

FIRST NATIONAL COMMUNITY BANCORP INC
Form 10-K/A
March 30, 2005
UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K/A

FOR ANNUAL AND TRANSITION REPORTS

PURSUANT TO SECTIONS 13 OR 15(d) OF THE

SECURITIES EXCHANGE ACT OF 1934

ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the fiscal year ended December 31, 2004

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 No. _____

FIRST NATIONAL COMMUNITY BANCORP, INC.

(Exact Name of Registrant as Specified in Its Charter)

Pennsylvania 23-2900790

(State or Other Jurisdiction of (I.R.S. Employer

Incorporation or Organization) Identification No.)

102 E. Drinker St., Dunmore, PA 18512

(Address of Principal Executive Offices) (Zip Code)

Registrant's telephone number, including area code (570) 346-7667

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Securities registered pursuant to Section 12(b) of the Act:

NONE

Securities registered pursuant to Section 12(g) of the Act:

Common Stock, \$1.25 par value

(Title of Class)

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 if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

Indicate by check mark whether the registrant is an accelerated filer (as defined in Exchange Act Rule 12b-2).

Yes No

The aggregate market value of the voting and non-voting common stock of the registrant, held by non-affiliates was approximately \$369,876,505 at June 30, 2004.

APPLICABLE ONLY TO CORPORATE REGISTRANTS

State the number of shares outstanding of each of the registrant's classes of common stock, as of the latest practicable date 10,944,225 shares of common stock as of March 11, 2005.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the Registrant's Proxy Statement for the Annual Meeting of Shareholders to be held May 18, 2005 are incorporated by reference into Part III of this report. Portions of the Registrant's Annual Report to security holders for the Fiscal Year Ended December 31, 2004 are incorporated by reference into Part IV of this report.

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EXPLANATORY STATEMENT:

This amendment to First National Community Bancorp, Inc.'s Annual Report on Form 10-K for the fiscal year ended December 31, 2004, is being filed to include the appropriate Report of Independent Registered Public Accounting Firm in Item 9A - Controls and Procedures and in Exhibit E - Report of Independent Registered Public Accounting Firm. No revisions have been made to the financial statements or any other disclosures contained in the Annual Report.

FIRST NATIONAL COMMUNITY BANCORP, INC.

Part I.

Item 1 Business

CORPORATE PROFILE

The Business of First National Community Bancorp, Inc.

THE COMPANY

First National Community Bancorp, Inc. (the "company") is a Pennsylvania business, incorporated in 1997 and is registered as a financial holding company under the Bank Holding Company Act of 1956, as amended. The company became an active bank holding company on July 1, 1998 when it assumed ownership of First National Community Bank (the "bank"). On November 2, 2000, the Federal Reserve Bank of Philadelphia approved the company's application to change its status to a financial holding company as a complement to the company's strategic objective. The bank is a wholly-owned subsidiary of the company.

The company's primary activity consists of owning and operating the bank, which provides customary retail and commercial banking services to individuals and businesses. The bank provides practically all of the company's earnings as a result of its banking services.

THE BANK

The bank was established as a national banking association in 1910 as The First National Bank of Dunmore. Based upon shareholder approval received at a Special Shareholders' Meeting held October 27, 1987, the bank changed its name to First National Community Bank effective March 1, 1988. The bank's operations are conducted from offices located in Lackawanna and Luzerne Counties, Pennsylvania:

| <u>Office</u> | <u>Date Opened</u> |
|----------------|--------------------|
| Main | October 1910 |
| Scranton | September 1980 |
| Dickson City | December 1984 |
| Fashion Mall | July 1988 |
| Wilkes-Barre | July 1993 |
| Pittston Plaza | April 1995 |

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| | |
|------------------|---------------|
| Kingston | August 1996 |
| Exeter | November 1998 |
| Daleville | April 2000 |
| Plains | June 2000 |
| Back Mountain | October 2000 |
| Clarks Green | October 2001 |
| Hanover Township | January 2002 |
| Nanticoke | April 2002 |
| Hazleton | October 2003 |
| Route 315 | February 2004 |

The bank provides many commercial banking services to individuals and businesses, including a wide variety of deposit instruments including Image Checking and E-Statement. Consumer loans include both secured and unsecured installment loans, fixed and variable rate mortgages, jumbo mortgages, home equity term loans and lines of credit and Instant Money overdraft protection loans. Additionally, the bank is also in the business of underwriting indirect auto loans which are originated through various auto dealers in northeastern Pennsylvania and dealer floor plan loans. MasterCard and VISA personal credit cards are available through the bank, as well as the FNCB Check Card which allows customers to access their checking account at any retail location that accepts VISA and serves the dual purpose of an ATM card. In the commercial lending field, the bank offers demand and term loans, either secured or unsecured, letters of credit, working capital loans, accounts receivable, inventory or equipment financing loans, and commercial mortgages. In addition, the bank offers MasterCard and VISA processing services to its commercial customers, as well as our Cash Management service which can be accessed through FNCBusiness Online, which is Internet based. FNCBusiness Online is a menu driven product that allows our business customers to have direct access to their account information and the ability to perform internal and external transfers and process Direct Deposit payroll transactions for employees, 24 hours a day, 7 days a week, from their place of business. As a result of the bank's partnership with INVEST, our customers are able to access alternative products such as mutual funds, annuities, stock and bond

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purchases, etc. directly from our INVEST representatives. The bank also offers customers the convenience of 24-hour banking, seven days a week, through FNCB Online via the Internet and its ATM network. Automated teller machines are available at the following locations:

Community Offices

Dunmore
Scranton
Dickson City
Fashion Mall
Wilkes-Barre
Pittston
Kingston
Exeter
Daleville
Plains
Back Mountain
Clarks Green
Hanover Township
Nanticoke
Hazleton
Route 315

Remote Locations

Petro Truck Stop, 98 Grove St., Dupont
Bill's Shursave Supermarket, Rt. 502, Daleville
Joe's Kwik Mart, 620 N. Blakely St., Dunmore
Joe's Kwik Mart, Rts 940 and I-380, Pocono Summit
Joe's Kwik Mart, RR1, Newfoundland
Joe's Kwik Mart, Providence Rd. and Main Ave., Scranton
Hess Gas Station, 5128 Milford Road, East Stroudsburg

Additionally, to further enhance 24-hour banking services, Telephone Banking (Account Link), Loan by Phone, and Mortgage Link are available to customers. These services provide consumers the ability to access account information, perform related account transfers, and apply for a loan through the use of a touch tone telephone. Also, in our efforts to continually provide consumers the best possible service, the bank implemented in 2004 a Bounce Protection service which provides consumers with an added level of protection against unanticipated cash flow emergencies and account reconciliation errors.

As of December 31, 2004, industry concentrations exist within the following eight industries. Loans and lines of credit to each of these industries were as follows:

| | % of Regulatory | |
|----------------------------|-----------------|----------------|
| | <u>Amount</u> | <u>Capital</u> |
| Shopping Centers/Complexes | \$36,914,000 | 45% |
| Hotels | \$33,510,000 | 41% |
| Restaurants | \$29,827,000 | 36% |
| Land Subdivision | \$27,874,000 | 34% |
| Automobile Dealers | \$24,818,000 | 30% |
| Office Complexes/Units | \$21,292,000 | 26% |
| General Government | \$20,797,000 | 25% |
| Gas Stations | \$20,137,000 | 25% |

First lien mortgages on the real estate and a diverse group of borrowers, including carefully selected automobile dealers, provide security against undue risks in the portfolio.

COMPETITION

The bank is one of two financial institutions with principal offices in Dunmore. Primary competition in the Lackawanna County market comes from numerous commercial banks and savings and loan associations operating in the area. Our Luzerne County offices share many of the same competitors we face in Lackawanna County as well as several banks and savings and loans that are not in our Lackawanna County market. Deposit deregulation has intensified the competition for deposits among banks in recent years. Additional competition is derived from credit unions, finance companies, brokerage firms, insurance companies and retailers.

SUPERVISION AND REGULATION

The company is subject to the Securities Exchange Act of 1934 (1934 Act) and must file quarterly and annual reports with the U.S. Securities and Exchange Commission regarding its business operations. As a registered financial holding company under the Bank Holding Company Act of 1956, as amended, the company is subject to the supervision and examination by the Federal Reserve Board.

The bank is subject to regulation and supervision by the Office of the Comptroller of the Currency, which includes regular examinations of the bank's records and operations. As a member of the Federal Deposit Insurance Corporation (FDIC), the bank's depositors' accounts are insured up to \$100,000 per ownership category. To obtain this protection for its depositors, the bank pays an assessment and is subject to the regulations of the FDIC. The bank is also a member of the Federal Reserve System and as such is subject to the rules promulgated by the Federal Reserve Board.

Financial Services Modernization Legislation. - In November 1999, the Gramm-Leach-Bliley Act of 1999, or the GLB, was enacted. The GLB repeals provisions of the Glass-Steagall Act which restricted the affiliation of Federal Reserve member banks with firms engaged principally in specified securities activities, and which restricted officer, director or employee interlocks between a member bank and any company or person primarily engaged in specified securities activities.

In addition, the GLB also contains provisions that expressly preempt any state law restricting the establishment of financial affiliations, primarily related to insurance. The general effect of the law is to establish a comprehensive framework to permit affiliations among commercial banks, insurance companies, securities firms and other financial service providers by revising and expanding the Bank Holding Company Act framework to permit a holding company to engage in a full range of financial activities through a new entity known as a financial holding company. Financial activities is broadly defined to include not only banking, insurance and securities activities, but also merchant banking and additional activities that the Federal Reserve Board, in consultation with the Secretary of the Treasury, determines to be financial in nature, incidental to such financial activities or complementary activities that do not pose a substantial risk to the safety and soundness of depository institutions or the financial system generally.

The GLB also permits national banks to engage in expanded activities through the formation of financial subsidiaries. A national bank may have a subsidiary engaged in any activity authorized for national banks directly or any financial activity, except for insurance underwriting, insurance investments, real estate investment or development, or merchant banking, which may only be conducted through a subsidiary of a financial holding company. Financial activities include all activities permitted under new sections of the Bank Holding Company Act or permitted by regulation.

To the extent that the GLB permits banks, securities firms and insurance companies to affiliate, the financial services industry may experience further consolidation. The GLB is intended to grant to community banks certain powers as a matter of right that larger institutions have accumulated on an ad hoc basis and which unitary savings and loan holding companies already possess. Nevertheless, the GLB may have the result of increasing the amount of competition that First National Community Bancorp, Inc. faces from larger institutions and other types of companies offering financial products, many of which may have substantially more financial resources than First National Community Bancorp, Inc. has.

USA Patriot Act of 2001 - In October 2001, the USA Patriot Act of 2001 was enacted in response to the terrorist attacks in New York, Pennsylvania and Washington D.C. which occurred on September 11, 2001. The Patriot Act is intended to strengthen U.S. law enforcement's and the intelligence communities' abilities to work cohesively to combat terrorism on a variety of fronts. The potential impact of the Patriot Act on financial institutions of all kinds is significant and wide ranging. The Patriot Act contains sweeping anti-money laundering and financial transparency laws and imposes various regulations, including standards for verifying client identification at account opening, and rules to promote cooperation among financial institutions, regulators and law enforcement entities in identifying parties that may be involved in terrorism or money laundering.

IMLAFATA - As part of the USA Patriot Act, Congress adopted the International Money Laundering Abatement and Financial Anti-Terrorism Act of 2001 (IMLAFATA). IMLAFATA amended the Bank Secrecy Act and adopted certain additional measures that increase the obligation of

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financial institutions, including First National Community Bancorp, Inc., to identify their customers, watch for and report upon suspicious transactions, respond to requests for information by federal banking regulatory authorities and law enforcement agencies, and share information with other financial institutions. The Secretary of the Treasury has adopted several regulations to

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implement these provisions. First National Community Bancorp, Inc. is also barred from dealing with foreign shell banks. In addition, IMLAFATA expands the circumstances under which funds in a bank account may be forfeited. IMLAFATA also amended the BHC Act and the Bank Merger Act to require the federal banking regulatory authorities to consider the effectiveness of a financial institution's anti-money laundering activities when reviewing an application to expand operations. First National Community Bancorp, Inc. has in place a Bank Secrecy Act compliance program.

Sarbanes-Oxley Act of 2002 - On July 30, 2002, President Bush signed into law the Sarbanes-Oxley Act of 2002 (the Act). The stated goals of the Act are to increase corporate responsibility, to provide for enhanced penalties for accounting and auditing improprieties at publicly traded companies and to protect investors by improving the accuracy and reliability of corporate disclosures pursuant to the securities laws.

The Act is the most far-reaching U.S. securities legislation enacted in decades. The Act generally applies to all companies, both U.S. and non-U.S., that file or are required to file periodic reports with the Securities and Exchange Commission (the SEC) under the Securities Exchange Act of 1934. Due to the SEC's extensive role in implementing rules relating to many of the Act's new requirements, the final scope of these requirements remains to be determined.

The Act includes very specific additional disclosure requirements and new corporate governance rules, requires the SEC and securities exchanges to adopt extensive additional disclosure, corporate governance and other related rules and mandates further studies of certain issues by the SEC. The Act represents significant federal involvement in matters traditionally left to state regulatory systems, such as the regulation of the accounting profession, and to state corporate law, such as the relationship between a board of directors and management and between a board of directors and its committees.

The Act addresses, among other matters:

- audit committees for all reporting companies;
- certification of financial statements by the chief executive officer and the chief financial officer;
- the forfeiture of bonuses or other incentive-based compensation and profits from the sale of an issuer's securities by directors and senior officers in the twelve month period following initial publication of any financial statements that later require restatement;
- a prohibition on insider trading during pension plan black out periods;
- disclosure of off-balance sheet transactions;
- a prohibition on personal loans to directors and officers; expedited filing requirements for Form 4's;
- disclosure of a code of ethics and filing a Form 8-K for a change or waiver of such code;
- real time filing of periodic reports;
- the formation of a public accounting oversight board;
- auditor independence; and
- various increased criminal penalties for violations of securities laws.

The Act contains provisions that were effective upon enactment on July 30, 2002 and provisions that will be phased in for up to one year after enactment. The SEC was delegated the task of enacting rules to implement various provisions with respect to, among other matters, disclosure in periodic filings pursuant to the Exchange Act.

Regulation W - Transactions between a bank and its affiliates are quantitatively and qualitatively restricted under the Federal Reserve Act. The Federal Deposit Insurance Act applies Sections 23A and 23B to insured nonmember banks in the same manner and to the same extent as if they were members of the Federal

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Reserve System. The Federal Reserve Board has also recently issued Regulation W, which codifies prior regulations under Sections 23A and 23B of the Federal Reserve Act and interpretative guidance with respect to affiliate transactions. Regulation W incorporates the exemption from the affiliate transaction rules but expands the exemption to cover the purchase of any type of loan or extension of credit from an affiliate. Affiliates of a bank include, among other entities, the bank's holding company and companies that are under common control with the bank. First National Community Bancorp, Inc. is considered to be an affiliate of First National Community Bank. In general, subject to certain specified exemptions, a bank or its subsidiaries are limited in their ability to engage in covered transactions with affiliates:

to an amount equal to 10% of the bank's capital and surplus, in the case of covered transactions with any one affiliate; and
to an amount equal to 20% of the bank's capital and surplus, in the case of covered transactions with all affiliates.

In addition, a bank and its subsidiaries may engage in covered transactions and other specified transactions only on terms and under circumstances that are substantially the same, or at least as favorable to the bank or its subsidiary, as those prevailing at the time for comparable transactions with nonaffiliated companies. A covered transaction includes:

a loan or extension of credit to an affiliate;
a purchase of, or an investment in, securities issued by an affiliate;
a purchase of assets from an affiliate, with some exceptions;
the acceptance of securities issued by an affiliate as collateral for a loan or extension of credit to any party; and
the issuance of a guarantee, acceptance or letter of credit on behalf of an affiliate.

In addition, under Regulation W:

a bank and its subsidiaries may not purchase a low-quality asset from an affiliate;
covered transactions and other specified transactions between a bank or its subsidiaries and an affiliate must be on terms and conditions that are consistent with safe and sound banking practices; and
with some exceptions, each loan or extension of credit by a bank to an affiliate must be secured by collateral with a market value ranging from 100% to 130%, depending on the type of collateral, of the amount of the loan or extension of credit.

Regulation W generally excludes all non-bank and non-savings association subsidiaries of banks from treatment as affiliates, except to the extent that the Federal Reserve Board decides to treat these subsidiaries as affiliates.

Concurrently with the adoption of Regulation W, the Federal Reserve Board has proposed a regulation which would further limit the amount of loans that could be purchased by a bank from an affiliate to not more than 100% of the bank's capital and surplus.

EMPLOYEES

As of December 31, 2004 the bank employed 264 persons, including 55 part-time employees.

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AVAILABLE INFORMATION

The company files reports, proxy and information statements and other information electronically with the Securities and Exchange Commission. You may read and copy any materials that the company files with the SEC at the SEC's Public Reference Room at 450 Fifth Street, NW, Washington, DC 20549. You can obtain information on the operation of the Public Reference Room by calling the SEC at 1-800-SEC-0330. The SEC maintains an Internet site that contains reports, proxy and information statements, and other information regarding issuers that file electronically with the SEC. The SEC's website site address is <http://www.sec.gov>. The company's web site address is <http://www.fncb.com>. The company makes available free of charge through our website, our annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, and amendments to those reports filed or furnished pursuant to Section 13(a) or 15(d) of the Exchange Act as soon as reasonably practicable after we

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electronically file such material with, or furnish it to, the SEC. Further, we will provide electronic or paper copies of the company's filings free of charge upon request. A copy of the company's Annual Report on Form 10-K for the year ended December 31, 2004 may be obtained without charge from our website at www.fnbc.com or via email at fnbc@fnbc.com. Information may also be obtained via written request to First National Community Bancorp, Inc. Attention: Treasurer, 102 East Drinker Street, Dunmore, PA 18512.

Item 2 - Properties

| <u>Property</u> | <u>Location</u> | <u>Ownership</u> | <u>Type of Use</u> |
|-----------------|---|------------------|-------------------------|
| 1 | 102 East Drinker Street Dunmore, PA | Own | Main Office |
| 2 | 419-421 Spruce Street Scranton, PA | Own | Scranton Branch |
| 3 | 934 Main Street Dickson City, PA | Own | Dickson City Branch |
| 4 | 277 Scranton/Carbondale Highway Scranton, PA | Lease | Fashion Mall Branch |
| 5 | 23 West Market Street Wilkes-Barre, PA | Lease | Wilkes-Barre Branch |
| 6 | 1700 North Township Blvd. Pittston, PA | Lease | Pittston Plaza Branch |
| 7 | 754 Wyoming Avenue Kingston, PA | Lease | Kingston Branch |
| 8 | 1625 Wyoming Avenue Exeter, PA | Lease | Exeter Branch |
| 9 | Route 502 & 435 Daleville, PA | Lease | Daleville Branch |
| 10 | 27 North River Road Plains, PA | Lease | Plains Branch |
| 11 | 169 North Memorial Highway Shavertown, PA | Lease | Back Mountain Branch |
| 12 | 269 East Grove Street Clarks Green, PA | Own | Clarks Green Branch |
| 13 | 734 Sans Souci Parkway Hanover Township, PA | Lease | Hanover Township Branch |
| 14 | 194 South Market Street Nanticoke, PA | Own | Nanticoke Branch |
| 15 | 200 South Blakely Street Dunmore, PA | Lease | Administrative Center |
| 16 | 330-352 West Broad Street Hazleton, PA | Own | Hazleton Branch |
| 17 | 3 Old Boston Road | | |

Pittston, PA

Lease

Route 315 Branch

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| | | | |
|----|---|-----|-------------|
| 18 | 107-109 South Blakely Street Dunmore, PA | Own | Parking Lot |
| 19 | 114-116 South Blakely Street Dunmore, PA | Own | Parking Lot |
| 20 | 1708 Tripp Avenue Dunmore, PA | Own | Parking Lot |
| 21 | Rt. 209 Marshalls Creek, PA | Own | Land |

Item 3 - Legal Proceedings

Neither the company nor its subsidiaries are involved in any material pending legal proceedings, other than routine litigation incidental to the business nor does the company know of any proceedings contemplated by governmental authorities.

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

Not Applicable

Part II.

Item 5 - Market for Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities

INVESTOR INFORMATION

MARKET PRICES OF STOCK AND DIVIDENDS PAID

The company's common stock is not actively traded. The principal market area for the company's stock is northeastern Pennsylvania, although shares are held by residents of other states across the country. First National Community Bancorp, Inc. is listed in the Over-The-Counter (OTC) Bulletin Board Stocks under the symbol FNCB. Quarterly market highs and lows and dividends paid for each of the past two years are presented below. These prices represent actual transactions. The company expects that comparable cash dividends will be paid in the future.

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DIVIDENDS

| <u>QUARTER</u> | <u>MARKET PRICE</u> | | <u>PAID</u> |
|----------------|---------------------|------------|------------------|
| | <u>HIGH</u> | <u>LOW</u> | |
| | | | <u>PER SHARE</u> |
| <u>2004</u> | | | |
| First | \$16.25 | \$14.25 | \$.08 |
| Second | 17.13 | 14.95 | .08 |
| Third | 20.88 | 15.50 | .09 |
| Fourth | 25.15 | 20.00 | <u>.11</u> |
| | | | <u>\$ 0.36</u> |
| <u>2003</u> | | | |
| First | \$13.90 | \$ 9.65 | \$.07 |
| Second | 16.00 | 13.50 | .07 |
| Third | 14.00 | 12.75 | .08 |
| Fourth | 14.75 | 12.75 | <u>.09</u> |
| | | | <u>\$ 0.31</u> |

* Share and per share information includes the retroactive effect of the 100% stock dividends paid September 30,

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2004, which resulted in the issuance of 5,423,425 new shares, and January 31, 2003.

MARKET MAKERS

F.J. Morrissey
1700 Market Street
Suite 1420
Philadelphia, PA 19103
(215) 563-8500

Ryan, Beck and Co.
220 South Orange Avenue
Livingston, NJ 07039
(973) 597-6000

Monroe Securities
47 State Street
Rochester, NY 14614
(716) 546-5560

RBC Dain Rauscher
1211 Avenue of the Americas
32nd Floor
New York, NY 10036
(866) 835-1422

TRANSFER AGENT

Registrar and Transfer Company

10 Commerce Drive

Cranford, NJ 07016-9982

Shareholder questions regarding stock ownership should be directed to the Investor Relations Department at Registrar and Transfer Company at 1-800-368-5948.

DIVIDEND CALENDAR

Dividends on the company's common stock, if approved by the Board of Directors, are customarily paid on or about March 15, June 15, September 15 and December 15. Record dates for dividends are customarily on or about March 1, June 1, September 1, and December 1. As of March 11, 2005, the latest practicable date, there were 1,285 shareholders.

Item 6 Selected Financial Data

FIRST NATIONAL COMMUNITY BANCORP, INC. AND SUBSIDIARIES

SELECTED FINANCIAL DATA

(In thousands, except per share data)

| | For the Years Ended December 31, | | | | |
|---|----------------------------------|------------|------------|------------|------------|
| | 2004 | 2003 | 2002 | 2001 | 2000 |
| Total assets | \$907,491 | \$816,303 | \$735,327 | \$676,307 | \$583,852 |
| Interest-bearing balances with financial institutions | 1,980 | 2,673 | 3,368 | 3,161 | 3,359 |
| Securities | 231,831 | 211,353 | 205,492 | 194,109 | 152,316 |
| Net loans | 625,792 | 552,197 | 487,976 | 439,884 | 393,125 |
| Total deposits | 671,713 | 602,069 | 540,475 | 517,334 | 460,418 |
| Stockholders' equity | 75,723 | 68,738 | 62,843 | 51,786 | 46,684 |
| Net interest income before provision for credit losses | 25,269 | 23,295 | 22,060 | 19,233 | 19,021 |
| Provision for credit losses | 1,400 | 1,200 | 1,400 | 1,220 | 970 |
| Other income | 4,789 | 4,184 | 3,676 | 3,151 | 1,382 |
| Other expenses | 17,399 | 15,483 | 14,248 | 12,683 | 11,752 |
| Income before income taxes | 11,259 | 10,796 | 10,088 | 8,481 | 7,681 |
| Provision for income taxes | 1,996 | 2,159 | 2,063 | 1,701 | 1,661 |
| Net income | 9,263 | 8,637 | 8,025 | 6,780 | 6,020 |
| Cash dividends paid | \$3,885 | \$3,267 | \$2,832 | \$2,455 | \$2,202 |
| Per share data: | | | | | |
| Net income - basic (1) | \$0.86 | \$0.82 | \$0.78 | \$0.67 | \$0.60 |
| Net income - diluted (1) | \$0.83 | \$0.79 | \$0.75 | \$0.65 | \$0.60 |
| Cash dividends (2) | \$0.36 | \$0.31 | \$0.28 | \$0.24 | \$0.22 |
| Book value (1)(3) | \$7.02 | \$6.53 | \$6.10 | \$5.12 | \$4.66 |
| Weighted average number of shares outstanding - basic(1) | 10,780,407 | 10,528,978 | 10,296,251 | 10,123,991 | 10,008,979 |
| Weighted average number of shares outstanding-diluted (1) | 11,172,587 | 10,987,190 | 10,706,854 | 10,378,882 | 10,075,383 |

(1) Earnings per share and book value per share are calculated based on the weighted average number of shares outstanding during each year, after giving retroactive effect to the 100% stock dividends paid September 30, 2004 and January 31, 2003. Basic earnings per common share is computed by dividing net income available to common shareholders by the weighted average number of common shares outstanding for the period. Diluted earnings per common share is computed by dividing net income available to common shareholders, adjusted for any changes in income that would result from the assumed conversion of all potential dilutive common shares, by the sum of the weighted average number of common shares outstanding and the effect of all dilutive potential common shares outstanding for the period.

(2) Cash dividends per share have been restated to reflect to retroactive effect of the 100% stock dividends paid September 30, 2004 and January 31, 2003.

(3) Reflects the effect of SFAS No. 115 in the amount of \$1,030,000 in 2004, \$2,635,000 in 2003, \$4,838,000 in 2002, \$536,000 in 2001 and \$880,000 in 2000.

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

Certain of the matters discussed in this document and in documents incorporated by reference herein, including matters discussed under the caption Management's Discussion and Analysis of Financial Condition and Results of Operation, may constitute forward-looking statements for purposes of the Securities Act of 1933, as amended, and the Securities Exchange Act of 1934, as amended, and as such may involve known and unknown risks, uncertainties and other factors which may cause the actual results, performance, or achievements of the Company to be materially different from future results, performance, or achievements expressed or implied by such forward-looking statements. The words expect, anticipate, intend, plan, believe, seek, estimate, and similar expressions are intended to identify such forward-looking statements.

The Company's actual results may differ materially from the results anticipated in these forward-looking statements due to a variety of factors, including, without limitation (a) the effects of future economic conditions on the Company and its customers; (b) the costs and effects of litigation and of unexpected or adverse outcomes in such litigation; (c) governmental monetary and fiscal policies, as well as legislative and regulatory changes; (d) the effect of changes in accounting policies and practices, as may be adopted by the regulatory agencies, as well as the Financial Accounting Standards Board and other accounting standard setters; (e) the risks of changes in interest rates on the level and composition of deposits, loan demand, and the values of loan collateral, securities and interest rate protection agreements, as well as interest rate risks; (f) the effects of competition from other commercial banks, thrifts, mortgage banking firms, consumer finance companies, credit unions, securities brokerage firms, insurance companies, money market and other mutual funds and other financial institutions operating in the Company's market area and elsewhere, including institutions operating locally, regionally, nationally, and internationally, together with such competitors offering banking products and services by mail, telephone, computer, and the Internet; (g) technological changes; (h) acquisitions and integration of acquired businesses; (i) the failure of assumptions underlying the establishment of reserves for loan losses and estimations of values of collateral and various financial assets and liabilities; and (j) acts of war or terrorism. All written or oral forward-looking statements attributable to the Company are expressly qualified in their entirety by these cautionary statements. The company undertakes no obligation to publicly revise or update these forward-looking statements to reflect events or circumstances that arise after the date of this report. Readers should carefully review the risk factors described in other documents that are filed periodically with the SEC.

The following financial review of First National Community Bancorp, Inc. is presented on a consolidated basis and is intended to provide a comparison of the financial performance of the company, including its wholly-owned subsidiary, First National Community Bank for the years ended December 31, 2004, 2003 and 2002. The information presented below should be read in conjunction with the company's consolidated financial statements and accompanying notes appearing elsewhere in this report.

SUMMARY

Net Income totaled \$9,263,000 in 2004 which was \$626,000, or 7%, higher than the \$8,637,000 earned in 2003. The \$8,637,000 earned in 2003 was \$612,000, or 8%, higher than the \$8,025,000 earned in 2002. Basic earnings per share were \$.86, \$.82 and \$.78 in 2004, 2003 and 2002. The weighted average number of shares outstanding in 2004 was 10,780,407 while the weighted average number of shares in 2003 and 2002 were 10,528,978 and 10,296,251.

The earnings improvement recognized in 2004 as compared to 2003 includes a \$2.0 million, or 8%, increase in net interest income before the provision for credit losses, a \$543,000, or 19%, increase in fee income and a \$62,000 increase in net gains from the sale of assets. Growth and increased costs contributed to a \$1.9 million, or 12%, increase in operating expenses and \$200,000 of additional credit loss provisions. Federal income tax expense decreased \$163,000 in comparison to 2003.

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The increase reported in 2003 over the 2002 earnings was due primarily to the \$1.2 million improvement in net interest income before providing for credit losses. Total other income also improved \$508,000 in comparison to the prior year as service charges and fees improved \$359,000, or 14%, and gains from the sale of loans, securities and other real estate increased \$149,000. The provision for credit losses was \$200,000 lower than the 2002 level, also contributing to the improved earnings. These increases were offset partially by a \$1.2 million increase in total expenses and \$96,000 of additional book tax expense.

Return on assets for the years ended December 31, 2004, 2003 and 2002 was 1.08%, 1.11% and 1.12%. Return on equity was 12.86% in 2004, 13.15% in 2003 and 13.96% in 2002.

NET INTEREST INCOME

Net interest income, the difference between interest income and fees on earning assets and interest expense on deposits and borrowed funds, is the largest component of the company's operating income and as such is the primary determinant of profitability. Changes in net interest income occur due to fluctuations in the balances and/or mixes of interest-earning assets and interest-bearing liabilities, and changes in their corresponding interest yields and costs. Before providing for future credit losses, net interest income increased \$1,974,000 in 2004 due to growth in loans and deposits and the positive effect of the spread earned on interest sensitive assets and liabilities. Changes in non-performing assets, together with interest lost and recovered on those assets, also impact comparisons of net interest income. In the following schedules, net interest income is analyzed on a tax-equivalent basis, thereby increasing interest income on certain tax-exempt loans and investments by the amount of federal income tax savings realized. In this manner, the true economic impact on earnings from various assets and liabilities can be more accurately compared.

In 2004, tax-equivalent net interest income increased \$2.0 million, or 8%, over the 2003 level. Growth of the balance sheet again proved positive, adding \$3.7 million to net interest income, while the impact of repricing reduced earnings by \$1.7 million. Increased income due to loan growth was the primary contributor to the improvement.

Average loans outstanding increased \$86 million, or 17%, in 2004, resulting in a \$2.5 million improvement in earnings. Commercial volume contributed \$4.6 million of improved earnings and retail growth added \$669,000. However, growth and repricing at lower than historic interest rate levels led to a .47% decrease in the yield earned on the portfolio, reducing income by \$2.8 million due to rates.

Average securities were \$3.0 million lower in 2004 as liquidity was utilized to fund the significant level of loan growth. The lower balances combined with a .34% decrease in the yield earned reduced interest income by \$870,000 from the 2003 level. Money market balances and rates were also lower in 2004, and earnings on this category decreased \$19,000 from the prior year total.

Average interest-bearing deposits grew \$55 million, or 11%, in 2004. Interest-bearing demand balances increased \$48 million due to additional municipal relationships and internal reclassification of accounts while average savings deposits increased \$13 million. This growth in lower costing demand and savings balances, combined with a \$6 million reduction in certificate of deposit balances led to a .35% reduction in the cost of deposits and a \$742,000 decrease in interest expense. Average borrowed funds increased \$17 million in 2004 but a .34% reduction in the cost of these balances limited the increase in interest expense to \$292,000.

Overall, growth of the balance sheet offset a .04% decrease in the net interest spread, resulting in the \$2.0 million improvement in net interest income. The net interest margin was reduced .10% in 2004 as much of the growth was recorded at historically low interest rate levels. Investment leveraging transactions continued to add to the profitability of the company in 2004, contributing over \$900,000 to pre-tax earnings, but the average spread earned on the transaction of 1.29% contributed to the reduced margin. Exclusive of these transactions, the net interest margin in 2004 would have been 3.56% compared to 3.82% in 2003.

During 2003, tax-equivalent net interest income increased \$1,250,000, or 5%, over the 2002 level. Significant loan growth had a major impact on the improved earnings. Effective asset-liability management techniques also contributed to the earnings improvement as sound pricing

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policies limited compression in the net interest margin during a year which saw interest rates reach decade old lows.

Average loans increased \$49 million, or 11%, over the 2002 level, but earnings on the portfolio decreased \$786,000 as rates earned on variable rate assets declined and new growth was added at historically low levels. Commercial loan balances increased by \$41 million, or 12%, but earnings on these assets decreased \$82,000 due to repricing and new growth rates. Average consumer loans increased \$7.5 million in 2003 due primarily to growth in home equity loans and an increase in the indirect auto portfolio. Falling interest rates also had a significant impact on consumer loan income as earnings from the portfolio was \$704,000 lower than the year before. Overall, the yield earned on total loans declined .81% in 2003 which resulted in \$786,000 less earnings on \$49 million more loans.

Total securities were \$10 million higher than the 2002 average balance. Falling interest rates also had a negative impact on the securities portfolio as the low rates of 2003 lead to record mortgage-refinancing activity, resulting in an acceleration of principal prepayments on securities. As these monies are reinvested at current rates, earnings

compression occurs. During 2003, the yield earned on average securities was .85% lower than in 2002, contributing to the \$1.2 million reduction in interest income. Money market assets were also impacted by falling rates combined with a planned reduction in this lowest yielding asset. A \$4 million decrease in average money market assets and a .57% drop in the rate earned on these assets lead to a \$140,000 decrease in interest income.

Average interest-bearing deposits increased \$25 million in 2003 due primarily to growth in lower costing demand and savings balances. Interest rate reductions had a positive impact on the company's earnings in this area as the .85% decrease in the cost of deposits resulted in a \$3.5 million reduction in interest expense. Borrowed funds and other interest-bearing liabilities were \$15 million higher on average than last year, but a .50% reduction in the cost of these funds limited the increased expense to \$151,000.

As a result of the growth of the balance sheet combined with a reduction in the yields earned and paid, the company's net interest margin decreased .09% from the 3.53% reported in 2002 to 3.44%. Another factor affecting the company's net interest margin are investment leveraging transactions which match assets with liabilities at various points in the interest rate cycles. These transactions provided over \$700,000 of net interest income in 2003, but the interest spread of .79% had a negative impact on the company's net interest margin. Exclusive of these transactions, the 2003 margin would have been 3.82% which is .12% lower than the comparable 3.94% recorded in 2002.

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Yield Analysis

(dollars in thousands-taxable equivalent basis)(1)

| | 2004 | | | 2003 | | | 2002 | | |
|--------------------------------------|-----------------|-------------------------|-----------------------|-----------------|-------------------------|-----------------------|-----------------|-------------------------|-----------------------|
| | Average Balance | Interest Income/Expense | Average Interest Rate | Average Balance | Interest Income/Expense | Average Interest Rate | Average Balance | Interest Income/Expense | Average Interest Rate |
| ASSETS: | | | | | | | | | |
| Earning Assets:(2) | | | | | | | | | |
| Commercial loans-taxable | \$435,758 | \$24,076 | 5.53% | \$371,296 | \$21,869 | 5.89% | \$329,175 | \$21,810 | 6.63% |
| Commercial loans-tax free | 28,348 | 2,004 | 7.07% | 18,412 | 1,384 | 7.52% | 19,250 | 1,525 | 7.92% |
| Mortgage loans | 21,863 | 1,372 | 6.28% | 20,869 | 1,435 | 6.88% | 22,307 | 1,742 | 7.81% |
| Installment loans | 110,560 | 6,212 | 5.62% | 100,287 | 6,521 | 6.50% | 91,296 | 6,918 | 7.58% |
| Total Loans | 596,529 | 33,664 | 5.64% | 510,864 | 31,209 | 6.11% | 462,028 | 31,995 | 6.92% |
| Securities-taxable | 163,782 | 6,617 | 4.04% | 161,089 | 6,989 | 4.34% | 153,831 | 8,383 | 5.45% |
| Securities-tax free | 49,586 | 3,824 | 7.71% | 55,234 | 4,322 | 7.83% | 52,119 | 4,141 | 7.95% |
| Total Securities | 213,368 | 10,441 | 4.89% | 216,323 | 11,311 | 5.23% | 205,950 | 12,524 | 6.08% |
| Interest-bearing deposits with banks | 2,063 | 44 | 2.13% | 3,285 | 82 | 2.50% | 3,380 | 138 | 4.08% |
| Federal funds sold | 4,121 | 62 | 1.50% | 3,528 | 43 | 1.22% | 7,659 | 127 | 1.66% |
| Total Money Market Assets | 6,184 | 106 | 1.70% | 6,813 | 125 | 1.83% | 11,039 | 265 | 2.40% |
| Total Earning Assets | 816,081 | 44,211 | 5.42% | 734,000 | 42,645 | 5.81% | 679,017 | 44,784 | 6.60% |
| Non-earning assets | 49,980 | | | 48,542 | | | 43,898 | | |
| Allowance for credit losses | (6,848) | | | (6,625) | | | (5,995) | | |
| Total Assets | \$859,213 | | | \$775,917 | | | \$716,920 | | |

LIABILITIES AND STOCKHOLDERS' EQUITY:

Interest-Bearing Liabilities:

| | | | | | | | | | |
|--|-----------|----------|-------|-----------|----------|-------|-----------|----------|-------|
| Interest-bearing demand deposits | \$163,826 | \$1,605 | 0.98% | \$116,196 | \$1,097 | 0.94% | \$104,968 | \$1,750 | 1.67% |
| Savings deposits | 80,112 | 599 | 0.75% | 66,974 | 599 | 0.89% | 56,878 | 799 | 1.40% |
| Time deposits over \$100,000 | 99,584 | 2,102 | 2.11% | 95,090 | 2,199 | 2.31% | 93,501 | 2,750 | 2.94% |
| Other time deposits | 216,453 | 6,125 | 2.83% | 226,592 | 7,278 | 3.21% | 224,820 | 9,414 | 4.19% |
| Total Interest-Bearing Deposits | 559,975 | 10,431 | 1.86% | 504,852 | 11,173 | 2.21% | 480,167 | 14,713 | 3.06% |
| Borrowed funds and other | | | | | | | | | |
| Interest-bearing liabilities | 148,309 | 6,529 | 4.40% | 131,616 | 6,237 | 4.74% | 116,220 | 6,086 | 5.24% |
| Total Interest-Bearing Liabilities | 708,284 | 16,960 | 2.39% | 636,468 | 17,410 | 2.74% | 596,387 | 20,799 | 3.49% |
| Demand deposits | 72,700 | | | 68,273 | | | 57,926 | | |
| Other liabilities | 6,224 | | | 5,763 | | | 5,382 | | |
| Stockholders' equity | 72,005 | | | 65,413 | | | 57,225 | | |
| Total Liabilities and Stockholders' Equity | \$859,213 | | | \$775,917 | | | \$716,920 | | |
| Net Interest Income Spread | | \$27,251 | 3.03% | | \$25,235 | 3.07% | | \$23,985 | 3.11% |
| Net Interest Margin | | | 3.34% | | | 3.44% | | | 3.53% |

(1) In this schedule and other schedules presented on a tax-equivalent basis, income that is exempt from federal income taxes, i.e. interest on state and municipal securities, has been adjusted to a tax-equivalent basis using a 34% federal income tax rate.

(2) Excludes non-performing loans.

RATE VOLUME ANALYSIS

The most significant impact on net income between periods is derived from the interaction of changes in the volume and rates earned or paid on interest-earning assets and interest-bearing liabilities. The volume of earning dollars in loans and investments, compared to the volume of interest-bearing liabilities represented by deposits and borrowings, combined with the spread, produces the changes in net interest income between periods. Components of interest income and interest expense are presented on a tax-equivalent basis using the statutory federal income tax rate of 34%.

The following table shows the effect of changes in volume and interest rates on net interest income. The variance in interest income or expense due to the combination of rate and volume has been allocated proportionately.

Rate/Volume Variance Report(1)
(in thousands-taxable equivalent basis)

| | 2004 vs 2003 | | | 2003 vs 2002 | | |
|---|-----------------|--|----------------|-----------------|--|----------------|
| | Total Change | Increase(Decrease) Due to Volume | Due to Rate | Total Change | Increase(Decrease) Due to Volume | Due to Rate |
| Interest Income: | | | | | | |
| Commercial loans-taxable | \$ 2,207 | \$ 3,881 | \$ (1,674) | \$ 59 | \$ 2,803 | \$ (2,744) |
| Commercial loans-tax free | 620 | 753 | (133) | (141) | (66) | (75) |
| Mortgage loans | (63) | 68 | (131) | (307) | (112) | (195) |
| Installment loans | (309) | 601 | (910) | (397) | 596 | (993) |
| Total Loans | 2,455 | 5,303 | (2,848) | (786) | 3,221 | (4,007) |
| Securities-taxable | (372) | 24 | (396) | (1,394) | 392 | (1,786) |
| Securities-tax free | (498) | (442) | (56) | 181 | 247 | (66) |
| Total Securities | (870) | (418) | (452) | (1,213) | 639 | (1,852) |
| Interest-bearing deposits with banks | (38) | (30) | (8) | (56) | (4) | (52) |
| Federal funds sold | 19 | 7 | 12 | (84) | (68) | (16) |
| Total Money Market Assets | (19) | (23) | 4 | (140) | (72) | (68) |
| Total Interest Income | 1,566 | 4,862 | (3,296) | (2,139) | 3,788 | (5,927) |
| Interest Expense: | | | | | | |
| Interest-bearing demand deposits | 508 | 401 | 107 | (653) | 182 | (835) |
| Savings deposits | 0 | 115 | (115) | (200) | 137 | (337) |
| Time deposits over \$100,000 | (97) | 70 | (167) | (551) | 47 | (598) |
| Other time deposits | (1,153) | (265) | (888) | (2,136) | 79 | (2,215) |
| Total Interest-Bearing Deposits | (742) | 321 | (1,063) | (3,540) | 445 | (3,985) |
| Borrowed funds and other interest-bearing liabilities | 292 | 791 | (499) | 151 | 806 | (655) |
| Total Interest Expense | (450) | 1,112 | (1,562) | (3,389) | 1,251 | (4,640) |
| Net Interest Income | \$ 2,016 | \$ 3,750 | \$ (1,734) | \$ 1,250 | \$ 2,537 | \$ (1,287) |

(1) Changes in interest income and interest expense attributable to changes in both volume and rate have been allocated proportionately to changes due to volume and changes due to rate.

CURRENT YEAR

In 2004, tax-equivalent net interest income increased \$2.0 million from the 2003 total. Balance sheet growth added \$3.7 million as the \$4.8 million of income attributed to growth more than offset the \$1.1 million of interest expense associated with increased deposits and borrowed funds. Repricing and growth at historically low interest rate levels had a negative impact on net interest income in 2004, resulting in a \$1.7 million reduction when compared to 2003 totals.

Loan growth added \$5.3 million to earnings in 2004, due primarily to the \$4.6 million of interest income generated from commercial loan growth. Growth during the first half of 2004 was originated at low interest rates, however, which resulted in a \$1.8 million decrease due to repricing. Retail growth contributed \$669,000 of interest income, but this increase was negated by a \$1.0 million negative variance due to repricing. Interest income from the securities portfolio was down \$870,000 from 2003 due to reduced balances and lower rates while earnings from money market assets were \$19,000 lower in 2004. Overall, interest income improved \$1.5 million comprised of a \$4.8 million increase due to volume and a \$3.3 million negative variance due to rate.

New deposits added \$321,000 of interest expense in 2004, but the effect of interest rates reduced interest expense by \$1.0 million compared to last year primarily due to repricing on certificates of deposit. New borrowings added \$791,000 of additional interest expense but lower interest rates reduced the cost by \$499,000 compared to 2003. Overall, interest expense was \$450,000 lower in 2004 as the \$1.6 million positive offset due to repricing more than offset the \$1.1 million increase due to growth.

PRIOR YEAR

In 2003, tax-equivalent net interest income was \$1,250,000 higher than the 2002 total. Growth of the balance sheet added \$2.5 million to earnings in 2003 as the \$3.8 million of income earned on new loans and securities more than offset the \$1.3 million cost of new deposits and borrowings. Loan growth added \$3.2 million of income while new securities and money market assets provided an additional \$567,000. Interest expense increased \$445,000 due to deposit growth while the additional borrowed funds cost \$806,000. Repricing and growth at historically low levels had a negative impact on earnings in 2003. The reduced yield on loans resulted in a \$4 million decrease due to rate while income from investment securities and money market assets decreased \$1.9 million from the 2002 level. Interest expense was also impacted by falling rates but to a lesser extent as rate reductions on lower costing demand and savings balances were limited. Interest on deposits decreased \$4.0 million in 2003 and the cost of borrowed funds decreased \$655,000 due to the lower cost of newly originated borrowings.

PROVISION FOR CREDIT LOSSES

The provision for credit losses varies from year to year based on management's evaluation of the adequacy of the allowance for credit losses in relation to the risks inherent in the loan portfolio. In its evaluation, management considers credit quality, changes in loan volume, composition of the loan portfolio, past experience, delinquency trends, and the economic conditions. Consideration is also given to examinations performed by regulatory authorities and the company's independent auditors. The provision for credit losses was \$1,400,000 in 2004, \$1,200,000 in 2003 and \$1,400,000 in 2002. The ratio of the loan loss reserve to total loans was 1.12% at December 31, 2004 and 1.18% at December 31, 2003.

OTHER INCOME

| <u>Other Income</u> | <u>2004</u> (in thousands) | <u>2003</u> | <u>2002</u> |
|---|-------------------------------|--------------|--------------|
| Service charges | \$1,929 | \$1,575 | \$1,371 |
| Net gain on the sale of securities | 846 | 657 | 366 |
| Net gain on the sale of loans | 499 | 555 | 339 |
| Net gain on the sale of other real estate | 25 | 96 | 454 |
| Other | <u>1,490</u> | <u>1,301</u> | <u>1,146</u> |
| Total Other Income | \$4,789 | \$4,184 | \$3,676 |

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The company's other income category can be separated into three distinct sub-categories; service charges make up the core component of this area of earnings while net gains (losses) from the sale of assets and other fee income comprise the balance.

In 2004, service charges on deposits increased \$354,000, or 22%, from the 2003 total. Approximately \$270,000 of this increase can be attributed to new overdraft privilege fees associated with the BOUNCE Protection program. Net gains from the sale of assets totaled \$1.4 million in 2004, a \$62,000 increase from the 2003 total, as securities and loans were sold to shed interest rate risk. Other income improved \$189,000 in 2004 due primarily to increased fees collected on outstanding letters of credit. In total, other income improved \$605,000, or 14%, in 2004.

During 2003, other income increased \$508,000, or 14%, over the prior year. Service charges on deposits improved by \$204,000, or 15%, due primarily to an increase in assessable accounts as well as revisions to the fee schedule. Other fee income improved \$155,000 in 2003 comprised of an \$89,000 increase in letter of credit fees, a \$35,000 increase in merchant credit card processing and a \$31,000 net increase in all other fees. Gains from asset sales totaled \$1.3 million in 2003 which was \$149,000 higher than the 2002 total. Investment securities were sold to restructure the portfolio while long-term, fixed-rate residential mortgage loans were sold to minimize interest rate risk.

OTHER EXPENSES

| Other Expenses | <u>2004</u> | <u>2003</u> | <u>2002</u> |
|--------------------------|----------------|--------------|--------------|
| | (in thousands) | | |
| Salary expense | \$ 6,905 | \$ 6,061 | \$ 5,569 |
| Employee benefit expense | 1,787 | 1,580 | 1,421 |
| Occupancy expense | 1,556 | 1,471 | 1,388 |
| Equipment expense | 1,257 | 1,193 | 1,161 |
| Directors fees | 468 | 464 | 372 |
| Advertising expense | 650 | 575 | 604 |
| Data processing expense | 1,309 | 1,116 | 941 |
| Bank shares tax | 583 | 410 | 342 |
| Other operating expenses | <u>2,884</u> | <u>2,613</u> | <u>2,450</u> |
| Total Other Expenses | \$17,399 | \$15,483 | \$14,248 |

During 2004, total other expenses increased \$1.9 million, or 12%, from the 2003 total. Employee costs rose \$1.1 million, which was over 50% of the increase. Occupancy and equipment costs rose \$149,000 while all other expenses increased \$716,000, or 14%. The company's overhead ratio, which measures non-interest expense as a percentage of average assets, was 2.02% in 2004 compared to 2.00% in 2003. A significant portion of the increased costs can be attributed to two new community offices which opened in October 2003 and February 2004.

Salary and benefit costs accounted for 50% of total operating expenses in 2004. Salaries increased \$844,000, or 14% in 2004, which includes \$148,000 attributed to two new community offices. The \$207,000 increase in benefit costs also includes \$30,000 due to the new offices, a \$60,000 increase in the company's contribution to the employee's profit sharing plan and a higher level of payroll related taxes. At December 31, 2004, the company had 236 full-time equivalent employees on staff, a 4% increase over the 227 reported on December 31, 2003.

The increase in occupancy and equipment costs includes \$128,000 due to the new offices while other significant increases include a \$193,000 increase in data processing costs and a \$173,000 increase in bank shares tax expense.

In 2003, total other expenses increased \$1.2 million, or 9%, from the 2002 level. Employee costs increased \$651,000, or 53% of the total while occupancy and equipment costs rose \$115,000. All other expenses increased \$469,000, or 38% of the total increase. The company's overhead ratio was 2.00% in 2003 compared to 1.99% in 2002.

Salary and benefit costs comprise approximately one-half of the company's non-interest expense. Salaries increased \$492,000 in 2003, including a \$182,000 expense for stock options which reflects the early adoption of SFAS No. 148 Accounting for Stock Based Compensation. Please refer to Note 12 to the financial statements for a complete disclosure of stock-based compensation. Exclusive of stock-based compensation, salaries increased \$310,000, or 6%, due to merit increases and the additional costs associated with expansion. At December 31, 2003, the company had 227 full-time equivalent employees on staff compared to the 210 reported on December 31, 2002.

Occupancy and equipment costs increased 6% and 3%, respectively, due primarily to costs associated with a new community office. All other operating expenses increased \$469,000, or 10%. Much of the increase was attributed to rising data processing costs and expenses associated with a new office.

PROVISION FOR INCOME TAXES

Federal income tax expense decreased \$163,000 compared to last year. The \$463,000 increase in income before taxes added \$157,000 to the book provision while benefits received from tax-exempt income and other permanent differences had a \$320,000 positive effect compared to 2003. Deferred tax items also contributed to the lower book provision. The company's effective tax rate was 17.7% in 2004 and 20.0% in 2003.

During 2003, federal income tax expense increased \$96,000 over the 2002 total. The increased expense at the statutory rate due to the earnings improvement was \$241,000 but this was reduced by benefits received from tax-exempt income, a reduction in non-deductible interest expense and an increased benefit from other deferred tax items. The company's effective tax rate was 20.0% in 2003 compared to 20.5% in 2002.

FINANCIAL CONDITION

Total assets increased \$91 million, or 11%, during 2004 to \$907 million which surpassed the \$81 million increase recorded in 2003. Loan growth of \$74 million and a \$20 million increase in securities was funded by a \$70 million increase in total deposits and a \$14 million increase in borrowed funds. A reduced level of cash and cash equivalents and increased capital from retained earnings funded all other balance sheet growth.

SECURITIES

The primary objectives in managing the company's securities portfolio are to maintain the necessary flexibility to meet liquidity and asset and liability management needs and to provide a stable source of interest income.

Total securities increased \$20 million during 2004. While interest rates remained low during the first half of the year, the forecast of higher rates and the ultimate action of the Federal Reserve to raise rates resulted in a slowdown in the amount of principal returned in the form of calls or prepayments. The forecast of higher rates also contributed to the sale of \$68 million of securities during the year as the portfolio was positioned for rising rates. In order to fulfill the objectives of the securities portfolio and to remain fully invested, over \$125 million of new purchases were added during 2004.

New purchases included \$13 million of securities which were funded with structured borrowings, thereby providing a favorable spread between the rate earned on the securities and the cost of the borrowings. As of December 31, 2004, the company had \$67 million of these leveraged transactions outstanding. Management remains committed to strategies which limit purchases to those that are virtually free of credit risk and will help to meet the objectives of the company's investment and asset/liability management policies. Other security purchases include bonds

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which will provide book income at current market rates with minimal extension risk in order to reduce the risk of rising rates. Investment sales were executed to shed the portfolio of bonds purchased for declining rates, low earning bonds and bonds which had been reduced in size by principal prepayments to below portfolio parameters.

The following table sets forth the carrying value of securities at the dates indicated:

| | <u>December 31,</u> <u>2004</u> (in thousands) | <u>2003</u> | <u>2002</u> |
|--|--|--------------|--------------|
| U.S. Treasury securities and obligations of U.S. government agencies | \$31,770 | \$ 17,771 | \$ 13,029 |
| Obligations of state and political subdivisions | 55,955 | 61,539 | 57,864 |
| Mortgage-backed securities | 117,050 | 110,278 | 127,424 |
| Corporate debt securities | 18,983 | 13,021 | 425 |
| Equity securities | <u>8,073</u> | <u>8,744</u> | <u>6,750</u> |
| Total | \$231,831 | \$211,353 | \$205,492 |

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The following table sets forth the maturities of securities at December 31, 2004 (in thousands) and the weighted average yields of such securities calculated on the basis of the cost and effective yields weighted for the scheduled maturity of each security. Tax-equivalent adjustments, using a 34% rate, have been made in calculating yields on obligations of state and political subdivisions.

| | Within | 2 - 5 | 6 - 10 | Over | Mortgage- Backed | No Fixed | |
|---|-----------------|--------------|--------------|-----------------|---------------------|-----------------|--------------|
| | <u>One Year</u> | <u>Years</u> | <u>Years</u> | <u>10 Years</u> | <u>Securities</u> | <u>Maturity</u> | <u>Total</u> |
| U.S. Treasury securities | \$ 0 | \$1,002 | \$ 0 | \$ 0 | \$ 0 | \$ 0 | \$ 1,002 |
| Yield | | 2.43% | | | | | 2.43% |
| Obligations of U.S. government agencies | 5,029 | 4,026 | 16,985 | 4,916 | | | 30,956 |
| Yield | 2.28% | 3.66% | 3.50% | 3.47% | | | 3.32% |
| Obligations of state and political subdivisions (1) | | 1,450 | 5,275 | 46,388 | | | 53,113 |
| Yield | | 6.81% | 6.57% | 7.43% | | | 7.33% |
| Corporate debt securities | | | 1,611 | 17,527 | | | 19,138 |
| Yield | | | 4.83% | 4.22% | | | 4.27% |
| Mortgage-backed securities | | | | | 117,986 | | 117,986 |
| Yield | | | | | 4.58% | | 4.58% |
| Equity securities (2) | | | | | | 8,073 | 8,073 |
| Yield | | | | | | 3.87% | 3.87% |
| Total maturities | \$5,029 | \$6,478 | \$23,871 | \$68,831 | \$117,986 | \$8,073 | \$230,268 |
| Weighted yield | 2.28% | 4.17% | 4.27% | 6.33% | 4.58% | 3.87% | 4.98% |

(1) Yields on state and municipal securities have been adjusted to a tax-equivalent basis using a 34% federal income tax rate.

(2) Yield presented represents 2004 actual return

LOANS

Total loans increased \$74 million, or 13%, in 2004. Almost 90% of the growth recorded during the year was real estate related, including a \$62 million increase in commercial mortgages and a \$3 million increase in home equity loans. Residential mortgage loans decreased \$1 million during the year as \$30 million of loan balances were sold in the secondary market to reduce the company's interest rate risk exposure and to secure funding for anticipated loan originations. The increase in other loans represents loans to state and municipal entities and includes a local issue funded in 2004 for \$7 million. Installment loan balances grew \$2 million in 2004 while other commercial loan balances decreased \$1 million as payments offset new growth.

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Details regarding the loan portfolio for each of the last five years ending December 31 are as follows:

Loans Outstanding

(in thousands)

| | <u>2004</u> | <u>2003</u> | <u>2002</u> | <u>2001</u> | <u>2000</u> |
|-----------------------------|----------------|----------------|----------------|----------------|----------------|
| Commercial and Financial | \$130,937 | \$132,319 | \$ 115,651 | \$ 94,360 | \$ 79,483 |
| Real Estate | 402,792 | 337,423 | 294,864 | 274,255 | 246,061 |
| Installment | 69,027 | 66,981 | 63,258 | 62,786 | 62,504 |
| Other | <u>30,136</u> | <u>22,052</u> | <u>20,343</u> | <u>14,077</u> | <u>10,327</u> |
| Total Loans Gross | 632,892 | 558,775 | 494,116 | 445,478 | 398,375 |
| Allowance for Credit Losses | <u>(7,100)</u> | <u>(6,578)</u> | <u>(6,140)</u> | <u>(5,594)</u> | <u>(5,250)</u> |
| Net Loans | \$625,792 | \$552,197 | \$487,976 | \$439,884 | \$393,125 |

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The following schedule shows the repricing distribution of loans outstanding as of December 31, 2004. Also provided are these amounts classified according to sensitivity to changes in interest rates.

Loans Outstanding - Repricing Distribution

(in thousands)

| | Within | One to | Over Five | <u>Total</u> |
|---|-----------------|-------------------|---------------|----------------|
| | <u>One Year</u> | <u>Five Years</u> | <u>Years</u> | |
| Commercial and Financial | \$107,666 | \$20,332 | \$2,939 | \$130,937 |
| Real Estate | 259,782 | 82,440 | 60,570 | 402,792 |
| Installment | 2,363 | 63,355 | 3,309 | 69,027 |
| Other | <u>5,770</u> | <u>6,841</u> | <u>17,525</u> | <u>30,136</u> |
| Total | \$375,581 | \$172,968 | \$84,343 | \$632,892 |
| Loans with predetermined interest rates | \$23,212 | \$94,682 | \$67,542 | \$185,436 |
| Loans with floating rates | <u>352,369</u> | <u>78,286</u> | <u>16,801</u> | <u>447,456</u> |
| Total | \$375,581 | \$172,968 | \$84,343 | \$632,892 |

ASSET QUALITY

The company manages credit risk through the application of policies and procedures designed to foster sound underwriting and credit monitoring practices, although, as is the case with any financial institution, a certain degree of credit risk is dependent in part on local and general economic conditions that are beyond the company's control.

The company's risk management committee meets quarterly or more often as required and makes recommendations to the board of directors regarding provisions for credit losses. The committee reviews individual problem credits and ensures that ample reserves are established considering both general allowances and specific allocations.

The following schedule reflects various non-performing categories as of December 31 for each of the last five years:

| | <u>2004</u> | <u>2003</u> | <u>2002</u> | <u>2001</u> | <u>2000</u> |
|---|----------------|-------------|-------------|-------------|-------------|
| | (in thousands) | | | | |
| Nonaccrual: | | | | | |
| Impaired | \$ 0 | \$ 0 | \$ 0 | \$ 0 | \$ 0 |
| Other | 303 | 844 | 37 | 343 | 645 |
| Loans past due 90 days or more and still accruing | | | | | |
| | 539 | 622 | 299 | 426 | 224 |

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| | | | | | |
|-----------------------------|----------|----------|----------|-----------|----------|
| Other Real Estate Owned | <u>0</u> | <u>0</u> | <u>0</u> | <u>50</u> | <u>0</u> |
| Total Non-Performing Assets | \$842 | \$1,466 | \$336 | \$819 | \$869 |

In 2004, total non-performing assets decreased \$624,000. Nonaccrual loans decreased \$541,000 as \$255,000 of the balances carried on December 31, 2003 were charged-off in 2004 and \$296,000 were paid in full. A total of \$53,000 of the charged-off balances has subsequently been recovered by the company. Management believes that of the loans currently carried as nonaccrual, loss potential is minimal. Loans past due over ninety days decreased \$83,000 during the year. The balance of other real estate owned on December 31, 2004 was \$0.

During 2003, total non-performing assets increased \$1.1 million due to an \$807,000 increase in nonaccrual loans and a \$323,000 increase in loans past due over ninety days. Management reported that of the loans carried as nonaccrual, loss potential only existed on \$444,000 of the balances. Any loss realized on the nonaccrual loans and past due loans would be limited to any collateral deficiency upon disposition. The balance of other real estate owned on December 31, 2003 was \$0.

On December 31, 2004, the company's ratio of nonaccrual loans to total loans was .05% compared to the .15% reported in 2003. We continue to rank well ahead of peer banks in measurements of delinquency. The company continues to acknowledge the weakness in local real estate markets, emphasizing strict underwriting standards to minimize the negative impact of the current environment.

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ALLOWANCE FOR CREDIT LOSSES

The following table presents an allocation of the allowance for credit losses as of the end of each of the last five years (in thousands):

Loan Loss Reserve Allocation
(in thousands)

| | <u>12/31/04</u> | | <u>12/31/03</u> | | <u>12/31/02</u> | | <u>12/31/01</u> | | <u>12/31/00</u> | |
|--------------------------|-----------------|--|-----------------|--|-----------------|--|-----------------|--|-----------------|--|
| | <u>Amount</u> | Percentage of Loans in Each Category to Total <u>Loans</u> | <u>Amount</u> | Percentage of Loans in Each Category to Total <u>Loans</u> | <u>Amount</u> | Percentage of Loans in Each Category to Total <u>Loans</u> | <u>Amount</u> | Percentage of Loans in Each Category to Total <u>Loans</u> | <u>Amount</u> | Percentage of Loans in Each Category to Total <u>Loans</u> |
| Commercial and Financial | \$3,041 | 79% | \$4,449 | 76% | \$4,154 | 76% | \$1,577 | 72% | \$2,483 | 67% |
| Real Estate | 44 | 3% | 53 | 4% | 44 | 5% | 138 | 7% | 190 | 12% |
| Installment | 272 | 18% | 259 | 20% | 210 | 19% | 183 | 21% | 98 | 21% |
| Unallocated | 3,743 | - | 1,817 | - | 1,732 | - | 3,696 | - | 2,479 | - |
| | \$7,100 | 100% | \$6,578 | 100% | \$6,140 | 100% | \$5,594 | 100% | \$5,250 | 100% |

The following schedule presents an analysis of the allowance for credit losses for each of the last five years (in thousands):

| | <u>Years Ended December 31</u> | | | | |
|----------------------------------|--------------------------------|--------------|--------------|--------------|-------------|
| | <u>2004</u> | <u>2003</u> | <u>2002</u> | <u>2001</u> | <u>2000</u> |
| Balance, January 1 | \$6,578 | \$6,140 | \$5,594 | \$5,250 | \$4,714 |
| Charge-Offs: | | | | | |
| Commercial and Financial | 293 | 314 | 256 | 233 | 70 |
| Real Estate | 412 | 109 | 455 | 474 | 268 |
| Installment | <u>423</u> | <u>579</u> | <u>307</u> | <u>360</u> | <u>355</u> |
| Total Charge-Offs | <u>1,128</u> | <u>1,002</u> | <u>1,018</u> | <u>1,067</u> | <u>693</u> |
| Recoveries on Charged-Off Loans: | | | | | |
| Commercial and Financial | 51 | 13 | 2 | 6 | 10 |
| Real Estate | 66 | 7 | 10 | 20 | 122 |
| Installment | <u>133</u> | <u>220</u> | <u>152</u> | <u>165</u> | <u>127</u> |
| Total Recoveries | <u>250</u> | <u>240</u> | <u>164</u> | <u>191</u> | <u>259</u> |
| Net Charge-Offs | <u>878</u> | <u>762</u> | <u>854</u> | <u>876</u> | <u>434</u> |

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| | | | | | |
|-----------------------------|--------------|--------------|--------------|--------------|------------|
| Provision for Credit Losses | <u>1,400</u> | <u>1,200</u> | <u>1,400</u> | <u>1,220</u> | <u>970</u> |
| Balance, December 31 | \$7,100 | \$6,578 | \$6,140 | \$5,594 | \$5,250 |

Net Charge-Offs during the period as a percentage of average loans outstanding during the period

| | | | | | |
|---|------|------|------|------|------|
| | .15% | .15% | .18% | .21% | .11% |
| Allowance for credit losses as a percentage of net loans outstanding at end of period | | | | | |

| | | | | | |
|--|-------|-------|-------|-------|-------|
| | 1.12% | 1.18% | 1.24% | 1.26% | 1.32% |
|--|-------|-------|-------|-------|-------|

Net charge-offs increased \$116,000 in 2004 but remained stable as a percentage of average loans. The installment loan charge-offs include \$289,000 of indirect auto loans of which \$121,000 was recovered through sale during the year. All other charge-offs include writedowns on credits incurred in the normal course of business. During 2004,

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\$255,000 of the balances carried as nonaccrual on December 31, 2003 were charged-off of which \$43,000 was recovered later in the year. The company's ratio of net charge-offs to average loans is comparable to its national peer group while the ratio of the allowance for credit losses to net loans is adequate considering delinquent balances.

DEPOSITS

The primary source of funds to support the company's growth is its deposit base, and emphasis has been placed on accumulating new deposits while making every effort to retain current relationships. Total deposits increased \$70 million in 2004 comprised of \$63 million in lower costing savings and demand accounts and a \$7 million increase in time deposit balances.

The average daily amount of deposits and rates paid on such deposits is summarized for the periods indicated in the following table:

| | <u>Year Ended December 31,</u> | | | | | |
|-------------------------------------|--------------------------------|-------------|----------------|-------------|----------------|-------------|
| | <u>2004</u> | | <u>2003</u> | | <u>2002</u> | |
| | <u>Amount</u> | <u>Rate</u> | <u>Amount</u> | <u>Rate</u> | <u>Amount</u> | <u>Rate</u> |
| | (dollars in thousands) | | | | | |
| Noninterest bearing demand deposits | \$72,700 | | \$68,273 | | \$57,926 | |
| Interest-bearing demand deposits | 163,826 | 0.98% | 116,196 | 0.94% | 104,968 | 1.67% |
| Savings deposits | 80,112 | 0.75% | 66,974 | 0.89% | 56,878 | 1.41% |
| Time deposits | <u>316,037</u> | 2.60% | <u>321,682</u> | 2.95% | <u>318,321</u> | 3.82% |
| Total | \$632,675 | | \$573,125 | | \$538,093 | |

Maturities of time certificates of deposit of \$100,000 or more outstanding at December 31, 2004, are summarized as follows:

| | <u>Time Certificates</u> |
|--------------------------|--------------------------|
| | <u>Of Deposit</u> |
| | (in thousands) |
| 3 months or less | \$ 50,126 |
| Over 3 through 6 months | 10,736 |
| Over 6 through 12 months | 13,532 |
| Over 12 months | <u>19,931</u> |
| Total | \$94,325 |

CAPITAL

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A strong capital base is essential to the continued growth and profitability of the company and is therefore a management priority. The company's principal capital planning goals are to provide an adequate return to shareholders while retaining a sufficient base from which to provide for future growth, while at the same time complying with all regulatory standards. As more fully described in Note 13 to the financial statements, regulatory authorities have prescribed specified minimum capital ratios as guidelines for determining capital adequacy to help insure the safety and soundness of financial institutions.

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The following schedules present information regarding the company's risk-based capital at December 31, 2004, 2003 and 2002 and selected other capital ratios.

CAPITAL ANALYSIS

(in thousands)

| | <u>December 31,</u> | | |
|--|---------------------|------------------|------------------|
| | <u>2004</u> | <u>2003</u> | <u>2002</u> |
| Tier I Capital: | | | |
| Shareholders' equity | \$ 74,693 | \$ 66,103 | \$ 58,005 |
| Total Tier I Capital | <u>\$ 74,693</u> | <u>\$ 66,103</u> | <u>\$ 58,005</u> |
| Tier II Capital: | | | |
| Allowable portion of allowance for credit losses | <u>\$ 7,100</u> | <u>\$ 6,578</u> | <u>\$ 6,140</u> |
| Total Risk-Based Capital | <u>\$ 81,793</u> | <u>\$ 72,681</u> | <u>\$ 64,145</u> |
| Total Risk-Weighted Assets | \$728,681 | \$633,762 | \$549,300 |

CAPITAL RATIOS

| | Regulatory | | | |
|---------------------------|----------------|-------------|-------------|-------------|
| | <u>Minimum</u> | <u>2004</u> | <u>2003</u> | <u>2002</u> |
| Total Risk-Based Capital | 8.00% | 11.22% | 11.47% | 11.68% |
| Tier I Risk-Based Capital | 4.00% | 10.25% | 10.43% | 10.56% |
| Tier I Leverage Ratio | 4.00% | 8.69% | 8.52% | 8.09% |
| Return on Assets | N/A | 1.08% | 1.11% | 1.12% |
| Return on Equity* | N/A | 12.86% | 13.15% | 13.96% |
| Equity to Assets Ratio* | N/A | 8.34% | 8.42% | 8.55% |
| Dividend Payout Ratio | N/A | 41.95% | 37.83% | 35.29% |

* Includes the effect of SFAS 115 in the amount of \$1,030,000 in 2004, \$2,635,000 in 2003 and \$4,838,000 in 2002.

During 1999, the company implemented a Dividend Reinvestment Plan which has resulted in an influx to capital of \$7.4 million to date. The company also adopted stock option plans for directors and senior officers. New capital generated from the exercise of stock options is \$2.5 million at December 31, 2004. In November 2002, the company declared a 100% stock dividend which was payable January 31, 2003. As a result of this stock dividend, 2,603,838 new shares were issued on the payable date. The company also paid a 100% stock dividend on September 30, 2004 which resulted in the issuance of 5,423,425 new shares.

In 2004, regulatory capital increased \$8.6 million comprised of a \$5.4 million increase in retained earnings after paying cash dividends of \$3.9 million, a \$2.1 million increase due to the company's dividend reinvestment plan and a \$1.1 million increase due to the issuance of shares from the company's stock option plans. As of December 31, 2004, there were 8,111,410 shares of stock available for future sale or stock dividends. The number of shareholders of record at December 31, 2004 was 1,246. Quarterly market highs and lows, dividends paid and known market makers are highlighted in the Investor Information section of this Annual Report. Refer to Note 13 to the financial statements for further discussion of capital requirements and dividend limitations.

ECONOMIC CONDITIONS AND FORWARD OUTLOOK

Economic conditions affect financial institutions, as they do other businesses, in a number of ways. Rising inflation affects all businesses through increased operating costs but affects banks primarily through the manner in which they manage their interest sensitive assets and liabilities in a rising rate environment. Economic recession can also have a material effect on financial institutions as the assets and liabilities affected by a decrease in interest rates must be managed in a way that will maximize the largest component of a bank's income, that being net interest income. Recessionary periods may also tend to decrease borrowing needs and increase the uncertainty inherent in the borrowers' ability to pay previously advanced loans. Additionally, reinvestment of investment portfolio maturities can pose a problem as attractive rates are not as available. Management closely monitors the interest rate risk of the balance sheet and the credit risk inherent in the loan portfolio in order to minimize the effects of fluctuations caused by changes in general economic conditions.

While we are optimistic about the prospect of continued growth and earnings improvement, any forward-looking statements by their nature are subject to assumptions, risks and uncertainties. Actual results could vary from those implied for a variety of reasons including:

A change in interest rates which is more immediate or more significant than anticipated.

The demand for new loans and the ability of borrowers to repay outstanding debt.

The timing of expansion plans could be altered by forces beyond our control such as weather or regulatory approvals.

Our ability to continue to attract new deposits from our marketplace to meet the daily liquidity needs of the company.

As of this writing, the company was not aware of any pronouncements or legislation that would have a material impact on the results of operations.

Item 7A Quantitative and Qualitative Disclosures About Market Risk

ASSET AND LIABILITY MANAGEMENT

The major objectives of the company's asset and liability management are to:

- (1) manage exposure to changes in the interest rate environment to achieve a neutral interest sensitivity position within reasonable ranges,
- (2) ensure adequate liquidity and funding,
- (3) maintain a strong capital base, and
- (4) maximize net interest income opportunities.

The company manages these objectives through its Senior Management and Asset and Liability Management Committees (ALCO). Members of the committees meet regularly to develop balance sheet strategies affecting the future level of net interest income, liquidity and capital. Items that are considered in asset and liability management include balance sheet forecasts, the economic environment, the anticipated direction of interest rates and the company's earnings sensitivity to changes in these rates.

INTEREST RATE SENSITIVITY

The company analyzes its interest sensitivity position to manage the risk associated with interest rate movements through the use of gap analysis and simulation modeling. Interest rate risk arises from mismatches in the repricing of assets and liabilities within a given time period. Gap analysis is an approach used to quantify these differences. A positive gap results when the amount of interest-sensitive assets exceeds that of interest-sensitive liabilities within a given time period. A negative gap results when the amount of interest-sensitive liabilities exceeds that of interest-sensitive assets.

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While gap analysis is a general indicator of the potential effect that changing interest rates may have on net interest income, the gap report has some limitations and does not present a complete picture of interest rate sensitivity. First, changes in the general level of interest rates do not affect all categories of assets and liabilities equally or simultaneously. Second, assumptions must be made to construct a gap table. For example, non-maturity deposits are assigned a repricing interval based on internal assumptions. Management can influence the actual repricing of these deposits independent of the gap assumption. Third, the gap table represents a one-day position and cannot incorporate a changing mix of assets and liabilities over time as interest rates change.

Because of the limitations of the gap reports, the company uses simulation modeling to project future net interest income streams incorporating the current gap position, the forecasted balance sheet mix, and the anticipated spread relationships between market rates and bank products under a variety of interest rate scenarios.

The company's interest sensitivity at December 31, 2004 was essentially neutral within reasonable ranges; for example, an interest rate fluctuation of up or down 200 basis points would not be expected to have a significant impact on net interest income.

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INTEREST RATE GAP

The following schedule illustrates the company's interest rate gap position as of December 31, 2004 which measures sensitivity to interest rate fluctuations for certain interest sensitivity periods.

Interest Rate Sensitivity Analysis
as of December 31, 2004
(in thousands)

| | 1 to 90 Days | 91 to 180 Days | Rate Sensitive 181 to 365 Days | 1 to 5 Years | Beyond 5 Years | Not Rate Sensitive | Total |
|---|-----------------|-------------------|--------------------------------------|-----------------|-------------------|--------------------------|-----------|
| Commercial loans | \$350,837 | \$5,134 | \$11,593 | \$ 95,520 | \$ 37,040 | \$ 0 | \$500,124 |
| Mortgage loans | 595 | 800 | 2,995 | 12,620 | 3,321 | 0 | 20,331 |
| Installment loans | 24,973 | 6,196 | 12,358 | 59,566 | 9,344 | 0 | 112,437 |
| Total Loans | 376,405 | 12,130 | 26,946 | 167,706 | 49,705 | 0 | 632,892 |
| Securities-taxable | 26,418 | 11,725 | 15,651 | 77,605 | 40,456 | 8,073 | 179,928 |
| Securities-tax free | 0 | 420 | 0 | 24,005 | 27,478 | 0 | 51,903 |
| Total Securities | 26,418 | 12,145 | 15,651 | 101,610 | 67,934 | 8,073 | 231,831 |
| Interest-bearing deposits with banks | 297 | 198 | 1,485 | 0 | 0 | 0 | 1,980 |
| Federal funds sold | 1,700 | 0 | 0 | 0 | 0 | 0 | 1,700 |
| Total Money Market Assets | 1,997 | 198 | 1,485 | 0 | 0 | 0 | 3,680 |
| Total Earning Assets | 404,820 | 24,473 | 44,082 | 269,316 | 117,639 | 8,073 | 868,403 |
| Non-earning assets | 0 | 0 | 0 | 0 | 0 | 46,188 | 46,188 |
| Allowance for credit losses | 0 | 0 | 0 | 0 | 0 | (7,100) | (7,100) |
| Total Assets | \$404,820 | \$24,473 | \$44,082 | \$269,316 | \$117,639 | \$47,161 | \$907,491 |
| Interest-bearing demand deposits | \$217,669 | \$ 0 | \$ 0 | \$ 0 | \$ 0 | \$ 0 | \$217,669 |
| Savings deposits | 85,630 | 574 | 789 | 0 | 0 | 0 | 86,993 |
| Time deposits \$100,000 and over | 50,127 | 10,736 | 13,532 | 18,508 | 1,422 | 0 | 94,325 |
| Other time deposits | 34,947 | 27,933 | 49,914 | 87,983 | 13,291 | 0 | 214,068 |
| Total Interest-Bearing Deposits | 388,373 | 39,243 | 64,235 | 106,491 | 14,713 | 0 | 613,055 |
| Borrowed funds and other interest-bearing liabilities | 28,325 | 1,717 | 8,491 | 46,439 | 69,095 | 0 | 154,067 |
| Total Interest-Bearing Liabilities | 416,698 | 40,960 | 72,726 | 152,930 | 83,808 | 0 | 767,122 |
| Demand deposits | 0 | 0 | 0 | 0 | 0 | 58,658 | 58,658 |
| Other liabilities | 0 | 0 | 0 | 0 | 0 | 5,988 | 5,988 |
| Stockholders' equity | 0 | 0 | 0 | 0 | 0 | 75,723 | 75,723 |
| Total Liabilities and Stockholders' Equity | \$416,698 | \$40,960 | \$72,726 | \$152,930 | \$83,808 | \$140,369 | \$907,491 |
| Interest Rate Sensitivity gap | \$(11,878) | \$(16,487) | \$(28,644) | \$116,386 | \$33,831 | \$(93,208) | |
| Cumulative gap | \$(11,878) | \$(28,365) | \$(57,009) | \$59,377 | \$93,208 | | |

EARNINGS AT RISK AND ECONOMIC VALUE AT RISK SIMULATIONS

The company recognizes that more sophisticated tools exist for measuring the interest rate risk in the balance sheet beyond static gap analysis. Although it will continue to measure its static gap position, the company utilizes additional modeling for identifying and measuring the interest rate risk in the overall balance sheet. The ALCO is responsible for focusing on earnings at risk and economic value at risk, and how both relate to the risk-based capital position when analyzing the interest rate risk.

EARNINGS AT RISK

Earnings at risk simulation measures the change in net interest income and net income should interest rates rise and fall. The simulation recognizes that not all assets and liabilities reprice equally and simultaneously with market rates (i.e., savings rate). The ALCO looks at earnings at risk to determine income changes from a base case scenario under an increase and decrease of 200 basis points in the interest rate simulation model.

ECONOMIC VALUE AT RISK

Earnings at risk simulation measures the short-term risk in the balance sheet. Economic value (or portfolio equity) at risk measures the long-term risk by finding the net present value of the future cash flows from the company's existing assets and liabilities. The ALCO examines this ratio monthly utilizing a rate shock of ± 200 basis points in the interest rate simulation model. The ALCO recognizes that, in some instances, this ratio may contradict the earnings at risk ratio.

The following table illustrates the simulated impact of a 200 basis point upward or downward movement in interest rates on net interest income, and the change in economic value. This analysis assumed that interest-earning asset and interest-bearing liability levels at December 31, 2004 remained constant. The impact of the rate movements were developed by simulating the effect of rates changing over a twelve-month period from the December 31, 2004 levels.

| | RATES + 200 | RATES - 200 |
|--|-------------|-------------|
| Earnings at risk: | | |
| Percent change in net interest income | 9.31% | (7.98)% |
| Economic value at risk: | | |
| Percent change in economic value of equity | (24.70)% | 13.76% |

Economic value has the most meaning when viewed within the context of risk-based capital. Therefore, the economic value may change beyond the company's policy guideline for a short period of time as long as the risk-based capital ratio is greater than 10%.

LIQUIDITY

The term liquidity refers to the ability of the company to generate sufficient amounts of cash to meet its cash-flow needs. Liquidity is required to fulfill the borrowing needs of the company's credit customers and the withdrawal and maturity requirements of its deposit customers, as well as to meet other financial commitments. Cash and cash equivalents (cash and due from banks and federal funds sold) are the company's most liquid assets. At December 31, 2004 cash and cash equivalents totaled \$15.3 million, compared to the December 31, 2003 level of \$23.3 million. Financing activities provided \$82.4 million and operating activities provided \$11.4 million of cash and cash equivalents during the year while investing activities utilized \$101.8 million. The cash flows provided by financing activities includes increases in deposits and borrowed funds while the funds provided by operating activities pertains to interest payments received on loans and investments. The cash used in investing activities consists of loan proceeds and security purchases.

Core deposits, which represent the company's primary source of liquidity, averaged \$533 million in 2004, an increase of \$55 million, or 12%, from the \$478 million average in 2003. This increase in average core deposits was supplemented with a \$5 million increase in average jumbo certificates and a \$17 million increase in average borrowed funds and other interest-bearing liabilities.

The company has other potential sources of liquidity, including repurchase agreements. Additionally, the company can borrow on credit lines established at several correspondent banks and at the Federal Home Loan Bank of Pittsburgh. The Federal Reserve Discount Window also provides an additional funding source.

Item 8 - Financial Statements and Supplementary Data

The information required in Part II, Item 8 is incorporated by reference from the Company's Annual Report to security holders for the fiscal year ended December 31, 2004.

| | |
|---|-----------|
| Balance Sheet | Exhibit A |
| Statement of Income | Exhibit B |
| Statement of Cash Flows | Exhibit C |
| Statement of Changes in Stockholders' Equity and Comprehensive Income | Exhibit D |
| Notes to Consolidated Financial Statements | |
| Report of Independent Registered Public Accounting Firm | Exhibit E |

Additional references are made in Part IV, Item 16 of this Form 10-K.

Item 9 - Changes in and Disagreements with Accountants on Accounting and Financial Disclosures

Not Applicable

Item 9A. Controls and Procedures

Conclusion Regarding the Effectiveness of Disclosure Controls and Procedures - 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 along with the company's Chief Financial Officer, of the effectiveness of the design and operation of the Company's disclosure controls and procedures, as such term is defined under Rule 13a-15(e) promulgated under the Securities Exchange Act of 1934, as amended (the Exchange Act). Based upon that evaluation, the company's Chief Executive Officer along with the company's Chief Financial Officer concluded that the company's disclosure controls and procedures are effective in timely alerting them to material information relating to the company (including its consolidated subsidiaries) required to be included in the company's periodic SEC filings.

Changes in Internal Controls over Financial Reporting - There were no changes in our internal control over financial reporting that occurred during the period covered by this annual report that have materially affected, or are, reasonably likely to materially affect, the company's internal controls over financial reporting.

Management's Report on Internal Control Over Financial Reporting

The management of First National Community Bancorp, Inc. (the Company) is responsible for (1) the preparation of the accompanying financial statements; (2) establishing and maintaining internal controls over financial reporting; and (3) the assessment of the effectiveness of internal control over financial reporting. The Securities and Exchange Commission defines effective internal control over financial reporting as a process designed under the supervision of the company's principal executive officer and principal financial officer, and implemented in conjunction with management and other personnel, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements in accordance with generally accepted accounting principles.

The company's internal control over financial reporting is supported by written policies and procedures. All internal control systems, no matter how well designed, have inherent limitations and provide only reasonable assurance that the objectives of the control system are met. Therefore, no evaluation of controls can provide absolute assurance that all control issues and misstatements due to error or fraud, if any, within the company have been detected. Additionally, any system of controls is subject to the risk that controls may become inadequate due to changes in conditions or that compliance with policies or procedures may deteriorate.

As of December 31, 2004, management of the company conducted an assessment of the effectiveness of the company's 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 (COSO). Based on this assessment, management has concluded that the company's internal control over financial reporting was effective as of December 31, 2004.

Management's assessment of the effectiveness of the company's internal control over financial reporting as of December 31, 2004, has been audited by Demetrius and Company, L.L.C., the independent registered public accounting firm that audited the company's financial statements for the period covered. A copy of the Demetrius and Company, L.L.C. report is included in this annual report.

/s/ J. David Lombardi
J. David Lombardi
President and Chief Executive Officer

/s/ William S. Lance
William S. Lance
Principal Financial Officer

Report of Independent Registered Public Accounting Firm

To the Board of Directors and Stockholders of

First National Community Bancorp, Inc.

We have audited management's assessment, included in the accompanying Management's Report on Internal Control over Financial Reporting, that First National Community Bancorp, Inc. maintained effective internal control over financial reporting as of December 31, 2004, based on criteria established in Internal Control - Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). First National Community Bancorp, Inc.'s management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express an opinion on management's assessment and an opinion on the effectiveness of the company's internal control over financial reporting based on our audit.

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

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

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

In our opinion, management's assessment that First National Community Bancorp, Inc. maintained effective internal control over financial reporting as of December 31, 2004, is fairly stated, in all material respects, based on criteria established in Internal Control Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Also in our opinion, First National Community Bancorp, Inc. maintained, in all material respects, effective internal control over financial reporting as of December 31, 2004, based on criteria established in Internal Control Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheets and the related consolidated statements of income, stockholders' equity and comprehensive income, and cash flows of First National Community Bancorp, Inc., and our report dated January 21, 2005 expressed an unqualified opinion.

DEMETRIUS & COMPANY, L.L.C.

Wayne, New Jersey

January 21, 2005

Item 9B. Other Information

None

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FIRST NATIONAL COMMUNITY BANCORP, INC.

Part III.

Item 10 - Directors and Executive Officers of the Registrant

Information regarding directors, nominees, principal officers, audit committees and audit committee financial experts required by this item is set forth under the captions Information as to Nominees and Directors , Principal Officers of the Company , Principal Officers of the Bank , Audit Committee Financial Expert , Audit Committee and Compliance with Section 16(a) of the Exchange Act in the Proxy Statement filed for the annual meeting of shareholders to be held on May 18, 2005 and is incorporated herein by reference.

The company has adopted a Code of Ethics that applies to directors, officers and employees of the company and the bank. A copy of the Code of Ethics was included as an exhibit to the company's Form 10-K for the year ended December 31, 2003 and filed with the Securities and Exchange Commission. A request for the Company's Code of Ethics can be made either in writing to William Lance, First National Community Bancorp, Inc., 102 East Drinker Street, Dunmore, Pennsylvania, 18512 or by email at fncb@fncb.com.

Item 11 - Executive Compensation

The information required by this item is set forth under the captions Executive Compensation , Option Grants in 2004 , Compensation of Directors , Employment Agreement , Compensation Report of the Board of Directors , and Stock Performance Graph and Table in the Proxy Statement filed for the annual meeting of shareholders to be held on May 18, 2005 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 regarding security ownership of certain beneficial owners and management is set forth under the caption Beneficial Ownership by Directors, Principal Officers and Nominees in the Proxy Statement filed for the annual meeting of shareholders to be held on May 18, 2005 and is incorporated herein by reference.

Information regarding the Company's compensation plans under which equity securities of the registrant are authorized for issuance as of December 31, 2004 is set forth under the caption Equity Compensation Plan Information in the Proxy Statement filed for the annual meeting of shareholders to be held on May 18, 2005 and is incorporated herein by reference.

Item 13 - Certain Relationships and Related Transactions

The information required by this item is set forth under the caption "Certain Relationships and Related Transactions" in the Proxy Statement filed for the annual meeting of shareholders to be held on May 18, 2005 and is incorporated herein by reference.

Item 14 Principal Accountant Fees and Services

The information required by this item is set forth under the caption "Independent Auditors" in the Proxy Statement filed for the annual meeting of shareholders to be held on May 18, 2005 and is incorporated herein by reference.

Part IV.

Item 15 - Exhibits and Financial Statement Schedules

The information required in Item 15 is incorporated by reference from the Company's Annual Report to security holders for the fiscal year ended December 31, 2004.

EXHIBIT A - Balance Sheet - December 31, 2004 and 2003

EXHIBIT B - Statement of Income - December 31, 2004, 2003 and 2002

EXHIBIT C - Statement of Cash Flows - December 31, 2004, 2003 and 2002

EXHIBIT D - Statement of Changes in Stockholders' Equity and Comprehensive Income - December 31, 2004, 2003 and 2002

Notes to Consolidated Financial Statements

- 1 Summary of Significant Accounting Policies
- 2 Restricted Cash Balances
- 3 Investment Securities - December 31, 2004 and 2003
- 4 Loans and Changes in Allowance for Loan Loss - December 31, 2004 and 2003
- 5 Bank Premises and Equipment - December 31, 2004 and 2003
- 6 Deposits
- 7 Borrowed Funds - December 31, 2004 and 2003
- 8 Benefit Plans
- 9 Income Taxes - December 31, 2004, 2003 and 2002
- 10 Related Party Transactions
- 11 Commitments
- 12 Stock Option Plans
- 13 Regulatory Matters - December 31, 2004 and 2003
- 14 Disclosures about Fair Value of Financial Instruments - December 31, 2004 and 2003
- 15 Condensed Financial Information - Parent Company Only
- 16 Selected Quarterly Financial Data - 2004 and 2003

EXHIBIT E - Report of Independent Registered Public Accounting Firm

Exhibit 10.1 1999 Dividend Reinvestment and Stock Purchase Plan

Exhibit 10.2 2000 Stock Incentive Plan

Exhibit 10.3 2000 Independent Directors Stock Option Plan

Exhibit 10.4 Non-qualified Deferred Compensation Plan

Exhibit 14

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The Registrant's Code of Ethics. (Incorporated by reference to Exhibit 99.1 of the Registrant's Form 10-K for the fiscal year ended December 31, 2003 filed with the Securities and Exchange Commission)

| | |
|--------------|--|
| Exhibit 31.1 | Certification of Chief Executive Officer |
| Exhibit 31.2 | Certification of Chief Financial Officer |
| Exhibit 32.1 | Section 1350 Certification Chief Executive Officer |
| Exhibit 32.2 | Section 1350 Certification Chief Financial Officer |

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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, thereunto duly authorized:

Registrant: FIRST NATIONAL COMMUNITY BANCORP, INC.

/s/ J. David Lombardi

J. David Lombardi, President and
Chief Executive Officer

/s/ William Lance

William Lance, Treasurer
Principal Financial Officer and
Principal Accounting Officer

/s/ Linda D'Amario

Linda D'Amario
Comptroller

DATE: March 30, 2005

Pursuant to the requirements of the Securities 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:

Directors:

| | | | |
|--------------------------|----------------|------------------------|----------------|
| /s/ Michael G. Cestone | March 30, 2005 | /s/ Louis A. DeNaples | March 30, 2005 |
| Michael G. Cestone | Date | Louis A. DeNaples | Date |
| /s/ Joseph J. Gentile | March 30, 2005 | /s/ Joseph O. Haggerty | March 30, 2005 |
| Joseph J. Gentile | Date | Joseph O. Haggerty | Date |
| /s/ Joseph Coccia | March 30, 2005 | /s/ J. David Lombardi | March 30, 2005 |
| Joseph Coccia | Date | J. David Lombardi | Date |
| /s/ William P. Conaboy | March 30, 2005 | /s/ John P. Moses | March 30, 2005 |
| William P. Conaboy | Date | John P. Moses | Date |
| /s/ Michael T. Conahan | March 30, 2005 | /s/ John R. Thomas | March 30, 2005 |
| Michael T. Conahan | Date | John R. Thomas | Date |
| /s/ Dominick L. DeNaples | March 30, 2005 | /s/ John R. Thomas | March 30, 2005 |
| Dominick L. DeNaples | Date | John R. Thomas | Date |

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Exhibit A Balance Sheet

FIRST NATIONAL COMMUNITY BANCORP, INC. AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS

| December 31, (in thousands, except share data) | 2004 | 2003 |
|---|------------|------------|
| ASSETS | | |
| Cash and cash equivalents: | | |
| Cash and due from banks | \$ 13,653 | \$ 23,290 |
| Federal funds sold | 1,700 | 0 |
| Total cash and cash equivalents | 15,353 | 23,290 |
| Interest-bearing balances with financial institutions | 1,980 | 2,673 |
| Securities: | | |
| Available-for-sale, at fair value | 222,282 | 201,204 |
| Held-to-maturity, at cost (fair value \$1,542 and \$1,442) | 1,486 | 1,415 |
| Federal Reserve Bank and FHLB stock, at cost | 8,063 | 8,734 |
| Net loans | 625,792 | 552,197 |
| Bank premises and equipment | 10,054 | 8,758 |
| Accrued interest receivable | 3,984 | 3,458 |
| Other assets | 18,497 | 14,574 |
| TOTAL ASSETS | \$ 907,491 | \$ 816,303 |
| LIABILITIES | | |
| Deposits: | | |
| Demand | \$ 58,658 | \$ 73,918 |
| Interest-bearing demand | 217,669 | 138,021 |
| Savings | 86,993 | 88,496 |
| Time (\$100,000 and over) | 94,325 | 91,375 |
| Other time | 214,068 | 210,259 |
| Total deposits | 671,713 | 602,069 |
| Borrowed funds | 154,067 | 140,421 |
| Accrued interest payable | 1,534 | 2,031 |
| Other liabilities | 4,454 | 3,044 |
| Total liabilities | \$ 831,768 | \$ 747,565 |
| STOCKHOLDERS' EQUITY | | |
| Common Stock (\$1.25 par) | | |
| Authorized: 20,000,000 shares | | |
| Issued and outstanding: 10,898,942 shares in 2004 and 10,663,670 shares in 2003 | \$ 13,624 | \$ 13,330 |
| Additional paid-in capital | 18,671 | 15,638 |
| Retained earnings | 42,398 | 37,135 |
| Accumulated other comprehensive income | 1,030 | 2,635 |
| Total stockholders' equity | 75,723 | 68,738 |
| TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY | \$ 907,491 | \$ 816,303 |

The accompanying Notes to Consolidated Financial Statements are an integral part of these statements.

Exhibit B Statements of Income

FIRST NATIONAL COMMUNITY BANCORP, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF INCOME

| Year Ended December 31, (in thousands, except per share data) | 2004 | 2003 | 2002 |
|---|-----------------|-----------------|-----------------|
| INTEREST INCOME | | | |
| Interest and fees on loans | \$ 32,982 | \$ 30,738 | \$ 31,477 |
| Interest and dividends on securities: | | | |
| U.S. Treasury and government agencies | 5,788 | 6,534 | 8,043 |
| State and political subdivisions | 2,524 | 2,853 | 2,734 |
| Other securities | 829 | 455 | 340 |
| Total interest and dividends on securities | 9,141 | 9,842 | 11,117 |
| Interest on balances with financial institutions | 44 | 82 | 138 |
| Interest on federal funds sold | 62 | 43 | 127 |
| TOTAL INTEREST INCOME | 42,229 | 40,705 | 42,859 |
| INTEREST EXPENSE | | | |
| Interest-bearing demand | 1,605 | 1,097 | 1,750 |
| Savings | 599 | 599 | 799 |
| Time (\$100,000 and over) | 2,102 | 2,199 | 2,750 |
| Other time | 6,125 | 7,278 | 9,414 |
| Interest on borrowed funds | 6,529 | 6,237 | 6,086 |
| TOTAL INTEREST EXPENSE | 16,960 | 17,410 | 20,799 |
| Net interest income before provision for credit losses | 25,269 | 23,295 | 22,060 |
| Provision for credit losses | 1,400 | 1,200 | 1,400 |
| NET INTEREST INCOME AFTER PROVISION FOR CREDIT LOSSES | 23,869 | 22,095 | 20,660 |
| OTHER INCOME | | | |
| Service charges | 1,929 | 1,575 | 1,371 |
| Net gain on the sale of securities | 846 | 657 | 366 |
| Net gain on the sale of loans | 499 | 555 | 339 |
| Net gain on the sale of other real estate | 25 | 96 | 454 |
| Other | 1,490 | 1,301 | 1,146 |
| TOTAL OTHER INCOME | 4,789 | 4,184 | 3,676 |
| OTHER EXPENSES | | | |
| Salaries and employee benefits | 8,692 | 7,641 | 6,990 |
| Occupancy expense | 1,556 | 1,471 | 1,388 |
| Equipment expense | 1,257 | 1,193 | 1,161 |
| Directors Fees | 468 | 464 | 372 |
| Advertising expense | 650 | 575 | 604 |
| Data processing expense | 1,309 | 1,116 | 941 |
| Bank shares tax | 583 | 410 | 342 |
| Other operating expenses | 2,884 | 2,613 | 2,450 |
| TOTAL OTHER EXPENSES | 17,399 | 15,483 | 14,248 |
| INCOME BEFORE INCOME TAXES | 11,259 | 10,796 | 10,888 |
| Provision for income taxes | 1,996 | 2,159 | 2,063 |
| NET INCOME | \$ 9,263 | \$ 8,637 | \$ 8,025 |

EARNINGS PER SHARE:

| | | | |
|----------------|----------------|---------|---------|
| BASIC | \$ 0.86 | \$ 0.82 | \$ 0.78 |
| DILUTED | \$ 0.83 | \$ 0.79 | \$ 0.75 |

The accompanying Notes to Consolidated Financial Statements are an integral part of these statements.

Exhibit C Statements of Cash Flows

FIRST NATIONAL COMMUNITY BANCORP, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS

| For The Years Ended December 31, (in thousands) | 2004 | 2003 | 2002 |
|--|------------------|------------------|------------------|
| INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS: | | | |
| CASH FLOWS FROM OPERATING ACTIVITIES: | | | |
| Interest received | \$ 42,633 | \$ 41,847 | \$ 44,085 |
| Fees and commissions received | 3,419 | 2,876 | 2,517 |
| Interest paid | (17,457) | (17,755) | (21,987) |
| Cash paid to suppliers and employees | (15,019) | (14,152) | (13,253) |
| Income taxes paid | (2,189) | (2,759) | (2,579) |
| NET CASH PROVIDED BY OPERATING ACTIVITIES | 11,387 | 10,057 | 8,783 |
| CASH FLOWS FROM INVESTING ACTIVITIES: | | | |
| Securities available for sale: | | | |
| Proceeds from maturities | 500 | 500 | 1,000 |
| Proceeds from sales prior to maturity | 67,933 | 51,282 | 40,088 |
| Proceeds from calls prior to maturity | 33,866 | 80,258 | 46,916 |
| Purchases | (125,292) | (141,876) | (94,313) |
| Securities held to maturity: | | | |
| Proceeds from calls prior to maturity | 0 | 0 | 643 |
| Net (increase)/decrease in interest-bearing bank balances | 693 | 695 | (207) |
| Purchase of bank owned life insurance | (2,500) | 0 | 0 |
| Net increase in loans to customers | (74,470) | (64,771) | (48,649) |
| Capital expenditures | (2,489) | (2,740) | (1,584) |
| NET CASH USED IN INVESTING ACTIVITIES | (101,759) | (76,652) | (56,106) |
| CASH FLOWS FROM FINANCING ACTIVITIES: | | | |
| Net increase in demand deposits, money market demand, NOW accounts, and savings accounts | 62,884 | 75,846 | 20,191 |
| Net increase/(decrease) in certificates of deposit | 6,759 | (14,252) | 2,950 |
| Net increase in borrowed funds | 13,646 | 13,513 | 25,298 |
| Proceeds from issuance of common stock net of stock issuance costs | 2,060 | 1,565 | 1,238 |
| Proceeds from issuance of common stock - Stock Option Plans | 971 | 982 | 324 |
| Cash dividends paid | (3,885) | (3,267) | (2,832) |
| NET CASH PROVIDED BY FINANCING ACTIVITIES | 82,435 | 74,387 | 47,169 |
| NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS | (7,937) | 7,792 | (154) |
| CASH AND CASH EQUIVALENTS AT BEGINNING OF YEAR | 23,290 | 15,498 | 15,652 |
| CASH AND CASH EQUIVALENTS AT END OF YEAR | \$ 15,353 | \$ 23,290 | \$ 15,498 |

RECONCILIATION OF NET INCOME TO NET CASH PROVIDED BY OPERATING ACTIVITIES:

| | | | |
|---|-----------|-----------|----------|
| Net income | \$ 9,263 | \$ 8,637 | \$ 8,025 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | | |
| Amortization and accretion, net | 931 | 1,293 | 1,169 |
| Depreciation and amortization | 1,192 | 1,085 | 1,082 |
| Stock based compensation - stock option plans | 181 | 181 | 0 |
| Provision for credit losses | 1,400 | 1,200 | 1,400 |
| Provision for deferred taxes | (405) | (323) | (528) |
| Gain on sale of securities | (846) | (657) | (366) |
| Gain on sale of loans | (499) | (555) | (339) |
| Gain on sale of other real estate | (25) | (96) | (454) |
| Decrease in interest payable | (497) | (345) | (1,189) |
| Increase in accrued expenses and other liabilities | 1,410 | 632 | 399 |
| Increase in prepaid expenses and other assets | (192) | (845) | (473) |
| Decrease (increase) in interest receivable | (526) | (150) | 57 |
| Total adjustments | 2,124 | 1,420 | 758 |
| NET CASH PROVIDED BY OPERATING ACTIVITIES | \$ 11,387 | \$ 10,057 | \$ 8,783 |

The accompanying Notes to Consolidated Financial Statements are an integral part of these statements.

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Exhibit D Statements of Changes in Stockholders' Equity and Comprehensive Income

FIRST NATIONAL COMMUNITY BANCORP, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CHANGES IN
STOCKHOLDERS' EQUITY AND COMPREHENSIVE INCOME

For the Years Ended December 31, 2004, 2003 and 2002 (in thousands, except share data)

| | COMP-REHEN-SIVE | | ADD L | | ACCUMULATED OTHER COMP-REHENSIVE | TOTAL | |
|--|-----------------|------------------------|----------|--------------------|--|---------|----------|
| | INCOME | COMMON STOCK SHARES | AMOUNT | PAID-IN CAPITAL | RETAINED EARNINGS (LOSS) | | |
| BALANCES, DECEMBER 31, 2001 | | 10,215,188 | \$12,768 | \$11,566 | \$26,916 | \$536 | \$51,786 |
| Comprehensive Income: | | | | | | | |
| Net income for the year | \$8,025 | | | | 8,025 | | 8,025 |
| Other comprehensive income, net of tax: | | | | | | | |
| Unrealized gain on securities available-for-sale, net of deferred income taxes of \$2,216 | 3,936 | | | | | | |
| Reclassification adjustment for gain or loss included in income | 366 | | | | | | |
| Total other comp. gain, net of tax | 4,302 | | | | | 4,302 | 4,302 |
| Comprehensive Income | \$12,327 | | | | | | |
| Cash dividends paid, \$0.275 per share | | | | | (2,832) | | (2,832) |
| Proceeds from issuance of Common Stock- | | 44,000 | 56 | 310 | (42) | | 324 |
| Stock option plans Proceeds from issuance of Common Stock through dividend reinvestment | | 156,164 | 196 | 1,189 | (147) | | 1,238 |
| BALANCES, DECEMBER 31, 2002 | | 10,415,352 | \$13,020 | \$13,065 | \$31,920 | \$4,838 | \$62,843 |
| Comprehensive Income: | | | | | | | |
| Net income for the year | \$8,637 | | | | 8,637 | | 8,637 |
| Other comprehensive income, net of tax: | | | | | | | |
| Unrealized loss on securities available-for-sale, net of deferred income tax benefit of \$1,135 | (2,860) | | | | | | |
| Reclassification adjustment for gain or loss included in income | 657 | | | | | | |
| Total other comp. loss, net of tax | (2,203) | | | | | (2,203) | (2,203) |
| Comprehensive Income | \$6,434 | | | | | | |
| Cash dividends paid, \$0.31 per share | | | | | (3,267) | | (3,267) |
| Stock based compensation - Stock Option Plans | | | | 181 | | | 181 |
| Proceeds from issuance of Common Stock- | | 129,600 | 162 | 901 | (81) | | 982 |

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| | | | | | | |
|-------------------------------------|------------|----------|----------|----------|---------|----------|
| Stock option plans | | | | | | |
| Proceeds from issuance of | | | | | | |
| Common Stock through dividend | | | | | | |
| reinvestment | 118,718 | 148 | 1,491 | (74) | | 1,565 |
| BALANCES, DECEMBER 31, 2003 | 10,663,670 | \$13,330 | \$15,638 | \$37,135 | \$2,635 | \$68,738 |
| Comprehensive Income: | | | | | | |
| Net income for the year | \$9,263 | | | | 9,263 | 9,263 |
| Other comprehensive income, net | | | | | | |
| of tax: | | | | | | |
| Unrealized loss on securities | | | | | | |
| available-for-sale, net of | | | | | | |
| deferred income tax benefit of | (2,451) | | | | | |
| \$826 | | | | | | |
| Reclassification adjustment for | | | | | | |
| gain or loss included in income | | | | | | |
| | 846 | | | | | |
| Total other comp. loss, net of tax | (1,605) | | | | (2,203) | (2,203) |
| Comprehensive Income | \$7,658 | | | | | |
| Cash dividends paid, \$0.36 per | | | | | (3,885) | (3,885) |
| share | | | | | | |
| Stock based compensation | | | 181 | | | 181 |
| Option Plans | | | | | | |
| Proceeds from issuance of Common | | | | | | |
| Stock- | 119,500 | 149 | 883 | (61) | | 971 |
| Stock option plans | | | | | | |
| Proceeds from issuance of Common | | | | | | |
| Stock through dividend reinvestment | 115,772 | 145 | 1,969 | (54) | | 2,060 |
| BALANCES, DECEMBER 31, 2004 | 10,898,942 | \$13,624 | \$18,671 | \$42,398 | \$1,030 | \$75,723 |

The accompanying Notes to Consolidated Financial Statements are an integral part of these statements.

Notes to Consolidated Financial Statements:

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES:

The accounting and reporting policies that affect the more significant elements of First National Community Bancorp, Inc.'s (the company) financial statements are summarized below. They have been followed on a consistent basis and are in accordance with generally accepted accounting principles and conform to general practice within the banking industry.

NATURE OF OPERATIONS

The company is a registered bank holding company, incorporated under the laws of the state of Pennsylvania. It is the parent company of First National Community Bank (the bank) and its wholly owned subsidiary FNCB Realty, Inc.

The bank provides a variety of financial services to individuals and corporate customers through its sixteen banking locations located in northeastern Pennsylvania. It provides a full range of commercial banking services which includes commercial, residential and consumer lending. Additionally, the bank provides to its customers a variety of deposit products, including demand checking and interest-bearing deposit accounts.

FNCB Realty, Inc.'s operating activities include the acquisition, holding, and disposition of certain real estate acquired in satisfaction of loan commitments owed by third party debtors to the bank.

PRINCIPLES OF CONSOLIDATION

The consolidated financial statements include the accounts of First National Community Bancorp, Inc., the bank and its wholly owned subsidiary FNCB Realty, Inc. All significant intercompany balances and transactions have been eliminated in consolidation.

USE OF ESTIMATES

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure 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.

SECURITIES

Debt securities that management has the ability and intent to hold to maturity are classified as held-to-maturity and carried at cost, adjusted for amortization of premium and accretion of discounts using methods approximating the interest method. Other marketable securities are classified as available-for-sale and are carried at fair value. Unrealized gains and losses on securities available-for-sale are recognized as direct increases or decreases in stockholders' equity. Cost of securities sold is recognized using the specific identification method.

Investments in the Federal Reserve Bank and FHLB stock are carried at cost due to restrictions on their sale due to regulatory requirements.

LOANS

Loans are stated at face value, net of unamortized loan fees and costs and the allowance for credit losses. Interest on all loans is recognized on the accrual basis, based upon the principal amount outstanding.

Loans are placed on nonaccrual when a loan is specifically determined to be impaired or when management believes that the collection of interest or principal is doubtful. This is generally when a default of interest or principal has existed for 90 days or more, unless such loan is fully secured and in the process of collection. When the interest accrual is discontinued, interest credited to income in the current year is reversed and the accrual of income from prior years is charged against the allowance for credit losses. Any payments received are applied, first to the outstanding loan amounts, then to the recovery of any charged-off loan amounts. Any excess is treated as a recovery of lost interest.

LOAN IMPAIRMENT

The Bank applies the provisions of SFAS No. 114, Accounting by Creditors for Impairment of a Loan, and SFAS No. 118, Accounting by Creditors for Impairment of a Loan - Income Recognition and Disclosures, in its evaluation of the loan portfolio. SFAS 114 requires that certain impaired loans be measured based on the present value of expected future cash flows, net of disposal costs, discounted at the loan's original effective interest rate. As a practical expedient, impairment may be measured based on the loan's observable market price or the fair value of the collateral, net of disposal costs, if the loan is collateral dependent. When the measure of the impaired loan is less than the recorded investment in the loan, the impairment is recorded through a valuation allowance.

ALLOWANCE FOR CREDIT LOSSES

The allowance for credit losses is maintained at a level which, in management's judgment, is adequate to absorb credit losses inherent in the loan portfolio. The amount of the allowance is based on management's evaluation of the collectibility of the loan portfolio, including the nature of the portfolio, credit concentrations, trends in historical loss experience, specific impaired loans, and economic conditions. Allowances for impaired loans are generally determined based on collateral values or the present value of estimated cash flows. The allowance is increased by a provision for credit losses, which is charged to expense, and reduced by charge-offs, net of recoveries. Amounts are charged off after giving due consideration to such factors as the customer's financial condition, underlying collateral and guarantees, and general and industry economic conditions. Changes in the allowance relating to impaired loans are charged or credited to the provision for credit losses.

LOAN FEES

Loan origination and commitment fees, as well as certain direct loan origination costs are deferred and the net amount is amortized as an adjustment of the related loan's yield. The bank is generally amortizing these amounts over the life of the related loans except for residential mortgage loans, where the timing and amount of prepayments can be reasonably estimated. For these mortgage loans, the net deferred fees are amortized over an estimated average life of 7.5 years. Amortization of deferred loan fees is discontinued when a loan is placed on nonaccrual status.

OTHER REAL ESTATE (ORE)

Real estate acquired in satisfaction of a loan and in-substance foreclosures are reported in other assets. In-substance foreclosures are properties in which the borrower has little or no equity in collateral, where repayment of the loan is expected only from the operation or sale of the collateral, and the borrower either effectively abandons control of the property or the borrower has retained control of the property but his ability to rebuild equity based on current financial conditions is considered doubtful. Properties acquired by foreclosure or deed in lieu of foreclosure and properties classified as in-substance foreclosures are transferred to ORE and recorded at the lower of cost or fair value (less estimated selling cost for disposal of real estate) at the date actually or constructively received. Costs associated with the repair or improvement of the real estate are capitalized when such costs significantly increase the value of the asset, otherwise, such costs are expensed. An allowance for losses on ORE is maintained for subsequent valuation adjustments on a specific property basis.

BANK PREMISES AND EQUIPMENT

Bank premises and equipment are stated at cost less accumulated depreciation. Routine maintenance and repair expenditures are expensed as incurred while significant expenditures are capitalized. Depreciation expense is determined on the straight-line method over the following ranges of useful lives:

| | |
|-----------------------------------|----------------|
| Buildings and improvements | 10 to 40 years |
| Furniture, fixtures and equipment | 3 to 15 years |
| Leasehold improvements | 5 to 30 years |

ADVERTISING COSTS

Advertising costs are charged to operations in the year incurred and totaled \$650,000, \$575,000 and \$604,000 in 2004, 2003 and 2002, respectively.

INCOME TAXES

Deferred tax assets and liabilities are reflected at currently enacted income tax rates applicable to the period in which the deferred tax assets or liabilities are expected to be realized or settled. As changes in tax laws or rates are enacted, deferred tax assets and liabilities are adjusted through the provision for income taxes.

The company and its subsidiaries file a consolidated Federal income tax return. Under tax sharing agreements, each subsidiary provides for and settles income taxes with the company as if they would have filed on a separate return basis.

CASH EQUIVALENTS

For purposes of reporting cash flows, cash equivalents include cash on hand, amounts due from banks, and federal funds sold. Generally, federal funds are purchased and sold for one-day periods.

NET INCOME PER SHARE

Basic earnings per share have been computed by dividing net income (the numerator) by the weighted-average number of common shares outstanding (the denominator) for the period. Such shares amounted to 10,780,407 in 2004, 10,528,978 in 2003 and 10,296,251 in 2002.

Diluted earnings per share have been computed by dividing net income (the numerator) by the weighted-average number of common shares and options outstanding (the denominator) for the period. Such shares amounted to 11,172,587 in 2004, 10,987,190 in 2003 and 10,706,854 in 2002.

All share and per share information has been adjusted to reflect the retroactive effect of the 100% stock dividends paid on September 30, 2004 and January 31, 2003.

STOCK-BASED COMPENSATION

As of January 1, 2003 the Company adopted SFAS No. 148, Accounting for Stock-Based Compensation Transition and Disclosure, an amendment to SFAS No. 123, to provide alternative methods of transition for a voluntary change to the fair value based method of accounting for stock-based employee compensation. The Company has elected to apply the prospective method as permitted by SFAS No. 148. Accordingly all options granted on and after January 1, 2003 are charged against income at their fair value. Those issued prior to adoption are accounted for on the intrinsic method in accordance with Accounting Principles Board Opinion (APB) No. 25. Refer to the table in Note 12 to the financial statements illustrating the effect on the earnings for the three years presented.

BANK OWNED LIFE INSURANCE

Bank owned life insurance policies (BOLI) are carried at the cash surrender value of the underlying policies. Income on the investments in the policies, net of insurance costs, is recorded as non-interest income.

SEGMENT REPORTING

In June 1997, the FASB issued SFAS No. 131, Disclosures about Segments of an Enterprise and Related Information. SFAS No. 131 requires that public companies report certain information about operating segments in complete sets of financial statements of the company and in condensed financial statements of interim periods issued to shareholders. It also requires that public companies report certain information about their products and services, the geographic areas in which they operate, and their major customers. SFAS No. 131 applies to fiscal years beginning after December 15, 1997.

First National Community Bancorp, Inc. is a one bank holding company operating primarily in northeastern Pennsylvania. The primary purpose of the company is the delivery of financial services within its market by means of a branch network located in Lackawanna and Luzerne counties. Each of the company's entities are part of the same reporting segment, whose operating results are regularly reviewed by management. Therefore, consolidated financial statements, as presented, fairly reflect the operating results of the financial services segment of our business.

NEW FINANCIAL ACCOUNTING STANDARDS

In January 2003, the FASB issued Interpretation No. 46, Consolidation of Variable Interest Entities (FIN 46), which establishes guidance for determining when an entity should consolidate another entity that meets the definition of a variable interest entity. FIN 46 requires a variable interest entity to be consolidated by a company if that company will absorb a majority of the expected losses, will receive a majority of the expected residual returns, or both. Transferors to qualified special-purpose entities (QSPEs) and certain other interests in a QSPE are not subject to the requirements of FIN 46. On December 17, 2003, the FASB revised FIN 46 (FIN 46R) and deferred the effective date of FIN 46 to no later than the end of the first reporting period that ends after March 15, 2004, however, for special-purpose entities the Company would be required to

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apply FIN 46 as of December 31, 2003. The Interpretation had no effect on the company's consolidated financial statements.

In May 2003, the FASB issued SFAS No. 150, Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity. This statement provides new rules on the accounting for certain financial instruments that, under previous guidance, issuers could account for as equity. Such financial instruments include mandatorily redeemable shares, instruments that require the issuer to buy back some of its shares in exchange for cash or other assets, or obligations that can be settled with shares, the monetary value of which is fixed. Most of the guidance in SFAS No. 150 is effective for financial instruments entered into or modified after May 31, 2003, and otherwise is effective at the beginning of the first interim period beginning after June 30, 2003. This statement had no effect on the company's consolidated financial statements.

2. RESTRICTED CASH BALANCES:

The bank is required to maintain certain average reserve balances as established by the Federal Reserve Bank. The amount of those reserve balances for the reserve computation period which included December 31, 2004 was \$75,000, which amount was satisfied through the restriction of vault cash.

In addition, the bank maintains compensating balances at correspondent banks, most of which are not required, but are used to offset specific charges for services. At December 31, 2004, the amount of these balances was \$800,000.

3. SECURITIES:

Securities have been classified in the consolidated financial statements according to management's intent. The carrying amount of securities and their approximate fair values (in thousands) at December 31 follow:

Available-for-sale Securities:

| | <u>Amortized Cost</u> | <u>Gross Unrealized Holding Gains</u> | <u>Gross Unrealized Holding Losses</u> | <u>Net Carrying Value</u> |
|--|---------------------------|---|--|-----------------------------------|
| <u>December 31, 2004</u> | | | | |
| U.S. Treasury securities and obligations of U.S. government agencies | \$ 31,958 | \$ 6 | \$ 194 | \$ 31,770 |
| Obligations of state and political subdivisions | 51,627 | 2,899 | 57 | 54,469 |
| Mortgage-backed securities | 117,986 | 183 | 1,119 | 117,050 |
| Corporate debt securities | 19,138 | 17 | 172 | 18,983 |
| Equity securities | <u>10</u> | <u>0</u> | <u>0</u> | <u>10</u> |
| Total | \$220,719 | \$3,105 | \$1,542 | \$222,282 |

December 31, 2003

U.S. Treasury securities and obligations of U.S. government agencies

| | | | | |
|---|-----------|--------|-------|-----------|
| | \$ 17,632 | \$ 186 | \$ 47 | \$ 17,771 |
| Obligations of state and political subdivisions | 56,527 | 3,631 | 34 | 60,124 |

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| | | | | |
|----------------------------|-----------|----------|----------|-----------|
| Mortgage-backed securities | 109,922 | 1,212 | 856 | 110,278 |
| Corporate debt securities | 13,121 | 4 | 104 | 13,021 |
| Equity securities | <u>10</u> | <u>0</u> | <u>0</u> | <u>10</u> |
| Total | \$197,212 | \$5,033 | \$1,041 | \$201,204 |

Held-to-maturity Securities:

| | <u>Net Carrying Value</u> | <u>Gross Unrealized Holding Gains</u> | <u>Gross Unrealized Holding Losses</u> | <u>Fair Value</u> |
|---|-----------------------------------|---|--|-----------------------|
| <u>December 31, 2004</u> | | | | |
| Obligations of state and political subdivisions | | | | |
| | <u>\$1,486</u> | <u>\$ 56</u> | <u>\$ 0</u> | <u>\$1,542</u> |
| Total | \$1,486 | \$ 56 | \$ 0 | \$1,542 |

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| | Net Carrying <u>Value</u> | Gross Unrealized Holding <u>Gains</u> | Gross Unrealized Holding <u>Losses</u> | Fair <u>Value</u> |
|---|---------------------------------|--|---|----------------------|
| <u>December 31, 2003</u> | | | | |
| Obligations of state and political subdivisions | | | | |
| | <u>\$1,415</u> | <u>\$ 27</u> | <u>\$ 0</u> | <u>\$1,442</u> |
| Total | <u>\$1,415</u> | <u>\$ 27</u> | <u>\$ 0</u> | <u>\$1,442</u> |

Information pertaining to securities with gross unrealized losses at December 31, 2004, aggregated by investment category and length of time that individual securities have been in a continuous loss position, follows:

| | <u>Less Than 12 Months</u> | | <u>12 Months or Greater</u> | | <u>Total</u> | |
|--|----------------------------|---------------|-----------------------------|---------------|--------------|---------------|
| | Gross | | Gross | | | Gross |
| | Fair | Unrealized | Fair | Unrealized | Fair | Unrealized |
| | <u>Value</u> | <u>Losses</u> | <u>Value</u> | <u>Losses</u> | <u>Value</u> | <u>Losses</u> |
| U.S. Treasury securities and obligations of U.S. government agencies | | | | | | |
| | \$ 25,779 | \$ 194 | \$ 0 | \$ 0 | \$ 25,779 | \$ 194 |
| Obligations of state and political subdivisions | | | | | | |
| | 2,888 | 36 | 402 | 21 | 3,290 | 57 |
| Mortgage-backed securities | 73,133 | 839 | 13,488 | 280 | 86,621 | 1,119 |
| Corporate debt securities | <u>5,927</u> | <u>101</u> | <u>2,040</u> | <u>71</u> | <u>7,967</u> | <u>172</u> |
| | \$107,727 | \$1,170 | \$15,930 | \$372 | \$123,657 | \$1,542 |

Management evaluates securities for other-than-temporary impairment on a monthly basis. Consideration is given to (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, and (3) the intent and ability of the company to retain its investment in the issuer for a period of time sufficient to allow for any anticipated recovery in fair value.

At December 31, 2004, the sixty-two debt securities with unrealized losses have depreciated 1.2% from their amortized cost basis. The maturity of these securities are guaranteed by either the U.S. Government, government sponsored agencies, other governments or corporations. These unrealized losses relate principally to current interest rates for similar types of securities. In analyzing an issuer's financial condition, management considers whether the securities are issued by the federal government, its agencies, other governments or corporations; whether downgrades by bond rating agencies have occurred; and the results of reviews of the issuer's financial condition. As management has the ability to hold debt securities until maturity, or for the foreseeable future if classified as available-for-sale, no declines are deemed to be other-than-temporary.

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The following table shows the amortized cost and approximate fair value of the company's debt securities (in thousands) at December 31, 2004 using contracted maturities. Expected maturities will differ from contractual maturity because issuers may have the right to call or prepay obligations with or without call or prepayment penalties.

| | Available-for-sale | | Held-to-maturity | |
|------------------------------------|--------------------------|---------------------------------|---------------------------------|----------------------|
| | Amortized <u>Cost</u> | Net Carrying <u>Value</u> | Net Carrying <u>Value</u> | Fair <u>Value</u> |
| Amounts maturing in: | | | | |
| One Year or Less | \$ 5,029 | \$ 5,028 | \$ 0 | \$ 0 |
| One Year through Five Years | 6,478 | 6,522 | 0 | 0 |
| After Five Years through Ten Years | 23,871 | 23,748 | 0 | 0 |
| After Ten Years | 67,345 | 69,924 | 1,486 | 1,542 |
| Mortgage-backed Securities | <u>117,986</u> | <u>117,050</u> | <u>0</u> | <u>0</u> |
| Total | \$220,709 | \$222,272 | \$1,486 | \$1,542 |

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Gross proceeds from the sale of securities for the years ended December 31, 2004, 2003, and 2002 were \$67,933,000, \$51,282,000, and \$40,088,000, respectively with the gross realized gains being \$1,152,000, \$999,000, and \$405,000, respectively, and gross realized losses being \$306,000, \$342,000, and \$39,000, respectively.

At December 31, 2004 and 2003, securities with a carrying amount of \$132,900,000 and \$76,692,000, respectively, were pledged as collateral to secure public deposits and for other purposes.

4. LOANS:

Major classifications of loans are summarized as follows:

| | (in thousands) | |
|--|----------------|----------------|
| | <u>2004</u> | <u>2003</u> |
| Real estate loans, secured by residential properties | \$ 93,888 | \$ 93,055 |
| Real estate loans, secured by nonfarm, nonresidential properties | 308,904 | 244,368 |
| Commercial and industrial loans | 130,937 | 132,319 |
| Loans to individuals for household, family and other personal expenditures | 69,027 | 66,981 |
| Loans to state and political subdivisions | 29,774 | 21,734 |
| All other loans, including overdrafts | <u>362</u> | <u>318</u> |
| Gross loans | 632,892 | 558,775 |
| Less: Allowance for credit losses | <u>(7,100)</u> | <u>(6,578)</u> |
| Net loans | \$625,792 | \$552,197 |

Changes in the allowance for credit losses were as follows:

| | (in thousands) | | |
|----------------------------------|----------------|--------------|--------------|
| | <u>2004</u> | <u>2003</u> | <u>2002</u> |
| Balance, beginning of year | \$6,578 | \$6,140 | \$5,594 |
| Recoveries credited to allowance | 250 | 240 | 164 |
| Provision for credit losses | <u>1,400</u> | <u>1,200</u> | <u>1,400</u> |
| TOTAL | 8,228 | 7,580 | 7,158 |
| Losses charged to allowance | <u>1,128</u> | <u>1,002</u> | <u>1,018</u> |
| Balance, end of year | \$7,100 | \$6,578 | \$6,140 |

Information concerning the bank's recorded investment in nonaccrual and restructured loans is as follows:

| | (in thousands) | |
|--------------------|----------------|-------------|
| | <u>2004</u> | <u>2003</u> |
| Nonaccrual loans | | |
| Impaired | \$ 0 | \$ 0 |
| Other | 303 | 844 |
| Restructured loans | <u>0</u> | <u>0</u> |
| Total | \$303 | \$844 |

The interest income that would have been earned in 2004, 2003 and 2002 on nonaccrual and restructured loans outstanding at December 31, 2004, 2003 and 2002 in accordance with their original terms approximated \$42,000, \$65,000 and \$4,000. The interest income actually realized on such loans in 2004, 2003 and 2002 approximated \$13,000, \$15,000 and \$0. As of December 31, 2004, there were no outstanding commitments to lend additional funds to borrowers of impaired, restructured or nonaccrual loans.

5. BANK PREMISES AND EQUIPMENT:

Bank premises and equipment are summarized as follows:

| | (in thousands) | |
|-----------------------------------|----------------|--------------|
| | <u>2004</u> | <u>2003</u> |
| Land | \$ 1,386 | \$ 1,386 |
| Buildings | 4,622 | 4,585 |
| Furniture, fixtures and equipment | 7,867 | 6,380 |
| Leasehold improvements | <u>3,717</u> | <u>3,183</u> |
| Total | 17,592 | 15,534 |
| Less accumulated depreciation | <u>7,538</u> | <u>6,776</u> |
| Net | \$10,054 | \$ 8,758 |

6. DEPOSITS:

At December 31, 2004 time deposits including certificates of deposit and Individual Retirement Accounts have the scheduled maturities as follows:

| | (in thousands) | | |
|---------------------|-----------------|----------------------|---------------|
| | Time Deposits | | |
| | \$100,000 | Other | |
| | <u>and Over</u> | <u>Time Deposits</u> | <u>Total</u> |
| 2005 | \$74,394 | \$111,813 | \$186,207 |
| 2006 | 6,462 | 38,709 | 45,171 |
| 2007 | 6,823 | 31,704 | 38,527 |
| 2008 | 1,038 | 9,270 | 10,308 |
| 2009 and Thereafter | <u>5,608</u> | <u>22,572</u> | <u>28,180</u> |
| Total | \$94,325 | \$214,068 | \$308,393 |

7. BORROWED FUNDS:

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Borrowed funds at December 31, 2004 and 2003 include the following (in thousands):

| | <u>2004</u> | <u>2003</u> |
|-----------------------------------|----------------|----------------|
| Treasury Tax and Loan Demand Note | \$ 325 | \$ 324 |
| Borrowings under Lines of Credit | <u>153,742</u> | <u>140,097</u> |
| Total | \$154,067 | \$140,421 |

During 2004, the average outstanding balance on these credit lines amounted to \$1,774,000 and the average rate paid in 2004 was 1.42%.

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The following table presents Federal Home Loan Bank of Pittsburgh (FHLB of Pittsburgh) advances at their maturity dates (in thousands):

| | December 31, 2004 | |
|---|-------------------|---------------|
| | | Weighted |
| | | Average |
| | Amount | Interest Rate |
| Within one year | \$ 15,293 | 3.49% |
| After one year but within two years | 22,624 | 2.76 |
| After two years but within three years | 2,480 | 4.71 |
| After three years but within four years | 28,727 | 4.79 |
| After four years but within five years | 9,452 | 4.77 |
| After five years | <u>75,166</u> | <u>4.75</u> |
| | \$153,742 | 4.34% |

The FHLB of Pittsburgh advances include \$16 million which reset quarterly and \$138 million with fixed rates. All advances are collateralized either under a blanket pledge agreement by one to four family mortgage loans or with mortgage-backed securities. In addition, the company is required to purchase stock based upon the amount of advances outstanding.

At December 31, 2004, the company had available from the FHLB of Pittsburgh an open line of credit for \$20,496,000 which expires on December 14, 2005. The line of credit may bear interest at either a fixed rate or a variable rate, such rate being set at the time of the funding request. In addition, at December 31, 2004, the company had available overnight repricing lines of credit with other correspondent banks totaling \$25,000,000. At December 31, 2004 and 2003, the company had no borrowings outstanding with correspondent banks.

The maximum amount of borrowings outstanding at any month end during the years ended December 31, 2004 and 2003 were \$163,469,000 and \$160,368,000, respectively.

8. BENEFIT PLANS:

The bank has a defined contribution profit sharing plan which covers all eligible employees. The bank's contribution to the plan is determined at management's discretion at the end of each year and funded. Contributions to the plan in 2004, 2003 and 2002 amounted to \$480,000, \$420,000, and \$375,000, respectively.

The bank has an unfunded non-qualified deferred compensation plan covering all eligible bank officers and directors as defined by the plan. This plan permits eligible participants to elect to defer a portion of their compensation. At December 31, 2004, elective deferred compensation amounting to \$1,975,000 plus \$1,103,000 in accrued interest has been included in other liabilities in the accompanying balance sheet.

9. INCOME TAXES:

The provision for income taxes included in the statement of income is comprised of the following components (in thousands):

| | <u>2004</u> | <u>2003</u> | <u>2002</u> |
|----------|--------------|--------------|--------------|
| Current | \$2,401 | \$2,482 | \$2,591 |
| Deferred | <u>(405)</u> | <u>(323)</u> | <u>(528)</u> |
| TOTAL | \$1,996 | \$2,159 | \$2,063 |

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The components of the net deferred tax asset, included in other assets, at December 31 are as follows (in thousands):

| | <u>2004</u> | <u>2003</u> |
|---|------------------|------------------|
| Allowance for Credit Losses | \$ 2,414 | \$ 2,236 |
| Deferred Compensation | 1,047 | 828 |
| Stock Based Compensation | <u>122</u> | <u>62</u> |
| Gross Deferred Tax Asset | <u>3,583</u> | <u>3,126</u> |
| | | |
| Unrealized Holding Gains on Securities Available-for-Sale | | |
| | \$(531) | \$(1,357) |
| Deferred Loan Origination Fees | (252) | (230) |
| Depreciation | <u>(367)</u> | <u>(253)</u> |
| Gross Deferred Tax Liability | <u>\$(1,150)</u> | <u>\$(1,840)</u> |
| Deferred Tax Asset Valuation Allowance | <u>(56)</u> | <u>(140)</u> |
| Net Deferred Tax Assets | \$ 2,377 | \$ 1,146 |

The provision for Income Taxes differs from the amount of income tax determined applying the applicable U.S. Statutory Federal Income Tax Rate to pre-tax income from continuing operations as a result of the following differences (in thousands):

| | <u>2004</u> | <u>2003</u> | <u>2002</u> |
|--|--------------|--------------|--------------|
| Provision at Statutory Tax Rates | \$3,828 | \$3,671 | \$3,430 |
| Add (Deduct): | | | |
| Tax Effects of Non-Taxable Interest Income | (1,308) | (1,280) | (1,272) |
| Non-Deductible Interest Expense | 109 | 115 | 145 |
| Other Items Net | <u>(633)</u> | <u>(347)</u> | <u>(240)</u> |
| Provision for Income Taxes | \$1,996 | \$2,159 | \$2,063 |

The net change in the valuation allowance for deferred tax asset was a decrease of \$84,000 in 2004 and \$111,000 in 2003. The changes relate to a decrease in the provision for income taxes to which this valuation relates.

10. RELATED PARTY TRANSACTIONS:

At December 31, 2004 and 2003, certain officers and directors and/or their affiliates were indebted to the bank in the aggregate amounts of \$21,477,000 and \$25,147,000. Such indebtedness was incurred in the ordinary course of business on substantially the same terms as those prevailing at the time for comparable transactions with other persons. During 2004, \$79,303,000 of new loans were made and repayments totaled \$82,973,000. The bank was also committed under standby letters of credit as described in Note 11.

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Deposits from certain officers and directors and/or their affiliates held by the bank at December 31, 2004 and 2003 amounted to \$62,352,000 and \$51,171,000.

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11. COMMITMENTS:

(a) Leases:

At December 31, 2004, the company was obligated under certain noncancelable operating leases with initial or remaining terms of one year or more. Minimum future obligations under noncancelable operating leases in effect at December 31, 2004 are as follows (in thousands):

| | <u>FACILITIES</u> | <u>EQUIPMENT</u> |
|---------------------|-------------------|------------------|
| 2005 | \$ 413 | \$102 |
| 2006 | 258 | 79 |
| 2007 | 247 | 66 |
| 2008 | 174 | 28 |
| 2009 and thereafter | <u>197</u> | <u>4</u> |
| Total | \$1,289 | \$279 |

Total rental expense under operating leases amounted to \$540,000 in 2004, \$490,000 in 2003, and \$492,000 in 2002.

(b) Financial Instruments with Off-Balance Sheet Risk:

The bank is a party to financial instruments with off-balance sheet risk in the normal course of business to meet the financing needs of its customers. Such financial instruments include commitments to extend credit and standby letters of credit which involve varying degrees of credit, interest rate or liquidity risk in excess of the amount recognized in the balance sheet. The bank's exposure to credit loss from nonperformance by the other party to the financial instruments for commitments to extend credit and standby letters of credit is represented by the contractual amount of those instruments.

Financial instruments whose contract amounts represent credit risk at December 31 are as follows (in thousands):

| | <u>2004</u> | <u>2003</u> |
|------------------------------|-------------|-------------|
| Commitments to extend credit | \$131,320 | \$103,987 |
| Standby letters of credit | 39,812 | 35,668 |

Commitments to extend credit are agreements to lend to customers in accordance with contractual provisions. These commitments usually are for specific periods or contain termination clauses and may require the payment of a fee. The total amounts of unused commitments do not necessarily represent future cash requirements, in that commitments often expire without being drawn upon.

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Letters of credit and financial guarantees are agreements whereby the company guarantees the performance of a customer to a third party. Collateral may be required to support letters of credit in accordance with management's evaluation of the creditworthiness of each customer. The credit exposure assumed in issuing letters of credit is essentially equal to that in other lending activities.

Outstanding commitments to extend credit and standby letters of credit issued to or on behalf of related parties amounted to \$11,833,000 and \$10,824,000 and \$2,076,000 and \$362,000 at December 31, 2004 and 2003, respectively.

(c) Concentration of Credit Risk:

Cash Concentrations: The bank maintains cash balances at several correspondent banks. The aggregate cash balances represent federal funds sold of \$1,700,000 and \$0; and due from bank accounts in excess of the limit covered by the Federal Deposit Insurance Corporation amounting to \$500,000 and \$944,000 as of December 31, 2004 and 2003, respectively.

Loan Concentrations: At December 31, 2004, 43% of the bank's commercial loan portfolio was concentrated in loans in the following eight industries. Substantially all of these loans are secured by first mortgages on commercial properties. Floor plan loans to automobile dealers are secured by a first lien security interest in the vehicle inventories of the dealer.

| | <u>In thousands</u> | <u>%</u> |
|----------------------------|---------------------|----------|
| Shopping Centers/Complexes | \$36,419 | 7.3% |
| Hotels | 33,510 | 6.7 |
| Restaurants | 29,827 | 6.0 |
| Land Subdivision | 27,874 | 5.6 |
| Automobile Dealers | 24,818 | 5.0 |
| Office Complexes/Units | 21,292 | 4.3 |
| General Government | 20,797 | 4.1 |
| Gas Stations | 20,137 | 4.0 |

(d) Other:

The company is also a party to routine litigation involving various aspects of its business, none of which, in the opinion of management and its legal counsel, is expected to have a material adverse impact on the consolidated financial condition, results of operations or liquidity of the company.

12. STOCK OPTION PLANS:

On August 30, 2000, the Corporation's board of directors adopted an Employee Stock Incentive Plan in which options may be granted to key officers and other employees of the Corporation. The aggregate number of shares which may be issued upon exercise of the options under the plan cannot exceed 800,000 shares. Options and rights granted under the plan may be exercised six months after the date the options are awarded and expire ten years after the award date.

The board of directors also adopted on August 30, 2000, the Independent Directors Stock Option Plan for members of the corporation's board of directors who are not officers or employees of the corporation or its subsidiaries. The aggregate number of shares issuable under the plan cannot exceed 400,000 shares and are exercisable six months from the date the awards are granted for a period of three years.

During the first quarter of calendar 2003, the company adopted the fair value recognition provisions of FASB Statement No. 123, Accounting for Stock-Based Compensation, for stock-based employee compensation, effective as of January 1, 2003. Under the prospective method of adoption selected by the company, stock-based compensation cost will be recognized using the fair value method for all awards granted, modified or settled on or after that effective date.

Prior to 2003, the Company measured stock compensation cost using the intrinsic value method of accounting prescribed by APB Opinion No. 25, Accounting for Stock Issued to Employees, and related interpretations. Accordingly, no compensation cost was recognized for stock option awards granted in 2002. The following table illustrates the effect on net income (in thousands) and earnings per share if the fair value based method had been applied to awards made in 2004, 2003 and 2002 consistent with the provisions of SFAS No. 123.

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| | <u>Year Ended December 31,</u> | | |
|---|--------------------------------|--------------|--------------|
| | <u>2004</u> | <u>2003</u> | <u>2002</u> |
| Net income, as reported | \$9,263 | \$8,637 | \$8,025 |
| Add: Stock-based employee compensation expense included in reported net income, net of related tax effects | 120 | 120 | 0 |
| Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards, net of related tax effects | <u>(120)</u> | <u>(120)</u> | <u>(149)</u> |
| Pro forma net income | \$9,263 | \$8,637 | \$7,876 |
| Basic Earnings per share: | | | |
| As reported | \$0.86 | \$0.82 | \$0.78 |
| Pro forma | \$0.86 | \$0.82 | \$0.76 |
| Diluted Earnings per share: | | | |
| As reported | \$0.83 | \$0.79 | \$0.75 |
| Pro forma | \$0.83 | \$0.79 | \$0.74 |

The fair value of each option grant is estimated on the date of grant using the Black-Scholes option-pricing model average assumptions:

| | <u>Year Ended December 31,</u> | | |
|-------------------------|--------------------------------|-------------|-------------|
| | <u>2004</u> | <u>2003</u> | <u>2002</u> |
| Dividend yield | 1.53% | 2.18% | 2.93% |
| Expected life | 10 years | 10 years | 5.98 years |
| Expected volatility | 25.6% | 21.8% | 20.0% |
| Risk-free interest rate | 4.43% | .96% | 1.70% |

A summary of the status of the company's stock option plans is presented below:

| <u>2004</u> | Weighted | <u>2003</u> | Weighted | <u>2002</u> | Weighted |
|-------------|----------|-------------|----------|-------------|----------|
|-------------|----------|-------------|----------|-------------|----------|

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| | Average | | Average | | Average | |
|--|---------------|--------------|---------------|--------------|----------------|--------------|
| | Exercise | | Exercise | | Exercise | |
| | <u>Shares</u> | <u>Price</u> | <u>Shares</u> | <u>Price</u> | <u>Shares</u> | <u>Price</u> |
| Outstanding at the beginning of the year | | | | | | |
| Granted | 458,000 | \$ 8.889 | 517,600 | \$ 7.903 | 359,600 | \$7.791 |
| Exercised | 21,700 | 22.980 | 70,000 | 13.760 | 206,000 | 7.993 |
| Forfeited | (119,500) | 8.126 | (129,600) | 7.580 | (44,000) | 7.365 |
| Outstanding at the end of the year | <u>0</u> | 0 | <u>0</u> | 0 | <u>(4,000)</u> | 8.388 |
| Options exercisable at year end | 360,200 | \$9.992 | 458,000 | \$8.889 | 517,600 | \$7.903 |
| Weighted average fair value of options granted during the year | 338,500 | \$9.159 | 388,000 | \$8.011 | 311,600 | \$7.844 |
| | | \$8.42 | | \$2.60 | | \$1.09 |

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Information pertaining to options outstanding at December 31, 2004 is as follows:

| <u>Options Outstanding</u> | | | <u>Options Exercisable</u> | | |
|----------------------------|----------------|-------------|----------------------------|----------------|--------------|
| | | Weighted | | | |
| | | Average | Weighted | | Weighted |
| Range of | | Remaining | Average | | Average |
| Exercise | Number | Contractual | Exercise | Number | Exercise |
| Price | Outstanding | Life | Price | Exercisable | <u>Price</u> |
| \$7.9925-\$7.9925 | 56,000 | 0.7 years | \$ 7.9925 | 56,000 | \$ 7.9925 |
| \$7.1375-\$22.9800 | <u>304,200</u> | 7.6 years | 10.3600 | <u>282,500</u> | 9.3900 |
| | 360,200 | | | 338,500 | |

13. REGULATORY MATTERS:

The bank is subject to various regulatory capital requirements administered by the federal banking agencies. Failure to meet minimum capital requirements can initiate certain mandatory - and possibly additional discretionary - actions by regulators that, if undertaken, could have a direct material effect on the bank's financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the bank must meet specific capital guidelines that involve quantitative measures of the bank's assets, liabilities, and certain off-balance-sheet items as calculated under regulatory accounting practices. The bank's capital amounts and classification are also subject to qualitative judgments by the regulators about components, risk weightings, and other factors.

Quantitative measures established by regulation to ensure capital adequacy require the bank to maintain minimum amounts and ratios (set forth in the table below) of total and Tier I capital (as defined in the regulations) to risk-weighted assets (as defined), and of Tier I capital (as defined) to average assets (as defined). Management believes, as of December 31, 2004, that the bank meets all capital adequacy requirements to which it is subject.

As of December 31, 2004, the most recent notification from the Office of the Comptroller of the Currency categorized the bank as "Well Capitalized" under the regulatory framework for prompt corrective action. To be categorized as "Well Capitalized" the bank must maintain minimum Total risk-based, Tier I risk-based, and Tier I leverage ratios as set forth in the table. There are no conditions or events since that notification that management believes have changed the institution's category.

(in thousands)

To Be Well
Capitalized Under
For Capital
Prompt Corrective

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| | <u>Actual</u> | | <u>Adequacy Purposes:</u> | | <u>Action Provisions:</u> | |
|---------------------------------|---------------|--------------|---------------------------|--------------|---------------------------|--------------|
| | <u>Amount</u> | <u>Ratio</u> | <u>Amount</u> | <u>Ratio</u> | <u>Amount</u> | <u>Ratio</u> |
| <u>As of December 31, 2004:</u> | | | | | | |
| Total Capital | \$81,793 | 11.22% | >\$58,294 | >8.0% | >\$72,868 | >10.0% |
| (to Risk Weighted Assets) | | | | | | |
| Tier I Capital | \$74,693 | 10.25% | >\$29,147 | >4.0% | >\$43,721 | >6.0% |
| (to Risk Weighted Assets) | | | | | | |
| Tier I Capital | \$74,693 | 8.69% | >\$34,369 | >4.0% | >\$42,961 | >5.0% |
| (to Average Assets) | | | | | | |
| <u>As of December 31, 2003:</u> | | | | | | |
| Total Capital | \$72,681 | 11.47% | >\$50,701 | >8.0% | >\$63,376 | >10.0% |
| (to Risk Weighted Assets) | | | | | | |
| Tier I Capital | \$66,103 | 10.43% | >\$25,350 | >4.0% | >\$38,026 | >6.0% |
| (to Risk Weighted Assets) | | | | | | |
| Tier I Capital | \$66,103 | 8.52% | >\$31,037 | >4.0% | >\$38,797 | >5.0% |
| (to Average Assets) | | | | | | |

Banking regulations also limit the amount of dividends that may be paid without prior approval of the bank's regulatory agency. Retained earnings against which dividends may be paid without prior approval of the federal banking regulators amounted to \$19,826,000 at December 31, 2004, subject to the minimum capital ratio requirements noted above.

14. DISCLOSURES ABOUT FAIR VALUE OF FINANCIAL INSTRUMENTS:

Statement of Financial Accounting Standards No. 107 Disclosures about Fair Value of Financial Instruments, (SFAS 107) requires annual disclosure of estimated fair value of on-and off-balance sheet financial instruments.

The following methods and assumptions were used to estimate the fair value of each class of financial instruments for which it is practicable to estimate that value:

Cash and short-term investments:

Cash and short-term investments include cash on hand, amounts due from banks, and federal funds sold. For these short-term instruments, the carrying amount is a reasonable estimate of fair value.

Interest-bearing balances with financial institutions:

The fair value of these financial instruments is estimated using rates currently available for investments of similar maturities.

Securities:

For securities held for investment purposes, the fair values have been individually determined based on currently quoted market prices. If a quoted market price is not available, fair value is estimated using quoted market prices for similar securities.

Loans:

The fair value of loans has been estimated by discounting the future cash flows using the current rates which similar loans would be made to borrowers with similar credit ratings and for the same remaining maturities.

Deposits:

The fair value of demand deposits, savings deposits, and certain money market deposits is the amount payable on demand at the reporting date. The fair value of fixed-maturity certificates of deposit is estimated using the rates currently offered for deposits of similar remaining maturities.

Borrowed funds:

Rates currently available to the bank for debt with similar terms and remaining maturities are used to estimate fair value of existing debt.

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Commitments to extend credit and standby letters of credit:

The fair value of commitments is estimated using the fees currently charged to enter into similar agreements, taking into account the remaining terms of the agreements and the present creditworthiness of the counterparties. For fixed-rate loan commitments, fair value also considers the difference between current levels of interest rates and the committed rates. The fair value of letters of credit is based on fees currently charged for similar agreements or on the estimated cost to terminate them or otherwise settle the obligations with the counterparties at the reporting date.

The estimated fair values of the bank's financial instruments (in thousands) are as follows:

| | December 31, 2004 Carrying | Fair |
|--|-------------------------------|--------------|
| | <u>Value</u> | <u>Value</u> |
| FINANCIAL ASSETS | | |
| Cash and short term investments | \$ 15,353 | \$ 15,353 |
| Interest-bearing balances with financial institutions | 1,980 | 1,975 |
| Securities | 231,831 | 231,887 |
| Gross Loans | 632,892 | 632,989 |
| FINANCIAL LIABILITIES | | |
| Deposits | \$671,713 | \$672,030 |
| Borrowed funds | 154,067 | 156,541 |
| OFF-BALANCE SHEET FINANCIAL INSTRUMENTS | | |
| Commitments to extend credit and standby letters of credit | \$0 | \$322 |

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| | December 31, 2003 Carrying | Fair |
|--|-------------------------------|--------------|
| | <u>Value</u> | <u>Value</u> |
| FINANCIAL ASSETS | | |
| Cash and short term investments | \$ 23,290 | \$ 23,290 |
| Interest-bearing balances with financial institutions | 2,673 | 2,672 |
| Securities | 211,353 | 211,380 |
| Gross Loans | 558,775 | 565,310 |
| FINANCIAL LIABILITIES | | |
| Deposits | \$602,069 | \$603,976 |
| Borrowed funds | 140,421 | 148,910 |
| OFF-BALANCE SHEET FINANCIAL INSTRUMENTS | | |
| Commitments to extend credit and standby letters of credit | | |
| | \$0 | \$280 |

15. CONDENSED FINANCIAL INFORMATION PARENT COMPANY ONLY:

Condensed parent company only financial information is as follows (in thousands):

| | | | |
|---|----------------|----------------|----------------|
| Condensed Balance Sheet December 31, | <u>2004</u> | <u>2003</u> | |
| Assets: | | | |
| Cash | \$ 381 | \$ 243 | |
| Investment in Subsidiary (equity method) | <u>75,342</u> | <u>68,495</u> | |
| Total Assets | \$75,723 | \$68,738 | |
| Liabilities and Stockholders' Equity: | | | |
| Stockholders' equity | \$75,723 | \$68,738 | |
| Condensed Statement of Income for the years ending December 31, 2004, 2003 and 2002 | <u>2004</u> | <u>2003</u> | <u>2002</u> |
| Income: | | | |
| Dividends from Subsidiary | \$1,025 | \$ 800 | \$1,125 |
| Equity in Undistributed Income of Subsidiary | <u>8,270</u> | <u>7,861</u> | <u>6,926</u> |
| Total Income | <u>\$9,295</u> | <u>\$8,661</u> | <u>\$8,051</u> |
| Expenses | <u>32</u> | <u>24</u> | <u>26</u> |
| Net Income | \$9,263 | \$8,637 | \$8,025 |

Condensed Statement of Cash Flows for the years ending December 31, 2004, 2003 and 2002

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| | <u>2004</u> | <u>2003</u> | <u>2002</u> |
|---|-----------------|-----------------|------------------|
| Cash Flows from Operating Activities: | | | |
| Net income | \$9,263 | \$8,637 | \$8,025 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | | |
| Equity in undistributed income of subsidiary | (8,270) | (7,861) | (6,926) |
| Decrease in other assets | <u>0</u> | <u>5</u> | <u>31</u> |
| Net Cash Provided by Operating Activities | <u>\$ 993</u> | <u>\$ 781</u> | <u>\$1,130</u> |
| Cash Flows from Financing Activities: | | | |
| Cash dividends | \$(3,885) | \$(3,267) | \$(2,832) |
| Proceeds from issuance of common stock net of stock issuance costs | <u>3,030</u> | <u>2,547</u> | <u>1,562</u> |
| Net Cash Used in Financing Activities | <u>\$(855)</u> | <u>\$(720)</u> | <u>\$(1,270)</u> |
| Increase (decrease) in Cash | \$ 138 | \$ 61 | \$ (140) |
| Cash at Beginning of Year | <u>243</u> | <u>182</u> | <u>322</u> |
| Cash at End of Year | \$ 381 | \$ 243 | \$ 182 |

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Non-cash investing and financing activities:

In 1999, the company adopted a dividend reinvestment plan. Shares of stock issued in 2004, 2003 and 2002 were 115,772 shares, 118,718 shares and 156,164 shares, respectively, in lieu of paying cash dividends of \$2,060,000 in 2004, \$1,565,000 in 2003 and \$1,238,000 in 2002.

16. SELECTED QUARTERLY FINANCIAL DATA (UNAUDITED):

In thousands, except per share amounts

| | Quarter Ending | | | |
|-----------------------------|----------------|--------------|---------------|--------------|
| | March 31, | June 30, | September 30, | December 31, |
| 2004 | | | | |
| Interest income | \$10,019 | \$10,156 | \$10,685 | \$11,369 |
| Interest expense | <u>4,049</u> | <u>4,109</u> | <u>4,265</u> | <u>4,537</u> |
| Net interest income | 5,970 | 6,047 | 6,420 | 6,832 |
| Provision for credit losses | 225 | 225 | 225 | 725 |
| Other income | 1,359 | 1,401 | 1,044 | 985 |
| Other expenses | 4,178 | 4,152 | 4,307 | 4,762 |
| Provision for income taxes | <u>595</u> | <u>679</u> | <u>628</u> | <u>94</u> |
| Net income | \$ 2,331 | \$ 2,392 | \$ 2,304 | \$ 2,236 |
| Earnings per share: | | | | |
| Basic | \$0.22 | \$0.22 | \$0.21 | \$0.21 |
| Diluted | \$0.21 | \$0.22 | \$0.21 | \$0.19 |
| 2003 | | | | |
| Interest income | \$10,191 | \$10,163 | \$10,150 | \$10,201 |
| Interest expense | <u>4,608</u> | <u>4,466</u> | <u>4,213</u> | <u>4,123</u> |
| Net interest income | 5,583 | 5,697 | 5,937 | 6,078 |
| Provision for credit losses | 325 | 325 | 225 | 325 |
| Other income | 1,188 | 1,217 | 840 | 939 |
| Other expenses | 3,625 | 3,665 | 3,918 | 4,275 |
| Provision for income taxes | <u>586</u> | <u>618</u> | <u>515</u> | <u>440</u> |
| Net income | \$ 2,235 | \$ 2,306 | \$ 2,119 | \$ 1,977 |
| Earnings per share: | | | | |
| Basic | \$0.22 | \$0.22 | \$0.20 | \$0.18 |
| Diluted | \$0.21 | \$0.21 | \$0.20 | \$0.17 |

Exhibit E Report of Independent Registered Public Accounting Firm

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Stockholders of

First National Community Bancorp, Inc.

We have audited the accompanying consolidated balance sheets of First National Community Bancorp, Inc. as of December 31, 2004 and 2003, and the related consolidated statements of income, changes in stockholders' equity and comprehensive income, and cash flows for each of the three years in the period ended December 31, 2004. These financial statements are the responsibility of the Company'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. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of First National Community Bancorp, Inc. as of December 31, 2004 and 2003, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2004, in conformity with U.S. generally accepted accounting principles.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the effectiveness of First National Community Bancorp, Inc.'s internal control over financial reporting as of December 31, 2004, based on criteria established in *Internal Control-Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO), and our report dated January 21, 2005 expressed an unqualified opinion on management's assessment of internal control over financial reporting and an unqualified opinion on the effectiveness of internal control over financial reporting.

DEMETRIUS & COMPANY, L.L.C.

Wayne, New Jersey

January 21, 2005

