

COMMERCIAL NATIONAL FINANCIAL CORP /PA  
Form 10-Q  
August 14, 2001

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D. C. 20549

**FORM 10-Q**

Quarterly Report Under Section 13 or 15(d) of the  
Securities Exchange Act of 1934

For the Quarter ended JUNE 30, 2001

Commission file number 0-18676

**COMMERCIAL NATIONAL FINANCIAL CORPORATION**

(Exact name of registrant as specified in its charter)

PENNSYLVANIA  
(State or other jurisdiction)

25-1623213  
(I.R.S. Employer Identification No.)

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of incorporation or organization)

900 LIGONIER STREET LATROBE, PA  
(Address of principal executive offices)

15650  
(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 the number of shares outstanding of each of the issuer's classes of common stock.

CLASS

OUTSTANDING AT JULY 31, 2001

Common Stock, \$2 Par Value 3,426,096 Shares

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| COMMERCIAL NATIONAL FINANCIAL CORPORATION |               |               |
|-------------------------------------------|---------------|---------------|
| CONSOLIDATED BALANCE SHEETS               |               |               |
|                                           | June 30       | December 31   |
|                                           | 2001          | 2000          |
| ASSETS                                    |               |               |
| Cash and due from banks                   | \$ 8,649,365  | \$ 9,532,528  |
| Interest bearing deposits with            |               |               |
| other banks                               | 16,962,099    | 284,136       |
| Total cash and due from banks             | 25,611,464    | 9,816,664     |
| Federal funds sold                        | 9,475,000     | —             |
| Investment securities available for sale  | 90,781,984    | 104,703,464   |
| Loans (all domestic)                      | 206,773,303   | 207,956,789   |
| Less allowance for loan losses            | (2,500,250)   | (2,736,712)   |
| Net loans                                 | 204,273,053   | 205,220,077   |
| Premises and equipment                    | 5,887,444     | 6,027,137     |
| Other assets                              | 8,297,632     | 4,097,781     |
| Total Assets                              | \$344,326,577 | \$329,865,123 |
| LIABILITIES AND SHAREHOLDERS' EQUITY      |               |               |
| Deposits (all domestic):                  |               |               |
| Non-interest bearing                      | \$ 46,453,820 | \$ 49,027,941 |
| Interest bearing                          | 215,946,052   | 217,583,429   |
| Total deposits                            | 262,399,872   | 266,611,370   |
| Short-term borrowings                     | —             | 7,575,000     |
| Other liabilities                         | 2,386,905     | 2,541,836     |
| Long-term borrowings                      | 35,000,000    | 10,000,000    |
| Total Liabilities                         | 299,786,777   | 286,728,206   |
| Shareholders' Equity:                     |               |               |
| Common stock, par value \$2; 10,000,000   |               |               |
| Shares authorized; 3,600,000 issued;      |               |               |
| 3,426,096 and 3,458,355 shares            |               |               |
| outstanding in 2001 and 2000              | 7,200,000     | 7,200,000     |
| Retained earnings                         | 38,596,635    | 37,438,970    |
| Accumulated other comprehensive income -  |               |               |
| net of deferred taxes of \$962,605        |               |               |
| in June 2001 and \$563,721 in             |               |               |
| December 2000                             | 1,868,585     | 1,094,282     |

Treasury stock, 173,904 and 141,645 shares

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|                                                                                         |                      |                      |
|-----------------------------------------------------------------------------------------|----------------------|----------------------|
| at cost in 2001 and 2000                                                                | (3,125,420)          | (2,596,335)          |
|                                                                                         |                      |                      |
| Total Shareholders' Equity                                                              | <u>44,539,800</u>    | <u>43,136,917</u>    |
|                                                                                         |                      |                      |
| Total Liabilities and                                                                   |                      |                      |
| Shareholders' Equity                                                                    | <u>\$344,326,577</u> | <u>\$329,865,123</u> |
|                                                                                         |                      |                      |
| The accompanying notes are an integral part of these consolidated financial statements. |                      |                      |

| COMMERCIAL NATIONAL FINANCIAL CORPORATION           |                  |                  |  |                  |                  |
|-----------------------------------------------------|------------------|------------------|--|------------------|------------------|
| CONSOLIDATED STATEMENT OF INCOME                    |                  |                  |  |                  |                  |
|                                                     | Three Months     |                  |  | Six Months       |                  |
|                                                     | Ending June 30   |                  |  | Ending June 30   |                  |
|                                                     | <u>2001</u>      | <u>2000</u>      |  | <u>2001</u>      | <u>2000</u>      |
| INTEREST INCOME:                                    |                  |                  |  |                  |                  |
| Interest and fees on loans                          | \$4,232,044      | \$4,288,154      |  | \$ 8,562,669     | \$ 8,581,315     |
| Interest and dividends on investments:              |                  |                  |  |                  |                  |
| Taxable interest                                    | 1,472,101        | 1,808,934        |  | 3,012,626        | 3,205,442        |
| Interest exempt from federal income tax             | 210,294          | 377,444          |  | 397,212          | 971,125          |
| Interest on federal funds sold                      | 93,469           | 26,506           |  | 180,505          | 94,140           |
| Interest on bank deposits                           | <u>186,089</u>   | <u>4,254</u>     |  | <u>203,537</u>   | <u>10,078</u>    |
| Total Interest Income                               | 6,193,997        | 6,505,292        |  | 12,356,549       | 12,862,100       |
|                                                     |                  |                  |  |                  |                  |
| INTEREST EXPENSE                                    |                  |                  |  |                  |                  |
| Interest on deposits                                | 2,154,350        | 2,278,443        |  | 4,420,324        | 4,587,484        |
| Interest on short-term borrowings                   | 13,756           | 235,600          |  | 36,400           | 399,742          |
| Interest on long-term borrowings                    | <u>432,839</u>   | <u>355,052</u>   |  | <u>652,868</u>   | <u>656,747</u>   |
| Total interest expense                              | 2,600,945        | 2,869,095        |  | 5,109,592        | 5,643,973        |
|                                                     |                  |                  |  |                  |                  |
| NET INTEREST INCOME                                 | 3,593,052        | 3,636,197        |  | 7,246,957        | 7,218,127        |
| PROVISION FOR LOAN LOSSES                           | -                | <u>465,000</u>   |  | -                | <u>630,000</u>   |
|                                                     |                  |                  |  |                  |                  |
| NET INTEREST INCOME AFTER PROVISION FOR LOAN LOSSES | <u>3,593,052</u> | <u>3,171,197</u> |  | <u>7,246,957</u> | <u>6,588,127</u> |
| OTHER INCOME                                        |                  |                  |  |                  |                  |
| Asset management and trust income                   | 137,455          | 122,993          |  | 284,316          | 240,962          |
| Service charges on deposit accounts                 | 188,445          | 176,207          |  | 372,358          | 348,322          |
| Other service charges and fees                      | 175,559          | 174,073          |  | 385,982          | 351,093          |
| Securities gains/(losses)                           | 19,782           | -                |  | (4,783)          | (862,844)        |
| Other income                                        | <u>144,400</u>   | <u>52,705</u>    |  | <u>212,371</u>   | <u>955,535</u>   |
| Total Other Income                                  | <u>665,641</u>   | <u>525,978</u>   |  | <u>1,250,244</u> | <u>1,033,068</u> |
|                                                     |                  |                  |  |                  |                  |
| OTHER EXPENSES                                      |                  |                  |  |                  |                  |
| Salaries and employee benefits                      | 1,373,706        | 1,278,503        |  | 2,787,530        | 2,656,725        |
| Net occupancy expense                               | 143,798          | 139,469          |  | 313,514          | 289,460          |
| Furniture and equipment expense                     | 187,888          | 210,041          |  | 361,672          | 412,965          |
| Pennsylvania shares tax                             | 105,579          | 97,006           |  | 205,442          | 187,817          |
| Other expense                                       | <u>734,802</u>   | <u>626,311</u>   |  | <u>1,402,656</u> | <u>1,202,172</u> |
| Total Other Expenses                                | <u>2,545,773</u> | <u>2,351,330</u> |  | <u>5,070,814</u> | <u>4,749,139</u> |

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|                                   |                    |                    |  |                    |                    |
|-----------------------------------|--------------------|--------------------|--|--------------------|--------------------|
|                                   |                    |                    |  |                    |                    |
| INCOME BEFORE INCOME TAXES        | 1,712,920          | 1,345,845          |  | 3,426,387          | 2,872,056          |
| Income tax expense                | <u>485,500</u>     | <u>308,500</u>     |  | <u>963,100</u>     | <u>613,200</u>     |
|                                   |                    |                    |  |                    |                    |
| NET INCOME                        | <u>\$1,227,420</u> | <u>\$1,037,345</u> |  | <u>\$2,463,287</u> | <u>\$2,258,856</u> |
|                                   |                    |                    |  |                    |                    |
| Average Shares Outstanding        | <u>3,438,787</u>   | <u>3,528,114</u>   |  | <u>3,438,787</u>   | <u>3,528,114</u>   |
|                                   |                    |                    |  |                    |                    |
| Earnings Per Share                | <u>\$ .36</u>      | <u>\$ .29</u>      |  | <u>\$ .72</u>      | <u>\$ .64</u>      |
|                                   |                    |                    |  |                    |                    |
| Cash Dividends Declared Per Share | <u>\$ .19</u>      | <u>\$ .17</u>      |  | <u>\$ .38</u>      | <u>\$ .34</u>      |

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



| COMMERCIAL NATIONAL FINANCIAL CORPORATION                 |                    |                     |                      |                     |                     |
|-----------------------------------------------------------|--------------------|---------------------|----------------------|---------------------|---------------------|
| CONSOLIDATED STATEMENT OF CHANGES IN SHAREHOLDERS' EQUITY |                    |                     |                      |                     |                     |
|                                                           |                    |                     |                      | Accumulated         |                     |
|                                                           |                    |                     |                      | Other               | Total               |
|                                                           | Common             | Retained            | Treasury             | Comprehensive       | Shareholders'       |
|                                                           | Stock              | Earnings            | Stock                | Income              | Equity              |
| <i>Balance at December 31, 1999</i>                       | \$7,200,000        | \$35,190,986        | \$(1,179,433)        | \$(1,807,660)       | \$39,403,893        |
| Comprehensive Income                                      |                    |                     |                      |                     |                     |
| Net income                                                | -                  | 2,258,856           | -                    | -                   | 2,258,856           |
| Other comprehensive income, net of tax:                   |                    |                     |                      |                     |                     |
| Unrealized gains on securities                            |                    |                     |                      |                     |                     |
| of \$356,133, net of reclassification                     |                    |                     |                      |                     |                     |
| adjustment for gains included in net                      |                    |                     |                      |                     |                     |
| income of \$569,477                                       | -                  | -                   | -                    | 925,610             | 925,610             |
| <i>Total Comprehensive Income</i>                         |                    |                     |                      |                     | <u>3,184,466</u>    |
| Cash dividends declared                                   |                    |                     |                      |                     |                     |
| \$ .34 per share                                          | -                  | (1,198,456)         | -                    | -                   | (1,198,456)         |
| Purchase of treasury stock                                | -                  | -                   | (376,115)            | -                   | (376,115)           |
| <i>Balance at June 30, 2000</i>                           | <u>\$7,200,000</u> | <u>\$36,251,386</u> | <u>\$(1,555,548)</u> | <u>\$(882,050)</u>  | <u>\$41,013,788</u> |
| <i>Balance at December 31, 2000</i>                       | \$7,200,000        | \$37,438,970        | \$(2,596,335)        | \$ 1,094,282        | \$43,136,917        |
| Comprehensive Income                                      |                    |                     |                      |                     |                     |
| Net income                                                | -                  | 2,463,287           | -                    | -                   | 2,463,287           |
| Other comprehensive income, net of tax:                   |                    |                     |                      |                     |                     |
| Unrealized net gains on securities                        |                    |                     |                      |                     |                     |
| of \$771,146, net of reclassification                     |                    |                     |                      |                     |                     |
| adjustment for losses included in net                     |                    |                     |                      |                     |                     |
| income of \$3,157                                         | -                  | -                   | -                    | 774,303             | 774,303             |
| <i>Total Comprehensive Income</i>                         |                    |                     |                      |                     | <u>3,237,570</u>    |
| Cash dividends declared                                   |                    |                     |                      |                     |                     |
| \$ .38 per share                                          | -                  | (1,305,622)         | -                    | -                   | (1,305,622)         |
| Purchase of treasury stock                                | -                  | -                   | (529,085)            | -                   | (529,085)           |
| <i>Balance at June 30, 2001</i>                           | <u>\$7,200,000</u> | <u>\$38,596,635</u> | <u>\$(3,125,420)</u> | <u>\$ 1,868,585</u> | <u>\$44,539,800</u> |

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

**COMMERCIAL NATIONAL FINANCIAL CORPORATION**  
**CONSOLIDATED STATEMENTS OF CASH FLOWS**

For Six Months

Ended June 30

|                                                                            | <u>2001</u>         | <u>2000</u>         |
|----------------------------------------------------------------------------|---------------------|---------------------|
| OPERATING ACTIVITIES                                                       |                     |                     |
| Net income                                                                 | \$2,463,287         | \$2,258,856         |
| Adjustments to reconcile net income to net cash from operating activities: |                     |                     |
| Depreciation and amortization                                              | 349,202             | 400,020             |
| Provision for loan losses                                                  | -                   | 630,000             |
| Net accretion/(amortization) of securities and loan fees                   | (163,620)           | (143,969)           |
| (Increase) decrease in interest receivable                                 | 258,919             | (300,055)           |
| Increase (decrease) in interest payable                                    | (89,596)            | (85,175)            |
| (Increase) decrease in taxes receivable                                    | 163,605             | 746,798             |
| Increase (decrease) in other liabilities                                   | (235,208)           | (549,778)           |
| (Increase) decrease in other assets                                        | 148,613             | 287,422             |
| Net security losses                                                        | <u>4,783</u>        | <u>862,844</u>      |
| Net cash provided by operating activities                                  | <u>2,899,985</u>    | <u>4,106,963</u>    |
| INVESTING ACTIVITIES                                                       |                     |                     |
| Net (increase) decrease in deposits with other banks                       | (16,677,963)        | 429,831             |
| (Increase) decrease in fed funds sold                                      | (9,475,000)         | 5,750,000           |
| Purchase of securities AFS                                                 | (12,371,032)        | (58,049,159)        |
| Maturities and calls of securities AFS                                     | 9,695,075           | 8,792,066           |
| Proceeds from sales of securities AFS                                      | 17,997,096          | 31,611,460          |
| Funding for BOLI program                                                   | (5,000,000)         | -                   |
| Net (increase) decrease in loans                                           | 879,390             | (5,472,105)         |
| Purchase of premises and equipment                                         | <u>(209,509)</u>    | <u>(397,976)</u>    |
| Net cash used in investing activities                                      | <u>(15,161,943)</u> | <u>(17,335,883)</u> |
| FINANCING ACTIVITIES                                                       |                     |                     |
| Net decrease in deposits                                                   | (4,211,498)         | (357,524)           |
| Net increase (decrease) in other short-term                                |                     |                     |

borrowings

(7,575,000)

15,875,000

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|                                           |                   |                   |
|-------------------------------------------|-------------------|-------------------|
| Proceeds from long-term borrowings        | 25,000,000        | -                 |
| Repayment of long-term borrowings         | -                 | -                 |
| Dividends paid                            | (1,305,622)       | (1,198,455)       |
| Purchase of treasury stock                | <u>(529,085)</u>  | <u>(376,115)</u>  |
| Net cash provided by financing activities | <u>11,378,795</u> | <u>13,942,906</u> |
|                                           | (883,163)         | 713,986           |

Cash and cash equivalents at beginning of year 9,532,528 8,654,617

Cash and cash equivalents at end of quarter \$ 8,649,365 \$ 9,368,603

Supplemental disclosures of cash flow  
information:

Cash paid during the year for:

Interest \$ 5,199,188 \$ 5,729,148

Income Taxes \$ 588,540 \$ 484,000

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

## COMMERCIAL NATIONAL FINANCIAL CORPORATION

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

June 30, 2001

-

**Note 1 Management Representation**

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 Commercial National Financial Corporation for the year ending December 31, 2000, 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 June 30, 2001 and the results of operations for the three and six month periods ended June 30, 2001 and 2000, and the statements of cash flows and changes in shareholders' equity for the six month periods ended June 30, 2001 and 2000. The results of the six months ended June 30, 2001 are not necessarily indicative of the results to be expected for the entire year.

-

**Note 2 Allowance for Loan Losses****Description of changes:**

|                                         | <u>2001</u>        | <u>2000</u>        |
|-----------------------------------------|--------------------|--------------------|
| Allowance balance January 1             | \$2,736,712        | \$1,919,453        |
| Additions:                              |                    |                    |
| Provision charged to operating expenses | -                  | 630,000            |
| Recoveries on previously charged off    |                    |                    |
| Loans                                   | 27,723             | 25,405             |
| Deductions:                             |                    |                    |
| Loans charged off                       | <u>(264,185)</u>   | <u>(278,949)</u>   |
| Allowance balance June 30               | <u>\$2,500,250</u> | <u>\$2,295,909</u> |

**Note 3 New Accounting Standards**

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In July 2001, the Financial Accounting Standards Board ("FASB") issued Statement of Financial Accounting Standards ("SFAS") 141, "Business Combinations", which requires that all business combinations be accounted for under a single method, the purchase method. Use of the pooling-of-interests method is no longer permitted. SFAS 141 requires that the purchase method be used for business combinations initiated after June 30, 2001. Since this accounting standard applies to business combinations initiated after June 30, 2001, it will have no effect on the corporation's financial statements unless the corporation enters into a business combination transaction.

In July 2001, the FASB also issued SFAS 142, "Goodwill and Other Intangible Assets", which requires that goodwill no longer be amortized to earnings, but instead be reviewed for impairment. The amortization of goodwill ceases upon adoption of the statement, which for most companies will be January 1, 2002. The corporation is currently studying the requirements of this new accounting standard to determine the impact to the financial statements.

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

#### **Overview**

With the aggressive easing in monetary policy by the Federal Reserve over the course of the year, many financial institutions have found it very difficult to improve upon prior year's net interest income as interest earning assets have been able to reprice downward more quickly than interest-bearing liabilities. The corporation has been able to maintain the year-to-date net interest income but has experienced modestly lower net interest income compared to second quarter a year ago due to the above mentioned circumstances.

In the first half of 2001, the corporation extended their liabilities as long-term borrowing costs declined in relation to the easing in monetary policy mentioned in the paragraph above. The use of these funds are currently being held in federal funds sold and interest bearing deposits with other banks until they are redeployed into investment securities or loans.

#### **RESULTS OF OPERATIONS**

**First Six Months of 2001 as compared to the First Six Months of 2000**

Pre-tax net income for the first six months of 2001 was \$3,426,387 compared to \$2,872,056 during the same period of 2000, representing a 19.30% increase.

Interest income was \$12,356,549, a decrease of 3.93%. Reasons for this decrease were the reduction in holdings of investment securities and decrease in the prime-lending rate that is associated with a weakening in the general economy. The loan return rate decreased thirteen (13) basis points to 8.29% and the securities return rate increased thirty-one (31) basis points to 6.70%. The return rate on total average earning assets increased to 7.73% versus a 7.62% return from a year ago. Average earning asset volume declined \$18,028,049, representing a 5.34% decrease.

Interest expense was \$5,109,592, a decrease of 9.47%. The cost rate on average interest-bearing liabilities was 4.18%, a seven (7) basis point decrease from a year ago. Average interest-bearing liability volume declined \$20,952,987, a decrease of 7.89%. This decrease in volume is mainly attributed towards the retirement of short-term borrowings held by the corporation a year ago.

Net interest income rose slightly to \$7,246,957 and represented 4.29% of average total assets compared to 4.12% during the first six months of 2000.

The average allowance for loan losses increased 31.56% to \$2,571,200. By comparison, total average loans grew 1.32% during the same period. There was no provision for loan losses for the first six months of 2001 as the reserve balance was adequate to absorb all currently projected loan losses. A provision of \$630,000 was added to the loan loss allowance during the first six months of 2000.

Net interest income after the application of the provision for loan losses increased 10.00% to \$7,246,957, representing a 4.29% return on total average assets compared to 3.76% for the first six months of 2000.

Non-interest income increased 21.02% to \$1,250,244. Asset management and trust fees increased 17.99% to \$284,316. Service charges on deposit accounts increased 6.90% to \$372,358. Other service charges and fees rose 9.94% reaching \$385,982. Other income decreased 77.77% to \$212,371. This decrease reflects an \$817,413 premium that the corporation received in 2000 from selling the credit card portfolio. Net securities losses of \$4,783 were realized on sold investments. In 2000, losses of \$862,844 were realized on sold investments as management repositioned the investment portfolio for better performance in the future.

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

**AND RESULTS OF OPERATIONS**

**RESULTS OF OPERATIONS (continued)**

Non-interest expense reached \$5,070,814, an increase of 6.77%, or \$321,675, while total average assets declined 3.63%. Personnel costs rose 4.92%, a \$130,805 increase. Net occupancy expense rose 8.31%, or \$24,054. Furniture and equipment expense declined 12.42%, representing a cost decrease of \$51,293. Pennsylvania shares tax expense was \$205,442, an increase of 9.38%. Other expense rose 16.68%, which equated to a \$200,484 increase. Increases in advertising, professional fees, donations and automated teller machine expense were the primary reasons for the rise in this category.

Federal income tax on total first six months earnings was \$963,100 compared to \$613,200 a year ago. The change in tax rate is due to the reduction in tax-free investment income that occurred with the restructuring of the investment portfolio. Net income after taxes increased \$204,431 to \$2,463,287, an increase of 9.05%. The annualized return on average assets was 1.46% for the first six months of 2001 compared to 1.29% for the six months ended June 30, 2000. The annualized return on average equity through June 30, 2001 was 11.16% and had been 11.11% through the first six months of 2000.

—

**Three Months Ended June 30, 2001 as Compared to the Three Months Ended June 30, 2000**

Pre-tax net income for the second quarter of 2001 rose 27.27% and was \$1,712,920 compared to \$1,345,845 during the same period of 2000.

Interest income was \$6,193,997 a decrease of 4.79%. The loan return rate decreased nineteen (19) basis points to 8.22%, the securities return rate decreased ten (10) basis points to 6.52% and the return rate on total average earning assets decreased eleven (11) basis points to 7.59%. Total average earning assets decreased \$11,623,872, or 3.44%.

Interest expense was \$2,600,945 a decrease of 9.35%. The average interest-bearing liabilities declined by \$14,415,304. The cost rate decreased to 4.14%, an eighteen (18) basis point decrease from a year ago.

The average allowance for loan losses increased 32.36% to \$2,605,947, while total average loans grew about 2,000,000 or .98%. There was no provision for loan losses allocated for the second quarter of 2001 as the reserve balance was adequate to absorb all currently projected loan losses. A provision of \$465,000 was added to the loan loss allowance in the second quarter of 2000.

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Net interest income after the application of the provision for loan losses rose 13.30% to \$3,593,052 representing a 4.16% return on total average assets compared to 3.61% for the second quarter of 2000.

Non-interest income increased 139,663 or 26.55%, to \$665,641. Asset management and trust income increase 11.76% to \$137,455. Service charges on deposit accounts increased 6.95% to \$188,445. Other service charges and fees grew .85% to \$175,559. Other income increased 173.98% to \$144,400 as the corporation realized increases in merchant and debit card revenue. Also included in this category is bank owned life insurance income that the bank purchased in June to attract, retain and reward valued management personnel. Net gains of \$19,782 were realized on securities sold in the second quarter.

Non-interest expense rose \$194,443, a 8.27% increase. Personnel costs rose \$95,203, a 7.45% increase. Net occupancy expense rose \$4,329 a 3.10% increase. Furniture and equipment expense declined \$22,153, a 10.55% decrease. Pennsylvania shares tax expense rose \$8,573, an increase of 8.84%. Other expense rose \$108,491, a 17.32% increase. Increases in advertising, professional fees, donations and automated teller machine expense were the primary reasons for the rise in this category.

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

#### AND RESULTS OF OPERATIONS

#### RESULTS OF OPERATIONS (continued)

—

Federal income tax on total second quarter earnings was \$485,500 compared to \$308,500 a year ago. The change in tax rate is due to the reduction in tax-free investment income that occurred with the restructuring of the investment portfolio. Net income after taxes increased \$190,075 to \$1,227,420, a 18.32% increase. The annualized return on average assets was 1.42% for the three months ended June 30, 2001 compared to 1.18% for the second quarter of 2000. The annualized return on average equity for the second quarter of 2001 was 11.05% compared to 10.30% for the second quarter of 2000.

#### LIQUIDITY

Liquidity, the measure of the corporation's ability to meet the normal cash flow needs of depositors and borrowers in an efficient manner, is generated primarily from the acquisition of deposit funds and the maturity of loans and securities. Additional liquidity can be provided by the sale of debt investment securities available for sale which amounted to \$88,923,984 on June 30, 2001. The bank is a member of the Federal Home Loan Bank (FHLB) system. The FHLB provides an additional source of liquidity for long- and short-term funding. Additional short-term funding is available through federal funds lines of credit that are established with correspondent banks.

#### AND RESULTS OF OPERATIONS

Investments maturing within one year were 1.74% of total assets on June 30, 2001 and 3.08% on June 30, 2000.

Average loans grew by \$2,694,683 and the average securities portfolio including federal funds sold decreased \$20,722,732.

#### **INTEREST SENSITIVITY**

Interest rate management seeks to maintain a balance between consistent income growth and the risk that is created by variations in ability to reprice deposit and investment categories. The effort to determine the effect of potential interest rate changes normally involves measuring the so called "gap" between assets (loans and securities) subject to rate fluctuation and liabilities (interest bearing deposits) subject to rate fluctuation as related to earning assets over different time periods and calculating the ratio of interest sensitive assets to interest sensitive liabilities.

Repricing periods for the loans, securities, interest bearing deposits, non-interest bearing assets and non-interest bearing liabilities are based on contractual maturities, where applicable, as well as the corporation's historical experience regarding the impact of interest rate fluctuations on the prepayment and withdrawal patterns of certain assets and liabilities. Regular savings, NOW and other similar interest-bearing demand deposit accounts are subject to immediate withdrawal and therefore are presented as beginning to reprice in the earliest period presented in the "gap" table.

**INTEREST****SENSITIVITY (In thousands)**

The following table presents this information as of June 30, 2001 and December 31, 2000:

|                                                  | <b>June 30, 2001</b>    |                          |                          |                          |                        |                         |
|--------------------------------------------------|-------------------------|--------------------------|--------------------------|--------------------------|------------------------|-------------------------|
|                                                  | <b>0-30 DAYS</b>        | <b>31-90 DAYS</b>        | <b>91-180 DAYS</b>       | <b>181-365 DAYS</b>      | <b>1 - 5 YEARS</b>     | <b>OVER 5 YRS</b>       |
| Interest-earning assets:                         |                         |                          |                          |                          |                        |                         |
| Securities                                       | \$ 795                  | \$ 1,588                 | \$ 2,362                 | \$ 10,527                | \$37,983               | \$ 32,809               |
| Federal funds sold and other deposits with banks | 26,437                  | -                        | -                        | -                        | -                      | -                       |
| Loans                                            | <u>32,434</u>           | <u>3,212</u>             | <u>6,029</u>             | <u>10,599</u>            | <u>87,860</u>          | <u>65,627</u>           |
| Total interest-sensitive assets                  | <b>59,666</b>           | <b>4,800</b>             | <b>8,391</b>             | <b>21,126</b>            | <b>125,843</b>         | <b>98,436</b>           |
| Interest-bearing liabilities:                    |                         |                          |                          |                          |                        |                         |
| Certificates of deposits                         | 17,223                  | 21,762                   | 18,054                   | 33,960                   | 22,323                 | 2,112                   |
| Other interest-bearing liabilities               | -                       | 3,984                    | 3,984                    | 5,675                    | 38,191                 | 48,908                  |
| Other-term borrowings                            | =                       | =                        | <u>5,000</u>             | =                        | <u>20,000</u>          | <u>10,000</u>           |
| Total interest sensitive liabilities             | <u>17,223</u>           | <u>25,746</u>            | <u>27,038</u>            | <u>39,635</u>            | <u>80,514</u>          | <u>61,020</u>           |
| Interest sensitivity gap                         | <b><u>\$ 42,443</u></b> | <b><u>\$(20,946)</u></b> | <b><u>\$(18,647)</u></b> | <b><u>\$(18,509)</u></b> | <b><u>\$45,329</u></b> | <b><u>\$ 37,416</u></b> |
| Cumulative gap                                   | <b><u>\$42,443</u></b>  | <b><u>\$ 21,497</u></b>  | <b><u>\$ 2,850</u></b>   | <b><u>\$(15,659)</u></b> | <b><u>\$29,670</u></b> | <b><u>\$ 67,086</u></b> |
| Ratio of cumulative gap to earning assets        | <b><u>13.14%</u></b>    | <b><u>6.66%</u></b>      | <b><u>.88%</u></b>       | <b><u>(4.85%)</u></b>    | <b><u>9.19%</u></b>    | <b><u>20.77%</u></b>    |

|                                                  | <b>December 31, 2000</b> |                   |                    |                     |                    |                   |
|--------------------------------------------------|--------------------------|-------------------|--------------------|---------------------|--------------------|-------------------|
|                                                  | <b>0-30 DAYS</b>         | <b>31-90 DAYS</b> | <b>91-180 DAYS</b> | <b>181-365 DAYS</b> | <b>1 - 5 YEARS</b> | <b>OVER 5 YRS</b> |
| Interest-earning assets:                         |                          |                   |                    |                     |                    |                   |
| Securities                                       | \$ 521                   | \$ 1,052          | \$ 1,601           | \$ 3,250            | \$41,089           | \$ 52,163         |
| Federal funds sold and other deposits with banks | 284                      | -                 | -                  | -                   | -                  | -                 |
| Loans                                            | <u>31,751</u>            | <u>3,771</u>      | <u>5,405</u>       | <u>13,842</u>       | <u>85,694</u>      | <u>66,958</u>     |
| Total interest-sensitive assets                  | <b>32,556</b>            | <b>4,823</b>      | <b>7,006</b>       | <b>17,092</b>       | <b>126,783</b>     | <b>119,121</b>    |
| Interest-bearing liabilities:                    |                          |                   |                    |                     |                    |                   |
| Certificates of deposits                         | 14,790                   | 21,175            | 18,767             | 29,502              | 24,337             | 5,750             |
| Other interest-bearing liabilities               | -                        | 4,122             | 4,122              | 6,009               | 39,222             | 49,787            |
| Other-term borrowings                            | <u>7,575</u>             | =                 | =                  | <u>5,000</u>        | <u>5,000</u>       | =                 |

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|                                           |                         |                          |                          |                          |                        |                         |
|-------------------------------------------|-------------------------|--------------------------|--------------------------|--------------------------|------------------------|-------------------------|
| Total-interest sensitive liabilities      | <u>22,365</u>           | <u>25,297</u>            | <u>22,889</u>            | <u>40,511</u>            | <u>68,559</u>          | <u>55,537</u>           |
| Interest sensitivity gap                  | <u><b>\$ 10,191</b></u> | <u><b>\$(20,474)</b></u> | <u><b>\$(15,883)</b></u> | <u><b>\$(23,419)</b></u> | <u><b>\$58,224</b></u> | <u><b>\$ 63,584</b></u> |
| Cumulative gap                            | <u><b>\$10,191</b></u>  | <u><b>\$(10,283)</b></u> | <u><b>\$(26,166)</b></u> | <u><b>\$(49,585)</b></u> | <u><b>\$ 8,639</b></u> | <u><b>\$ 72,223</b></u> |
| Ratio of cumulative gap to earning assets | <u><b>3.26%</b></u>     | <u><b>(3.29%)</b></u>    | <u><b>(8.38%)</b></u>    | <u><b>(15.87%)</b></u>   | <u><b>2.77%</b></u>    | <u><b>23.12%</b></u>    |

**ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION****AND RESULTS OF OPERATIONS (Continued)****CREDIT QUALITY RISK**

The following table presents a comparison of loan performance as of June 30, 2001 with that of June 30, 2000. Non-accrual loans are those for which interest income is recorded only when received and past due loans are those which are contractually past due 90 days or more in respect to interest or principal payments. As of June 30, 2001 the corporation had no other real estate owned and no in-substance foreclosures.

|                                                                   | 2001                | <u>At June 30,</u><br>2000 |
|-------------------------------------------------------------------|---------------------|----------------------------|
| Non-performing Loans:                                             |                     |                            |
| Loans on non-accrual basis                                        | \$ 805,198          | \$ 436,791                 |
| Past due loans                                                    | 79,751              | 60,129                     |
| Renegotiated loans                                                | <u>312,607</u>      | <u>449,548</u>             |
| Total Non-performing Loans                                        | \$ <u>1,197,556</u> | \$ <u>946,468</u>          |
| Other real estate owned                                           | \$ -                | \$ 73,154                  |
| Total Non-performing Assets                                       | \$ <u>1,197,556</u> | \$ <u>1,019,622</u>        |
| Loans outstanding at end of period                                | \$ 206,773,303      | \$ 210,114,087             |
| Average loans outstanding (year-to-date)                          | \$ 206,530,478      | \$ 203,835,795             |
| Non-performing loans as percent of total Loans                    | .58%                | .49%                       |
| Provision for loan losses                                         | \$ -                | \$ 630,000                 |
| Net charge-offs                                                   | \$ 236,462          | \$ 253,544                 |
| Net charge-offs as percent of average Loans                       | .11%                | .12%                       |
| Provision for loan losses as percent of net charge-offs           | -                   | 248.48%                    |
| Allowance for loan losses as percent of average loans outstanding | 121.06%             | 113.19%                    |

**CAPITAL RESOURCES**

Shareholders' equity for the first six months of 2001 averaged \$44,126,411, which represents an increase of \$3,458,100 over the average capital of \$40,668,311 recorded in the same period of 2000. These capital levels represented a capital ratio of 13.06% in 2001 and 11.60 in 2000. When the loan loss allowance is included, the 2001 capital ratio becomes 13.82%.

The Federal Reserve Board's risk-based capital adequacy guidelines are designed principally as a measure of credit risk. These guidelines require that: (1) at least 50% of a banking organization's total capital be common and certain other "core" equity capital ("Tier I Capital"); (2) assets and off-balance sheet items must be weighted according to risk; and (3) the total capital to risk-weighted assets ratio be at least 8%; and (4) a minimum 4.00% leverage ratio of Tier I capital to average total assets. The minimum leverage ratio is to be 4-5 percent for all but the most highly rated banks, as determined by a regulatory rating system. As of June 30, 2001, the corporation, under these guidelines, had a Tier I and total equity capital to risk adjusted assets ratio of 20.07% and 21.75% respectively. The leverage ratio was 12.45%.

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

AND RESULTS OF OPERATIONS (Continued)

-

CAPITAL RESOURCES (continued)

The table below presents the corporation's capital position at June 30, 2001

(Dollar amounts in thousands)

|                                  | <u>Amount</u> | Percent<br>of Adjusted<br><u>Assets</u> |
|----------------------------------|---------------|-----------------------------------------|
| Tier I Capital                   | \$ 42,671     | 20.07                                   |
| Tier I Requirement               | 8,502         | 4.00                                    |
| Total Equity Capital             | \$ 45,171     | 21.55                                   |
| Total Equity Capital Requirement | 17,004        | 8.00                                    |
| Leverage Capital                 | \$ 42,671     | 12.45                                   |
| Leverage Requirement             | 13,705        | 4.00                                    |

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PART II - OTHER INFORMATION

**ITEM 1. LEGAL PROCEEDINGS**

Not applicable.

**ITEM 2. CHANGES IN SECURITIES**

Not applicable.

**ITEM 3. DEFAULTS UPON SENIOR SECURITIES**

Not applicable.

**ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS**

a. May 15, 2001 Annual Meeting of Shareholders

b.c. Directors elected at the meeting and results of voting:

| <u>Director</u>      | <u>For</u> | <u>Against</u> | <u>Withheld</u> | <u>Abstentions</u> |
|----------------------|------------|----------------|-----------------|--------------------|
| John T. Babilya      | 3,015,697  | 5,000          |                 |                    |
| George A. Conti, Jr. | 3,019,617  | 1,080          |                 |                    |
| Frank E. Jobe        | 3,015,697  | 5,000          |                 |                    |
| Roy M. Landers       | 3,015,697  | 5,000          |                 |                    |
| C. Edward Wible      | 3,017,947  | 2,750          |                 |                    |

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Continuing directors:

|                      |                   |
|----------------------|-------------------|
| Richmond H. Ferguson | Joedda M. Sampson |
| Dorothy S. Hunter    | Debra L. Spatola  |
| Gregg E. Hunter      | Louis A. Steiner  |
| John C. McClatchey   | Louis T. Steiner  |
| Joseph A. Mosso      | George V. Welty   |

Ratification of the appointment of Beard Miller Company, LLP, as independent auditors:

| <u>For</u> | <u>Against</u> | <u>Withheld</u> | <u>Abstain</u> |
|------------|----------------|-----------------|----------------|
| 3,007,927  | 2,090          |                 | 10,680         |

d. N/A

### ITEM 5. OTHER INFORMATION

Not applicable

### ITEM 6. EXHIBITS AND REPORTS ON FORM 8-K

Not applicable

**SIGNATURES**

Pursuant to the requirements 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.

|                        |                                           |
|------------------------|-------------------------------------------|
|                        |                                           |
|                        | COMMERCIAL NATIONAL FINANCIAL CORPORATION |
|                        | (Registrant)                              |
|                        |                                           |
|                        |                                           |
|                        |                                           |
|                        |                                           |
|                        |                                           |
|                        | <u>/s/ Gregg E. Hunter</u>                |
| Dated: August 10, 2001 | Gregg E. Hunter,                          |
|                        | Vice Chairman and Chief Financial Officer |
|                        |                                           |
|                        |                                           |
|                        |                                           |
|                        |                                           |
| Dated: August 10, 2001 | <u>/s/ Ryan M. Glista</u>                 |
|                        | Ryan M. Glista                            |
|                        | Vice President                            |
|                        |                                           |

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Commercial National Financial Corporation  
900 Ligonier Street  
Latrobe, Pennsylvania 15650  
Telephone (724) 539-3501

Commercial National Bank of Pennsylvania

### OFFICE LOCATIONS

Latrobe Area

|                     |                |
|---------------------|----------------|
| 900 Ligonier Street | (724) 539-3501 |
| 1900 Lincoln Avenue | (724) 537-9980 |
| 11 Terry Way        | (724) 539-9774 |

Pleasant Unity

|               |                |
|---------------|----------------|
| Church Street | (724) 423-5222 |
|---------------|----------------|

Ligonier

|                 |                |
|-----------------|----------------|
| 201 Main Street | (724) 238-9538 |
|-----------------|----------------|

West Newton

|                      |                |
|----------------------|----------------|
| 109 East Main Street | (724) 872-5100 |
|----------------------|----------------|

Greensburg Area

|                                     |                |
|-------------------------------------|----------------|
| Georges Station Road                | (724) 836-7698 |
| 19 North Main Street                | (724) 836-7699 |
| Asset Management and Trust Division | (724) 836-7670 |
| 19 North Main Street                |                |

Drive-up Facility

Latrobe

|                                  |                |
|----------------------------------|----------------|
| Lincoln Road at Josephine Street | (724) 537-9927 |
|----------------------------------|----------------|

Murrysville

|                               |                |
|-------------------------------|----------------|
| 4785 Old William Penn Highway | (724) 733-4888 |
|-------------------------------|----------------|

In addition to the full-service MAC machines located at all Commercial National Bank community office indicated above (except Latrobe and Courthouse Square), additional ATMs are available for your 24-hour banking convenience at Arnold Palmer Regional Airport, Greensburg Kirk Nevin Arena, Latrobe Area Hospital, New Alexandria Qwik Mart, Norvelt Open Pantry and Saint Vincent College. All are linked to the national Cirrus, Honor and Plus networks and also accept MasterCard, Visa, Discover and American Express for cash advances.

**Touchtone Teller 24-hour banking service:** Website Address:

**(724) 537-9977**

**[www.cnbthebank.com](http://www.cnbthebank.com)**

Free from Blairsville, Derry,  
Greensburg, Kecksburg, Latrobe,  
Ligonier and New Alexandria.

**1-800-803-BANK**

Free from all other locations.

## CAPITAL RESOURCES

**INSURANCE**

Commercial National Insurance Services  
232 North Market Street  
Ligonier, PA 15658  
724/238-4617  
877/205-4617 (toll free)  
724/238-0160 (fax)

**[cnisinfo@cnbinsurance.com](mailto:cnisinfo@cnbinsurance.com)**

**[www.cnbinsurance.com](http://www.cnbinsurance.com)**

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