

FIRST NATIONAL COMMUNITY BANCORP INC  
Form 10-Q  
August 09, 2010

UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549

FORM 10-Q

(Mark One)

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE  
SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended June 30, 2010

OR

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE  
SECURITIES EXCHANGE ACT OF 1934

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission File No. 000-53869

FIRST NATIONAL COMMUNITY BANCORP, INC.  
(Exact Name of Registrant as Specified in Its Charter)

Pennsylvania  
(State or Other Jurisdiction  
of Incorporation or Organization)

23-2900790  
(I.R.S. Employer  
Identification No.)

102 E. Drinker St., Dunmore, PA  
(Address of Principal Executive Offices)

18512  
(Zip Code)

Registrant's telephone number, including area code (570) 346-7667

\_\_\_\_\_  
(Former Name, Former Address and Former Fiscal Year, if Changed Since Last Report)

Indicate by check mark whether the registrant: (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

YES  NO

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

YES  NO

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

Large Accelerated Filer  Accelerated Filer

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Non-Accelerated Filer

Smaller reporting company

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes  No

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

Common Stock, \$1.25 par value  
(Title of Class)

16,415,605 shares  
(Outstanding at August 5,  
2010)

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## PART I Financial Information

## Item 1 – Financial Statements

FIRST NATIONAL COMMUNITY BANCORP, INC.  
CONSOLIDATED STATEMENTS OF FINANCIAL CONDITION

June 30,      December 31,  
2010              2009  
(UNAUDITED) (AUDITED)  
(dollars in thousands,  
except share data)

## ASSETS

|  |             |             |
|--|-------------|-------------|
| Cash and cash equivalents:   |             |             |
| Cash and due from banks  | \$21,795    | \$24,189    |
| Federal funds sold   | 60,925      | 62,175      |
| Total cash and cash equivalents                                    | 82,720      | 86,364      |
| Securities:  |             |             |
| Available-for-sale, at fair value                                  | 260,266     | 259,955     |
| Held-to-maturity, at cost (fair value \$1,869 and \$1,788)         | 1,945       | 1,899       |
| Federal Reserve Bank and FHLB stock, at cost                       | 12,115      | 11,779      |
| Loans, net of allowance for credit losses of \$20,577 and \$22,502 | 874,103     | 927,324     |
| Bank premises and equipment  | 20,620      | 20,667      |
| Intangible Assets  | 9,865       | 9,928       |
| Other assets   | 77,904      | 77,495      |
| Total Assets   | \$1,339,538 | \$1,395,411 |

## LIABILITIES

|                               |             |             |
|-------------------------------|-------------|-------------|
| Deposits:                     |             |             |
| Demand – non-interest bearing | \$75,743    | \$85,370    |
| Interest bearing demand       | 340,515     | 352,631     |
| Savings                       | 95,682      | 86,455      |
| Time (\$100,000 and over)     | 227,302     | 238,839     |
| Other time                    | 282,537     | 308,313     |
| Total deposits                | 1,021,779   | 1,071,608   |
| Borrowed funds                | 186,093     | 194,367     |
| Subordinated debentures       | 25,000      | 23,100      |
| Other liabilities             | 13,175      | 15,203      |
| Total Liabilities             | \$1,246,047 | \$1,304,278 |

## SHAREHOLDERS' EQUITY

|  |          |          |
|--|----------|----------|
| Common Stock, \$1.25 par value,<br>Authorized: 50,000,000 shares                 |          |          |
| Issued and outstanding:  |          |          |
| 16,315,605 shares at June 30, 2010 and<br>16,289,970 shares at December 31, 2009 | \$20,395 | \$20,362 |
| Additional Paid-in Capital   | 61,270   | 61,190   |
| Retained Earnings  | 27,063   | 26,854   |
| Accumulated Other Comprehensive Income (Loss)                                    | (15,237) | (17,273) |
| Total shareholders' equity   | \$93,491 | \$91,133 |

|  |             |             |
|--|-------------|-------------|
| Total Liabilities and Shareholders' Equity | \$1,339,538 | \$1,395,411 |
|--|-------------|-------------|

Note: The balance sheet at December 31, 2009 has been derived from the audited financial statements at that date but does not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements.

See notes to financial statements

(1)

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FIRST NATIONAL COMMUNITY BANCORP, INC.  
CONSOLIDATED STATEMENTS OF INCOME (UNAUDITED)

|  | Three Months Ended<br>June 30,            |           | Six Months Ended<br>June 30, |          |
|--|---|-----------|------------------------------|----------|
|  | 2010                                      | 2009      | 2010                         | 2009     |
|  | (dollars in thousands, except share data) |           |                              |          |
| <b>Interest Income:</b>  |   |           |                              |          |
| Loans  | \$11,542                                  | \$13,039  | \$23,730                     | \$26,397 |
| Investments  | 2,876                                     | 3,290     | 5,949                        | 6,782    |
| Federal Funds Sold   | 31  | 13        | 67                           | 13       |
| Total interest income  | 14,449                                    | 16,342    | 29,746                       | 33,192   |
| <b>Interest Expense:</b>   |   |           |                              |          |
| Deposits   | 3,666                                     | 4,322     | 7,698                        | 8,467    |
| Subordinated debt  | 568                                       | 0         | 1,107                        | 0        |
| Borrowed Funds   | 1,400                                     | 1,841     | 2,901                        | 3,879    |
| Total interest expense   | 5,634                                     | 6,163     | 11,706                       | 12,346   |
| Net Interest Income before Loan Loss Provision                                 | 8,815                                     | 10,179    | 18,040                       | 20,846   |
| Provision for credit losses  | 4,960                                     | 7,250     | 7,762                        | 9,710    |
| Net interest income  | 3,855                                     | 2,929     | 10,278                       | 11,136   |
| <b>Other Income:</b>   |   |           |                              |          |
| Total other-than-temporary impairment losses                                   | 2,924                                     | 11,340    | (28,504)                     | (35,945) |
| Portion of loss/(gain) recognized in other comprehensive income (before taxes) | (3,611)                                   | (11,722)  | 26,902                       | 35,563   |
| Net impairment losses  | (687)                                     | (382)     | (1,602)                      | (382)    |
| Service charges  | 646                                       | 722       | 1,296                        | 1,410    |
| Other Income   | 655                                       | 584       | 1,311                        | 1,247    |
| <b>Gain/(Loss) on sale of:</b>   |   |           |                              |          |
| Loans  | 159                                       | 462       | 432                          | 1,007    |
| Securities   | (21)                                      | 298       | 1,175                        | 825      |
| Other Real Estate  | (848)                                     | 0         | (848)                        | 0        |
| Total other income   | (96)                                      | 1,684     | 1,764                        | 4,107    |
| <b>Other expenses:</b>   |   |           |                              |          |
| Salaries & benefits  | 3,283                                     | 2,984     | 6,403                        | 6,316    |
| Occupancy & equipment  | 1,013                                     | 1,011     | 2,080                        | 2,081    |
| Advertising expense  | 225                                       | 240       | 450                          | 480      |
| Data processing expense  | 496                                       | 430       | 983                          | 866      |
| FDIC assessment  | 502                                       | 1,192     | 971                          | 1,432    |
| Bank shares tax  | 255                                       | 215       | 510                          | 432      |
| Expense of ORE   | 343                                       | 42        | 463                          | 42       |
| Credit for off-balance sheet commitments                                       | (322)                                     | 0         | (1,353)                      | 0        |
| Other  | 1,654                                     | 1,229     | 3,324                        | 2,371    |
| Total other expenses   | 7,449                                     | 7,343     | 13,831                       | 14,020   |
| Income before income taxes   | (3,690)                                   | (2,730)   | (1,789)                      | 1,223    |
| Income tax expense (benefit)   | (1,941)                                   | (514)     | (1,998)                      | 201      |
| NET INCOME   | (1,749)                                   | \$(2,216) | 209                          | \$1,022  |

|   |            |            |            |            |
|---|------------|------------|------------|------------|
| Basic earnings per share                  | \$(0.11)   | \$(0.14)   | \$0.01     | \$0.06     |
| Diluted earnings per share                | \$(0.11)   | \$(0.14)   | \$0.01     | \$0.06     |
| Weighted average number of basic shares   | 16,306,670 | 16,158,640 | 16,300,515 | 16,111,808 |
| Weighted average number of diluted shares | 16,306,670 | 16,158,640 | 16,638,884 | 16,508,354 |

See notes to financial statements

(2)

FIRST NATIONAL COMMUNITY BANCORP, INC.  
CONSOLIDATED STATEMENTS OF CASH FLOWS  
(UNAUDITED)

For the Six Months Ended  
June 30,  
2010          2009  
(dollars in thousands)

| INCREASE (DECREASE) IN CASH EQUIVALENTS:  |                 |                 |
|---|-----------------|-----------------|
| Cash Flows From Operating Activities:   |                 |                 |
| Interest Received   | \$28,763        | \$32,195        |
| Fees & Commissions Received   | 2,699           | 2,719           |
| Interest Paid   | (12,065)        | (13,414)        |
| Income Taxes Paid   | 3,323           | (1,861)         |
| Cash Paid to Suppliers & Employees  | (15,094)        | (16,000)        |
| Net Cash Provided by Operating Activities   | \$ 7,626        | \$ 3,639        |
| Cash Flows from Investing Activities:   |                 |                 |
| Securities available for sale:  |                 |                 |
| Proceeds from Sales prior to maturity   | \$25,548        | \$12,378        |
| Proceeds from Calls prior to maturity   | 17,502          | 22,531          |
| Purchases   | (39,105)        | (11,371)        |
| Net (Increase)/Decrease in Loans to Customers   | 41,502          | (1,754)         |
| Capital Expenditures  | (628)           | (434)           |
| Net Cash Provided by Investing Activities   | \$44,819        | \$21,350        |
| Cash Flows from Financing Activities:   |                 |                 |
| Net Decrease in Demand Deposits, Money Market Demand,<br>NOW Accounts, and Savings Accounts |                 |                 |
|   | \$(12,515)      | \$(4,562)       |
| Net Increase/(Decrease) in Certificates of Deposit  | (37,313)        | 46,603          |
| Proceeds from issuance of Subordinated Debentures   | 1,900           | 0               |
| Net Decrease in Borrowed Funds  | (8,274)         | (24,386)        |
| Net Proceeds from Issuance of Common Stock<br>Through Dividend Reinvestment                 |                 |                 |
|   | 113             | 1,106           |
| Dividends Paid  | 0               | (2,087)         |
| Net Cash Provided/(Used) by Financing Activities  | \$(56,089)      | \$16,674        |
| Net Increase/(Decrease) in Cash and Cash Equivalents  | \$(3,644)       | \$41,663        |
| Cash & Cash Equivalents at Beginning of Year  | \$86,364        | \$18,171        |
| <b>CASH &amp; CASH EQUIVALENTS AT END OF PERIOD</b>   | <b>\$82,720</b> | <b>\$59,834</b> |



(Continued)  
(3)

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FIRST NATIONAL COMMUNITY BANCORP, INC.  
CONSOLIDATED STATEMENTS OF CASH FLOW (CONTINUED)  
(UNAUDITED)

For the Six Months Ended  
June 30,  
2010          2009  
(dollars in thousands)

| RECONCILIATION OF NET INCOME TO NET CASH PROVIDED BY OPERATING ACTIVITIES:        |                |                |
|---|----------------|----------------|
| Net Income  | \$209          | \$1,022        |
| Adjustments to Reconcile Net Income to Net Cash Provided by Operating Activities: |                |                |
| Amortization (Accretion), Net   | (1,411)        | (1,921)        |
| Equity in trust   | (2)            | (3)            |
| Depreciation and Amortization   | 881            | 907            |
| Provision for Probable Credit Losses  | 7,762          | 9,710          |
| Provision for Deferred Taxes  | (44)           | (112)          |
| Gain on Sale of Loans   | (404)          | (1,007)        |
| Gain on Sale of Investment Securities   | (1,175)        | (825)          |
| Impairment losses on Investment Securities  | 1,602          | 382            |
| Loss on Sale of Other Assets  | 820            | 0              |
| Increase/(Decrease) in Taxes Payable  | 0              | (1,692)        |
| Decrease in Interest Receivable   | 429            | 924            |
| Decrease in Interest Payable  | (360)          | (1,068)        |
| Decrease/(Increase) in Prepaid Expenses and Other Assets                          | 765            | (2,576)        |
| Increase in Accrued Expenses and Other Liabilities                                | (1,446)        | (102)          |
| Total Adjustments   | \$7,417        | \$2,617        |
| <b>NET CASH PROVIDED BY OPERATING ACTIVITIES</b>                                  | <b>\$7,626</b> | <b>\$3,639</b> |

See notes to financial statements  
(4)

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FIRST NATIONAL COMMUNITY BANCORP, INC. AND SUBSIDIARIES  
CONSOLIDATED STATEMENTS OF CHANGES IN  
STOCKHOLDERS' EQUITY  
For The Six Months Ended June 30, 2010  
(In thousands, except share data)  
(UNAUDITED)

|   | COMP-REHEN-SIVE<br>INCOME | COMMON STOCK<br>SHARES | ADD'L<br>PAID-IN CAPITAL | RETAINED<br>EARNINGS | ACCUM-<br>ULATED OTHER<br>COMP-REHEN-SIVE<br>INCOME/<br>(LOSS) | TOTAL              |
|---|---------------------------|------------------------|--------------------------|----------------------|--|--------------------|
| BALANCES,<br>DECEMBER 31,<br>2009   |                           | 16,289,970             | \$20,362                 | \$61,190             | \$26,854   | \$(17,273)\$91,133 |
| Comprehensive<br>Income:  |                           |                        |                          |                      |  |                    |
| Net income for the<br>period  | \$209                     |                        |                          | 209                  |  | 209                |
| Other<br>comprehensive<br>income, net of tax:   |                           |                        |                          |                      |  |                    |
| Unrealized loss<br>on securities<br>available-for-sale<br>net of deferred<br>tax benefit of<br>\$3,550            | (6,894)                   |                        |                          |                      |  |                    |
| Noncredit related<br>gains on<br>securities not<br>expected to be<br>sold, net of<br>deferred taxes of<br>\$4,200 | 8,154                     |                        |                          |                      |  |                    |
| Reclassification<br>adjustment for<br>gain or loss<br>included in<br>income (tax effect<br>of \$399)              | 776                       |                        |                          |                      |  |                    |
| Total other<br>comprehensive<br>income,<br>net of tax   | \$2,036                   |                        |                          |                      | 2,036  | 2,036              |
| Comprehensive<br>Income   | \$2,245                   |                        |                          |                      |  |                    |

|   |            |          |          |          |  |                    |
|---|------------|----------|----------|----------|--|--------------------|
| Issuance of<br>Common Stock<br>through Dividend<br>Reinvestment | 25,635     | 33       | 80       |          |  | 113                |
| BALANCES, JUNE<br>30, 2010                                      | 16,315,605 | \$20,395 | \$61,270 | \$27,063 |  | \$(15,237)\$93,491 |

See notes to financial statements  
(5)

FIRST NATIONAL COMMUNITY BANCORP, INC. AND SUBSIDIARIES  
CONSOLIDATED STATEMENTS OF CHANGES IN  
STOCKHOLDERS' EQUITY  
For The Six Months Ended June 30, 2009  
(In thousands, except share data)  
(UNAUDITED)

|  | COMP-REHEN-SIVE<br>INCOME | COMMON STOCK<br>SHARES | ADD'L<br>PAID-IN CAPITAL | RETAINED<br>EARNINGS | ACCUM-<br>ULATED OTHER<br>COMP-REHEN-SIVE<br>INCOME/<br>(LOSS) | TOTAL               |
|--|---------------------------|------------------------|--------------------------|----------------------|--|---------------------|
| BALANCES,<br>DECEMBER 31,<br>2008  |                           | 16,047,928             | \$20,060                 | \$59,591             | \$40,892   | \$(20,201)\$100,342 |
| Comprehensive<br>Income:   |                           |                        |                          |                      |  |                     |
| Net income for the<br>period   | \$1,022                   |                        |                          | 1,022                |  | 1,022               |
| Other<br>comprehensive<br>income, net of tax:  |                           |                        |                          |                      |  |                     |
| Unrealized loss on<br>securities<br>available-for-sale,<br>net of deferred<br>income tax benefit<br>of \$358             | (666)                     |                        |                          |                      |  |                     |
| Reclassification<br>adjustment for<br>gain or loss<br>included in<br>income, net of<br>deferred income<br>taxes of \$155 | 288                       |                        |                          |                      |  |                     |
| Total other<br>comprehensive<br>loss,<br>net of tax  | \$(378)                   |                        |                          |                      | (378)  | (378)               |
| Comprehensive<br>Income  | \$644                     |                        |                          |                      |  |                     |
| Stock Options<br>Awarded   |                           |                        |                          | 159                  |  | 159                 |
| Issuance of<br>Common Stock<br>through Dividend<br>Reinvestment  |                           | 131,635                | 164                      | 942                  |  | 1,106               |
|  |                           |                        |                          | (2,087)              |  | (2,087)             |

|                                       |            |          |          |          |            |           |
|---------------------------------------|------------|----------|----------|----------|------------|-----------|
| Cash dividends paid, \$0.13 per share |            |          |          |          |            |           |
| BALANCES, JUNE 30, 2009               | 16,179,563 | \$20,224 | \$60,692 | \$39,827 | \$(20,579) | \$100,164 |

See notes to financial statements  
(6)

FIRST NATIONAL COMMUNITY BANCORP, INC.  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(1) The accounting and financial reporting policies of First National Community Bancorp, Inc. and its subsidiary conform to U.S. generally accepted accounting principles and to general practice within the banking industry. The consolidated statements of First National Community Bancorp, Inc. and its subsidiary, First National Community Bank (Bank) including its subsidiary, FNCB Realty, Inc. (collectively, Company) were compiled in accordance with the accounting policies set forth in note 1 of Notes to Consolidated Financial Statements in the Company's 2009 Annual Report to Shareholders. All material intercompany accounts and transactions have been eliminated in consolidation. The accompanying interim financial statements are unaudited. In management's opinion, the consolidated financial statements reflect a fair presentation of the consolidated financial position of the Company and subsidiary, and the results of its operations and its cash flows for the interim periods presented, in conformity with U.S. generally accepted accounting principles. Also in the opinion of management, all adjustments (which include only normal recurring adjustments) necessary to present fairly the Company's financial position, results of operations and cash flows at June 30, 2010 and for all periods presented have been made.

These interim financial statements should be read in conjunction with the audited financial statements and footnote disclosures in the Company's Annual Report to Shareholders for the fiscal year ended December 31, 2009.

(2) The following table identifies the related tax effects allocated to each component of other comprehensive income in the Consolidated Statements of Changes in Stockholders' Equity:

|   | June 30, 2010     |                             |                         | June 30, 2009     |                             |                         |
|---|-------------------|-----------------------------|-------------------------|-------------------|-----------------------------|-------------------------|
|   | Pre-tax<br>Amount | Tax<br>(Expense)<br>Benefit | Net of<br>Tax<br>Amount | Pre-tax<br>Amount | Tax<br>(Expense)<br>Benefit | Net of<br>Tax<br>Amount |
| (dollars in thousands)  |                   |                             |                         |                   |                             |                         |
| Unrealized gains (losses) on securities:                                  |                   |                             |                         |                   |                             |                         |
| Unrealized holding gains (losses) arising during the period               | \$(10,444)        | \$3,550                     | \$(6,894)               | \$(1,009)         | \$343                       | \$(666)                 |
| Noncredit related losses on securities not expected to be sold            | 12,354            | (4,200)                     | 8,154                   | 0                 | 0                           | 0                       |
| Less: reclassification adjustment for gain or loss realized in net income | 1,175             | (399)                       | 776                     | 436               | (148)                       | 288                     |
| Net unrealized gains (losses)   | \$3,085           | \$(1,049)                   | \$2,036                 | \$(573)           | \$195                       | \$(378)                 |
| Other comprehensive income (loss)   | \$3,085           | \$(1,049)                   | \$2,036                 | \$(573)           | \$195                       | \$(378)                 |

(3) Basic earnings per share have been computed by dividing net income (the numerator) by the weighted average number of common shares (the denominator) for the period. Such shares amounted to 16,300,515 and 16,111,808 for the periods ending June 30, 2010 and 2009, respectively.

Diluted earnings per share have been computed by dividing net income (the numerator) by the weighted average number of common shares and options outstanding (the denominator) for the period. Such shares amounted to 16,638,884 and 16,508,354 for the periods ending June 30, 2010 and 2009, respectively.



(4) On August 30, 2000, the Corporation's board of directors adopted an Employee Stock Incentive Plan in which options may be granted to key officers and other employees of the Corporation. The aggregate number of shares which may be issued upon exercise of the options under the plan cannot exceed 1,100,000 shares. Options and rights granted under the plan become exercisable six months after the date the options are awarded and expire ten years after the award date.

The board of directors also adopted on August 30, 2000, the Independent Directors Stock Option Plan for members of the corporation's board of directors who are not officers or employees of the corporation or its subsidiaries. The aggregate number of shares issuable under the plan cannot exceed 550,000 shares and are exercisable six months from the date the awards are granted and expire three years after the award date.

(7)

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In accordance with current accounting guidance, all options granted have been charged against income at their fair value. Awards granted under the plans vest immediately and the entire expense of the award is recognized in the year of grant.

A summary of the status of the Corporation's stock option plans is presented below:

|  | 2010      |                                 | Six months ended June 30, 2009 |                                 |
|--|-----------|---------------------------------|--------------------------------|---------------------------------|
|  | Shares    | Weighted Average Exercise Price | Shares                         | Weighted Average Exercise Price |
| Outstanding at the beginning of the period                       | 366,248   | \$12.18                         | 325,134                        | \$12.36                         |
| Granted  | 0         |                                 | 74,600                         | 10.81                           |
| Exercised  | 0         |                                 | 0                              |                                 |
| Forfeited  | (133,721) | 11.53                           | (3,061)                        | 18.80                           |
| Outstanding at the end of the period                             | 232,527   | 12.55                           | 396,673                        | 12.02                           |
| Options exercisable at June 30, 2010                             | 232,527   | 12.55                           | 322,073                        | 12.30                           |
| Weighted average fair value of options granted during the period | ---       | --                              | ---                            | 2.13                            |

Information pertaining to options outstanding at June 30, 2010 is as follows:

| Range of Exercise Price | Number Outstanding | Options Outstanding                         |                                 | Options Exercisable |                                 |
|-------------------------|--------------------|---|---------------------------------|---------------------|---------------------------------|
|                         |                    | Weighted Average Remaining Contractual Life | Weighted Average Exercise Price | Number Exercisable  | Weighted Average Exercise Price |
| \$5.19-\$23.13          | 232,527            | 5.1 years                                   | \$12.55                         | 232,527             | \$12.55                         |

(5) **FHLB Stock:** As a member of the Federal Home Loan Bank of Pittsburgh ("FHLB"), First National Community Bank is required to purchase and hold stock in the FHLB to satisfy membership and borrowing requirements. This stock is restricted in that it can only be sold to the FHLB or to another member institution, and all sales of FHLB stock must be at par. As a result of these restrictions, FHLB stock is unlike other investment securities insofar as there is no trading market for FHLB stock and the transfer price is determined by FHLB membership rules and not by market participants. As of June 30, 2010 and December 31, 2009, our FHLB stock totaled \$10.9 million.

In December 2008, the FHLB voluntarily suspended dividend payments on its stock, as well as the repurchase of excess stock from members. The FHLB cited a significant reduction in the level of core earnings resulting from lower short-term interest rates, the increased cost of liquidity, and constrained access to the debt markets at attractive rates and maturities as the main reasons for the decision to suspend dividends and the repurchase of excess capital stock. The FHLB last paid a dividend in the third quarter of 2008.

FHLB stock is held as a long-term investment and its value is determined based on the ultimate recoverability of the par value. First National Community Bancorp, Inc. evaluates impairment quarterly. The decision of whether

impairment exists is a matter of judgment that reflects our view of the FHLB's long-term performance, which includes factors such as the following:

- its operating performance;
- the severity and duration of declines in the fair value of its net assets related to its capital stock amount;
- its commitment to make payments required by law or regulation and the level of such payments in relation to its operating performance;

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- the impact of legislative and regulatory changes on the FHLB, and accordingly, on the members of FHLB; and
  - its liquidity and funding position.

After evaluating all of these considerations, First National Community Bancorp, Inc. concluded that the par value of its investment in FHLB stock will be recovered. Accordingly, no impairment charge was recorded on these securities for the six months ended June 30, 2010. Our evaluation of the factors described above in future periods could result in the recognition of impairment charges on FHLB stock.

(6) Change in Estimate – As of April 1, 2010 the company refined its calculation of the reserve for losses on off balance sheet commitments and the related expense. It now provides a reserve based on lines of credit and letters of credit for facilities to which the bank is committed and are likely to be drawn. In prior quarters the calculation was based on all outstanding lines and letters of credit. Also, the company adjusted its reserve calculation to consider projected usage by customers and historical losses experienced by the company.

We believe these changes will more accurately reflect the appropriate reserve and the related expense in the company's financial statements and concluded that these changes represent a change in an estimate and are not a correction of an error or a change in an accounting method.

These changes had a positive effect of \$1 million pre-tax and \$667,000 after tax in the reported second quarter earnings. Had the changes been made at December 31, 2009, the loss reported for that year would have been \$10.2 million rather than the \$11.3 million that was reported.

Had the change been made at January 1, 2010, the company would have reported earnings of \$1.55 million (EPS of \$.10) rather than \$1.959 million (EPS of \$.12) for the first quarter of 2010. For the six months ended June 30, 2010, the company would have reported a loss of \$866,000 (EPS of \$(.05)), rather than net income of \$209,000 (EPS of \$.01).

(7) Subsequent Events – In accordance with current accounting guidance, subsequent events have been evaluated through the filing date. Through that date, there were no events requiring disclosure.

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

### Forward Looking Statements

This quarterly report contains forward-looking statements as defined in the Private Securities Litigation Reform Act of 1995. Actual results and trends could differ materially from those set forth in such statements due to various risks, uncertainties and other factors. Such risks, uncertainties and other factors that could cause actual results and experience to differ include, but are not limited to, the following: the strategic initiatives and business plans may not be satisfactorily completed or executed, if at all; increased demand or prices for the company's financial services and products may not occur; changing economic and competitive conditions; technological developments; the effectiveness of the company's business strategy due to changes in current or future market conditions; actions of the U.S. government, Federal Reserve and other governmental and regulatory bodies for the purpose of stabilizing the financial markets; effects of deterioration of economic conditions on customers specifically the effect on loan customers to repay loans; inability of the company to raise or achieve desired or required levels of capital; paying significantly higher Federal Deposit Insurance Corporation (FDIC) premiums in the future; the effects of competition, and of changes in laws and regulations, such as the Dodd-Frank Wall Street Reform and Consumer Protection Act, including industry consolidation and development of competing financial products and services; interest rate movements; relationships with customers and employees; challenges in establishing and maintaining operations; volatilities in the securities markets and related potential impairments of investment securities; and deteriorating

economic conditions and declines in housing prices and real estate values and other risks and uncertainties, including those detailed in the company's filings with the Securities and Exchange Commission. When we use words such as "believes", "expects", "anticipates", or similar expressions, we are making forward-looking statements. The company undertakes no obligation to publicly revise or update these forward-looking statements to reflect events or circumstances that arise after the date of this report.

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Readers should carefully review the risk factors described in the Annual Report and other documents that we periodically file with the Securities and Exchange Commission, including our Form 10-K for the year ended December 31, 2009.

The consolidated financial information of First National Community Bancorp, Inc. (the “company”) provides a comparison of the performance of the company for the periods ended June 30, 2010 and 2009. The financial information presented should be read in conjunction with the consolidated financial statements and accompanying notes appearing elsewhere in this report.

## Background

The company is a Pennsylvania corporation, incorporated in 1997 and is registered as a financial holding company under the Bank Holding Company Act of 1956, as amended. The company became an active bank holding company on July 1, 1998 when it assumed ownership of First National Community Bank (the “bank”). On November 2, 2000, the Federal Reserve Bank of Philadelphia approved the company’s application to change its status to a financial holding company as a complement to the company’s strategic objective which includes expansion into financial services activities. The bank is a wholly-owned subsidiary of the company.

The company’s primary activity consists of owning and operating the bank, which provides the customary retail and commercial banking services to individuals and businesses. The bank provides practically all of the company’s earnings as a result of its banking services. As of June 30, 2010, the company had 21 full-service branch banking offices in its principal market area in Lackawanna, Luzerne, Wayne and Monroe Counties, Pennsylvania. At June 30, 2010, the company had 307 full-time equivalent employees.

The bank was established as a national banking association in 1910 as "The First National Bank of Dunmore." Based upon shareholder approval received at a Special Shareholders' Meeting held October 27, 1987, the bank changed its name to "First National Community Bank" effective March 1, 1988. The bank's operations are conducted from offices located in Lackawanna, Luzerne, Wayne and Monroe Counties, Pennsylvania:

| Office            | Date Opened    |
|-------------------|----------------|
| Main              | October 1910   |
| Scranton          | September 1980 |
| Dickson City      | December 1984  |
| Keyser Village    | April 2008     |
| Wilkes-Barre      | July 1993      |
| Pittston Plaza    | April 1995     |
| Kingston          | August 1996    |
| Exeter            | November 1998  |
| Daleville         | April 2000     |
| Plains            | June 2000      |
| Back Mountain     | October 2000   |
| Clarks Green      | October 2001   |
| Hanover Township  | January 2002   |
| Nanticoke         | April 2002     |
| Hazleton          | October 2003   |
| Route 315         | February 2004  |
| Honesdale         | November 2006  |
| Stroudsburg       | May 2007       |
| Honesdale Route 6 | October 2007   |
| Marshalls Creek   | May 2008       |

Dunmore - Wheeler Avenue December 2009

The bank provides the usual commercial banking services to individuals and businesses, including a wide variety of loan, deposit instruments and investment options. As a result of the bank's partnership with FNCB Wealth Management Services, our customers are able to access alternative products such as mutual funds, bonds, equities and annuities directly from our FNCB Wealth Management Services representatives.

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During 1996, FNCR Realty Inc. was formed as a wholly owned subsidiary of the bank to manage, operate and liquidate properties acquired through foreclosure.

Summary:

Net income for the first six months of 2010 amounted to \$209,000, a decrease of \$813,000, or 79.6%, when compared to \$1.022 million for the same period of the 2009. For the three months ended June 30, 2010 the company reported a loss of \$1.749 million, an improvement of \$467,000 over the loss reported for the second quarter of 2009.

Presented in tabular form are the components of increases and (decreases) to net income for the two periods ended June 30, 2010:

|                               | For the three<br>months ended<br>June 30, 2010 | For the six months<br>ended<br>June 30, 2010 |
|-------------------------------|--|--|
| (dollars in thousands)        |  |  |
| Interest income               | \$(1,893)                                      | \$(3,446)                                    |
| Interest expense              | (529)  | (640)  |
| Net interest income           | (1,364)  | (2,806)                                      |
| Provision for credit losses   | 2,290  | 1,948  |
| Other income                  | (1,780)  | (2,343)                                      |
| Other expenses                | 106  | 189  |
| Income before income<br>taxes | (960)  | (3,012)                                      |
| Income tax expense            | 1,427  | 2,199  |
| Net income                    | \$467  | \$(813)                                      |

For the six months ended June 30, 2010, the decrease of \$813,000 is primarily due to a decrease in interest income of \$3.446 million which was partially offset by the tax benefit of the operating loss. Other income decreased \$2.343 million primarily due to a \$1.220 million increase in impairment charges on securities and a \$1.073 million reduction in the gain on asset sales. Other expenses were \$189,000 lower than the same period of last year due to \$1.353 million credit in the reserve for off-balance sheet commitments, offset by an increase in other operating expenses of \$953,000 and an increase in expenses of ORE of \$421,000.

On a quarterly basis, the improvement of \$467,000 is primarily due to an improvement in the provision for credit losses of \$2.290 million. Other income for the quarter decreased \$1.780 million while other expenses increased \$106,000.

## RESULTS OF OPERATIONS

### Net Interest Income:

The company's primary source of revenue is net interest income which totaled \$18.040 million and \$20.846 million (before the provision for credit losses) during the first six months of 2010 and 2009, respectively. The year to date net interest margin (tax equivalent) decreased forty basis points to 3.25% in 2010 compared to 2009 comprised of a fifty-three basis point decrease in the yield earned on earning assets which was offset by a nineteen basis point decrease in the cost of interest-bearing liabilities. Excluding investment leveraging transactions, the 2010 margin would be 3.29% which is forty-eight basis points lower than the 3.77% recorded during the first six months of last year.



Earning assets decreased \$65 million to \$1.212 billion during the first six months of 2010 and total 90.5% of total assets, a slight decrease from the 91.5% at year-end.

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## Yield/Cost Analysis

The following tables set forth certain information relating to the company's Statement of Financial Condition and reflect the weighted average yield on assets and weighted average costs of liabilities for the periods indicated. Such yields and costs are derived by dividing the annualized income or expense by the weighted average balance of assets or liabilities, respectively, for the periods shown:

|   | Six months ended June 30,<br>2010 |               |  | Six months ended June 30,<br>2009 |               |                |
|---|-----------------------------------|---------------|--|-----------------------------------|---------------|----------------|
|   | Average<br>Balance                | Interest      | Yield/<br>Cost<br>(Dollars in thousands) | Average<br>Balance                | Interest      | Yield/<br>Cost |
| <b>Assets:</b>  |                                   |               |  |                                   |               |                |
| <b>Interest-earning assets:</b>   |                                   |               |  |                                   |               |                |
| Loans (taxable)   | \$843,529                         | \$22,499      | 5.32%                                    | \$900,371                         | \$25,220      | 5.59%          |
| Loans (tax-free) (1)  | 54,829                            | 1,231         | 6.87                                     | 51,616                            | 1,177         | 6.98           |
| Investment securities (taxable)   | 173,348                           | 3,157         | 3.64                                     | 169,440                           | 4,309         | 5.08           |
| Investment securities (tax-free)(1)                                     | 121,229                           | 2,792         | 7.09                                     | 109,608                           | 2,473         | 6.94           |
| Time deposits with banks and federal funds sold                         | 52,340                            | 67            | 0.25                                     | 11,603                            | 13            | 0.22           |
| <b>Total interest-earning assets</b>                                    | <b>1,245,275</b>                  | <b>29,746</b> | <b>5.12%</b>                             | <b>1,242,638</b>                  | <b>33,192</b> | <b>5.65%</b>   |
| Non-interest earning assets   | 121,233                           |               |  | 84,089                            |               |                |
| <b>Total Assets</b>   | <b>\$1,366,508</b>                |               |  | <b>\$1,326,727</b>                |               |                |
| <b>Liabilities and Shareholders' Equity:</b>                            |                                   |               |  |                                   |               |                |
| <b>Interest-bearing liabilities:</b>                                    |                                   |               |  |                                   |               |                |
| Deposits  | \$964,927                         | \$7,698       | 1.61%                                    | \$886,983                         | \$ 8,467      | 1.92%          |
| Borrowed funds  | 215,106                           | 4,008         | 3.71                                     | 248,029                           | 3,879         | 3.11           |
| <b>Total interest-bearing liabilities</b>                               | <b>1,180,033</b>                  | <b>11,706</b> | <b>1.99%</b>                             | <b>1,135,012</b>                  | <b>12,346</b> | <b>2.18%</b>   |
| Other liabilities and shareholders' equity                              | 186,475                           |               |  | 191,715                           |               |                |
| <b>Total Liabilities and Shareholders' Equity</b>                       | <b>\$1,366,508</b>                |               |  | <b>\$1,326,727</b>                |               |                |
| <b>Equity</b>   |                                   |               |  |                                   |               |                |
| Net interest income/rate spread   |                                   | \$18,040      | 3.13%                                    |                                   | \$20,846      | 3.46%          |
| Net yield on average interest-earning assets                            |                                   |               | 3.25%                                    |                                   |               | 3.65%          |
| Interest-earning assets as a percentage of interest-bearing liabilities |                                   |               | 106%                                     |                                   |               | 109%           |

(1) Yields on tax-exempt loans and investment securities have been computed on a tax equivalent basis.

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## Rate Volume Analysis

The table below sets forth certain information regarding the changes in the components of net interest income for the periods indicated. For each category of interest earning asset and interest bearing liability, information is provided on changes attributed to: (1) changes in rate (change in rate multiplied by current volume); (2) changes in volume (change in volume multiplied by old rate); (3) the total. The net change attributable to the combined impact of volume and rate has been allocated proportionately to the change due to volume and the change due to rate (in thousands).

|   | Period Ended June 30,<br>2010 vs 2009 |            |            | Period Ended June 30,<br>2009 vs 2008 |            |            |
|---|---------------------------------------|------------|------------|---------------------------------------|------------|------------|
|   | Increase                              |            |            | Increase                              |            |            |
|   | Increase (Decrease)                   | (Decrease) | (Decrease) | Increase (Decrease)                   | (Decrease) | (Decrease) |
|   | Due to                                | Due to     | Due to     | Due to                                | Due to     | Due to     |
|   | Rate                                  | Volume     | Total      | Rate                                  | Volume     | Total      |
| Loans (taxable)                                 | \$(435)                               | \$(2,286)  | \$(2,721)  | \$(5,335)                             | \$1,629    | \$(3,706)  |
| Loans (tax-free)                                | (19)                                  | 73         | 54         | (30)                                  | 104        | 74         |
| Investment securities (taxable)                 | (987)                                 | (165)      | (1,152)    | (469)                                 | (953)      | (1,422)    |
| Investment securities (tax-free)                | 57                                    | 262        | 319        | 107                                   | 644        | 751        |
| Time deposits with banks and federal funds sold | 8                                     | 46         | 54         | (111)                                 | 119        | 8          |
| Total interest income                           | \$(1,376)                             | \$(2,070)  | \$(3,446)  | \$(5,838)                             | \$1,543    | \$(4,295)  |
| Deposits  | \$(1,336)                             | \$567      | \$(769)    | \$(4,988)                             | \$556      | \$(4,432)  |
| Borrowed funds                                  | 643                                   | (514)      | 129        | (1,356)                               | 268        | (1,088)    |
| Total interest expense                          | \$(693)                               | \$53       | \$(640)    | \$(6,344)                             | \$824      | \$(5,520)  |
| Net change in net interest income               | \$(683)                               | \$(2,123)  | \$(2,806)  | \$ 506                                | \$719      | \$1,225    |

## Other Income and Expenses:

Other income in the first half of 2010 decreased \$2.3 million in comparison to the same period of 2009, primarily due to a \$1.2 million increase in other-than-temporary impairment losses on securities. Service charges and fees decreased \$50,000 compared to the prior period. Income from service charges on deposits decreased \$114,000, or 8%, in comparison to the same period of last year. Other fee income increased \$64,000, or 5%. Net gains from asset sales decreased \$1.1 million comprised of a \$350,000 increase in security gains as securities were sold to restructure the portfolio and to generate liquidity to meet loan demand offset by a \$575,000 decrease in gains on residential mortgage loans and an \$848,000 loss on the sale of other real estate as three properties were written down to current appraisal amounts.

On a quarterly basis, other income decreased \$1.8 million in comparison to the same period of 2009, primarily due to a decrease in net gains from asset sales of \$1.5 million and an increase in other-than-temporary impairment losses on securities of \$305,000. Service charges on deposit accounts decreased \$76,000, or 11%, in comparison to the same period of last year. Net gains on the sale of residential mortgages decreased \$303,000, net gains on the sale of securities decreased \$319,000. A net loss on the sale of other real estate of \$848,000 was recorded as three properties were written down to current appraisal amounts.

Other expenses decreased \$189,000 or 1% for the period ended June 30, 2010 compared to the same six month period of the previous year primarily due to a decrease in the provision for off-balance sheet commitments of \$1.4 million (refer to Footnote 6 on page 9). Salaries and Benefits costs increased \$87,000 in comparison to the first six months of

2009, and data processing expenses increased \$117,000, or 14%. FDIC insurance expense decreased \$461,000, or 32%, due to the impact of the special assessment in 2009 that was recorded during the second quarter of 2009, bank shares tax expense increased \$78,000, or 18%, expenses of other real estate increased \$421,000 and other operating expenses increased \$953,000.

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On a quarterly basis, other expenses increased \$106,000 in comparison to the same period of 2009. Salaries and Benefits costs increased \$299,000, expenses of other real estate increased \$301,000 and other operating expenses increased \$425,000, offset by decreases in FDIC insurance expense of \$690,000 and the provision for off-balance sheet commitments of \$322,000.

#### Other Comprehensive Income:

The company's other comprehensive income includes unrealized holding gains (losses) on securities which it has classified as available-for-sale in accordance with current accounting guidance.

#### Provision for Income Taxes:

The provision for income taxes is calculated based on annualized taxable income. The provision for income taxes differs from the amount of income tax determined applying the applicable U.S. statutory federal income tax rate to pre-tax income from continuing operations as a result of the following differences:

|   | 2010      | 2009    |
|---|-----------|---------|
| Provision at statutory rate               | \$(608)   | \$416   |
| Add (Deduct):                             |           |         |
| Tax effect of non-taxable interest income | (1,368)   | (1,241) |
| Tax effect of other tax free income       | (132)     | (152)   |
| Non-deductible interest expense           | 98        | 118     |
| Deferred tax benefits                     | (16)      | (14)    |
| Other timing differences                  |           | 1,049   |
| Other items, net                          | 28        | 25      |
| Income tax expense                        | \$(1,998) | \$201   |

#### Federal Deposit Insurance Corporation ("FDIC") Activity:

On February 27, 2009, The Board of Directors of the FDIC voted to amend the restoration plan for the Deposit Insurance Fund ("DIF"). Under the current restoration plan, the FDIC Board set a rate schedule to raise the DIF reserve ratio to 1.15 percent within seven years. The amended restoration plan was accompanied by a final rule that sets assessment rates and makes adjustments that improve how the assessment system differentiates for risk.

Prior to the final rule, most banks were in the best risk category and paid anywhere from 12 cents per \$100 of deposits to 14 cents per \$100 for insurance. Beginning April 1, 2009, banks in this category began paying initial base rates ranging from 12 cents per \$100 to 16 cents per \$100 on an annual basis. Changes to the assessment system include higher rates for institutions that rely significantly on secured liabilities, which may increase the FDIC's loss in the event of failure without providing additional assessment revenue. Under the final rule, assessments are higher for institutions that rely significantly on brokered deposits but, for well-managed and well-capitalized institutions, only when accompanied by rapid asset growth. Brokered deposits combined with rapid asset growth have played a role in a number of costly failures, including recent failures. The final rule also provided incentives in the form of a reduction in assessment rates for institutions to hold long-term unsecured debt and, for smaller institutions, high levels of Tier 1 capital.

The FDIC Board also adopted a rule imposing a 5 basis point emergency special assessment on the industry on June 30, 2009. The assessment was collected on September 30, 2009. For the bank, based upon our deposit levels at June 30, 2009, the additional amount of 2009 FDIC insurance expense related to this special assessment was \$603,000. This adjustment was recognized during the second quarter of 2009. On November 12, 2009, the FDIC

Board adopted rulemaking requiring banks to prepay, on December 30, 2009, their estimated quarterly risk-based assessments for the fourth quarter of 2009 and for all of 2010, 2011 and 2012. Prepaid assessments for the fourth quarter of 2009 amounted to \$385,000, for 2010 - \$1.6 million, for 2011 - \$2 million and for 2012 - \$2.1 million. Under the new rule, banks will be assessed through 2010 according to the risk-based premium schedule adopted earlier this year. Beginning January 1, 2011, the base rate will increase by 3 basis points.

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## Securities:

Carrying amounts and approximate fair value of investment securities are summarized as follows (in thousands):

|  | June 30, 2010   |            | December 31, 2009 |            |
|--|-----------------|------------|-------------------|------------|
|  | Carrying Amount | Fair Value | Carrying Amount   | Fair Value |
| U.S. Treasury securities and obligations of U.S. government agencies | \$27,786        | \$27,786   | \$27,089          | \$27,089   |
| Obligations of state and political subdivisions                      | 118,734         | 118,658    | 120,569           | 120,458    |
| Collateralized mortgage obligations:                                 |                 |            |                   |            |
| Government sponsored agency  | 71,663          | 71,663     | 53,495            | 53,495     |
| Private label  | 12,776          | 12,776     | 21,059            | 21,059     |
| Residential mortgage-backed securities                               | 19,788          | 19,788     | 27,442            | 27,442     |
| Pooled Trust Preferred Senior Class                                  | 2,686           | 2,686      | 2,639             | 2,639      |
| Pooled Trust Preferred Mezzanine Class                               | 7,366           | 7,366      | 8,180             | 8,180      |
| Corporate debt securities  | 394             | 394        | 356               | 356        |
| Equity securities  | 1,018           | 1,018      | 1,025             | 1,025      |
| Total  | \$262,211       | \$262,135  | \$261,854         | \$261,743  |

The following summarizes the amortized cost, approximate fair value, gross unrealized holding gains, and gross unrealized holding losses at June 30, 2010 of the company's Investment Securities classified as available-for-sale (in thousands):

|   | June 30, 2010  |                                |                                 |            |
|---|----------------|--------------------------------|---------------------------------|------------|
|   | Amortized Cost | Gross Unrealized Holding Gains | Gross Unrealized Holding Losses | Fair Value |
| U.S. Treasury securities and obligations of U.S. government agencies: | \$27,989       | \$389                          | \$592                           | \$27,786   |
| Obligations of state and political subdivisions:                      | 120,061        | 2,536                          | 5,808                           | 116,789    |
| Collateralized mortgage obligations:                                  |                |                                |                                 |            |
| Government sponsored agency   | 70,348         | 1,484                          | 169                             | 71,663     |
| Private label   | 14,859         | 109                            | 2,192                           | 12,776     |
| Residential mortgage-backed securities:                               | 18,972         | 816                            | 0                               | 19,788     |
| Pooled Trust Preferred Senior Class                                   | 3,796          | 0                              | 1,110                           | 2,686      |
| Pooled Trust Preferred Mezzanine Class                                | 25,816         | 0                              | 18,450                          | 7,366      |
| Corporate debt securities:  | 500            | 0                              | 106                             | 394        |
| Equity securities and mutual funds:                                   | 1,010          | 8                              | 0                               | 1,018      |



|       |           |         |          |           |
|-------|-----------|---------|----------|-----------|
| Total | \$283,351 | \$5,342 | \$28,427 | \$260,266 |
|-------|-----------|---------|----------|-----------|

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The following summarizes the amortized cost, approximate fair value, gross unrealized holding gains, and gross unrealized holding losses at June 30, 2010 of the company's Investment Securities classified as held-to-maturity (dollars in thousands):

|  | June 30, 2010     |   |  |               |
|--|-------------------|---|--|---------------|
|  | Amortized<br>Cost | Gross<br>Unrealized<br>Holding<br>Gains | Gross<br>Unrealized<br>Holding<br>Losses | Fair<br>Value |
| Obligations of state and political subdivisions: | \$1,945           | \$ 0                                    | \$76                                     | \$1,869       |
| Total  | \$1,945           | \$ 0                                    | \$76                                     | \$1,869       |

The following table shows the amortized cost and approximate fair value of the company's debt securities at June 30, 2010 using contractual maturities. Expected maturities will differ from contractual maturity because issuers may have the right to call or prepay obligations with or without call or prepayment penalties (in thousands).

|                                     | Available- for sale |               | Held-to-maturity  |               |
|-------------------------------------|---------------------|---------------|-------------------|---------------|
|                                     | Amortized<br>Cost   | Fair<br>Value | Amortized<br>Cost | Fair<br>Value |
| Amounts maturing in:                |                     |               |                   |               |
| One year or less                    | \$ 0                | \$ 0          | \$ 0              | \$ 0          |
| After one year through five years   | 2,826               | 2,836         | 0                 | 0             |
| After five years through ten years  | 7,438               | 7,505         | 470               | 456           |
| After ten years                     | 167,898             | 144,680       | 1,475             | 1,413         |
| Collateralized mortgage obligations | 85,207              | 84,439        | 0                 | 0             |
| Mortgage-backed securities          | 18,972              | 19,788        | 0                 | 0             |
| Total                               | \$282,341           | \$259,248     | \$1,945           | \$1,869       |

Gross proceeds from the sale of investment securities for the periods ended June 30, 2010 and 2009 were \$25,547,542 and \$12,378,431 respectively with the gross realized gains being \$ 1,231,864 and \$824,744 respectively, and gross realized losses being \$ 1,659,106 and \$382,140, respectively.

At June 30, 2010 and 2009, investment securities with a carrying amount of \$201,939,466 and \$164,780,179 respectively, were pledged as collateral to secure public deposits and for other purposes.

#### Impairment of Investment Securities

Our investment portfolio is reviewed on a quarterly basis for indications of impairment. This review includes analyzing the length of time and the extent to which the fair value has been lower than the cost, the financial condition and near-term prospects of the issuer, including any specific events which may influence the operations of the issuer and the intent and ability to hold the investment for a period of time sufficient to allow for any anticipated recovery in the market. We evaluate our intent and ability to hold debt securities based upon our investment strategy for the particular type of security and our cash flow needs, liquidity position, capital adequacy and interest rate risk position. In addition, the risk of future other-than-temporary impairment may be influenced by additional bank failures, prolonged recession in the U.S. economy, changes in real estate values, interest deferrals, and whether the federal government provides assistance to financial institutions. Our pooled trust preferred collateralized debt obligations are beneficial interests in securitized financial assets within the scope of current accounting guidance, and are therefore evaluated for other-than-temporary impairment using management's best estimate of future cash flows. If these estimated cash flows determine that it is probable an adverse change in cash flows has occurred, then other-than-temporary impairment would be recognized. There is a risk that this quarterly review could result in First

National Community Bank recording additional other-than-temporary impairment charges in the future.

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As of June 30, 2010, 23.1% of the total unrealized losses were comprised of fixed income securities issued by U.S. Government agencies, U.S. Government-sponsored enterprises and municipalities. Pooled trust preferred collateralized debt obligations accounted for 68.8% of the total unrealized losses and 7.7% came from private label mortgage-backed securities.

As of June 30, 2010, the amortized cost of our pooled trust preferred collateralized debt obligations totaled \$29.6 million with an estimated fair value of \$10.1 million. One of our pooled securities is a senior tranche and the remainder are mezzanine tranches. During 2009, all of the pooled issues were downgraded by Moody's Investor Services. At the time of initial issue, no more than 5% of any pooled security consisted of a security issued by any one institution.

Lack of liquidity in the market for trust preferred collateralized debt obligations, credit rating downgrades and market uncertainties related to the financial industry are factors contributing to the temporary impairment on these securities.

On a quarterly basis we evaluate our trust preferred collateralized debt obligations for other-than-temporary impairment. In the second quarter of 2010, \$159,890 in other-than-temporary impairment charges were recognized on our pooled trust preferred collateralized debt obligations, bringing the year-to-date 2010 total to \$744,179. When evaluating these investments we determine a credit related portion and a noncredit related portion of other-than-temporary impairment. The credit related portion is recognized in earnings and represents the expected shortfall in future cash flows. The noncredit related portion is recognized in other comprehensive income and represents the difference between the fair value of the security and the amount of credit related impairment. A discounted cash flow analysis provides the best estimate of credit related other-than-temporary impairment for these securities.

Our pooled trust preferred collateralized debt obligations are measured for other-than-temporary impairment within the scope of current accounting guidance by determining whether it is probable that an adverse change in estimated cash flows has occurred. Determining whether there has been an adverse change in estimated cash flows from the cash flows previously projected involves comparing the present value of remaining cash flows previously projected against the present value of the cash flows estimated at June 30, 2010. We consider the discounted cash flow analysis to be our primary evidence when determining whether credit related other-than-temporary impairment exists.

The following table presents the gross unrealized losses and fair values at June 30, 2010 for both available for sale and held to maturity securities by investment category and time frame for which the loss has been outstanding (dollars in thousands):

| Description of Securities  | Less Than 12 Months |                   | 12 Months or Greater |                   | Total      |                   |
|--|---------------------|-------------------|----------------------|-------------------|------------|-------------------|
|  | Fair Value          | Unrealized Losses | Fair Value           | Unrealized Losses | Fair Value | Unrealized Losses |
| U.S. Treasury securities and obligations of U.S. government agencies | \$0                 | \$0               | \$10,841             | \$592             | \$10,841   | \$592             |
| Obligation of state and political subdivisions                       | 28,516              | 1,231             | 19,311               | 4,654             | 47,827     | 5,885             |
| Collateralized mortgage obligations                                  |                     |                   |                      |                   |            |                   |
| Government sponsored agency  | 11,799              | 169               | 0                    | 0                 | 11,799     | 169               |
| Private Label  | 0                   | 0                 | 8,207                | 2,192             | 8,207      | 2,192             |
| Residential Mortgage-backed securities                               | 0                   | 0                 | 0                    | 0                 | 0          | 0                 |

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|  |          |         |          |          |          |          |
|--|----------|---------|----------|----------|----------|----------|
| Corporate debt securities              | 0        | 0       | 394      | 106      | 394      | 106      |
| Pooled Trust Preferred Senior Class    | 0        | 0       | 2,686    | 1,108    | 2,686    | 1,108    |
| Pooled Trust Preferred Mezzanine Class | 0        | 0       | 7,366    | 18,452   | 7,366    | 18,452   |
| Mutual Fund                            | 0        | 0       | 0        | 0        | 0        | 0        |
|  | \$40,315 | \$1,400 | \$48,805 | \$27,104 | \$89,120 | \$28,504 |

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Corporate securities had a total unrealized loss of \$19.7 million as of June 30, 2010. \$19.6 million of the unrealized losses were from pooled trust preferred collateralized debt obligations.

The following table presents the gross unrealized losses and fair values at June 30, 2009 for both available for sale and held to maturity securities by investment category and time frame for which the loss has been outstanding (dollars in thousands):

| Description of Securities                      | Less Than 12 Months |                   | 12 Months or Greater |                   | Total      |                   |
|--|---------------------|-------------------|----------------------|-------------------|------------|-------------------|
|  | Fair Value          | Unrealized Losses | Fair Value           | Unrealized Losses | Fair Value | Unrealized Losses |
| U.S. Treasury securities and obligations of    |                     |                   |                      |                   |            |                   |
| U.S. government agencies                       | \$998               | \$2               | \$8,254              | \$2,515           | \$9,252    | \$2,517           |
| Obligation of state and political subdivisions | 28,167              | 617               | 43,039               | 5,748             | 71,206     | 6,365             |
| Collateralized mortgage obligations            |                     |                   |                      |                   |            |                   |
| Government sponsored agency                    | 0                   | 0                 | 0                    | 0                 | 0          | 0                 |
| Private Label                                  | 7,832               | 505               | 21,160               | 7,628             | 28,992     | 8,133             |
| Residential Mortgage-backed securities         | 0                   | 0                 | 0                    | 0                 | 0          | 0                 |
| Corporate debt securities                      | 0                   | 0                 | 1,445                | 614               | 1,445      | 614               |
| Pooled Trust Preferred Senior Class            | 0                   | 0                 | 2,695                | 1,351             | 2,695      | 1,351             |
| Pooled Trust Preferred Mezzanine Class         | 0                   | 0                 | 16,762               | 16,569            | 16,762     | 16,569            |
| Mutual Fund                                    | 0                   | 0                 | 986                  | 14                | 986        | 14                |
|  | \$36,997            | \$1,124           | \$94,341             | \$34,439          | \$131,338  | \$35,563          |

The OTTI analysis for the private label mortgage-backed securities relies on a review of the individual loans that provide the collateral for each security. This information is then used to develop default and severity assumptions over a future horizon for each security. The factors involved in constructing these assumptions are:

- MSA (metropolitan statistical area), Geographics
  - HPI (Home Price Index) of specific MSA
    - Loan Balance
    - Rate Premium
- LTV (both individual and combined if other loans)
  - FICO
  - Loan Purpose (cash-out versus purchase)
    - Documentation
    - Loan Structure
    - Occupancy Status
    - Property Type
  - Borrower Payment History
- Historical delinquency and roll/cure rates

Adjustments are made to the default/severity vectors that may be warranted given the current environment. We then apply a fairness check to each vector to review whether future default/severity assumptions are “in line” with current observable performance. The data used to perform this analysis is provided by Performance Trust and the individual loan performance.

Once we have default/severity assumptions on the underlying collateral (on a deal specific basis), we then have to understand how the timing of losses impacts each specific bond/tranche and how each cash flow changes over time. The default and severity vectors are modeled using either Intex or Bloomberg and both total collateral and tranche specific cash flows are established. We can then compute various metrics based on the resulting tranche cash flow:

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- Total Collateral Principal Loss
  - Total Tranche Loss
  - Lifetime Tranche Yield
  - Tranche Loss Timing

A security is considered to be other-than-temporarily impaired if the analysis results in a change of cash flows from the original expectation which indicates that there is the potential that all principal and/or interest may not be received.

Credit ratings are one factor of the analysis utilized to determine OTTI. As of June 30, 2010, the following private label CMO's were determined to be credit impaired resulting in a charge to earnings:

| Description           | S&P<br>Credit<br>Rating | Collateral<br>Type | Cumulative<br>Credit<br>Impairment<br>Recognized |
|-----------------------|-------------------------|--------------------|--|
| RAST 2006 – A10 A5    | D                       | ALT-A30            | \$258,000  |
| RAST 2006 – A8 2A2    | D                       | ALT-A30            | 520,000  |
| CWALT 2007 – 7T2 A12  | CC                      | ALT-A30            | 538,000  |
| RALI 2006 – QS 16 A10 | D                       | ALT-A30            | 236,000  |
| RALI 2006 – QS4 A2    | CC                      | ALT-A30            | 230,000  |
| HALO 2007 – 1 3A6     | CCC                     | WH30               | 246,000  |
| WMALT 2006 – 2 2CB    | CCC                     | ALT-A30            | 260,000  |
| PRIME 2006 – 1 1A1    | CC                      | WH30               | 45,404   |
|                       |                         |                    | \$2,333,404                                      |

Information affecting cash flows and the impact on the collectability of principal and interest are evaluated on a monthly basis as received from service providers. The results are recognized through earnings as they become available.

The credit impairment recognized as of the dates indicated represents an estimate of uncollectable principal utilizing the factors referenced previously.

Future default and severity assumptions are determined by analyzing each security and liquidating all 60+ day delinquent loans and realize losses at current 3-month trailing severities.

| Description         | 60-89<br>Days<br>Deliq | 90+<br>Days<br>Deliq | Fore-<br>closure | REO   | 1 Mo<br>Severity | 2 Mo<br>Severity | 3 Mo<br>Severity |
|---------------------|------------------------|----------------------|------------------|-------|------------------|------------------|------------------|
| RAST 2006-A10 A5    | 3.37%                  | 11.09%               | 13.44%           | 2.30% | 104.07%          | 57.67%           | 0.00%            |
| RAST 2006-A8 2A2    | 3.20%                  | 6.89%                | 14.06%           | 3.14% | 57.51%           | 45.30%           | 64.47%           |
| CWALT 2007-7T2 A12  | 24.64%                 | 17.49%               | 14.72%           | 1.96% | 0.00%            | 22.65%           | 59.06%           |
| RALI 2006-QS 16 A10 | 163.26%                | 8.63%                | 16.91%           | 2.03% | 54.43%           | 67.53%           | 55.83%           |
| RALI 2006-QS4 A2    | 3.09%                  | 6.64%                | 12.25%           | 0.91% | 54.53%           | 57.18%           | 63.75%           |
| HALO 2007-1 3A6     | 2.05%                  | 10.59%               | 5.90%            | 1.49% | 57.45%           | 70.94%           | 57.61%           |
| WMALT 2006-2 2CB    | 1.45%                  | 9.53%                | 11.45%           | 1.92% | 24.23%           | 24.66%           | 25.37%           |



PRIME 2006-1 1A1 1.05% 7.84% 5.42% 1.99% 26.70% 67.19% 49.32%



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The following table provides additional information related to our corporate securities as of June 30, 2010:

| Name of Issuer | Name of Issuer's Parent Company | Book Value | Fair Value | Unrealized Gain/Loss | Current Moody's /Fitch Issuer Ratings |
|----------------|---------------------------------|------------|------------|----------------------|---------------------------------------|
| Chase Capital  | JP Morgan Chase & Co.           | \$500      | \$394      | \$(106)              | A2/A                                  |

(dollars in thousands)

As of June 30, 2010, the book value of our pooled trust preferred collateralized debt obligations totaled \$29.6 million with an estimated fair value of \$10.1 million, which includes securities comprised of 412 banks and other financial institutions.

The following table provides additional information related to our pooled trust preferred collateralized debt obligations as of June 30, 2010:

| Deal          | Class     | Book Value | Fair Value | Unrealized Gain/Loss | Moody's / Fitch Ratings | Actual Current Number of Defaults as a % of Current Issuers | Actual Deferrals / Collateral |
|---------------|-----------|------------|------------|----------------------|-------------------------|---|-------------------------------|
| PreTSL VIII   | Mezzanine | \$1,124    | \$395      | \$(729)              | C/C                     | 23  | 43.7                          |
| PreTSL IX     | Mezzanine | 2,690      | 1,036      | (1,654)              | Ca/C                    | 35  | 29.2                          |
| PreTSL X      | Mezzanine | 1,428      | 115        | (1,313)              | C/C                     | 36  | 44.9                          |
| PreTSL XI     | Mezzanine | 5,000      | 1,825      | (3,175)              | Ca/C                    | 49  | 23.7                          |
| PreTSL XIX    | Mezzanine | 7,118      | 2,416      | (4,702)              | B3/B                    | 53  | 23.2                          |
| PreTSL XXVI   | Senior    | 3,796      | 2,686      | (1,110)              | B1/B                    | 52  | 31.5                          |
| PreTSL XXVIII | Mezzanine | 8,455      | 1,578      | (6,877)              | Ca/CC                   | 42  | 21.2                          |

(dollars in thousands)

In accordance with EITF 99-20 and FSP 115-2, each Trust Preferred Security owned is evaluated for impairment after consideration of the specific collateral (banks) underlying each individual security, actual defaults/deferrals previously recorded on the underlying collateral, and future loss estimates.

While variances in the level of future defaults/deferrals assumptions could result in levels of stress that would be higher or lower than the base scenario, it should be noted that only future assumptions have any impact on the results and that actual credit events are recognized as losses on a timely basis.

Prepayments can occur on scheduled call dates. The following list details information for each of our securities:

|            | First Par Call Date | Original Collateral Balance | Collateral Redemptions to date |
|------------|---------------------|-----------------------------|--------------------------------|
| PreTSL VII | 01/03/08            | \$508,550,000               | \$83,750,000                   |
| PreTSL IX  | 04/03/08            | 504,030,000                 | 54,000,000                     |
| PreTSL X   | 07/03/08            | 550,645,000                 | 50,300,000                     |
| PreTSL XI  | 09/24/08            | 635,775,000                 | 34,000,000                     |
| PreTSL XIX | 09/22/10            | 700,535,000                 | 0                              |

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|               |          |             |   |
|---------------|----------|-------------|---|
| PreTSL XXVI   | 06/22/12 | 964,200,000 | 0 |
| PreTSL XXVIII | 09/22/12 | 360,850,000 | 0 |

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During the early years of PreTSL instruments, prepayments were common as issuers were able to refinance into lower costing borrowings. Since the middle of 2007, however, this option has all but disappeared and we are operating in an environment which makes early redemption of these instruments unlikely.

Lack of liquidity in the market for trust preferred collateralized debt obligations, credit rating downgrades, and market uncertainties related to the financial industry are factors contributing to the temporary impairment on these securities.

On a quarterly basis, we evaluate our trust preferred securities for other-than-temporary impairment. In 2010, \$744,000 in credit related OTTI charges have been recognized on our pooled trust preferred securities.

Our pooled trust preferred collateralized debt obligations are measured for OTTI within the scope of current accounting guidance by determining whether it is probable that an adverse change in estimated cash flows has occurred. Determining whether there has been an adverse change in estimated cash flows from the cash flows previously projected involves comparing the present value of remaining cash flows previously projected against the present value of the cash flows estimated at June 30, 2010. We consider the discounted cash flow analysis to be our primary evidence when determining whether credit related other-than-temporary impairment exists.

Estimate of Future Cash Flows – Cash flows are constructed using an INTEX cash flow model. INTEX is a proprietary cash flow model recognized as the industry standard for analyzing all types of collateralized debt obligations. It includes each deal’s structural features updated with trustee information, including asset-by-asset detail, as it becomes available. The modeled cash flows are then used to determine if all the scheduled principal and interest payments of our investments will be returned.

The table below provides a cumulative roll forward of credit losses recognized:

|   | For the Six<br>Months Ended<br>June 30, 2010 |
|---|--|
| Beginning Balance   | \$6,199                                      |
| Credit losses on debt securities for which other-than-temporary impairment was not previously recognized.       | 0  |
| Additional credit losses on debt securities for which other-than temporary impairment was previously recognized | 1,602  |
| Ending Balance  | \$7,801                                      |

OTTI analysis is derived from present value calculations which use Moody’s Analytics as a source of data. The first step is to evaluate the credit quality of the collateral and the deal structure. This process produces a set of expected cash flows that have been adjusted for expected credit events. These expected cash flows are compared to the carrying value of the security to determine OTTI.

The discount rate used is determined by adding the discount margin at the time of purchase (based on the original purchase price) to the appropriate 3-month LIBOR forward rate obtained from the forward LIBOR curve. In this manner, we are using the current yield of the individual security in our OTTI analysis in accordance with current accounting guidance.

The discount rate approach used is consistent with the effective yield method (ASC Topic 325-40-35). The effective yield for a floating rate security is the original discount margin plus the underlying index. Our OTTI approach calculates a present value of future cashflows discounted at the effective yield. We believe that this approach has the

effect of preserving the original effective yield since the rate that equates the future projected cashflows with the present value (or book value) is equal to the effective yield. Every quarter, we calculate the present value of the expected future cashflows at the effective yield and reduce the book value to that amount if it is less than the current book value.

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The valuations are calculated in two steps. The first step is to evaluate the credit quality of the collateral and the deal structure. This process produces a set of expected cash flows that have been adjusted for expected credit events (this is the credit component of the discount rate). These expected cash flows are then discounted at 3-month LIBOR plus 300 basis points (a risk free rate plus a premium for liquidity) to produce a discounted cash flow valuation. The discount rate is all-inclusive since it includes the risk free rate, a credit component, and a spread for illiquidity.

The market rate for fair value measurement is provided by Moody's Analytics using a Level 3 approach. This methodology is in accordance with SFAS 157 due to the presence of an inactive or distressed market for these types of securities. The inactivity was evidenced first by a significant widening of the bid-ask spread and then by a significant decrease in the volume of trades relative to historic levels. The new issue market is also inactive as no new trust preferred securities have been issued since 2007. Additionally, most (if not all) sellers of those securities over the past year have been forced sellers due to forced liquidation or bankruptcy.

The discount rate for securities that were previously impaired is calculated similar to the methodology stated above. The prior carrying value of the security is adjusted for previous impairment charges, and the present value of cash flows is used to determine additional impairment.

Future deferrals/defaults are projected to approximate the long-term performance of FDIC regulated banks. Actual deferrals/defaults are recognized as a loss immediately. For current deferrals, our projections incorporate a 50% anticipated recovery with a two year lag. There are no recoveries projected on defaults.

Future deferrals/defaults are also reviewed by using the participating bank's Texas ratio as a determination of bank failures. The Texas ratio is a measure of a bank's credit troubles. It is calculated by dividing the value of the lender's non-performing assets (Non performing loans + Real Estate Owned) by the sum of its tangible common equity capital and loan loss reserves. All banks with a ratio over the target level of 100 are projected to fail immediately with no recovery assumed whether the bank is currently in deferral or default. Currently performing banks with a ratio over the target level are projected to pay for two additional quarters before failing. No pre-payments are assumed and current deferring banks with a ratio under the target level are projected with a fifteen percent recovery. This bottom-up analysis reviews the individual bank collateral by each bank's Texas ratio with a default failure rate for each bank that exceeds the target ratio. This analysis provides varying deferral/default rates as it is customized to the individual banks in each pool.

Subordination represents the amount of performing collateral that is in excess of what is needed to payoff a specified class of bonds and all classes senior to the specified class. It can also be referred to as credit enhancement. The coverage ratio, or overcollateralization, of a specific security measures the rate of performing collateral to a given class of notes. It is calculated by dividing the performing collateral in a deal by the current balance of the class of notes plus all classes senior to that class. In the table below, the information pertinent to the excess subordination is disclosed along with historical credit related impairment for each of our pooled trust preferred securities:

| Deal        | Performing Collateral  | Bonds Outstanding | Excess Collateral | Coverage Ratio | Excess Subord-ination | Credit Impairment, this period | Credit Impairment, Cumulative |
|-------------|------------------------|-------------------|-------------------|----------------|-----------------------|--------------------------------|-------------------------------|
|             | (dollars in thousands) |                   |                   |                |                       |                                |                               |
| PreTSL VIII | \$241,094              | \$394,862         | \$(153,768)       | 61.1           | N/A                   | \$0                            | \$0                           |
| PreTSL IX   | 322,930                | 420,380           | (97,450)          | 76.8           | N/A                   | 0                              | 82                            |
| PreTSL X    | 280,186                | 466,770           | (186,584)         | 60.0           | N/A                   | 20                             | 522                           |
| PreTSL XI   | 464,550                | 558,347           | (93,797)          | 83.2           | N/A                   | 0                              | 0                             |
| PreTSL XIX  | 540,915                | 550,573           | (9,658)           | 98.3           | N/A                   | 81                             | 81                            |
| PreTSL XXVI | 663,432                | 637,921           | 25,511            | 104.0          | 3.85%                 | 59                             | 59                            |

|                       |         |         |          |      |     |       |       |
|-----------------------|---------|---------|----------|------|-----|-------|-------|
| P r e T S L<br>XXVIII | 285,273 | 316,600 | (31,327) | 90.1 | N/A | 0     | 0     |
|                       |         |         |          |      |     | \$160 | \$744 |

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FASB ASC 820 defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles, and expands disclosures about fair value measurements.

ASC 820 established a fair value hierarchy that prioritizes the inputs to valuation techniques used to measure fair value. The hierarchy gives the highest priority to unadjusted quoted prices in active markets for identical assets or liabilities (level 1 measurements) and the lowest priority to unobservable inputs (level 3 measurements). The three levels of the fair value hierarchy under SFAS No. 157 are described below:

Basis of Fair Value Measurement

Level 1                      Unadjusted quoted prices in active markets that are accessible at the measurement date for identical, unrestricted assets or liabilities;

Level 2                      Quoted prices in markets that are not active, or inputs that are observable either directly or indirectly, for substantially the full term of the asset or liability;

Level 3                      Prices or valuation techniques that require inputs that are both significant to the fair value measurement and unobservable (i.e., supported by little or no market activity).

Fair values of assets and liabilities measured on a recurring basis at June 30, 2010 and December 31, 2009 are as follows (dollars in thousands):

|                               | Fair Value | Fair Value Measurements at Reporting Date Using  |   |  |
|-------------------------------|------------|--|---|--|
|                               |            | Quoted Prices<br>In<br>Active<br>Markets<br>for Identical<br>Assets/<br>Liabilities<br>(Level 1) | Significant<br>Other<br>Observable<br>Inputs<br>(Level 2) | Significant<br>Unobservable<br>Inputs<br>(Level 3) |
| <b>June 30, 2010</b>          |            |  |   |  |
| Available-for-sale securities | \$260,256  | \$250,204  | \$0   | \$10,052   |
| <b>December 31, 2009</b>      |            |  |   |  |
| Available-for-sale securities | \$259,955  | \$249,136  | \$0   | \$10,819   |



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Available-for-sale securities measured at fair value on a recurring basis using significant unobservable inputs (Level 3) (dollars in thousands):

|   |          |
|---|----------|
| January 1, 2009                             | \$17,652 |
| Total gains or losses (realized/unrealized) |          |
| Included in earnings                        | (4,724)  |
| Included in other comprehensive income      | (2,109)  |
| Purchases, issuance, and settlements        | 0        |
| Transfers in and/or out of Level 3          | 0        |
| December 31, 2009                           | 10,819   |
| Total gains or losses (realized/unrealized) |          |
| Included in earnings                        | (744)    |
| Included in other comprehensive income      | (23)     |
| Purchases, issuance, and settlements        | 0        |
| Transfers in and/or out of Level 3          | 0        |
| June 30, 2010                               | \$10,052 |

|  |         |
|--|---------|
| The amount of total gains or losses for the year ended December 31, 2009 included in earnings attributable to the change in unrealized gains or losses relating to assets still held at the reporting date | \$4,724 |
|--|---------|

|  |       |
|--|-------|
| The amount of total gains or losses for the period ended June 30, 2010 included in earnings attributable to the change in unrealized gains or losses relating to assets still held at the reporting date | \$744 |
|--|-------|

Gains and losses (realized and unrealized) included in earnings for the period are reported in other income as follows (dollars in thousands):

|  |         |
|--|---------|
| June 30, 2010  |         |
| Total gains or losses included in earnings for the year                        | \$744   |
| Change in unrealized gains or losses relating to assets still held at year end | \$0     |
| December 31, 2009  |         |
| Total gains or losses included in earnings for the year                        | \$4,724 |
| Change in unrealized gains or losses relating to assets still held at year end | \$0     |

As of June 30, 2010, the Company owned \$29,612,000 collateralized debt obligation securities that are backed by trust preferred securities issued by banks, thrifts, and insurance companies (TRUP CDOs). The market for these securities at June 30, 2010 is not active and markets for similar securities are also not active. The inactivity was evidenced first by a significant widening of the bid-ask spread in the brokered markets in which TRUP CDOs trade and then by a significant decrease in the volume of trades relative to historical levels. The new issue market is also inactive as no new TRUP CDOs have been issued since 2007. There are currently very few market participants who are willing and or able to transact for these securities.

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The market values for these securities (and any securities other than those issued or guaranteed by the US Treasury) are very depressed relative to historical levels. For example, the yield spreads for the broad market of investment grade and high yield corporate bonds reached all time wide levels versus Treasuries at the end of November 2008 and remain near those levels today. Thus in today's market, a low market price for a particular bond may only provide evidence of stress in the credit markets in general versus being an indicator of credit problems with a particular issuer.

Given conditions in the debt markets today and the absence of observable transactions in the secondary and new issue markets, we determined:

- The few observable transactions and market quotations that are available are not reliable for purposes of determining fair value at June 30, 2010;
- An income valuation approach technique (present value technique) that maximizes the use of relevant observable inputs and minimizes the use of unobservable inputs will be equally or more representative of fair value than the market approach valuation technique used at prior measurement dates; and
- Our TRUP CDOs are classified within Level 3 of the fair value hierarchy because we determined that significant adjustments are required to determine fair value at the measurement date.

The Company's TRUP CDO valuations were prepared by Moody's Analytics, an independent third party. Their approach to determining fair value involved these steps:

1. The credit quality of the collateral is estimated using average probability of default values for each issuer (adjusted for rating levels);
2. The default probabilities also considered the potential for correlation among issuers within the same industry (e.g. banks with other banks);
  3. The loss given default was assumed to be 95% (i.e. a 5% recovery);
4. The cash flows were forecast for the underlying collateral and applied to each CDO tranche to determine the resulting distribution among the securities;
  5. The expected cash flows were discounted to calculate the present value of the security;
6. The calculations were modeled in several thousand scenarios using a Monte Carlo engine and the average price was used for valuation purposes; and
7. Moody's Analytics used 3-month LIBOR (USD) plus 300 basis points as a discount rate for this analysis. The discount rate used is highly dependent upon the credit quality of the collateral, the relative position of the tranche in the capital structure of the CDO and the prepayment assumptions.

As of June 30, 2010, an unrealized loss of \$19,560,000 was recognized in accordance with FASB ASC 320 on TRUP CDOs utilizing the above mentioned methodology.

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## Loans:

The following table sets forth detailed information concerning the composition of the company's loan portfolio as of the dates specified (in thousands):

|                                   | June 30, 2010 |       | December 31, 2009 |       |
|-----------------------------------|---------------|-------|-------------------|-------|
|                                   | Amount        | %     | Amount            | %     |
| Residential Real Estate           | \$133,159     | 14.9  | \$137,409         | 14.5  |
| Commercial Real Estate            | 387,534       | 43.2  | 415,940           | 43.8  |
| Commercial & Industrial           | 217,729       | 24.3  | 231,766           | 24.4  |
| Installment                       | 117,308       | 13.1  | 128,392           | 13.5  |
| Other                             | 39,211        | 4.5   | 36,617            | 3.8   |
| Total Gross Loans                 | \$894,941     | 100.0 | \$950,124         | 100.0 |
| Less: Allowance for Credit Losses | (20,577)      |       | (22,502)          |       |
| Less: Unearned Discount           | (261)         |       | (298)             |       |
| Net Loans                         | \$874,103     |       | \$927,324         |       |

The company's net loan portfolio declined \$53.2 million during the first half of 2010 from \$927.3 million as of December 31, 2009 to \$874.1 million as of June 30, 2010. Within the portfolio, the only category showing an increase during the first half of the year was other loans, which includes obligations of state and municipal governments. All other categories decreased during this time period. Commercial lending activities continue to represent the largest portion of the company's loan portfolio, totaling 67.6% of total gross loans as of June 30, 2010, which is a slight decrease from 68.2% as of December 31, 2009. Additionally, a majority of the company's loan portfolio continues to be secured by real estate (58.2% of total gross loans as of June 30, 2010 and December 31, 2009).

Commercial and industrial loans decreased \$14.0 million from \$231.8 million as of December 31, 2009 to \$217.8 million as of June 30, 2010. Commercial and industrial loans consist primarily of equipment loans, permanent working capital financing, revolving lines of credit and loans secured by cash and marketable securities. Loans secured by commercial real estate decreased \$28.4 million from \$415.9 million as of December 31, 2009 to \$387.5 million as of June 30, 2010. Commercial real estate loans include long-term commercial mortgage financing, construction loans and land development loans, and are primarily secured by first or second lien mortgages. The decrease in commercial real estate loans is attributable to some large loan payoffs, significant charge-offs and transfers to other real estate.

All other loans, which include obligations of state and municipal governments, totaled \$39.2 million as of June 30, 2010. This represents an increase from \$36.6 million as of December 31, 2009. The increase is primarily a result of tax anticipation notes issued to municipal governments that are issued for one year terms or less.

Residential real estate loans totaled \$133.2 million as of June 30, 2010. This represents a decrease of \$4.2 million, or 3%, from \$137.4 million as of December 31, 2009. The components of residential real estate loans include fixed rate mortgage loans sold in the secondary market, and home equity loans and lines of credit. The company continues to adhere to a philosophy of underwriting fixed rate purchase and refinance residential mortgage loans that are generally sold in the secondary market to reduce interest rate risk and provide funding for additional loans. Installment loans decreased \$11.1 million during the first half of 2010, or 9%, from \$128.4 million as of December 31, 2009 to \$117.3 million as of June 30, 2010. The decrease in installment loans is due primarily to run-off in the company's indirect auto loan portfolio.

## Asset Quality

The company manages credit risk through the efforts of loan officers, loan review personnel, loan quality and risk management committees and oversight from the board of directors, along with the application of policies and procedures designed to foster sound underwriting and credit monitoring practices. The company continually evaluates this process to ensure it is reacting to problems in the loan portfolio in a timely manner. Although, as is the case with any financial institution, a certain degree of credit risk is dependent in part on local and general economic conditions that are beyond the company's control.

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Under the company's grading system, loans graded as special mention, substandard, doubtful or loss are reviewed regularly as part of the company's risk management practices. The company's risk management committee meets quarterly or more often as required and makes recommendations to the board of directors regarding provisions for credit losses. The committee reviews individual problem credits and ensures that ample reserves are established. The methodology utilized for the provision for credit losses was improved during 2009 to include enhanced measurement processes.

Non-performing assets are comprised of impaired and nonaccrual loans, loans past due 90 days or more and still accruing, and other real estate owned. Loans are generally placed in nonaccrual status when a default of interest or principal has existed for 90 days or more, or for which payment in full of principal and interest is not expected. When interest accrual is discontinued, interest previously accrued but not received is charged to current period earnings. Any payments received are applied, first to the outstanding loan amounts, then to the recovery of any charged-off loan amounts. Any excess is treated as a recovery of lost interest.

Under current accounting guidelines, a loan is impaired when it is probable that the bank will be unable to collect all amounts due (including principal and interest) according to the contractual terms of the loan agreement. A loan is generally considered to be impaired if it exhibits the same level of weaknesses and probability of loss as loans classified doubtful or loss in the bank's grading system. For purposes of the company's analysis, loans which are doubtful are considered impaired. In addition, the company considers loans which are rated substandard and on nonaccrual to be impaired. As of June 30, 2010, the recorded investment in loans for which impairment has been recognized totaled \$44.7 million. The allowance for credit losses related to these loans was \$9.3 million.

All impaired loans are analyzed individually for the amount of impairment. Current accounting guidelines allow several methods for the determination of impairment. The Company generally utilizes the fair value of collateral method, as this is the preferred method for collateral dependent loans which make up the majority of the company's impaired loans. A loan is considered to be collateral dependent when repayment of the loan is anticipated to come from the liquidation of the collateral held. To determine the fair value of the collateral, the company generally utilizes external appraisals. For loans that are recognized as impaired, external appraisals are to be obtained at a minimum annually, or more frequently as warranted, to ascertain a current market value so that the impairment analysis can be updated. However, it is the company's policy to utilize all available information, including current letters of intent, broker price opinions or executed agreements of sale to determine a current fair value of the collateral.

Under the fair value of collateral method, an allocation is made to the allowance for the difference between the loan balance and the net realizable value of the collateral. For the Company's calculations, a factor of 10% is typically utilized to estimate costs to sell, which is based on typical cost factors, such as a 6% broker commission, 2% transfer taxes, and various other miscellaneous costs associated with the sales process. For loans which are considered to be impaired, but for which the appraised value (minus costs to sell) exceeds the loan value, the impairment is considered to be zero.

The following table presents information about the company's non-performing assets for the periods indicated (in thousands):

|   | June 30, 2010 | December 31,<br>2009 |
|---|---------------|----------------------|
| Non-performing loans:                             |               |                      |
| Impaired / nonaccrual loans                       | \$41,497      | \$36,048             |
| Loans past due 90 days or more and still accruing | 0             | 646                  |
| Total non-performing loans                        | 41,497        | 36,694               |
| Other Real Estate Owned                           | 15,022        | 11,184               |



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|   |          |          |
|---|----------|----------|
| Total non-performing assets                           | \$56,519 | \$47,878 |
| Non-performing loans as a percentage of gross loans   | 4.6%     | 3.9%     |
| Non-performing assets as a percentage of total assets | 4.2%     | 3.4%     |
| Total ALLL as a percentage of non-performing loans    | 49.6%    | 61.3%    |

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Total non-performing assets increased \$8.6 million during the first half of 2010, from \$47.8 million as of December 31, 2009 to \$56.5 million as of June 30, 2010, as the effects of the severe and prolonged economic downturn continued to impact individual and business customers of the company. Included in non-performing assets are non-accrual loans and impaired loans, which totaled \$41.5 million as of June 30, 2010, an increase from \$36.0 million as of December 31, 2009.

The company is actively monitoring the loan portfolio and continues to aggressively address problem situations. Management is diligently working to improve the loan portfolio and reduce non-performing loans.

Reclassifications of non-performing loans during the first half of 2010 primarily consisted of four (4) large credits totaling \$4.3 million. These credits are:

- \$6,782,000 – This credit represents various time loans secured by land; \$1.4 million of the allowance for loan losses is allocated to this credit.
- \$2,233,000 – This credit represents the non-sold portion of a government guaranteed loan secured by commercial real estate; due to sufficient collateral value, no allocation is provided for this credit in the allowance for loan losses.
- \$2,056,000 – This credit represents a time loan secured by residential and commercial real estate; \$888 thousand of the allowance for loan losses is allocated to this credit.
- \$1,800,000 – This credit represents a term loan and line of credit secured by commercial real estate; \$180 thousand of the allowance for loan losses is allocated to this credit.

Other Real Estate Owned totaled \$15.0 million as of June 30, 2010, which is an increase of \$3.8 million from \$11.1 million as of December 31, 2009. As of June 30, 2010, other real estate owned consists of fifteen (15) properties. Seven (7) of the properties held in other real estate owned as of June 30, 2010 represent approximately 96% of the total. Included in other real estate owned are two properties totaling \$2.7 million, or 18%, of other real estate owned, that are located outside of the company's general market area. Additionally, \$8.1 million, or 54%, of other real estate owned is located in a specific region located within the company's primary market area that has been particularly hard hit during this protracted economic recession.

The company is actively marketing these properties for sale through a variety of channels including internal marketing and the use of outside brokers/realtors. The carrying value of other real estate owned is generally calculated at an amount not greater than 90% of the most recent fair market appraised value. This market value is updated on an annual basis. However, adjustments will be made as other valuation sources become available, including letters of intent, broker price opinions and executed agreements of sale. Further deterioration in the real estate market could result in additional losses on these properties. Recognition of the gain or loss from the sale of other real estate owned is identified in a separate line item on the company's income statement. Additionally, expenses associated with other real estate owned are listed as a separate category in other expenses on the company's income statement.

The following schedule reflects a breakdown of other real estate owned for the periods reviewed.

|                               | June 30, 2010 | December 31,<br>2009 |
|-------------------------------|---------------|----------------------|
| Land / Lots                   | \$ 9,081      | \$ 5,887             |
| Commercial Real Estate        | 5,374         | 4,852                |
| Residential Real Estate       | 567           | 445                  |
| Total Other Real Estate Owned | \$15,022      | \$11,184             |

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A recap of delinquency within the company's loan portfolio is provided below.

|                     | June 30, 2010 | December 31,<br>2009 |
|---------------------|---------------|----------------------|
| 30-59 days          | .61%          | .40%                 |
| 60-89 days          | .40%          | .05%                 |
| 90 + days           | .00%          | .07%                 |
| Non-Accrual         | 4.64%         | 3.79%                |
| Total Delinquencies | 5.65%         | 4.31%                |

As previously indicated, the increase in delinquencies in the periods reviewed is primarily related to the downturn in the economy and its impact on the company's borrowers.

#### Provision for Credit Losses:

The provision for credit losses is analyzed in accordance with GAAP and varies from year to year based on management's evaluation of the adequacy of the allowance for credit losses in relation to the risks inherent in the loan portfolio. During 2009, the Allowance for Loan and Lease Losses (ALLL) methodology was revised to include an enhanced impairment measurement process. Enhancements were also made to the historical loss / migration analysis, including a more defined loan pool analysis and detailed migration adjustment factors. The Company retained outside consultants to evaluate and help revise its procedures in computing the Allowance for Loan and Lease Losses (ALLL). Revisions to the ALLL methodologies were complete and in effect for the December 31, 2009 calculations. By implementing these enhancements, the company greatly improved its ALLL analysis and methodology.

An allocation of \$9.3 million was determined for impaired loans under SFAS 114, which accounted for 45.1% of the total allocation of \$20.6 million at June 30, 2010. An allocation of \$11.3 million was also established for loans analyzed under SFAS 5, which accounted for 54.9% of the total allocation of \$20.6 million.

At March 31, 2010, an allocation of \$13.1 million was determined for impaired loans under SFAS 114, which accounted for 56.3% of the total allocation of \$23.3 million. An allocation of \$10.1 million was calculated for loans analyzed under SFAS 5, which accounted for 43.7% of the total allocation of \$23.3 million at March 31, 2010.

At December 31, 2009, an allocation of \$12.4 million was determined for impaired loans under SFAS 114, which accounted for 55.2% of the total allocation of \$22.5 million. An allocation of \$10 million was calculated for loans analyzed under SFAS 5, which accounted for 44.8% of the total allocation of \$22.5 million at December 31, 2009.

The ratio of the loan loss reserve to total loans at June 30, 2010, March 31, 2010 and December 31, 2009 was 2.30%, 2.47% and 2.37%, respectively.

Under the impairment measurement process, all doubtful and substandard, non-accrual loans are considered to be impaired and are analyzed individually to determine the amount of impairment. Construction delays, declining real estate values, and the inability of the borrowers to make scheduled payments have resulted in these loan relationships being classified as impaired. The fair value of collateral method is generally used to perform this measurement. Appraisals are received annually, or more often if deemed necessary, to ensure adequate impairment measurements reflecting current market conditions. Should a current appraisal not be available at the time of impairment analysis, current Letters of Intent, Broker Price Opinions, or executed agreements of sale would be used if such an item would exist. Only downward adjustments are made based on these supporting values. Included in all impairment calculations is a cost to sell adjustment of 10%, which is comprised of typical cost factors, including a 6% broker commission, 2% transfer taxes, and various other miscellaneous costs associated with the sales

process. ALLL analyses are adjusted in concurrence with events that may arise subsequent to the end of a quarter, but before financial information is filed.

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In its historical loss / migration analysis evaluation, loans are analyzed by industry concentration and loan type. Management measures the effects of various qualitative factors on each of these loan segments. The factors include changes in lending policies and procedures, changes in concentrations of credit, changes in the nature and volume of the portfolio, changes in the volume and severity of delinquencies, classified and non accrual loans, changes in competition and legal and regulatory environments, management capabilities, current local and national economic trends, peer group information, changes in loan review methodology and Board of Directors oversight, as well as various other factors. Consideration is also given to examinations performed by regulatory authorities and the company's independent accountants.

These evaluations are intrinsically subjective, as the results are estimated based on management knowledge and experience and are subject to interpretation and modification as information becomes available or as future events occur. Management monitors the loan portfolio on an ongoing basis. With current forces including real estate market declines and a weakened economy affecting loan repayment, management is more diligently focused on risk management. Adjustments to the monthly provision and / or quarterly allowance for loan loss are made based on management's assessment of the factors noted above.

Management is prepared for continued negative trends in this difficult economic environment and real estate market. Management continues to aggressively manage impaired loans in an effort to reduce loan balances through concerted efforts with affected customers to develop strategies to resolve borrower issues, through sale or liquidation of collateral, foreclosure, or other means to reduce the bank's exposure to impaired loans. If real estate values continue to decline, it is more likely that we would be required to further increase our allowance for loan losses, which in turn, could result in reduced earnings.

The following table sets forth certain information with respect to the company's allowance for credit losses and charge-offs (in thousands)

|                             | Six months Ended<br>June 30, 2010 | Year to date<br>Ended December<br>31, 2009 |
|-----------------------------|-----------------------------------|--|
| Balance, January 1          | \$22,502                          | \$8,254                                    |
| Recoveries Credited         | 100                               | 133  |
| Losses Charged              | (9,787)                           | (17,835)                                   |
| Provision for Credit Losses | 7,762                             | 31,950                                     |
| Balance at End of Period    | \$20,577                          | \$22,502                                   |

A monthly provision of \$500,000 was credited to the allowance for loan and lease losses for the first six months of 2010. In addition, a \$3.5 million insertion was made to bring the June 30, 2010 reserve balance to an adequate level of \$20.6 million based on management's analysis and assessment of the loan portfolio. The company recorded total provisions for loan losses of \$7.8 million for the first six months of 2010 in order to adequately provide for potential losses, compared to a provision of \$7.3 million for the same period ended June 30, 2009. The increases in the provision for loan losses are primarily a result of the prolonged deterioration in the economy along with a variety of other factors. These issues directly caused an increase in non-performing assets and net charge-offs primarily in the commercial real estate portfolio.

The increase in non-performing assets is primarily concentrated in land development loans. Declines in real estate values, along with a decrease in demand for new home construction have led to this increase. In each case, real estate collateral provides for an alternate source of repayment in the event of default by the borrower. Management continues to monitor real estate values, which may continue to deteriorate in this real estate market and result in a further increase in impaired loans and / or charge-offs.

The downturn in the real estate market has resulted in increased loan delinquencies, defaults and foreclosures, primarily in the commercial real estate portfolio. Delinquencies net of non accrual loans were 1.01% of total loans at June 30, 2010. Non accrual loans totaled \$40.1 million at June 30, 2010. During the second quarter of 2010, thirty-five (35) borrowers with loan balances totaling \$13.5 million were reclassified to non accrual status. Of these thirty-five (35) borrowers, five (5) borrowers accounted for \$11.7 million, or 86.7%. Updated real estate appraisals are obtained on all non-performing loans secured by real estate.

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Net charge-offs totaled \$9.7 million for the six month period ended June 30, 2010, of which \$7.8 million or 80.4% resulted from the charge down of land subdivision loans. The decline in real estate markets was primarily responsible for over \$17 million of net charge-offs taken in 2009. The majority of the 2009 charge-offs resulted from participations in a small number of out of area real estate bridge loans made to Non-Bank related customers. At the time these loans were issued, the Bank was looking to expand into other market areas and spread risk. The decision to participate in these credit facilities was based upon very favorable market conditions, substantial equity positions, excellent loan to value ratios, fee income, and above average interest rates at the time these loans were approved. Management has since made a decision to no longer participate in out of area loans.

#### Asset/Liability Management, Interest Rate Sensitivity and Inflation

The major objectives of the company's asset and liability management are to (1) manage exposure to changes in the interest rate environment to achieve a net interest income within reasonable ranges, (2) ensure adequate liquidity and funding, and (3) maintain a strong capital base. The bank manages these objectives through its Senior Management and Asset and Liability Management Committees. Members of the committees meet regularly to develop balance sheet strategies affecting the future level of net interest income, liquidity and capital. Items that are considered in asset and liability management include balance sheet forecasts, the economic environment, the anticipated direction of interest rates and the bank's earnings sensitivity to changes in these rates.

The company analyzes its interest sensitivity position to manage the risk associated with interest rate movements through the use of gap analysis and simulation modeling. Because of the limitations of the gap reports, the bank uses simulation modeling to project future net interest income streams incorporating the current "gap" position, the forecasted balance sheet mix, and the anticipated spread relationships between market rates and bank products under a variety of interest rate scenarios.

Economic conditions affect financial institutions, as they do other businesses, in a number of ways. Rising inflation affects all businesses through increased operating costs but affects banks primarily through the manner in which they manage their interest sensitive assets and liabilities in a rising rate environment. Economic recession can also have a material effect on financial institutions as the assets and liabilities affected by a decrease in interest rates must be managed in a way that will maximize the largest component of a bank's income, that being net interest income. Recessionary periods may also tend to decrease borrowing needs and increase the uncertainty inherent in the borrowers' ability to pay previously advanced loans. Additionally, reinvestment of investment portfolio maturities can pose a problem as attractive rates are not as available. Management closely monitors the interest rate risk of the balance sheet and the credit risk inherent in the loan portfolio in order to minimize the effects of fluctuations caused by changes in general economic conditions.

#### Liquidity

The term liquidity refers to the ability of the company to generate sufficient amounts of cash to meet its cash-flow needs. Liquidity is required to fulfill the borrowing needs of the bank's credit customers and the withdrawal and maturity requirements of its deposit customers, as well as to meet other financial commitments.

The short-term liquidity position of the company is strong as evidenced by \$82.7 million in cash and cash equivalents. A secondary source of liquidity is provided by the investment portfolio with \$29.7 million or 10% of the portfolio maturing or expected to provide cash flow within one year through maturities, projected calls or principal reductions.

The company's focus is on retail deposits as a source of funds, although short-term needs can be funded with municipal deposits. The bank has the ability to sell Federal funds to invest excess cash; however, the bank can also



borrow in the Federal Funds market to meet temporary liquidity needs. Other sources of potential liquidity include Federal Home Loan Bank advances, the Federal Reserve Discount Window, CDARS deposits and the Brokered CD market.

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## Capital Management

A strong capital base is essential to the continued growth and profitability of the company and in that regard the maintenance of appropriate levels of capital is a management priority. The company's principal capital planning goal is to provide a sufficient base to support current and future operations, while complying with all regulatory standards. As more fully described in Note 15 to the year end audited financial statements, regulatory authorities have prescribed specified minimum capital ratios as guidelines for determining capital adequacy to help insure the safety and soundness of financial institutions.

Total stockholders' equity increased \$2.358 million, or 3%, during the first six months of 2010 comprised of increases in retained earnings in the amount of \$209,000, \$113,000 from stock issued through Dividend Reinvestment and Stock Options, and \$2.036 million in accumulated other comprehensive income. During the first six months of 2010, the company recognized a \$1.6 million impairment charge on investment securities due to an Other-Than-Temporary-Impairment (OTTI). The entire \$1.6 million was considered a credit impairment and was charged to earnings. During the same period of 2009, total stockholders' equity decreased \$178,000 comprised of a decrease in retained earnings of \$1.065 million after paying cash dividends, \$1.106 million from stock issued through Dividend Reinvestment, Stock Option awards of \$159,000 and a \$378,000 decrease in accumulated other comprehensive income. During the second quarter of 2009, the company recognized a \$382,000 impairment charge on investment securities due to an Other-Than-Temporary-Impairment (OTTI).

The Board of Directors has voted to suspend payment of the company's quarterly dividend indefinitely in an effort to conserve capital. The Board recognizes the importance of preserving cash and, given the challenging economic conditions that continue to impact the health and stability of many businesses within the region we serve. Suspending the \$0.02 per share dividend will save the company approximately \$1.3 million. The Board will reevaluate the policy in the future on a quarter-by-quarter basis. The total dividend payout during the first six months of 2009 represented \$.13 per share. Excluding the impact due to securities valuation, core equity increased \$322,000 and \$200,000 during the first six months of 2010 and 2009, respectively.

The dividend suspension is among several initiatives in place to conserve cash reserves and the company's capital base during the nation's protracted economic slump. The company recently announced it had raised \$25 million through the sale of subordinated notes which will mature on September 1, 2019. The net proceeds of the completed sale will be used to strengthen the institution's capital position, improve liquidity, increase lending capacity and support the company's continuing growth objectives.

The Board of Governors of the Federal Reserve System and other various regulatory agencies have specified guidelines for purposes of evaluating a bank's capital adequacy. Currently, banks must maintain a leverage ratio of core capital to total assets at a prescribed level, namely 3%. In addition, bank regulators have issued risk-based capital guidelines. Under such guidelines, minimum ratios of core capital and total qualifying capital as a percentage of risk-weighted assets and certain off-balance sheet items of 4% and 8% are required. As of June 30, 2010, the company and the bank met all capital requirements.

Effective September 1, 2009, the company offered only to accredited investors (as defined by SEC Rule 501(a)) up to \$25,000,000 principal amount of Subordinated Notes Due 2019 at a fixed interest rate of 9% per annum (the "Notes") in denominations of \$100,000 and integral multiples of \$100,000 in excess thereof. The Notes will mature on September 1, 2019. For the first five years from issuance, the company will pay interest only on the Notes. Commencing September 1, 2015, the company will pay interest and a portion of the principal calculated to return the entire principal amount of the Notes at maturity. Payments of interest will be payable to registered holders of the Notes (the "Noteholders") quarterly on the first of every third month beginning on December 1, 2009. Payments of principal will be payable to the Noteholders annually beginning on September 1, 2015. The Notes will be issued in registered form and without coupons.

The Notes are unsecured obligations of the company and are subordinate in right of payment to the company's senior indebtedness. Neither the company nor the bank has guaranteed payment of interest and principal on the Notes. The Notes will not be subject to a trust indenture with an independent trustee and, upon default, the Noteholders will have no special remedy against the company. The Notes will not be rated by a nationally recognized statistical rating organization.

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The following table presents information regarding the Company's risk-based capital at June 30, 2010:

|  | First National<br>Community Bank |         | First National<br>Community Bancorp,<br>Inc. |         |
|--|----------------------------------|---------|--|---------|
|  | Amount                           | Ratio   | Amount                                       | Ratio   |
| <b>Actual:</b>   |                                  |         |  |         |
| Total Capital (to Risk Weighted Assets)                                  | \$145,877                        | 12.62%  | \$149,864                                    | 12.96%  |
| Tier I Capital (to Risk Weighted Assets)                                 | \$131,337                        | 11.36%  | \$110,320                                    | 9.54%   |
| Tier I Capital (to Average Assets)                                       | \$131,337                        | 9.69%   | \$110,320                                    | 8.10%   |
| <b>For Capital Adequacy Purposes:</b>                                    |                                  |         |  |         |
| Total Capital (to Risk Weighted Assets)                                  | >\$92,479                        | >8.00%  | >\$92,507                                    | >8.00%  |
| Tier I Capital (to Risk Weighted Assets)                                 | >\$46,240                        | >4.00%  | >\$46,254                                    | >4.00%  |
| Tier I Capital (to Average Assets)                                       | >\$54,221                        | >4.00%  | >\$54,509                                    | >4.00%  |
| <b>To Be Well Capitalized Under Prompt Corrective Action Provisions:</b> |                                  |         |  |         |
| Total Capital (to Risk Weighted Assets)                                  | >\$115,599                       | >10.00% | >\$115,634                                   | >10.00% |
| Tier I Capital (to Risk Weighted Assets)                                 | >\$69,360                        | >6.00%  | >\$69,380                                    | >6.00%  |
| Tier I Capital (to Average Assets)                                       | >\$67,776                        | >5.00%  | >\$68,136                                    | >5.00%  |

**Disclosures about Fair Value of Financial Instruments:**

Current accounting pronouncements require quarterly disclosure of estimated fair value of on-and off-balance sheet financial instruments beginning with the period ending after June 15, 2009.

The following methods and assumptions were used to estimate the fair value of each class of financial instruments for which it is practicable to estimate that value:

**Cash and short-term investments:**

Cash and short-term investments include cash on hand, amounts due from banks, and federal funds sold. For these short-term instruments, the carrying amount is a reasonable estimate of fair value.

**Securities:**

For securities held for investment purposes, the fair values have been individually determined based on currently quoted market prices. If a quoted market price is not available, fair value is estimated using quoted market prices for similar securities.

**Loans:**

The fair value of loans has been estimated by discounting the future cash flows using the current rates which similar loans would be made to borrowers with similar credit ratings and for the same remaining maturities.

**Deposits:**

The fair value of demand deposits, savings deposits, and certain money market deposits is the amount payable on demand at the reporting date. The fair value of fixed-maturity certificates of deposit is estimated using the rates currently offered for deposits of similar remaining maturities.

**Borrowed funds:**

Rates currently available to the bank for debt with similar terms and remaining maturities are used to estimate fair value of existing debt.

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**Commitments to extend credit and standby letters of credit:**

The fair value of commitments is estimated using the fees currently charged to enter into similar agreements, taking into account the remaining terms of the agreements and the present creditworthiness of the counterparties. For fixed-rate loan commitments, fair value also considers the difference between current levels of interest rates and the committed rates. The fair value of letters of credit is based on fees currently charged for similar agreements or on the estimated cost to terminate them or otherwise settle the obligations with the counterparties at the reporting date.

The estimated fair values of the company's financial instruments (in thousands) are as follows:

|  | June 30, 2010  |             | December 31, 2009 |             |
|--|----------------|-------------|-------------------|-------------|
|  | Carrying Value | Fair Value  | Carrying Value    | Fair Value  |
| <b>FINANCIAL ASSETS</b>                                    |                |             |                   |             |
| Cash and short term investments                            | \$82,720       | \$82,720    | \$86,364          | \$86,364    |
| Securities   | 274,326        | 274,250     | 273,633           | 273,522     |
| Gross Loans  | 894,680        | 902,089     | 949,826           | 955,369     |
| <b>FINANCIAL LIABILITIES</b>                               |                |             |                   |             |
| Deposits   | \$1,021,779    | \$1,026,221 | \$1,071,608       | \$1,076,700 |
| Borrowed funds   | 211,093        | 213,606     | 217,467           | 220,434     |
| <b>OFF-BALANCE SHEET FINANCIAL INSTRUMENTS</b>             |                |             |                   |             |
| Commitments to extend credit and standby letters of credit | \$0            | \$353       | \$0               | \$783       |

**Recent Developments****Dodd-Frank Wall Street Reform and Consumer Protection Act**

On July 21, 2010, President Obama signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Act"). The Act will result in sweeping financial regulatory reform aimed at strengthening the nation's financial services sector.

The Act's provisions that have received the most public attention generally have been those applying to larger institutions or institutions that engage in practices in which we do not engage. These provisions include growth restrictions, credit exposure limits, higher prudential standards, prohibitions on proprietary trading, and prohibitions on sponsoring and investing in hedge funds and private equity funds.

However, the Act contains numerous other provisions that likely will directly impact us and our banking subsidiary. These include increased fees payable by banks to regulatory agencies, new capital guidelines for banks and bank holding companies, permanently increasing the FDIC insurance coverage from \$100,000 to \$250,000 per depositor, new liquidation procedures for banks, new regulations affecting consumer financial products, new corporate governance disclosures and requirements and the increased cost of supervision and compliance more generally. Many aspects of the law are subject to rulemaking by various government agencies and will take effect over several years. This time table, combined with the Act's significant deference to future rulemaking by various regulatory agencies, makes it difficult for us to anticipate the Act's overall financial, competitive and regulatory impact on us, our customers, and the financial industry more generally.

**ITEM 3 – QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

There has been no material change in the company's exposure to market risk during the first six months of 2010. For discussion of the company's exposure to market risk, refer to Item 7A, Quantitative and Qualitative Disclosure about Market Risk, contained in the company's Annual Report incorporated by reference in Form 10-K for the year ended December 31, 2009.

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#### ITEM 4 – CONTROLS AND PROCEDURES

Subsequent to filing our Form 10-Q for the quarter ended March 31, 2010, the company determined that disclosure controls and procedures were not effective as of March 31, 2010 due to missing disclosures regarding the enhancement of our impairment measurement process and historical loss/migration analysis, including a more defined loan pool analysis and detailed migration adjustment factors, as well as the fair value disclosures required by ASC 820-10-50. The company has since carried out remediation efforts to ensure these required disclosures are included in all future filings.

The company carried out an evaluation, under the supervision and with the participation of the company's management, including the company's Principal Executive Officer along with the company's Principal Financial Officer, of the effectiveness of the design and operation of the Company's disclosure controls and procedures, as such term is defined under Rule 13a – 15(e) promulgated under the Securities Exchange Act of 1934, as amended (the Exchange Act). Based upon that evaluation, the company's Principal Executive Officer along with the company's Principal Financial Officer concluded that the company's disclosure controls and procedures are effective to ensure that information required to be disclosed in the reports that the company files or submits under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the rules and forms of the Securities and Exchange Commission.

There were no changes in our internal control over financial reporting that occurred during the period covered by this quarterly report that have materially affected, or are, reasonably likely to materially affect, the company's internal control over financial reporting.

#### PART II Other Information

##### Item 1 – Legal Proceedings.

The company and bank are not involved in any material pending legal proceedings, other than routine litigation incidental to the business. In addition, no material proceedings are pending or are known to be threatened or contemplated against the corporation or its subsidiaries by government authorities.

##### Item 1A. – Risk Factors.

Management of the company does not believe there have been any material changes in the risk factors that were previously disclosed in the company's Form 10-K for the year ending December 31, 2009.

##### Item 2 – Unregistered Sales of Equity Securities and Use of Proceeds.

None

##### Item 3 - Defaults upon Senior Securities.

None

##### Item 4 – [Removed and Reserved.]

##### Item 5 - Other Information.

None



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Item 6 – Exhibits.

- Exhibit 3.1 Amended and Restated Articles of Incorporation (Incorporated by reference to Exhibit 3.1 of the Company’s Form 8-K filed on May 19, 2010)
- Exhibit 3.2 Amended and Restated Bylaws (Incorporated by reference to Exhibit 3(ii) of the Company’s Form 8-K filed on December 16, 2009)
- Exhibit 4.1 Form of Subordinated Note (Incorporated by reference to Exhibit 4.1 of the Company’s Form 8-K filed with the Commission on August 28, 2009)
- Exhibit 4.2 Form of Common Stock Certificate of the Company (Incorporated by reference to Exhibit 4.1 of the Company’s Form 10-K for the year ended December 31, 2009)
- Exhibit 10.1 Amended Dividend Reinvestment and Stock Purchase Plan (Incorporated by reference to the Company’s Amended Registration Statement on Form S-3 filed on July 19, 2009)
- Exhibit 10.2 2000 Stock Incentive Plan (Incorporated by reference to Exhibit 10.2 to the Company’s Form 10-K for the year ended December 31, 2004)
- Exhibit 10.3 2000 Independent Directors Stock Option Plan (Incorporated by reference to Exhibit 10.3 to the Company’s Form 10-K for the year ended December 31, 2004)
- Exhibit 10.4 Directors’ and Officers’ Deferred Compensation Plan (Incorporated by reference to Exhibit 10.4 to the Company’s Form 10-K for the year ended December 31, 2004)
- Exhibit 10.5 Discretionary Cash Bonus Plan Description (Incorporated by reference to Exhibit 10.5 to the Company’s Form 10-K for the year ended December 31,2009)
- Exhibit 31.1 Certification of Principal Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act
- Exhibit 31.2 Certification of Principal Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act
- Exhibit 32.1 Certification of Principal Executive Officer Pursuant to Section 906 of the Sarbanes-Oxley Act
- Exhibit 32.2 Certification of Principal Executive Officer Pursuant to Section 906 of the Sarbanes-Oxley Act
- Exhibit 99.1 Professional Services Agreement dated April 5, 2010 by and between First National Community Bank and Eugene T. Sobol (Incorporated by reference to Exhibit 99.1 to the Company’s Form 8-K filed on April 5, 2010)

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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.

Registrant: FIRST NATIONAL COMMUNITY BANCORP, INC

Date: August 9, 2010

By: /s/ Gerard A. Champi  
Gerard A. Champi,  
Interim President/Chief Executive Officer

Date: August 9, 2010

By: /s/ Linda A. D'Amario  
Linda A. D'Amario  
Interim Principal Financial Officer

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