AMERISERV FINANCIAL INC /PA/
Form 10-Q/A
January 07, 2005

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q/A

(Mark One)

X

Quarterly Report Pursuant to Section 13 or 15(d) of the

Securities Exchange Act of 1934

For the period ended **June 30, 2004**

Transaction Report Pursuant to Section 13 or 15(d) of

the Securities Exchange Act of 1934

For the transaction period from ____________ to ____________

Commission File Number **0-11204**

AmeriServ Financial, Inc.

(Exact name of registrant as specified in its charter)

Pennsylvania **25-1424278**

(State or other jurisdiction of incorporation (I.R.S. Employer Identification No.)

or organization)

Main & Franklin Streets, P.O. Box 430, Johnstown, PA 15907-0430

(Address of principal executive offices) (Zip Code)

Registrant's telephone number, including area code **(814) 533-5300**

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.

X Yes

No

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

Yes

X No

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date.

Class

Outstanding at August 2, 2004

Common Stock, par value $2.50

13,974,778

per share

This amendment No. 1 on Form 10-Q/A is being refiled to reflect the restatement of the Company s Statement of Cash Flows for the six months ended June 30, 2003, as discussed in Note 18 to the Condensed Consolidated Financial Statements included at Item 1.

AmeriServ Financial, Inc.

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AmeriServ Financial, Inc.

CONDENSED CONSOLIDATED BALANCE SHEETS

(In thousands)

(Unaudited)

-	June 30, 2004	December 31, 2003
ASSETS		
Cash and due from banks	$ 19,446	$ 24,484
Interest bearing deposits	308	289
Investment securities:		
Available for sale	540,036	524,573
Held to maturity (market value $40,933 on		
June 30, 2004, and $28,095 on		
December 31, 2003)	41,517	28,089
Loans held for sale	1,886	1,423
Loans	500,732	504,890
Less: Unearned income	2,096	2,926
Allowance for loan losses	10,932	11,682
Net loans	487,704	490,282
Premises and equipment, net	10,471	11,141
Accrued income receivable	5,260	4,922
Mortgage servicing rights	1,642	1,718
Goodwill	9,544	9,544
Core deposit intangibles	4,003	4,719
Bank owned life insurance	30,066	29,515
Other assets	26,523	17,187
TOTAL ASSETS	$ 1,178,406	$ 1,147,886
LIABILITIES		
Non-interest bearing deposits	$ 108,098	$ 103,982
Interest bearing deposits	562,843	550,615
Total deposits	670,941	654,597
Other short-term borrowings	170,989	144,643
Advances from Federal Home Loan Bank	226,047	231,063
Guaranteed junior subordinated deferrable interest		
debentures	35,567	34,500
Total borrowed funds	432,603	410,206
Other liabilities	7,649	8,813
TOTAL LIABILITIES	1,111,193	1,073,616
STOCKHOLDERS' EQUITY		

Preferred stock, no par value; 2,000,000 shares authorized; there were no shares issued and outstanding for the periods presented	-	-
Common stock, par value $2.50 per share; 24,000,000 shares authorized; 18,063,343 shares issued and 13,972,424 outstanding on June 30, 2004; 18,048,518 shares issued and 13,957,599 outstanding on December 31, 2003	45,158	45,121
Treasury stock at cost, 4,090,919 shares for all periods presented	(65,824)	(65,824)
Capital surplus	66,850	66,809
Retained earnings	29,577	29,096
Accumulated other comprehensive loss, net	(8,548)	(932)
TOTAL STOCKHOLDERS' EQUITY	67,213	74,270
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	$ 1,178,406	$ 1,147,886

See accompanying notes to condensed consolidated financial statements.

AmeriServ Financial, Inc.

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(In thousands except per share data)

Unaudited

	Three Months Ended	Three Months Ended	Six Months Ended	Six Months Ended
	June 30,	June 30,	June 30,	June 30,

	2004	2003	2004	2003
INTEREST INCOME				
Interest and fees on loans and loans held for sale	$ 7,679	$ 8,595	$ 15,370	$ 17,678
Deposits with banks	7	23	15	37
Federal funds sold	-	-	1	-
Investment securities:				
Available for sale	4,570	5,285	9,518	10,715
Held to maturity	366	323	637	539
Total Interest Income	12,622	14,226	25,541	28,969
INTEREST EXPENSE				
Deposits	2,529	2,965	5,072	6,105
Federal funds purchased and securities				
sold under agreements to repurchase	-	9	-	17
Other short-term borrowings	440	372	855	704
Advances from Federal Home Loan Bank	2,977	3,706	5,963	7,582
Guaranteed junior subordinated deferrable interest	-	-	-	-
debentures	763	740	1,526	1,480
Total Interest Expense	6,709	7,792	13,416	15,888
NET INTEREST INCOME	5,913	6,434	12,125	13,081
Provision for loan losses	259	534	643	2,193
NET INTEREST INCOME AFTER PROVISION FOR LOAN LOSSES	5,654	5,900	11,482	10,888
NON-INTEREST INCOME				
Trust fees	1,347	1,253	2,614	2,506
Net realized gains on investment securities	111	1,420	1,048	2,698
Net realized gains on loans held for sale	115	221	155	394
Service charges on deposit accounts	716	800	1,446	1,567
Net mortgage servicing fees	47	77	99	148
Bank owned life insurance	276	307	551	605
Loss on sale of mortgage servicing	-	-	-	(758)
Other income	893	1,017	1,657	1,930
Total Non-Interest Income	3,505	5,095	7,570	9,090
NON-INTEREST EXPENSE				

Salaries and employee benefits	4,803	4,717	9,718	9,506
Net occupancy expense	699	701	1,456	1,453
Equipment expense	687	750	1,391	1,567
Professional fees	833	1,058	1,637	1,961
Supplies, postage and freight	308	338	625	714
Miscellaneous taxes and insurance	412	403	854	823
FDIC deposit insurance expense	71	26	143	54
Amortization of core deposit intangibles	358	358	716	716
Impairment charge (credit) for mortgage servicing rights	(264)	254	(164)	620
Goodwill impairment loss	-	-	-	199
Other expense	1,049	1,181	2,251	2,293
Total Non-Interest Expense	$ 8,956	$ 9,786	$ 18,627	$ 19,906

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CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

CONTINUED FROM PREVIOUS PAGE

(In thousands, except per share data)

Unaudited

	Three Months Ended June 30, 2004	Three Months Ended June 30, 2003	Six Months Ended June 30, 2004	Six Months Ended June 30, 2003
INCOME BEFORE INCOME TAXES	$ 203	$ 1,209	$ 425	$ 72
Provision (benefit) for income taxes	(51)	294	(55)	(48)
NET INCOME	$ 254	$ 915	$ 480	$ 120
PER COMMON SHARE DATA:				
Basic:				
Net income	$ 0.02	$ 0.07	$ 0.03	$ 0.01
Average shares outstanding	13,969	13,935	13,966	13,929
Diluted:				
Net income	$ 0.02	$ 0.07	$ 0.03	$ 0.01
Average shares outstanding	14,024	13,940	14,023	13,934
Cash dividends declared	$ 0.00	$ 0.00	$ 0.00	$ 0.00

See accompanying notes to condensed consolidated financial statements.

AmeriServ Financial, Inc.

CONDENSED **CONSOLIDATED STATEMENTS OF CASH FLOWS**

(In thousands)

Unaudited

	Six months ended June 30, 2004	Six months ended June 30, 2003 **(As restated See Note 18)**
OPERATING ACTIVITIES		
Net income	$ 480	$ 120
Adjustments to reconcile net income to net cash used in operating activities:		
Provision for loan losses	643	2,193
Depreciation expense	1,048	1,100
Amortization expense of core deposit intangibles	716	716
Goodwill impairment loss	-	199
Amortization expense of mortgage servicing rights	239	477
Impairment (credit) charge for mortgage servicing rights	(164)	620
Net amortization of investment securities	1,224	1,247
Net realized gains on investment securities	(1,048)	(2,698)
Net realized gains on loans held for sale	(155)	(394)
Loss on sale of mortgage servicing rights	-	758
Origination of mortgage loans held for sale	(15,805)	(38,786)
Sales of mortgage loans held for sale	13,456	36,547
Decrease (increase) in accrued income receivable	(338)	564

Decrease in accrued expense payable	(239)	(1,326)
Net (increase) decrease in other assets	(5,785)	2,474
Net increase (decrease) in other liabilities	1,601	(363)
Net cash used in operating activities	(4,127)	3,448
INVESTING ACTIVITIES		
Purchases of investment securities and other short-term investments -		
available for sale	(298,831)	(332,842)
Purchases of investment securities and other short-term investments -		
held to maturity	(17,050)	(18,221)
Proceeds from maturities of investment securities and		
other short-term investments available for sale	49,322	68,079
Proceeds from maturities of investment securities and		
other short-term investments held to maturity	3,548	1,504
Proceeds from sales of investment securities and		
other short-term investments available for sale	222,227	231,246
Long-term loans originated	(103,567)	(54,195)
Principal collected on long-term loans	84,754	119,053
Loans purchased or participated	(8,526)	(16,535)
Loans sold or participated	31,500	-
Net (increase) decrease in other short-term loans	(185)	1,384
Purchases of premises and equipment	(378)	(433)
Net sale of mortgage servicing rights	-	3,278
Net cash (provided by) used in investing activities	(37,186)	2,318
FINANCING ACTIVITIES		
Proceeds from sales of certificates of deposit	208,644	149,579
Payments for maturing certificates of deposit	(201,936)	(158,360)
Net increase in demand and savings deposits	9,636	784
Net increase in federal funds purchased, securities sold		
under agreements to repurchase, and other short-term borrowings	26,346	8,343
Net principal repayments of advances from FHLB	(5,016)	(3,767)
Net guaranteed junior subordinated deferrable interest debenture dividends paid	(1,458)	(1,458)
Proceeds from dividend reinvestment, stock		
purchase plan, and stock options exercised	78	131
Net cash provided by (used in) financing activities	36,294	(4,748)
NET (DECREASE) INCREASE IN CASH AND CASH EQUIVALENTS	(5,019)	1,018

CASH AND CASH EQUIVALENTS AT JANUARY 1	24,773	27,174
CASH AND CASH EQUIVALENTS AT JUNE 30	$ 19,754	$ 28,192

See accompanying notes to condensed consolidated financial statements.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

1.

Principles of Consolidation

The accompanying condensed consolidated financial statements include the accounts of AmeriServ Financial, Inc. (the Company) and its wholly-owned subsidiaries, AmeriServ Financial Bank (Bank), AmeriServ Trust and Financial Services Company (Trust Company), AmeriServ Associates, Inc., (AmeriServ Associates) and AmeriServ Life Insurance Company (AmeriServ Life). The Bank is a state-chartered full service bank with 23 locations in Pennsylvania. Standard Mortgage Corporation of Georgia (SMC), a subsidiary of the Bank, is a mortgage banking company whose business includes the servicing of mortgage loans. AmeriServ Associates, based in State College, is a registered investment advisory firm that provides investment portfolio and asset/liability management services to small and mid-sized financial institutions. AmeriServ Life is a captive insurance company that engages in underwriting as a reinsurer of credit life and disability insurance. The Trust Company offers a complete range of trust and financial services and has $1.2 billion in assets under management. The Trust Company also offers the ERECT and BUILD Funds which are collective investment funds for trade union controlled pension fund assets.

In addition, the Parent Company is an administrative group that provides support in such areas as audit, finance, investments, loan review, general services, and marketing. Significant intercompany accounts and transactions have been eliminated in preparing the condensed consolidated financial statements.

In the first quarter of 2004, the Company adopted FASB Interpretation Number 46-Revised December 2003 (FIN 46-R) Consolidation of Variable Interest Entities Revised which required the Company to deconsolidate its capital trust subsidiary. This deconsolidation resulted in the Company recording an additional $1.1 million in assets and liabilities that had previously been eliminated in consolidation.

2.

Basis of Preparation

The unaudited condensed consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America for interim financial information. In the opinion of management, all adjustments, consisting only of normal recurring entries, considered necessary for a fair presentation have been included. They are not, however, necessarily indicative of the results of consolidated operations for a full-year.

For further information, refer to the consolidated financial statements and accompanying notes included in the Company's Annual Report on Form 10-K/A for the year ended December 31, 2003.

3.

Earnings Per Common Share

Basic earnings per share include only the weighted average common shares outstanding. Diluted earnings per share include the weighted average common shares outstanding and potentially dilutive common stock equivalent shares in the calculation. Treasury shares are treated as retired for earnings per share purposes. Options to purchase 112,857 and 288,776 shares of common stock were outstanding as of June 30, 2004 and 2003, respectively, but were not included in the computation of diluted earnings per common share as the options exercise prices were greater than the average market price of the common stock for the respective periods.

Stock-based Compensation

Employee compensation expense under stock options is reported using the intrinsic value method. The following pro forma information regarding net income and earnings per share assumes stock options granted subsequent to December 31, 1994, had been accounted for under the fair value method and the estimated fair value of the options is amortized to expense over the vesting period. Compensation expense, net of related tax, of $19,000 and $34,000 for the three and six months ended June 30, 2004, and $18,000 and $35,000 for the three and six months ended June 30, 2003, respectively, is included in the pro forma net income as reported below (in thousands, except per share data).

	Three Months Ended		Six Months Ended	
	June 30,		June 30,	
	2004	2003	2004	2003
Reported net income	$254	$915	$480	$120
Pro forma net income	235	897	446	85
Reported earnings				
per share				
Basic	$0.02	$0.07	$0.03	$0.01
Diluted	0.02	0.07	0.03	0.01
Pro forma earnings				
per share:				
Basic	$0.02	$0.06	$0.03	$0.01
Diluted	0.02	0.06	0.03	0.01

4.

Comprehensive Income (Loss)

For the Company, comprehensive income (loss) includes net income (loss) and unrealized holding gains and losses from available for sale investment securities. The changes in other comprehensive income (loss) are reported net of income taxes, as follows (in thousands):

	Three Months Ended		Six Months Ended	
	June 30, 2004	June 30, 2003	June 30, 2004	June 30, 2003
Net income	$ 254	$ 915	$ 480	$ 120
Other comprehensive income (loss), before tax:				
Unrealized security gains (losses) arising during period	(16,505)	1,522	(10,669)	201
Less: reclassification adjustment for gains included in net income	111	1,420	1,048	2,698
Other comprehensive income (loss), before tax:	(16,616)	102	(11,717)	(2,497)
Income tax expense (benefit) related to items of other comprehensive income	(5,816)	36	(4,101)	(874)
Other comprehensive income (loss), net of tax:	(10,800)	66	(7,616)	(1,623)
Comprehensive income (loss)	$ (10,546)	$ 981	$ (7,136)	$(1,503)

5.

Condensed Consolidated Statement of Cash Flows

On a consolidated basis, cash and cash equivalents include cash and due from banks, interest-bearing deposits with banks, and federal funds sold and securities purchased under agreements to resell. For the parent company, cash and cash equivalents also include short-term investments. The Company made $3,165,000 in income tax payments in the first six months of 2004 as compared to $54,000 for the first six months of 2003. Total interest expense paid amounted to $13,655,000 in 2004's first six months compared to $17,214,000 in the same 2003 period.

6.

Investment Securities

Securities are classified at the time of purchase as investment securities held to maturity if it is management s intent and the Company has the ability to hold the securities until maturity. These held to maturity securities are carried on the Company s books at cost, adjusted for amortization of premium and accretion of discount which is computed using the level yield method which approximates the effective interest method. Alternatively, securities are classified as available for sale if it is management s intent at the time of purchase to hold the securities for an indefinite period of time and/or to use the securities as part of the Company s asset/liability management strategy. Securities classified as available for sale include securities which may be sold to effectively manage interest rate risk exposure, prepayment risk, and other factors (such as liquidity requirements). These available for sale securities are reported at fair value with unrealized aggregate appreciation/(depreciation) excluded from net income and credited/(charged) to accumulated other comprehensive income (loss) within stockholders' equity on a net of tax basis. Any securities classified as trading assets are reported at fair value with unrealized aggregate appreciation/(depreciation) included in income on a net of tax basis. The Company presently does not engage in trading activities. The mark-to-market of the available for sale portfolio does inject more volatility in the book value of equity, but has no impact on regulatory capital. All purchased investment securities are recorded on settlement date which is not materially different from trade date. Realized gain or loss on securities sold was computed upon the adjusted cost of the specific securities sold.

The cost basis and market values of investment securities are summarized as follows (in thousands):

Investment securities available for sale (AFS):

June 30, 2004	Cost Basis	Gross Unrealized Gains	Gross Unrealized Losses	Market Value
U.S. Treasury	$ 14,550	$ -	$ (364)	$ 14,186
U.S. Agency	44,580	7	(1,396)	43,191
U.S. Agency mortgage-backed securities	461,394	24	(11,460)	449,958
Other securities (1)	32,663	38	-	32,701
Total	$ 553,187	$ 69	$ (13,220)	$ 540,036

(1)Other investment securities include corporate notes and bonds, asset-backed securities, and equity securities.

Investment securities held to maturity (HTM):

June 30, 2004	Cost Basis	Gross Unrealized Gains	Gross Unrealized Losses	Market Value
U.S. Treasury	$ 3,378	$ 13	$ (20)	$ 3,371
U.S. Agency	22,887	-	(370)	22,517
U.S. Agency mortgage-backed securities	15,252	-	(207)	15,045
Total	$ 41,517	$ 13	$ (597)	$ 40,933

Investment securities available for sale (AFS):

December 31, 2003	Cost Basis	Gross Unrealized Gains	Gross Unrealized Losses	Market Value
U.S. Treasury	$ 9,498	$ 131	$ (32)	$ 9,597
U.S. Agency	13,508	3	(33)	13,478
U.S. Agency mortgage-backed securities	469,086	1,535	(3,051)	467,570
Other securities (1)	33,916	32	(20)	33,928
Total	$ 526,008	$ 1,701	$ (3,136)	$ 524,573

(1)Other investment securities include corporate notes and bonds, asset-backed securities, and equity securities.

Investment securities held to maturity (HTM):

December 31, 2003	Cost Basis	Gross Unrealized Gains	Gross Unrealized Losses	Market Value
U.S. Treasury	$ 1,155	$ 6	$ -	$ 1,161
U.S. Agency	8,096	-	(138)	7,958
U.S. Agency mortgage-backed securities	18,838	138	-	18,976
Total	$ 28,089	$ 144	$ (138)	$ 28,095

Maintaining investment quality is a primary objective of the Company's investment policy which, subject to certain limited exceptions, prohibits the purchase of any investment security below a Moody's Investor's Service or Standard & Poor's rating of "A." At June 30, 2004, 98.1% of the portfolio was rated "AAA" as compared to 97.6% of the portfolio at December 31, 2003. Less than 1.0% of the portfolio was rated below "A" or unrated at both June 30, 2004, and December 31, 2003.

The following tables present information concerning investments with unrealized losses as of June 30, 2004 (in thousands):

Investment securities available for sale:

June 30, 2004	Less than 12 months		12 months or longer		Total	
	Market Value	Unrealized Losses	Market Value	Unrealized Losses	Market Value	Unrealized Losses
U.S. Treasury	$ 14,186	$ (364)	$ -	$ -	$ 14,186	$ (364)
U.S. Agency	42,147	(1,396)	-	-	42,147	(1,396)
U.S. Agency mortgage-backed securities	420,721	(10,733)	18,785	(727)	439,506	(11,460)
Total	$ 477,054	$ (12,493)	$ 18,785	$ (727)	$495,839	$ (13,220)

Investment securities held to maturity:

June 30, 2004	Less than 12 months		12 months or longer		Total	
	Market Value	Unrealized Losses	Market Value	Unrealized Losses	Market Value	Unrealized Losses
U.S. Treasury	$ 1,124	$ (20)	$ -	$ -	$ 1,124	$ (20)
U.S. Agency	14,632	(179)	7,885	(191)	22,517	(370)
U.S. Agency mortgage-backed securities	15,045	(207)	-	-	15,045	(207)
Total	$ 30,801	$ (406)	$ 7,885	$ (191)	$ 38,686	$ (597)

In March 2004, the FASB s Emerging Issues Task Force (EITF) reached a consensus regarding EITF 03-1, The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments. The consensus provides guidance for evaluating whether an investment is other-than-temporarily impaired and requires certain disclosures for debt and equity investments accounted for under the cost method. Annual disclosures about unrealized losses on available for sale securities that have not been recognized as other-than-temporary impairments that were required under an earlier EITF 03-1 consensus remain in effect. The EITF 03-1 guidance for determining other-than-temporary impairment is effective for our quarter ending September 30, 2004, and the disclosures for cost method investments are effective for our fiscal year ending December 31, 2004. The amount of any other-than-temporary impairment, if any, that may need to be recognized upon our adoption of EITF 03-1 will depend on market conditions and our intent and ability to hold underwater investments until value is restored. At June 30, 2004, the total after-tax net unrealized loss on such investments was $8.6 million. Given the quality of the investment portfolio (greater than 98% rated AAA), the Company believes the unrealized losses that have existed for greater than 12 months are temporary in nature and resulted from interest rate movements.

7.

Loans Held for Sale

At June 30, 2004, $1,886,000 of certain newly originated fixed-rate residential mortgage loans were classified as held for sale, because it is management's intent to sell these residential mortgage loans. The residential mortgage loans held for sale are carried at the lower of aggregate cost or market value. Net realized and unrealized gains and losses are included in "Net realized gains on loans held for sale"; unrealized net valuation adjustments (if any) are recorded in the same line item on the Consolidated Statements of Operations. Management has identified potential embedded derivatives in certain loan commitments for residential mortgages where the Company has the intent to sell to an outside investor. The historical dollar amount of commitments outstanding has not been material.

8.

Loans

The loan portfolio of the Company consists of the following (in thousands):

	June 30,	December 31,

	2004	2003
Commercial	$ 68,138	$ 75,738
Commercial loans secured		
by real estate	212,108	206,204
Real estate mortgage	196,062	194,605
Consumer	24,424	28,343
Loans	500,732	504,890
Less: Unearned income	2,096	2,926
Loans, net of unearned income	$ 498,636	$ 501,964

Real estate-construction loans comprised 3.1%, and 3.2% of total loans, net of unearned income, at June 30, 2004 and December 31, 2003, respectively. The Company has no direct credit exposure to foreign countries.

9.

Allowance for Loan Losses and Charge-Off Procedures

As a financial institution which assumes lending and credit risks as a principal element of its business, the Company anticipates that credit losses will be experienced in the normal course of business. Accordingly, the Company consistently applies a comprehensive methodology and procedural discipline to perform an analysis which is updated on a quarterly basis at the Bank level to determine both the adequacy of the allowance for loan losses and the necessary provision for loan losses to be charged against earnings. This methodology includes:

* a detailed review of all criticized and impaired loans with balances over $250,000 to determine if any specific reserve allocations are required on an individual loan basis. The specific reserve established for these criticized and impaired loans is based on careful analysis of the loan's performance, the related collateral value, cash flow considerations and the financial capability of any guarantor.

*

the application of formula driven reserve allocations for all commercial and commercial real-estate loans are calculated by using a three-year migration analysis of net losses incurred within each risk grade for the entire commercial loan portfolio. The difference between estimated and actual losses is reconciled through the dynamic nature of the migration analysis.

* the application of formula driven reserve allocations to consumer and mortgage loans which are based upon historical net charge-off experience for those loan types. The residential mortgage loan allocation is based upon the Company's five-year historical average of actual loan net charge-offs experienced in that category. The same methodology is used to determine the allocation for consumer loans except the allocation is based upon an average of the most recent actual three-year historical net charge-off experience for consumer loans.

*

the application of formula driven reserve allocations to all outstanding loans is based upon review of historical losses and qualitative factors, which include but are not limited to: economic trends, delinquencies, concentrations of credit, trends in loan volume, experience and depth of management, examination and audit results, effects of any changes in lending policies and trends in policy, financial information and documentation exceptions.

*

the maintenance of a general unallocated reserve to accommodate inherent risk in the Company s portfolio that is not identified through the Company s specific loan and portfolio segment reviews discussed above. Management recognizes that there may be events or economic factors that have occurred affecting specific borrowers or segments of borrowers that may not yet be fully reflected in the information that the Company uses for arriving at reserves for a specific loan or portfolio segment. Therefore, the Company and its Board of Directors believe a general unallocated reserve is needed to recognize the estimation risk associated with the specific and formula driven allowances. In conjunction with the establishment of the general unallocated reserve, the Company also looks at the total allowance for loan losses in relation to the size of the total loan portfolio and the level of non-performing assets.

After completion of this process, a formal meeting of the Loan Loss Reserve Committee is held to evaluate the adequacy of the reserve.

When it is determined that the prospects for recovery of the principal of a loan have significantly diminished, the loan is immediately charged against the allowance account; subsequent recoveries, if any, are credited to the allowance account. In addition, non-accrual and large delinquent loans are reviewed monthly to determine potential losses. Consumer loans are considered losses when they are 90 days past due, except loans that are insured for credit loss.

#

The Company's policy is to individually review, as circumstances warrant, each of its commercial and commercial mortgage loans to determine if a loan is impaired. At a minimum, credit reviews are mandatory for all commercial and commercial mortgage loans with balances in excess of $250,000 within a 12-month period. The Company defines classified loans as those loans rated substandard or doubtful. The Company has also identified two pools of small dollar value homogeneous loans which are evaluated collectively for impairment. These separate pools are for residential mortgage loans and consumer loans. Individual loans within these pools are reviewed and removed from the pool if factors such as significant delinquency in payments of 90 days or more, bankruptcy, or other negative economic concerns indicate impairment.

An analysis of the changes in the allowance for loan losses follows (in thousands, except ratios):

	Three Months Ended		Six Months Ended	
	June 30, 2004	June 30, 2003	June 30, 2004	June 30, 2003
Balance at beginning of period	$11,379	$11,415	$11,682	$10,035
Transfer to reserve for unfunded loan commitments	(99)	-	(189)	-
Charge-offs:				
Commercial and commercial real estate	(220)	-	(1,081)	(2)
Residential mortgage	(25)	-	(119)	(181)
Consumer	(408)	(58)	(508)	(205)
Total charge-offs	(653)	(58)	(1,708)	(388)
Recoveries:				
Commercial and commercial real estate	11	2	387	17
Residential mortgage	3	3	34	15
Consumer	32	20	83	44
Total recoveries	46	25	504	76
Net charge-offs	(607)	(33)	(1,204)	(312)
Provision for loan losses	259	534	643	2,193
Balance at end of period	$10,932	$11,916	$10,932	$11,916
As a percent of average loans and loans held for sale, net of unearned income:				
Annualized net charge-offs	0.48%	0.02%	0.48%	0.11%

Annualized provision for loan losses	0.21	0.40	0.26	0.80
Allowance as a percent of loans and loans held for sale, net of unearned income at period end	2.18	2.27	2.18	2.27
Total classified loans	$24,617	$32,776	$24,617	$32,776

10.

Components of Allowance for Loan Losses

For impaired loans, the measurement of impairment may be based upon: 1) the present value of expected future cash flows discounted at the loan's effective interest rate; 2) the observable market price of the impaired loan; or 3) the fair value of the collateral of a collateral dependent loan.

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The Company had loans totaling $14,940,000 and $13,232,000 being specifically identified as impaired and a corresponding reserve allocation of $4,127,000 and $2,459,000 at June 30, 2004, and December 31, 2003, respectively. The average outstanding balance for loans being specifically identified as impaired was $10,789,000 for the six months of 2004 compared to $11,995,000 for the six months of 2003. All of the impaired loans are collateral dependent, therefore the fair value of the collateral of the impaired loans is evaluated in measuring the impairment. The interest income recognized on impaired loans during the first six months of 2004 was $255,000, compared to $233,000 for the first six months of 2003.

The following table sets forth the allocation of the allowance for loan losses among various categories. This allocation is determined using the quarterly process which was discussed above. This allocation, however, is not necessarily indicative of the specific amount or specific loan category in which future losses may ultimately occur (in thousands, except percentages):

	June 30, 2004	December 31, 2003