COMMERCIAL NATIONAL FINANCIAL CORP /PA
Form 10-Q
November 12, 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 September 30, 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 October 31, 2004
Common Stock, $2 Par Value	3,413,426 Shares

PART I - FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

Page

PART II - OTHER INFORMATION

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

	September 30, 2004 (unaudited)	**December 31, 2003**
ASSETS		
Cash and due from banks	$ 10,330	$ 8,877
Interest bearing deposits with other banks	693	764
Total cash and cash equivalents	11,023	9,641
Investment securities available for sale	109,202	164,340
Restricted investments in bank stock	2,372	4,345
	111,574	168,685
Loans:	188,538	187,382
Allowance for loan losses	(1,839)	(2,462)
Net loans	186,699	184,920
Premises and equipment	4,888	5,005

Other assets	17,114	16,777
Total assets	$331,298	$ 385,028
LIABILITIES AND SHAREHOLDERS' EQUITY		
Deposits:		
Non-interest bearing	$ 60,531	$ 51,344
Interest bearing	208,411	207,872
Total deposits	268,942	259,216
Other liabilities	2,351	3,825
Short-term borrowings	15,125	17,450
Long-term borrowings	-	55,000
Total liabilities	286,418	335,491
Shareholders' equity:		
Common stock, par value $2; 10,000,000 shares authorized; 3,600,000 issued; 3,413,426 and 3,430,376 shares outstanding in 2004 and 2003	7,200	7,200
Retained earnings	39,018	41,748
Accumulated other comprehensive income	2,240	3,746
Treasury stock, at cost, 186,574 shares in 2004 and 169,624 shares in 2003	(3,578)	(3,157)
Total shareholders' equity	44,880	49,537
Total liabilities and shareholders' equity	$331,298	$385,028

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

COMMERCIAL NATIONAL FINANCIAL CORPORATION AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF INCOME
(Dollar amounts in thousands, except per share data)

	Three Months Ended September 30 (unaudited)		Nine Months Ended September 30 (unaudited)	
	2004	2003	2004	2003
INTEREST INCOME:				
Interest and fees on loans	$ 2,667	$ 2,895	$ 8,088	$ 8,635
Interest and dividends on securities:				
Taxable	1,561	1,386	5,508	5,270
Exempt from federal income taxes	36	386	364	978
Other	100	36	122	161
Total interest income	4,364	4,703	14,082	15,044
INTEREST EXPENSE				
Interest on deposits	916	828	2,693	2,750
Interest on short-term borrowings	13	-	95	-
Interest on long-term borrowings	678	734	2,129	2,179
Total interest expense	1,607	1,562	4,917	4,929
NET INTEREST INCOME	2,757	3,141	9,165	10,115
PROVISION (CREDIT) FOR LOAN LOSSES	-	-	(436)	-
NET INTEREST INCOME AFTER PROVISION (CREDIT) FOR LOAN LOSSES	2,757	3,141	9,601	10,115
OTHER OPERATING INCOME:				

Asset management and trust income	230	162	692	513
Service charges on deposit accounts	159	237	539	640
Other service charges and fees	168	128	511	458
Net security gains	349	-	1,195	-
Commissions and fees from insurance sales	-	204	342	689
Income from investment in life insurance	107	122	384	420
Loss on Gooder asset sale	-	-	(39)	-
Other income	88	129	275	266
Total other operating income	1,101	982	3,899	2,986
OTHER OPERATING EXPENSES:				
Salaries and employee benefits	1,483	1,619	4,894	4,589
Executive severance	-	-	233	-
Net occupancy	180	170	552	540
Furniture and equipment	196	175	612	523
Pennsylvania shares tax	133	127	400	373
Legal and professional	196	211	562	616
FHLB Advance prepayment penalty	4,402	-	4,402	-
Other expenses	780	805	2,627	2,599
Total other operating expenses	7,370	3,107	14,282	9,240
INCOME/(LOSS) BEFORE INCOME TAXES	(3,512)	1,016	(782)	3,861
Income tax expense/(benefit)	(1,286)	146	(622)	744
Net income/(loss)	$ (2,226)	$ 870	$ (160)	$ 3,117
Average Shares Outstanding	3,419,415	3,436,539	3,426,056	3,445,324
Earnings/(Loss) Per Share, basic	$ (0.65)	$ 0.25	$ (0.05)	$ 0.90
Dividends Paid Per Share	$ 0.25	$ 0.25	$ 0.75	$ 0.75

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

COMMERCIAL NATIONAL FINANCIAL CORPORATION

CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY

(Dollar amounts 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 Loss					
Net (loss)	-	(160)	-	-	(160)
Other comprehensive loss, net of tax:					
Unrealized net losses on securities	-	-	-	(1,506)	(1,506)
Total Comprehensive (Loss)					(1,666)
Cash dividends declared					
$.75 per share	-	(2,570)	-	-	(2,570)
Purchase of treasury stock (16,950 shares)	-	-	(421)	-	(421)
Balance at September 30, 2004	$7,200	$39,018	$ (3,578)	$ 2,240	$44,880
(unaudited)					
Balance at December 31, 2002	$ 7,200	$41,628	$ (2,504)	$ 4,881	$51,205
Comprehensive Income					

Net income	-	3,117	-	-	3,117
Other comprehensive loss, net of tax:					
Unrealized net losses on securities	-	-	-	(2,215)	(2,215)
Total Comprehensive Income					902
Cash dividends declared					
$.75 per share	-	(2,584)	-	-	(2,584)
Purchase of treasury stock (23,584 shares)	-	-	(653)	-	(653)
Balance at September 30, 2003	$ 7,200	$42,161	$(3,157)	$ 2,666	$48,870

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

COMMERCIAL NATIONAL FINANCIAL CORPORATION

CONSOLIDATED STATEMENTS OF CASH FLOWS

(Dollar amounts in thousands)

(unaudited)

	For Nine Months Ended September 30	
	2004	2003
OPERATING ACTIVITIES		
Net income/(loss)	$ (160)	$3,117
Adjustments to reconcile net income to net cash from operating activities:		
Depreciation and amortization	574	471
Amortization of intangibles	120	153
Provision (credit) for loan losses	(436)	-
Net accretion of loans and securities	(103)	(522)
Net securities gains	(1,195)	-
Loss on sale of Gooder assets	39	-
Loss on sale of foreclosed real estate	24	-
Income from investment in life insurance	(384)	(420)
Decrease in other liabilities	(434)	(248)
Increase in other assets	(1,350)	(119)
Net cash provided by (used in) operating activities	(3,305)	2,432
INVESTING ACTIVITIES		
Increase in federal funds sold	-	(1,575)
Purchase of securities	(112,674)	(41,207)
Maturities and calls of securities	34,769	58,330
Proceeds from sales of securities available for sale	133,969	-
Proceeds from sale of Gooder assets	950	-
Net cash used in acquisition	-	(100)
Net increase in loans	(1,280)	(20,677)
Purchase of premises and equipment	(457)	(637)
Net cash provided by (used in) investing activities	55,277	(5,866)
FINANCING ACTIVITIES		
Net increase (decrease) in deposits	9,726	(12,660)
Decrease in short-term borrowings	(2,325)	-
Repayment of long-term borrowings	(55,000)	-
Dividends paid	(2,570)	(2,584)
Purchase of treasury stock	(421)	(653)
Net cash used in financing activities	(50,590)	(15,897)
Increase (decrease) in cash and cash equivalents	1,382	(19,331)
Cash and cash equivalents at beginning of year	9,641	30,928
Cash and cash equivalents at end of period	$11,023	$ 11,597
Supplemental disclosures of cash flow information:		
Cash paid during the period for:		
Interest	$ 5,197	$ 5,146

Income Taxes	$ 683	$ 421

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

COMMERCIAL NATIONAL FINANCIAL CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

September 30, 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 the 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. In June 2004, the Corporation sold all assets relating to Gooder. This move coincides with the Board of Directors' business strategy that concentrates on growing its core banking business of loans and deposits while supplementing those services with trust and asset management related services. 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 September 30, 2004 and the results of operations for the three and nine month periods ended September 30, 2004. The results of operations for the three and nine months ended September 30, 2004 are not necessarily indicative of the results to be expected for the entire year.

Note 2 Divestitures

In June 2004, the Corporation sold all assets relating to its insurance agency subsidiary, Gooder. In the transaction, the Corporation received $950,000. A $39,000 loss was recognized on the sale of such assets. The results of operations of Gooder prior to the sale were not material to the consolidated results of operations.

Note 3 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.

During the Corporation's second quarter evaluation, management considered the allowance for loan losses to be over allocated by $492,000. Due to this overage, the Corporation reduced the allowance for loan losses by $492,000. The reduction in the allowance consisted of specific allocations for several classified loans, totaling $3.2 million, which paid off during the first half of 2004. The excess allocation was recorded as a credit in the provision for loan losses.

The Corporation recorded a net credit of $436,000 to the allowance for loan losses for the nine month period ended September 30, 2004. By comparison, the Corporation recorded no provision for the nine month period ended September 30, 2003. Net charge-offs amounted to $187,000 and $33,000 for the nine months ended September 30, 2004 and 2003, respectively.

Description of changes:

	(Dollar amounts in thousands)	
	2004	2003
Allowance balance January 1	$2,462	$2,707

Additions:		
Provision (credit) charged against operating expenses	(436)	-
Recoveries on previously charged off loans	167	29
Deductions:		
Loans charged off	(354)	(62)
Allowance balance September 30	**$1,839**	**$2,674**

COMMERCIAL NATIONAL FINANCIAL CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 4 Comprehensive Income

The components of other comprehensive income (loss) and related tax effects for the three and nine month periods ended September 30, 2004 and 2003 are as follows: **(dollars in thousands)**

	For three months ended September 30		For nine months ended September 30	
	2004	2003	2004	2003
Gross change in unrealized gains (losses) on securities available for sale	$ 3,302	$(2,259)	$ (1,087)	$ (3,356)
Less: reclassification adjustment for gains realized in income	(349)	-	(1,195)	-
Net unrealized gains (losses)	2,953	(2,259)	(2,282)	(3,356)
Tax effect	1,004	(768)	(776)	(1,141)
Net of tax amount	**$ 1,949**	**$(1,491)**	**$ (1,506)**	**$ (2,215)**

Note 5 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 6 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, $347,000 automatically renew within the next twelve months, $57,000 will expire within the next twelve months and $4,100,000 will expire within thirteen to one hundred and eighty months. The credit risk involved in issuing letters of credit is essentially the same as those that are involved in extending loan facilities to customers. $4,250,000 of these letters of credit are secured. The current amount of the liability as of September 30, 2004 for guarantees under standby letters of credit issued is not material.

Note 7 Securities

The amortized cost and fair values of securities available for sale are as follows: (dollars in thousands)

	Amortized Cost	**Gross Unrealized Gains**	**Gross Unrealized Losses**	**Fair Value**
September 30, 2004				
Obligations of U.S.				
Government Agencies	$ 10,439	$ 30	$ (26)	$ 10,443
Obligations of states and political subdivisions	4,306	106	(91)	4,321
Mortgage-backed securities	91,062	3,376	-	94,438
	$105,807	**$3,512**	**$ (117)**	**$109,202**

COMMERCIAL NATIONAL FINANCIAL CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(continued)

Note 8 Earnings (Loss) Per Share

The Corporation has a simple capital structure with no dilutive securities outstanding.

Note 9 New Accounting Pronouncements

In March 2004, the Emerging Issues Task Force (EITF), revised EITF No. 03-01(EITF 03-01), "The Meaning of Other than Temporary Impairment and its Application to Certain Investments." EITF 03-01 includes revised guidance for evaluating and recording impairment losses on whether an investment is other-than-temporarily impaired, and the required disclosures about unrealized losses on available-for-sale debt and equity securities. The EITF 03-01 guidance is effective for fiscal years ending after June 15, 2004.

In September 2004, the FASB issued FASB Staff Position No. EITF Issue 03-01-1 (EITF 03-1-1), "Effective Date of Paragraphs 10-20 of EITF Issue No. 03-01, "The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments"." EITF 03-1-1 delays the effective date for the measurement and recognition guidance contained in paragraphs 10-20 of EITF 03-01 from reporting periods beginning after June 15, 2004, until implementation guidance is issued. Once additional guidance has been released, the Corporation will evaluate the impact of implementation on the Corporation's financial condition and results of operations.

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION

ITEM 2.
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).

In a move to improve future quarterly and annual earnings, the Corporation restructured its balance sheet and incurred a $4.4 million pretax charge relating to the prepayment of $55.0 million in advances from the Federal Home Loan Bank. The Corporation made the prepayment to reduce its exposure to interest rate risk and expects increased net interest income due to the reduction of interest expense. With this move, the Corporation can more competitively price loan and deposit products to gain market share from our competitors. The average rate paid on the advances was 5.22%. The advances were paid down from proceeds from a bond sale that occurred in August. These funds were temporarily placed in overnight deposits and were earning 1.35%. This obligation is listed in the Annual Report to Shareholders on Form 10-K as long-term debt under the caption Aggregate Contractual Obligations.

The Corporation had a net loss of $160,000, or $0.05 per share, for the nine months ended September 30, 2004 compared to net income of $3.1 million or $0.90 per share for the same period ended a year ago. The Corporation’s return on average assets for nine months ended 2004 and 2003 was (0.06%) and 1.12%, respectively. Return on average equity for the same two periods was (0.44%) and 8.40%, respectively.

In addition to the previously mentioned prepayment penalty, 2004 earnings have been affected by $1.2 million in net securities gains as the investment portfolio was repositioned to reduce our alternative minimum tax position (AMT), to offset a $233,000 executive severance related to the departure of the Corporation’s previous President and Chief Executive Officer and to reduce extension, market and interest rate risks. In addition to these events, the Corporation reduced the allowance for loan losses by $436,000 and recognized this reduction as a credit in the provision for loan losses on the income statement. The reason for this decision is previously stated in Note 3 of the notes to consolidated financial statements. Also affecting earnings was a loss of $39,000 relating to the sale of the Corporation’s insurance subsidiary’s assets.

MANAGEMENT’S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION

ITEM 2.
AND RESULTS OF OPERATIONS

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 nine months ended September 30, 2004 and 2003, net interest income was $9.2 million and $10.1 million, respectively. The Corporation’s net interest income has declined in 2004 due to lower earnings on loans and securities. This decline is due to loans and securities reinvesting at lower rates than what the Corporation was previously earning. Further compressing net interest income is the inability to lower interest liability costs any further as the Corporation utilized this advantage in prior years and interest rates have begun to stabilize. With prepayment of FHLB borrowings during the third quarter, the Corporation expects net interest income to significantly improve during the fourth quarter.

The Corporation’s management intends to focus on core banking functions and on growing through traditional loans and deposits supplemented by offering trust products to customers in its marketplace. 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 operate in a more efficient manner in the future.

FINANCIAL CONDITION

The Corporation’s total assets decreased by $53.7 million, or 13.95%, from December 31, 2003 to September 30, 2004. The decrease was due to a decline in investment securities, which were used to pay the Corporation’s long-term FHLB borrowings and penalties. The decline in securities was mainly the result of sales and prepayments of mortgage-backed securities. Total loans year to date has increased slightly as the Corporation’s lending activity has leveled off from the brisk pace experienced in 2003.

The Corporation’s total deposits increased $9.7 million from December 31, 2003 to September 30, 2004. Of this increase, $9.2 million was in non-interest bearing demand accounts. These increases can be attributed to the Corporation offering free checking and free business checking which commenced in December 2003. Continued competition for interest bearing deposits remains strong as these deposits have increased only $500,000 for the year.

For the year, long-term debt decreased by $55.0 million. This was due to the early redemption strategy that was implemented during the third quarter. This debt was paid off with pre-existing surplus cash and cash equivalents from the sale and prepayments of investment securities.

Shareholders' equity was $44.9 million on September 30, 2004 compared to $49.5 million on December 31, 2003. This decrease resulted from a net loss of $160,000, unrealized losses of $1.5 million on securities available for sale for the nine month period ended September 30, 2004, payment of cash dividends of $2.6 million and $421,000 in treasury stock purchases. Book value per common share decreased from $14.44 at December 31, 2003 to $13.15 at September 30, 2004.

RESULTS OF OPERATIONS

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

A pre-tax loss for the first nine months of 2004 was $782,000 compared to pre-tax income of $3.8 million for the same period of 2003, representing a 120.24% decrease. The decrease was primarily due to a $4.4 million charge relating to the prepayment of the Corporation’s long-term FHLB borrowings. Included in operating income is a gain of $1.2 million on the sale of investment securities. These securities were sold to offset a $233,000 executive severance expense, alleviate the Corporation’s alternative minimum tax position and to reduce extension, market and interest rate risks. Also included in operating income is a reduction of $436,000 in the loan loss allowance due to specified problem loans that paid off during 2004. These loans had allocated loss allowances while they were included in the Corporation’s balance sheet. Since they are no longer carried on the balance sheet, the Corporation deemed it not necessary to carry this excess in the allowance.

Interest income for the nine months ended September 30, 2004 was $14.1 million, a decrease of 6.39% from interest income of $15.0 million for the nine months ended September 30, 2003. The yield on the loan portfolio for the first nine months of 2004 decreased fifty-six (56) basis points to 5.77%. 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 by more than 200 basis points since year-end 2001. The yield on the securities portfolio for the first nine months of 2004 decreased fifty-three (53) basis points to 4.94%.

MANAGEMENT’S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION

ITEM 2.
AND RESULTS OF OPERATIONS

This yield, like the yield on loans, continues to be negatively impacted by prepayments on higher yielding mortgage-backed securities and those funds were reinvested into lower yielding securities and federal funds sold. As a result, the yield on total average

earning assets for the first nine months of 2004 decreased fifty-four (54) basis points from 2003 to 5.39%.

Total interest expense of $4.9 million for the first nine months of 2004 was slightly lower than the first nine months of 2003. For the nine months ended September 30, 2004, interest on deposits decreased $57,000 or 2.07% from the same period a year ago. Due to volume, short-term borrowing expense was $95,000, or 100% greater in the first nine months of 2004 than it was during the same period of 2003. The average cost of interest-bearing liabilities for the first nine months of 2004 was 2.41%, a five (5) basis points decrease from the same period in 2003.

As a result of the foregoing, net interest income for the first nine months of 2004 was $9.2 million, a decrease of $950,000, or 9.39% from net interest income for the same period in 2003.

The Corporation recorded a net credit in the provision for loan losses in the amount of $436,000 for the nine months ended September 30, 2004 compared to no provision for the nine months ended September 30, 2003. This credit was the result of the reduction of an excess in the allowance for loan losses. See Footnote 3 of the notes to consolidated financial statements.

Non-interest income for the first nine months of 2004 was $3.9 million, an increase of $900,000 from non-interest income for the first nine months of 2003. The reason for this increase was gains of $1.2 million on the sale of investment securities. Excluding this item, non-interest income would have decreased $200,000. Negatively affecting other income was a decrease in commission income from insurance sales due to the sale of Gooder, a loss on the sale Gooder assets and a decline in service charges due to the elimination of the overdraft privilege program and the introduction of free business checking.

Non-interest expense for the first nine months of 2004 reached $14.3 million, an increase of $5.0 million or 54.57% from non-interest expense for the first nine months of 2003. $4.4 million of this increase is due to prepayment charges relating to the repayment of the Corporation’s long-term FHLB borrowings. Personnel costs rose by $500,000, or 11.73% 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 hospitalization and wages also contributed to the increase in personnel expense. An $89,000 increase in furniture and equipment expense was due to depreciation expense on equipment which was purchased in the fourth quarter of 2003. Other expenses grew slightly. Increases in advertising and directors' fees were offset with decreases in other expense categories.

Due to the year-to-date net loss, the Corporation realized a federal income tax benefit for the first nine months of 2004 equal to $622,000 compared to federal income tax expense of $744,000 for the same period in 2003.

Three Months Ended September 30, 2004 as Compared to the Three Months Ended September 30, 2003

The Corporation's pretax loss for the third quarter of 2004 was $3.5 million compared to pretax income $1.0 million for the same period of 2003. This loss can be attributed to the previously mentioned prepayment of long-term FHLB advances. This action created a prepayment penalty of $4.4 million and is recognized in other operating expense in the income statement.

Interest income for the third quarter of 2004 was $4.4 million, a decrease of 7.21% from interest income of $4.7 million for the third quarter of 2003. The decrease in interest income is the result of lower yields on loans and securities than what was earned a year ago. The loan yield decreased forty-five (45) basis points to 5.67%, the securities yield decreased forty-six (46) basis points to 4.49%. The yield on total average earning assets decreased forty-six (46) basis points to 5.15%.

Interest expense during the third quarter of 2004 increased $45,000 to $1.6 million when compared to the third quarter of 2003. The average cost increased to 2.47%, a ten (10) basis points increase from a year ago. The increase in interest expense is due to competitive pressures experienced by the Corporation to maintain and grow current deposit balances.

Net interest income declined 12.23% to $2.8 million during the third quarter of 2004 and yielded 3.25% of average total earning assets compared to 3.75% during the same period a year ago.

The Corporation recorded no provision for loan losses during the third quarters of 2004 and 2003.

Non-interest income increased $119,000 or 12.12%, to $1.1 million during the third quarter of 2004. This increase is due to securities gains of $349,000 taken during the quarter. Excluding securities gains, non-interest income decreased $230,000. Lower

RESULTS OF OPERATIONS (continued)

commission revenues from insurance sales due to the sale of Gooder and a decline in service charges due to the elimination of an overdraft priviledge checking program were the primary reasons for this decrease.

Non-interest expense increased $4.3 million during the third quarter of 2004, a 137.21% increase from the same period in 2003. Excluding the previously mentioned FHLB prepayment penalty, non-interest expense would have decreased $139,000 for the third quarter ended September 30, 2004. Personnel costs declined by $136,000 to $1.5 million due mainly by attrition from the selling of Gooder and related reduced benefits. There were no significant changes in all other expense categories during the third quarter, when compared with the same period of the prior year. The Corporation continues to focus on operating expense controls.

Federal income tax benefit on the third quarter 2004 pretax loss was $1.3 million compared to federal income tax expense of $276,000 for the same period a year ago.

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.

The statement of cash flows indicates there were cash outflows of $174.7 million. Security purchases ($112.7 million) and a reduction in long-term debt ($55.0 million) were the primary contributors to these outflows. Cash inflows of $179.4 million came from the sales, maturities and prepayments of securities, deposit growth and proceeds from the sale of Gooder assets.

As of September 30, 2004, the Corporation had available funding of approximately $227.3 million at the FHLB with an additional $24.9 million of short-term funding available through federal funds lines of credit.

OFF BALANCE SHEET ARRANGEMENTS

The Corporation's financial statements do not reflect off balance sheet arrangements that consist of commitments to extend credit. Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Since many of the commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. The types of collateral obtained by the Corporation may include accounts receivable, inventory, property, plant and equipment and income producing commercial properties.

Standby letters of credit, financial standby letters of credit and commercial letters of credit written are conditional commitments issued by the Corporation to guarantee the performance of a customer to a third party. Those guarantees are primarily issued to support public and private borrowing arrangements. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending loan facilities to customers.

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION

ITEM 2.
AND RESULTS OF OPERATIONS

RESULTS OF OPERATIONS (continued)

The following table identifies the Corporation's commitments to extend credit and obligations under letters of credit as of September 30, 2004.

(dollar amounts in thousands)	TOTAL AMOUNT COMMITTED
Financial instruments whose contractual amounts represent credit risk:	
Commitments to extend credit	$37,899
Standby letters of credit	454
Financial standby letters of credit	4,050
Total	42,403

CREDIT QUALITY RISK

The following table presents a comparison of loan quality as of September 30, 2004 with that as of December 31, 2003. Cash payments received on non-accrual loans are recognized as interest income as long as the remaining balance of the loan is deemed to be fully collectible. When doubt exists as to the collectibility of a loan in non-accrual status, any payments received are applied to principal to the extent the doubt is eliminated. Once a loan is placed on non-accrual status, any unpaid interest is charged against income.

	For the nine month period ended September 30, 2004	For the year ended December 31, 2003
	(dollar amounts in thousands)	
Non-performing loans:		
Loans on non-accrual basis	$1,698	$2,332
Past due loans > 90 days	-	5
Total non-performing loans	1,698	2,337

Foreclosed real estate	736	1,027
Total non-performing assets	$2,434	$3,364
Loans outstanding at end of period	$188,538	$187,382
Average loans outstanding (year-to-date)	$186,749	$194,664
Non-performing loans as a percent of total loans	0.90%	1.25%
Provision (credit) for loan losses	$ (436)	$ 39
Net charge-offs (recoveries)	$ 187	$ 284
Net charge-offs as a percent of average loans	.10%	.15%
Provision for loan losses as a percent of net charge-offs	-	13.73%
Allowance for loan losses as a percent of average loans outstanding	0.99%	1.34%

Total non-performing assets consist of loans past due 90 days or more, nonaccrual loans and foreclosed real estate. Total nonperforming assets declined by $930, 000 to $2.4 million on September 30, 2004 compared to $3.4 million on December 31, 2003. During 2004, the Corporation received principal reductions and pay-offs amounting to $1.4 million on nonperforming assets and added $452,000 in new nonperforming assets. Of total nonperforming assets, $918,000 remain current and all payments received for the loans are applied to principal.

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION

ITEM 2.
AND RESULTS OF OPERATIONS

CAPITAL RESOURCES

The Federal Reserve Board's risk-based capital 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 be weighted according to risk; and (3) the total capital to risk-weighted assets ratio be at least 8.00%; and (4) a minimum 4.00% leverage ratio of Tier I capital to average total assets be maintained for financial institutions that meet certain specified criteria, including asset quality, high liquidity, low interest-rate exposure and the highest regulatory rating. As of September 30, 2004, the Corporation, under these guidelines, had Tier I and total equity capital to risk weighted assets ratios of 22.80% and 23.80% respectively. The leverage ratio was 11.43%. Due to the simple holding company structure of the Corporation, total assets are comprised mostly from the Bank. Therefore, the Bank's capital ratios are not materially different than the Corporation's.

The table below presents the Corporation's capital position at September 30, 2004

(Dollar amounts in thousands)

	Amount	Percent of Adjusted Assets
Tier I Capital	$ 41,884	22.72%
Tier I Capital Requirement	7,375	4.00
Total Equity Capital	$ 43,726	23.71%
Total Equity Capital Requirement	14,750	8.00
Leverage Capital	$ 41,884	11.43%
Leverage Requirement	14,653	4.00

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

The Corporation's primary market risk is interest rate risk. Interest rate risk arises due to timing differences between interest sensitive assets and liabilities. The effort to determine the effect of potential interest rate changes normally involves measuring the "gap" between assets (loans and securities) subject to rate fluctuation and liabilities (interest bearing deposits and long-term borrowings) 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 and long-term borrowings 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 without penalty. However, based upon historical performance, management considers a certain portion of the accounts to be stable core deposits and therefore are projected to reprice over a variety of time periods.

The cumulative gap at the one-year repricing period was asset sensitive in the amount of $6.0 million or 2.02% of total earning assets at September 30, 2004. This position is more asset-sensitive than the $577,000, or 0.17% position at December 31, 2003. The change in our current position from year-end is due to the reduction in interest-bearing liabilities created by the prepayment of long-term FHLB borrowings.

Asset sensitivity can change depending on what type of interest rate environment the economy is experiencing. An asset or liability is considered to be sensitive if its cash flow characteristics or the interest yield it earns or pays is set to change within a certain time period. When the amount of interest-sensitive assets is greater than the interest-sensitive liabilities, the gap is labeled positive and the institution’s interest rate spread will widen and earnings will respond favorably to a general rise in interest rates. The opposite relationship produces a negative gap and the interest rate spread will increase and earnings will respond favorably to a general decline in interest rates. Although the gap analysis provides management with a method of measuring current interest rate risk, it only measures rate sensitivity at a specific point in time, and not all assets and liabilities with similar maturities and repricing characteristics will reprice at the same time. An example of this would be

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK (continued)

with the deposit products. Certain deposit products can reprice immediately; however, they are not tied to an index. Management controls the pricing of all deposit products and can slowly reprice these deposits in a rising rate environment but in a rapidly rising rate environment, deposit rates may rise more quickly than management prefers and this action could have a negative impact on operating results. Another item that can affect interest sensitivity are cashflows from mortgage related assets. Cashflows are expected to decrease (or extend the assets) in a rising rate environment and increase (or shorten the assets) in a declining rate environment.

The Corporation utilizes a computer simulation analysis that projects the impact of changing interest rates on earnings. Simulation modeling projects a baseline net interest income (assuming no changes in interest rate levels) and estimates changes to that baseline resulting from changes in interest rate levels. The Corporation utilizes the results of this model in evaluating its interest rate risk. This model incorporates a number of additional factors. These factors include: (1) the expected exercise of call features on various assets and liabilities; (2) the expected rates at which various rate sensitive assets and liabilities will reprice; (3) the expected relative movements in different interest rate indexes that are used as the basis for pricing or repricing various assets and liabilities; (4) expected changes in administered rates on interest-bearing transaction, savings, money market and time deposit accounts and the expected impact of competition on the pricing or repricing of such accounts; and (5) other factors. Inclusion of these factors in the model is intended to estimate the Corporation’s changes in net interest income resulting from an immediate and sustained parallel shift in interest rates of up 100 basis points (bps), up 200 bps, down 100 bps and down 200 bps. While the Corporation believes this model provides a useful projection of its interest rate risk, the model includes a number of assumptions and predictions that are subject to continual refinement. These assumptions and predictions include inputs to compute net interest income under different interest rate scenarios, growth rates and a variety of other factors that are difficult to accurately predict.

The following tables present the simulation model’s projected impact of an immediate and sustained parallel shift in interest rates on the projected baseline net interest income for a twelve-month period commencing October 1, 2004 and January 1, 2004

	As of October 1, 2004	
Change in Interest Rates	% Change in Projected Baseline Net Interest Income	% Change in Projected Economic Value of Capital
+200 basis points	(0.5%)	(5.6%)
+100 basis points	0.2%	(0.8%)
-100 basis points	(1.2%)	(7.1%)
-200 basis points	(5.1%)	(13.6%)

	As of January 1, 2004	
Change in Interest Rates	% Change in Projected Baseline Net Interest Income	% Change in Projected Economic Value of Capital
+200 basis points	(2.8%)	(8.9%)
+100 basis points	(3.6%)	(2.0%)
-100 basis points	(5.2%)	(8.2%)
-200 basis points	(12.9%)	(12.9%)

ITEM 4. CONTROLS AND PROCEDURES

Evaluation of Disclosure Controls and Procedures

The Corporation maintains a system of disclosure controls and procedures that is designed to ensure that information required to be disclosed by the Corporation in this Form 10-Q, and in other reports required to be filed under the Securities Exchange Act of 1934 (Exchange Act), is recorded, processed, summarized and reported within the time periods specified in the rules and forms for such filings. Management of the Corporation, under the direction of the Corporation's Chief Executive Officer and Chief Financial Officer, reviewed and performed an evaluation of the effectiveness of the Corporation's disclosure controls and procedures (as defined in Rules 13a-15a(e) and 15d-15(e) under the Exchange Act) as of September 30, 2004. Based on that review and evaluation, the Chief Executive Officer and Chief Financial Officer, along with other key management of the Corporation, have determined that the disclosure controls and procedures were and are effective as designed to ensure that material information relating to the Corporation and its consolidated subsidiaries required to be disclosed by the Corporation by the Exchange Act, was recorded, processed, summarized and reported within the applicable time periods.

Changes in Internal Controls

There have been no significant changes in our internal controls or in other factors that could significantly affect our internal controls during the quarter ended September 30, 2004.

PART II - OTHER INFORMATION

ITEM 1. 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 management's opinion, will have any material effect on the financial position of the Corporation and its subsidiaries.

ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS

ISSUER PURCHASES OF EQUITY SECURITIES

Period	Total Number of Shares (or Units) Purchased	Average Price Paid per Share (or Unit)	Total Number of Shares (or Units) Purchased as Part of Publicly Announced Plans or Programs	Maximum Number (or Approximate Dollar Value) of Shares (or Units) that May Yet Be Purchased Under the Plans or Programs
July 2004	0	-	0	
August 2004	10,500	$24.31	10,500	173,426
September 2004	0	-	0	173,426
Total	10,500	$24.31	10,500	173,426

On November 17, 1998, the Board of Directors of the Corporation authorized a stock buyback program. The program authorizes the Corporation to purchase up to 360,000 shares of common stock at such times after December 31, 1998.

ITEM 3. DEFAULTS UPON SENIOR SECURITIES

Not applicable.

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

a. September 21, 2004 Special Meeting of Shareholders

b. Proposal of the Board of Directors to amend the Articles of Incorporation to eliminate cumulative voting.

c.	For	Against	Withheld	Abstentions
	1,872,478	359,137		200

d. Not applicable

ITEM 5. OTHER INFORMATION

a. Not applicable

At its regularly scheduled Board meeting on October 19, 2004, Commercial National Financial Corporation's Board of Directors unanimously approved an amendment to the Corporation's by-laws that revises the procedures for nominating the nominees to the Corporation's Board of Directors. The amendment to the bylaws amends Section 9.1 of the current bylaws by deleting it and adding a completely new Section 9.1 in its place. The amendment provides more stringent and detailed procedures that must be followed before a proposed nominee for election to the Board can be nominated at the annual meeting of shareholders. For more information on this matter, please refer to the Corporation's Form 8-K filing submitted on October 21, 2004.

ITEM 6. EXHIBITS

a. Exhibits

Exhibit Number	Description	Page Number or Incorporated by Reference to
3.1	Articles of Incorporation	Exhibit C to Form S-4 Registration Statement Filed April 9, 1990
3.2	By-Laws of Registrant	Exhibit D to Form S-4 Registration Statement Filed April 9, 1990
3.3	Amendment to Articles of Incorporation	Exhibit A to definitive Proxy Statement filed for the special meeting of shareholders held September 18, 1990
3.4	Amendment to Articles of Incorporation	Exhibit A to definitive Proxy Statement filed for the meeting of shareholders held on April 15, 1997
3.5	Amendment to Articles of Incorporation	Exhibit A to definitive Proxy Statement filed for the meeting of shareholders held on September 22, 2004
3.6	Complete Articles of Incorporation, including all amendments to date	Filed Herewith
3.7	Amendment to By-Laws of Registrant	Exhibit 3 to Form 8-K filed October 21, 2004
3.8	Complete By-Laws of Registrant, including all amendment to date	Filed Herewith
10.1	Employment agreement between Gregg E. Hunter and Commercial Bank of Pennsylvania	Exhibit 10.1 to Form 10-Q for the quarter ended September 30, 2003
10.3	Mutual Release and Non-Disparagement Agreement between Commercial Bank of Pennsylvania and Louis T. Steiner	Exhibit 10.3 to Form 10-K for the year ended December 31, 2003
31.1	Section 302 Certification of Chief Executive Officer	Filed herewith

31.2	Section 302 Certification of Chief Financial Officer	Filed herewith
32.1	Section 1350 Certification of the Chief Executive Officer	Filed herewith
32.2	Section 1350 Certification of the Chief Financial Officer	Filed herewith

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)

Dated: November 12, 2004 /s/ Gregg E. Hunter
Gregg E. Hunter, Vice Chairman
President and Chief Executive Officer

Dated: November 12, 2004 /s/ Ryan M. Glista
Ryan M. Glista, Senior Vice President and
Chief Financial Officer