RESULTS OF OPERATIONS

General

Our principal asset is the ownership of our Banks. Accordingly, our results of operations are primarily dependent upon the results of operations of our Banks. Our Banks conduct a commercial banking business which consists of attracting deposits from the general public and applying those funds to the origination of commercial, consumer and real estate loans (including commercial loans collateralized by real estate). The Banks' profitability depends primarily on net interest income, which is the difference between interest income generated from interest-earning assets (i.e., loans and investments) less the interest expense incurred on interest-bearing liabilities (i.e., customer deposits and borrowed funds). Net interest income is affected by the relative amounts of interest-earning assets and interest-bearing liabilities, and the interest rate paid and earned on these balances. Net interest income is dependent upon the Banks' interest rate spread, which is the difference between the average yield earned on its interest-earning assets and the average rate paid on its interest-bearing liabilities. When interest-earning assets approximate or exceed interest-bearing liabilities, any positive interest rate spread will generate interest income. The interest rate spread is impacted by interest rates, deposit flows and loan demand. Additionally, and to a lesser extent, the profitability of the Banks is affected by such factors as the level of noninterest income and expenses, the provision for loan losses and the effective tax rate. Noninterest income consists primarily of service charges on deposit accounts and other fees and income from the sale of investment securities and origination of mortgage loans. Noninterest expenses consist of compensation and benefits, occupancy-related expenses and other operating expenses.

Earnings Summary

We reported earnings of $13.1 million for 2004 representing an increase of $1.1 million, or 9.17%, compared to earnings of $12.0 million for 2003. Diluted earnings per common share were $1.11 in 2004 compared to $1.02 in 2003 and $0.87 in 2002.

As required by FASB, we discontinued the amortization of goodwill in 2002. We periodically test goodwill to determine whether the carrying value of our goodwill is impaired. We continue to amortize core deposit premiums and other identifiable intangibles as a noncash charge that increases our operating expenses. Intangible asset amortization included as an operating expense amounted to $.8 million, $1.0 million and $1.8 million in 2004, 2003 and 2002, respectively.

Net interest income, on a taxable-equivalent basis, increased 6.37% in 2004 to $45.1 million from $42.4 million in 2003. Net interest income decreased 1.85% in 2003 to $42.4 million from $43.2 million in 2002. The significant increase in net interest income in 2004 is attributable to lower cost of funds. Cost of funds decreased 12.22% to $19.4 in 2004 from $22.1 in 2003. The net interest margin increased 21 basis points to 4.18% in 2004 from 3.97% in 2003. The net interest margin decreased 11 basis points to 3.97% from 4.08% in 2002. During 2003 and 2002, the decrease in general interest rates as a result of action undertaken by the Federal Reserve resulted in net interest margin compression for those years. During 2004, the Federal Reserve raised interest rates six times for a total increase of 1.5% in the discount rate. We expect that gradual increases in the discount rate in 2005 will favorably impact our earnings.

Our provision for loan losses totaled $1.8 million in 2004, $3.9 million in 2003 and $5.6 million in 2002. The allowance for loan losses represented 1.77% of total loans outstanding at December 31, 2004 and 1.78% of total loans outstanding at both December 31, 2003 and December 31, 2002. The allowance for loan losses is discussed in more detail under "Summary of Loan Loss Experience."

Noninterest income decreased 11.56% to $13.0 million in 2004 compared to $14.7 million in 2003. Noninterest income decreased 6.37% in 2003 to $14.7 million from $15.7 million in 2002. The decrease in noninterest income in 2004 is attributable to a decrease in income of $.6 million related to credit card receivables, a decrease of $.2 million in mortgage origination fees and a decrease of $.6 million in service charges, commissions and fees. The decrease in noninterest income in 2003 is attributable to securities transactions. In 2002, we recorded gains on sales of securities in the amount of $1.6 million; whereas in 2003, we recorded losses on sales of securities in the amount of $5,000. We recorded an increase of $.2 million in mortgage origination fees in 2003 from the amount recorded in 2002. We also recorded in 2003 approximately $.6 million representing gains on the sale of bank property and the reversal of contingent liabilities recorded in connection with the sale of our credit card portfolio in 2002.

Noninterest expense increased $1.4 million to $36.5 million in 2004 from $35.1 million in 2003. Salaries and employee benefits increased $1.3 million and all other expenses increased a net of $.1 million. Noninterest expense decreased $2.7 million to $35.1 in 2003 from