

COMMUNITY BANK SYSTEM, INC.

Form 11-K

June 27, 2017

United States

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 11-K

(Mark One)

ANNUAL REPORT PURSUANT TO SECTION 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the fiscal year ended December 31, 2016

TRANSITION REPORT PURSUANT TO SECTION 15 (d) OF THE SECURITIES AND EXCHANGE ACT OF 1934

For the transition period from _____ to _____

Commission File Number 001-13695

A. Full title of the plan and the address of the plan, if different from that of the issuer named below:

Community Bank System, Inc.
401(k) Employee Stock Ownership Plan

B. Name of Issuer of the securities held pursuant to the plan and the address of its principal executive office.

Community Bank System, Inc.
5790 Widewaters Parkway
DeWitt, New York 13214

REQUIRED INFORMATION

1. Not applicable
2. Not applicable
3. Not applicable
4. The Community Bank System, Inc. 401(k) Employee Stock Ownership Plan (the “Plan”) is subject to the requirements of the Employee Retirement Income Security Act of 1974 (“ERISA”). Attached hereto as Appendix I is a copy of the most recent financial statements of the Plan prepared in accordance with the financial reporting requirements of ERISA.

Exhibits

- (23) Consent of Independent Registered Public Accounting Firm.
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Signatures

Pursuant to the requirements of the Securities Exchange Act of 1934, the trustee (or other persons who administer the employee benefit plan) have duly caused this annual report to be signed on its behalf by the undersigned, hereunto duly authorized.

Community Bank System, Inc.
401(k) Employee Stock Ownership Plan

Community Bank, N. A., Trustee

Dated: June 27, 2017

/s/ Scott Kingsley
Scott Kingsley
Executive Vice President and Chief
Financial Officer

Community Bank System, Inc.
401(k) Employee Stock Ownership Plan
Financial Statements and Supplemental Schedule
December 31, 2016 and 2015

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| Note: All other schedules are omitted since they are not applicable or are not required based on the disclosure requirements of the Employee Retirement Income Security Act of 1974 and applicable regulations issued by the Department of Labor. | |

Report of Independent Registered Public Accounting Firm

June 27, 2017

To the Participants and Administrators of the
Community Bank System, Inc. 401(k) Employee Stock Ownership Plan

We have audited the accompanying statements of net assets available for benefits of the Community Bank System, Inc. 401(k) Employee Stock Ownership Plan (the "Plan") as of December 31, 2016 and 2015, and the related statements of changes in net assets available for benefits for the years then ended. These financial statements are the responsibility of the Plan's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. The Plan is not required to have, nor were we engaged to perform, an audit of its internal control over financial reporting. Our audits included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Plan's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the net assets available for benefits of the Community Bank System, Inc. 401(k) Employee Stock Ownership Plan as of December 31, 2016 and 2015, and the changes in net assets available for benefits for the years then ended in conformity with accounting principles generally accepted in the United States of America.

The supplemental information in the accompanying Schedule H, Line 4i - Schedule of Assets (Held at End of Year) as of December 31, 2016, has been subjected to audit procedures performed in conjunction with the audit of the Plan's financial statements. The supplemental information is presented for the purpose of additional analysis and is not a required part of the basic financial statements but includes supplemental information required by the Department of Labor's Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974. This supplemental information is the responsibility of the Plan's management. Our audit procedures included determining whether the supplemental information reconciles to the financial statements or the underlying accounting and other records, as applicable, and performing procedures to test the completeness and accuracy of the information presented in the supplemental information. In forming our opinion on the supplemental information in the accompanying schedule, we evaluated whether the supplemental information, including its form and content, is presented in conformity with the Department of Labor's Rules and Regulations for Reporting and Disclosures under the Employee Retirement Income Security Act of 1974. In our opinion, the supplemental information in the accompanying schedule is fairly stated in all material respects in relation to the financial statements as a whole.

/s/ Dannible & McKee, LLP

Dannible & McKee, LLP
Syracuse, New York

Community Bank System, Inc.
 401(k) Employee Stock Ownership Plan
 Statements of Net Assets Available for Benefits
 December 31, 2016 and 2015

| | 2016 | 2015 |
|--|----------------|----------------|
| Assets | | |
| Investments, at fair value (Notes B and C): | | |
| Mutual funds | \$ 126,245,791 | \$ 70,910,330 |
| Collective investment funds | - | 15,975,567 |
| Community Bank System, Inc. common stock | 84,583,102 | 44,066,781 |
| Self-directed brokerage | 2,000,932 | 1,594,431 |
| Money market fund | 4,636 | 1,194,397 |
| Total investments | 212,834,461 | 133,741,506 |
| Investments, at contract value (Notes B and C): | | |
| Stable value fund | 25,857,788 | 19,328,682 |
| Total investments | 238,692,249 | 153,070,188 |
| Receivables | | |
| Contributions receivable – employer | 220 | - |
| Contributions receivable – employee | 867 | - |
| Notes receivable from participants, net (Note B) | 3,105,235 | 3,503,845 |
| Total receivables | 3,106,322 | 3,503,845 |
| Net assets available for benefits | \$ 241,798,571 | \$ 156,574,033 |

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

Community Bank System, Inc.
 401(k) Employee Stock Ownership Plan
 Statements of Changes in Net Assets Available for Benefits
 Years Ended December 31, 2016 and 2015

| | 2016 | 2015 |
|---|----------------|----------------|
| Additions | | |
| Employee contributions | \$ 10,798,367 | \$ 7,456,859 |
| Employer contributions | 4,914,138 | 4,619,280 |
| Interest and dividend income | 5,152,618 | 4,124,363 |
| Net appreciation in the fair value of investments | 40,642,079 | 849,356 |
| Total additions | 61,507,202 | 17,049,858 |
| Deductions | | |
| Benefit payments | 18,772,941 | 8,450,344 |
| Administrative fees | 87,545 | 103,162 |
| Reserve for deemed distributions | 851,469 | 455,313 |
| Total deductions | 19,711,955 | 9,008,819 |
| Net increase in net assets available for benefits | 41,795,247 | 8,041,039 |
| Transfer of assets from merged plan (Note G) | 43,429,291 | - |
| Net assets available for benefits | | |
| Beginning of Year | 156,574,033 | 148,532,994 |
| End of Year | \$ 241,798,571 | \$ 156,574,033 |

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

Community Bank System, Inc.
401(k) Employee Stock Ownership Plan
Notes to Financial Statements
December 31, 2016 and 2015

A. Description of the Plan

The following description of the Community Bank System, Inc. 401(k) Employee Stock Ownership Plan (the "Plan") provides only general information. Participants should refer to the Plan agreement for a more complete description of the Plan's provisions.

Recent accounting pronouncements not yet effective

In May 2015, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) No. 2015-07, Disclosures for Investments in Certain Entities That Calculate Net Asset Value per Share (or Its Equivalent), which removes the requirement to categorize within the fair value hierarchy all investments for which the fair value is measured using the net asset value per share practical expedient. The ASU also removes the requirement to make certain disclosures for all investments that are eligible to be measured at fair value using the net asset value per share practical expedient. Rather, those disclosures are limited to investments for which the entity has elected to measure the fair value using that practical expedient. The ASU is effective for fiscal years beginning after December 15, 2016, and interim periods within those fiscal years. Early adoption is permitted for all entities. The Company is currently evaluating the effect that implementation of the new standard will have on its financial statements.

General

The Plan is a defined contribution plan covering substantially all employees of Community Bank System, Inc. (the "Company") who are age 18 or older. Employees are automatically enrolled in the plan after 90 days of service unless participants elect not to participate. The Plan also qualifies as an employee stock ownership plan under the meaning of Section 4975(e)(7) of the Internal Revenue Code. The Plan is subject to the provisions of the Employment Retirement Income Security Act of 1974 (ERISA).

Contributions

Participants may make voluntary contributions of up to 90% of their total compensation on a pre-tax or after-tax basis up to a maximum contribution of \$18,000 for 2016 or \$24,000 if an employee is older than 50, to the Plan starting the first day of the month after 90 days of employment. Voluntary cash contributions of up to 6% of total eligible compensation are matched 100% by the Company for the first 3% contributed and 50% for the next 3% contributed. The Company match amounted to \$4,213,560 and \$3,508,549 in 2016 and 2015, respectively. In addition, as defined in the plan document, employees participating in the Community Bank System, Inc. Pension Plan under the Worker Retirement Accumulation Plan ("WRAP") design received an additional Company contribution to the Plan in 2016 and 2015 equal to the interest credit on service credits earned subsequent to January 1, 2010 under the WRAP design. The Company contribution for employees participating in the WRAP amounted to \$700,578 and \$1,110,731 in 2016 and 2015, respectively.

Community Bank System, Inc.
401(k) Employee Stock Ownership Plan
Notes to Financial Statements
December 31, 2016 and 2015

Participant Accounts

Each participant's account is credited with the participant's contribution, the Company's matching contribution, the Company's WRAP interest credit, an allocation of Plan earnings, and charged with an allocation of administrative expenses. Allocation of Plan earnings and administrative expenses are based on participant earnings or account balances, as defined. Participants are entitled to the benefit that can be provided from their vested account balance. Forfeited accounts are allocated annually to eligible participant accounts based on the ratio of each eligible participant's compensation to total eligible participant compensation. Forfeited accounts allocated to eligible participants amounted to \$0 and \$11,226 for 2016 and 2015, respectively.

Vesting

Participants are immediately vested in their contributions. Vesting in the Company's matching contribution portion plus actual earnings thereon is based on years of continuous service. A participant is 100 percent vested after two years of service. Vesting in the employer contributions related to the WRAP design is based on years of continuous service. A participant is 100 percent vested after three years of service.

Notes Receivable from Participants

Participants may borrow from the Plan a minimum of \$1,000 up to a maximum equal to the lesser of \$50,000 or 50 percent of their vested account balance. Notes receivable from participants are reported at their unpaid principal balances plus any accrued but unpaid interest. Interest accrues at the prime rate in effect at the inception of the loan plus 1% for residential loans and prime rate plus 2.9% for Reserve Plus loans. Interest rates on participant loans generally range from 3.50% to 10.50%. All notes that are in default as defined by the plan document are reported as deemed distributions. Deemed distributions represent the amount of unpaid principal on loans from participants who are actively participating in the Plan and have not continued to make payments on the outstanding balance as required by the Plan document.

Payment of Benefits

Normal retirement date for participants under the Plan is the later of age 65 or the completion of 5 years of service. Upon termination of service due to death, disability or retirement, the participant will receive either a lump sum amount or installment payments equal to the value of the participant's vested interest in his or her account. If some or all of a participant's account balance is allocated to the employee stock ownership feature of the Plan, that portion of the Plan benefit may be paid in the form of Company stock. Upon termination of employment, if the account balance is less than \$5,000, the participant will receive a single lump sum amount equal to the value of his or her account, otherwise, the participant may elect to defer payment up to age 65. Hardship withdrawals of up to 100% of employee contributions are available if Internal Revenue Service guidelines are met.

Plan Termination

Although it has not expressed any intent to do so, the Company has the right under the Plan to discontinue contributions at any time and terminate the Plan subject to the provisions set forth under ERISA. In the event the Plan terminates, the net assets of the Plan are to be set aside for participating employees based upon balances then credited to individual accounts. Participants shall be vested 100% in the assets so allocated to their accounts.

Community Bank System, Inc.
401(k) Employee Stock Ownership Plan
Notes to Financial Statements
December 31, 2016 and 2015

B. Significant Accounting Policies

Basis of Accounting

The accompanying financial statements are prepared on an accrual basis of accounting in accordance with accounting principles generally accepted in the United States of America.

Valuation of Investments

Investments are stated at aggregate fair value, except for the HB&T Metlife Stable Value Fund, which is stated at contract value. Securities that are traded on a national securities exchange are valued at the last reported sales price on the last business day of the Plan year. Shares of mutual funds are valued at the net asset value of shares held by the Plan at year-end.

The Plan presents in the Statement of Changes in Net Assets the net appreciation in the fair value of its investments, which consists of realized gains or losses as well as unrealized appreciation or depreciation on those investments.

Purchases and sales of securities are recorded on the trade date. Gains or losses on sales of securities are based on average cost. Interest income is recorded on the accrual basis. Dividends are recorded on the ex-dividend date.

The HB&T Metlife Stable Value Fund is stated at contract value in accordance with the Financial Accounting Standards Board guidance on Reporting of Fully Benefit-Responsive Investment Contracts Held by Certain Investment Companies Subject to the AICPA Investment Company Guide and Defined-Contribution Health and Welfare and Pension Plans Guide, which states that contract value is the relevant measurement attribute for that portion of the net assets available for benefits of a defined-contribution plan attributable to fully benefit-responsive investment contracts because contract value is the amount participants would receive if they were to initiate permitted transactions under the terms of the plan.

The accompanying Statement of Changes in Net Assets Available for Benefits is prepared on a contract value basis. Contract value represents contributions made under the contract, plus earnings, less participant withdrawals and administrative expenses. Participants may ordinarily direct the withdrawal or transfer of all or a portion of their investments at contract value. There are no reserves against contract value for credit risk of the contract issuer or otherwise. If an event occurs that may impair the ability of the contract issuer to perform in accordance with the contract terms, fair value may be less than contract value. The average yields earned on the HB&T Metlife Stable Value Fund for the years ended December 31, 2016 and 2015 were 2.03% and 0.33%, respectively. The crediting interest rates to the HB&T Metlife Stable Value Fund were 2.02% and 1.96% for the years ended December 31, 2016 and 2015, respectively.

Payment of Benefits

Benefits are recorded when paid.

Community Bank System, Inc.
401(k) Employee Stock Ownership Plan
Notes to Financial Statements
December 31, 2016 and 2015

Administrative Expenses

The Plan's expenses are paid either by the Plan or the Company, as provided by the plan document. Expenses that are paid directly by the Company are excluded from these financial statements. These amounted to approximately \$1,006,000 and \$765,000, including approximately \$987,000 and \$703,000 paid to Benefit Plans Administrative Services, LLC ("BPAS"), in 2016 and 2015, respectively, (See Note E). Certain expenses incurred in connection with the general administration of the Plan that are paid by the Plan are recorded as deductions in the accompanying statement of changes in net assets available for benefits. In addition, certain investment related expenses are included in net appreciation of fair value of investments presented in the accompanying statements of changes in net assets available for benefits.

Inactive Accounts

Account balances of individuals who have withdrawn from participation in the Plan had an accumulated basis of approximately \$49,465,449 and \$27,491,350 at December 31, 2016 and 2015, respectively.

Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amount of assets and liabilities and disclosures of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Risks and Uncertainties

The Plan provides for various investment options in mutual funds, collective investment funds and Company stock. Investment securities are exposed to various risks, such as interest rate, market and credit. Due to the level of risk associated with certain investment securities and the level of uncertainty related to changes in the value of investment securities, it is at least reasonably possible that changes in risk in the near term would materially affect participants' account balances and the amounts reported in the Statements of Net Assets Available for Benefits and the Statements of Changes in Net Assets Available for Benefits.

Valuation Allowance

The carrying amount of notes receivable from participants is reduced by a valuation allowance that reflects management's best estimate of the amounts that will not be collected. Management determines the valuation allowance by applying an average of historical deemed distributions to the aggregate remaining notes receivable from participants to estimate a valuation allowance. The valuation allowance is \$575,000 and \$453,000 at December 31, 2016 and 2015, respectively, (See Note H).

Subsequent Events

The Company has evaluated subsequent events through June 27, 2017, the date the financial statements were available for issue (See Note I).

Community Bank System, Inc.
401(k) Employee Stock Ownership Plan
Notes to Financial Statements
December 31, 2016 and 2015

C. Investments

Investments are held within various common funds maintained by the Community Bank, N.A. Trust Department. Participants, at their discretion, may allocate contributions and account balances between various investment options offered by the Plan. A brief description of these investment options, as provided by the plan administrator, follows:

Community Bank System, Inc. Employee Stock Ownership Fund – these Funds invest in the common stock of the Plan sponsor, which is traded on the New York Stock Exchange under the symbol "CBU".

Federated Total Return Bond Fund – a mutual fund seeking to provide total return by investing primarily in a diversified portfolio of investment grade fixed income securities.

American Funds EuroPacific Growth Fund Class A – a mutual fund that invests in stocks of issuers located in Europe and the Pacific Basin.

DFA Real Estate Securities I – fund that purchases readily marketable equity securities of companies whose principal activities include ownership, management, development, construction, or sale of residential, commercial, or industrial real estate.

T. Rowe Price Blue Chip Growth Fund – a mutual fund that invests primarily in stocks of U.S. companies.

T. Rowe Price Inflation Protected Bond Fund – a mutual fund that invests primarily in inflation-protected bonds issued by the U.S. Treasury.

T. Rowe Price Mid-Cap Growth Fund – a mutual fund that invests primarily in a diversified portfolio of common stocks and mid-cap companies.

T. Rowe Price Mid-Cap Value Fund – a mutual fund that invests primarily in U.S. common stocks of mid-size companies that appear to be undervalued. The fund may invest in other securities, including foreign stocks, and use futures and options.

T. Rowe Price New Horizons Fund – a mutual fund that invests primarily in a diversified group of small, emerging growth companies, preferably early in the corporate life cycle before a company becomes widely recognized by the investment community. The fund invests primarily in domestic stocks.

Goldman Sachs Small Cap Value Fund I – mutual fund that invests in equity investments of small-cap issuers within the range of the market capitalizations of companies constituting the Russell 2000 Value Index.

Manning & Napier Pro-Blend Conservative Term Fund I – a mutual fund that invests primarily in investment grade, fixed-income securities, including U.S. Treasury securities, pass-through securities, and corporate bonds.

Community Bank System, Inc.
401(k) Employee Stock Ownership Plan
Notes to Financial Statements
December 31, 2016 and 2015

Manning & Napier Pro-Blend Extended Term Fund I – a mutual fund that invests primarily in common stocks, but may also invest a substantial portion of assets in long-term, fixed-income securities with maturities of 7 to 20 years.

Manning & Napier Pro-Blend Moderate Term Fund I – a mutual fund that invests primarily in common stocks and intermediate to long-term fixed income securities with maturities of 5 to 10 years.

Oppenheimer Developing Markets Fund A – a mutual fund that invests primarily in equity securities of issuers with high growth potential whose principal activities are in at least three developing markets.

Symons Value Institutional Fund – a mutual fund that invests primarily in a diversified portfolio of companies with market capitalizations above approximately \$500 million, that are trading at attractive prices and that appear to have limited downside price risk over the long-term.

Vanguard Equity Income Admiral – a mutual fund that invests mainly in common stocks of mid-size and large companies whose stocks typically pay above-average levels of dividend income and are undervalued relative to other such stock; under normal circumstances it will invest 80% of its assets in equity securities.

Vanguard Institutional Index I – a mutual fund that invests substantially all of its assets in the stocks that make up the Standard & Poor's 500 Index, holding each stock in approximately the same proportion as its weighting in the index.

Vanguard Mid-Cap Index I – a mutual fund that attempts to track the performance of CRSP US Mid Cap Index, a broadly diversified index of stocks of mid-size U.S. companies.

Vanguard Target Retirement 2015 – a mutual fund that seeks to provide capital appreciation and current income consistent with its current asset allocation; designed for investors planning to retire and leave the workforce in or within a few years of 2015 (the target year).

Vanguard Target Retirement 2020 – a mutual fund that seeks to provide capital appreciation and current income consistent with its current asset allocation; designed for investors planning to retire and leave the workforce in or within a few years of 2020 (the target year).

Vanguard Target Retirement 2025 – a mutual fund that seeks to provide capital appreciation and current income consistent with its current asset allocation; designed for investors planning to retire and leave the workforce in or within a few years of 2025 (the target year).

Vanguard Target Retirement 2030 – a mutual fund that seeks to provide capital appreciation and current income consistent with its current asset allocation; designed for investors planning to retire and leave the workforce in or within a few years of 2030 (the target year).

Community Bank System, Inc.
401(k) Employee Stock Ownership Plan
Notes to Financial Statements
December 31, 2016 and 2015

Vanguard Target Retirement 2035 – a mutual fund that seeks to provide capital appreciation and current income consistent with its current asset allocation; designed for investors planning to retire and leave the workforce in or within a few years of 2035 (the target year).

Vanguard Target Retirement 2040 – a mutual fund that seeks to provide capital appreciation and current income consistent with its current asset allocation; designed for investors planning to retire and leave the workforce in or within a few years of 2040 (the target year).

Vanguard Target Retirement 2045 – a mutual fund that seeks to provide capital appreciation and current income consistent with its current asset allocation; designed for investors planning to retire and leave the workforce in or within a few years of 2045 (the target year).

Vanguard Target Retirement 2050 – a mutual fund that seeks to provide capital appreciation and current income consistent with its current asset allocation; designed for investors planning to retire and leave the workforce in or within a few years of 2050 (the target year).

Vanguard Target Retirement 2055 – a mutual fund that seeks to provide capital appreciation and current income consistent with its current asset allocation; designed for investors planning to retire and leave the workforce in or within a few years of 2055 (the target year).

Vanguard Target Retirement 2060 – a mutual fund that seeks to provide capital appreciation and current income consistent with its current asset allocation; designed for investors planning to retire and leave the workforce in or within a few years of 2060 (the target year).

Vanguard Target Retirement Income – a mutual fund that seeks to provide current income and some capital appreciation; designed for investors currently in retirement.

Vanguard Total Bond Index Fund – a mutual fund that attempts to track the performance of the Barclays U.S. Capital Aggregate Float Adjusted Index, which represents a wide spectrum of public, investment grade, taxable, fixed-income securities in the U.S.

Vanguard Small-Cap Index Fund – a mutual fund that attempts to track the performance of the CRSP US Small Cap Index, a broadly diversified index of stocks of smaller U.S. companies. The fund invests all, or substantially all, of its assets in the stocks that make up the index, holding each stock in approximately the same proportion as its weighting in the index.

HB&T Metlife Stable Value Fund Class R1 Shares – a stable value fund that invests in fixed income securities such as U.S. Governmental Agencies and Treasuries, mortgages, asset backed securities, corporate debt and cash equivalents. Investments in the HB&T Metlife Stable Value Fund are reported at contract value.

Ameritrade IDA Account – participants select the individual investment securities, including equity securities, mutual funds and bonds.

Community Bank System, Inc.
 401(k) Employee Stock Ownership Plan
 Notes to Financial Statements
 December 31, 2016 and 2015

D. Fair Value Measurements

The Financial Accounting Standards Board has established authoritative guidance regarding accounting for fair value measurements. This framework establishes a common definition for fair value to be applied to generally accepted accounting principles requiring the use of fair value, establishes a framework for measuring fair value and expands disclosure about such fair value instruments. It defines fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date (exit price). It also classifies the inputs used to measure fair value into the following hierarchy:

- Level 1 – Quoted prices in active markets for identical assets or liabilities.
- Level 2 – Quoted prices in active markets for similar assets or liabilities, or quoted prices for identical or similar assets or liabilities in markets that are not active, or inputs other than quoted prices that are observable for the asset or liability.
- Level 3 – Significant valuation assumptions not readily observable in a market.

A financial instrument's categorization within the valuation hierarchy is based upon the lowest level of input that is significant to the fair value measurement. The following tables set forth the Plan's financial assets that were accounted for at fair value on a recurring basis:

As of December 31, 2016

| | Level 1 | Level 2 | Level 3 | Total Fair Value |
|------------------------------|---------------|---------|---------|------------------|
| Mutual funds | \$126,245,791 | \$ - | \$ - | \$126,245,791 |
| Common stock of plan sponsor | 84,583,102 | - | - | 84,583,102 |
| Self-directed brokerage | 2,000,932 | - | - | 2,000,932 |
| Money market fund | 4,636 | - | - | 4,636 |
| Total assets at fair value | \$212,834,461 | \$ - | \$ - | \$212,834,461 |

As of December 31, 2015

| | Level 1 | Level 2 | Level 3 | Total Fair Value |
|------------------------------|---------------|--------------|---------|------------------|
| Mutual funds | \$70,910,330 | \$- | \$ - | \$70,910,330 |
| Collective investment funds | | 15,975,567 | | 15,975,567 |
| Common stock of plan sponsor | 44,066,781 | - | - | 44,066,781 |
| Self-directed brokerage | 1,594,431 | - | - | 1,594,431 |
| Money market fund | 1,194,397 | - | - | 1,194,397 |
| Total assets at fair value | \$117,765,939 | \$15,975,567 | \$ - | \$133,741,506 |

Community Bank System, Inc.
401(k) Employee Stock Ownership Plan
Notes to Financial Statements
December 31, 2016 and 2015

The valuation techniques used to measure fair value for the items in the table above are as follows:

Mutual funds: Valued at the closing price of the shares held by the Plan at year end reported on the active market.

Collective investment funds: The units held of collective investment funds are valued periodically by the trustee of the respective fund. The values are based on the current market values of the underlying assets of the fund.

Common stock and self directed brokerage: Valued at the closing price reported on the active market on which the individual securities are traded.

Money market funds: Managed portfolios including commercial paper and other fixed income securities issued by U.S. and foreign corporations, asset-backed commercial paper, U.S. government securities, obligations of foreign governments and the U.S. and foreign banks, valued at the closing price reported on the active market on which the individual security is traded.

The methods described above may produce a fair value calculation that may not be indicative of net realizable value or reflective of future fair values. Furthermore, while the Plan believes its valuation methods 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 fair value measurement at the reporting date.

E. Transactions with Parties-in-Interest

The assets of the Plan are administered by BPAS, a subsidiary of Community Bank System, Inc. The Company paid BPAS approximately \$987,000 and \$703,000 for record keeping, trustee, and other services in 2016 and 2015, respectively.

The Plan held 1,368,880 and 1,103,325 shares of the Plan sponsor's common stock at December 31, 2016 and 2015, respectively. The cost of these shares at December 31, 2016 and 2015 is \$37,971,418 and \$30,247,284, respectively, and their fair value at December 31, 2016 and 2015 is \$84,583,102 and \$44,066,781, respectively. Dividends received on the investment in Community Bank System, Inc. common stock amounted to \$1,809,119 and \$1,364,514 in 2016 and 2015, respectively. The Plan sold 604,204 and 347,106 shares of Community Bank System, Inc. common stock during 2016 and 2015, respectively, and purchased 869,759 and 350,852 shares of Community Bank System, Inc. common stock during 2016 and 2015, respectively.

The Company has investments in the HB&T Metlife Stable Value R1 Fund administered by Hand Benefits and Trust Company. Hand Benefits and Trust Company is a wholly-owned subsidiary of Benefit Plans Administrative Services, Inc., which is a wholly-owned subsidiary of the Company.

Community Bank System, Inc.
 401(k) Employee Stock Ownership Plan
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F. Income Tax Status

The Plan obtained its most recent determination letter in January 2016, in which the Internal Revenue Service stated that the Plan, as then designed, was in compliance with Section 401(a) of the Internal Revenue Code. The Plan has been amended since receiving the determination letter, however, the Plan administrator believes that the Plan is currently designed and being operated in compliance with the applicable requirements of the Internal Revenue Code. Therefore, no provision for income taxes has been included in the accompanying financial statements.

As discussed above, the Plan is a tax-exempt entity. The Plan has reviewed its operations for uncertain tax positions and believes there are no significant exposures. The Plan will include interest on income tax liabilities in other expenses if such amounts arise. The Plan did not incur any penalties and interest for the years ended December 31, 2016 and 2015. The Plan is no longer subject to Federal or New York state examinations by tax authorities for the closed tax years before 2013.

G. Summary of Plan
 Merger

Effective January 26, 2016, the Oneida Savings Bank 401(k) Savings Plan was merged into and became part of the Community Bank System, Inc. 401(k) Employee Stock Ownership Plan. The total amount of assets transferred from the Oneida Savings Bank 401(k) Savings Plan was \$34,292,336. As of the merger date, participants are 100% vested in their accounts. The transfer of assets was presented in the statements of changes in net assets available for benefits for the year ended December 31, 2016.

Effective March 16, 2016, the Oneida Savings Bank Employee Stock Ownership plan was merged into and became part of the Community Bank System, Inc. 401(k) Employee Stock Ownership Plan. The total amount of assets transferred from the Oneida Savings Bank Employee Stock Ownership Plan was \$9,136,955. The transfer of assets was presented in the statement of changes in net assets available for benefits for the year ended December 31, 2016.

H. Reconciliation of financial statements to
 Form 5500

The following is a reconciliation of net assets available for benefits per the financial statements to Form 5500 as of December 31:

| | 2016 | 2015 |
|--|---------------|---------------|
| Net assets available for benefits per financial statements | \$241,798,571 | \$156,574,033 |
| Allowance for notes receivable from participants | 575,000 | 453,000 |
| Net assets available for benefits per Form 5500 | \$242,373,571 | \$157,027,033 |

Community Bank System, Inc.
 401(k) Employee Stock Ownership Plan
 Notes to Financial Statements
 December 31, 2016 and 2015

The following is a reconciliation of the net increase in net assets available for benefits per the financial statements to Form 5500 for the year ended December 31:

| | 2016 | 2015 |
|--|--------------|-------------|
| Net increase in net assets available for benefits per financial statements | \$41,795,247 | \$8,041,039 |
| Allowance utilized for deemed distributions | (729,469) | (466,313) |
| Reserve for deemed distributions | 851,469 | 455,313 |
| Net increase in net assets available for benefits per Form 5500 | \$41,917,247 | \$8,030,039 |

I. Economic dependency and concentration of credit risk

At December 31, 2016 and 2015, approximately 35% and 29% of the Plan's investments are invested in Company stock, respectively, and 25% and 11% are invested in Vanguard mutual funds, respectively.

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Community Bank System, Inc.
 401(k) Employee Stock Ownership Plan
 Schedule of Assets (Held at End of Year)
 (Schedule H, Part IV, Line 4i)
 December 31, 2016

| (a) | (b) Identity of issue, borrower, lessor or similar party | (c) Description of investment including maturity date, rate of interest, collateral, par or maturity value | (e) Current value |
|-----|--|--|-------------------|
| | Mutual Funds | | |
| | American Funds EuroPacific Growth Fund | Mutual fund – 193,376 shares | \$ 8,709,676 |
| | DFA Real Estate Securities I | Mutual fund – 12,922 shares | 445,943 |
| | Federated Total Return Bond Fund | Mutual fund – 657,960 shares | 7,092,809 |
| | T. Rowe Price Blue Chip Growth Fund | Mutual fund – 205,097 shares | 14,892,112 |
| | T. Rowe Price Infl Prot Bond | Mutual fund – 134,237 shares | 1,575,937 |
| | T. Rowe Price Mid-Cap Growth | Mutual fund – 66,853 shares | 5,038,725 |
| | T. Rowe Price Mid-Cap Value | Mutual fund – 141,146 shares | 4,101,692 |
| | T. Rowe Price New Horizons | Mutual fund – 227,481 shares | 9,852,222 |
| | Goldman Sachs Small Cap Value Fund I | Mutual fund – 4,498 shares | 270,084 |
| | M&N Pro-Blend Conservative Term I | Mutual fund – 68,652 shares | 693,385 |
| | M&N Pro-Blend Extended Term I | Mutual fund – 177,888 shares | 1,618,782 |
| | M&N Pro-Blend Moderate Term I | Mutual fund – 223,807 shares | 2,173,165 |
| | Oppenheimer Developing Markets I | Mutual fund – 84,758 shares | 2,708,872 |
| | Symons Value Institutional Fund | Mutual fund – 769,264 shares | 8,408,057 |
| | Vanguard Equity Income Admiral | Mutual fund – 24,271 shares | 1,659,433 |
| | Vanguard Institutional Index Fund | Mutual fund – 80,100 shares | 16,326,868 |
| | Vanguard Mid-Cap Index I | Mutual fund – 187,869 shares | 6,761,417 |
| | Vanguard Target Retirement 2015 | Mutual fund – 119,657 shares | 1,736,220 |

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| | | |
|--|---|----------------|
| | Mutual fund – | |
| Vanguard Target Retirement 2020 | 218,760 shares | 6,182,170 |
| | Mutual fund – | |
| Vanguard Target Retirement 2025 | 81,334 shares | 1,329,810 |
| | Mutual fund – | |
| Vanguard Target Retirement 2030 | 234,270 shares | 6,840,692 |
| | Mutual fund – | |
| Vanguard Target Retirement 2035 | 36,673 shares | 650,582 |
| | Mutual fund – | |
| Vanguard Target Retirement 2040 | 130,187 shares | 3,932,941 |
| | Mutual fund – | |
| Vanguard Target Retirement 2045 | 20,762 shares | 392,188 |
| | Mutual fund – | |
| Vanguard Target Retirement 2050 | 73,601 shares | 2,236,729 |
| | Mutual fund – | |
| Vanguard Target Retirement 2055 | 2,966 shares | 97,614 |
| | Mutual fund – 742 | |
| Vanguard Target Retirement 2060 | shares | 21,546 |
| | Mutual fund – | |
| Vanguard Small-Cap Index Admiral | 76,006 shares | 4,694,895 |
| | Mutual fund – | |
| Vanguard Target Retirement Income | 194,360 shares | 2,489,751 |
| | Mutual fund – | |
| Vanguard Total Bond Index Admiral | 310,937 shares | 3,311,474 |
| | | 126,245,791 |
| Common stock of plan sponsor | | |
| * Community Bank System, Inc. | Common stock – 1,368,880 shares | 84,583,102 |
| ** Stable Value Fund | | |
| * HB&T Metlife Stable Value R1 | Stable value fund – 2,202,537 shares | 25,857,788 |
| Loan Fund | | |
| * Participants | Participant loans, 3.50% – 10.50% | 3,680,235 |
| Self Directed brokerage | | |
| IDA Account | Self-directed brokerage | 2,000,932 |
| Money Market Fund | | |
| * MPL Money Market | Money market fund - 4,637 shares | 4,636 |
| | Total investments | \$ 242,372,484 |
| * – Denotes party-in-interest as defined by ERISA | | |
| ** – Investment stated at Contract Value. | | |