COMMERCIAL NATIONAL FINANCIAL CORP /PA
Form 10-Q
May 21, 2004

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, DC 20549

FORM 10-Q

(Mark One)

ý **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the quarterly period ended March 31, 2004
o **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the transition period from _______ to _______

Commission file number 0-18676

COMMERCIAL NATIONAL FINANCIAL CORPORATION
(Exact name of registrant as specified in its charter)

PENNSYLVANIA	25-1623213
(State or other jurisdiction of incorporation or organization)	*(I.R.S. Employer Identification No.)*

900 LIGONIER STREET LATROBE, PA	15650
(Address of principal executive offices)	*(Zip Code)*

Registrant's telephone number, including area code: (724) 539-3501

Indicate by checkmark 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[X] No [ ]

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act). [ ] Yes [x] No

Indicate the number of shares outstanding of each of the issuer's classes of common stock.

CLASS	OUTSTANDING AT April 30, 2004
Common Stock, $2 Par Value	3,430,376 Shares

PART I - FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

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PART II - OTHER INFORMATION

COMMERCIAL NATIONAL FINANCIAL CORPORATION
CONSOLIDATED STATEMENTS OF FINANCIAL CONDITION
(dollars in thousands, except per share amounts)

	March 31, 2004	**December 31, 2003**
	(unaudited)	
ASSETS		
Cash and due from banks	$ 8,676	$ 8,877
Interest bearing deposits with other banks	728	764
Total cash and cash equivalents	9,404	9,641
Investment securities available for sale	202,549	164,340
Restricted investments in bank stock	5,523	4,345
Loans (all domestic)	184,171	187,382
Allowance for loan losses	(2,480)	(2,462)
Net loans	181,691	184,920

Premises and equipment	5,143	5,005
Other assets	17,233	16,777
Total assets	$421,543	$ 385,028
LIABILITIES AND SHAREHOLDERS' EQUITY		
Deposits (all domestic):		
Non-interest bearing	$ 52,987	$ 51,344
Interest bearing	210,876	207,872
Total deposits	263,863	259,216
Other liabilities	3,983	3,825
Short-term borrowings	48,650	17,450
Long-term borrowings	55,000	55,000
Total liabilities	371,496	335,491
Shareholders' equity:		
Common stock, par value $2; 10,000,000		
shares authorized; 3,600,000 issued;		
3,430,376 shares outstanding		
in 2004 and 2003	7,200	7,200
Retained earnings	41,942	41,748
Accumulated other comprehensive income -	4,062	3,746
Treasury stock, at cost, 169,624 shares in		
2004 and 2003	(3,157)	(3,157)
Total shareholders' equity	50,047	49,537
Total liabilities and		
shareholders' equity	$421,543	$385,028

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

COMMERCIAL NATIONAL FINANCIAL CORPORATION		
CONSOLIDATED STATEMENTS OF INCOME		
(Dollars in thousands, except per share data)		
	Three Months Ended	Three Months Ended
	March 31	March 31
	2004	2003
	(unaudited)	(unaudited)
INTEREST INCOME:		
Interest and fees on loans	$2,706	$2,850
Interest and dividends on investments:		
Taxable interest	1,935	2,092
Interest exempt from federal		
income tax	278	291
Other	4	80
Total interest income	4,923	5,313
INTEREST EXPENSE		
Interest on deposits	877	997
Interest on short-term borrowings	51	-
Interest on long-term borrowings	726	720
Total interest expense	1,654	1,717
NET INTEREST INCOME	3,269	3,596
Provision for loan losses	56	-
NET INTEREST INCOME AFTER		
PROVISION FOR LOAN LOSSES	3,213	3,596

OTHER INCOME		
Asset management and trust income	225	153
Service charges on deposit accounts	207	185
Other service charges and fees	193	174
Security gains	795	-
Commissions and fees from insurance sales	170	208
Income from investment in life insurance	139	149
Other income	61	66
Total other income	1,790	935
OTHER EXPENSES		
Salaries and employee benefits	1,740	1,528
Executive severance	233	-
Net occupancy expense	188	194
Furniture and equipment expense	201	167
Pennsylvania shares tax	134	119
Legal and professional	223	209
Other expense	924	849
Total other expenses	3,643	3,066
INCOME BEFORE INCOME TAXES	1,360	1,465
Income tax expense	308	322
NET INCOME	$1,052	$1,143
Average shares outstanding	3,430,376	3,452,123
EARNINGS PER SHARE, BASIC	$ .31	$ .33

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

COMMERCIAL NATIONAL FINANCIAL CORPORATION
CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY
(dollars in thousands, except per share data)

	Common Stock	Retained Earnings	Treasury Stock	Accumulated Other Comprehensive Income	Total Shareholders' Equity
(unaudited)					
Balance at December 31, 2003	$7,200	$41,748	$ (3,157)	$ 3,746	$49,537
Comprehensive Income					
Net income	-	1,052	-	-	1,052
Other comprehensive income, net of tax:					
Unrealized net gains on securities	-	-	-	316	316
Total Comprehensive Income					1,368
Cash dividends declared					
$.25 per share	-	(858)	-	-	(858)
Balance at March 31, 2004	$7,200	$41,942	$ (3,157)	$ 4,062	$50,047
(unaudited)					
Balance at December 31, 2002	$ 7,200	$41,628	$ (2,504)	$ 4,881	$51,205
Comprehensive Income					
Net income	-	1,143	-	-	1,143
Other comprehensive income, net of tax:					
Unrealized net losses on securities	-	-	-	(518)	(518)
Total Comprehensive Income					625

Cash dividends declared					
$.25 per share	-	(864)	-	-	(864)
Purchase of treasury stock	-	-	(180)	-	(180)
Balance at March 31, 2003	$ 7,200	$41,907	$(2,684)	$ 4,363	$50,786

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

COMMERCIAL NATIONAL FINANCIAL CORPORATION

CONSOLIDATED STATEMENTS OF CASH FLOWS

(dollars in thousands)

(unaudited)

	For Three Months Ended March 31	
	2004	2003
OPERATING ACTIVITIES		
Net income	$1,052	$1,143
Adjustments to reconcile net income to net cash from operating activities:		
Depreciation and amortization	195	146
Amortization of intangibles	48	-
Provision for loan losses	56	-
Net accretion of loans and securities	(37)	(236)
Net securities gains	(795)	-
Income from investment in life insurance	(139)	(149)
Increase (decrease) in other liabilities	9	(586)
Increase in other assets	(379)	(210)
Net cash provided by operating activities	10	108
INVESTING ACTIVITIES		
Increase in federal funds sold	-	(200)
Purchase of securities	(81,953)	(20,561)
Maturities and calls of securities	9,006	18,750
Proceeds from sales of securities available for sale	34,861	-
Net cash used in acquisition	-	(100)
Net (increase) decrease in loans	3,183	(9,565)
Purchase of premises and equipment	(333)	(371)
Net cash used in investing activities	(35,236)	(12,047)
FINANCING ACTIVITIES		
Net increase (decrease) in deposits	4,647	(8,011)
Increase in other short-term borrowings	31,200	-
Dividends paid	(858)	(864)
Purchase of treasury stock	-	(180)
Net cash provided by (used in) financing activities	34,989	(9,055)
Increase (decrease) in cash and cash equivalents	(237)	(20,994)
Cash and cash equivalents at beginning of year	9,641	30,928
Cash and cash equivalents at end of quarter	$9,404	$ 9,934
Supplemental disclosures of cash flow information:		
Cash paid during the period for:		
Interest	$ 1,657	$ 1,848
Income Taxes	$ -	$ -

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

COMMERCIAL NATIONAL FINANCIAL CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

March 31, 2004

Note 1 Basis of Presentation

The accompanying consolidated financial statements include the accounts of Commercial National Financial Corporation (the Corporation) and its wholly owned subsidiaries, Commercial Bank of Pennsylvania (the Bank), formerly known as Commercial National Bank of Pennsylvania, Commercial National Insurance Services, Inc. (CNIS) and Highview Trust Company (HTC). In December 2002, CNIS acquired Gooder Agency Inc., (Gooder). Gooder is a full service provider of insurance products to individuals and businesses and acts as an agent for fifteen national, regional and mutual insurance companies. Gooder's results of operations are not material to the consolidated financial statements. In July 2003, the Bank's application to convert to a Pennsylvania state chartered bank was approved by the Pennsylvania Department of Banking, and the Bank changed its name to Commercial Bank of Pennsylvania. In October 2003, the Corporation's application to form a trust company was approved. This subsidiary, HTC, enables the Corporation to offer more investment products and the Corporation's trust operations were transferred to HTC from the Bank. All material intercompany transactions have been eliminated.

The accompanying unaudited consolidated interim financial statements have been prepared in accordance with generally accepted accounting principles for interim financial information. However, they do not include all information and footnotes required by generally accepted accounting principles for complete financial statements and should be read in conjunction with the annual financial statements of the Corporation for the year ended December 31, 2003, including the notes thereto. In the opinion of management, the unaudited interim consolidated financial statements include all adjustments (consisting of only normal recurring adjustments) necessary for a fair statement of financial position as of March 31, 2004 and the results of operations for the three month period ended March 31, 2004. The results of operations for the three months ended March 31, 2004 are not necessarily indicative of the results to be expected for the entire year.

Note 2 Allowance for Loan Losses

The provision for loan losses is the amount added to the allowance against which actual loan losses are charged. The amount of the provision is determined by management through an evaluation of the size and quality of the loan portfolio, economic conditions, concentrations of credit, recent loan loss trends, delinquencies and other risks inherent within the loan portfolio.Based upon the Corporation's most recent quarterly evaluation, management considers the allowance for loan losses to be adequate to absorb losses within in the loan portfolio.

The Corporation recorded a $56,000 provision for the three month period ended March 31, 2004. By comparison, the Corporation recorded no provision for the three month period ended a year ago. Net charge-offs amounted to $38,000 for the three months ended March 31, 2004.

Description of changes:

(dollars in thousands)	2004	2003
Allowance balance January 1	$2,462	$2,707
Additions:		
Provision charged to operating expenses	56	-
Recoveries on previously charged off loans	46	14
Deductions:		
Loans charged off	(84)	(8)
Allowance balance March 31	$2,480	$2,713

COMMERCIAL NATIONAL FINANCIAL CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 3 Comprehensive Income

The components of other comprehensive income (loss) and related tax effects for the three month periods ended March 31, 2004 and 2003 are as follows: **(dollars in thousands)**

For three months

	ended March 31	
	2004	2003
Gross change in unrealized gains (losses) on securities available for sale	$ 1,274	$(784)
Less: reclassification adjustment for gains realized in income	(795)	-
Net unrealized gains (losses)	479	(784)
Tax effect	163	(266)
Net of tax amount	$ 316	$(518)

Note 4 Legal Proceedings

Other than proceedings which occur in the normal course of business, there are no legal proceedings to which either the Corporation or any of its subsidiaries is a party which, in the opinion of management, will have any material effect on the financial position of the Corporation and its subsidiaries.

Note 5 Guarantees

The Corporation does not issue any guarantees that would require liability recognition or disclosure, other than its standby letters of credit. Standby letters of credit written are conditional commitments issued by the Corporation to guarantee the performance of a customer to a third party. Of these letters of credit, $337,000 automatically renew within the next twelve months, $96,000 will expire within the next twelve months and $2,975,000 will expire within thirteen to one hundred and sixty months. The Corporation, generally, holds collateral and/or personal guarantees supporting these commitments. Management believes that the proceeds obtained through a liquidation of collateral and the enforcement of guarantees would be sufficient to cover the potential amount of future payment required under the corresponding guarantees. The credit risk involved in issuing letters of credit is essentially the same as those that are involved in extending loan facilities to customers. The current amount of the liability as of March 31, 2004 for guarantees under standby letters of credit issued is not material.

ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

SAFE HARBOR STATEMENT

Forward-looking statements (statements which are not historical facts) in this Quarterly Report on Form 10-Q are made pursuant to the safe harbor provisions of the Private Securities Litigation Reform Act of 1995. For this purpose, any statements contained herein that are not statements of historical fact may be deemed to be forward-looking statements. Without limiting the generality of the foregoing, words such as "may," "will," "to," "expect," "believe," "anticipate," "intend," "could," "would," "estimate," or "continue" or the negative or other variations there terminology are intended to identify forward-looking statements. These statements are based on information currently available to the Corporation, and the Corporation assumes no obligation to update these statements as circumstances change. Investors are cautioned that all forward-looking statements involve risk and uncertainties, including changes in general economic and financial market conditions, unforeseen credit problems, and the Corporation's ability to execute its business plans. The actual results of future events could differ materially from those stated in any forward-looking statements herein.

CRITICAL ACCOUNTING ESTIMATES

Disclosure of the Corporation's significant accounting policies is included in Note 1 to the Corporation's Consolidated Financial Statements contained in the Corporation's Annual Report on Form 10-K for the year ended December 31, 2003 (the 2003 Annual Report). Some of these policies are particularly sensitive, requiring that significant judgments, estimates and assumptions be made by management. Additional information is contained in the Management's Discussion and Analysis section of the 2003 Annual Report for the most sensitive of these issues, including the provision and allowance for loan losses.

Significant estimates are made by management in determining the allowance for loan losses. Management considers a variety of factors in establishing these estimates, including current economic conditions, diversification of the loan portfolio, delinquency statistics, results of internal loan reviews, financial and managerial strengths of borrowers, adequacy of collateral (if collateral dependent) and other relevant factors. Estimates related to the value of collateral also have a significant impact on whether or not the Corporation continues to accrue income on delinquent loans and on the amounts at which foreclosed real estate is recorded on the Consolidated Statements of Financial Condition.

Management discussed the development and selection of critical accounting estimates and related Management and Discussion and Analysis disclosure with the Corporation's Audit Committee. There were no material changes made to the critical accounting estimates during the periods presented within.

OVERVIEW

The Corporation is a financial holding company, with wholly-owned subsidiaries Commercial Bank of Pennsylvania (the Bank), Commercial National Insurance Services, Inc. (CNIS) and Highview Trust Company (HTC).

The Corporation had net income of $1.1 million, or $0.31 per share, for the first quarter ended March 31, 2004 compared to $1.1 million or $0.33 per share for the quarter ended March 31, 2003. The Corporation's return on average assets for the first quarter of 2004 and 2003 was 1.08% and 1.22%, respectively. Return on average equity for the same two periods was 8.47% and 9.09%, respectively.

The Corporation's largest segment of operating results is dependent upon net interest income. Net interest income is interest earned on interest-earning assets less interest paid on interest-bearing liabilities. For the first quarter ended March 31, 2004 and 2003, net interest income was $3.3 million and $3.6 million, respectively. The Corporation's net interest income declined in the first quarter of 2004 as earning asset yields continued to decline due to lower rates on new loans and increased loan refinancing activity. Further compressing the Corporation's net interest income was its inability to lower interest liability costs any further as the Corporation utilized this advantage in prior years.

The Corporation realized $795,000 in securities gains as the investment portfolio was repositioned to increase taxable income and reduce our alternative minimum tax position (AMT). Partly offsetting this gain was severance expense of $233,000 related to the departure of the Corporation's previous President and Chief Executive Officer.

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION

ITEM 2.
AND RESULTS OF OPERATIONS

With its recent changes in management, the Corporation now intends to focus on the banking subsidiary and growing through traditional loans and deposits supplemented by offering trust products to customers in its marketplace. Management anticipates continued pressure on net interest income. The Corporation will continue to competitively price its loans and deposits with the intention of acquiring profitable market share. The Corporation will seek to reduce its operating expenses in order to offset an anticipated continued decline in net interest income. This renewed focus will take time to implement and total operating results will be pressured until the focus is completely in place.

FINANCIAL CONDITION

The Corporation's total assets increased by $36.5 million, or 9.48%, from December 31, 2003 to March 31, 2004. The increase was due to an increase of $39.4 million in investment securities, which was slightly offset by a decline of $3.2 million in loans outstanding. The Corporation increased its investment securities by purchasing mortgage backed securities with the proceeds of short-term borrowings. This was done in order to increase taxable income from the difference of income earned on these investments less the interest paid on the borrowings. In April 2004, the Corporation sold these investments with the proceeds used to reduce associated short-term borrowings as bond yields rose to levels that exceeded the Corporation's market risk tolerance. The decrease in loans outstanding in the first quarter of 2004 can be attributed to a $2.9 million decline in residential real estate secured loans as the Corporation's lending activity has leveled off from the brisk pace experienced in 2003.

The Corporation's total deposits increased $4.6 million from December 31, 2003 to March 31, 2004. $3.0 million of such increase was in the interest-bearing deposit accounts, while the remaining $1.6 million was in non-interest bearing demand accounts. These increases can be attributed to the Corporation offering free checking, competitive certificate of deposit rates and free business checking which commenced in December 2003.

Short-term borrowings increased from $17.5 million on December 31, 2003 to $48.7 million at March 31, 2004. This increase is directly related to the increase in investment securities described above. The Corporation made short-term borrowings to fund its purchases of investment securities. As noted earlier, these borrowings were reduced in April 2004 with proceeds from the sale of investment securities.

Shareholders' equity was $50.0 million on March 31, 2004 compared to $49.5 million on December 31, 2003. This increase is comprised of comprehensive income of $1.4 million less cash dividends of $858,000. Comprehensive income for the three months ended March 31, 2004 included net income of $1.1 million and an unrealized gain on securities available for sale of $316,000. Book value per common share increased from $14.44 at December 31, 2003 to $14.59 at March 31, 2004.

RESULTS OF OPERATIONS

First Three Months of 2004 as compared to the First Three Months of 2003

Pre-tax income for the first three months of 2004 was $1.4 million compared to $1.5 million for the same period of 2003, representing a 7.17% decrease. The decrease was the result of lower net interest income and higher operating expense during the first three months of 2004. Included in pre-tax income is a gain of $795,000 on the sale of investment securities. These securities were sold to offset a $233,000 executive severance expense and to alleviate the Corporation's alternative minimum tax position.

Interest income for the three months ended March 31, 2004 was $4.9 million, a decrease of 7.55% from interest income of $5.3 million for the three months ended March 31, 2003. The yield on the loan portfolio for the first three months of 2004 decreased seventy-five (75) basis points to 5.87%. This decrease is due to declining interest rates on loans over the past few years. Refinancing in all loan categories has caused the Corporation's overall loan yield to decrease 200 basis points since year-end 2001. The yield on the securities portfolio for the first three months of 2004 decreased fifty-six (56) basis points to 5.22%. This yield, like the yield on loans, continues to be negatively impacted by prepayments on higher yielding mortgage-backed securities and the reinvestment of funds into lower yielding securities. As a result, the yield on total average earning assets for the first three months of 2004 decreased sixty-four (64) basis points from 2003 to 5.56%.

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION

ITEM 2.
AND RESULTS OF OPERATIONS

Total interest expense of $1.7 million for the first three months of 2004 was relatively unchanged from the first three months of 2003. For the three months ended March 31, 2004, interest on deposits decreased $120,000 or 12.04% from the same period a year ago. Due to higher volume, short-term borrowing expense was $51,000, or 100% greater in the first quarter of 2004 than it was in the first quarter of 2003. The average cost of interest-bearing liabilities for the first three months of 2004 was 2.34%, an eighteen (18) basis points decrease from the same period in 2003. After three years of interest expense savings in the declining interest rate environment, the Corporation will not benefit as greatly in 2004 as interest costs appear to have bottomed in the rate cycle. This is due to the perceived economic recovery and management's reluctance to reduce our core deposit rates (interest-bearing and savings deposit accounts) and our decision to remain competitive in the pricing of certificates of deposit.

As a result of the foregoing, net interest income for the first three months of 2004 was $3.3 million, a decrease of $327,000, or 8.33% from net interest income for the same period in 2003.

The Corporation recorded a provision for loan losses of $56,000 for the three months ended March 31, 2004 compared to no provision for the three months ended March 31, 2003. The provision was determined based upon projected charge-offs and loan growth for the first quarter and the amount needed in the allowance as calculated in the adequacy for loan loss study.

Non-interest income for the first three months of 2004 was $1.8 million, an increase of $855,000 from non-interest income for the first three months of 2003. The main reason for this increase were gains of $795,000 on the sale of securities. Excluding these gains, non-interest income would have increased $60,000. The Corporation's other income components increased due to increases in trust income, service charges on deposit accounts and fee income from services provided for customers. Partially offsetting these increases was a decrease in commission income from insurance sales.

Non-interest expense for the first three months of 2004 reached $3.6 million, an increase of $577,000 or 18.82% from non-interest expense for the first three months of 2003. Most of the increase is related to personnel costs, which rose by $445,000, or 29.12% from period to period. Of this increase, $233,000 was severance expense relating to the resignation of the Corporation's previous President and Chief Executive Officer. Higher benefits and wages also contributed to the increase in personnel expense. A $34,000 increase in furniture and equipment expense was due to depreciation of equipment purchases in the fourth quarter of 2003. Other expense grew by 8.83%, representing a $75,000 increase. Higher advertising expense was the main reason for the increase in other expenses.

Federal income tax for the first three months of 2004 was $308,000 compared to $322,000 for the same period in 2003. The effective tax rates for the first three months of 2004 and 2003 were 22.65% and 21.98%, respectively.

LIQUIDITY

Liquidity measurements evaluate the Corporation’s ability to meet the cash flow requirements of its depositors and borrowers. The most desirable source of liquidity is deposit growth. Additional liquidity is provided by the maturity of investments in loans and securities and the principal and interest received from those earning assets. Another source of liquidity is represented by the Corporation’s ability to sell both loans and securities. The Bank is a member of the Federal Home Loan Bank (FHLB) system. The FHLB provides an additional source for liquidity for long- and short-term funding. Additional sources of funding from financial institutions have been established for short-term funding needs.

As of March 31, 2004, the Corporation had available funding of approximately $97.0 million at the FHLB with an additional $26.4 million of short-term funding available through federal funds lines of credit.