

FINANCIAL INSTITUTIONS INC

Form 10-Q

November 04, 2015

[Table of Contents](#)

**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, 2015**

**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**  
**(State or other jurisdiction of**  
**incorporation or organization)**

**16-0816610**  
**(I.R.S. Employer**  
**Identification No.)**

**220 LIBERTY STREET, WARSAW, NEW YORK**  
**(Address of principal executive offices)**

**14569**  
**(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 and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted 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 and post such files). Yes  No

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

Large accelerated filer  Accelerated filer   
Non-accelerated filer  (Do not check if a smaller company) Smaller reporting company

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 14,189,535 shares of Common Stock, \$0.01 par value, outstanding as of October 28, 2015.

**Table of Contents**

**FINANCIAL INSTITUTIONS, INC.**

**Form 10-Q**

**For the Quarterly Period Ended September 30, 2015**

**TABLE OF CONTENTS**

	<b>PAGE</b>
<b>PART I. <u>FINANCIAL INFORMATION</u></b>	3
ITEM 1. <u>Financial Statements</u>	3
<u>Consolidated Statements of Financial Condition (Unaudited) - at September 30, 2015 and December 31, 2014</u>	3
<u>Consolidated Statements of Income (Unaudited) - Three and nine months ended September 30, 2015 and 2014</u>	4
<u>Consolidated Statements of Comprehensive Income (Unaudited) - Three and nine months ended September 30, 2015 and 2014</u>	5
<u>Consolidated Statements of Changes in Shareholders' Equity (Unaudited) - Nine months ended September 30, 2015 and 2014</u>	6
<u>Consolidated Statements of Cash Flows (Unaudited) - Nine months ended September 30, 2015 and 2014</u>	7
<u>Notes to Consolidated Financial Statements (Unaudited)</u>	8
ITEM 2. <u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	32
ITEM 3. <u>Quantitative and Qualitative Disclosures About Market Risk</u>	52
ITEM 4. <u>Controls and Procedures</u>	53
<b>PART II. <u>OTHER INFORMATION</u></b>	54
ITEM 1. <u>Legal Proceedings</u>	54
ITEM 1A. <u>Risk Factors</u>	54
ITEM 6. <u>Exhibits</u>	54
<u>Signatures</u>	55

**Table of Contents****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, 2015	December 31, 2014
<b>ASSETS</b>		
Cash and cash equivalents	\$ 51,334	\$ 58,151
Securities available for sale, at fair value	577,509	622,494
Securities held to maturity, at amortized cost (fair value of \$496,751 and \$298,695, respectively)	490,638	294,438
Loans held for sale	1,568	755
Loans (net of allowance for loan losses of \$26,455 and \$27,637, respectively)	2,009,781	1,884,365
Company owned life insurance	62,486	61,004
Premises and equipment, net	38,032	36,394
Goodwill and other intangible assets, net	67,925	68,639
Other assets	58,335	63,281
<b>Total assets</b>	<b>\$ 3,357,608</b>	<b>\$ 3,089,521</b>
<b>LIABILITIES AND SHAREHOLDERS EQUITY</b>		
Deposits:		
Noninterest-bearing demand	\$ 623,296	\$ 571,260
Interest-bearing demand	563,731	490,190
Savings and money market	942,673	795,835
Certificates of deposit	623,800	593,242
<b>Total deposits</b>	<b>2,753,500</b>	<b>2,450,527</b>
Short-term borrowings	241,400	334,804
Long-term borrowings, net of issuance costs of \$1,028	38,972	
Other liabilities	28,302	24,658
<b>Total liabilities</b>	<b>3,062,174</b>	<b>2,809,989</b>
Shareholders equity:		
Series A 3% preferred stock, \$100 par value; 1,533 shares authorized and 1,492 shares issued and outstanding	149	149
Series B-1 8.48% preferred stock, \$100 par value; 200,000 shares authorized and 171,906 shares issued and outstanding	17,191	17,191
<b>Total preferred equity</b>	<b>17,340</b>	<b>17,340</b>

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Common stock, \$0.01 par value; 50,000,000 shares authorized and 14,397,509 shares issued	144	144
Additional paid-in capital	72,427	72,955
Retained earnings	215,470	203,312
Accumulated other comprehensive loss	(6,052)	(9,011)
Treasury stock, at cost 208,674 and 279,461 shares, respectively	(3,895)	(5,208)
Total shareholders equity	295,434	279,532
Total liabilities and shareholders equity	\$ 3,357,608	\$ 3,089,521

See accompanying notes to the consolidated financial statements.

**Table of Contents****FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES****Consolidated Statements of Income (Unaudited)***(In thousands, except per share amounts)*

	<b>Three months ended September 30,</b>		<b>Nine months ended September 30,</b>	
	<b>2015</b>	<b>2014</b>	<b>2015</b>	<b>2014</b>
<b>Interest income:</b>				
Interest and fees on loans	\$ 21,210	\$ 20,671	\$ 61,793	\$ 61,168
Interest and dividends on investment securities	5,797	4,458	16,170	13,903
Total interest income	27,007	25,129	77,963	75,071
<b>Interest expense:</b>				
Deposits	1,917	1,627	5,364	4,729
Short-term borrowings	342	244	785	706
Long-term borrowings	617		1,132	
Total interest expense	2,876	1,871	7,281	5,435
Net interest income	24,131	23,258	70,682	69,636
Provision for loan losses	754	2,015	4,783	5,879
Net interest income after provision for loan losses	23,377	21,243	65,899	63,757
<b>Noninterest income:</b>				
Service charges on deposits	2,037	2,277	5,880	6,768
Insurance income	1,265	922	3,930	979
ATM and debit card	1,297	1,263	3,773	3,694
Investment advisory	523	524	1,551	1,647
Company owned life insurance	488	421	1,448	1,249
Investments in limited partnerships	336	187	865	894
Loan servicing	153	120	416	450
Net gain on sale of loans held for sale	53	76	161	231
Net gain on disposal of investment securities	286	515	1,348	1,777
Net gain on disposal of other assets		72	20	61
Amortization of tax credit investment	(390)		(390)	
Other	957	884	2,755	2,445
Total noninterest income	7,005	7,261	21,757	20,195
<b>Noninterest expense:</b>				
Salaries and employee benefits	10,278	9,725	31,107	28,044
Occupancy and equipment	3,417	3,131	10,491	9,505
Professional services	1,064	976	2,898	3,332

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Computer and data processing	779	725	2,291	2,225
Supplies and postage	540	507	1,611	1,554
FDIC assessments	444	390	1,277	1,200
Advertising and promotions	312	216	789	609
Other	2,484	2,285	7,101	6,507
Total noninterest expense	19,318	17,955	57,565	52,976
Income before income taxes	11,064	10,549	30,091	30,976
Income tax expense	2,748	3,365	8,389	9,541
Net income	\$ 8,316	\$ 7,184	\$ 21,702	\$ 21,435
Preferred stock dividends	366	366	1,097	1,097
Net income available to common shareholders	\$ 7,950	\$ 6,818	\$ 20,605	\$ 20,338
Earnings per common share (Note 3):				
Basic	\$ 0.56	\$ 0.49	\$ 1.46	\$ 1.47
Diluted	\$ 0.56	\$ 0.49	\$ 1.46	\$ 1.46
Cash dividends declared per common share	\$ 0.20	\$ 0.19	\$ 0.60	\$ 0.57
Weighted average common shares outstanding:				
Basic	14,087	13,953	14,076	13,840
Diluted	14,139	14,007	14,124	13,890
See accompanying notes to the consolidated financial statements.				

**Table of Contents****FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES****Consolidated Statements of Comprehensive Income (Unaudited)***(Dollars in thousands)*

	<b>Three months ended September 30,</b>		<b>Nine months ended September 30,</b>	
	<b>2015</b>	<b>2014</b>	<b>2015</b>	<b>2014</b>
Net income	\$ 8,316	\$ 7,184	\$ 21,702	\$ 21,435
Other comprehensive income (loss), net of tax:				
Net unrealized gains (losses) on securities available for sale	5,492	(1,745)	2,546	4,683
Pension and post-retirement obligations	138	19	413	58
Total other comprehensive income (loss), net of tax	5,630	(1,726)	2,959	4,741
Comprehensive income	\$ 13,946	\$ 5,458	\$ 24,661	\$ 26,176

See accompanying notes to the consolidated financial statements.



Table of Contents

## FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

## Consolidated Statements of Changes in Shareholders' Equity (Unaudited)

Nine months ended September 30, 2015 and 2014

<i>(Dollars in thousands, except per share data)</i>	Preferred Equity	Common Stock	Additional Paid-in Capital	Retained Earnings	Accumulated Other Comprehensive Loss	Treasury Stock	Total Shareholders' Equity
<b>Balance at January 1, 2014</b>	<b>\$ 17,342</b>	<b>\$ 142</b>	<b>\$ 67,574</b>	<b>\$ 186,137</b>	<b>\$ (10,187)</b>	<b>\$ (6,169)</b>	<b>\$ 254,839</b>
Comprehensive income:							
Net income				21,435			21,435
Other comprehensive income, net of tax					4,741		4,741
Issuance of common stock for acquisition		2	5,398				5,400
Purchases of common stock for treasury						(195)	(195)
Repurchase of Series B-1 8.48% preferred stock	(2)						(2)
Share-based compensation plans:							
Share-based compensation			383				383
Stock options exercised			2			158	160
Restricted stock awards issued, net			(554)			554	
Cash dividends declared:							
Series A 3% Preferred-\$2.25 per share				(3)			(3)
Series B-1 8.48% Preferred-\$6.36 per share				(1,094)			(1,094)
Common-\$0.57 per share				(7,906)			(7,906)
<b>Balance at September 30, 2014</b>	<b>\$ 17,340</b>	<b>\$ 144</b>	<b>\$ 72,803</b>	<b>\$ 198,569</b>	<b>\$ (5,446)</b>	<b>\$ (5,652)</b>	<b>\$ 277,758</b>
<b>Balance at January 1, 2015</b>	<b>\$ 17,340</b>	<b>\$ 144</b>	<b>\$ 72,955</b>	<b>\$ 203,312</b>	<b>\$ (9,011)</b>	<b>\$ (5,208)</b>	<b>\$ 279,532</b>
Comprehensive income:							
Net income				21,702			21,702
Other comprehensive income, net of tax					2,959		2,959
Purchases of common stock for treasury						(41)	(41)
Share-based compensation plans:							

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Share-based compensation	520			520
Stock options exercised	1		251	252
Restricted stock awards issued, net	(1,060)		1,060	
Stock awards	11		43	54
Cash dividends declared:				
Series A 3% Preferred-\$2.25 per share		(3)		(3)
Series B-1 8.48% Preferred-\$6.36 per share		(1,094)		(1,094)
Common-\$0.60 per share		(8,447)		(8,447)
<b>Balance at September 30, 2015</b>	<b>\$ 17,340</b>	<b>\$ 144</b>	<b>\$ 72,427</b>	<b>\$ 215,470</b>
		<b>\$ (6,052)</b>	<b>\$ (3,895)</b>	<b>\$ 295,434</b>

See accompanying notes to the consolidated financial statements.

**Table of Contents****FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES****Consolidated Statements of Cash Flows (Unaudited)**

<i>(Dollars in thousands)</i>	<b>Nine months ended September 30,</b>	
	<b>2015</b>	<b>2014</b>
<b>Cash flows from operating activities:</b>		
Net income	\$ 21,702	\$ 21,435
<b>Adjustments to reconcile net income to net cash provided by operating activities:</b>		
Depreciation and amortization	4,065	3,247
Net amortization of premiums on securities	2,355	2,435
Provision for loan losses	4,783	5,879
Share-based compensation	520	383
Deferred income tax expense	318	802
Proceeds from sale of loans held for sale	10,370	12,649
Originations of loans held for sale	(11,022)	(10,919)
Increase in company owned life insurance	(1,448)	(1,249)
Net gain on sale of loans held for sale	(161)	(231)
Net gain on disposal of investment securities	(1,348)	(1,777)
Amortization of tax credit investment	390	
Net gain on sale and disposal of other assets	(20)	(61)
Decrease in other assets	2,830	5,420
Increase (decrease) in other liabilities	1,819	(61)
<b>Net cash provided by operating activities</b>	<b>35,153</b>	<b>37,952</b>
<b>Cash flows from investing activities:</b>		
Purchases of available for sale securities	(271,899)	(179,203)
Purchases of held to maturity securities	(53,768)	(50,394)
Proceeds from principal payments, maturities and calls on available for sale securities	118,378	123,625
Proceeds from principal payments, maturities and calls on held to maturity securities	23,826	26,432
Proceeds from sales of securities available for sale	37,620	76,100
Net loan originations	(130,485)	(79,138)
Purchases of company owned life insurance	(34)	(5,034)
Proceeds from sales of other assets	167	1,289
Purchases of premises and equipment	(4,957)	(4,448)
Cash consideration paid for acquisition, net of cash acquired		(7,995)
<b>Net cash used in investing activities</b>	<b>(281,152)</b>	<b>(98,766)</b>
<b>Cash flows from financing activities:</b>		
Net increase in deposits	302,973	218,768
Net decrease in short-term borrowings	(93,404)	(121,075)
Issuance of long-term debt	40,000	
Debt issuance costs	(1,060)	

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Repurchase of preferred stock		(2)
Purchase of common stock for treasury	(41)	(195)
Proceeds from stock options exercised	252	160
Cash dividends paid to common and preferred shareholders	(9,538)	(8,952)
Net cash provided by financing activities	239,182	88,704
Net (decrease) increase in cash and cash equivalents	(6,817)	27,890
Cash and cash equivalents, beginning of period	58,151	59,692
Cash and cash equivalents, end of period	\$ 51,334	\$ 87,582
Supplemental information:		
Cash paid for interest	\$ 5,566	\$ 5,056
Cash paid for income taxes	4,257	9,739
Noncash investing and financing activities:		
Real estate and other assets acquired in settlement of loans	286	394
Accrued and declared unpaid dividends	3,183	3,032
Increase in net unsettled security purchases	2,232	1,724
Securities transferred from available for sale to held to maturity (at fair value)	165,238	12,802
Loans transferred from held for sale to held for investment		853
Common stock issued for acquisition		5,400
See accompanying notes to the consolidated financial statements.		

**Table of Contents**

**FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES**

**Notes to Consolidated Financial Statements (Unaudited)**

**(1.) BASIS OF PRESENTATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

**Nature of Operations**

Financial Institutions, Inc., (the Company) is a financial holding company organized in 1931 under the laws of New York State. 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, Five Star Bank (the Bank). The Company has also expanded its indirect lending network to include relationships with franchised automobile dealers in the Capital District of New York and Northern Pennsylvania. On August 1, 2014, the Company acquired Scott Danahy Naylon Co., Inc., a full service insurance agency located in Amherst, New York. The Company provides insurance and risk consulting services through its wholly-owned insurance subsidiary, Scott Danahy Naylon, LLC (SDN).

**Basis of Presentation**

The consolidated financial statements include the accounts of Financial Institutions, Inc. and its subsidiaries. All significant intercompany accounts and transactions have been eliminated in consolidation. The accounting and reporting policies conform to U.S. generally accepted accounting principles (GAAP). Certain information and footnote disclosures normally included in financial statements prepared in conformity with GAAP have been condensed or omitted pursuant to applicable rules and regulations of the Securities and Exchange Commission. However, in the opinion of management, the accompanying consolidated financial statements reflect all adjustments of a normal and recurring nature necessary for a fair presentation of the consolidated statements of financial condition, income, comprehensive income, changes in shareholders' equity and cash flows for the periods indicated, and contain adequate disclosure to make the information presented not misleading. Prior years' consolidated financial statements are re-classified whenever necessary to conform to the current year's presentation. These consolidated financial statements should be read in conjunction with the Company's 2014 Annual Report on Form 10-K for the year ended December 31, 2014. The results of operations for any interim periods are not necessarily indicative of the results which may be expected for the entire year.

**Subsequent Events**

The Company has evaluated events and transactions for potential recognition or disclosure through the day the financial statements were issued and determined that there were no subsequent events.

**Use of Estimates**

The preparation of these financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. Actual results could differ from those estimates. Material estimates relate to the determination of the allowance for loan losses, the carrying value of goodwill and deferred tax assets, the valuation and other than temporary impairment (OTTI) considerations related to the securities portfolio, and assumptions used in the defined benefit pension plan accounting.

**Recent Accounting Pronouncements**

In May 2014, the Financial Accounting Standards Board issued Accounting Standards Update ( ASU ) No. 2014-09, *Revenue from Contracts with Customers (Topic 606)*. ASU 2014-09 implements a common revenue standard that clarifies the principles for recognizing revenue. The core principle of ASU 2014-09 is that an entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. To achieve that core principle, an entity should apply the following steps: (i) identify the contract(s) with a customer, (ii) identify the performance obligations in the contract, (iii) determine the transaction price, (iv) allocate the transaction price to the performance obligations in the contract and (v) recognize revenue when (or as) the entity satisfies a performance obligation. The effective date was recently deferred for one year to the interim and annual periods beginning on or after December 15, 2017. Early adoption is permitted as of the original effective date interim and annual periods beginning on or after December 15, 2016. The Company is evaluating the potential impact of ASU 2014-09 on the Company s financial statements.

In June 2014, the FASB issued ASU 2014-12, *Compensation Stock Compensation (Topic 718)*. The pronouncement was issued to clarify the accounting for share-based payments when the terms of an award provide that a performance target could be achieved after the requisite service period. ASU 2014-12 will be effective for the Company beginning January 1, 2016, though early adoption is permitted. The adoption of ASU 2014-12 is not expected to have a significant impact on the Company s financial statements.

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**Table of Contents**

**FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES**

**Notes to Consolidated Financial Statements (Unaudited)**

**(1.) BASIS OF PRESENTATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES  
(Continued)**

In January 2015, the FASB issued ASU 2015-01, *Income Statement - Extraordinary and Unusual Items (Subtopic 225-20) - Simplifying Income Statement Presentation by Eliminating the Concept of Extraordinary Items*. ASU 2015-01 eliminates from U.S. GAAP the concept of extraordinary items, which, among other things, required an entity to segregate extraordinary items considered to be unusual and infrequent from the results of ordinary operations and show the item separately in the income statement, net of tax, after income from continuing operations. ASU 2015-01 will be effective for the Company beginning January 1, 2016, though early adoption is permitted. ASU 2015-01 is not expected to have a significant impact on the Company's financial statements.

In April 2015, the FASB issued ASU 2015-03, *Simplifying the Presentation of Debt Issuance Costs*. Under ASU 2015-03, the Company will present debt issuance costs in the balance sheet as a reduction from the related debt liability rather than as an asset. Amortization of such costs will continue to be reported as interest expense. ASU 2015-03 will be effective for the Company beginning January 1, 2016, though early adoption is permitted. Retrospective adoption is required. The Company early adopted this standard during the quarter ended June 30, 2015, concurrent with the issuance of the Subordinated Notes described in Note 7. Unamortized debt issuance costs of \$1.0 million are included in the net balance of long-term borrowings reported on the Consolidated Statements of Financial Condition. Retrospective application of this standard did not impact previously issued financial statements.

**(2.) BUSINESS COMBINATIONS**

***SDN Acquisition***

On August 1, 2014, the Company completed the acquisition of Scott Danahy Naylor Co., Inc., a full service insurance agency located in Amherst, New York. Consideration for the acquisition included both cash and stock totaling \$16.9 million, including up to \$3.4 million of future payments, contingent upon SDN meeting certain revenue targets through 2017. The estimated fair value of the contingent consideration at the date of acquisition was \$3.2 million, which was estimated using a probability-weighted discounted cash flow model. As a result of the acquisition, the Company recorded goodwill of \$12.6 million and other intangible assets of \$6.6 million. The goodwill is not expected to be deductible for income tax purposes. Pro forma results of operations for this acquisition have not been presented because the effect of this acquisition was not material to the Company's consolidated financial statements.

This acquisition was accounted for under the acquisition method in accordance with FASB ASC Topic 805. Accordingly, the assets and liabilities, both tangible and intangible, were recorded at their estimated fair values as of the acquisition date. The following table summarizes the consideration paid for Scott Danahy Naylor Co., Inc. and the amounts of the assets acquired and liabilities assumed.

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Consideration paid:	
Cash	\$ 8,100
Stock	5,400
Contingent consideration	3,227
Fair value of total consideration transferred	16,727
Fair value of assets acquired:	
Cash	105
Identified intangible assets	6,640
Premises and equipment, accounts receivable and other assets	1,094
Total identifiable assets acquired	7,839
Fair value of liabilities assumed:	
Deferred tax liability	2,556
Other liabilities	1,173
Total liabilities assumed	3,729
Fair value of net assets acquired	4,110
Goodwill resulting from acquisition	\$ 12,617

- 9 -



**Table of Contents****FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES****Notes to Consolidated Financial Statements (Unaudited)****(3.) EARNINGS PER COMMON SHARE ( EPS )**

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

	<b>Three months ended September 30,</b>		<b>Nine months ended September 30,</b>	
	<b>2015</b>	<b>2014</b>	<b>2015</b>	<b>2014</b>
Net income available to common shareholders	\$ 7,950	\$ 6,818	\$ 20,605	\$ 20,338
Weighted average common shares outstanding:				
Total shares issued	14,398	14,318	14,398	14,214
Unvested restricted stock awards	(100)	(64)	(92)	(64)
Treasury shares	(211)	(301)	(230)	(310)
Total basic weighted average common shares outstanding	14,087	13,953	14,076	13,840
Incremental shares from assumed:				
Exercise of stock options	23	26	22	25
Vesting of restricted stock awards	29	28	26	25
Total diluted weighted average common shares outstanding	14,139	14,007	14,124	13,890
Basic earnings per common share	\$ 0.56	\$ 0.49	\$ 1.46	\$ 1.47
Diluted earnings per common share	\$ 0.56	\$ 0.49	\$ 1.46	\$ 1.46
For each of the periods presented, average shares subject to the following instruments were excluded from the computation of diluted EPS because the effect would be antidilutive:				
Stock options				5
Restricted stock awards			1	1
			1	6

**Table of Contents****FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES****Notes to Consolidated Financial Statements (Unaudited)****(4.) INVESTMENT SECURITIES**

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

	Amortized Cost	Unrealized Gains	Unrealized Losses	Fair Value
<b>September 30, 2015</b>				
<b>Securities available for sale:</b>				
U.S. Government agencies and government sponsored enterprises	\$ 261,364	\$ 2,539	\$ 351	\$ 263,552
Mortgage-backed securities:				
Federal National Mortgage Association	220,626	3,482	468	223,640
Federal Home Loan Mortgage Corporation	27,371	582	73	27,880
Government National Mortgage Association	33,533	1,399	3	34,929
Collateralized mortgage obligations:				
Federal National Mortgage Association	20,798	408	5	21,201
Federal Home Loan Mortgage Corporation	5,181	1	6	5,176
Privately issued		920		920
Total mortgage-backed securities	307,509	6,792	555	313,746
Asset-backed securities		211		211
Total available for sale securities	\$ 568,873	\$ 9,542	\$ 906	\$ 577,509
<b>Securities held to maturity:</b>				
State and political subdivisions	289,986	6,110	70	296,026
Mortgage-backed securities:				
Federal National Mortgage Association	9,293	81	11	9,363
Government National Mortgage Association	26,121	112	109	26,124
Collateralized mortgage obligations:				
Federal National Mortgage Association	59,490			59,490