FINANCIAL INSTITUTIONS INC
Form 10-Q
November 07, 2018
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

Form 10-Q

(Mark One)

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended September 30, 2018

or

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the transition period from ________ to ________

Commission File Number: 000-26481

(Exact name of registrant as specified in its charter)

NEW YORK	16-0816610
(State or other jurisdiction of	(I.R.S. Employer
incorporation or organization)	Identification No.)

220 LIBERTY STREET, WARSAW, NEW YORK 14569
(Address of principal executive offices) (Zip Code)
Registrant's telephone number, including area code: (585) 786-1100

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

Indicate by check mark whether the registrant has submitted electronically every Interactive Data File required to be submitted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit such files). Yes No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, a smaller reporting company, or an emerging growth company. See the definitions of "large accelerated filer," "accelerated filer," "smaller reporting company" and "emerging growth company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer Accelerated filer

Non-accelerated filer Smaller reporting company

Emerging Growth Company

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act.

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

The registrant had 15,924,959 shares of Common Stock, $0.01 par value, outstanding as of October 31, 2018.

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FINANCIAL INSTITUTIONS, INC.

Form 10-Q

For the Quarterly Period Ended September 30, 2018

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PART I. FINANCIAL INFORMATION

ITEM 1. Financial Statements

FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

Consolidated Statements of Financial Condition (Unaudited)

(Dollars in thousands, except share and per share data)	September 30, 2018	December 31, 2017
ASSETS		
Cash and due from banks	$ 117,331	$ 99,195
Securities available for sale, at fair value	458,310	524,973
Securities held to maturity, at amortized cost (fair value of $447,718 and $512,983, respectively)	459,623	516,466
Loans held for sale	3,166	2,718
Loans (net of allowance for loan losses of $33,955 and $34,672, respectively)	2,954,376	2,700,345
Company owned life insurance	66,628	65,288
Premises and equipment, net	43,309	45,189
Goodwill and other intangible assets, net	78,853	74,703
Other assets	76,789	76,333
Total assets	$ 4,258,385	$ 4,105,210
LIABILITIES AND SHAREHOLDERS' EQUITY		
Deposits:		
Noninterest-bearing demand	$ 748,167	$ 718,498
Interest-bearing demand	711,321	634,203
Savings and money market	988,486	1,005,317
Time deposits	1,037,755	852,156
Total deposits	3,485,729	3,210,174
Short-term borrowings	308,200	446,200
Long-term borrowings, net of issuance costs of $816 and $869, respectively	39,184	39,131
Other liabilities	33,118	28,528
Total liabilities	3,866,231	3,724,033
Shareholders' equity:		
Series A 3% preferred stock, $100 par value; 1,533 shares authorized; 1,439 shares issued	144	144
Series B-1 8.48% preferred stock, $100 par value; 200,000 shares authorized; 171,847 shares issued	17,185	17,185
Total preferred equity	17,329	17,329
Common stock, $0.01 par value; 50,000,000 shares authorized; 16,056,178 shares issued	161	161
Additional paid-in capital	122,478	121,058
Retained earnings	276,563	257,078

Accumulated other comprehensive loss	(21,820)	(11,916)
Treasury stock, at cost – 131,219 and 131,240 shares, respectively	(2,557)	(2,533)
Total shareholders’ equity	392,154	381,177
Total liabilities and shareholders’ equity	$ 4,258,385	$ 4,105,210

See accompanying notes to the consolidated financial statements.

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FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

Consolidated Statements of Income (Unaudited)

(In thousands, except per share amounts)	Three months ended		Nine months ended	
	September 30,		September 30,	
	2018	2017	2018	2017
Interest income:				
Interest and fees on loans	$33,750	$27,455	$94,851	$77,540
Interest and dividends on investment securities	5,283	5,941	16,449	17,736
Other interest income	2	-	6	67
Total interest income	39,035	33,396	111,306	95,343
Interest expense:				
Deposits	5,163	3,089	12,872	7,820
Short-term borrowings	2,434	1,251	6,047	2,815
Long-term borrowings	617	618	1,853	1,853
Total interest expense	8,214	4,958	20,772	12,488
Net interest income	30,821	28,438	90,534	82,855
Provision for loan losses	2,061	2,802	5,050	9,415
Net interest income after provision for loan losses	28,760	25,636	85,484	73,440
Noninterest income:				
Service charges on deposits	1,813	1,901	5,254	5,486
Insurance income	1,501	1,488	3,918	4,052
ATM and debit card	1,557	1,445	4,509	4,230
Investment advisory	2,245	1,497	5,934	4,357
Company owned life insurance	440	449	1,333	1,367
Investments in limited partnerships	328	(14)	1,019	91
Loan servicing	78	105	396	348
Net gain on sale of loans held for sale	303	150	530	270
Net (loss) gain on investment securities	(95)	184	(88)	600
Net gain on derivative instruments	354	127	606	127
Net gain on other assets	37	21	49	25
Contingent consideration liability adjustment	—	—	—	1,200
Other	1,337	1,221	3,971	3,590
Total noninterest income	9,898	8,574	27,431	25,743
Noninterest expense:				
Salaries and employee benefits	13,970	12,348	40,270	35,703
Occupancy and equipment	4,337	4,087	12,911	12,235
Professional services	1,353	1,157	3,132	3,229
Computer and data processing	1,291	1,208	3,884	3,691
Supplies and postage	485	492	1,545	1,496
FDIC assessments	498	440	1,486	1,366
Advertising and promotions	949	344	2,647	1,451
Amortization of intangibles	334	288	927	876

Goodwill impairment	—	—	—	1,575
Other	2,304	2,103	6,271	5,728
Total noninterest expense	25,521	22,467	73,073	67,350
Income before income taxes	13,137	11,743	39,842	31,833
Income tax expense	2,560	3,464	7,807	9,365
Net income	$ 10,577	$ 8,279	$ 32,035	$ 22,468
Preferred stock dividends	365	366	1,096	1,097
Net income available to common shareholders	$ 10,212	$ 7,913	$ 30,939	$ 21,371
Earnings per common share (Note 3):				
Basic	$ 0.64	$ 0.52	$ 1.95	$ 1.44
Diluted	$ 0.64	$ 0.52	$ 1.94	$ 1.44
Cash dividends declared per common share	$ 0.24	$ 0.21	$ 0.72	$ 0.63

See accompanying notes to the consolidated financial statements.

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FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

Consolidated Statements of Comprehensive Income (Unaudited)

(Dollars in thousands)	Three months ended September 30,		Nine months ended September 30,	
	2018	2017	2018	2017
Net income	$ 10,577	$ 8,279	$ 32,035	$ 22,468
Other comprehensive (loss) income, net of tax:				
Securities available for sale and transferred securities	(1,736)	284	(10,493)	2,600
Hedging derivative instruments	85	—	208	—
Pension and post-retirement obligations	127	171	381	513
Total other comprehensive (loss) income, net of tax	(1,524)	455	(9,904)	3,113
Comprehensive income	$ 9,053	$ 8,734	$ 22,131	$ 25,581

See accompanying notes to the consolidated financial statements.

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FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

Consolidated Statements of Changes in Shareholders' Equity (Unaudited)

Nine months ended September 30, 2018 and 2017

(Dollars in thousands, except per share data)	Preferred Equity	Common Stock	Additional Paid-in Capital	Retained Earnings	Accumulated Other Comprehensive Loss	Treasury Stock	Total Shareholders' Equity
Balance at December 31, 2016	$17,340	$147	$ 81,755	$ 237,687	$ (13,951)	$ (2,924)	$ 320,054
Cumulative-effect adjustment	—	—	(279)	279	—	—	—
Balance at January 1, 2017	$17,340	$147	$ 81,476	$ 237,966	$ (13,951)	$ (2,924)	$ 320,054
Comprehensive income:							
Net income	—	—	—	22,468	—	—	22,468
Other comprehensive income, net of tax	—	—	—	—	3,113	—	3,113
Common stock issued	—	11	29,653	—	—	—	29,664
Purchases of common stock for treasury	—	—	—	—	—	(148)	(148)
Repurchase of Series B-1 8.48% preferred stock	(6)	—	—	—	—	—	(6)
Share-based compensation plans:							
Share-based compensation	—	—	885	—	—	—	885
Stock options exercised	166	359	608	1,057	769		

Income before income tax expense	50,847	45,230	40,778	30,740	15,789	10,001	5,872	4,729
	(5,745)	4,992	577	9,185	720	322	163	282

Income tax expense (benefit)								
Income from continuing operations	56,592	40,238	40,201	21,555	15,069	9,679	5,709	4,447
Minority interests	33	22	(12)	8	5	12	18	12
Net income from continuing operations	56,625	40,260	40,189	21,563	15,074	9,691	5,727	4,459
Gain (Loss) from discontinued e-commerce operations		1		(1)	(2)	(5)	(20)	7
Net income	$ 56,625	$ 40,261	$ 40,189	$ 21,562	$ 15,072	$ 9,686	$ 5,707	$ 4,466
Basic net income per share	$ 1.48	$ 1.05	$ 1.05	$ 0.57	$ 0.40	$ 0.26	$ 0.15	$ 0.12
Shares used in computing basic net income per share	38,311	38,496	38,108	37,759	37,589	37,307	36,903	36,722
Diluted net income per share	$ 1.45	$ 1.02	$ 1.02	$ 0.55	$ 0.39	$ 0.25	$ 0.15	$ 0.12
Shares used in computing diluted net income per share	39,090	39,321	39,429	39,037	39,034	38,516	39,130	38,986

LIQUIDITY AND CAPITAL RESOURCES

For the three years ended December 31, 2008, we financed our operations primarily through cash flows from operations. As of December 31, 2008, we had cash and cash equivalents, and investments in marketable debt securities totaling approximately $314.4 million, compared to $122.7 million and $129.7 million as of December 31, 2007 and 2006, respectively.

As of December 31, 2008, approximately $279 million of earnings held by our foreign subsidiaries are designated as infinitely reinvested outside the United States. If dividends are paid by our China or other non-U.S. subsidiaries to Sohu.com Inc., the dividends would be taxed at Sohu.com Inc. s rate of taxation, which is 34% or 35% (as reduced by any applicable deemed-paid foreign tax credits for foreign income taxes paid by such subsidiaries). For the foreseeable future, we do not intend for the China or other non-U.S. subsidiaries to pay dividends to Sohu.com Inc.

In October, 2008, the board of directors approved a stock repurchase program of up to $150 million of Sohu s outstanding shares of common stock until the end of 2009. During the fourth quarter of 2008, we repurchased 501,686 shares in the open market, at an average price of $39.86 for a total consideration of $20 million. We expect to continue to execute this program during the year ending December 31, 2009.

We completed a private placement on July 14, 2003 of $90.0 million principal amount of zero coupon convertible senior notes due July 2023, which resulted in net proceeds to us of approximately $87.4 million after deduction of the initial purchaser s discount and our offering expenses. The notes did not pay any interest, had a zero yield to maturity, and were convertible into Sohu s common stock at a conversion price of $44.76 per share, subject to adjustment for dividends, distributions, and upon the occurrence of certain other events. Each $1,000 principal of the notes was initially convertible into 22.3414 shares of Sohu s common stock. Each holder of the notes had the right, at the holder s option, to require Sohu to repurchase all or any portion of the principal amount of the holder s notes on July 14 in 2007, 2013 and 2018 at a price equal to 100% of the outstanding principal amount. Sohu had the right to redeem all or a portion of the notes for cash at any time on or after July 14, 2008 at 100% of the principal amount of the notes if the closing price of Sohu s common stock for each of the 30 consecutive trading days prior to such time was at least 130% of the conversion price or at such time at least 90% of the initial aggregate principal amount of the notes had been converted, repurchased or redeemed. In addition, upon a change of control event, each holder of the notes could require Sohu to repurchase some or all of its notes at a repurchase price equal to 100% of the principal amount of the notes. During the year ended December 31, 2005, we redeemed a portion of our zero coupon convertible senior notes with face value of $15,220,000 at a discount. During the year ended December 31, 2006, we redeemed a portion of our zero coupon convertible senior notes at a discount for $15,000,000 in aggregate face value. As of the end of the notification period associated with the July 14, 2007 repurchase date, note holders had exercised their right to require us to repurchase such notes in an aggregate principal amount of $58.5 million. We repurchased such notes on July 16, 2007. In November 2007, the majority of remaining note holders with $1,250,000 in face amount of convertible notes exercised their right to convert their notes to our common stock at a conversion price of $44.76 per share. During the year ended December 31, 2008, the remaining $6,000 of zero coupon convertible senior notes were redeemed; therefore the outstanding balance was zero as of December 31, 2008.

Our principal commitments consist of obligations under various operating leases for office facilities in Beijing, Shanghai, Guangzhou and Hong Kong. Our commitments under these leases total approximately $3.1 million, $2.8 million and $2.7 million for the years ending December 31, 2009, 2010 and 2011, respectively. We expect that capital expenditures, totaling $33.3 million in 2009 will consist of $16.7 million for purchases of servers, network equipment and software and $16.6 million for miscellaneous purchases.

We have entered into arrangements with Dr. Zhang, our Chief Executive Officer, and certain of our employees to satisfy PRC regulations which prohibit or restrict foreign companies from owning or operating telecommunications, Internet content and certain other businesses in China. These arrangements have taken the form of loans to Dr. Zhang and the employees, who then invested the amounts loaned in what are currently our VIEs. While the arrangements have taken the form of loans to Dr. Zhang and the employees, they are, in substance, investments in the VIEs. Accordingly, we do not expect the loans to have any special effect upon our liquidity. The loan agreements do not contain any material financial covenants.

The Chinese economy recently has experienced a slowing growth rate. This slowdown has been exacerbated by the current global crisis in the financial services and credit markets, which has resulted in significant volatility and dislocation of the global capital markets. It is uncertain how long the global crisis in the financial services and credit markets will continue and how much of an impact it will have on the global economy in general or the Chinese economy. However we believe we are well positioned to weather the current economic downturn because of our status in the industry and our financial flexibility.

Although our net cash provided by operating activities might be negatively affected by general economic conditions, we believe that we will continue to generate strong cash flow from our brand advertising and online game business, which, along with our available cash, will provide sufficient liquidity and financial flexibility. We expect to rely on the cash we generate from our operations and our available cash to meet our obligations, support our operation and fund our capital expenditures over the next twelve months.

Our cash flows were summarized below (in thousands):

	Year Ended December 31,		
	2008	2007	2006
Net cash provided by operating activities	$ 218,358	$ 91,425	$ 36,765
Net cash used in investing activities	(27,021)	(49,742)	(10,245)
Net cash used in financing activities	(7,390)	(47,492)	(23,801)
Effect of exchange rate change on cash and cash equivalents	7,772	3,759	2,946
Net increase (decrease) in cash and cash equivalents	191,719	(2,050)	5,665
Cash and cash equivalents at beginning of year	122,706	124,756	119,091
Cash and cash equivalents at end of year	$ 314,425	$ 122,706	$ 124,756

For the year ended December 31, 2008, net cash provided by operating activities was $218.4 million. This was primarily attributable to our net income of $158.6 million, adjusted by non-cash items of depreciation and amortization of $16.6 million, share-based compensation expense of $10.6 million, provision for allowance for doubtful accounts and other miscellaneous non-cash expenses of $1.6 million, and a $31.0 million decrease in working capital. For the year ended December 31, 2007, net cash provided by operating activities was $91.4 million. This was primarily attributable to our net income of $34.9 million, adjusted by non-cash items of depreciation and amortization of $12.9 million, share-based compensation expense of $8.8 million, provision for allowance for doubtful accounts of $1.7million, and a $33.4 million decrease in working capital. This increase was offset by excess tax benefits of $247,000 from share-based payment arrangements. For the year ended December 31, 2006, net cash provided by operating activities was $36.8 million. This was primarily attributable to our net income of $25.9 million, adjusted by non-cash items of depreciation and amortization of $10.0 million, share-based compensation expense of $6.9 million, provision for allowance for doubtful accounts of $1.1 million. This increase was offset by gains on early redemption of zero coupon convertible senior notes of $793,000, excess tax benefits of $431,000 from share-based payment arrangements and a $5.9 million increase in working capital.

For the year ended December 31, 2008, net cash used in investing activities was $27.0 million, and was primarily attributable to $28.7 million used in purchasing fixed assets and other assets, which was offset by a $1.7 million decrease in restricted cash. For the year ended December 31, 2007, net cash used in investing activities was $49.7 million, and was primarily attributable to $55.8 million used in purchasing fixed assets and other assets, and $1.1 million for an earn-out payment for Go2Map. This amount was partially offset by $5.0 million received as a result of the maturities of marketable debt securities, $1.7 million in proceeds from disposal of interest in an associate, and a $450,000 decrease in restricted cash. For the year ended December 31, 2006, net cash used in investing activities was $10.2 million, and was primarily attributable to the purchase of fixed assets of $11.3 million, $3.8 million for acquisition of 21 East and earn-out payment for Focus.cn, an increase in restricted cash of $3.8 million, and the addition of intangible assets and other assets of $359,000.

For the year ended December 31, 2008, net cash used in financing activities was $7.4 million, and was primarily attributable to $20.0 million used for the repurchase of our common stock, $6,000 used for redemption of our zero coupon convertible senior notes, and $0.9 million used for miscellaneous financing activities. This amount was partially offset by $13.1 million received from the issuance of common stock upon the exercise of options granted under our stock incentive plan, and $427,000 from cash contributions received form a minority shareholder. For the year ended December 30, 2007, net cash used in financing activities was $47.5 million, and was primarily attributable to $58.5 million used in redemption of zero coupon convertible senior notes. This amount was partially offset by $10.8 million cash collection from issuance of common stock upon the exercise of share-based awards granted under our stock incentive plan and $247,000 in excess tax benefits from share-based payment arrangements. For the year ended December 31, 2006, net cash used in financing activities was $23.8 million, and was primarily attributable to $15 million used for the repurchase of our common stock and $14.1 million used for early redemption of our zero coupon convertible senior notes. This amount was partially offset by $4.8 million received from the issuance of common stock upon the exercise of options granted under our stock incentive plan, and $431,000 in excess tax benefits from share-based payment arrangements.

We believe that current cash and cash equivalents will be sufficient to meet anticipated working capital (net cash used in operating activities), commitments and capital expenditures for at least the next twelve months. We may, however, require additional cash resources due to changed business conditions or other future developments.

Tabular Disclosure of Contractual Obligations (in thousands)

The following table sets forth our contractual obligations as of December 31, 2008:

		Payment Due by Period			
Contractual Obligations	**Total**	**Less than 1 year**	**1-3 years**	**3-5 years**	**More than 5 years**
Operating lease obligations	$ 10,883	$ 3,063	$ 5,449	$ 2,371	$
Purchase obligations	36,669	21,317	15,352		
Total contractual obligations	$ 47,552	$ 24,380	$ 20,801	$ 2,371	$

Off-balance Sheet Commitments and Arrangements

We have not entered into any financial guarantees or other commitments to guarantee the payment obligations of third parties. We have not entered into any derivative contracts that are indexed to our shares and classified as shareholder s equity, or that are not reflected in our consolidated financial statements. Furthermore, we do not have any retained or contingent interest in assets transferred to an unconsolidated entity that serves as credit, liquidity or market risk support to such entity. We do not have any variable interest in any unconsolidated entity that provides financing, liquidity, market risk or credit support to us or that engages in leasing, hedging or product development services with us.

ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURE ABOUT MARKET RISK
FOREIGN CURRENCY EXCHANGE RATE RISK

While our reporting currency is the US dollar, to date the majority of our revenues and costs are denominated in RMB and a significant portion of our assets and liabilities are denominated in RMB. As a result, we are exposed to foreign exchange risk as our revenues and results of operations may be affected by fluctuations in the exchange rate between US Dollar and RMB. If the RMB depreciates against the US Dollar, the value of our RMB revenues and assets as expressed in our US Dollar financial statements will decline. We do not hold any derivative or other financial instruments that expose us to substantial market risk. See Risk Factors We may suffer currency exchange losses if the RMB depreciates relative to the US Dollar.

The RMB is currently freely convertible under the current account , which includes dividends, trade and service-related foreign exchange transactions, but not under the capital account , which includes foreign direct investment. In addition, commencing on July 21, 2005, China reformed its exchange rate regime by changing to a managed floating exchange rate regime based on market supply and demand with reference to a basket of currencies. Under the managed floating exchange rate regime, the RMB is no longer pegged to the US Dollar. The exchange rate of the RMB against the US Dollar was adjusted to RMB 8.11 per US Dollar as of July 21, 2005, representing an appreciation of about 2%. The People s Bank of China will announce the closing prices of foreign currencies such as the US Dollar traded against the RMB in the inter-bank foreign exchange market after the closing of the market on each business day, and will make such prices the central parity for trading against the RMB on the following business day. On May 19, 2007, the People s Bank of China announced a policy to expand the maximum daily floating range of RMB trading prices against the U.S. dollar in the inter-bank spot foreign exchange market from 0.3% to 0.5%. While the international reactions to the RMB revaluation and widening of the RMB s daily trading band have generally been positive, with the increased floating range of the RMB s value against foreign currencies, the RMB may appreciate or depreciate significantly in value against the U.S. dollar or other foreign currencies in the long term, depending on the fluctuation of the basket of currencies against which it is currently valued. To date, we have not entered into any hedging transactions in an effort to reduce our exposure to foreign currency exchange risk. While we may decide to enter into hedging transactions in the future, the effectiveness of these hedges may be limited and we may not be able to successfully hedge our exposure. Accordingly, we may incur economic losses in the future due to foreign exchange rate fluctuations, which could have a negative impact on our financial condition and results of operations.

The following table sets forth a summary of our foreign currency sensitive financial instruments as of December 31, 2008, which consisted of cash and cash equivalents, restricted cash accounts, receivables, and accounts payables. The maturity of those financial instruments was less than one year and their book value approximated fair value.

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(in thousands)	Denominated in US$	RMB	HK$	Total
Cash and cash equivalents	$ 85,074	$ 228,903	$ 448	$ 314,425
Restricted cash	1,500	1,171		2,671
Accounts receivable	1,908	62,405	108	64,421
Accounts payable	4,800	120,744	5,238	130,782

INFLATION RATE RISK

According to the National Bureau of Statistics of China, the change in the consumer price index in China was 5.9%, 4.8% and 1.5% in 2008, 2007 and 2006, respectively. If inflation continues to rise, it could have a material adverse effect on our business.

INTEREST RATE RISK

The basic objectives of our investment program are to protect the invested funds from excessive risk and to provide for liquidity that is sufficient to meet operating and investment cash requirements. Our investment policy limits our investments of excess cash in high-quality corporate securities and limits the amount of credit exposure to any one issuer.

During 2008, we redeemed the remaining $6,000 zero coupon convertible senior notes, therefore we had no interest rate sensitive financial instrument as of December 31, 2008. We do not expect to be exposed to material risk due to changes in interest rates on borrowings in the foreseeable future.

ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

Reference is made to the Index to Consolidated Financial Statements which appear on page F-1 of this report. The Management s Report on Internal Control over Financial Reporting, Report of Independent Registered Public Accounting Firm, Consolidated Financial Statements, Notes to Consolidated Financial Statements and Financial Statements Schedules which are listed in the Index to Consolidated Financial Statements and which appear beginning on page F-2 of this report are incorporated into this Item 8. Quarterly Results of Operations information is included on page 60 of this report and is incorporated into this Item 8.

ITEM 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE

None.

ITEM 9A. CONTROLS AND PROCEDURES

Evaluation of Disclosure Controls and Procedures

Our Chief Executive Officer and Chief Financial Officer, after evaluating the effectiveness of our disclosure controls and procedures (as defined in the Securities Exchange Act of 1934 Rules 13a-15(e) and 15d-15(e)) as of the end of the period covered by this report (the Evaluation Date), have concluded that as of the Evaluation Date our disclosure controls and procedures were effective and designed to ensure that all material information relating to Sohu required to be included in our reports filed or submitted under the Securities Exchange Act of 1934 is recorded, processed, summarized and reported within the time periods specified in the rules and forms of the Securities and Exchange Commission and to ensure that information required to be disclosed is accumulated and communicated to our management, including our principal executive and financial officers, as appropriate to allow timely decisions regarding required disclosure.

Management s Report on Internal Control over Financial Reporting

Our management s annual report on internal control over financial reporting and the related report of our independent registered public accounting firm are included in this Report on pages F-2 and F-3, respectively.

Changes in Internal Control Over Financial Reporting

There have not been any changes in the Company s internal control over financial reporting, as such term is defined in Rules 13a-15 (f) and 15d-15(f) under the Exchange Act during the Company s fiscal quarter ended December 31, 2008 that have materially affected, or are reasonably likely to materially affect, the Company s internal control over financial reporting.

ITEM 9B. OTHER INFORMATION

None.

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PART III

ITEM 10. DIRECTORS, EXECUTIVE OFFICERS AND CORPORATE GOVERNANCE

The information required by this item will be included in the Proxy Statement for Sohu s 2008 Annual Meeting of Stockholders to be filed with the Securities and Exchange Commission on or about April 30, 2009 and is incorporated herein by reference.

ITEM 11. EXECUTIVE COMPENSATION

The information required by this item will be included in the Proxy Statement for Sohu s 2008 Annual Meeting of Stockholders under the heading Executive Compensation and is incorporated herein by reference.

ITEM 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCKHOLDER MATTERS

The information required by this item, other than the table included below, will be included in the Proxy Statement for Sohu s 2008 Annual Meeting of Stockholders under the heading Beneficial Ownership of Common Stock and is incorporated herein by reference.

Equity Compensation Plan Information

Plan category	Number of securities to be issued upon exercise of outstanding options, warrants and rights (a) (in thousands)	Weighted-average exercise price of outstanding options, warrants and rights (b)	Number of securities remaining available for future issuance under equity compensation plans (excluding securities reflected in column (a)) (c) (in thousands)
Equity compensation plans approved by security holders-2000 Stock Incentive Plan			
Stock Options	799	$ 16.72	
Restricted Stock Units	405	$	
Subtotal	1,204		1,053
Equity compensation plans not approved by security holders			
Total	1,204		1,053

ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS, AND DIRECTOR INDEPENDENCE

The information required by this item will be included in the Proxy Statement for Sohu s 2008 Annual Meeting of Stockholders under the heading Certain Relationships and Related Transactions and is incorporated herein by reference.

ITEM 14. PRINCIPAL ACCOUNTANT FEES AND SERVICES

The information required by this item will be included in the Proxy Statement for Sohu s 2008 Annual Meeting of Stockholders under the heading Principal Accountant Fees and Services and is incorporated herein by reference.

PART IV

ITEM 15. EXHIBITS AND FINANCIAL STATEMENT SCHEDULES

(a)(1) Index to Consolidated Financial Statements

Please see the accompanying Index to Consolidated Financial Statements which appears on page F-1 of this report. The Management s Report on Internal Control over Financial Reporting, Report of Independent Registered Public Accounting Firm, Consolidated Financial Statements and Notes to Consolidated Financial Statements which are listed in the Index to Consolidated Financial Statements and which appear beginning on page F-2 of this report are included in Item 8 above.

(a)(2) Financial Statements Schedule

Schedule I, Condensed Financial Information of Registrant, is included on page F-30 of this report and is incorporated into this Item 15(a)(2) by reference.

All other financial statements schedules have been omitted because the information required to be set forth therein is not applicable or is included in the Consolidated Financial Statements or notes thereto.

(b) Exhibits

See the Exhibit Index following the signature pages of this report.

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SIGNATURES

Pursuant to the requirements of Section 13 or 15 (d) of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereto duly authorized.

Date: February 26, 2009

Sohu.com Inc.

By: /s/ CAROL YU
Carol Yu
Co-President and Chief Financial Officer

KNOW ALL MEN BY THESE PRESENTS, that each person whose signature appears below hereby constitutes and appoints Charles Zhang and Carol Yu, and each of them, his true and lawful proxies, attorneys-in-fact and agents, with full power of substitution and resubstitution, for him and in his name, place and stead, in any and all capacities, to (i) act on, sign and title with the SEC any and all amendments to this Annual Report on Form 10-K, together with all exhibits thereto, (ii) act, sign and file such certificates, instruments, agreements and other documents as may be necessary or appropriate in connection therewith, and (iii) take any and all actions which may be necessary or appropriate in connection therewith, granting unto such agents, proxies and attorneys- in-fact, and each of them and his and their substitute or substitutes, full power and authority to do and perform each and every act and thing necessary or appropriate to be done in connection therewith, as fully for all intents and purposes as he might or could do in person, hereby approving, ratifying and confirming all that such agents, proxies and attorneys-in-fact, any of them or any of his or their substitute or substitutes may lawfully do or cause to be done by virtue hereof.

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.

SIGNATURE	TITLE	DATE
/s/ CHARLES ZHANG **Charles Zhang**	Chairman of the Board of Directors and Chief Executive Officer (Principal Executive Officer)	February 26, 2009
/s/ CAROL YU **Carol Yu**	Co-President and Chief Financial Officer (Principal Financial Officer and Principal Accounting Officer)	February 26, 2009
/s/ EDWARD B. ROBERTS **Edward B. Roberts**	Director	February 26, 2009
/s/ CHARLES HUANG **Charles Huang**	Director	February 26, 2009
/s/ DAVE QI **Dave Qi**	Director	February 26, 2009
/s/ SHI WANG **Shi Wang**	Director	February 26, 2009
/s/ JOHN DENG **John Deng**	Director	February 26, 2009

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SOHU.COM INC.

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All other schedules have been omitted because the information required to be set forth therein is not applicable or is shown in the Consolidated Financial Statements or Notes.

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MANAGEMENT S REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING

The Company s management is responsible for establishing and maintaining adequate internal control over financial reporting as defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act. Under the supervision and with the participation of the Company s management, including our Chief Executive Officer and Chief Financial Officer, the Company conducted an evaluation of the effectiveness of its internal control over financial reporting based on criteria established in *Internal Control Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission. Based on this evaluation, the Company s management concluded that its internal control over financial reporting was effective as of December 31, 2008.

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. The effectiveness of our internal control over financial reporting as of December 31, 2008 has been audited by PricewaterhouseCoopers Zhong Tian CPAs Limited Company, an independent registered public accounting firm, as stated in their report which is included herein.

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To Board of Directors and Shareholders of Sohu.com Inc.:

In our opinion, the consolidated financial statements listed in the accompanying index present fairly, in all material respects, the financial position of Sohu.com Inc. and its subsidiaries at December 31, 2008 and December 31, 2007, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2008 in conformity with accounting principles generally accepted in the United States of America. In addition, in our opinion, the financial statement schedule listed in the accompanying index presents fairly, in all material respects, the information set forth therein when read in conjunction with the related consolidated financial statements. Also in our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 2008, 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 these financial statements and financial statement schedule, for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting, included in management s report on internal control over financial reporting appearing on Page F-2 of Form 10-K. Our responsibility is to express opinions on these financial statements, on the financial statement schedule, and on the Company s internal control over financial reporting based on our integrated 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 audits to obtain reasonable assurance about whether the financial statements are free of material misstatement and whether effective internal control over financial reporting was maintained in all material respects. Our audits of the financial statements included examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. Our audit of internal control over financial reporting 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 audits also included performing such other procedures as we considered necessary in the circumstances. We believe that our audits provide a reasonable basis for our opinions.

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

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

PricewaterhouseCoopers Zhong Tian CPAs Limited Company

Beijing, the People s Republic of China

February 26, 2009

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SOHU.COM INC.

CONSOLIDATED BALANCE SHEETS

(in thousands)

	As of December 31, 2008	2007
ASSETS		
Current assets:		
Cash and cash equivalents	$ 314,425	$ 122,706
Accounts receivable, net	36,869	27,058
Prepaid and other current assets	27,551	7,551
Total current assets	378,845	157,315
Fixed assets, net	76,237	65,027
Goodwill	55,555	55,542
Intangible assets, net	5,654	7,041
Restricted cash	2,671	4,324
Other assets, net	2,914	1,268
Total assets	$ 521,876	$ 290,517
LIABILITIES AND SHAREHOLDERS EQUITY		
Current liabilities:		
Accounts payable	$ 4,339	$ 2,667
Accrued liabilities to suppliers and agents	33,054	23,741
Receipts in advance and deferred revenue	31,446	14,139
Tax payable	18,892	6,850
Other accrued liabilities	43,051	24,210
Zero coupon convertible senior notes		6
Total current liabilities	130,782	71,613
Commitments and contingencies (Note 16)		
Minority interests (Note 18)	5,148	7
Shareholders equity:		
Common stock: $0.001 par value per share (75,400 authorized; 38,095 and 37,715 shares issued and outstanding, respectively)	43	42
Additional paid-in capital	201,196	182,225
Treasury stock (4,638 and 4,137 shares, respectively)	(74,683)	(54,686)
Accumulated other comprehensive income	21,349	11,912
Retained earnings	238,041	79,404
Total shareholders equity	385,946	218,897
Total liabilities, minority interests and shareholders equity	$ 521,876	$ 290,517

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

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SOHU.COM INC.

CONSOLIDATED STATEMENTS OF OPERATIONS

(in thousands, except per share data)

	Year Ended December 31,		
	2008	**2007**	**2006**
Revenues:			
Advertising:			
Brand advertising	$ 169,268	$ 112,106	$ 78,993
Sponsored search	6,669	7,110	12,765
Subtotal of advertising revenues	175,937	119,216	91,758
Non-advertising:			
Online game	201,845	42,096	8,525
Wireless	47,046	26,337	32,592
Others	4,223	1,285	1,361
Subtotal of non-advertising revenues	253,114	69,718	42,478
Total revenues	429,051	188,934	134,236
Cost of revenues:			
Advertising:			
Brand advertising	59,443	38,733	23,211
Sponsored search	6,816	5,644	5,246
Subtotal of cost of advertising revenues	66,259	44,377	28,457
Non-advertising:			
Online game	14,567	7,113	3,895
Wireless	24,538	12,334	15,441
Others	1,950	939	570
Subtotal of cost of non-advertising revenues	41,055	20,386	19,906
Total cost of revenues	107,314	64,763	48,363
Gross profit	321,737	124,171	85,873
Operating expenses:			
Product development	49,713	25,443	17,651
Sales and marketing	84,691	47,506	28,532
General and administrative	22,695	17,418	13,092
Amortization of intangible assets	796	1,093	1,993
Total operating expenses	157,895	91,460	61,268
Operating profit	163,842	32,711	24,605
Other (expense) income	(535)	887	477

Interest income and exchange difference	4,288	2,793	3,216
Income before income tax expense	167,595	36,391	28,298
Income tax expense	9,009	1,487	1,579
Income from continuing operations	158,586	34,904	26,719
Minority interests	51	47	7
Net income from continuing operations	158,637	34,951	26,726
Loss from discontinued e-commerce operations		(20)	(841)
Net income	$ 158,637	$ 34,931	$ 25,885
Basic net income per share	$ 4.16	$ 0.94	$ 0.70
Shares used in computing basic net income per share	38,168	37,133	36,730
Diluted net income per share	$ 4.06	$ 0.90	$ 0.68
Shares used in computing diluted net income per share	39,117	38,919	39,105

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

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SOHU.COM INC.

CONSOLIDATED STATEMENTS OF CASH FLOWS

(in thousands)

	Year Ended December 31,		
	2008	2007	2006
Cash flows from operating activities:			
Net income	$ 158,637	$ 34,931	$ 25,885
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation	13,485	9,801	5,969
Share-based compensation expense	10,620	8,786	6,939
Amortization of intangible assets and other assets	3,159	3,082	4,085
Losses on disposal of fixed assets	1,269	837	188
Provision for allowance for doubtful accounts	579	1,719	1,067
Excess tax benefits from share-based payment arrangements		(247)	(431)
Gains on early redemption of zero coupon convertible senior notes			(793)
Minority interests	(51)	(47)	(7)
Others	(241)	(793)	(131)
Changes in current assets and liabilities:			
Accounts receivable	(8,653)	(1,977)	(5,684)
Prepaid and other current assets	(19,630)	(81)	(2,497)
Accounts payable	1,672	1,490	(506)
Tax payable	12,042	3,286	1,922
Accrued liabilities to suppliers and agents	9,313	11,440	1,700
Receipts in advance and deferred revenue	17,307	7,949	315
Other accrued liabilities	18,850	11,249	(1,256)
Net cash provided by operating activities	218,358	91,425	36,765
Cash flows from investing activities:			
Purchase of fixed assets	(26,373)	(53,588)	(11,303)
Purchase of intangible assets and other assets	(2,301)	(2,218)	(359)
Decrease (increase) of restricted cash	1,653	450	(3,750)
Acquisitions, net of cash acquired		(1,117)	(3,833)
Proceeds from maturities of marketable debt securities		5,000	9,000
Proceeds from disposal of interest in an associate		1,731	
Net cash used in investing activities	(27,021)	(49,742)	(10,245)
Cash flows from financing activities:			
Issuance of common stock	13,103	10,785	4,830
Repurchase of common stock	(19,997)		(15,000)
Redemption of zero coupon convertible senior notes	(6)	(58,524)	(14,062)
Cash contribution received from a minority shareholder	427		
Excess tax benefits from share-based payment arrangements		247	431
Other cash payments relating to financing activities	(917)		
Net cash used in financing activities	(7,390)	(47,492)	(23,801)
Effect of exchange rate change on cash and cash equivalents	7,772	3,759	2,946
Net increase (decrease) in cash and cash equivalents	191,719	(2,050)	5,665
Cash and cash equivalents at beginning of year	122,706	124,756	119,091
Cash and cash equivalents at end of year	$ 314,425	$ 122,706	$ 124,756

Supplemental cash flow disclosures:			
Cash paid for income taxes	(4,484)	(1,292)	(4)
Non-cash financing activities:			
Issuance of common stock in connection with conversion of zero coupon convertible senior notes		1,250	
Barter transactions	519	397	353

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

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SOHU.COM INC.

CONSOLIDATED STATEMENTS OF SHAREHOLDERS EQUITY

(in thousands)

	Year Ended December 31,		
	2008	**2007**	**2006**
Common stock:			
Balance, beginning of year	$ 42	$ 41	$ 40
Issuance of common stock	1	1	1
Balance, end of year	43	42	41
Additional paid-in capital:			
Balance, beginning of year	182,225	161,033	148,780
Issuance of common stock	13,103	12,034	4,829
Compensatory stock options	5,868	8,786	6,939
Tax benefits from stock option		372	485
Balance, end of year	201,196	182,225	161,033
Treasury stock:			
Balance, beginning of year	(54,686)	(54,686)	(39,686)
Repurchase of common stock	(19,997)		(15,000)
Balance, end of year	(74,683)	(54,686)	(54,686)
Accumulated other comprehensive income:			
Balance, beginning of year	11,912	5,102	2,126
Net unrealized gains on marketable debt securities		58	177
Foreign currency translation adjustment	9,437	6,752	2,799
Balance, end of year	21,349	11,912	5,102
Retained earnings:			
Balance, beginning of year	79,404	44,473	18,588
Net income	158,637	34,931	25,885
Balance, end of year	238,041	79,404	44,473
Total stockholders equity	$ 385,946	$ 218,897	$ 155,963
Comprehensive income:			
Net income	$ 158,637	$ 34,931	$ 25,885
Other comprehensive income:			
Net unrealized gains on marketable debt securities		58	177
Foreign currency translation adjustment	9,437	6,752	2,799
Total comprehensive income	$ 168,074	$ 41,741	$ 28,861

	Number of Outstanding Shares		
Common stock:			
Balance, beginning of year	37,715	36,647	36,680
Issuance of common stock	881	1,068	658
Repurchase of common stock	(501)		(691)
Balance, end of year	38,095	37,715	36,647

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

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SOHU.COM INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

1. Organization and Nature of Operations

Sohu.com Inc. (the Company or Sohu), a Delaware corporation commenced operations in 1996, is a leading Internet company providing comprehensive online products and services in the People s Republic of China (the PRC or China). The Company, its subsidiaries and variable interest entities (VIEs), offer its brand advertising, sponsored search, online game and wireless services through the Company s Internet sites, www.sohu.com, www.sogou.com, www.17173.com, www.focus.cn, www.chinaren.com, and www.changyou.com.

Brand advertising and online game are the Company s core businesses. For the brand advertising business, the Company provides advertisements on portal websites to advertisers that expect to build up their brand awareness online. For the online games business, the Company operates two massively multi-player online role-playing games (or MMORPGs), Tian Long Ba Bu (or TLBB) and Blade Online (or BO). TLBB is the first in-house developed MMORPG and has been one of the most popular online games in China.

Possible Initial Public Offering of Changyou

On July 28, 2008, the Company announced plans to submit on a confidential basis to the SEC a draft registration statement for an initial public offering, or IPO, of American Depositary Shares, or ADSs, representing ordinary shares of Changyou.com Limited (or Changyou), a recently-organized Cayman Islands company that is Sohu s online games business subsidiary. The Company announced that the number and dollar amount of ADSs proposed to be offered and sold had not yet been determined.

The Company announced that Sohu s and Changyou s purposes for conducting the IPO, if commenced, include allowing Sohu to focus principally on its core online media, communications, search, and mobile value-added services businesses, and providing Changyou a sharper focus on the online games business and related strategic opportunities, while Sohu remained Changyou s majority shareholder.

The Company announced that the IPO was expected to commence as market conditions permit, and was subject to Changyou s filing with the SEC a registration statement on Form F-1 in compliance with the U.S. Securities Act of 1933, as amended, and the SEC s declaring such registration statement effective. As of the date of this report, Changyou has not filed such a registration statement on Form F-1 with the SEC.

2. Summary of Significant Accounting Policies

(a) Accounting Standards

The consolidated financial statements have been prepared on a historical cost basis to reflect the financial position and results of operations of the Company in accordance with accounting principles generally accepted in the United States of America.

(b) Consolidation

The consolidated financial statements include the accounts of the Company, its subsidiaries and its VIEs from the respective dates of their acquisition or formation. All intercompany balances and transactions have been eliminated.

The Company adopted the provisions of Financial Accounting Standards Board Interpretation No. 46R, *Consolidation of Variable Interest Entities* (or FIN 46R). Pursuant to FIN 46R, Beijing Century High Tech Investment Co., Ltd. (or High Century), Beijing Sohu Entertainment Culture Media Co., Ltd. (or Sohu Entertainment , formerly known as Beijing Hengda Yitong Internet Technology Development Co., Ltd, or Hengda), Beijing Sohu Internet Information Service Co., Ltd. (or Sohu Internet), Beijing GoodFeel Information Technology Co., Ltd. (GoodFeel), Beijing Fire Fox Digital Technology Co., Ltd. (or Beijing Fire Fox , also known as Beijing Huohu Digital Technology Co., Ltd, or Huohu), Beijing Tu Xing Tian Xia Information Consultancy Co., Ltd. (or Tu Xing Tian Xia), Beijing Feng Yang Tian Lang Advertising Co., Ltd. (or Feng Yang Tian Lang), Beijing Sogou Information Service Co., Ltd. (or Sogou Information) and Beijing Gamease Age Digital Technology Co., Ltd. (or Gamease) are VIEs of the Company and the Company is the primary beneficiary of the VIEs. Accordingly, the VIEs have been consolidated in the Company s financial statements.

(c) Use of estimates

The Company s discussion and analysis of its financial condition and results of operations are based upon its consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States. The preparation of these financial statements requires the Company to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses, and related disclosure of contingent assets and liabilities. On an on-going basis, the Company evaluates its estimates based on historical experience and on various other assumptions that are believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates under different assumptions or conditions. The Company believes accounting for brand advertising and sponsored search revenues, accounting for online game revenues, accounting for wireless revenues and cost of revenues, gross versus net basis of revenue recognition, determination of functional currencies, allowance for doubtful accounts, assessment of impairment for goodwill, intangible assets, fixed assets and other assets, determination of share-based compensation expense, and income taxes and assessment of valuation allowance against deferred tax assets, represent critical accounting policies that reflect the more significant judgments and estimates used in the preparation of its consolidated financial statements.

(d) Revenue recognition

The Company recognizes revenue when persuasive evidence of an arrangement exists, delivery has occurred, the sales price is fixed or determinable, and collectability is reasonably assured. The Company derives revenue from both advertising and non-advertising sources.

i) Advertising revenues

Advertising revenues include revenues from brand advertising and sponsored search services, after deducting agent rebates and applicable business tax. Revenue from barter transactions, other than advertising-for-advertising barter transactions, is recognized based on the fair value of the nonmonetary assets acquired and the assets surrendered to obtain it. No revenues from advertising-for-advertising barter transactions were recognized.

Brand advertising contracts establish the fixed price and advertising services to be provided. Pursuant to brand advertising contracts, the Company provides advertisement placements on various Website channels and in different formats, including but not limited to banners, links, logos, buttons, rich media and content integration. Revenue is recognized ratably over the period the advertising is provided and, as such, the Company considers the services to have been delivered. The Company treats all elements of advertising contracts as a single unit of accounting for revenue recognition purposes. Based upon the Company s credit assessments of its customers prior to entering into contracts, the Company determines if collectability is reasonably assured. In situations where collectability is not deemed to be reasonably assured, the company recognizes revenue upon receipt of cash from customers, only after services have been provided and all other criteria for revenue recognition have been met.

Sponsorship contracts may include services similar to those in the brand advertising contracts, are generally for larger dollar amounts and for a longer period of time, may allow advertisers to sponsor a particular area on the Websites of the Company, may include brand affiliation services and/or a larger volume of services, and may require some exclusivity or premier placements. Sponsorship advertisement revenues are normally recognized on a straight-line basis over the contract period, provided the Company is meeting its obligations under the contract.

Pursuant to sponsored search contracts, which are normally for relatively small dollar amounts and are with small and medium-sized enterprises, sponsored search services mainly include priority placements in the Company s search directory and pay-for-click services consisting of displaying the text-based links to the Websites of the Company s advertisers and the Company s Website Alliance network. The Company normally provides the priority placements services for a fixed fee over the service period of the contracts. Revenues of these services are normally recognized on a straight-line basis over the service period of the contracts. Pay-for- click services of displaying the text-based links to the Company s advertisers Websites is charged on a cost per click basis, so that an advertiser pays the Company only when a user clicks on the displayed link. The priority of the display of text-based links is based on the bidding price of different advertisers. Revenues from the pay-for-click services are recognized as the users click on the links.

ii) Non-advertising revenues

Non-advertising revenues include revenue principally from online game and wireless services.

The Company earns online game revenue through providing MMORPGs to players pursuant to the item-based revenue model. Under the item-based model, the basic game play functions are free of charge and players are charged for purchases of in-game virtual items. Prior to December 2006, the MMORPGs were operated under the time-based revenue model, whereby players are charged based on the time they spend playing games.

Game revenues from domestic operations are collected through sale of the Company s prepaid cards, which it sells in both virtual and physical forms to third-party distributors.

For games which use the item-based revenue model, proceeds from sale of prepaid cards are deferred when received and revenue is recognized over the estimated lives of the virtual items purchased or as the virtual items are consumed. If different assumptions were used in deriving the estimated lives of the virtual items, the timing in which the Company records its revenues would be impacted. For games which use the time-based revenue model, the proceeds from sale of prepaid cards from distributors are deferred when received and revenue is recognized based upon the actual usage of time units by the game players.

The revenues are recorded net of business tax, discounts and rebates to distributors.

Under both the item-based and the time-based revenue models, proceeds received from sales of prepaid cards are initially recorded as receipts in advance from customers and, upon activation or charge of the prepaid cards, transferred from receipts in advance from customers to deferred revenues. As we do not have control of, and generally do not know, the ultimate selling price of the prepaid cards sold by the distributors, net proceeds from distributors form the basis of revenue recognition.

Prepaid cards will expire two years after the date of card production if they have never been activated. The proceeds from the expired game cards are recognized as revenue upon expiration of cards.

In contrast, once the prepaid cards are activated and credited to a player s personal game account, they will not expire as long as the personal game account remains active. The Company is entitled to suspend and close a player s personal game account if it has been inactive for a period of 180 consecutive days. The unused balances in an inactive player s personal game account are recognized as revenues when the account is suspended and closed.

For the years ended December 2008, 2007 and 2006, the Company recognized revenues in connection with expired un-activated prepaid cards and unused balances of activated prepaid cards in inactive account amounting to approximately $173,000, $150,000 and $380,000, respectively.

The Company enters into licensing arrangements with overseas licensees to operate its MMORPGs in other countries or territories. These licensing agreements provided for two revenue streams, namely an initial license fee and a monthly revenue-based royalty fee based on monthly revenue and sales from ancillary products of the games. The initial license fee is based on both a fixed amount and additional amount receivable upon achieving certain sales targets. Since the Company is obligated to provide post-sales services such as technical support and provision of updates and when-and-if-available upgrades to the licensee during the license period, the initial license fee from the licensing arrangement is recognized as revenue ratably over the license period. The fixed amount of the initial license fee is recognized ratably over the remaining license period from the launch of the game and the additional amount is recognized ratably over the remaining license period from the date such additional amount is certain. The monthly revenue-based royalty fee is recognized when earned, provided that collectability is reasonably assured.

Wireless revenues are derived from providing short messaging services or SMS, Ring Back Tone or RBT, Wireless Application Protocol or WAP, multi-media messaging services or MMS and interactive voice response or IVR, mainly consisting of news, weather forecast, chatting, entertainments information, ring tones, and logo downloads and various other mobile related products provided to mobile phone users. The Company contracts with third party mobile network operators for wireless services provided to its users and records the fee charged by third party mobile network operators as cost of revenues. Wireless revenues are recognized in the month in which the service is performed, provided that no significant company obligations remain.

Wireless revenues are recorded on a gross basis as the Company is the primary obligor in the arrangement, which is evidenced by a number of factors including that the content and the nature of the wireless services are designed and developed by the Company (either independently or with third parties) and originates from the Company s Websites, the links located on third parties Websites, or one of the dedicated phone numbers of the Company. Also, the mobile network operators that the Company contracts with to deliver these services to the end customers are not involved in the design or development of the services that are provided by the Company. The end customer purchases the wireless content, community access or value-added services that the Company provides. The end customer receives identical services from the Company regardless of which third party mobile network operator is used to deliver the message. In addition, the Company provides customer services to the end customers directly and it could be requested by the mobile network operators to assume the credit risk if the operators are not able to collect fees from the end customers. The Company is primarily responsible for fulfillment, adds value to the products, has inventory risk related to the content and products, and has reasonable pricing latitude.

(e) Cash and cash equivalents

The Company considers all highly liquid investments with an original maturity of three months or less when purchased to be cash equivalents. Cash equivalents are composed primarily of time deposits and investments in money market accounts stated at cost which approximates fair value.

(f) Investments in marketable debt securities

The Company invests its excess cash in certain marketable debt securities of high-quality corporate issuers. The Company s marketable debt securities are classified as available-for-sale and are reported at fair market values with the unrealized gains or losses recorded as accumulated other comprehensive income in shareholders equity. Additionally, the Company assesses whether an other- than-temporary impairment loss on investments in marketable debt securities has occurred due to declines in fair value or other market conditions. Declines in fair values that are considered other than temporary are recorded as an impairment of certain equity investments in the consolidated statements of operations.

Investments in marketable debt securities with original maturities greater than twelve months when purchased are considered long- term investments. Long-term investments in marketable securities with maturities less than twelve months from the balance sheet date are recorded as current portion of long-term investments in marketable debt securities.

(g) Accounts receivable, net

The carrying amount of accounts receivable is reduced by an allowance that reflects the Company s best estimate of the amounts that will not be collected. In addition to reviewing delinquent accounts receivable, the Company considers many factors in estimating its general allowance, including aging analysis, historical bad debt records, customer credit analysis and any specific known troubled accounts.

(h) Associates

Associates are entities over which the Company has significant influence, but which it does not control. Investments in associates are accounted for by the equity method of accounting. Under this method, the Company s share of the post-acquisition profits or losses of associates is

recognized in the income statement and its share of post-acquisition movements in reserves is recognized in reserves. Unrealized gains on transactions between the Company and its associates are eliminated to the extent of the Company s interest in the associates; unrealized losses are also eliminated unless the transaction provides evidence of an impairment of the asset transferred. When the Company s share of losses in an associate equals or exceeds its interest in the associates, the Company does not recognize further losses, unless the Company has incurred obligations or made payments on behalf of the associates.

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(i) Fixed assets and depreciation

Fixed assets, comprising computer equipment and hardware, office building, leasehold improvements, investment properties, vehicles and office furniture are stated at cost less accumulated depreciation. Depreciation is computed using the straight-line method over the estimated useful lives listed below.

Fixed assets	Estimated useful lives (years)
Computer equipment and hardware	4
Office building	47
Leasehold improvements	Lesser of term of the lease or the estimated useful lives of the assets
Investment properties	47
Vehicles	5
Office furniture	5

(j) Goodwill

Goodwill represents the excess of the purchase price over the fair value of the identifiable assets and liabilities acquired as a result of the Company s acquisitions of interests in its subsidiaries and VIEs.

The Company tests goodwill for impairment at the reporting unit level (operating segment) on an annual basis as of October 1st or more frequently if an event occurs or circumstances change that could more likely than not reduce the fair value of the goodwill below its carrying amount. The impairment of goodwill is determined by the Company estimating the fair value based upon the present value of future cash flows. In estimating the future cash flows, the Company has taken into consideration the overall and industry economic conditions and trends, market risk of the Company and historical information.

(k) Intangible assets

Intangible assets, comprising domain names, trademarks, customer relationship, computer software purchased from unrelated third parties and others, are stated at cost less accumulated amortization. Amortization is computed using the straight-line method over the estimated useful lives of the assets, generally three years for customer lists and computer software and fifteen years for domain names and trademarks, with no residual value. The weighted average amortization period for intangible assets is five years.

(l) Other assets

Other assets mainly include the prepaid content fees, prepaid license fees and rental deposits. The Company amortizes content fees and license fees over the term of the contracts. During the year ended December 31, 2007, the estimated remaining economic lives for certain other assets were shortened as a result of certain events. Accordingly, net income and earnings per share for 2007 were reduced by $1.3 million and $0.04, respectively. There was no impact of those events on net income or earnings per share for the year ended December 31, 2008.

(m) Impairment for long-lived assets

The carrying amounts of long-lived assets are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of assets to be held and used is evaluated by a comparison of the carrying amount of assets to future undiscounted net cash flows expected to be generated by the assets. If such assets are considered to be impaired, the impairment to be recognized is measured by the amount by which the carrying amounts of the assets exceed the fair value of the assets. Assets to be disposed of are reported at the lower of the carrying amount or fair value less cost to sell.

(n) Foreign currency translation

Foreign currency transactions are translated at the applicable rates of exchange in effect at the transaction dates. Monetary assets and liabilities denominated in foreign currencies at the balance sheet date are translated at the applicable rates of exchange in effect at that date.

The Company s reporting currency is the US Dollar. The functional currency of the Company s subsidiaries and VIEs in China is the Renminbi (RMB), and the functional currency of the Company s subsidiaries outside China is the US Dollar. Sales and purchases and other expense transactions are generally denominated in RMB. Accordingly, assets and liabilities of the China subsidiaries are translated at the current exchange rate in effect at the balance sheet

date, and revenues and expenses are translated at the average exchange rates in effect during the reporting period. Gains and losses resulting from foreign currency translation are recorded in a separate component of shareholders equity. Foreign currency translation adjustments are included in accumulated other comprehensive income in the consolidated statements of shareholders equity for the years presented.

(o) Cost of revenues

i) Advertising

Cost of advertising revenues consists of compensation and related overhead costs for employees, depreciation expenses, fees for bandwidth leasing charges, content and services. Royalties paid to content providers are expensed as incurred and included as cost of revenues. Contracts with content providers generally range from one to three years in duration and may be terminated by either party upon notice.

ii) Non-advertising

Cost of online game revenues consists of salary and benefits, PRC business tax and VAT that AmazGame pays on the revenues that it derives from its contractual arrangements with Gamease, bandwidth leasing and communication costs, depreciation of computer equipment, and revenue-based royalty payments to game developers of licensed games.

Cost of wireless revenues consists of collection charges and transmission fees paid to third party network operators, payments to third party content suppliers, penalties, depreciation expenses, and fees for bandwidth leasing charges.

(p) Product development

Operating, classification and organization of listings, and enhancement costs of the Website are expensed as incurred. Significant direct costs of materials, labor and services incurred during the application development stage of a project are capitalized.

(q) Advertising expenses

Advertising expenses, which generally represent the cost of promotions to create or stimulate a positive image of the Company or a desire to buy the Company s products and services, are expensed as incurred. Advertising expenses are charged to the statements of operations when incurred. Included in sales and marketing expenses are advertising costs of $47.4 million, $22.5 million and $10.6 million, for the years ended December 31, 2008, 2007 and 2006, respectively.

(r) Share-based compensation

Effective from January 1, 2006, the Company adopted SFAS 123(R), which requires all share-based payments to employees and directors, including grants of employee stock options and restricted stock units, to be recognized in the financial statements based on their grant date fair values. The valuation provisions of SFAS 123(R) apply to new awards, to awards granted to employees and directors before the adoption of SFAS 123(R) whose related requisite services had not been provided, and to awards which were subsequently modified or cancelled. In March 2005, the SEC issued SAB 107 regarding the SEC s interpretation of SFAS 123(R) and the valuation of share-based payments for public companies. The Company has applied the provisions of SAB 107 in its adoption of SFAS 123(R). Prior to SFAS 123(R), the Company accounted for share-based payments in accordance with APB 25, and complied with the disclosure provisions of SFAS 123. In general, compensation cost under APB 25 was recognized based on the difference, if any, between the estimated fair value of the Company s common stock and the amount an employee must pay to acquire the stock, as determined on the date the option is granted. Pro forma information was disclosed to illustrate the effect on net income and net income per share if the Company had applied the fair value recognition provisions of SFAS 123 to stock-based employee compensation for the reporting periods.

Under SFAS 123(R), the Company applied the Black-Scholes valuation model in determining the fair value of options granted to employees and directors. Under the transition provisions of SFAS 123(R), the Company recognizes compensation expense on options granted prior to the adoption of SFAS 123(R) on an accelerated basis over the requisite service period, which is consistent with the methods the Company adopted when preparing pro forma information under SFAS 123. Restricted stock units are measured based on the fair market value of the underlying stock on the dates of grant. The Company recognizes the relevant share-based compensation expenses on an accelerated basis over the requisite service period, generally ranging from one to four years.

Under SFAS 123(R), the number of share-based awards for which the service is not expected to be rendered for the requisite period should be estimated, and the related compensation cost not recorded for that number of awards. For pro forma disclosure under SFAS 123, the effect of forfeitures was accounted for only as the forfeitures occurred. The Company applied the modified prospective transition method, and therefore has not restated prior years results.

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The Company s assumptions were based on historical experience, with consideration to developing expectations about the future. The assumptions used in calculating the fair value of share-based awards and related share based compensation expenses represent management s best estimates, but these estimates involve inherent uncertainties and the application of management judgment. As a result, if factors change or different assumptions are used the share-based compensation expense could be materially different for any period.

(s) Income taxes

Income taxes are accounted for using an asset and liability approach which requires the recognition of income taxes payable or refundable for the current year and deferred tax liabilities and assets for the future tax consequences of events that have been recognized in the Company s financial statements or tax returns. Deferred income taxes are determined based on the differences between the financial reporting and tax basis of assets and liabilities and are measured using the currently enacted tax rates and laws. The deferred tax assets are reduced by a valuation allowance, if based on available evidence, it is considered that more likely than not some portion of or all of the deferred tax assets will not be realized.

(t) Uncertain tax positions

The Company adopted Financial Accounting Standards Board Interpretation No. 48, Accounting for Uncertainty in Income Taxes (FIN 48), on January 1, 2007. FIN 48 prescribes a more likely than not threshold for financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. This Interpretation also provides guidance on recognition of income tax assets and liabilities, classification of current and deferred income tax assets and liabilities, accounting for interest and penalties associated with tax positions, accounting for income taxes in interim periods, and income tax disclosures. The Company did not have any adjustment to the opening balance of retained earnings as of January 1, 2007 as a result of the implementation of FIN 48. For the year ended December 31, 2008, the Company did not have any interest and penalties associated with tax positions. As of December 31, 2008, the Company did not have any significant unrecognized uncertain tax positions.

(u) Net income per share

Basic net income per share is computed using the weighted average number of common shares outstanding during the year. Diluted net income per share is computed using the weighted average number of common and, if dilutive, potential common shares

outstanding during the year. Potential common shares consist of shares issuable upon the exercise of stock options and restricted stock units (using the treasury stock method) and the conversion of zero coupon convertible senior notes.

(v) Comprehensive income

Comprehensive income is defined as the change in equity of a company during a period from transactions and other events and circumstances excluding transactions resulting from investments from owners and distributions to owners. Accumulated other comprehensive income, as presented on the accompanying consolidated balance sheets, consists of the unrealized gains on investments in marketable debt securities and the cumulative foreign currency translation adjustment.

(w) Segment reporting

In accordance with its internal financial reporting structure, the Company has determined that its business segments constitute its primary reporting segments. Prior to 2007, the Company mainly had four reportable segments: brand advertising, sponsored search, wireless and others. In 2007, the Company adjusted its reportable segments and has reclassified results of its online game segment from its other operations and reported online game results as a separate segment. Accordingly, the Company reclassified the related revenue and cost of revenue for previous years presented to conform to the revised classification.

The Company does not allocate any operating expenses or assets to its brand advertising, sponsored search, online game, wireless and other segments as management does not use this information to measure the performance of the operating segments.

(x) Recent accounting pronouncements

In May 2008, the FASB issued SFAS No. 162, The Hierarchy of Generally Accepted Accounting Principles. SFAS No. 162 identifies the sources of accounting principles and provides entities with a framework for selecting the principles used in preparation of financial statements that are presented in conformity with GAAP. The current GAAP hierarchy has been criticized because it is directed to the auditor rather than the entity, it is complex, and it ranks FASB Statements of Financial Accounting Concepts, which are subject to the same level of due process as FASB Statements of Financial Accounting Standards, below industry practices that are widely recognized as generally accepted but that are not subject to due process. The adoption of FASB 162 is not expected to have a material impact on the Company s consolidated financial position and results of operations.

In April 2008, the FASB issued Staff Position No. FAS 142-3, Determination of the Useful Life of Intangible Assets (FSP FAS 142-3). FSP FAS 142-3 amends the factors that should be considered in developing renewal or extension assumptions used to determine the useful life of a recognized intangible asset under SFAS No. 142, Goodwill and Other Intangible Assets (SFAS 142). The intent of FSP FAS 142-3 is to improve the consistency between the useful life of a recognized intangible asset under SFAS 142 and the period of expected cash flows used to measure the fair value of the asset under SFAS 141(R) and other applicable accounting literature. FSP FAS 142-3 is effective for fiscal years beginning after December 15, 2008. The Company is currently evaluating the potential impact of FSP FAS 142-3 on its consolidated financial statements.

In December 2007, the SEC issued Staff Accounting Bulletin 110 (SAB 110). SAB 110 states that the staff will continue to accept, under certain circumstances, the use of the simplified method for estimating the expected term of plain vanilla share options in accordance with SFAS 123(R) beyond December 31, 2007. The Company believes there will be no material impact on its financial statements upon adoption of this standard.

In December 2007, the Financial Accounting Standards Board issued FASB Statement No. 160, Noncontrolling Interests in Consolidated Financial Statements an amendment of ARB No. 51 (SFAS 160).SFAS 160 amends ARB No. 51 to establish accounting and reporting standards for a non-controlling interest in a subsidiary and for the deconsolidation of a subsidiary. This Statement is effective for fiscal years and interim periods within those fiscal years, beginning on or after December 15, 2008. The Company believes there will be no material impact on its financial statements upon adoption of this standard.

In December 2007, the Financial Accounting Standards Board issued FASB Statement No. 141 (Revised 2007), Business Combinations (SFAS 141(R)). SFAS 141(R) provides additional guidance on improving the relevance, representational faithfulness, and comparability of the financial information that a reporting entity provides in its financial reports about a business combination and its effects. This Statement applies prospectively to business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after December 15, 2008. The Company believes there will be no material impact on its financial statements upon adoption of this standard.

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In September 2006, the Financial Accounting Standards Board issued FASB Statement No. 157, Fair Value Measurements (or SFAS 157), which defines fair value, establishes a framework for measuring fair value under generally accepted accounting principles, and expands disclosures about fair value measurements. SFAS 157 applies to other accounting pronouncements that require or permit fair value measurements. SFAS 157 is effective for fiscal years beginning after November 15, 2007. However, on February 12, 2008, the FASB issued FSP FAS 157-2, which would delay the effective date of SFAS 157 for all nonfinancial assets and nonfinancial liabilities, except those that are recognized or disclosed at fair value in the financial statements on a recurring basis (at least annually). This FSP partially defers the effective date of Statement 157 to fiscal years beginning after November 15, 2008, and interim periods within those fiscal years for items within the scope of this FSP. The Company believes there will be no material impact on its financial statements upon adoption of this standard.

(y) Fair value measurements

On January 1, 2008, the Company adopted the Statement of Financial Accounting Standards No. 157, Fair Value Measurements, (or SFAS 157) for financial assets and liabilities. As permitted by FASB Staff Position No. FAS 157-2, Effective Date of FASB Statement No 157, the Company elected to defer the adoption of SFAS 157 for all nonfinancial assets and nonfinancial liabilities, except those that are recognized or disclosed at fair value in the financial statements on a recurring basis. SFAS 157 defines fair value, establishes a framework for measuring fair value under generally accepted accounting principles, and expands disclosures about fair value measurement. The carrying amount of the Company s cash approximates their fair value due to the short maturity of those instruments. The carrying value of receivables and payables approximates their market value based on their short-term maturities. As of December 31, 2008, the initial adoption of SFAS 157 had no effect on the consolidated results of operations and financial condition.

(z) Reclassification

Prior to 2007, most of the costs and expenses of the game department were related to product development and research. Accordingly, the Company recorded all such costs and expenses in product development expenses in the statements of operations. In 2007, in order to better present operating results and enhance comparability with industry peers, the Company reclassified expenses in relation to game operations, mainly salary and benefits of game masters, from product development expense to cost of online game revenues. To conform to current period presentations, the relevant amounts for prior periods have been reclassified accordingly. Such reclassification amounted to $1.3 million for the year ended December 31, 2006.

3. Discontinuance of E-commerce Operation

The Company discontinued its e-commerce platform of physical consumer goods on June 20, 2006, in order to focus on profitable segments. As a result of the disposal, the e-commerce business is accounted for as a discontinued operation. Accordingly, the Company s consolidated statements of operations separate the discontinued operation for all years presented. For the year ended December 31, 2008, no gain or loss was recognized from the discontinued operation. For the years ended December 31, 2007 and 2006, revenues from the e-commerce operation amounted to $92,000 and $1.2 million, respectively. For the year ended December 31, 2007 and 2006, net loss from the e-commerce operation amounted to $20,000 and $0.8 million, respectively.

At the discontinuance of the e-commerce operation, the Company performed a specific review on all the assets related to the e-commerce segment, and provided full provisions for doubtful receivables and the entire inventory balances. As the fixed assets previously used by the e-commerce operation could generally be used by other segments, the Company did not dispose of significant fixed assets nor provide impairment on the fixed assets.

4. Segment Information

Based on the criteria established by SFAS No. 131, Disclosures about Segments of an Enterprise and Related Information , the Company mainly operated in four principal segments: brand advertising, sponsored search, online game and wireless. In June 2006, the Company terminated its e-commerce business. Accordingly, the results of operations for e-commerce have been reclassified as loss from discontinued operation for all periods presented. In 2007, the Company adjusted its reported segments and reclassified the results of its online game segment from its other operations and now reported online game results as a separate segment. Such reclassification amounted to approximately $8.5 million in revenues, and $3.9 million in cost of revenues for the year ended December 31, 2006.

The Company does not allocate any operating expenses or assets to its brand advertising, sponsored search, online game, wireless and other segments as management does not use this information to measure the performance of the operating segments. Management does not consider share-based compensation for their segment reporting as shown in the tables as such information does not impact the decisions on resource allocation and segment performance evaluation.

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The following tables present summarized information by segments (in thousands):

	Year Ended December 31, 2008					
	Brand Advertising	Sponsored Search	Online Game	Wireless	Others	Total
Revenues	$ 169,268	$ 6,669	$ 201,845	$ 47,046	$ 4,223	$ 429,051
Segment cost of revenues	(58,243)	(6,797)	(14,553)	(24,538)	(1,945)	(106,076)
Segment gross profit	$ 111,025	$ (128)	$ 187,292	$ 22,508	$ 2,278	$ 322,975
Share-based compensation expense under SFAS 123(R)						(1,238)
Gross profit						$ 321,737

	Year Ended December 31, 2007					
	Brand Advertising	Sponsored Search	Online Game	Wireless	Others	Total
Revenues	$ 112,106	$ 7,110	$ 42,096	$ 26,337	$ 1,285	$ 188,934
Segment cost of revenues	(37,161)	(5,588)	(7,075)	(12,334)	(927)	(63,085)
Segment gross profit	$ 74,945	$ 1,522	$ 35,021	$ 14,003	$ 358	$ 125,849
Share-based compensation expense under SFAS 123(R)						(1,678)
Gross profit						$ 124,171

	Year Ended December 31, 2006					
	Brand Advertising	Sponsored Search	Online Game	Wireless	Others	Total
Revenues	$ 78,993	$ 12,765	$ 8,525	$ 32,592	$ 1,361	$ 134,236
Segment cost of revenues	(21,817)	(5,158)	(3,822)	(15,441)	(551)	(46,789)
Segment gross profit	$ 57,176	$ 7,607	$ 4,703	$ 17,151	$ 810	$ 87,447
Share-based compensation expense under SFAS 123(R)						(1,574)
Gross profit						$ 85,873

5. Other Income (Expense)

The following table summarizes the Company s other income (expense) (in thousands):

	Year Ended December 31,		
	2008	2007	2006
Charitable donation for Sichuan earthquake	$ (573)	$	$
Gain from disposal of interest in an associate		561	
Receipts of tax refunds and reversal of certain taxes previously accrued	11	503	
Gains on early redemption of zero coupon convertible senior notes			793
Amortization of offering costs for zero coupon convertible senior notes		(248)	(537)

Share of profits from investment in an associate		9	151
Others	27	62	70
	$ (535)	$ 887	$ 477

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6. Balance Sheet Components (in thousands)

	As of December 31, 2008	2007
Cash and cash equivalents		
Cash	$ 190,002	$ 84,195
Time deposits	124,423	
Investments in money market funds		38,511
	$ 314,425	$ 122,706
Accounts receivable, net		
Accounts receivable	$ 38,988	$ 29,114
Allowance for doubtful accounts:		
Balance at beginning of year	(2,056)	(1,563)
Additional provision for bad debt	(978)	(1,925)
Write-offs	515	1,226
Cash collection	400	206
Balance at end of year	(2,119)	(2,056)
	$ 36,869	$ 27,058
Prepaid and other current assets		
Corporate income tax refund receivable (Note 20)	$ 18,854	$
Deferred expenses in relation to possible IPO of Changyou	1,740	
Prepaid content and license	1,436	3,360
Employee advances	973	1,116
VAT refund receivable	879	
Rent deposit	778	498
Prepaid professional fees	465	356
Prepaid advertising and promotion fees	221	1,247
Others	2,205	974
	$ 27,551	$ 7,551
Fixed assets, net		
Computer equipment and hardware	$ 60,435	$ 44,366
Office building	40,325	34,330
Leasehold improvements	11,899	7,622
Investment properties	1,450	4,757
Vehicles	1,213	886
Office furniture	985	851
	116,307	98,812
Accumulated depreciation	(40,070)	(27,785)
	$ 76,237	$ 65,027
Other accrued liabilities		
Accrued compensation and benefit	$ 27,348	$ 12,271
Contract deposits from customers	9,163	5,238
Accrued professional fees	3,658	2,828
Others	2,882	3,873

	$ 43,051	$ 24,210

7. Investment in an Associate

In August 2004, the Company made an investment of approximately $1.0 million in Beijing Pixel Software Technology Co. Ltd. (Pixel) to acquire 15% of its equity interest (the Acquisition). The Company has the right to appoint one of four members of the Board of Directors, who has the right to veto any cooperation between Pixel and competitors of the Company. The Company believes that it can exercise a significant influence on Pixel s operations; accordingly, the investment was accounted for under the equity method. During the years ended December 31, 2007 and 2006, the Company recorded a share of profits of $9,000 and $151,000 in the consolidated statements of operations, respectively. In August 2007, the Company disposed of its 15% equity interests in Pixel to the controlling shareholders of Pixel. Accordingly, starting from September 1, 2007, Pixel ceased to be an associate of the Company.

8. Goodwill

The changes in the carrying amount of goodwill by segment are as follows (in thousands):

	Brand Advertising	Sponsored Search	Online Game	Wireless	Total
Balance as of December 31, 2006	$ 32,443	$ 6,932	$ 172	$ 15,439	$ 54,986
Additional contingent consideration		545			545
Foreign currency translation adjustment			11		11
Balance as of December 31, 2007	32,443	7,477	183	15,439	55,542
Foreign currency translation adjustment			13		13
Inter-segment transfers	196		(196)		
Balance as of December 31, 2008	$ 32,639	$ 7,477	$	$ 15,439	$ 55,555

As of October 1, 2008, the Company performed a goodwill impairment test by comparing the book value to the fair value of each reporting unit. Based on assessment, the fair value of each reporting unit is greater than the book value thus no impairment charge was recorded. In estimating the fair value of a reporting unit, the Company has taken into consideration the overall and industry economic conditions and trends, market risk of the Company and historical information. Going forward, the Company will continue to test goodwill for impairment on an annual basis or more frequently if an event occurs or circumstances change that could more likely than not reduce the fair value of the goodwill below its carrying amount.

9. Intangible Assets, Net

The following table summarizes the Company s intangible assets, net (in thousands):

	As of December 31, 2008			As of December 31, 2007		
	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount
Customer lists	$ 2,343	$ (2,327)	$ 16	$ 2,343	$ (2,289)	$ 54
Trademarks and domain names	3,785	(1,397)	2,388	3,711	(1,125)	2,586
Developed technologies	1,169	(750)	419	1,160	(532)	628
Computer software	8,301	(5,498)	2,803	7,151	(4,369)	2,782
Marketing rights and others	3,631	(3,603)	28	3,426	(2,435)	991
Others	1,580	(1,580)		1,580	(1,580)	
	$ 20,809	$ (15,155)	$ 5,654	$ 19,371	$ (12,330)	$ 7,041

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As of December 31, 2008, estimated amortization expenses for future periods are expected to be as follows:

For the year ending December 31,	(in thousands)
2009	$ 1,447
2010	1,075
2011	784
2012	536
2013	485
Thereafter	1,327
Total expected amortization expense	$ 5,654

10. Restricted Cash

As of December 31, 2008 and 2007, the Company had made deposits of $2.7 million and $4.3 million, respectively, into restricted bank accounts as guarantees to meet the requirements under certain content purchase and marketing rights contracts.

11. Acquisitions

21 East

On October 31, 2006, the Company completed the acquisition of a 70% interest in 21 East Entertainment Limited (21 East Hong Kong) and Beijing 21 East Culture Development Co., Ltd. (21 East Beijing) (collectively 21 East) for consideration of $3.5 million in cash. The main purpose of the acquisition of the 70% interest in 21 East is to enable the Company to secure and develop attractive, high-quality music and content. The acquisition was accounted for as a purchase business combination and resulted goodwill of US$3.5 million and the results of operations from the acquisition date have been included in the Company s consolidated financial statements in accordance with SFAS 94.

The acquisition had been accounted for as a purchase business combination and the results of operations from the acquisition date have been included in the Company s consolidated financial statements in accordance with SFAS 94. The allocation of the purchase price is as follows (in thousands):

Tangible assets acquired	$ 317
Identifiable intangible assets	26
Goodwill	3,542
Liabilities assumed	(143)
Total	$ 3,742

The excess of purchase price over tangible assets and identifiable intangible assets (mainly copyrights of song lyrics) acquired and liabilities assumed were recorded as goodwill relating to the wireless segment.

Prior to the acquisition, 21 East did not prepare its financial statements under accounting principles generally accepted in the United States of America. The Company determined that the cost of reconstructing the financial statements of 21 East for the periods prior to the acquisition outweighed its benefits. Accordingly, unaudited pro forma consolidated financial information reflecting the results of operations of 21 East has not been presented.

12. Zero Coupon Convertible Senior Notes

The Company completed a private placement on July 14, 2003 of $90 million principal amount of zero coupon convertible senior notes due July 2023, which resulted in net proceeds to the Company of approximately $87,350,000 after deduction of the initial purchaser s discount of $2,250,000 and offering expenses of $400,000. The notes are a senior unsecured obligation of the Company and rank equally in right of payment

with all of other unsecured and unsubordinated indebtedness of the Company. The notes do not pay any interest, have a zero yield to maturity, and are convertible into the Company s common stock at a conversion price of $44.76 per share, subject to adjustment for dividends, distributions, and upon the occurrence of certain other events. Each $1,000 principal of the notes is initially convertible into 22.3414 shares of common stock of the Company. Each holder of the notes will have the right, at the holder s option, to require the Company to repurchase all or any portion of the principal amount of the holder s notes on July 14th, in 2007, 2013 and 2018 at a price equal to 100% of the outstanding principal amount. The Company may also redeem all or a portion of the notes for cash at any time on or after July 14, 2008 at 100% of the principal amount of the notes if the closing price of its common stock for each of the 30 consecutive trading days prior to such time was at least 130% of the conversion price or at such time at least 90% of the initial aggregate principal amount of the notes have been converted, repurchased or redeemed. In addition, upon a change of control event, each holder of the notes has the right to require the Company to repurchase some or all of its notes at a repurchase price equal to 100% of the principal amount of the notes.

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For the year ended December 31, 2006, the Company early redeemed from the market a portion of its zero coupon convertible senior notes at a discount for $15,000,000 in aggregate face value, after deducting the related portion of unamortized offering cost.

As of the end of the notification period associated with the July 14, 2007 repurchase date, note holders had exercised their right to require the Company to repurchase such notes in an aggregate principal amount of $58.5 million. The Company repurchased such notes on July 16, 2007. In November 2007, the majority of remaining note holders with $1,250,000 in face amount of convertible notes exercised their right to convert their notes to the Company s common stock at a conversion price of $44.76 per share.

During the year ended December 31, 2008, the remaining $6,000 of zero coupon convertible senior notes were redeemed: therefore the outstanding balance was zero as of December 31, 2008.

13. China Contribution Plan

The Company s subsidiaries in China participate in a government-mandated multi-employer defined contribution plan pursuant to which certain retirement, medical and other welfare benefits are provided to employees. Chinese labor regulations require the Company s subsidiaries to pay to the local labor bureau a monthly contribution at a stated contribution rate based on the monthly basic compensation of qualified employees. The relevant local labor bureau is responsible for meeting all retirement benefit obligations; the Company has no further commitments beyond its monthly contribution. During the years ended December 31, 2008, 2007 and 2006, the Company contributed a total of $17.7 million, $11.2 million and $7.4 million, respectively, to these funds.

14. Profit Appropriation

Pursuant to the laws applicable to China s Foreign Investment Enterprises, each of the Company s subsidiaries in China must make appropriations from its after-tax profit to non-distributable reserve funds as determined by the Board of Directors. These reserve funds include a (i) general reserve, (ii) enterprise expansion fund and (iii) staff bonus and welfare fund. The general reserve fund requires annual appropriations of 10% of after-tax profit (as determined under PRC GAAP) until these reserves equal 50% of the amount of paid-in capital; the other fund appropriations are at the Company s discretion.

Since Beijing Sohu Interactive Software Co., Ltd (Sohu Software), Go2Map Software (Beijing) Co., Ltd (Go2Map Software) and Beijing Sogou Technology Development Co., Ltd (Sogou Technology) under PRC GAAP, are either in an accumulated loss position or with loss in year of 2008, no appropriations have been made to the general reserve fund for the year ended December 31, 2008.

For the year ended December 31, 2005, Beijing Sohu New Era Information Technology Co., Ltd (Sohu Era) appropriated $1.7 million into the general reserve and the cumulative general reserve equal to 50% of its paid-in capital; therefore Sohu Era did not appropriate any additional reserve during 2006. In 2007, Sohu Era further made an appropriation of approximately $0.2 million due to its increased paid-in capital as a result of reinvestment. In 2008, since Sohu Era ended with a loss, no appropriation has been made to the general reserve fund for the year ended December 31, 2008. For the years ended December 31, 2008 and 2007, Beijing Sohu New Media Information Technology Co., Ltd (Sohu Media) made an appropriation of approximately $1.8 million and $3.8 million to the general reserve fund, respectively, which made the cumulative general reserve equal to 50% of its paid-in capital. For the year ended December 31, 2008, Beijing AmazGame Internet Technology Co., Ltd (AmazGame) and Beijing Gamease Age Digital Technology Co., Ltd (Gamease) made an appropriation of approximately $4.7 million and $0.6 million to the general reserve fund, respectively, which made the cumulative general reserve equal to 50% of their paid-in capitals. For the year ended December 31, 2007, AmazGame and Gamease, made an appropriation of approximately $0.3 million and $0.1 million to the general reserve fund, respectively. Upon certain regulatory approvals and subject to certain limitations, the general reserve fund can be used to offset prior year losses, if any, and could be converted into paid-in capital of Sohu Era, Sohu Media, Sogou Technology, AmazGame and Gamease for PRC GAAP and legal purposes. Other than the appropriations to the general reserve fund, the Company did not make any other appropriations for the years ended December 31, 2008 and 2007.

15. Concentration of Risks

The operations of the Company are substantially located in the PRC. Accordingly, investing in the shares of the Company is subject to among others, the PRC s political, economic and legal risks.

There are no revenues from clients that individually represent greater than 10% of the total revenues for the years ended December 31, 2008, 2007 and 2006.

44% of the Company s total revenue or 94% of the Company s online game revenue, for the year ended December 31, 2008 was derived from a single massively multi-player online role-playing game which is named Tian Long Ba Bu, which was launched in May 2007.

Substantially all of the Company s wireless revenues for all periods presented are derived from providing wireless services. The Company relies on two major third party mobile network operators and their subsidiaries for the billing of and collection from mobile phone users. If the annual contracts with these operators were not renewed or were terminated, the Company s wireless business could be adversely affected. As of December 31, 2008 and 2007, $9.6 million and $4.8 million of accounts receivable balances were ultimately due from mobile network operators providing wireless services.

Financial instruments that potentially subject the Company to significant concentration of credit risk consist primarily of cash and cash equivalents. As of December 31, 2008, approximately 73% of the Company s cash and cash equivalents were held in 9 financial institutions in China, and 27% of the Company s cash and cash equivalents were held by financial institutions in the United States, Singapore, or Hong Kong. Accounts receivable are typically unsecured, denominated in RMB, and derived from revenues earned from customers primarily located in the People s Republic of China. The Company performs ongoing credit evaluations of its customers and, if necessary, maintains reserves for potential credit losses. Historically, such losses have been within management s expectations.

16. Commitments and Contingencies

The Chinese market in which the Company operates poses certain macro-economic and regulatory risks and uncertainties. These uncertainties extend to the ability of the Company to operate an Internet business, and to conduct brand advertising, sponsored search, online game and wireless services in the PRC. Though the PRC has, since 1978, implemented a wide range of market-oriented economic reforms, continued reforms and progress towards a full market-oriented economy are uncertain. In addition, the telecommunication, information, and media industries remain highly regulated. Restrictions that are currently in place and are unclear with respect to which segments of these industries foreign owned entities, like the Company, may operate. The Chinese government may issue from time to time new laws or new interpretations on existing laws to regulate areas such as telecommunication, information and media. Regulatory risks also encompass the interpretation by the tax authorities of current tax laws and regulations, including the applicability of certain preferential tax treatments. The Company s legal structure and scope of operations in China could be subjected to restrictions which could result in severe limits to the Company s ability to conduct business in the PRC.

The Company s sales, purchase and expense transactions are generally denominated in RMB and a significant portion of the Company s assets and liabilities are denominated in RMB. The RMB is not freely convertible into foreign currencies. In China, foreign exchange transactions are required by law to be transacted only by authorized financial institutions. Remittances in currencies other than RMB by the Company s subsidiaries in China may require certain supporting documentation in order to effect the remittance.

From time to time, the Company becomes subject to legal proceedings and claims in the ordinary course of its business, including claims of alleged infringement of trademarks, copyrights and other intellectual property rights in connection with the content published on our Websites. The Company provides for the amount of loss, if there is information available prior to issuance of the Company s financial statements indicating that it is probable that a liability had been incurred at the date of the financial statements and the amount of loss can be reasonably estimated. In March 2008, the Company was sued by four major record companies, Sony BMG, Warner, Universal and Gold Label, which alleged that the Company provided music search links and download services the violated copyrights they owned. As of December 31, 2008, the lawsuits with these four record companies were still in process.

The Company has entered in certain sponsorship agreements, under which the Company is obliged to provide advertising services and Website construction, operation and maintenance services to third parties during the contract periods.

The Company has commitments related to future minimum content and service purchases and rental payments. As of December 31, 2008, the Company had made certain deposits into restricted bank accounts as guarantees to meet the requirements under those contracts.

The following table sets forth the Company s contractual obligations as of December 31, 2008 (in thousands):

For the year ending December 31,	Content and service purchases	Rental payments	Total minimum payments required
2009	$ 21,317	$ 3,063	$ 24,380
2010	15,094	2,798	17,892
2011	258	2,651	2,909
2012		1,480	1,480
2013		891	891
Thereafter			
Total minimum payments required	$ 36,669	$ 10,883	$ 47,552

Contractual obligations, including content and service purchases and rental payments, were approximately $23.0 million, $19.9 million and $8.8 million for the years ended December 31, 2008, 2007 and 2006, respectively, and were charged to the statement of operations when incurred.

17. VIEs and Related Party Transactions

(a) VIEs

FIN 46R Consolidation of Variable Interest Entities requires a VIE to be consolidated by a company if that company is the primary beneficiary of that VIE.

To satisfy PRC laws and regulations, the Company conducts its Internet information, wireless and certain other businesses in the PRC via its VIEs. These VIEs are directly or indirectly owned by Dr. Charles Zhang (Dr. Zhang), the Company s Chairman, Chief Executive Officer and a major shareholder, and certain employees of the Company. Capital for the VIEs is funded by the Company through loans provided to Dr. Zhang and those employees, and is initially recorded as loans to related parties. These loans are eliminated for accounting purposes with the capital of VIEs during consolidation.

Under contractual agreements with the Company, Dr. Zhang and other Sohu employees who are shareholders of the VIEs are required to transfer their ownership in these entities to the Company, if permitted by PRC laws and regulations, or, if not so permitted, to designees of the Company at any time to repay the loans outstanding. All voting rights of the VIEs are assigned to the Company, and the Company has the right to designate all directors and senior management personnel of the VIEs. Dr. Zhang and the other Sohu employees who are shareholders of the VIEs have pledged their shares in the VIEs as collateral for the loans. As of December 31, 2008, the aggregate amount of these loans was $11.9 million.

The following is a summary of the VIEs of the Company which have been consolidated under FIN 46R:

a) High Century

Beijing Century High Tech Investment Co., Ltd. (or High Century) was incorporated in the PRC in 2001 and engages in investment holding in the PRC on behalf of the Company. The registered capital of High Century is $4.6 million. Dr. Zhang and Wei Li, an employee of the Company, hold 80% and 20% interests in High Century, respectively.

b) Sohu Entertainment

Beijing Sohu Entertainment Culture Media Co., Ltd. (or Sohu Entertainment, formerly known as Beijing Hengda Yitong Internet Technology Development Co., Ltd. or Hengda) was incorporated in the PRC in 2002 and engages in entertainment business in the PRC on behalf of the Company. The registered capital of Sohu Entertainment is $1.2 million. Originally, High Century and Wei Li held 80% and 20% interests in Sohu Entertainment, respectively. In November 2004, to further comply with PRC regulations, High Century and Wei Li transferred their interests in Sohu Entertainment to Xin Wang (Belinda Wang) and Jianjun Wang, each of whom is an employee of the Company. In July 2007, Jianjun Wang transferred all his interests in Sohu Entertainment to Ye Deng, an employee of the Company. As a result, Xin Wang (Belinda Wang) and Ye Deng own 80% and 20% interests in Sohu Entertainment, respectively.

c) Sohu Internet

Beijing Sohu Internet Information Service Co., Ltd. (or Sohu Internet) was incorporated in the PRC in 2003 and engages in Internet information, wireless and advertising services in the PRC on behalf of the Company. The original registered capital was $605,000, and High Century and Jinmei He held 80% and 20% interests in Sohu Internet, respectively. In December 2003, Sohu Entertainment made a $0.6 million investment in Sohu Internet. In April 2005, Jinmei He transferred all her interests in Sohu Internet to High Century, and High Century made a $1.2 million additional investment in Sohu Internet. As a result, the registered capital is now $2.4 million, with High Century and Sohu Entertainment holding 75% and 25% interests, respectively.

d) GoodFeel

Beijing GoodFeel Information Technology Co., Ltd. (or GoodFeel) was incorporated in the PRC in 2001 and engages in value-added telecommunication services in the PRC. The registered capital of GoodFeel is $1.2 million. In May 2004, High Century and Sohu Internet acquired 73% and 27% interests in GoodFeel, respectively. In July 2004, High Century and Sohu Internet invested $0.6 million and $0.5 million in GoodFeel, respectively, so that High Century owned 58.1% interests in GoodFeel with the remaining 41.9% interests owned by Sohu Internet. In October 2004, to further comply with PRC regulations, High Century and Sohu Internet transferred their interests in GoodFeel to Xiufeng Deng and Jing Zhou, each of whom is an employee of the Company. In August 2007, Xiufeng Deng transferred all his interests in GoodFeel to Guofeng Yue, an employee of the Company. As a result, Guofeng Yue and Jing Zhou own 58.1% and 41.9% interests in GoodFeel, respectively.

e) Beijing Fire Fox

Beijing Fire Fox Digital Technology Co., Ltd. (or Beijing Fire Fox, also known as Beijing Huohu Digital Technology Co., Ltd. or Huohu), was incorporated in the PRC in 2005 as a subsidiary of Sohu Era, one of the indirect China-based subsidiaries of the Company. Until December 1, 2007, Beijing Fire Fox engaged in software and technology development for the online games business. The registered capital of Beijing Fire Fox is $0.1 million. Prior to January 2, 2008, an employee of the Company held a contingent right to receive a payment equal to 25% of the value of Beijing Fire Fox. The Company provided the employee with a non-interest bearing loan of $37,000 to finance his capital contribution to Beijing Fire Fox. The loan was repayable upon demand by the Company at any time or upon termination of the employment of the employee and could only be repaid through transfer of the employee s shares in Beijing Fire Fox to a designated third party. Based on the arrangement between Sohu Era and the employee, Sohu Era was the sole and primary beneficiary of Beijing Fire Fox.

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f) Tu Xing Tian Xia

Beijing Tu Xing Tian Xia Information Consultancy Co., Ltd. (or Tu Xing Tian Xia) was incorporated in the PRC in 1999 and engages in mapping services in the PRC. The registered capital of Tu Xing Tian Xia is $0.2 million. In May 2005, in connection with the Company s acquisition of Go2Map, the Company designated High Century and Sohu Internet as its designees to purchase the outstanding registered capital of Tu Xing Tian Xia. As a result, High Century and Sohu Internet own 56.1% and 43.9% interests in Tu Xing Tian Xia, respectively.

g) Feng Yang Tian Lang

Beijing Feng Yang Tian Lang Advertising Co., Ltd. (or Feng Yang Tian Lang) was incorporated in the PRC in 2005 and engages in advertising services in the PRC. The registered capital of Feng Yang Tian Lang is $0.2 million. Sohu Internet and High Century each holds 50% interests in Feng Yang Tian Lang.

h) Sogou Information

Beijing Sogou Information Service Co., Ltd. (or Sogou Information) was incorporated in the PRC in 2005 and engages in providing Internet information services in the PRC. The registered capital of Sogou Information is $2.5 million. Jing Zhou and Wei Li, each of whom is an employee of the Company, each owns 50% interests in Sogou Information.

i) Guangzhou Interactive

Guangzhou Sohu Interactive Network Technology Co., Ltd. (or Guangzhou Interactive) was incorporated in the PRC in 2006 and engages in providing Internet information services in Guangdong Province. The registered capital of Guangzhou Interactive is $0.6 million. Sohu Internet and High Century each holds a 50% interests in Guangzhou Interactive. In January 2008, Guangzhou Interactive was liquidated.

j) Gamease

Beijing Gamease Age Digital Technology Co., Ltd. (or Gamease) was incorporated in the PRC in August 2007 and engages in Internet information services. The registered capital of Gamease is $1.3 million. Tao Wang, an employee of the Company, and another employee of the Company, own 60% and 40% interests, respectively, in Gamease.

Pursuant to FIN 46R, High Century, Sohu Entertainment, Sohu Internet, GoodFeel, Beijing Fire Fox, Tu Xing Tian Xia, Feng Yang Tian Lang, Sogou Information, Guangzhou Interactive and Gamease are VIEs, of which the Company is the primary beneficiary. Accordingly, the VIEs have been consolidated in the Company s financial statements. As of December 31, 2008 and 2007, the above VIEs have aggregated accumulated net profit of approximately $17.1 million and $3.7 million, respectively, and have been reflected in the consolidated financial statements.

(b) Related Party Transactions

The following table summarizes related party transactions during the years ended December 31, 2008, 2007 and 2006, respectively (in thousands):

Name or Description of Related Party	**Description of Transactions**	**Year Ended December 31,**		
		2008	**2007**	**2006**
Qingfan, a company controlled by Dr Zhang s brother	Delivery services provided by Qingfan	$	$	$ 27
An investee of the Company*	Amortization of licensing fee			69
	Cost of revenues		949	1,761

*

This investee ceased to be a related party of the Company starting September 1, 2007, when the Company disposed its equity investment. Accordingly, since then, transactions with this party are not regarded as related party transactions.

18. Minority Interests

Minority interests in the Consolidated Balance Sheets for the year ended December 31, 2008 consist primarily of an employee s share interests in a subsidiary, which were granted through a share-based awards arrangement. See footnote 19 (c). The employee s share interests are not reflected in minority interests in the Consolidated Statements of Operations, because the employee s shares are not entitled to participate in any distributions by the subsidiary until the earlier of the subsidiary s completion of an initial public offering or February 2012. Minority interests in the Consolidated Statements of Operations for the years ended December 31, 2008, 2007 and 2006 reflect the Company s completion on October 31, 2006 of the acquisition of a 70% interest in 21 East Hong Kong and 21 East Beijing (collectively 21 East), an entertainment company, the results of operations of which have been included in the Consolidated Statements of Operations from the acquisition date. The minority interests in 21 East are also reflected in the Consolidated Balance Sheets for the years ended December 31, 2008, 2007 and 2006.

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19. Shareholders Equity

(a) Stockholder Rights Plan

The Company adopted a stockholder rights plan (the Plan) in 2001. The Plan is designed to deter coercive takeover tactics, including the accumulation of shares in the open market or through private transactions, and to prevent an acquirer from gaining control of the Company without offering a fair and adequate price and terms to all of the Company s stockholders. In general, the Plan vests stockholders of Sohu with rights to purchase preferred stock of the Company at a substantial discount from those securities fair market value upon a person or group acquiring without the approval of the Board of Directors more than 20% of the outstanding shares of common stock of the Company. Any person or group who triggers the purchase right distribution becomes ineligible to participate in the Plan, causing substantial dilution of such person or group s holdings. The rights will expire on July 25, 2011.

(b) Treasury Stock

During the year ended December 31, 2008, the Company repurchased 501,686 shares of its common stock for total consideration of $20 million including brokerage commission, to demonstrate confidence in the health and future prosperity of the Company. During the year ended December 31, 2007, the Company did not purchase any shares of its common stock. And during the year ended December 31, 2006, the Company repurchased 690,580 shares of its common stock for total consideration of $15 million. The shares repurchased by the Company are no longer outstanding, and are being held by the Company as treasury stock. Treasury stock is accounted for under the cost method.

(c) Stock Incentive Plan

In accordance with SFAS 123(R), effective from January 1, 2006, all share-based payments to employees and directors are recognized in the financial statements based on their grant date fair values. The valuation provisions of SFAS 123(R) apply to new awards, to awards granted to employees and directors before the adoption of SFAS 123(R) whose related requisite services had not been provided, and to awards which were subsequently modified or cancelled. In March 2005, the SEC issued SAB 107 regarding the SEC s interpretation of SFAS 123(R) and the valuation of share-based payments for public companies. The Company has applied the provisions of SAB 107 in its adoption of SFAS 123(R).

Estimates of fair value are not intended to predict actual future events or the value that ultimately will be realized by employees who receive equity awards, and subsequent events are not indicative of the reasonableness of the original estimates of fair value made by the Company under SFAS 123(R).

Share-based compensation expense included in costs and expenses includes (in thousands):

	Year Ended December 31,		
	2008	**2007**	**2006**
Cost of revenues	$ 1,238	$ 1,678	$ 1,501
Product development expenses	6,749	2,805	1,929
Sales and marketing expenses	896	1,541	1,633
General and administrative expenses	1,737	2,762	1,876
Total Share-based compensation expense	$ 10,620	$ 8,786	$ 6,939

1) Sohu.com Inc. Share Awards

The Company s 2000 Stock Incentive Plan, including stock options and restricted stock units, provides for the issuance of up to 9,500,000 shares of common stock. The maximum term of any issued stock right is ten years from the grant date.

The Company has reserved 9,500,000 shares of new common stock for issuance under the Company s 2000 Stock Incentive Plan. For the year ended December 31, 2008, the Company granted 54,010 restricted stock units to its employees and directors. As of December 31, 2008, 1,053,059 shares were available for grant under the plan. The total fair value of Sohu.com Inc share awards expensed during the years ended December 31, 2008, 2007 and 2006 were $5.8 million, $8.8 million and $6.9 million, respectively.

A summary of option activity under the Company s 2000 Stock Incentive Plan as of December 31, 2008, and changes during the year then ended, is presented below:

Options	Number of Shares (in thousands)	Weighted Average Exercise Price	Weighted Average Remaining Contractual Life (Years)	Aggregate Intrinsic Value (in thousands)
Outstanding at January 1, 2008	1,509	$ 17.68	6.58	$ 55,610
Exercised	(698)	18.78		
Forfeited or expired	(12)	17.28		
Outstanding at December 31, 2008	799	16.72	5.63	$ 24,474
Vested at December 31, 2008 and expected to vest thereafter	776	16.66	5.60	$ 23,780
Exercisable at December 31, 2008	723	16.64	5.54	$ 22,196

The aggregate intrinsic value in the preceding table represents the total intrinsic value based on the Company s closing stock price of $47.34 as of December 31, 2008.

The total intrinsic value of options exercised during the year ended December 31, 2008 was $36.6 million.

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A summary of restricted stock unit activity under the Company s 2000 Stock Incentive Plan as of December 31, 2008, and changes during the year then ended, is presented below:

Restricted Stock Units	Number of Units (in thousands)	Weighted-Average Grant-Date Fair Value
Unvested at January 1, 2008	549	$ 24.65
Granted	54	81.06
Vested	(168)	26.09
Forfeited	(30)	28.16
Unvested at December 31, 2008	405	31.35
Expected to vest thereafter	283	31.36

The following table summarizes significant ranges of outstanding and exercisable options as of December 31, 2008:

	Options Outstanding as of December 31, 2008			Options Exercisable as of December 31, 2008	
Range of Exercise Price	Number Outstanding (in thousands)	Weighted Average Remaining Contractual Life (Years)	Weighted Average Exercise Price	Number Exercisable (in thousands)	Weighted Average Exercise Price
$0.86 - $1.18	38	2.58	$ 0.99	38	$ 0.99
$1.37 - $2.27	16	3.74	1.86	16	1.87
$3.85 - $7.64	55	4.01	7.62	54	7.62
$8.39	37	4.02	8.39	37	8.39
$13 - $16.84	86	5.39	15.94	76	16.01
$17 - $22.86	502	6.36	18.11	437	18.13
$23.17 - $34.51	65	4.83	32.23	65	32.23
	799			723	

As of December 31, 2008, there was $0.2 million of total unrecognized compensation cost related to options for which services had not been provided. That cost is expected to be recognized over a weighted average period of 0.37 year. The total fair value of options expensed during the years ended December 31, 2008, 2007 and 2006 were $1.3 million, $2.7 million and $5.0 million, respectively.

As of December 31, 2008, there was $4.4 million of unrecognized compensation cost related to unvested restricted stock units, net of forecasted forfeitures. This amount is expected to be recognized over a weighted average period of 1.02 years. Total fair value of restricted stock units expensed during the years ended December 31, 2008, 2007 and 2006 were $4.5 million, $6.1 million and $1.9 million, respectively.

There were no capitalized share-based compensation costs during the years ended December 31, 2008, 2007 and 2006.

During the year ended December 31, 2008, total cash received from the exercise of stock options amounted to $13.1 million.

2) Share Awards in a Subsidiary

In March 2005, the Company formed an indirect subsidiary, Beijing Fire Fox, to carry out game development, and granted to an employee a contingent right to receive a payment equal to 25% of the value of Beijing Fire Fox upon the occurrence of certain events. As the substance of this arrangement is similar to the grant of an option, this arrangement was accounted for as share-based compensation under APB 25. The

amount of compensation to be recorded is based upon the intrinsic value on the grant date, which was determined based on its fair market value. As of the date of grant, the intrinsic value was determined to be zero. The Company later agreed with the employee that his contingent right in Beijing Fire Fox would be modified to provide to the employee an equity interest in Changyou, a subsidiary set up to own and operate its online game business, in lieu of the contingent right.

In January 2008, Sohu communicated to and agreed with the employee that the equity interest granted to him consisted of 700,000 ordinary shares and 800,000 restricted shares in Changyou, which represent approximately 7% and 8% of fully diluted equity interest of Changyou. The restricted shares included, as a condition of vesting, the completion of an initial public offering by Changyou on an internationally recognized stock exchange, and also were subject to a vesting schedule. In addition, the employee will not be entitled to participate in any distributions by Changyou, on his ordinary shares and restricted shares, until the earlier of its completion of an initial public offering or February 2012. In April 2008, Changyou modified the vesting conditions of the restricted shares to provide for vesting over a four-year period commencing on February 1, 2008, with no condition that an initial public offering be completed.

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The difference between the fair values, or the Incremental Fair Value, of the 700,000 ordinary shares and 800,000 restricted shares granted to the employee and his contingent right in Beijing Fire Fox is accounted for as share-based compensation. Because the terms of the issuance of the ordinary shares and restricted shares had been approved and were communicated to and agreed with the employee as of January 2, 2008, this was considered the grant date under US GAAP and, accordingly, the Incremental Fair Value was determined as of that date. The portion of the Incremental Fair Value related to the 700,000 ordinary shares, equal to $1.8 million, was recognized as share-based compensation expense in product development expenses for the three months ended March 31, 2008. As result of the modification of the vesting terms of the 800,000 restricted shares in April 2008, the portion of the Incremental Fair Value related to those shares, equal to $7.0 million, was determined as of that date and is accounted for as share-based compensation over the vesting period starting from the date of the modification, following the accelerated basis of attribution. Share based compensation expense relating to the 800,000 restricted shares for the year ended December 31, 2008 was $3.0 million and recognized in product development expenses. The Incremental Fair Values were determined using the discounted cash flow method.

A summary of restricted shares activity, relating to the restricted shares of Changyou held by the employee as of and for the year ended December 31, 2008, is presented below:

Restricted Shares	Number of Shares (in thousands)	Weighted-Average Grant-Date Fair Value
Unvested at January 1, 2008		$
Granted	800	13.57
Vested		
Unvested at December 31, 2008	800	19.81
Expected to vest thereafter	800	19.81

As of December 31, 2008, there was $4.0 million of unrecognized compensation cost related to unvested restricted shares of Changyou granted to the employee.

In April 2008, Sohu approved and communicated to other employees of Changyou the grant of an aggregate of 180,000 restricted shares and 94,000 restricted share units of Changyou, which are settleable in ordinary shares upon vesting. These restricted shares and restricted share units are subject to vesting over a four-year period commencing February 1, 2008 and are subject to completion of an initial public offering by Changyou. The grant date fair value of the awards will be recognized in the consolidated statement of operations starting from the date when those vesting conditions become probable.

A summary of restricted shares activity in the subsidiary as of and for the year ended December 31, 2008, is presented below:

Restricted Shares	Number of Shares (in thousands)	Weighted-Average Grant-Date Fair Value
Unvested at January 1, 2008		
Granted	180	$ 19.81
Vested		
Forfeited		
Unvested at December 31, 2008	180	19.81
Expected to vest thereafter	180	19.81

As of December 31, 2008, there was $3.6 million of unrecognized compensation cost related to these 180,000 unvested restricted shares of Changyou granted to employees.

A summary of restricted share units activity in the subsidiary as of and for the year ended December 31, 2008, is presented below:

Restricted Share Units	Number of Shares (in thousands)	Weighted-Average Grant-Date Fair Value
Unvested at January 1, 2008		$
Granted	94	19.81
Vested		
Forfeited		
Unvested at December 31, 2008	94	19.81
Expected to vest thereafter	94	19.81

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As of December 31, 2008, there was $1.9 million of unrecognized compensation cost related to unvested restricted share units of Changyou granted to certain employees.

The fair values as of the January 2008 and April 2008 grant dates of restricted shares and restricted share unites were determined by relying in part on a report prepared by a qualified professional appraiser. Determining the fair value of the ordinary shares of one of its subsidiaries required complex and subjective judgments regarding its projected financial and operating results, its unique business risks, the liquidity of its ordinary shares and its operating history and prospects at the time the grants were made.

Because at the time of the grants the subsidiary s business was at a different stage of its product life cycle than that of the publicly-listed companies in the online game industry, it was concluded that a market comparison approach would not have been meaningful in determining the fair value of Changyou ordinary shares. As a result, the Company and the professional appraiser used the income approach/discounted cash flow method to derive the fair values. The Company applied the discounted cash flow, or DCF, analysis based on the subsidiary s projected cash flow using management s best estimate as of the respective valuation dates. The projected cash flow estimate included, among other things, an analysis of projected revenue growth, gross margins, effective tax rates, capital expenditures and working capital requirements. The income approach involves applying appropriate discount rates, based on earnings forecasts, to estimated cash flows. The assumptions the Company used in deriving the fair value of its ordinary shares were consistent with the assumptions used in developing its online game business plan, which included no material changes in the existing political, legal, fiscal and economic conditions in China; its ability to recruit and retain competent management, key personnel and technical staff to support its ongoing operations; and no material deviation in industry trends and market conditions from economic forecasts. These assumptions are inherently uncertain and subjective. The discount rates reflect the risks the management perceived as being associated with achieving the forecasts and are based on the Company s estimated cost of capital, which was derived by using the capital asset pricing model, after taking into account systemic risks and company-specific risks. The capital asset pricing model is a model for pricing securities that adds an assumed risk premium rate of return to an assumed risk-free rate of return. Using this method, the Company determined the appropriate discount rates to be 22% as of the January 2008 valuation date and 23% as of the April 2008 valuation date.

The Company also applied a discount for lack of marketability, or DLOM, to reflect the fact that, at the time of the grants, Changyou was a closely-held company and there was no public market for its ordinary shares. To determine the discount for lack of marketability, the Company and the professional appraiser used the Black-Scholes option pricing model. Pursuant to the Black-Scholes option pricing model, the Company used the cost of a put option, which can be used to hedge the price change before a privately held share can be sold, as the basis to determine the discount for lack of marketability. Based on the foregoing analysis, the Company used a DLOM of 19% to discount the value of the Changyou s ordinary share as of the January 2008 and April 2008 valuation dates. Because there was no evidence to indicate that there would be a disproportionate return between majority and minority shareholders, the Company did not apply a minority discount.

20. Income Taxes

The Company is subject to taxes in the United States at 34% or 35%, depending upon taxable income levels. Certain of the Company s subsidiaries are subject to taxes in Hong Kong at 16.5% and certain subsidiaries are subject to taxes in the People s Republic of China.

Most of the Company s income is earned by our China-based subsidiaries and VIEs. Prior to January 1, 2008, its subsidiaries in China were governed by the *Income Tax Law of the People s Republic of China concerning Foreign Investment Enterprises and Foreign Enterprises* and *local income tax laws* (the previous income tax laws and rules). Pursuant to the previous income tax laws and rules, enterprises were subject to a statutory tax rate of 33% (30% state income tax plus 3% local income tax), or 15% for certain technology enterprises, on PRC taxable income. Under the previous income tax laws and rules, New Technology Enterprises could enjoy a favorable tax rate of 15% and were exempted from income tax for three years beginning with their first year of operations, and were entitled to a 50% tax reduction to 7.5% for the subsequent three years and 15% thereafter. The Company China-based subsidiaries and VIEs, Sohu Era, Sohu Media, Sogou Technology, AmazGame, Sohu Internet, Sogou Information and Gamease, were qualified as New Technology Enterprises under the previous income tax laws and rules.

In March 2007, the Chinese government enacted the *Corporate Income Tax Law*, and promulgated related regulation *Implementing Regulations for the PRC Corporate Income Tax Law*. The law and regulation went into effect on January 1, 2008. The *Corporate Income Tax Law*, among other things, imposes a unified income tax rate of 25% for both domestic and foreign invested enterprises. New Technology Enterprises will still enjoy a favorable tax rate of 15%.

The *Corporate Income Tax Law* provides a five-year transitional period for those entities established before March 16, 2007, which enjoyed a favorable income tax rate of less than 25% under the previous income tax laws and rules, to gradually change their rates to 25%. In addition, the *Corporate Income Tax Law* provides grandfather treatment for enterprises which were qualified as New Technology Enterprises under the previous income tax laws and were established before March 16, 2007, if they continue to meet the criteria for New Technology Enterprises after January 1, 2008. The grandfather provision allows these enterprises continue to enjoy their unexpired tax holiday provided by the previous

income tax laws and rules.

In the year of 2008, Sohu Era, Sohu Media and Sogou Technology have been qualified as New Technology Enterprises under the new *Corporate Income Tax Law*, and they can enjoy their unexpired tax holidays.

In addition, the *Corporate Income Tax Law* provides that Software Enterprise can enjoy an income tax exemption for two years beginning with their first profitable year and a 50% tax reduction to rate of 12.5% for the subsequent three years. AmazGame and Gamease, PRC subsidiary and VIE of the Company s online game business, are qualified as Software Enterprises, and this status began to apply in 2008. As informed by the relevant tax bureau, both AmazGame and Gamease will be subject to a 0% income tax rate for the full year 2008 and a 50% tax reduction to a rate of 12.5% from fiscal 2009 to fiscal 2011. Thus, both AmazGame and Gamease adopted a 0% tax rate for the year ended December 31, 2008. Despite the fact that both AmazGame and Gamease were subject to a 0% tax rate, they were still required by the relevant tax bureau to prepay income tax at the statutory rate of 25% for the first three quarters of 2008, which amounted to $18.9 million. The Company was not required to prepay income tax for the fourth quarter of 2008. In January 2009, a full refund of such prepaid income tax was received from the relevant tax authorities.

The *Corporate Income Tax Law* also imposes a 10% withholding income tax for dividends distributed by a foreign invested enterprise to its immediate holding company outside China, which were exempted under the previous income tax laws and rules. A lower withholding tax rate will be applied if there is a tax treaty arrangement between mainland China and the jurisdiction of the foreign holding company. Holding companies in Hong Kong, for example, will be subject to a 5% rate. All of the China-based subsidiaries are invested by immediate foreign holding companies in Hong Kong, except for Sogou Technology and New Software. All the foreign invested enterprises will be subject to the withholding tax on January 1, 2008. In the fourth quarter of 2008, AmazGame declared a dividend to its immediate holding company in Hong Kong and a withholding tax of approximately $5.0 million was accrued based on a 5% withholding tax rate. Except for this, since the Company intends to reinvest earnings to further expand its businesses in mainland China, its foreign invested enterprises do not intend to declare dividends to their immediate foreign holding companies in the foreseeable future. Accordingly, as of December 31, 2008, the Company has not recorded any other withholding tax on the retained earnings of its foreign invested enterprises in China.

Income before income tax expense of $167.6 million, $36.4 million and $28.3 million for 2008, 2007 and 2006 mainly represented the China income. Income tax accrued for China income of 2008 is $9.0 million, including $5.0 million withholding tax which has been mentioned above. The remaining income tax expenses are mainly from the Company s online game business.

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The combined effects of the income tax exemption and reduction available to the company are as follows (in thousands, except per share data):

	Year Ended December 31,		
	2008	2007	2006
Tax holiday effect	$ 48,413	$ 15,133	$ 10,478
Basic net income per share effect	1.27	0.41	0.29

The following is a reconciliation between the U.S. federal statutory rate and the Company s effective tax rate:

	Year Ended December 31,		
	2008	2007	2006
U.S. federal statutory rate:	34%	34%	34%
Tax differential from statutory rate applicable to the subsidiaries and the VIEs	(11%)	(2%)	(2%)
Effect of tax holidays applicable to the subsidiaries and the VIEs	(29%)	(41%)	(37%)
Effect of withholding taxes	4%	0%	
Change in valuation allowance for deferred tax assets	6%	14%	3%
Others	1%	(1%)	8%
	5%	4%	6%

Significant components of the Company s deferred tax assets and liabilities consist of the following (in thousands):

	As of December 31,	
	2008	2007
Deferred tax assets:		
Net operating loss from operations	$ 5,957	$ 8,047
Net operating loss from exercise of share-based awards	18,388	10,883
Share-based compensation	1,211	1,616
Intangible assets transfer	2,403	
Accrued bonus and commissions	2,146	
Others	1,786	955
Total deferred tax assets	31,891	21,501
Less: Valuation allowance	(31,416)	(21,501)
Net deferred tax assets	$ 475	$
Deferred tax liabilities		
Intangible assets from an acquisition	$ (539)	$ (195)
Others	(18)	(8)
Total deferred tax liabilities	$ (557)	$ (203)

As of December 31, 2008, the Company had federal net operating loss (NOL) of approximately $42 million available to offset against future federal income tax liabilities. The U.S. NOL will expire beginning 2020. The PRC NOL will expire beginning 2009.

The Company uses the short-cut method to pool its windfall tax benefit as prescribed by FASB Staff Position No. FAS 123(R)-3, Transition Election Related to Accounting for the Tax Effects of Share-Based Payment Awards.

The Company does not provide for United States federal income taxes or tax benefits on the undistributed earnings or losses of its international subsidiaries or VIEs because earnings are reinvested and, in the opinion of management, will continue to be reinvested indefinitely. As of December 31, 2008 and 2007, these cumulative undistributed earnings are included in consolidated retained earnings on the balance sheet and amounted to $279 million and $124 million, respectively. An estimated $94.9 million and $42.2 million in U.S. income and foreign withholding taxes would be due if these earnings were remitted as dividends, after payment of all deferred taxes as of December 31, 2008 and 2007.

21. Financial Instruments

The carrying amounts of the Company s cash and cash equivalents and restricted cash approximated their fair value due to the short maturity of those instruments. The carrying values of receivables and payables also approximated their market values based on their short-term maturities.

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22. Net Income per Share

The following table sets forth the computation of basic and diluted net income per share for the years indicated (in thousands except per share data):

	Year Ended December 31,		
	2008	**2007**	**2006**
Numerator:			
Income from continuing operations	$ 158,637	$ 34,951	$ 26,726
Loss from discontinued e-commerce operations		(20)	(841)
Net income	158,637	34,931	25,885
Effect of dilutive securities:			
Amortization of offering costs for zero coupon convertible senior notes		248	537
Net income adjusted for dilutive securities	$ 158,637	$ 35,179	$ 26,422
Denominator:			
Weighted average basic common shares outstanding	38,168	37,133	36,730
Effect of dilutive securities:			
Stock options and restricted stock units	949	1,135	927
Zero coupon convertible senior notes		651	1,448
Weighted average diluted common shares outstanding	39,117	38,919	39,105
Basic income per share from continuing operations	$ 4.16	$ 0.94	$ 0.73
Basic loss per share from discontinued e-commerce operations	(0.00)	(0.00)	(0.03)
Basic net income per share	$ 4.16	$ 0.94	$ 0.70
Diluted net income per share from continuing operations	$ 4.06	$ 0.90	$ 0.70
Diluted loss per share from discontinued e-commerce operations	(0.00)	(0.00)	(0.02)
Diluted net income per share	$ 4.06	$ 0.90	$ 0.68

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SCHEDULE I CONDENSED FINANCIAL INFORMATION OF REGISTRANT

SOHU.COM INC.

CONDENSED BALANCE SHEETS

(in thousands)

	As of December 31, 2008	As of December 31, 2007
ASSETS		
Current assets:		
Cash and cash equivalents	$ 20,853	$ 40,322
Prepaid and other current assets	572	342
Total current assets	21,425	40,664
Interests in subsidiaries and variable interest entities	391,703	266,543
	$ 413,128	$ 307,207
LIABILITIES AND SHAREHOLDERS EQUITY		
Current liabilities:		
Accrued liabilities	$ 3,252	$ 5,116
Due to subsidiaries and variable interest entities	23,930	83,188
Zero coupon convertible senior notes		6
Total current liabilities	27,182	88,310
Shareholders equity:		
Common stock: $0.001 par value per share (75,400 authorized; 38,095 and 37,715 shares issued and outstanding, respectively)	43	42
Additional paid-in capital	201,196	182,225
Treasury stock (4,638 and 4,137 shares, respectively)	(74,683)	(54,686)
Accumulated other comprehensive income	21,349	11,912
Retained earnings	238,041	79,404
Total shareholders equity	385,946	218,897
	$ 413,128	$ 307,207

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SOHU.COM INC.

CONDENSED STATEMENTS OF OPERATIONS

(in thousands)

	Year Ended December 31,		
	2008	**2007**	**2006**
Revenues	$	$	$
Cost of revenues			
Gross profit			
Operating expenses:			
General and administrative	3,366	5,149	4,278
Operating loss	(3,366)	(5,149)	(4,278)
Equity in profit of subsidiaries and variable interest entities	155,328	33,395	23,709
Other (expense) income		(248)	267
Interest income	6,675	6,941	6,270
Income before income tax expense	158,637	34,939	25,968
Income tax expense (benefit)		8	83
Net income	$ 158,637	$ 34,931	$ 25,885

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SOHU.COM INC.

CONDENSED STATEMENTS OF CASH FLOWS

(in thousands)

	Year Ended December 31,		
	2008	**2007**	**2006**
Cash flows from operating activities:			
Net income	$ 158,637	$ 34,931	$ 25,885
Adjustments to reconcile net income to net cash (used in) provided by operating activities:			
Equity in profit of subsidiaries and variable interest entities	(155,328)	(33,395)	(23,709)
Amortization of other assets		248	767
Share-based compensation expense	952	1,590	784
Gains on early redemption of zero coupon convertible senior notes			(793)
Others		7	83
Changes in current assets and liabilities:			
Due (from) to subsidiaries and variable interest entities	(64,580)	52,260	29,832
Prepaid and other current assets	(231)	122	60
Accrued liabilities	(1,860)	1,029	(3,626)
Net cash (used in) provided by operating activities	(62,410)	56,792	29,283
Cash flows from investing activities:			
Proceeds from maturities of marketable debt securities		5,000	9,000
Receipts from collections of loans to a subsidiary	49,841		
Net cash provided by investing activities	49,841	5,000	9,000
Cash flows from financing activities:			
Redemption of zero coupon convertible senior notes	(6)	(58,524)	(14,062)
Repurchase of common stock	(19,997)		(15,000)
Issuance of common stock	13,103	10,785	4,830
Net cash used in financing activities	(6,900)	(47,739)	(24,232)
Net (decrease) increase in cash and cash equivalents	(19,469)	14,053	14,051
Cash and cash equivalents at beginning of year	40,322	26,269	12,218
Cash and cash equivalents at end of year	$ 20,853	$ 40,322	$ 26,269

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NOTES TO SCHEDULE I CONDENSED FINANCIAL INFORMATION OF SOHU.COM INC.

1. The condensed financial statements of Sohu.com Inc. (the Company) have been prepared in accordance with accounting principles generally accepted in the United States of America.

2. The Company records its investment in subsidiaries under the equity method of accounting as prescribed in APB Opinion No. 18, The Equity Method of Accounting for Investments in Common Stock. Such investment and long-term loans to subsidiaries are presented on the balance sheet as interests in subsidiaries and VIEs and the profit of the subsidiaries is presented as equity in profit of subsidiaries and VIEs on the statement of operations.

For VIEs where the Company is the primary beneficiary, the amount of the Company s investment is included on the balance sheet as interests in subsidiaries and VIEs and the profit or loss of the VIEs is included in equity in profit of subsidiaries and VIEs on the statement of operations.

Certain information and footnote disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States have been condensed or omitted. The footnote disclosures contain supplemental information relating to the operations of the Company and, as such, these statements should be read in conjunction with the notes to the Consolidated Financial Statements of the Company.

3. As of December 31, 2008 and 2007, there were no material contingencies, significant provisions of long-term obligations, mandatory dividend or redemption requirements of redeemable stocks or guarantees of the Company, except for those which have been separately disclosed in the Consolidated Financial Statements, if any.

4. For each of the years in the three-year period ended December 31, 2008, there were no cash dividends paid to the Company by its consolidated subsidiaries, VIEs or associate.

5. Related party transactions

   a) During the year ended December 31, 2008, $5.3 million interest was principalized at a 4.8% interest rate per annum and $49.8 million of long-term loans were repaid. During the year ended December 31, 2007, interest of $5.0 million was principalized at a 6.0% interest rate per annum.

   b) As of December 31, 2008, the long-term loans to subsidiaries bore an interest rate of 5.05% per annum. As of December 31, 2008, the maturity dates for the long-term loans to subsidiaries is five years. For the years ended December 31, 2008 and 2007, the interest income from the loan amounted to $5.6 million and $5.3 million, respectively.

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EXHIBIT INDEX

Exhibit No.	Description
3.1(3)	Sixth Amended and Restated Certificate of Incorporation of Sohu.com Inc. as filed with the Delaware Secretary of State on July 17, 2000.
3.2(2)	Amended and Restated By-Laws of Sohu.com Inc., effective July 17, 2000.
4.1(4)	Rights Agreement, dated as of July 25, 2001, between Sohu.com Inc. and The Bank of New York, as Rights Agent.
4.2(8)	Indenture, dated as of July 14, 2003, between Sohu.com Inc. and The Bank of New York.
10.1(14)	2000 Stock Incentive Plan, as amended.
10.2(1)	Form of Stock Option Agreement.
10.3(1)	Form of Non-Competition, Confidential Information and Work Product Agreement with the Registrant s Executive Officers.
10.4(1)	Loan Agreement between Sohu.com Inc. and Charles Zhang.
10.5(1)	Loan Agreement between Sohu.com Inc. and Jinmei He.
10.6(5)	Loan and Share Pledge Agreement dated November 19, 2001, among Sohu.com Inc., Dr. Charles Zhang and Li Wei.
10.7(6)	Loan and Share Pledge Agreement, dated January 23, 2002, among Sohu.com Inc. and Li Wei.
10.8(6)	Shareholder s Agreement, dated March 16, 2002, by and between Beijing Century Hi-Tech Investment Co., Ltd. and Guolian Securities Co., Ltd. (portions of this exhibit have been omitted pursuant to a request for confidential treatment and have been filed separately with the SEC).
10.9(7)	Employment Agreement, effective as of January 1, 2003, by and between Sohu.com Inc. and Charles Zhang.
10.10(9)	Loan and Share Pledge Agreement between Sohu.com Inc. and Jinmei He dated June 9, 2003.
10.11(12)	Hosting Service Agreement effective July 21, 2003 between Beijing Sohu New Era Information Technology Co., Ltd., Sales Office of Beijing Communication Corporation and Beijing Sohu Internet Information Service Co., Ltd. (portions of this exhibit have been omitted pursuant to a request for confidential treatment and have been filed separately with the SEC).
10.12(10)	Mobile Data Service Cooperation Agreement dated March 25, 2003 between China Unicom Co., Ltd. and Beijing Sohu Online Network Information Service Co., Ltd.
10.13(17)	Hosting Service Agreement Among Sohu Internet, Sohu Era and China Network.
10.14(17)	Hosting Service Agreement between Sohu Era and China Telecom.
10.15(16)	China Mobile and Moternet WAP Service Providers Cooperation Agreement dated May 23, 2003 between China Mobile Communication Corporation and Beijing G. Feel Technology Co., Ltd.
10.16(16)	Moternet SMS Cooperation Agreement dated May 1, 2004 between Beijing Mobile Communication Co., Ltd. and Beijing Sohu Internet Information Services Co., Ltd.
10.17(16)	China Mobile and Moternet WAP Service Providers Cooperation Agreement dated May 26, 2003 between China Mobile Communication Corporation and Beijing Sohu Online Network Information Service Co., Ltd.
10.18(11)	Agreement dated September 1, 2003 between Beijing Sohu New Era Technology Information Co., Ltd. and Sohu Internet Information Services Co., Ltd.
10.19(13)	Employment Agreement, effective as of March 8, 2004, by and between Sohu.com Inc. and Carol Yu.
10.20(15)	Preliminary Agreement among Beijing Sohu New Era Information Technology Co. Ltd. and Vision Huaqing (Beijing) Development Co. Ltd. (portions of this exhibit have been omitted pursuant to a request for confidential treatment and have been filed separately with the SEC).
10.21(15)	Loan and Share Pledge Agreement between Sohu.com Inc. and Deng Xiufeng.
10.22(15)	Loan and Share Pledge Agreement between Sohu.com Inc. and Zhou Jing.

10.23(15)	Loan and Share Pledge Agreement between Sohu.com Inc. and Wang Jianjun.
10.24(15)	Loan and Share Pledge Agreement between Sohu.com Inc. and Wang Xin.
10.25(18)	Hosting Service Agreement Among Sohu Internet, Sohu Era and China Network.

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10.26(18)	Hosting Service Agreement Between Sohu Era and China Telecom.
10.27(19)	Employment Agreement, effective as of March 8, 2007, by and between Sohu.com Inc. and Carol Yu.
10.28(19)	Purchasing Agreement of Real Property Between Sohu New Era and Vision Hua Qing.
10.29(20)	Employment Agreement, effective as of June 1, 2007, by and between Sohu.com Inc. and Xin Wang (Belinda).
10.30(20)	Employment Agreement, effective as of June 1, 2007, by and between Sohu.com Inc. and Yu Gong.
10.31(21)	Employment Agreement, effective as of January 1, 2009, by and between Sohu.com Inc. and Charles Zhang.
14.1(11)	Code of Ethics and Conduct.
21.1(21)	Subsidiaries of the registrant.
23.1(21)	Consent of Independent Registered Public Accounting Firm.
23.2(21)	Consent of TransAsia Lawyers, PRC Counsel.
24.1(21)	Power of Attorney (included in signature page to Form 10-K).
31.1(21)	Rule 13a-14(a)/15d-14(a) Certification of Dr. Charles Zhang.
31.2(21)	Rule 13a-14(a)/15d-14(a) Certification of Carol Yu.
32.1(21)	Section 1350 Certification of Dr. Charles Zhang.
32.2(21)	Section 1350 Certification of Carol Yu.

(1) Incorporated herein by reference to the registrant s Registration Statement on Form S-1 (File No. 333-96137).

(2) Incorporated herein by reference to the registrant s Current Report on Form 8-K filed on November 2, 2000.

(3) Incorporated herein by reference to the registrant s Quarterly Report on Form 10-Q filed on November 14, 2000.

(4) Incorporated herein by reference to the registrant s Registration Statement on Form 8-A filed on July 30, 2001.

(5) Incorporated herein by reference to the registrant s Annual Report on Form 10-K filed on March 15, 2002.

(6) Incorporated herein by reference to the registrant s Quarterly Report on Form 10-Q filed on May 14, 2002.

(7) Incorporated herein by reference to the registrant s Annual Report on Form 10-K filed on March 28, 2003.

(8) Incorporated herein by reference to the registrant s Current Report on Form 8-K filed on July 16, 2003.

(9) Incorporated herein by reference to the registrant s Quarterly Report on Form 10-Q filed on August 12, 2003.

(10) Incorporated herein by reference to the registrant s Quarterly Report on Form 10-Q filed on November 14, 2003.

(11) Incorporated herein by reference to the registrant s Annual Report on Form 10-K filed on March 2, 2004.

(12) Incorporated herein by reference to the registrant s Quarterly Report on Form 10-Q/A filed on March 26, 2004.

(13) Incorporated herein by reference to the registrant s Quarterly Report on Form 10-Q filed on May 10, 2004.

(14) Incorporated herein by reference to the registrant s Registration Statement on Form S-8 (File No. 333-125960).

(15) Incorporated herein by reference to the registrant s Quarterly Report on Form 10-Q filed on November 9, 2004.

(16) Incorporated herein by reference to the registrant s Annual Report on Form 10-K filed on March 25, 2005.

(17) Incorporated herein by reference to the registrant s Quarterly Report on Form 10-Q filed on May 2, 2005.

(18) Incorporated herein by reference to the registrant s Annual Report on Form 10-K filed on March 8, 2007.

(19) Incorporated herein by reference to the registrant s Quarterly Report on Form 10-Q filed on May 8, 2007.

(20) Incorporated herein by reference to the registrant s Quarterly Report on Form 10-Q filed on August 6, 2007.

(21) Filed herewith

e:10pt;font-family:Times New Roman;font-weight:normal;font-style:normal;text-transform:none;font-variant: normal;">519

$

12,424

$

447,718

December 31, 2017

Securities available for sale:

U.S. Government agency and government sponsored enterprises

$

163,025

$

122

$

1,258

$

161,889

Mortgage-backed securities:

Federal National Mortgage Association

311,830

313

3,220

308,923

Federal Home Loan Mortgage Corporation

41,290

76

675

40,691

Government National Mortgage Association

12,051

193

12

12,232

Collateralized mortgage obligations:

Federal National Mortgage Association

217

1

1

217

Federal Home Loan Mortgage Corporation

45

—

—

45

Privately issued

—

976

—

976

Total mortgage-backed securities

365,433

1,559

3,908

363,084

Total available for sale securities

$

528,458

$

1,681

$

5,166

$

524,973

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FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Unaudited)

(4.)INVESTMENT SECURITIES (Continued)

	Amortized Cost	Unrealized Gains	Unrealized Losses	Fair Value
December 31, 2017 (continued)				
Securities held to maturity:				
State and political subdivisions	283,557	2,317	662	285,212
Mortgage-backed securities:				
Federal National Mortgage Association	9,732	16	88	9,660
Federal Home Loan Mortgage Corporation	3,213	—	119	3,094
Government National Mortgage Association	26,841	—	330	26,511
Collateralized mortgage obligations:				
Federal National Mortgage Association	76,432	—	1,958	74,474
Federal Home Loan Mortgage Corporation	93,810	3	2,165	91,648
Government National Mortgage Association	22,881	5	502	22,384
Total mortgage-backed securities	232,909	24	5,162	227,771
Total held to maturity securities	$ 516,466	$ 2,341	$ 5,824	$ 512,983

Investment securities with a total fair value of $788.9 million and $838.4 million at September 30, 2018 and December 31, 2017, respectively, were pledged as collateral to secure public deposits and for other purposes required or permitted by law.

Sales and calls of securities available for sale were as follows (in thousands):

	Three months ended September 30,		Nine months ended September 30,	
	2018	2017	2018	2017
Proceeds from sales	$ 21,470	$ 24,117	$ 27,238	$ 49,424
Gross realized gains	64	190	73	606
Gross realized losses	159	6	161	6

The scheduled maturities of securities available for sale and securities held to maturity at September 30, 2018 are shown below (in thousands). Actual expected maturities may differ from contractual maturities because issuers may have the right to call or prepay obligations.

	Amortized Cost	Fair Value
Debt securities available for sale:		
Due in one year or less	$ 35,676	$ 35,471
Due from one to five years	139,223	135,043
Due after five years through ten years	214,640	204,681
Due after ten years	86,579	83,115
Total available for sale securities	$ 476,118	$ 458,310
Debt securities held to maturity:		
Due in one year or less	$ 49,829	$ 49,878
Due from one to five years	150,749	150,479
Due after five years through ten years	83,277	79,898
Due after ten years	175,768	167,463
Total held to maturity securities	$ 459,623	$ 447,718

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FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Unaudited)

(4.)INVESTMENT SECURITIES (Continued)

Unrealized losses on investment securities 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, were 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
September 30, 2018						
Securities available for sale:						
U.S. Government agency and government sponsored enterprises	$88,647	$ 2,621	$63,162	$ 3,356	$151,809	$ 5,977
Mortgage-backed securities:						
Federal National Mortgage Association	54,316	1,380	208,371	9,398	262,687	10,778
Federal Home Loan Mortgage Corporation	2,374	80	32,041	1,767	34,415	1,847
Government National Mortgage Association	4,125	121	742	5	4,867	126
Collateralized mortgage obligations:						
Federal National Mortgage Association	—	—	58	—	58	—
Federal Home Loan Mortgage Corporation	—	—	6	—	6	—
Total mortgage-backed securities	60,815	1,581	241,218	11,170	302,033	12,751
Total available for sale securities	149,462	4,202	304,380	14,526	453,842	18,728
Securities held to maturity:						
State and political subdivisions	105,290	858	28,646	1,334	133,936	2,192
Mortgage-backed securities:						
Federal National Mortgage Association	5,467	151	6,098	316	11,565	467
Federal Home Loan Mortgage Corporation	1,455	30	2,889	242	4,344	272
Government National Mortgage Association	17,258	374	17,197	879	34,455	1,253
Collateralized mortgage obligations:						
Federal National Mortgage Association	1,982	41	59,878	3,229	61,860	3,270
Federal Home Loan Mortgage Corporation	9,845	390	67,728	3,713	77,573	4,103
Government National Mortgage Association	1,020	15	16,937	852	17,957	867
Total mortgage-backed securities	37,027	1,001	170,727	9,231	207,754	10,232
Total held to maturity securities	142,317	1,859	199,373	10,565	341,690	12,424

Total temporarily impaired securities	$291,779	$ 6,061	$503,753	$ 25,091	$795,532	$ 31,152
December 31, 2017						
Securities available for sale:						
U.S. Government agencies and government sponsored enterprises	$95,046	$ 571	$31,561	$ 687	$126,607	$ 1,258
Mortgage-backed securities:						
Federal National Mortgage Association	201,754	1,855	67,383	1,365	269,137	3,220
Federal Home Loan Mortgage Corporation	20,446	192	15,601	483	36,047	675
Government National Mortgage Association	2,432	—	880	12	3,312	12
Collateralized mortgage obligations:						
Federal National Mortgage Association	—	—	119	1	119	1
Federal Home Loan Mortgage Corporation	—	—	8	—	8	—
Total mortgage-backed securities	224,632	2,047	83,991	1,861	308,623	3,908
Total available for sale securities	319,678	2,618	115,552	2,548	435,230	5,166

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FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Unaudited)

(4.)INVESTMENT SECURITIES (Continued)

	Less than 12 months		12 months or longer		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
December 31, 2017 (continued)						
Securities held to maturity:						
State and political subdivisions	36,368	295	14,492	367	50,860	662
Mortgage-backed securities:						
Federal National Mortgage Association	3,766	29	2,694	59	6,460	88
Federal Home Loan Mortgage Corporation	—	—	3,094	119	3,094	119
Government National Mortgage Association	17,327	136	9,184	194	26,511	330
Collateralized mortgage obligations:						
Federal National Mortgage Association	16,830	202	57,645	1,756	74,475	1,958
Federal Home Loan Mortgage Corporation	23,727	337	66,467	1,828	90,194	2,165
Government National Mortgage Association	15,401	340	5,635	162	21,036	502
Total mortgage-backed securities	77,051	1,044	144,719	4,118	221,770	5,162
Total held to maturity securities	113,419	1,339	159,211	4,485	272,630	5,824
Total temporarily impaired securities	$433,097	$ 3,957	$274,763	$ 7,033	$707,860	$ 10,990

The total number of security positions in the investment portfolio in an unrealized loss position at September 30, 2018 was 750 compared to 411 at December 31, 2017. At September 30, 2018, the Company had positions in 308 investment securities with a fair value of $503.8 million and a total unrealized loss of $25.1 million that have been in a continuous unrealized loss position for more than 12 months. At September 30, 2018, there were a total of 442 securities positions in the Company’s investment portfolio with a fair value of $291.8 million and a total unrealized loss of $6.1 million that had been in a continuous unrealized loss position for less than 12 months. At December 31, 2017, the Company had positions in 172 investment securities with a fair value of $274.8 million and a total unrealized loss of $7.0 million that had been in a continuous unrealized loss position for more than 12 months. At December 31, 2017, there were a total of 239 securities positions in the Company’s investment portfolio with a fair value of $433.1 million and a total unrealized loss of $4.0 million that had been in a continuous unrealized loss position for less than 12 months. The unrealized loss on investment securities was predominantly caused by changes in market interest rates subsequent to purchase. The fair value of most of the investment securities in the Company’s portfolio fluctuates as market interest rates change.

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 then available to management. There was no impairment recorded during the nine months ended September 30, 2018 and 2017.

Based on management’s review and evaluation of the Company’s debt securities as of September 30, 2018, the debt securities with unrealized losses were not considered to be OTTI. As of September 30, 2018, the Company did not intend to sell any of the securities in a loss position and believes that it is not likely that it will be required to sell any such securities before the anticipated recovery of amortized cost. Accordingly, as of September 30, 2018, 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.

FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Unaudited)

(5.)LOANS

The Company's loan portfolio consisted of the following as of the dates indicated (in thousands):

	Principal Amount Outstanding	Net Deferred Loan (Fees) Costs	Loans, Net
September 30, 2018			
Commercial business	$537,160	$782	$537,942
Commercial mortgage	907,107	(2,096)	905,011
Residential real estate loans	498,883	8,715	507,598
Residential real estate lines	108,227	2,977	111,204
Consumer indirect	878,316	31,118	909,434
Other consumer	16,975	167	17,142
Total	$2,946,668	$41,663	2,988,331
Allowance for loan losses			(33,955)
Total loans, net			$2,954,376
December 31, 2017			
Commercial business	$449,763	$563	$450,326
Commercial mortgage	810,851	(1,943)	808,908
Residential real estate loans	457,761	7,522	465,283
Residential real estate lines	113,422	2,887	116,309
Consumer indirect	845,682	30,888	876,570
Other consumer	17,443	178	17,621
Total	$2,694,922	$40,095	2,735,017
Allowance for loan losses			(34,672)
Total loans, net			$2,700,345

Loans held for sale (not included above) were comprised entirely of residential real estate mortgages and totaled $3.2 million and $2.7 million as of September 30, 2018 and December 31, 2017, respectively.

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 the dates indicated (in thousands):

	30-59 Days Past Due	60-89 Days Past Due	Greater Than 90 Days	Total Past Due	Nonaccrual	Current	Total Loans
September 30, 2018							
Commercial business	$364	$—	$ —	$364	$ 2,203	$534,593	$537,160
Commercial mortgage	916	—	—	916	1,900	904,291	907,107
Residential real estate loans	871	55	—	926	2,057	495,900	498,883
Residential real estate lines	185	—	—	185	297	107,745	108,227
Consumer indirect	2,327	544	—	2,871	1,385	874,060	878,316
Other consumer	118	6	8	132	—	16,843	16,975
Total loans, gross	$4,781	$605	$ 8	$5,394	$ 7,842	$2,933,432	$2,946,668
December 31, 2017							
Commercial business	$64	$36	$ —	$100	$ 5,344	$444,319	$449,763
Commercial mortgage	56	375	—	431	2,623	807,797	810,851
Residential real estate loans	1,908	56	—	1,964	2,252	453,545	457,761
Residential real estate lines	349	—	—	349	404	112,669	113,422
Consumer indirect	2,806	672	—	3,478	1,895	840,309	845,682
Other consumer	174	15	11	200	2	17,241	17,443
Total loans, gross	$5,357	$1,154	$ 11	$6,522	$ 12,520	$2,675,880	$2,694,922

FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Unaudited)

(5.)LOANS (Continued)

There were no loans past due greater than 90 days and still accruing interest as of September 30, 2018 and December 31, 2017. There were $8 thousand and $11 thousand in consumer overdrafts which were past due greater than 90 days as of September 30, 2018 and December 31, 2017, respectively. Consumer overdrafts are overdrawn deposit accounts which have been reclassified as loans but by their terms do not accrue interest.

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. 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, collateral concessions, forgiveness of principal, forbearance agreements, or substituting or adding a new borrower or guarantor.

There were no loans modified as a TDR during the nine months ended September 30, 2018 and 2017. There were no loans modified as a TDR within the previous 12 months that defaulted during the nine months ended September 30, 2018 and 2017. For purposes of this disclosure, a loan modified as a TDR is considered to have defaulted when the borrower becomes 90 days past due.

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 the recorded investment, unpaid principal balance and related allowance of impaired loans as of the dates indicated and average recorded investment and interest income recognized on impaired loans for the nine months ended September 30, 2018 and twelve-month period ended December 31, 2017 (in thousands):

	Recorded Investment (1)	Unpaid Principal Balance (1)	Related Allowance	Average Recorded Investment	Interest Income Recognized
September 30, 2018					
With no related allowance recorded:					
Commercial business	$ 1,155	$ 2,090	$ —	$ 1,307	$ —
Commercial mortgage	525	525	—	568	—
	1,680	2,615	—	1,875	—
With an allowance recorded:					
Commercial business	1,183	1,183	431	2,931	—

Commercial mortgage	1,838	1,838	460	2,132	—
	3,021	3,021	891	5,063	—
	$ 4,701	$ 5,636	$ 891	$ 6,938	$ —
December 31, 2017					
With no related allowance recorded:					
Commercial business	$ 1,635	$ 2,370	$ —	$ 853	$ —
Commercial mortgage	584	584	—	621	—
	2,219	2,954	—	1,474	—
With an allowance recorded:					
Commercial business	3,853	3,853	2,056	4,468	—
Commercial mortgage	2,528	2,528	115	1,516	—
	6,381	6,381	2,171	5,984	—
	$ 8,600	$ 9,335	$ 2,171	$ 7,458	$ —

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

FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Unaudited)

(5.)LOANS (Continued)

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.

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 that do not meet 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 the dates indicated (in thousands):

	Commercial Business	Commercial Mortgage
September 30, 2018		
Uncriticized	$ 505,865	$ 889,608
Special mention	21,141	10,221
Substandard	10,154	7,278
Doubtful	—	—
Total	$ 537,160	$ 907,107
December 31, 2017		
Uncriticized	$ 429,692	$ 791,127

Special mention	7,120	12,185
Substandard	12,951	7,539
Doubtful	—	—
Total	$ 449,763	$ 810,851

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 the dates indicated (in thousands):

	Residential Real Estate Loans	Residential Real Estate Lines	Consumer Indirect	Other Consumer
September 30, 2018				
Performing	$ 496,826	$ 107,930	$ 876,931	$ 16,967
Non-performing	2,057	297	1,385	8
Total	$ 498,883	$ 108,227	$ 878,316	$ 16,975
December 31, 2017				
Performing	$ 455,509	$ 113,018	$ 843,787	$ 17,430
Non-performing	2,252	404	1,895	13
Total	$ 457,761	$ 113,422	$ 845,682	$ 17,443

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FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Unaudited)

(5.)LOANS (Continued)

Allowance for Loan Losses

Loans and the related allowance for loan losses are presented below as of the dates indicated (in thousands):

	Commercial Business	Commercial Mortgage	Residential Real Estate Loans	Residential Real Estate Lines	Consumer Indirect	Other Consumer	Total
September 30, 2018							
Loans:							
Ending balance	$ 537,160	$ 907,107	$ 498,883	$ 108,227	$ 878,316	$ 16,975	$ 2,946,668
Evaluated for impairment:							
Individually	$ 2,338	$ 2,363	$ —	$ —	$ —	$ —	$ 4,701
Collectively	$ 534,822	$ 904,744	$ 498,883	$ 108,227	$ 878,316	$ 16,975	$ 2,941,967
Allowance for loan losses:							
Ending balance	$ 14,231	$ 5,422	$ 1,305	$ 212	$ 12,355	$ 430	$ 33,955
Evaluated for impairment:							
Individually	$ 431	$ 460	$ —	$ —	$ —	$ —	$ 891
Collectively	$ 13,800	$ 4,962	$ 1,305	$ 212	$ 12,355	$ 430	$ 33,064
September 30, 2017							
Loans:							
Ending balance	$ 418,873	$ 759,898	$ 438,936	$ 114,747	$ 827,154	$ 17,460	$ 2,577,068
Evaluated for impairment:							
Individually	$ 7,126	$ 2,459	$ —	$ —	$ —	$ —	$ 9,585
Collectively	$ 411,747	$ 757,439	$ 438,936	$ 114,747	$ 827,154	$ 17,460	$ 2,567,483
Allowance for loan losses:							
Ending balance	$ 15,749	$ 3,727	$ 1,161	$ 157	$ 13,217	$ 336	$ 34,347
Evaluated for impairment:							
Individually	$ 2,658	$ 171	$ —	$ —	$ —	$ —	$ 2,829
Collectively	$ 13,091	$ 3,556	$ 1,161	$ 157	$ 13,217	$ 336	$ 31,518

The following table sets forth the changes in the allowance for loan losses for the three and nine-month periods ended September 30, 2018 (in thousands):

Commercial Business	Commercial Mortgage	Residential	Residential	Consumer Indirect	Other Consumer	Total

			Real Estate Loans	Real Estate Lines			
Three months ended September 30, 2018							
Beginning balance	$ 14,242	$ 5,371	$ 1,255	$ 248	$ 12,520	$ 319	$ 33,955
Charge-offs	(672)	(113)	(24)	(23)	(2,474)	(301)	(3,607)
Recoveries	241	3	8	2	1,228	64	1,546
Provision (credit)	420	161	66	(15)	1,081	348	2,061
Ending balance	$ 14,231	$ 5,422	$ 1,305	$ 212	$ 12,355	$ 430	$ 33,955
Nine months ended September 30, 2018							
Beginning balance	$ 15,668	$ 3,696	$ 1,322	$ 180	$ 13,415	$ 391	$ 34,672
Charge-offs	(1,113)	(117)	(53)	(124)	(8,089)	(969)	(10,465)
Recoveries	438	11	140	17	3,862	230	4,698
Provision (credit)	(762)	1,832	(104)	139	3,167	778	5,050
Ending balance	$ 14,231	$ 5,422	$ 1,305	$ 212	$ 12,355	$ 430	$ 33,955

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FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Unaudited)

(5.)LOANS (Continued)

The following table sets forth the changes in the allowance for loan losses for the three and nine-month periods ended September 30, 2017 (in thousands):

	Commercial Business	Commercial Mortgage	Residential Real Estate Loans	Residential Real Estate Lines	Consumer Indirect	Other Consumer	Total
Three months ended September 30, 2017							
Beginning balance	$ 14,622	$ 3,906	$ 1,247	$ 232	$ 12,833	$ 319	$ 33,159
Charge-offs	(130)	—	(198)	(21)	(2,330)	(230)	(2,909)
Recoveries	86	5	37	2	1,086	79	1,295
Provision (credit)	1,171	(184)	75	(56)	1,628	168	2,802
Ending balance	$ 15,749	$ 3,727	$ 1,161	$ 157	$ 13,217	$ 336	$ 34,347
Nine months ended September 30, 2017							
Beginning balance	$ 7,225	$ 10,315	$ 1,478	$ 303	$ 11,311	$ 302	$ 30,934
Charge-offs	(1,908)	(10)	(298)	(64)	(7,343)	(620)	(10,243)
Recoveries	332	257	85	58	3,259	250	4,241
Provision (credit)	10,100	(6,835)	(104)	(140)	5,990	404	9,415
Ending balance	$ 15,749	$ 3,727	$ 1,161	$ 157	$ 13,217	$ 336	$ 34,347

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, potentially resulting in 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 real estate loans (comprised of conventional mortgages and home equity loans) and residential real estate lines (comprised of home equity lines) are generally made based on 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.

FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Unaudited)

(6.)GOODWILL AND OTHER INTANGIBLE ASSETS

Goodwill

The carrying amount of goodwill totaled $68.4 million and $65.8 million as of September 30, 2018 and December 31, 2017, respectively. The Company performs a goodwill impairment test on an annual basis as of October 1st or more frequently if events and circumstances warrant.

	Banking	Non-Banking	Total
Balance, December 31, 2017	$48,536	$ 17,304	$65,840
Acquisition	—	2,572	2,572
Balance, September 30, 2018	$48,536	$ 19,876	$68,412

Goodwill and other intangible assets added during the period relates to the acquisition of HNP Capital, which was completed on June 1, 2018. See Note 2 – Business Combinations for additional information.

Other Intangible Assets

The Company has other intangible assets that are amortized, consisting of core deposit intangibles and other intangibles (primarily related to customer relationships). Gross carrying amount, accumulated amortization and net book value, were as follows (in thousands):

	September 30, 2018	December 31, 2017
Other intangibles assets:		
Gross carrying amount	$ 15,925	$ 13,420
Accumulated amortization	(5,484)	(4,557)
Net book value	$ 10,441	$ 8,863

Amortization expense for total other intangible assets was $334 thousand and $927 thousand for the three and nine months ended September 30, 2018, and $288 thousand and $876 thousand for the three and nine months ended September 30, 2017, respectively. As of September 30, 2018, the estimated amortization expense of other intangible assets for the remainder of 2018 and each of the next five years is as follows (in thousands):

2018 (remainder of year)	$330

2019	1,250
2020	1,134
2021	1,014
2022	923
2023	852

FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Unaudited)

(7.)DERIVATIVE INSTRUMENT AND HEDGING ACTIVITIES

Risk Management Objective of Using Derivatives

The Company is exposed to certain risks arising from both its business operations and economic conditions. The Company principally manages its exposures to a wide variety of business and operational risks through management of its core business activities. The Company manages economic risks, including interest rate, liquidity and credit risk, primarily by managing the amount, sources, and duration of its assets and liabilities, and the use of derivative financial instruments. Specifically, the Company enters into derivative financial instruments to manage exposures that arise from business activities that result in the receipt or payment of future known and uncertain cash amounts, the value of which are determined by interest rates. The Company's derivative financial instruments are used to manage differences in the amount, timing, and duration of the Company's known or expected cash receipts and its known or expected cash payments.

Cash Flow Hedges of Interest Rate Risk

The Company's objectives in using interest rate derivatives are to add stability to interest expense and to manage its exposure to interest rate movements. To accomplish this objective, the Company primarily uses interest rate caps as part of its interest rate risk management strategy. Interest rate caps designated as cash flow hedges involve the receipt of variable amounts from a counterparty if interest rates rise above the strike rate on the contract in exchange for an up-front premium. During 2018, such derivatives were used to hedge the variable cash flows associated with short-term borrowings.

For derivatives designated and that qualify as cash flow hedges of interest rate risk, the gain or loss on the derivative is recorded in accumulated other comprehensive income (loss) and subsequently reclassified into interest expense in the same period(s) during which the hedged transaction affects earnings. Amounts reported in accumulated other comprehensive income (loss) related to derivatives will be reclassified to interest expense as interest payments are made on the Company's borrowings. The ineffective portion of the change in fair value of the derivatives is recognized directly in earnings. The Company's cash flow hedge derivatives did not have any hedge ineffectiveness recognized in earnings during the three and nine months ended September 30, 2018 and 2017. During the next twelve months, the Company estimates that an additional $29 thousand will be reclassified as a decrease to interest expense.

Interest Rate Swaps

The Company executes interest rate swaps with commercial banking customers to facilitate their respective risk management strategies. These interest rate swaps are simultaneously hedged by offsetting interest rate swaps that the Company executes with a third party, such that the Company minimizes its net risk exposure resulting from such transactions. As the interest rate swaps associated with this program do not meet hedge accounting requirements, changes in the fair value of both the customer swaps and the offsetting swaps are recognized directly in earnings.

Credit-risk-related Contingent Features

The Company has agreements with certain of its derivative counterparties that contain one or more of the following provisions: (a) if the Company defaults on any of its indebtedness, including a default where repayment of the indebtedness has not been accelerated by the lender, the Company could also be declared in default on its derivative obligations, and (b) if the Company fails to maintain its status as a well-capitalized institution, the counterparty could terminate the derivative positions and the Company would be required to settle its obligations under the agreements.

FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Unaudited)

(7.)DERIVATIVE INSTRUMENT AND HEDGING ACTIVITIES (Continued)

Fair Values of Derivative Instruments on the Balance Sheet

The table below presents the notional amounts, respective fair values of the Company’s derivative financial instruments, as well as their classification on the balance sheet as of September 30, 2018 and December 31, 2017 (in thousands):

	Gross notional amount		Asset derivatives			Liability derivatives		
			Balance	Fair value		Balance	Fair value	
	Sept. 30, 2018	Dec. 31, 2017	sheet line item	Sept. 30, 2018	Dec. 31, 2017	sheet line item	Sept. 30, 2018	Dec. 31, 2017
Derivatives designated as hedging instruments								
Cash flow hedges	$100,000	$—	Other assets	$1,305	$ —	Other liabilities	$—	$ —
Total derivatives	$100,000	$—		$1,305	$ —		$—	$ —
Derivatives not designated as hedging instruments								
Interest rate swaps	$35,915	$—	Other assets	$298	$ —	Other liabilities	$348	$ —
Credit contracts	34,741	12,282	Other assets	—	—	Other liabilities	8	4
Total derivatives	$70,656	$12,282		$298	$ —		$356	$ 4

Effect of Derivative Instruments on the Income Statement

The table below presents the effect of the Company’s derivative financial instruments on the income statement for the three and nine months ended September 30, 2018 and 2017 (in thousands):

		Gain (loss) recognized in income Three months ended		Gain (loss) recognized in income Nine months ended	
	Line item of gain (loss)	September 30,		September 30,	
Undesignated derivatives	recognized in income	2018	2017	2018	2017
Interest rate swaps	Net gain on derivative instruments	$ 349	$ —	$ 419	$ —

Credit contracts	Net gain on derivative instruments	5	127	187	127
Total undesignated		$ 354	$ 127	$ 606	$ 127

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FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Unaudited)

(8.)SHAREHOLDERS' EQUITY

Common Stock

The changes in shares of common stock were as follows for the nine months ended September 30, 2018 and 2017:

	Outstanding	Treasury	Issued
September 30, 2018			
Shares at December 31, 2017	15,924,938	131,240	16,056,178
Restricted stock awards issued	7,370	(7,370)	—
Restricted stock awards forfeited	(23,901)	23,901	—
Stock options exercised	17,450	(17,450)	—
Stock awards	2,724	(2,724)	—
Treasury stock purchases	(3,622)	3,622	—
Shares at September 30, 2018	15,924,959	131,219	16,056,178
September 30, 2017			
Shares at December 31, 2016	14,537,597	154,617	14,692,214
Common stock issued for "at-the-market" equity offering	1,069,635	—	1,069,635
Restricted stock awards issued	8,510	(8,510)	—
Restricted stock awards forfeited	(10,359)	10,359	—
Stock options exercised	21,320	(21,320)	—
Stock awards	3,914	(3,914)	—
Treasury stock purchases	(4,323)	4,323	—
Shares at September 30, 2017	15,626,294	135,555	15,761,849

FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Unaudited)

(9.)ACCUMULATED OTHER COMPREHENSIVE INCOME (LOSS)

The following table presents the components of other comprehensive income (loss) for the three and nine months ended September 30, 2018 and 2017 (in thousands):

	Pre-tax Amount	Tax Effect	Net-of-tax Amount
Three months ended September 30, 2018			
Securities available for sale and transferred securities:			
Change in unrealized gain/loss during the period	$(2,532)	$(639)	$(1,893)
Reclassification adjustment for net gains included in net income [1]	209	52	157
Total securities available for sale and transferred securities	(2,323)	(587)	(1,736)
Hedging derivative instruments:			
Change in unrealized gain/loss during the period	114	29	85
Pension and post-retirement obligations:			
Amortization of prior service credit included in income	(18)	(4)	(14)
Amortization of net actuarial loss included in income	188	47	141
Total pension and post-retirement obligations	170	43	127
Other comprehensive loss	$(2,039)	$(515)	$(1,524)
Nine months ended September 30, 2018			
Securities available for sale and transferred securities:			
Change in unrealized gain/loss during the period	$(14,411)	$(3,633)	$(10,778)
Reclassification adjustment for net gains included in net income [1]	381	96	285
Total securities available for sale and transferred securities	(14,030)	(3,537)	(10,493)
Hedging derivative instruments:			
Change in unrealized gain/loss during the period	278	70	208
Pension and post-retirement obligations:			
Amortization of prior service credit included in income	(54)	(14)	(40)
Amortization of net actuarial loss included in income	563	142	421
Total pension and post-retirement obligations	509	128	381
Other comprehensive loss	$(13,243)	$(3,339)	$(9,904)

(1) Includes amounts related to the amortization/accretion of unrealized net gains and losses related to the Company's reclassification of available for sale investment securities to the held to maturity category. The unrealized net gains/losses will be amortized/accreted over the remaining life of the investment securities as an adjustment of yield.

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FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Unaudited)

(9.)ACCUMULATED OTHER COMPREHENSIVE INCOME (LOSS) (Continued)

	Pre-tax Amount	Tax Effect	Net-of-tax Amount
Three months ended September 30, 2017			
Securities available for sale and transferred securities:			
Change in unrealized gain/loss during the period	$ 589	$ 226	$ 363
Reclassification adjustment for net gains included in net income (1)	(127)	(48)	(79)
Total securities available for sale and transferred securities	462	178	284
Hedging derivative instruments:			
Change in unrealized gain/loss during the period	—	—	—
Pension and post-retirement obligations:			
Amortization of prior service credit included in income	(12)	(4)	(8)
Amortization of net actuarial loss included in income	291	112	179
Total pension and post-retirement obligations	279	108	171
Other comprehensive income	$ 741	$ 286	$ 455
Nine months ended September 30, 2017			
Securities available for sale and transferred securities:			
Change in unrealized gain/loss during the period	$ 4,747	$ 1,831	$ 2,916
Reclassification adjustment for net gains included in net income (1)	(514)	(198)	(316)
Total securities available for sale and transferred securities	4,233	1,633	2,600
Hedging derivative instruments:			
Change in unrealized gain/loss during the period	—	—	—
Pension and post-retirement obligations:			
Amortization of prior service credit included in income	(38)	(14)	(24)
Amortization of net actuarial loss included in income	874	337	537
Total pension and post-retirement obligations	836	323	513
Other comprehensive income	$ 5,069	$ 1,956	$ 3,113

(1) Includes amounts related to the amortization/accretion of unrealized net gains and losses related to the Company's reclassification of available for sale investment securities to the held to maturity category. The unrealized net gains/losses will be amortized/accreted over the remaining life of the investment securities as an adjustment of yield.

FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Unaudited)

(9.)ACCUMULATED OTHER COMPREHENSIVE INCOME (LOSS) (Continued)

Activity in accumulated other comprehensive income (loss), net of tax, for the three and nine months ended September 30, 2018 and 2017 was as follows (in thousands):

	Hedging Derivative Instruments	Securities Available for Sale and Transferred Securities	Pension and Post-retirement Obligations	Accumulated Other Comprehensive Income (Loss)
Three months ended September 30, 2018				
Balance at beginning of period	$ 123	$ (12,032)	$ (8,387)	$ (20,296)
Other comprehensive income (loss) before reclassifications	85	(1,893)	—	(1,808)
Amounts reclassified from accumulated other comprehensive income (loss)	—	157	127	284
Net current period other comprehensive income (loss)	85	(1,736)	127	(1,524)
Balance at end of period	$ 208	$ (13,768)	$ (8,260)	$ (21,820)
Nine months ended September 30, 2018				
Balance at beginning of period	$ —	$ (3,275)	$ (8,641)	$ (11,916)
Other comprehensive income (loss) before reclassifications	208	(10,778)	—	(10,570)
Amounts reclassified from accumulated other comprehensive income (loss)	—	285	381	666
Net current period other comprehensive income (loss)	208	(10,493)	381	(9,904)
Balance at end of period	$ 208	$ (13,768)	$ (8,260)	$ (21,820)
Three months ended September 30, 2017				
Balance at beginning of period	$ —	$ (1,413)	$ (9,880)	$ (11,293)
Other comprehensive income (loss) before reclassifications	—	363	—	363
Amounts reclassified from accumulated other comprehensive income (loss)	—	(79)	171	92
Net current period other comprehensive income (loss)	—	284	171	455

Balance at end of period	$	—	$	(1,129	)	$	(9,709	)	$	(10,838	)
Nine months ended September 30, 2017											
Balance at beginning of period	$	—	$	(3,729	)	$	(10,222	)	$	(13,951	)
Other comprehensive income (loss) before reclassifications		—		2,916			—			2,916	
Amounts reclassified from accumulated other comprehensive income (loss)		—		(316	)		513			197	
Net current period other comprehensive income (loss)		—		2,600			513			3,113	
Balance at end of period	$	—	$	(1,129	)	$	(9,709	)	$	(10,838	)

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FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Unaudited)

(9.)ACCUMULATED OTHER COMPREHENSIVE INCOME (LOSS) (Continued)

The following table presents the amounts reclassified out of each component of accumulated other comprehensive income (loss) for the three and nine months ended September 30, 2018 and 2017 (in thousands):

Details About Accumulated Other Comprehensive Income (Loss) Components	Amount Reclassified from Accumulated Other Comprehensive Income (Loss)		Affected Line Item in the Consolidated Statement of Income
	Three months ended September 30,		
	2018	2017	
Realized (loss) gain on sale of investment securities	$ (95)	$ 184	Net gain on investment securities
Amortization of unrealized holding gains (losses) on investment securities transferred from available for sale to held to maturity	(114)	(57)	Interest income
	(209)	127	Total before tax
	52	(48)	Income tax benefit (expense)
	(157)	79	Net of tax
Amortization of pension and post-retirement items:			
Prior service credit [(1)]	18	12	Salaries and employee benefits
Net actuarial losses [(1)]	(188)	(291)	Salaries and employee benefits
	(170)	(279)	Total before tax
	43	108	Income tax benefit
	(127)	(171)	Net of tax
Total reclassified for the period	$ (284)	$ (92)	
	Nine months ended September 30,		
	2018	2017	
Realized (loss) gain on sale of investment securities	$ (88)	$ 600	Net gain on investment securities
Amortization of unrealized holding gains (losses)	(293)	(86)	Interest income

on investment securities transferred from available for sale to held to maturity			
	(381)	514	Total before tax
	96	(198)	Income tax benefit (expense)
	(285)	316	Net of tax
Amortization of pension and post-retirement items:			
Prior service credit [1]	54	38	Salaries and employee benefits
Net actuarial losses [1]	(563)	(874)	Salaries and employee benefits
	(509)	(836)	Total before tax
	128	323	Income tax benefit
	(381)	(513)	Net of tax
Total reclassified for the period	$ (666)	$ (197)	

(1) These items are included in the computation of net periodic pension expense. See Note 11 – Employee Benefit Plans for additional information.

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FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Unaudited)

(10.)SHARE-BASED COMPENSATION PLANS

The Company maintains certain stock-based compensation plans, approved by the Company's shareholders that are administered by the Management Development and Compensation Committee (the "MD&C Committee") of the Board. The share-based compensation plans were established to allow for the grant of compensation awards to attract, motivate and retain employees, executive officers and non-employee directors who contribute to the long-term growth 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 MD&C Committee approved the grant of restricted stock units ("RSUs") and performance share units ("PSUs") shown in the table below to certain members of management during the nine months ended September 30, 2018.

	Number of Underlying Shares	Weighted Average Per Share Grant Date Fair Value
RSUs	32,655	$ 28.50
PSUs	14,855	27.25

The grant-date fair value for the RSUs granted during the nine months ended September 30, 2018 is equal to the closing market price of our common stock on the date of grant reduced by the present value of the dividends expected to be paid on the underlying shares.

The number of PSUs that ultimately vest is contingent on achieving specified total shareholder return ("TSR") targets relative to the SNL Small Cap Bank & Thrift Index, a market index the MD&C Committee has selected as a peer group for this purpose. The shares will be earned based on the Company's achievement of a relative TSR performance requirement, on a percentile basis, compared to the SNL Small Cap Bank & Thrift Index over a three-year performance period ended December 31, 2020. The shares earned based on the achievement of the TSR performance requirement, if any, will vest on February 27, 2021 assuming the recipient's continuous service to the Company.

The grant-date fair value of the PSUs granted during the nine months ended September 30, 2018 was determined using the Monte Carlo simulation model on the date of grant, assuming the following (i) expected term of 2.84 years, (ii) risk free interest rate of 2.39%, (iii) expected dividend yield of 2.83% and (iv) expected stock price volatility over

the expected term of the TSR award of 21.2%. The Monte Carlo simulation model is a risk analysis method that selects a random value from a range of estimates.

During the nine months ended September 30, 2018, the company issued a total of 2,724 shares of common stock in-lieu of cash for the annual retainer of five non-employee directors and granted a total of 7,370 restricted shares of common stock to non-employee directors, of which 3,690 shares vested immediately and 3,680 shares will vest after completion of a one-year service requirement. The market price of the stock and restricted stock on the date of grant was $33.90.

The following is a summary of restricted stock awards and restricted stock units activity for the nine months ended September 30, 2018:

	Number of Shares	Weighted Average Market Price at Grant Date
Outstanding at beginning of year	130,586	$ 24.32
Granted	54,880	28.89
Vested	(23,836)	25.74
Forfeited	(25,251)	11.61
Outstanding at end of period	136,379	$ 28.26

At September 30, 2018, there was $2.0 million of unrecognized compensation expense related to unvested restricted stock awards and restricted stock units that is expected to be recognized over a weighted average period of 1.9 years.

FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Unaudited)

(10.)SHARE-BASED COMPENSATION PLANS (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 the first nine months of 2018 or 2017. There was no unrecognized compensation expense related to unvested stock options as of September 30, 2018. The following is a summary of stock option activity for the nine months ended September 30, 2018 (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	22,199	$ 18.40		
Exercised	(17,450)	18.38		
Expired	(4,749)	18.50		
Outstanding and exercisable at end of period	—	$ —	—	$ —

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 nine months ended September 30, 2018 and 2017 was $236 thousand and $297 thousand, respectively. The total cash received as a result of option exercises under stock compensation plans for the nine months ended September 30, 2018 and 2017 was $320 thousand and $413 thousand, respectively.

The Company amortizes the expense related to stock-based compensation awards over the vesting period. Share-based compensation expense is recorded as a component of salaries and employee benefits in the consolidated statements of income for awards granted to management and as a component of other noninterest expense for awards granted to directors. The share-based compensation expense included in the consolidated statements of income, is as follows (in thousands):

	Three months ended September 30,		Nine months ended September 30,	
	2018	2017	2018	2017
Salaries and employee benefits	$ 306	$ 248	$ 872	$ 676

Other noninterest expense	32	32	225	209
Total share-based compensation expense	$ 338	$ 280	$ 1,097	$ 885

(11.)EMPLOYEE BENEFIT PLANS

The components of the Company’s net periodic benefit expense for its pension and post-retirement obligations were as follows (in thousands):

	Three months ended September 30,		Nine months ended September 30,	
	2018	2017	2018	2017
Service cost	$ 836	$ 785	$ 2,509	$ 2,355
Interest cost on projected benefit obligation	598	613	1,793	1,840
Expected return on plan assets	(1,321)	(1,193)	(3,963)	(3,581)
Amortization of unrecognized prior service credit	(18)	(12)	(54)	(38)
Amortization of unrecognized net actuarial loss	188	291	563	874
Net periodic benefit expense	$ 283	$ 484	$ 848	$ 1,450

The net periodic benefit expense is recorded as a component of salaries and employee benefits in the consolidated statements of income. 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 the Internal Revenue Code. The Company has no minimum required contribution for the 2018 fiscal year.

FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Unaudited)

(12.)COMMITMENTS AND CONTINGENCIES

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 consist of the following (in thousands):

	September 30, 2018	December 31, 2017
Commitments to extend credit	$ 664,138	$ 661,021
Standby letters of credit	12,707	12,181

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 which 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 $6.0 million and $566 thousand at September 30, 2018 and December 31, 2017, respectively. 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.

(13.)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. There have been no changes in the valuation techniques used during the current period. 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.

Transfers between levels of the fair value hierarchy are recorded as of the end of the reporting period.

FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Unaudited)

(13.)FAIR VALUE MEASUREMENTS (Continued)

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.

Derivative instruments: The fair value of derivative instruments is determined using quoted secondary market prices for similar financial instruments and are classified as Level 2 in the fair value hierarchy.

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.

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.

Commitments to extend credit and letters of credit: Commitments to extend credit and fund letters of credit are principally at current interest rates, and, therefore, the carrying amount approximates fair value. The fair value of commitments is not material.

FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Unaudited)

(13.)FAIR VALUE MEASUREMENTS (Continued)

Assets Measured at Fair Value

The following tables present 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 the dates indicated (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
September 30, 2018				
Measured on a recurring basis:				
Securities available for sale:				
U.S. Government agency and government sponsored enterprises	$ —	$ 151,809	$ —	$ 151,809
Mortgage-backed securities	—	306,501	—	306,501
Other assets:				
Hedging derivative instruments	—	1,305	—	1,305
Fair value adjusted through comprehensive income	$ —	$ 459,615	$ —	$ 459,615
Other assets:				
Derivative instruments - interest rate products	$ —	$ 298	$ —	$ 298
Other liabilities:				
Derivative instruments - credit contracts	—	(8)	—	(8)
Derivative instruments - interest rate products	—	(348)	—	(348)
Fair value adjusted through net income	$ —	$ (58)	$ —	$ (58)
Measured on a nonrecurring basis:				
Loans:				
Loans held for sale	$ —	$ 3,166	$ —	$ 3,166
Collateral dependent impaired loans	—	—	3,810	3,810
Other assets:				

Loan servicing rights	—	—	999	999
Other real estate owned	—	—	290	290
Total	$ —	$ 3,166	$ 5,099	$ 8,265
December 31, 2017				
Measured on a recurring basis:				
Securities available for sale:				
U.S. Government agency and government sponsored enterprises	$ —	$ 161,889	$ —	$ 161,889
Mortgage-backed securities	—	363,084	—	363,084
Fair value adjusted through comprehensive income	$ —	$ 524,973	$ —	$ 524,973
Other liabilities:				
Derivative instruments - credit contracts	$ —	$ 4	$ —	$ 4
Fair value adjusted through net income	$ —	$ 4	$ —	$ 4
Measured on a nonrecurring basis:				
Loans:				
Loans held for sale	$ —	$ 2,718	$ —	$ 2,718
Collateral dependent impaired loans	—	—	3,847	3,847
Other assets:				
Loan servicing rights	—	—	990	990
Other real estate owned	—	—	148	148
Total	$ —	$ 2,718	$ 4,985	$ 7,703

FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Unaudited)

(13.)FAIR VALUE MEASUREMENTS (Continued)

There were no transfers between Levels 1 and 2 during the nine months ended September 30, 2018 and 2017. There were no liabilities measured at fair value on a nonrecurring basis during the nine months ended September 30, 2018 and 2017.

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	$3,810	Appraisal of collateral (1)	Appraisal adjustments (2)	10% - 50% discount
Loan servicing rights	999	Discounted cash flow	Discount rate	10.3% (3)
			Constant prepayment rate	12.8% (3)
Other real estate owned	290	Appraisal of collateral (1)	Appraisal adjustments (2)	26% - 44% 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 or during the nine months ended September 30, 2018.

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, Federal Home Loan Bank ("FHLB") and Federal Reserve Bank ("FRB") stock, accrued interest receivable, non-maturity deposits, short-term borrowings and accrued interest payable.

FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Unaudited)

(13.)FAIR VALUE MEASUREMENTS (Continued)

The following presents (in thousands) the carrying amount, estimated fair value, and placement in the fair value measurement hierarchy of the Company's financial instruments as of the dates indicated.

	Level in Fair Value Measurement Hierarchy	September 30, 2018		December 31, 2017	
		Carrying Amount	Estimated Fair Value	Carrying Amount	Estimated Fair Value
Financial assets:					
Cash and cash equivalents	Level 1	$117,331	$117,331	$99,195	$99,195
Securities available for sale	Level 2	458,310	458,310	524,973	524,973
Securities held to maturity	Level 2	459,623	447,718	516,466	512,983
Loans held for sale	Level 2	3,166	3,166	2,718	2,718
Loans	Level 2	2,950,566	2,904,727	2,696,498	2,660,936
Loans (1)	Level 3	3,810	3,810	3,847	3,847
Accrued interest receivable	Level 1	12,559	12,559	10,776	10,776
FHLB and FRB stock	Level 2	21,997	21,997	27,730	27,730
Derivative instruments – cash flow hedge	Level 2	1,305	1,305	—	—
Derivative instruments – interest rate products	Level 2	298	298	—	—
Financial liabilities:					
Non-maturity deposits	Level 1	2,447,974	2,447,974	2,358,018	2,358,018
Time deposits	Level 2	1,037,755	1,030,548	852,156	848,055
Short-term borrowings	Level 1	308,200	308,200	446,200	446,200
Long-term borrowings	Level 2	39,184	39,451	39,131	41,485
Accrued interest payable	Level 1	9,008	9,008	8,038	8,038
Derivative instruments – credit contracts	Level 2	8	8	4	4
Derivative instruments – interest rate products	Level 2	348	348	—	—

(1) Comprised of collateral dependent impaired loans.

FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Unaudited)

(14.)SEGMENT REPORTING

The Company has two reportable segments: Banking and Non-Banking. These reportable segments have been identified and organized based on the nature of the underlying products and services applicable to each segment, the type of customers to whom those products and services are offered and the distribution channel through which those products and services are made available.

The Banking segment includes all of the Company's retail and commercial banking operations. The Non-Banking segment includes the activities of SDN, a full-service insurance agency that provides a broad range of insurance services to both personal and business clients, and Courier Capital and HNP Capital, our investment advisor and wealth management firms that provide customized investment management, investment consulting and retirement plan services to individuals, businesses, institutions, foundations and retirement plans. Holding company amounts are the primary differences between segment amounts and consolidated totals and are reflected in the Holding Company and Other column below, along with amounts to eliminate balances and transactions between segments.

The following tables present information regarding our business segments as of and for the periods indicated (in thousands).

	Banking	Non-Banking	Holding Company and Other	Consolidated Totals
September 30, 2018				
Goodwill	$48,536	$ 19,876	$ —	$ 68,412
Other intangible assets, net	249	10,192	—	10,441
Total assets	4,221,168	37,389	(172)	4,258,385
December 31, 2017				
Goodwill	$48,536	$ 17,304	$ —	$ 65,840
Other intangible assets, net	373	8,490	—	8,863
Total assets	4,069,086	31,466	4,658	4,105,210

	Banking	Non-Banking (1)	Holding Company and Other	Consolidated Totals
Three months ended September 30, 2018				

Net interest income (expense)	$31,438	$ —	$ (617)	$ 30,821
Provision for loan losses	(2,061)	—	—	(2,061)
Noninterest income	6,949	3,118	(169)	9,898
Noninterest expense	(22,050)	(2,832)	(639)	(25,521)
Income (loss) before income taxes	14,276	286	(1,425)	13,137
Income tax (expense) benefit	(2,797)	(76)	313	(2,560)
Net income (loss)	$11,479	$ 210	$ (1,112)	$ 10,577
Nine months ended September 30, 2018				
Net interest income (expense)	$92,387	$ —	$ (1,853)	$ 90,534
Provision for loan losses	(5,050)	—	—	(5,050)
Noninterest income	19,754	8,127	(450)	27,431
Noninterest expense	(62,710)	(7,647)	(2,716)	(73,073)
Income (loss) before income taxes	44,381	480	(5,019)	39,842
Income tax (expense) benefit	(8,933)	(127)	1,253	(7,807)
Net income (loss)	$35,448	$ 353	$ (3,766)	$ 32,035

(1) Reflects activity from the acquisition of HNP Capital since June 1, 2018 (the date of acquisition).

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FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Unaudited)

(14.)SEGMENT REPORTING (Continued)

	Banking	Non-Banking (2)	Holding Company and Other	Consolidated Totals
Three months ended September 30, 2017				
Net interest income (expense)	$29,056	$ —	$ (618)	$ 28,438
Provision for loan losses	(2,802)	—	—	(2,802)
Noninterest income	6,410	2,315	(151)	8,574
Noninterest expense	(19,939)	(1,947)	(581)	(22,467)
Income (loss) before income taxes	12,725	368	(1,350)	11,743
Income tax (expense) benefit	(3,923)	(144)	603	(3,464)
Net income (loss)	$8,802	$ 224	$ (747)	$ 8,279
Nine months ended September 30, 2017				
Net interest income (expense)	$84,708	$ —	$ (1,853)	$ 82,855
Provision for loan losses	(9,415)	—	—	(9,415)
Noninterest income	18,203	6,760	780	25,743
Noninterest expense	(58,263)	(7,209)	(1,878)	(67,350)
Income (loss) before income taxes	35,233	(449)	(2,951)	31,833
Income tax (expense) benefit	(10,544)	(440)	1,619	(9,365)
Net income (loss)	$24,689	$ (889)	$ (1,332)	$ 22,468

(2) Reflects activity from the acquisition of the assets of Robshaw & Julian since August 31, 2017 (the date of acquisition).

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

This Quarterly Report on Form 10-Q should be read in conjunction with the more detailed and comprehensive disclosures included in our Annual Report on Form 10-K for the year ended December 31, 2017. In addition, please read this section in conjunction with our Consolidated Financial Statements and Notes to Consolidated Financial Statements contained herein.

FORWARD LOOKING INFORMATION

Statements and financial analysis contained in this Quarterly Report on Form 10-Q that are based on other than historical data are forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. Forward-looking statements provide current expectations or forecasts of future events and include, among others:

- statements with respect to the beliefs, plans, objectives, goals, guidelines, expectations, anticipations, and future financial condition, results of operations and performance of Financial Institutions, Inc. (the "Parent") and its subsidiaries (collectively, the "Company," "we," "our" or "us"); and
- statements preceded by, followed by or that include the words "may," "could," "should," "would," "believe," "anticipate," "estimate," "expect," "intend," "plan," "projects," or similar expressions.

These forward-looking statements are not guarantees of future performance, nor should they be relied upon as representing management's views as of any subsequent date. Forward-looking statements involve significant risks and uncertainties and actual results may differ materially from those presented, either expressed or implied, in this Quarterly Report on Form 10-Q and our Annual Report on Form 10-K for the fiscal year ended December 31, 2017 (the "Form 10-K"), including, but not limited to, those presented in the Management's Discussion and Analysis of Financial Condition and Results of Operations. Factors that might cause such material differences include, but are not limited to:

- If we experience greater credit losses than anticipated, earnings may be adversely impacted;
- Our tax strategies and the value of our deferred tax assets and liabilities could adversely affect our operating results and regulatory capital ratios;
- Geographic concentration may unfavorably impact our operations;
- We depend on the accuracy and completeness of information about or from customers and counterparties;
- Our insurance brokerage subsidiary is subject to risk related to the insurance industry;
- Our investment advisory and wealth management operations are subject to risk related to the financial services industry;
- We may be unable to successfully implement our growth strategies, including the integration and successful management of newly-acquired businesses;
- We are subject to environmental liability risk associated with our lending activities;
- Our commercial business and mortgage loans increase our exposure to credit risks;
- Our indirect lending involves risk elements in addition to normal credit risk;
- We accept deposits that do not have a fixed term and which may be withdrawn by the customer at any time for any reason;
- Any future FDIC insurance premium increases may adversely affect our earnings;
- We are highly regulated and any adverse regulatory action may result in additional costs, loss of business opportunities, and reputational damage;
- We make certain assumptions and estimates in preparing our financial statements that may prove to be incorrect, which could significantly impact our results of operations, cash flows and financial condition, and we are subject to

new or changing accounting rules and interpretations, and the failure by us to correctly interpret or apply these evolving rules and interpretations could have a material adverse effect;

- Legal and regulatory proceedings and related matters could adversely affect us;
- A breach in security of our or third-party information systems, including the occurrence of a cyber incident or a deficiency in cybersecurity, or a failure by us to comply with New York State cybersecurity regulations, may subject us to liability, result in a loss of customer business or damage our brand image;
- We face competition in staying current with technological changes to compete and meet customer demands;
- We rely on other companies to provide key components of our business infrastructure;
- We use financial models for business planning purposes that may not adequately predict future results;
- We may not be able to attract and retain skilled people;

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MANAGEMENT'S DISCUSSION AND ANALYSIS

- Acquisitions may disrupt our business and dilute shareholder value;
- We are subject to interest rate risk;
- Our business may be adversely affected by conditions in the financial markets and economic conditions generally;
- The policies of the Federal Reserve have a significant impact on our earnings;
- The soundness of other financial institutions could adversely affect us;
- The value of our goodwill and other intangible assets may decline in the future;
- We operate in a highly competitive industry and market area;
- Severe weather, natural disasters, acts of war or terrorism, and other external events could significantly impact our business;
- Liquidity is essential to our businesses;
- We may need to raise additional capital in the future and such capital may not be available on acceptable terms or at all;
- We rely on dividends from our subsidiaries for most of our revenue;
- We may not pay or may reduce the dividends on our common stock;
- We may issue debt and equity securities or securities convertible into equity securities, any of which may be senior to our common stock as to distributions and in liquidation, which could dilute our current shareholders or negatively affect the value of our common stock;
- Our certificate of incorporation, our bylaws, and certain banking laws may have an anti-takeover effect; and
- The market price of our common stock may fluctuate significantly in response to a number of factors.

We caution readers not to place undue reliance on any forward-looking statements, which speak only as of the date made, and advise readers that various factors, including those described above, could affect our financial performance and could cause our actual results or circumstances for future periods to differ materially from those anticipated or projected. See also Item 1A, Risk Factors, in the Form 10-K for further information. Except as required by law, we do not undertake, and specifically disclaim any obligation to publicly release any revisions to any forward-looking statements to reflect the occurrence of anticipated or unanticipated events or circumstances after the date of such statements.

GENERAL

The Parent is a financial holding company headquartered in New York State, providing diversified financial services through its subsidiaries, Five Star Bank (the "Bank"), Scott Danahy Naylon, LLC ("SDN"), Courier Capital, LLC ("Courier Capital") and HNP Capital, LLC ("HNP Capital"). The Company offers a broad array of deposit, lending and other financial services to individuals, municipalities and businesses in Western and Central New York through its wholly-owned New York-chartered banking subsidiary, the Bank. Our indirect lending network includes relationships with franchised automobile dealers in Western and Central New York, the Capital District of New York and Northern and Central Pennsylvania. SDN provides a broad range of insurance services to personal and business clients across 45 states. Courier Capital and HNP Capital provide customized investment management, investment consulting and retirement plan services to individuals, businesses, institutions, foundations and retirement plans.

Our primary sources of revenue are net interest income (interest earned on our loans and securities, net of interest paid on deposits and other funding sources) and noninterest income, particularly fees and other revenue from insurance, investment advisory and financial services provided to customers or ancillary services tied to loans and deposits. Business volumes and pricing drive revenue potential, and tend to be influenced by overall economic factors, including market interest rates, business spending, consumer confidence, economic growth, and competitive

conditions within the marketplace. We are not able to predict market interest rate fluctuations with certainty and our asset/liability management strategy may not prevent interest rate changes from having a material adverse effect on our results of operations and financial condition.

Our business strategy has been to maintain a community bank philosophy, which consists of focusing on and understanding the individualized banking and other financial needs of individuals, municipalities and businesses of the local communities surrounding our primary service area. We believe this focus allows us to be more responsive to our customers' needs and provide a high level of personal service that differentiates us from larger competitors, resulting in long-standing and broad-based banking relationships. Our core customers are primarily small- to medium-sized businesses, individuals and community organizations who prefer to build banking, insurance and wealth management relationships with a community bank that combines high quality, competitively-priced products and services with personalized service. Because of our identity and origin as a locally operated bank, we believe that our level of personal service provides a competitive advantage over larger banks, which tend to consolidate decision-making authority outside local communities.

A key aspect of our current business strategy is to foster a community-oriented culture where our customers and employees establish long-standing and mutually beneficial relationships. We believe that we are well-positioned to be a strong competitor within our market area because of our focus on community banking needs and customer service, our comprehensive suite of deposit, loan, insurance and wealth management

products typically found at larger banks, our highly experienced management team and our strategically located banking centers. We believe that the foregoing factors all help to grow our core deposits, which supports a central element of our business strategy - the growth of a diversified and high-quality loan portfolio.

EXECUTIVE OVERVIEW

Summary of 2018 Third Quarter Results

Net income increased $2.3 million, or 28%, to $10.6 million for the third quarter of 2018 compared to $8.3 million for the third quarter of 2017. Net income available to common shareholders for the third quarter of 2018 was $10.2 million, or $0.64 per diluted share, compared with $7.9 million, or $0.52 per diluted share, for the third quarter of last year. Return on average common equity was 10.82% and return on average assets was 1.00% for the third quarter of 2018 compared to 9.21% and 0.83%, respectively, for the third quarter of 2017.

Net interest income totaled $30.8 million in the third quarter of 2018, up from $28.4 million in the third quarter of 2017 and the increase was driven by growth in interest-earning assets. Average interest-earning assets were up $231.9 million, led by a $374.3 million increase in average loans in the third quarter of 2018 compared to the same quarter in 2017.

The provision for loan losses was $2.1 million in the third quarter of 2018 compared to $2.8 million in the third quarter of 2017. Net charge-offs during the recent quarter were $2.1 million, up from $1.6 million in the third quarter of 2017. Net charge-offs expressed as an annualized percentage of average loans outstanding were 0.28% during the third quarter of 2018 compared with 0.25% in the third quarter of 2017. See the "Allowance for Loan Losses" and "Non-Performing Assets and Potential Problem Loans" sections of this Management's Discussion and Analysis for further discussion regarding the decrease in the provision for loan losses and the increase in net-charge-offs.

Noninterest income totaled $9.9 million in the third quarter of 2018, compared to $8.6 million in the third quarter of 2017. The increase is primarily attributed to increases in investment advisory income, income from investments in limited partnerships, net gain on sale of loans held for sale and net gain on derivative instruments. Investment advisory income was $2.2 million in the third quarter of 2018, $748 thousand higher than the third quarter of 2017. The increase was primarily driven by the HNP Capital acquisition, the third quarter of 2017 acquisition of the assets of Robshaw & Julian and growth in assets under management at Courier Capital. Income from investments in limited partnerships was $342 thousand higher in the third quarter of 2018, compared to the third quarter of 2017. Income from these investments fluctuate based on the maturity and performance of the underlying investments. The increases in net gain on sale of loans held for sale and net gain on derivative instruments was driven by an increase in the number and value of transactions executed in the quarter.

Noninterest expense in the third quarter of 2018 totaled $25.5 million compared with $22.5 million in the third quarter of 2017. The increase in noninterest expense was primarily the result of increases in salaries and employee benefits, occupancy and equipment, professional services and advertising and promotions expenses. The increase in salaries and employee benefits was a result of investments in Bank personnel and the two wealth management subsidiary acquisitions. The increase in occupancy and equipment was primarily the result of investments in software and facilities. The increase in professional services expense was primarily related to a shelf registration statement filed in August 2018 and professional search services related to the addition of talent. The increase in advertising and promotions expense was related to the Five Star Bank brand campaign that was launched in February 2018.

The regulatory Common Equity Tier 1 Ratio and Total Risk-Based Capital Ratio were 9.81%, and 12.58%, respectively, for the third quarter of 2018. See the "Liquidity and Capital Management" section of this Management's Discussion and Analysis for further discussion regarding regulatory capital and the Basel III capital rules.

RESULTS OF OPERATIONS

Net Interest Income and Net Interest Margin

Net interest income is our primary source of revenue, comprising 77% of revenue during the nine months ended September 30, 2018. Net interest income is the difference between interest income on interest-earning assets, such as loans and investment securities, and the interest expense on interest-bearing deposits and other borrowings used to fund interest-earning and other assets or activities. Net interest income is affected by changes in interest rates and by the amount and composition of earning assets and interest-bearing liabilities, as well as the sensitivity of the balance sheet to changes in interest rates, including characteristics such as the fixed or variable nature of the financial instruments, contractual maturities and repricing frequencies.

MANAGEMENT’S DISCUSSION AND ANALYSIS

We use interest rate spread and net interest margin to measure and explain changes in net interest income. Interest rate spread is the difference between the yield on earning assets and the rate paid for interest-bearing liabilities that fund those assets. The net interest margin is expressed as the percentage of net interest income to average earning assets. The net interest margin exceeds the interest rate spread because noninterest-bearing sources of funds (“net free funds”), principally noninterest-bearing demand deposits and stockholders’ equity, also support earning assets. To compare tax-exempt asset yields to taxable yields, the yield on tax-exempt investment securities is computed on a taxable equivalent basis. Net interest income, interest rate spread, and net interest margin are discussed on a taxable equivalent basis.

The following table reconciles interest income per the consolidated statements of income to interest income adjusted to a fully taxable equivalent basis (dollars in thousands):

	Three months ended		Nine months ended	
	September 30,		September 30,	
	2018	2017	2018	2017
Interest income per consolidated statements of income	$ 39,035	$ 33,396	$ 111,306	$ 95,343
Adjustment to fully taxable equivalent basis	320	776	1,045	2,395
Interest income adjusted to a fully taxable equivalent basis	39,355	34,172	112,351	97,738
Interest expense per consolidated statements of income	8,214	4,958	20,772	12,488
Net interest income on a taxable equivalent basis	$ 31,141	$ 29,214	$ 91,579	$ 85,250

Analysis of Net Interest Income for the Three Months Ended September 30, 2018 and 2017

Net interest income on a taxable equivalent basis for the three months ended September 30, 2018, was $31.1 million, an increase of $1.9 million versus the comparable quarter last year of $29.2 million. The increase in net interest income was due to an increase in average earning assets of $231.9 million or 6% compared to the third quarter of 2017.

The net interest margin for the third quarter of 2018 was 3.18%, one-basis point higher than 3.17% for the same period in 2017. This comparable period increase was a function of a ten-basis point higher contribution from net free funds, partially offset by a nine-basis point decrease in interest rate spread. The lower interest rate spread was a result of a 30-basis point increase in the yield on average interest-earning assets and a 39-basis point increase in the cost of average interest-bearing liabilities.

For the third quarter of 2018, the yield on average earning assets of 4.01% was 30 basis points higher than the third quarter of 2017 of 3.71%. Loan yields increased 31 basis points during the third quarter of 2018 to 4.55% from 4.24%. The yield on investment securities decreased ten basis points during the third quarter of 2018 to 2.35% from 2.45%. Overall, the earning asset rate changes increased interest income by $1.8 million during the third quarter of 2018 and a favorable volume variance increased interest income by $3.4 million, which collectively drove a $5.2 million increase in interest income.

Average interest-earning assets were $3.90 billion for the third quarter 2018 compared to $3.67 billion for the third quarter of 2017, an increase of $231.9 million or 6% from the comparable quarter last year, with average loans up $374.3 million from $2.57 billion to $2.95 billion and average securities down $142.3 million from $1.10 billion to $954.0 million. The growth in average loans reflected increases in most loan categories. Commercial loans, in particular, were up $257.3 million from $1.16 billion to $1.42 billion or 22% from the third quarter of 2017. Loans represented 75.5% of average interest-earning assets during the third quarter of 2018 compared to 70.1% during the third quarter of 2017. The increase in the volume of average loans resulted in a $4.3 million increase in interest income, in addition to a $2.0 million increase due to the favorable rate variance. Securities represented 24.5% of average interest-earning assets during third quarter of 2018 compared to 29.9% during the third quarter of 2017. The decrease in the volume of average securities resulted in a $872 thousand decrease in interest income, in addition to a $242 thousand decrease due to the unfavorable rate variance.

The cost of average interest-bearing liabilities of 1.07% in the third quarter of 2018 compared to 0.68% in the third quarter of 2017 was 39-basis points higher than the third quarter of 2017. The cost of average interest-bearing deposits increased 30 basis points from 0.50% to 0.80% and the cost of short-term borrowings increased 95 basis points from 1.29% to 2.24% in the third quarter of 2018 compared to the same quarter of 2017. The increase in the cost of short-term borrowings was a result of increases in the federal funds rate. The cost of long-term borrowings for the third quarter of 2018 decreased one basis point from 6.32% to 6.31% in the third quarter of 2018 compared to the same quarter of 2017. Overall, interest-bearing liability rate and volume increases resulted in $3.3 million of higher interest expense.

MANAGEMENT'S DISCUSSION AND ANALYSIS

Average interest-bearing liabilities of $3.04 billion in the third quarter of 2018 were $146.0 million or 5% higher than the third quarter of 2017. On average, interest-bearing deposits grew $100.8 million from $2.47 billion to $2.57 billion, while noninterest-bearing demand deposits (a principal component of net free funds) were up $51.7 million from $679.3 million to $731.0 million. The increase in average deposits was due to successful business development efforts in municipal and retail banking, and an increase in deposits from our Certificate of Deposit Account Registry Service ("CDARS") and Insured Cash Sweep ("ICS") programs. For further discussion of the CDARS and ICS programs, refer to the "Funding Activities - Deposits" section of this Management's Discussion and Analysis. Overall, interest-bearing deposit rate and volume changes resulted in $2.1 million of higher interest expense during the third quarter of 2018. Average borrowings increased $45.3 million from $424.6 million to $469.9 million compared to the third quarter of 2017. Overall, short and long-term borrowing rate and volume changes resulted in $1.2 million of higher interest expense during the third quarter of 2018.

Analysis of Net Interest Income for the Nine Months Ended September 30, 2018 and 2017

Net interest income on a taxable equivalent basis for the nine months ended September 30, 2018, was $91.6 million, an increase of $6.3 million versus the comparable period last year of $85.3 million. The increase in net interest income was due to an increase in average earning assets of $281.4 million or 8% compared to the first nine months of 2017.

The net interest margin for the first nine months of 2018 was 3.18%, one-basis point lower than 3.19% for the same period in 2017. The majority of the reduction in net interest margin was attributed to the lower tax-equivalent adjustment on tax-exempt securities as a result of the lower Federal corporate tax rate in 2018 due to the TCJ Act. This comparable period decrease was a function of a nine-basis point decrease in interest rate spread, partially offset by an eight-basis point higher contribution from net free funds. The lower interest rate spread was a result of a 24-basis point increase in the yield on average interest-earning assets and a 33-basis point increase in the cost of average interest-bearing liabilities.

For the first nine months of 2018, the yield on average earning assets of 3.90% was 24 basis points higher than the first nine months of 2017 of 3.66%. Loan yields increased 25 basis points during the first nine months of 2018 to 4.45% from 4.20%. The yield on investment securities decreased 13 basis points during the first nine months of 2018 to 2.33% from 2.46%. Overall, the earning asset rate changes increased interest income by $3.7 million during the first nine months of 2018 and a favorable volume variance increased interest income by $10.9 million, which collectively drove a $14.6 million increase in interest income.

Average interest-earning assets were $3.85 billion for the first nine months of 2018 compared to $3.57 billion for the first nine months of 2017, an increase of $281.4 million or 8% from the comparable period last year, with average loans up $380.5 million from $2.47 billion to $2.85 billion and average securities down $90.5 million from $1.09 billion to $1.00 billion. The growth in average loans reflected increases in most loan categories. Commercial loans, in particular, were up $242.6 million from $1.10 billion to $1.34 billion or 22% from the first nine months of 2017. Loans represented 74.0% of average interest-earning assets during first nine months of 2018 compared to 69.2% during the first nine months of 2017. The increase in the volume of average loans resulted in a $12.7 million increase in interest income, in addition to a $4.6 million increase due to the favorable rate variance. Securities represented 26.0% of average interest-earning assets during first nine months of 2018 compared to 30.6% during the first nine months of 2017. The decrease in the volume of average securities resulted in a $1.7 million decrease in

interest income, in addition to a $958 thousand decrease due to the unfavorable rate variance.

The cost of average interest-bearing liabilities of 0.92% in the first nine months of 2018 compared to 0.59% in the first nine months of 2017 was 33 basis points higher than the first nine months of 2017. The cost of average interest-bearing deposits increased 24 basis points from 0.43% to 0.67% and the cost of short-term borrowings increased 89 basis points from 1.09% to 1.98% in the first nine months of 2018 compared to the same period of 2017. The increase in the cost of short-term borrowings was a result of increases in the federal funds rate. The cost of long-term borrowings for the first nine months of 2018 decreased one basis point from 6.32% to 6.31% in the first nine months of 2018 compared to the same period of 2017. Overall, interest-bearing liability rate and volume increases resulted in $8.3 million of higher interest expense.

Average interest-bearing liabilities of $3.02 billion in the first nine months of 2018 were $196.7 million or 7% higher than the first nine months of 2017. On average, interest-bearing deposits grew $134.3 million from $2.44 billion to $2.58 billion, while noninterest-bearing demand deposits (a principal component of net free funds) were up $41.0 million from $665.2 million to $706.2 million. The increase in average deposits was due to successful business development efforts in municipal and retail banking, and an increase in deposits from our CDARS and ICS programs. For further discussion of the CDARS and ICS programs, refer to the “Funding Activities - Deposits” section of this Management’s Discussion and Analysis. Overall, interest-bearing deposit rate and volume changes resulted in $5.1 million of higher interest expense during the first nine months of 2018. Average borrowings increased $62.3 million from $384.7 million to $447.1 million compared to the first nine months of 2017. Overall, short and long-term borrowing rate and volume changes resulted in $3.2 million of higher interest expense during the first nine months of 2018.

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MANAGEMENT'S DISCUSSION AND ANALYSIS

The following table sets forth certain information relating to the consolidated balance sheets and reflects the average yields earned on interest-earning assets, as well as the average rates paid on interest-bearing liabilities for the periods indicated (in thousands).

	Three months ended September 30,					
	2018			2017		
	Average Balance	Interest	Average Rate	Average Balance	Interest	Average Rate
Interest-earning assets:						
Federal funds sold and interest-earning deposits	$—	$2	0.00 %	$—	$—	0.00 %
Investment securities (1):						
Taxable	708,005	4,080	2.31	803,814	4,501	2.24
Tax-exempt (2)	246,022	1,523	2.48	292,560	2,216	3.03
Total investment securities	954,027	5,603	2.35	1,096,374	6,717	2.45
Loans:						
Commercial business	519,114	6,590	5.04	405,308	4,586	4.49
Commercial mortgage	896,159	11,275	4.99	752,634	8,876	4.68
Residential real estate loans	498,371	4,769	3.83	438,436	4,080	3.72
Residential real estate lines	111,762	1,358	4.82	117,597	1,241	4.19
Consumer indirect	904,480	9,239	4.05	841,081	8,145	3.84
Other consumer	16,633	519	12.36	17,184	527	12.17
Total loans	2,946,519	33,750	4.55	2,572,240	27,455	4.24
Total interest-earning assets	3,900,546	39,355	4.01	3,668,614	34,172	3.71
Less: Allowance for loan losses	(34,833)			(33,740)		
Other noninterest-earning assets	321,825			316,128		
Total assets	$4,187,538			$3,951,002		
Interest-bearing liabilities:						
Deposits:						
Interest-bearing demand	$642,234	302	0.19 %	$612,401	224	0.14 %
Savings and money market	978,578	819	0.33	998,769	386	0.15
Time deposits	946,499	4,042	1.69	855,371	2,479	1.15
Total interest-bearing deposits	2,567,311	5,163	0.80	2,466,541	3,089	0.50
Short-term borrowings	430,697	2,434	2.24	385,512	1,251	1.29
Long-term borrowings	39,174	617	6.31	39,103	618	6.32
Total borrowings	469,871	3,051	2.58	424,615	1,869	1.75
Total interest-bearing liabilities	3,037,182	8,214	1.07	2,891,156	4,958	0.68
Noninterest-bearing demand deposits	730,960			679,303		
Other noninterest-bearing liabilities	27,585			22,226		
Shareholders' equity	391,811			358,317		
Total liabilities and shareholders' equity	$4,187,538			$3,951,002		
Net interest income (tax-equivalent)		$31,141			$29,214	

Interest rate spread		2.94 %		3.03 %
Net earning assets	$863,364		$777,458	
Net interest margin (tax-equivalent)		3.18 %		3.17 %
Ratio of average interest-earning assets to average interest-bearing liabilities		128.43 %		126.89 %

(1) Investment securities are shown at amortized cost.
(2) The interest on tax-exempt securities is calculated on a tax equivalent basis assuming a Federal tax rate of 21% and 35% for the three-month periods ended September 30, 2018 and 2017, respectively.

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MANAGEMENT'S DISCUSSION AND ANALYSIS

	Nine months ended September 30, 2018				2017			
	Average Balance	Interest	Average Rate		Average Balance	Interest	Average Rate	
Interest-earning assets:								
Federal funds sold and interest-earning deposits	$220	$6	3.56	%	$8,869	$67	1.02	%
Investment securities (1):								
Taxable	733,232	12,518	2.28		790,407	13,287	2.24	
Tax-exempt (2)	267,040	4,976	2.48		300,318	6,844	3.04	
Total investment securities	1,000,272	17,494	2.33		1,090,725	20,131	2.46	
Loans:								
Commercial business	484,711	17,657	4.87		385,025	12,522	4.35	
Commercial mortgage	853,571	31,443	4.93		710,690	24,761	4.66	
Residential real estate loans	484,288	13,705	3.77		432,838	12,157	3.74	
Residential real estate lines	113,761	3,920	4.61		119,493	3,611	4.04	
Consumer indirect	896,493	26,590	3.97		804,051	22,962	3.82	
Other consumer	16,685	1,536	12.31		16,941	1,527	12.05	
Total loans	2,849,509	94,851	4.45		2,469,038	77,540	4.20	
Total interest-earning assets	3,850,001	112,351	3.90		3,568,632	97,738	3.66	
Less: Allowance for loan losses	(35,630)				(32,325)			
Other noninterest-earning assets	324,967				315,283			
Total assets	$4,139,338				$3,851,590			
Interest-bearing liabilities:								
Deposits:								
Interest-bearing demand	$663,827	$732	0.15	%	$632,596	$667	0.14	%
Savings and money market	1,007,734	1,930	0.26		1,027,927	1,073	0.14	
Time deposits	903,645	10,210	1.51		780,374	6,080	1.04	
Total interest-bearing deposits	2,575,206	12,872	0.67		2,440,897	7,820	0.43	
Short-term borrowings	407,903	6,047	1.98		345,637	2,815	1.09	
Long-term borrowings	39,156	1,853	6.31		39,085	1,853	6.32	
Total borrowings	447,059	7,900	2.36		384,722	4,668	1.62	
Total interest-bearing liabilities	3,022,265	20,772	0.92		2,825,619	12,488	0.59	
Noninterest-bearing demand deposits	706,222				665,221			
Other noninterest-bearing liabilities	25,167				20,954			
Shareholders' equity	385,684				339,796			
Total liabilities and shareholders' equity	$4,139,338				$3,851,590			
Net interest income (tax-equivalent)		$91,579				$85,250		
Interest rate spread			2.98	%			3.07	%
Net earning assets	$827,736				$743,013			

Net interest margin (tax-equivalent)	3.18 %	3.19 %
Ratio of average interest-earning assets to average interest-bearing liabilities	127.39 %	126.30 %

(1) Investment securities are shown at amortized cost.
(2) The interest on tax-exempt securities is calculated on a tax equivalent basis assuming a Federal tax rate of 21% and 35% for the nine-month periods ended September 30, 2018 and 2017, respectively.

MANAGEMENT'S DISCUSSION AND ANALYSIS

The following table presents, on a tax equivalent basis, the relative contribution of changes in volumes and changes in rates to changes in net interest income for the periods indicated. The change in interest income not solely due to changes in volume or rate has been allocated in proportion to the absolute dollar amounts of the change in each (in thousands):

	Three months ended September 30, 2018 vs. 2017			Nine months ended September 30, 2018 vs. 2017		
Increase (decrease) in:	Volume	Rate	Total	Volume	Rate	Total
Interest income:						
Federal funds sold and interest-earning deposits	$2	$—	$2	$(111)	$50	$(61)
Investment securities:						
Taxable	(549)	128	(421)	(973)	204	(769)
Tax-exempt	(323)	(370)	(693)	(706)	(1,162)	(1,868)
Total investment securities	(872)	(242)	(1,114)	(1,679)	(958)	(2,637)
Loans:						
Commercial business	1,397	607	2,004	3,508	1,627	5,135
Commercial mortgage	1,777	622	2,399	5,200	1,482	6,682
Residential real estate loans	571	118	689	1,455	93	1,548
Residential real estate lines	(64)	181	117	(179)	488	309
Consumer indirect	634	460	1,094	2,716	912	3,628
Other consumer	(17)	9	(8)	(23)	32	9
Total loans	4,298	1,997	6,295	12,677	4,634	17,311
Total interest income	3,428	1,755	5,183	10,887	3,726	14,613
Interest expense:						
Deposits:						
Interest-bearing demand	11	67	78	34	31	65
Savings and money market	(8)	441	433	(21)	878	857
Time deposits	287	1,276	1,563	1,072	3,058	4,130
Total interest-bearing deposits	290	1,784	2,074	1,085	3,967	5,052
Short-term borrowings	162	1,021	1,183	582	2,650	3,232
Long-term borrowings	1	(2)	(1)	3	(3)	—
Total borrowings	163	1,019	1,182	585	2,647	3,232
Total interest expense	453	2,803	3,256	1,670	6,614	8,284
Net interest income	$2,975	$(1,048)	$1,927	$9,217	$(2,888)	$6,329

Provision for Loan Losses

The provision for loan losses is based upon credit loss experience, growth or contraction of specific segments of the loan portfolio, and the estimate of losses inherent in the current loan portfolio. The provision for loan losses for the three and nine months ended September 30, 2018 was $2.1 million and $5.1 million, respectively, compared to $2.8

million and $9.4 million for the corresponding periods in 2017. The decrease in provision is the result of a combination of factors which include lower historical net charge-off experience, an increase in the collateral values supporting impaired loans, and improved qualitative factors which include but are not limited to: national and local economic trends and conditions, the regulatory environment and levels and trends in delinquent and non-accruing loans.

See the "Allowance for Loan Losses" and "Non-Performing Assets and Potential Problem Loans" sections of this Management's Discussion and Analysis for further discussion.

MANAGEMENT'S DISCUSSION AND ANALYSIS

Noninterest Income

The following table details the major categories of noninterest income for the periods presented (in thousands):

	Three months ended September 30,		Nine months ended September 30,	
	2018	2017	2018	2017
Service charges on deposits	$ 1,813	$ 1,901	$ 5,254	$ 5,486
Insurance income	1,501	1,488	3,918	4,052
ATM and debit card	1,557	1,445	4,509	4,230
Investment advisory	2,245	1,497	5,934	4,357
Company owned life insurance	440	449	1,333	1,367
Investments in limited partnerships	328	(14)	1,019	91
Loan servicing	78	105	396	348
Net gain on sale of loans held for sale	303	150	530	270
Net (loss) gain on investment securities	(95)	184	(88)	600
Net gain on derivative instruments	354	127	606	127
Net gain on other assets	37	21	49	25
Contingent consideration liability adjustment	—	—	—	1,200
Other	1,337	1,221	3,971	3,590
Total noninterest income	$ 9,898	$ 8,574	$ 27,431	$ 25,743

Insurance income for the nine months ended September 30, 2018 decreased $134 thousand to $3.9 million compared to $4.1 million during the nine months ended September 30, 2017. The decrease was primarily the result of non-renewals in one of the agency's specialty lines of business during the second quarter of 2018. This negative impact was partially offset by new commercial business generated as a result of successful business development efforts and integration with the Bank.

Investment advisory income for the nine months ended September 30, 2018 increased $1.6 million to $5.9 million compared to $4.4 million during the nine months ended September 30, 2017, reflecting higher assets under management driven by the acquisition of the assets of Robshaw & Julian in the third quarter of 2017, the acquisition of HNP Capital in the second quarter of 2018 and growth in assets under management at Courier Capital.

We have investments in limited partnerships, primarily small business investment companies, and account for these investments under the equity method. The income (loss) from these equity method investments fluctuates based on the maturity and performance of the underlying investments.

During the first nine months of 2018, we recognized net losses on investment securities totaling $88 thousand from the sale of five agency securities and 21 mortgage-backed securities. During the first nine months of 2017, we recognized net gains on investment securities totaling $600 thousand from the sale of eleven agency securities and six mortgage-backed securities. The amount and timing of our sale of investment securities is dependent on several

factors, including our prudent efforts to realize gains while managing duration, premium and credit risk.

Net gain on derivative instruments primarily consists of income associated with interest rate swap products offered to commercial loan customers. The program was implemented in the third quarter of 2017. The net gain for the nine months ended September 30, 2018 increased $479 thousand to $606 thousand compared to $127 thousand during the nine months ended September 30, 2017, as a result of an increase in the number and value of transactions executed in 2018.

In the second quarter of 2017, we recognized a $1.2 million non-cash fair value adjustment of the contingent consideration liability related to the 2014 acquisition of SDN.

MANAGEMENT'S DISCUSSION AND ANALYSIS

Noninterest Expense

The following table details the major categories of noninterest expense for the periods presented (in thousands):

	Three months ended September 30,		Nine months ended September 30,	
	2018	2017	2018	2017
Salaries and employee benefits	$ 13,970	$ 12,348	$ 40,270	$ 35,703
Occupancy and equipment	4,337	4,087	12,911	12,235
Professional services	1,353	1,157	3,132	3,229
Computer and data processing	1,291	1,208	3,884	3,691
Supplies and postage	485	492	1,545	1,496
FDIC assessments	498	440	1,486	1,366
Advertising and promotions	949	344	2,647	1,451
Amortization of intangibles	334	288	927	876
Goodwill impairment	—	—	—	1,575
Other	2,304	2,103	6,271	5,728
Total noninterest expense	$ 25,521	$ 22,467	$ 73,073	$ 67,350

Salaries and employee benefits expense increased by $4.6 million to $40.3 million in the first nine months of 2018 compared to $35.7 million during the same period in 2017, primarily due to investments in Bank personnel, the acquisition of the assets of Robshaw & Julian in the third quarter of 2017 and the acquisition of HNP Capital in the second quarter of 2018.

Occupancy and equipment expense increased $676 thousand to $12.9 million in the first nine months of 2018 compared to $12.2 million during the same period in 2017, primarily as a result of investments in software and facilities.

Advertising and promotions expense increased $1.2 million to $2.6 million when comparing the first nine months of 2018 to the same period in 2017, as a result of the new Five Star Bank brand campaign launched in February 2018.

In the second quarter of 2017, we recognized a $1.6 million non-cash goodwill impairment charge related to the 2014 SDN acquisition.

Our efficiency ratio for the first nine months of 2018 was 61.36% compared with 61.01% for the first nine months of 2017. The higher efficiency ratio is a result of the higher noninterest expenses associated with our organic growth initiatives. The efficiency ratio is calculated by dividing total noninterest expense by net revenue, defined as the sum of tax-equivalent net interest income and noninterest income before net gains on investment securities. An increase in the efficiency ratio indicates that more resources are being utilized to generate the same volume of income, while a decrease indicates a more efficient allocation of resources. The efficiency ratio, a banking industry financial measure, is not required by GAAP. However, the efficiency ratio is used by management in its assessment of financial

performance specifically as it relates to noninterest expense control. Management also believes such information is useful to investors in evaluating Company performance.

Income Taxes

For the nine months ended September 30, 2018, we recorded income tax expense of $7.8 million, versus $9.4 million a year ago. The effective tax rates for the first nine months of 2018 and 2017 were 19.6% and 29.4%, respectively. The decrease in income tax expense and effective tax rate was primarily due to the lower federal corporate tax rate as a result of the TCJ Act. Effective tax rates are impacted by items of income and expense that are not subject to federal or state taxation. Our effective tax rates reflect the impact of these items, which include, but are not limited to, interest income from tax-exempt securities and earnings on company owned life insurance. In addition, our effective tax rate for 2018 and 2017 reflects the New York State tax benefit generated by our real estate investment trust.

MANAGEMENT'S DISCUSSION AND ANALYSIS

ANALYSIS OF FINANCIAL CONDITION

INVESTING ACTIVITIES

Investment Securities

The following table summarizes the composition of our investment securities portfolio as of the dates indicated (in thousands):

	Investment Securities Portfolio Composition			
	September 30, 2018		December 31, 2017	
	Amortized Cost	Fair Value	Amortized Cost	Fair Value
Securities available for sale:				
U.S. Government agency and government-sponsored enterprise securities	$157,786	$151,809	$163,025	$161,889
Mortgage-backed securities:				
Agency mortgage-backed securities	318,332	305,651	365,433	362,108
Non-Agency mortgage-backed securities	—	850	—	976
Total available for sale securities	476,118	458,310	528,458	524,973
Securities held to maturity:				
State and political subdivisions	241,637	239,964	283,557	285,212
Mortgage-backed securities	217,986	207,754	232,909	227,771
Total held to maturity securities	459,623	447,718	516,466	512,983
Total investment securities	$935,741	$906,028	$1,044,924	$1,037,956

The available for sale ("AFS") investment securities portfolio decreased $66.7 million from $525.0 million at December 31, 2017 to $458.3 million at September 30, 2018. The AFS portfolio had net unrealized losses totaling $17.8 million and $3.5 million at September 30, 2018 and December 31, 2017, respectively. The unrealized losses in the AFS portfolio were predominantly caused by changes in market interest rates. The fair value of most of the investment securities in the AFS portfolio fluctuates as market interest rates change.

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 September 30, 2018. 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. No tax-equivalent adjustments were made to the weighted average yields (dollars in thousands).

	Due in one year or less Cost	Yield	Due from one to five years Cost	Yield	Due after five years through ten years Cost	Yield	Due after ten years Cost	Yield	Total Cost	Yield
Available for sale debt securities:										
U.S. Government agencies and government-sponsored enterprises	$10,087	1.70%	$62,220	2.22%	$85,479	2.40%	$—	0.00%	$157,786	2.29%
Mortgage-backed securities	25,589	1.98	77,003	1.97	129,161	2.52	86,579	2.32	318,332	2.29
	35,676	1.90	139,223	2.08	214,640	2.47	86,579	2.32	476,118	2.29
Held to maturity debt securities:										
State and political subdivisions	49,829	2.21	148,276	2.15	43,532	1.80	—	—	241,637	2.10
Mortgage-backed securities	—	—	2,473	2.30	39,745	1.77	175,768	2.35	217,986	2.25
	49,829	2.21	150,749	2.15	83,277	1.79	175,768	2.35	459,623	2.17
Total investment securities	$85,505	2.08%	$289,972	2.12%	$297,917	2.28%	$262,347	2.34%	$935,741	2.23%

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MANAGEMENT'S DISCUSSION AND ANALYSIS

Impairment Assessment

We review investment securities on an ongoing basis for the presence of other than temporary impairment ("OTTI") with formal reviews performed quarterly. Declines in the fair value of held to maturity and available for sale 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 losses or the security is intended to be sold or will be required to be sold. The amount of the impairment related to non-credit related factors for available for sale securities is recognized in other comprehensive income. Evaluating whether the impairment of a debt security is other than temporary involves assessing i.) the intent to sell the debt security or ii.) the likelihood of being required to sell the security before the recovery of its amortized cost basis. In determining whether the OTTI includes a credit loss, we use our best estimate of the present value of cash flows expected to be collected from the debt security considering factors such as: a.) the length of time and the extent to which the fair value has been less than the amortized cost basis, b.) adverse conditions specifically related to the security, an industry, or a geographic area, c.) the historical and implied volatility of the fair value of the security, d.) the payment structure of the debt security and the likelihood of the issuer being able to make payments that increase in the future, e.) failure of the issuer of the security to make scheduled interest or principal payments, f.) any changes to the rating of the security by a rating agency, and g.) recoveries or additional declines in fair value subsequent to the balance sheet date. The assessment of whether OTTI exists involves a high degree of subjectivity and judgment and is based on the information available to management at a point in time. There were no securities deemed to be OTTI during the nine months ended September 30, 2018 and 2017.

LENDING ACTIVITIES

The following table summarizes the composition of our loan portfolio, excluding loans held for sale and including net unearned income and net deferred fees and costs, as of the dates indicated (in thousands).

	Loan Portfolio Composition			
	September 30, 2018		December 31, 2017	
	Amount	% of Total	Amount	% of Total
Commercial business	$537,942	18.0 %	$450,326	16.5 %
Commercial mortgage	905,011	30.3	808,908	29.6
Total commercial	1,442,953	48.3	1,259,234	46.1
Residential real estate loans	507,598	17.0	465,283	17.0
Residential real estate lines	111,204	3.7	116,309	4.3
Consumer indirect	909,434	30.4	876,570	32.0
Other consumer	17,142	0.6	17,621	0.6
Total consumer	1,545,378	51.7	1,475,783	53.9
Total loans	2,988,331	100.0%	2,735,017	100.0%
Less: Allowance for loan losses	33,955		34,672	
Total loans, net	$2,954,376		$2,700,345	

Total loans increased $253.3 million to $2.99 billion at September 30, 2018 from $2.74 billion at December 31, 2017. The increase in loans was attributable to our organic growth initiatives.

Commercial loans increased $183.7 million during the nine months ended September 30, 2018 and represented 48.3% of total loans as of September 30, 2018 as a result of our continued commercial business development efforts.

The consumer indirect portfolio totaled $909.4 million and represented 30.4% of total loans as of September 30, 2018. During the first nine months of 2018, we originated $297.1 million in indirect auto loans with a mix of approximately 39% new auto and 61% used auto. During the first nine months of 2017, we originated $334.9 million in indirect auto loans with a mix of approximately 42% new auto and 58% used auto. Our origination volumes and mix of new and used vehicles financed fluctuate depending on general market conditions.

Loans Held for Sale and Loan Servicing Rights

Loans held for sale (not included in the loan portfolio composition table) were entirely comprised of residential real estate loans and totaled $3.2 million and $2.7 million as of September 30, 2018 and December 31, 2017, respectively.

We sell certain qualifying newly originated or refinanced residential real estate loans on the secondary market. Residential real estate loans serviced for others, which are not included in the consolidated statements of financial condition, amounted to $167.6 million and $163.3 million as of September 30, 2018 and December 31, 2017, respectively.

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MANAGEMENT'S DISCUSSION AND ANALYSIS

Allowance for Loan Losses

The following table summarizes the activity in the allowance for loan losses for the periods indicated (in thousands).

	Loan Loss Analysis Three months ended September 30,		Nine months ended September 30,	
	2018	2017	2018	2017
Allowance for loan losses, beginning of period	$33,955	$33,159	$34,672	$30,934
Charge-offs:				
Commercial business	672	130	1,113	1,908
Commercial mortgage	113	—	117	10
Residential real estate loans	24	198	53	298
Residential real estate lines	23	21	124	64
Consumer indirect	2,474	2,330	8,089	7,343
Other consumer	301	230	969	620
Total charge-offs	3,607	2,909	10,465	10,243
Recoveries:				
Commercial business	241	86	438	332
Commercial mortgage	3	5	11	257
Residential real estate loans	8	37	140	85
Residential real estate lines	2	2	17	58
Consumer indirect	1,228	1,086	3,862	3,259
Other consumer	64	79	230	250
Total recoveries	1,546	1,295	4,698	4,241
Net charge-offs	2,061	1,614	5,767	6,002
Provision for loan losses	2,061	2,802	5,050	9,415
Allowance for loan losses, end of period	$33,955	$34,347	$33,955	$34,347
Net loan charge-offs to average loans (annualized)	0.28 %	0.25 %	0.27 %	0.33 %
Allowance for loan losses to total loans	1.14 %	1.31 %	1.14 %	1.31 %
Allowance for loan losses to non-performing loans	433 %	273 %	433 %	273 %

The allowance for loan losses represents the estimated amount of probable credit losses inherent in our loan portfolio. We perform periodic, systematic reviews of the loan portfolio to estimate probable losses in the respective loan portfolios. In addition, we regularly evaluate prevailing economic and business conditions, industry concentrations, changes in the size and characteristics of the portfolio and other pertinent factors. The process we use to determine the overall allowance for loan losses is based on this analysis. Based on this analysis, we believe the allowance for loan losses is adequate as of September 30, 2018.

Assessing the adequacy of the allowance for loan losses involves substantial uncertainties and is based upon management's evaluation of the amounts required to meet estimated charge-offs in the loan portfolio after weighing a variety of factors, including the risk-profile of our loan products and customers.

The adequacy of the allowance for loan losses is subject to ongoing management review. 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 increase the allowance based on their judgments about information available to them at the time of their examination.

Net charge-offs of $2.1 million in the third quarter of 2018 represented 0.28% of average loans on an annualized basis compared to $1.6 million or 0.25% in the third quarter of 2017. For the nine months ended September 30, 2018, net charge-offs of $5.8 million represented 0.27% of average loans, compared to $6.0 million or 0.33% of average loans for the same period in 2017. The decrease in net charge-offs in the nine months ended September 30, 2018 is primarily due to improved credit quality of our outstanding loans portfolio. The allowance for loan losses was $34.0 million at September 30, 2018, compared with $34.7 million at December 31, 2017. The ratio of the allowance for loan losses to total loans was 1.14% and 1.27% at September 30, 2018 and December 31, 2017, respectively. The ratio of allowance for loan losses to non-performing loans was 433% at September 30, 2018, compared with 277% at December 31, 2017.

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Non-Performing Assets and Potential Problem Loans

The table below summarizes our non-performing assets at the dates indicated (in thousands).

	Non-Performing Assets	
	September 30, 2018	December 31, 2017
Nonaccrual loans:		
Commercial business	$2,203	$ 5,344
Commercial mortgage	1,900	2,623
Residential real estate loans	2,057	2,252
Residential real estate lines	297	404
Consumer indirect	1,385	1,895
Other consumer	—	2
Total nonaccrual loans	7,842	12,520
Accruing loans 90 days or more delinquent	8	11
Total non-performing loans	7,850	12,531
Foreclosed assets	290	148
Total non-performing assets	$8,140	$ 12,679
Non-performing loans to total loans	0.26 %	0.46 %
Non-performing assets to total assets	0.19 %	0.31 %

Changes in the level of nonaccrual loans typically represent increases for loans that reach a specified past due status, offset by reductions for loans that are charged-off, paid down, sold, transferred to foreclosed real estate, or are no longer classified as nonaccrual because they have returned to accrual status. Activity in nonaccrual loans for the three and nine months ended September 30, 2018 was as follows (in thousands):

	Three months ended September 30, 2018	Nine months ended September 30, 2018
Nonaccrual loans, beginning of period	$ 9,727	$ 12,520
Additions	4,673	13,417
Payments	(2,539)	(6,382)
Charge-offs	(3,449)	(9,833)
Returned to accruing status	(388)	(1,284)
Transferred to other real estate or repossessed assets	(182)	(596)
Nonaccrual loans, end of period	$ 7,842	$ 7,842

Non-performing assets include non-performing loans and foreclosed assets. Non-performing assets at September 30, 2018 were $8.1 million, a decrease of $4.5 million from the $12.7 million balance at December 31, 2017. The primary component of non-performing assets is non-performing loans, which were $7.8 million or 0.26% of total loans at September 30, 2018, compared with $12.5 million or 0.46% of total loans at December 31, 2017.

Approximately $563 thousand, or 7%, of the $7.8 million in non-performing loans as of September 30, 2018 were current with respect to payment of principal and interest but were classified as non-accruing because repayment in full of principal and/or interest was uncertain. Included in nonaccrual loans are troubled debt restructurings ("TDRs") of $581 thousand and $691 thousand at September 30, 2018 and December 31, 2017, respectively. We had one TDR of $598 thousand that was accruing interest as of September 30, 2018 and one TDR of $633 thousand that was accruing interest as of December 31, 2017.

Foreclosed assets consist of real property formerly pledged as collateral for loans, which we have acquired through foreclosure proceedings or acceptance of a deed in lieu of foreclosure. Foreclosed asset holdings represented four properties totaling $290 thousand at September 30, 2018 and four properties totaling $148 thousand at December 31, 2017.

MANAGEMENT'S DISCUSSION AND ANALYSIS

Potential problem loans are loans that are currently performing, but information known about possible credit problems of the borrowers causes us to have concern as to the ability of such borrowers to comply with the present loan payment terms and may result in disclosure of such loans as nonperforming at some time in the future. These loans remain in a performing status due to a variety of factors, including payment history, the value of collateral supporting the credits, and/or personal or government guarantees. We consider loans classified as substandard, which continue to accrue interest, to be potential problem loans. We identified $13.3 million and $12.5 million in loans that continued to accrue interest which were classified as substandard as of September 30, 2018 and December 31, 2017, respectively.

FUNDING ACTIVITIES

Deposits

The following table summarizes the composition of our deposits at the dates indicated (dollars in thousands):

	Deposit Composition			
	September 30, 2018		December 31, 2017	
	Amount	% of Total	Amount	% of Total
Noninterest-bearing demand	$748,167	21.5 %	$718,498	22.4 %
Interest-bearing demand	711,321	20.4	634,203	19.8
Savings and money market	988,486	28.3	1,005,317	31.3
Time deposits < $250,000	785,204	22.6	698,179	21.7
Time deposits of $250,000 or more	252,551	7.2	153,977	4.8
Total deposits	$3,485,729	100.0%	$3,210,174	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 September 30, 2018, total deposits were $3.49 billion, representing an increase of $275.6 million from December 31, 2017. Time deposits were approximately 30% and 27% of total deposits at September 30, 2018 and December 31, 2017, respectively.

Nonpublic deposits, the largest component of our funding sources, totaled $2.17 billion and $2.07 billion at September 30, 2018 and December 31, 2017, respectively, and represented 62% and 65% of total deposits as of the end of each period, 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.

As an additional source of funding, we offer a variety of public (municipal) deposit products to the towns, villages, counties and school districts within our market. Public deposits generally range from 20% to 30% 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 $971.5 million and $829.5 million at September 30, 2018 and December 31, 2017, respectively, and represented 28% and 26% of total

deposits as of the end of each period, respectively. The increase in public deposits during 2018 was due largely to successful business development efforts.

We also participate in CDARS and ICS programs, which enable 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. Prior to the Economic Growth, Regulatory Relief and Consumer Protection Act (“EGRRCPA”) enacted on May 14, 2018, all CDARS and ICS deposits were considered brokered deposits for regulatory reporting purposes. With the enactment of EGRRCPA, reciprocal CDARS and ICS deposits, subject to certain restrictions, are no longer required to be reported as brokered deposits. CDARS deposits and ICS deposits, the majority of which were reciprocal, totaled $185.3 million and $162.8 million, respectively, at September 30, 2018, compared to $159.2 million and $147.3 million, respectively, at December 31, 2017, and collectively represented 10% and 9% of total deposits as of the end of each period, respectively.

Borrowings

The Company classifies borrowings as short-term or long-term in accordance with the original terms of the applicable agreement. Outstanding borrowings consisted of the following as of the dates indicated (in thousands):

	September 30, 2018	December 31, 2017
Short-term borrowings - Short-term FHLB borrowings	$ 308,200	$ 446,200
Long-term borrowings - Subordinated notes, net	39,184	39,131
Total borrowings	$ 347,384	$ 485,331

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MANAGEMENT'S DISCUSSION AND ANALYSIS

Short-term Borrowings

Short-term Federal Home Loan Bank ("FHLB") borrowings have original maturities of less than one year and include overnight borrowings which we typically utilize to address short term funding needs as they arise. Short-term FHLB borrowings at September 30, 2018 consisted of $90.7 million in overnight borrowings and $217.5 million in short-term borrowings. The maximum amount of short-term FHLB borrowings outstanding at any month-end during the nine months ended September 30, 2018 was $477.1 million. Short-term FHLB borrowings at December 31, 2017 consisted of $304.7 million in overnight borrowings and $141.5 million in short-term borrowings.

We have credit capacity with the FHLB and can borrow through facilities that include amortizing and term advances or repurchase agreements. We had approximately $77.6 million of immediate credit capacity with the FHLB as of September 30, 2018. We had approximately $663.9 million in secured borrowing capacity at the Federal Reserve Bank ("FRB") discount window, none of which was outstanding at September 30, 2018. The FHLB and FRB credit capacity are collateralized by securities from our investment portfolio and certain qualifying loans. We had approximately $145.0 million of credit available under unsecured federal funds purchased lines with various banks as of September 30, 2018. Additionally, we had approximately $104.3 million of unencumbered liquid securities available for pledging.

The Parent has a revolving line of credit with a commercial bank allowing borrowings up to $20.0 million in total as an additional source of working capital. At September 30, 2018, no amounts have been drawn on the line of credit.

Long-term Borrowings

On April 15, 2015, we issued $40.0 million of Subordinated Notes in a registered public offering. The Subordinated Notes bear interest at a fixed rate of 6.0% per year, payable semi-annually, for the first 10 years. From April 15, 2025 to the April 15, 2030 maturity date, the interest rate will reset quarterly to an annual interest rate equal to the then-current three-month London Interbank Offered Rate (LIBOR) plus 3.944%, payable quarterly. The Subordinated Notes are redeemable by us at any quarterly interest payment date beginning on April 15, 2025 to maturity at par, plus accrued and unpaid interest. Proceeds, net of debt issuance costs of $1.1 million, were $38.9 million. The Subordinated Notes qualify as Tier 2 capital for regulatory purposes.

LIQUIDITY AND CAPITAL MANAGEMENT

Liquidity

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 both core customer funds and maturing short-term assets; we also rely on our ability to sell or pledge securities and lines-of-credit and our overall ability to access to the financial and capital markets.

Liquidity for the Bank is managed through the monitoring of anticipated changes in loans, the investment portfolio, 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 source of our non-deposit borrowings is FHLB advances, of which we had $308.2 million outstanding at September 30, 2018. In addition to this amount, we have additional collateralized wholesale borrowing capacity of approximately $886.4 million from various funding sources which include the FHLB, the FRB, and commercial banks that we can use to fund lending activities, liquidity needs, and/or to adjust and manage our asset and liability position.

The Parent's funding requirements consist primarily of dividends to shareholders, debt service, income taxes, operating expenses, funding of nonbank subsidiaries, repurchases of our stock, and acquisitions. The Parent obtains funding to meet obligations from dividends received from the Bank, net taxes collected from subsidiaries included in the federal consolidated tax return, and the issuance of debt and equity securities. In addition, the Parent maintains a revolving line of credit with a commercial bank for an aggregate amount of up to $20.0 million, all of which was available at September 30, 2018. The line of credit has a one-year term and matures in May 2019. Funds drawn would be used for general corporate purposes and backup liquidity.

Cash and cash equivalents were $117.3 million as of September 30, 2018, up $18.1 million from $99.2 million as of December 31, 2017. Net cash provided by operating activities totaled $50.8 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 $158.2 million, which included outflows of $259.7 million for net loan originations and was partially offset by inflows of $107.5 million from net investment securities transactions. Net cash provided by financing activities of $125.5 million was attributed to a $275.6 million increase in deposits, partially offset by a $138.0 million decrease in short-term borrowings and by $12.2 million in dividend payments.

MANAGEMENT'S DISCUSSION AND ANALYSIS

Capital Management

We actively manage capital, commensurate with our risk profile, to enhance shareholder value. We also seek to maintain capital levels for the Company and the Bank at amounts in excess of the regulatory "well-capitalized" thresholds. Periodically, we may respond to market conditions by implementing changes to our overall balance sheet positioning to manage our capital position.

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 result in certain mandatory and possibly additional discretionary actions by regulators that, if undertaken, could have a direct material impact on our 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.

Shareholders' equity was $392.2 million at September 30, 2018, an increase of $11.0 million from $381.2 million at December 31, 2017. Net income for the nine months ended September 30, 2018 increased shareholders' equity by $32.0 million, which was partially offset by common and preferred stock dividends declared of $12.6 million. Accumulated other comprehensive loss included in shareholders' equity increased $9.9 million during the first nine months of 2018 due primarily to higher net unrealized losses on securities available for sale.

The FRB and FDIC have adopted a system using risk-based capital guidelines to evaluate the capital adequacy of banks and bank holding companies. The final rules implementing the Basel Committee on Banking Supervision's ("BCBS") capital guidelines for U.S. banks became effective for the Company on January 1, 2015, with full compliance with all of the final requirements phased in over a multi-year schedule, to be fully phased-in by January 1, 2019. As of September 30, 2018, the Company's capital levels remained characterized as "well-capitalized" under the new rules.

The following table reflects the ratios and their components (dollars in thousands):

	September 30, 2018	December 31, 2017
Common shareholders' equity	$ 374,825	$ 363,848
Less: Goodwill and other intangible assets	75,972	70,413
Net unrealized loss on investment securities (1)	(13,768)	(3,275)
Hedging derivative instruments	208	—
Net periodic pension and postretirement benefits plan adjustments	(8,260)	(8,641)
Other	—	—
Common Equity Tier 1 ("CET1") Capital	320,673	305,351
Plus: Preferred stock	17,329	17,329
Less: Other	—	—
Tier 1 Capital	338,002	322,680
Plus: Qualifying allowance for loan losses	33,955	34,672
Subordinated Notes	39,184	39,131

Total regulatory capital	$ 411,141		$ 396,483	
Adjusted average total assets (for leverage capital purposes)	$ 4,133,239		$ 3,967,749	
Total risk-weighted assets	$ 3,269,366		$ 3,005,655	
Regulatory Capital Ratios				
Tier 1 Leverage (Tier 1 capital to adjusted average assets)	8.18	%	8.13	%
CET1 Capital (CET1 capital to total risk-weighted assets)	9.81		10.16	
Tier 1 Capital (Tier 1 capital to total risk-weighted assets)	10.34		10.74	
Total Risk-Based Capital (Total regulatory capital to total risk-weighted assets)	12.58		13.19	

(1) Includes unrealized gains and losses related to the Company’s reclassification of available for sale investment securities to the held to maturity category.

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MANAGEMENT'S DISCUSSION AND ANALYSIS

BCBS Capital Rules

The BCBS Capital Rules include a new Common Equity Tier 1 Capital to risk-weighted assets minimum ratio of 4.5%, increase the minimum Tier 1 capital to risk-weighted assets ratio from 4.0% to 6.0%, require a minimum total capital to risk-weighted assets ratio of 8.0%, and require a minimum Tier 1 leverage ratio of 4.0%. A new capital conservation buffer is also established above the regulatory minimum capital requirements, effectively increasing the minimum required risk-weighted asset ratios. This capital conservation buffer was phased-in as of January 1, 2016 at 0.625% of risk-weighted assets and has increased each subsequent year by an additional 0.625% (currently 1.875% as of June 30, 2018) until reaching its final level of 2.5% on January 1, 2019. Banking institutions with a capital conservation buffer below the minimum level will face constraints on dividends, equity repurchases and compensation based on the amount of the shortfall. The BCBS Capital Rules also provide for a "countercyclical capital buffer" that is applicable to only certain covered institutions and does not have any current applicability to the Company or the Bank. Strict eligibility criteria for regulatory capital instruments were also implemented under the final rules. The final rules also revised the definition and calculation of Tier 1 capital, total capital, and risk-weighted assets.

The following table presents actual and required capital ratios as of September 30, 2018 and December 31, 2017 for the Company and the Bank under the BCBS Capital Rules. The minimum required capital amounts presented include the minimum required capital levels as of those dates based on the phase-in provisions of the BCBS Capital Rules and the minimum required capital levels as of January 1, 2019 when the BCBS Capital Rules have been fully phased-in. Capital levels required to be considered well capitalized are based upon prompt corrective action regulations, as amended to reflect the changes under the BCBS Capital Rules (in thousands):

	Actual		Minimum Capital Required – Basel III Phase-in Schedule		Minimum Capital Required – Basel III Fully Phased-in		Required to be Considered Well Capitalized	
	Amount	Ratio	Amount	Ratio	Amount	Ratio	Amount	Ratio
September 30, 2018								
Tier 1 leverage:								
Company	$338,002	8.18 %	$165,330	4.00 %	$165,330	4.00 %	$206,662	5.00 %
Bank	367,159	8.90	165,002	4.00	165,002	4.00	206,253	5.00
CET1 capital:								
Company	320,673	9.81	208,422	6.38	228,856	7.00	212,509	6.50
Bank	367,159	11.26	207,856	6.38	228,234	7.00	211,931	6.50
Tier 1 capital:								
Company	338,002	10.34	257,463	7.88	277,896	8.50	261,549	8.00
Bank	367,159	11.26	256,763	7.88	277,141	8.50	260,839	8.00
Total capital:								
Company	411,141	12.58	322,850	9.88	343,283	10.50	326,937	10.00
Bank	401,115	12.30	321,973	9.88	342,351	10.50	326,048	10.00
December 31, 2017								

Tier 1 leverage:								
Company	$322,680	8.13 %	$158,710	4.00 %	$158,710	4.00 %	$198,387	5.00 %
Bank	346,532	8.75	158,372	4.00	158,372	4.00	197,965	5.00
CET1 capital:								
Company	305,351	10.16	172,825	5.75	210,396	7.00	195,368	6.50
Bank	346,532	11.57	172,224	5.75	209,664	7.00	194,688	6.50
Tier 1 capital:								
Company	322,680	10.74	217,910	7.25	255,481	8.50	240,452	8.00
Bank	346,532	11.57	217,152	7.25	254,592	8.50	239,616	8.00
Total capital:								
Company	396,483	13.19	278,023	9.25	315,594	10.50	300,565	10.00
Bank	381,204	12.73	277,056	9.25	314,496	10.50	299,520	10.00

Dividend Restrictions

In the ordinary course of business, the Company is dependent upon dividends from the Bank to provide funds for the payment of 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.

ITEM 3. Quantitative and Qualitative Disclosures About Market Risk

Quantitative and qualitative disclosures about market risk were presented at December 31, 2017 in Item 7A of the Company's Annual Report on Form 10-K for the year ended December 31, 2017, as filed with the Securities and Exchange Commission on March 14, 2018. The following is an update of the discussion provided therein.

Portfolio Composition

There was no material change in the composition of assets, deposit liabilities or borrowings from December 31, 2017 to September 30, 2018. See the section titled "Analysis of Financial Condition" in Part I, Item 2, "Management's Discussion and Analysis of Financial Condition and Results of Operations" for a discussion of asset, deposit and borrowing activity during the period.

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 September 30, 2018, the Company's sensitivity was relatively neutral, meaning that net interest income is modestly impacted as interest rates change.

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. The following table sets forth the estimated changes to net interest income over the 12-month period ending September 30, 2019 assuming instantaneous changes in interest rates for the given rate shock scenarios (dollars in thousands):

	Changes in Interest Rate			
	-100 bp	+100 bp	+200 bp	+300 bp
Estimated change in net interest income	$(4,443)	$1,127	$2,277	$3,463
% Change	(3.30)%	0.84 %	1.69 %	2.57 %

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 simulation referenced above is based on our 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 future results, does not measure the effect of changing interest rates on noninterest income 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 variance 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.

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 on historical data (back-testing).

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The analysis that follows presents the estimated EVE resulting from market interest rates prevailing at a given quarter-end ("Pre-Shock Scenario"), and under other interest rate scenarios (each a "Rate Shock Scenario") represented by immediate, permanent, parallel shifts in interest rates from those observed at September 30, 2018 and December 31, 2017 (dollars in thousands). The analysis additionally presents a measurement of the interest rate sensitivity at September 30, 2018 and December 31, 2017. EVE amounts are computed under each respective Pre- Shock Scenario and Rate Shock Scenario. An increase in the EVE amount is considered favorable, while a decline is considered unfavorable.

	September 30, 2018			December 31, 2017		
			Percentage			Percentage
Rate Shock Scenario:	EVE	Change	Change	EVE	Change	Change
Pre-Shock Scenario	$627,171			$578,550		
- 100 Basis Points	636,995	$9,824	1.57 %	592,527	$13,977	2.42 %
+ 100 Basis Points	598,310	(28,861)	(4.60)	544,507	(34,043)	(5.88)
+ 200 Basis Points	567,334	(59,837)	(9.54)	507,137	(71,413)	(12.34)
+ 300 Basis Points	536,596	(90,575)	(14.44)	468,787	(109,763)	(18.97)

The Pre-Shock Scenario EVE was $627.2 million at September 30, 2018, compared to $578.6 million at December 31, 2017. The increase in the Pre-Shock Scenario EVE at September 30, 2018 resulted primarily from a more favorable valuation of non-maturity deposits that reflected alternative funding rate changes used for discounting future cash flows.

The +200 basis point Rate Shock Scenario EVE increased from $507.1 million at December 31, 2017 to $567.3 million at September 30, 2018, reflecting the more favorable valuation of non-maturity deposits. The percentage change in the EVE amount from the Pre-Shock Scenario to the +200 basis point Rate Shock Scenario changed from (12.34)% at December 31, 2017 to (9.54)% at September 30, 2018. The decrease in sensitivity resulted from the addition of the interest rate cap and a change in the valuation of certain fixed rate assets in the +200 basis point Rate Shock Scenario EVE as of September 30, 2018, compared to December 31, 2017.

ITEM 4. Controls and Procedures

Evaluation of Disclosure Controls and Procedures

As of September 30, 2018, 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 and Chief Financial 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 SEC under the Securities Exchange Act of 1934, as amended ("Exchange Act"). Based upon that evaluation, the Company's 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 report.

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 Company's Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosure.

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 September 30, 2018 that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

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PART II. OTHER INFORMATION

ITEM 1. Legal Proceedings

The Company has experienced no material developments in its legal proceedings from the disclosure included in the Company's Annual Report on Form 10-K for the year ended December 31, 2017, dated March 14, 2018, as filed with the SEC.

ITEM 6. Exhibits

(a)The following is a list of all exhibits filed or incorporated by reference as part of this Report:

Exhibit Number	Description	Location
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	

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SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

FINANCIAL INSTITUTIONS, INC.

/s/ Martin K. Birmingham , November 7, 2018
Martin K. Birmingham
President and Chief Executive Officer
(Principal Executive Officer)

/s/ Kevin B. Klotzbach , November 7, 2018
Kevin B. Klotzbach
Executive Vice President, Chief Financial Officer and Treasurer
(Principal Financial Officer)

/s/ Michael D. Grover , November 7, 2018
Michael D. Grover
Senior Vice President and Chief Accounting Officer
(Principal Accounting Officer)