Estimated Fair Value
Financial assets:					
Cash and cash equivalents	Level 1	$ 60,436	$ 60,436	$ 57,583	$ 57,583
Securities available for sale	Level 2	823,796	823,796	625,882	625,882
Securities available for sale [(1)]	Level 3			1,636	1,636
Securities held to maturity	Level 2	17,905	18,478	23,297	23,964

Loans held for sale	Level 2	1,518	1,547	2,410	2,442
Loans	Level 2	1,678,648	1,701,419	1,459,356	1,490,999
Loans [2]	Level 3	2,364	2,364	2,160	2,160
Accrued interest receivable	Level 1	7,843	7,843	7,655	7,655
FHLB and FRB stock	Level 2	12,321	12,321	10,674	10,674
Financial liabilities:					
Non-maturity deposits	Level 1	1,606,856	1,606,856	1,230,923	1,230,923
Time deposits	Level 2	654,938	658,342	700,676	702,720
Short-term borrowings	Level 1	179,806	179,806	150,698	150,698
Accrued interest payable	Level 1	3,819	3,819	5,207	5,207

(1) Comprised of trust preferred asset-backed securities.

(2) Comprised of collateral dependent impaired loans.

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FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

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(19.) PARENT COMPANY FINANCIAL INFORMATION

Condensed financial statements pertaining only to the Parent are presented below (in thousands).

Condensed Statements of Condition	**December 31, 2012**	**December 31, 2011**
Assets:		
Cash and due from subsidiary	$ 6,602	$ 11,621
Investment in and receivables due from subsidiary	246,535	223,577
Other assets	3,563	4,337
Total assets	$ 256,700	$ 239,535
Liabilities and shareholders equity:		
Other liabilities	$ 2,803	$ 2,341
Shareholders equity	253,897	237,194
Total liabilities and shareholders equity	$ 256,700	$ 239,535

Condensed Statements of Income	**Years ended December 31, 2012**	**2011**	**2010**
Dividends from subsidiary and associated companies	$ 4,000	$ 9,233	$ 23,151
Management and service fees from subsidiary	517	1,161	1,163
Other income (loss)	24	78	(134)
Total income	4,541	10,472	24,180
Operating expenses	2,732	3,787	4,005
Loss on extinguishment of debt		1,083	
Total expenses	2,732	4,870	4,005
Income before income tax benefit and equity in undistributed earnings of subsidiary	1,809	5,602	20,175
Income tax benefit	991	1,539	1,323
Income before equity in undistributed earnings of subsidiary	2,800	7,141	21,498
Equity in undistributed earnings (excess distributions) of subsidiary	20,649	15,658	(211)
Net income	$ 23,449	$ 22,799	$ 21,287

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FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2012, 2011 and 2010

(19.) PARENT COMPANY FINANCIAL INFORMATION (Continued)

Condensed Statements of Cash Flows	**Years ended December 31,**		
	2012	**2011**	**2010**
Cash flows from operating activities:			
Net income	$ 23,449	$ 22,799	$ 21,287
Adjustments to reconcile net income to net cash provided by operating activities:			
Equity in (undistributed earnings) excess distributions of subsidiary	(20,649)	(15,658)	211
Depreciation and amortization	65	116	193
Share-based compensation	526	1,105	1,031
Decrease in other assets	805	771	980
Increase (decrease) in other liabilities	44	(534)	8
Net cash provided by operating activities	4,240	8,599	23,710
Cash flows from financing activities:			
Redemption of junior subordinated debentures		(16,702)	
Proceeds from issuance of preferred and common shares, net of issuance costs		43,127	
Purchase of preferred and common shares	(559)	(37,764)	(69)
Repurchase of warrant issued to U.S. Treasury		(2,080)	
Proceeds from stock options exercised	69	91	216
Dividends paid	(8,866)	(7,564)	(7,690)
Other	97	20	
Net cash used in financing activities	(9,259)	(20,872)	(7,543)
Net (decrease) increase in cash and cash equivalents	(5,019)	(12,273)	16,167
Cash and cash equivalents as of beginning of year	11,621	23,894	7,727
Cash and cash equivalents as of end of the year	$ 6,602	$ 11,621	$ 23,894

ITEM 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE

None.

ITEM 9A. CONTROLS AND PROCEDURES

Effectiveness of Controls and Procedures

As of the end of the period covered by this report, the Company carried out an evaluation, under the supervision and with the participation of the Company s management, including the Company s Chief Executive Officer (Principal Executive Officer) and Chief Financial Officer (Principal Accounting Officer), of the effectiveness of the design and operation of the Company s disclosure controls and procedures pursuant to Rule 13a-15(b), as adopted by the Securities and Exchange Commission (SEC) under the Securities Exchange Act of 1934 (Exchange Act). Based upon that evaluation, the Chief Executive Officer and Chief Financial Officer concluded that the Company s disclosure controls and procedures were effective as of the end of the period covered by this Annual Report on Form 10-K.

Disclosure controls and procedures are the controls and other procedures that are designed to ensure that information required to be disclosed in the reports that the Company files or submits under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the SEC s rules and forms. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed in the reports that the Company files or submits under the Exchange Act is accumulated and communicated to management, including the Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosure.

All internal control systems, no matter how well designed, have inherent limitations. Therefore, even those systems determined effective can provide only reasonable assurance with respect to financial statement preparation and presentation.

Management Report on Internal Control over Financial Reporting and Attestation Report of Independent Registered Public Accounting Firm

Management of the Company is responsible for establishing and maintaining adequate internal control over financial reporting. Management assessed the Company s internal control over financial reporting based on criteria established in the Internal Control Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Based on this assessment, management has concluded that, as of December 31, 2012, the Company maintained effective internal control over financial reporting. Management s Report on Internal Control over Financial Reporting is included under Item 8 Financial Statements and Supplementary Data in Part II of this Form 10-K.

KPMG LLP, an independent registered public accounting firm, has audited the consolidated financial statements included in this Annual Report on Form 10-K, and has issued an attestation report on the effectiveness of the Company s internal control over financial reporting. The Report of Independent Registered Public Accounting Firm that attests the effectiveness of internal control over financial reporting is included under Item 8 Financial Statements and Supplementary Data in Part II of this Form 10-K.

Changes in Internal Control over Financial Reporting

There were no changes in the Company s internal control over financial reporting that occurred during the quarter ended December 31, 2012 that have materially affected, or are reasonably likely to materially affect, the Company s internal control over financial reporting.

ITEM 9B. OTHER INFORMATION

Not applicable.

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PART III

ITEM 10. DIRECTORS, EXECUTIVE OFFICERS AND CORPORATE GOVERNANCE

In response to this Item, the information set forth in the Company s Proxy Statement for its 2013 Annual Meeting of Shareholders (the 2013 Proxy Statement) to be filed within 120 days following the end of the Company s fiscal year, under the headings Election of Directors, Business Experience and Qualification of Directors, and Section 16(a) Beneficial Ownership Reporting Compliance is incorporated herein by reference.

The information under the heading Executive Officers of the Registrant in Part I, Item 1 of this Form 10-K is also incorporated herein by reference.

Information concerning the Company s Audit Committee and the Audit Committee s financial expert is set forth under the caption Corporate Governance Information in the 2013 Proxy Statement and is incorporated herein by reference.

The Company has adopted a Code of Business Conduct and Ethics that applies to its principal executive officer, principal financial officer, principal accounting officer or controller, or persons performing similar functions. The Code of Business Conduct and Ethics is posted on the Company s internet website at www.fiiwarsaw.com under the Corporate Overview/Governance Documents tabs of the Investor Relations drop down menu. In addition, the Company will provide a copy of the Code of Business Conduct and Ethics to anyone, without charge, upon request addressed to Director of Human Resources at Financial Institutions, Inc., 220 Liberty Street, Warsaw, NY 14569. The Company intends to disclose any amendment to, or waiver from, a provision of its Code of Business Conduct and Ethics that applies to the Company s principal executive officer, principal financial officer, principal accounting officer or controller, or persons performing similar functions, and that relates to any element of the Code of Business Conduct and Ethics, by posting such information on the Company s website.

ITEM 11. EXECUTIVE COMPENSATION

In response to this Item, the information set forth in the 2013 Proxy Statement under the heading Elements of Executive Compensation is incorporated herein by reference.

ITEM 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCKHOLDER MATTERS

In response to this Item, the information set forth in the 2013 Proxy Statement under the heading Beneficial Ownership of Common Stock is incorporated herein by reference. The information under the heading Equity Compensation Plan Information in Part II, Item 5 of this Form 10-K is also incorporated herein by reference.

ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS, AND DIRECTOR INDEPENDENCE

In response to this Item, the information set forth in the 2013 Proxy Statement under the headings Certain Relationships and Related Party Transactions and Corporate Governance Information is incorporated herein by reference.

ITEM 14. PRINCIPAL ACCOUNTANT FEES AND SERVICES

In response to this Item, the information set forth in the 2013 Proxy Statement under the headings Audit Committee Report and Independent Registered Public Accounting Firm is incorporated herein by reference.

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PART IV

ITEM 15. EXHIBITS AND FINANCIAL STATEMENT SCHEDULES

(a) FINANCIAL STATEMENTS

Reference is made to the Index to Consolidated Financial Statements of Financial Institutions, Inc. and subsidiaries under Item 8 Financial Statements and Supplementary Data in Part II of this Annual Report on Form 10-K.

(b) EXHIBITS

The following is a list of all exhibits filed or incorporated by reference as part of this Report.

Exhibit Number	Description	Location
3.1	Amended and Restated Certificate of Incorporation of the Company	Incorporated by reference to Exhibits 3.1, 3.2 and 3.3 of the Form 10-K for the year ended December 31, 2008, dated March 12, 2009
3.2	Amended and Restated Bylaws of the Company	Incorporated by reference to Exhibit 3.4 of the Form 10-K for the year ended December 31, 2008, dated March 12, 2009
10.1	1999 Management Stock Incentive Plan	Incorporated by reference to Exhibit 10.1 of the S-1 Registration Statement
10.2	Amendment Number One to the 1999 Management Stock Incentive Plan	Incorporated by reference to Exhibit 10.1 of the Form 8-K, dated July 28, 2006
10.3	Form of Non-Qualified Stock Option Agreement Pursuant to the 1999 Management Stock Incentive Plan	Incorporated by reference to Exhibit 10.2 of the Form 8-K, dated July 28, 2006
10.4	Form of Restricted Stock Award Agreement Pursuant to the 1999 Management Stock Incentive Plan	Incorporated by reference to Exhibit 10.3 of the Form 8-K, dated July 28, 2006
10.5	Form of Restricted Stock Award Agreement Pursuant to the 1999 Management Stock Incentive Plan	Incorporated by reference to Exhibit 10.1 of the Form 8-K, dated January 23, 2008
10.6	1999 Directors Stock Incentive Plan	Incorporated by reference to Exhibit 10.2 of the S-1 Registration Statement
10.7	Amendment to the 1999 Director Stock Incentive Plan	Incorporated by reference to Exhibit 10.7 of the Form 10-K for the year ended December 31, 2008, dated March 12, 2009
10.8	2009 Management Stock Incentive Plan	Incorporated by reference to Exhibit 10.8 of the Form 10-Q for the quarterly period ended June 30, 2009, dated August 5, 2009
10.9	2009 Directors Stock Incentive Plan	Incorporated by reference to Exhibit 10.9 of the Form 10-Q for the quarterly period ended June 30, 2009, dated August 5, 2009
10.10	Form of Restricted Stock Award Agreement Pursuant to the 2009 Directors Stock Incentive Plan	Filed Herewith
10.11	Form of Restricted Stock Award Agreement Pursuant to the 2009 Management Stock Incentive Plan (Special, one-time Award)	Incorporated by reference to Exhibit 10.1 of the Form 8-K, dated January 19, 2010
10.12		

Form of Restricted Stock Award Agreement Pursuant to the 2009 Management Stock Incentive Plan (LTIP Award)	Incorporated by reference to Exhibit 10.2 of the Form 8-K, dated March 1, 2010

Exhibit Number	Description	Location
10.13	Form of Service Based Restricted Stock Award Agreement Pursuant to the 2009 Management Stock Incentive Plan	Incorporated by reference to Exhibit 10.12 of the Form 10-K for the year ended December 31, 2011, dated March 9, 2012
10.14	Form of 2012 Performance Program Master Agreement	Incorporated by reference to Exhibit 10.13 of the Form 10-K for the year ended December 31, 2011, dated March 9, 2012
10.15	Form of 2012 Performance Program Award Certificate	Incorporated by reference to Exhibit 10.14 of the Form 10-K for the year ended December 31, 2011, dated March 9, 2012
10.16	Form of 2013 Performance Program Master Agreement	Filed Herewith
10.17	Form of 2013 Performance Program Award Certificate	Filed Herewith
10.18	Amended and Restated Executive Agreement between Financial Institutions, Inc. and Peter G. Humphrey	Incorporated by reference to Exhibit 10.1 of the Form 8-K, dated July 5, 2012
10.19	Amended and Restated Executive Agreement between Financial Institutions, Inc. and Martin K. Birmingham	Incorporated by reference to Exhibit 10.2 of the Form 8-K, dated July 5, 2012
10.20	Executive Agreement between Financial Institutions, Inc. and Karl F. Krebs	Incorporated by reference to Exhibit 10.3 of the Form 8-K, dated July 5, 2012
10.21	Executive Agreement between Financial Institutions, Inc. and Ronald Mitchell McLaughlin	Incorporated by reference to Exhibit 10.4 of the Form 8-K, dated July 5, 2012
10.22	Executive Agreement between Financial Institutions, Inc. and Kenneth V. Winn	Incorporated by reference to Exhibit 10.5 of the Form 8-K, dated July 5, 2012
10.23	Separation and release agreement between Five Star Bank and George D. Hagi	Incorporated by reference to Exhibit 10.6 of the Form 8-K, dated July 5, 2012
10.24	Voluntary Retirement Agreement with Ronald A. Miller	Incorporated by reference to Exhibit 10.2 of the Form 8-K, dated September 26, 2008
10.25	Amendment to Voluntary Retirement Agreement with Ronald A. Miller	Incorporated by reference to Exhibit 10.1 of the Form 8-K, dated March 3, 2010
10.26	Separation and release agreement between Financial Institutions, Inc. and Peter G. Humphrey	Incorporated by reference to Exhibit 10.2 of the Form 10-Q for the quarterly period ended September 30, 2012, dated November 6, 2012
10.27	Supplemental Executive Retirement Agreement between Financial Institutions, Inc. and Peter G. Humphrey	Incorporated by reference to Exhibit 10.3 of the Form 10-Q for the quarterly period ended September 30, 2012, dated November 6, 2012
10.28	Assignment, Purchase and Assumption Agreement dated January 19, 2012 between First Niagara Bank, National Association and Five Star Bank	Incorporated by reference to Exhibit 10.24 of the Form 10-K for the year ended December 31, 2011, dated March 9, 2012
10.29	Amendment No. 1 to Assignment, Purchase and Assumption Agreement, effective as of August 16, 2012, by and between Five Star Bank and First Niagara Bank, National Association	Incorporated by reference to Exhibit 10.1 of the Form 10-Q for the quarterly period ended September 30, 2012, dated November 6, 2012
10.30	Purchase and Assumption Agreement dated January 19, 2012 between First Niagara Bank, National Association and Five Star Bank	Incorporated by reference to Exhibit 10.25 of the Form 10-K for the year ended December 31, 2011, dated March 9, 2012
10.31	Amendment No. 1 to Purchase and Assumption Agreement, effective as of June 21, 2012, by and between Five Star Bank and First Niagara Bank, National Association.	Incorporated by reference to Exhibit 10.1 of the Form 8-K, dated June 28, 2012

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Exhibit Number	Description	Location
10.32	Underwriting Agreement dated March 9, 2011 between Financial Institutions, Inc. and Keefe, Bruyette & Woods, Inc., as representative of the underwriters	Incorporated by reference to Exhibit 1.1 of the Form 8-K, dated March 9, 2011
21	Subsidiaries of Financial Institutions, Inc.	Filed Herewith
23	Consent of Independent Registered Public Accounting Firm	Filed Herewith
31.1	Certification pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 Principal Executive Officer	Filed Herewith
31.2	Certification pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 Principal Financial Officer	Filed Herewith
32	Certification pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002	Filed Herewith
*101.INS	XBRL Instance Document	
*101.SCH	XBRL Taxonomy Extension Schema Document	
*101.CAL	XBRL Taxonomy Extension Calculation Linkbase Document	
*101.LAB	XBRL Taxonomy Extension Label Linkbase Document	
*101.PRE	XBRL Taxonomy Extension Presentation Linkbase Document	
*101.DEF	XBRL Taxonomy Extension Definition Linkbase Document	

* Pursuant to Rule 406T of Regulation S-T, the information in this exhibit shall not be deemed to be filed for purposes of Section 18 of the Securities Exchange Act of 1934, or otherwise subject to the liability of that section, and shall not be incorporated by reference into any registration statement, prospectus or other document filed under the Securities Act of 1933, or the Securities Exchange Act of 1934, except as shall be expressly set forth by specific reference in such filings.

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Exchange Act, the registrant caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

FINANCIAL INSTITUTIONS, INC.

March 18, 2013

By: ***/s/ Martin K. Birmingham***
Martin K. Birmingham
President and Chief Executive Officer

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

Signatures	Title	Date
/s/ Martin K. Birmingham Martin K. Birmingham	President and Chief Executive Officer (Principal Executive Officer)	March 18, 2013
/s/ Karl F. Krebs Karl F. Krebs	Executive Vice President and Chief Financial Officer (Principal Financial and Accounting Officer)	March 18, 2013
/s/ Karl V. Anderson, Jr. Karl V. Anderson, Jr.	Director	March 18, 2013
/s/ John E. Benjamin John E. Benjamin	Director, Chairman	March 18, 2013
/s/ Barton P. Dambra Barton P. Dambra	Director	March 18, 2013
/s/ Samuel M. Gullo Samuel M. Gullo	Director	March 18, 2013
/s/ Susan R. Holliday Susan R. Holliday	Director	March 18, 2013
/s/ Peter G. Humphrey Peter G. Humphrey	Director	March 18, 2013
/s/ Erland E. Kailbourne Erland E. Kailbourne	Director	March 18, 2013
/s/ Robert N. Latella Robert N. Latella	Director, Vice Chairman	March 18, 2013
/s/ James L. Robinson James L. Robinson	Director	March 18, 2013
/s/ James H. Wyckoff James H. Wyckoff	Director	March 18, 2013