NORTHWAY FINANCIAL INC
Form 10-K
March 30, 2005

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, DC 20549
FORM 10-K

[X] Annual Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934. For the fiscal year ended December 31, 2004

[ ] Transition Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934

Commission File Number 000-23129

NORTHWAY FINANCIAL, INC.
(Exact name of registrant as specified in its charter)

New Hampshire	04-3368579
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
9 Main Street Berlin, New Hampshire	03570
Address of principal executive offices	(Zip Code)

(603) 752-1171
(Registrant's telephone number, including area code)

Securities Registered Pursuant to Section 12(b) of the Act:
None

Securities Registered Pursuant to Section 12(g) of the Act:
Common Stock, Par Value $1.00

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 twelve 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 ninety days. YES [X] NO [ ]

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. [ ]

Indicate by check mark whether the registrant is an accelerated filer (as defined in Exchange Act Rule 12b-2). YES [ ] NO [X]

The number of shares of voting and nonvoting common stock, par value $1.00 per share, held by nonaffiliates of the registrant as of June 30, 2004 was 1,278,868 shares with an aggregate market value, computed by reference to the last reported sales price on the NASDAQ National Market on such date, of $44,696,437. Although directors and executive officers of the registrant were

assumed to be "affiliates" of the registrant for purposes of this calculation, this classification is not to be interpreted as an admission of such status.

At March 25, 2005, there were 1,507,574 shares of common stock outstanding, par value $1.00 per share.

DOCUMENTS INCORPORATED BY REFERENCE
Portions of the registrant's proxy statement for its 2005 Annual Meeting of Stockholders are incorporated by reference in Items 10, 11, 12, 13 and 14 of Part III.

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NORTHWAY FINANCIAL, INC.
2004 FORM 10-K ANNUAL REPORT

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FORWARD-LOOKING STATEMENTS

Certain statements in this report are "forward-looking statements" within the meaning of the Private Securities Litigation Reform Act of 1995. Such forward-looking statements may include, but are not limited to, projections of revenue, income or loss, plans for future operations and acquisitions, projections based on assumptions regarding market and liquidity risk, and plans related to products or services of Northway Financial, Inc. ("Northway") and its subsidiaries (the "Company", see description of business below). Such forward-looking statements are subject to known and unknown risks, uncertainties and contingencies, many of which are beyond the control of the Company. To the extent any such risks, uncertainties and contingencies are realized, the Company's actual results, performance or achievements could differ materially from anticipated results, performance or achievements. Factors that might affect such forward-looking statements include, among other factors, the factors described under the caption "Risk Factors" in Item 1 of this report, overall economic and business conditions, economic and business conditions in the Company's market areas, interest rate fluctuations, the demand for the Company's products and services, competitive factors in the industries in which the Company competes, changes in government regulations, and the timing, impact and other uncertainties of future acquisitions.

In addition to the factors described above, the following are some additional factors that could cause our financial performance to differ from any forward-looking statement contained herein: i) changes in interest rates over the past year and the relative relationship between the various interest rate indices that the Company uses; ii) a determination in the financial market affecting the valuation of securities held in the Company's investment portfolio; (iii) a change in product mix attributable to changing interest rates, customer preferences or competition; iv) a significant portion of the Company's loan customers are in the hospitality business and therefore could be affected by a slower economy, adverse weather conditions and/or rising gasoline prices; and v) the effectiveness of advertising, marketing and promotional programs.

The words "believe," "expect," "anticipate," "intend," "estimate," "project" or the negative of such terms and other similar expressions which are predications of or indicate future events and trends and which do not relate to historical matters identify forward-looking statements. Reliance should not be placed on forward-looking statements because they involve known or unknown risks, uncertainties or other factors, which may cause the actual results, performance or achievements of the Company to differ materially from anticipated future results, performance or achievements expressed or implied by such forward-looking statements. The Company expressly disclaims any obligation to publicly update or revise any forward-looking statement, whether as a result of new information, future events or otherwise.

Though the Company has attempted to list comprehensively the factors which might affect forward-looking statements, the Company wishes to caution you that other factors may in the future prove to be important in affecting the Company's results of operations. New factors emerge from time to time and it is not possible for management to anticipate all of such factors, nor can it assess the impact of each such factor, or combination of factors, which may cause actual results to differ materially from forward-looking statements.

PART 1

ITEM 1. BUSINESS

DESCRIPTION OF BUSINESS

Northway Financial, Inc. was incorporated on March 7, 1997, under the laws of the State of New Hampshire, for the purpose of becoming the holding company of The Berlin City Bank, a New Hampshire chartered bank headquartered in Berlin, New Hampshire ("BCB"), pursuant to a reorganization transaction (the "BCB Reorganization") by and among the Company, BCB, and a subsidiary of BCB, and, thereafter, effecting the merger (the "Merger") by and among the Company, BCB, Pemi Bancorp, Inc. ("PEMI"), and PEMI's wholly owned subsidiary, The Pemigewasset National Bank of Plymouth, New Hampshire, a national bank headquartered in Plymouth, New Hampshire ("PNB"). The BCB Reorganization and the Merger became effective on September 30, 1997. As of such date, BCB and PNB (collectively the "Banks"), became wholly owned subsidiaries of the Company. Unless the context otherwise requires, references herein to the "Company" include Northway Financial, Inc. and its consolidated subsidiaries.

The Company derives substantially all of its revenue and income from the furnishing of bank and bank-related services, principally to individuals and small and medium-sized companies in New Hampshire. BCB and PNB operate as typical community banking institutions and do not engage in any specialized finance or capital market activities. The Company functions primarily as the holder of stock of its subsidiaries and assists the management of its subsidiaries as appropriate.

The Company is subject to regulation by the New Hampshire Bank Commissioner (the "Commissioner"), the Federal Deposit Insurance Corporation (the "FDIC"), the Comptroller of the Currency of the United States (the "OCC"), and the Board of Governors of the Federal Reserve System. See "Supervision and Regulation."

BCB, which was first organized in 1891, and PNB, which was first organized in 1881, are engaged in a general commercial banking business and offer commercial and construction loans, real estate mortgages, consumer loans, including personal secured and unsecured loans, and lines of credit.

During 1998, the Company, through the BCB subsidiary, established an indirect lending business unit in Concord, New Hampshire. As of July 31, 2004 this line of business accounted for approximately 30% of the Company's loan portfolio. On August 25, 2004, the Company announced its exit from the indirect automobile lending line of business. Effective August 31, 2004, the Company ceased accepting applications from its dealer network. BCB will continue to service the existing portfolio of approximately 13,000 loans. The decision to exit this line of business was predicated on the low interest rate environment and competitive pressures of the past eighteen months. Over the next twenty-four months, cash flows from the existing portfolio are expected to be redeployed into commercial loans, residential mortgage loans, consumer loans such as home equity loans and automobile loans, and the Company's investment portfolio.

The Banks accept savings, time, demand, NOW and money market deposit accounts, and offer a variety of banking services including safe deposit boxes, credit card accounts, official checks and money orders, overdraft lines of credit and wire transfer services.

Northway is a legal entity separate and distinct from its subsidiaries. The right of Northway to participate in any distribution of assets or earnings of any subsidiary is subject to the prior claims of creditors of the subsidiary, except to the extent that claims, if any, of Northway itself as a creditor may be recognized. See "Supervision and Regulation".

The following information concerning the Company's investment activities, lending activities, asset quality and allowance for loan losses should be read in conjunction with "Management's Discussion and Analysis of Financial Condition and Results of Operations," appearing under Item 7 of this report and

the Company's Consolidated Financial Statements and Notes thereto.

INVESTMENT ACTIVITIES

The following table presents the carrying amount of the Company's securities available-for-sale as of December 31, 2004, 2003 and 2002 (dollars in thousands):

	2004	2003	2002
US Treasury and other US government agency securities	$ 54,563	$37,840	$36,188
Mortgage-backed securities (1)	29,301	2,903	12,646
Marketable equity securities	1,931	2,766	2,377
Corporate bonds	12,287	21,983	33,848
State and political subdivision bonds and notes	3,051	2,590	2,717
Total securities	$101,133	$68,082	$87,776

(1) Includes collateralized mortgage obligations

The following table sets forth the amortized cost of the Company's investment in debt securities maturing within stated periods and their related weighted average yields, reported on a tax equivalent basis, as of December 31, 2004 (dollars in thousands):

	Maturities				
	Within one year	One to five years	Five to ten years	Over ten years	Total amortized cost
Available-for-sale:					
US Treasury and other US government agency securities	$1,999	$47,915	$5,000	$ -	$54,914
Mortgage-backed securities(1)	2	1,158	120	28,177	29,457
Corporate bonds	-	9,983	2,018	-	12,001
State and political subdivision bonds and notes	1,129	498	819	520	2,966
Total amortized cost	$3,130	$59,554	$7,957	$28,697	$99,338
Market value	$3,130	$59,591	$7,961	$28,520	$99,202
Weighted average yield	2.71%	3.95%	5.43%	4.64%	4.23%

(1) Includes collateralized mortgage obligations

LENDING ACTIVITIES

The following table sets forth information with respect to the composition of the Company's loan portfolio, excluding loans held for sale, as of December 31, 2004, 2003, 2002, 2001 and 2000 (dollars in thousands):

	December 31,				
	2004	2003	2002	2001	2000
Real estate:					
Residential	$147,333	$129,493	$114,526	$109,261	$129,805
Commercial	130,334	120,366	111,941	111,642	100,608
Construction	5,366	3,851	6,330	1,581	5,752
Commercial	27,013	24,528	23,885	22,727	22,270
Installment	29,345	30,291	40,169	28,210	28,177
Indirect installment	116,520	150,807	139,477	120,761	98,919
Other	18,901	14,530	9,652	6,303	7,881
Total loans	474,812	473,866	445,980	400,485	393,412
Less:					
Unearned income	106	247	207	169	154
Allowance for loan losses	5,204	5,036	4,920	4,642	4,354
Total unearned income and allowance for loan losses	5,310	5,283	5,127	4,811	4,508
Net loans	$469,502	$468,583	$440,853	$395,674	$388,904

The following table presents the maturity distribution of the Company's real estate construction and commercial loans at December 31, 2004 (dollars in thousands):

	Amount	Percent of Total
Within one year	$13,361	41.26%
One to five years	9,092	28.08
Over five years	9,926	30.66
	$32,379	100.00%

The Company's real estate construction and commercial loans due after one year at December 31, 2004 were comprised of the following (dollars in thousands):

	Amount
Fixed interest rate	$ 7,995
Adjustable interest rate	11,023
	$19,018

ANALYSIS OF THE ALLOWANCE FOR LOAN LOSSES

The following table reflects activity in the Company's allowance for loan losses for the years ended December 31, 2004, 2003, 2002, 2001 and 2000 (dollars in thousands):

	Years ended December 31,				
	2004	2003	2002	2001	2000
Balance at the beginning of period	$5,036	$4,920	$4,642	$4,354	$4,887

Charge-offs:					
Real estate	56	-	83	110	213
Commercial	28	120	12	95	1,006
Installment loans to individuals	581	750	729	529	424
Total	665	870	824	734	1,643
Recoveries:					
Real estate	162	25	64	35	32
Commercial	16	11	4	-	-
Installment loans to individuals	160	145	134	87	96
Credit card	-	-	-	-	2
Total	338	181	202	122	130
Net charge-offs	327	689	622	612	1,513
Provision charged to expense	495	805	900	900	980
Balance at the end of period	$5,204	$5,036	$4,920	$4,642	$4,354
Ratio of net charge-offs to average loans	0.07%	0.15%	0.15%	0.15%	0.39%

ALLOCATION OF THE ALLOWANCE FOR LOAN LOSSES

The following table sets forth the breakdown of the Company's allowance for loan losses in the Company's portfolio by category of loan and the percentage of loans in each category to total loans in the respective portfolios at the dates indicated (dollars in thousands):

	December 31,							
	2004		2003		2002		2001	
	Amount	Percent of loans in each category to total loans	Amount	Percent of loans in each category to total loans	Amount	Percent of loans in each category to total loans	Amount	Pe loa ca to
Real estate:								
Residential	$ 644	31.0%	624	27.3	598	25.9	585	
Commercial & construction	1,892	28.6	1,724	26.2	2,008	26.7	1,621	
Commercial	174	5.7	155	5.2	216	5.4	208	
Installment	2,398	30.7	2,505	38.2	2,084	40.6	1,719	
Other	96	4.0	28	3.1	14	1.4	17	
Unallocated	--	N/A	--	N/A	--	N/A	492	
	$5,204	100.0%	$5,036	100.0%	$4,920	100.0%	$4,642	

DEPOSITS

See "Financial Statements and Supplementary Data" in Item 8 of this report.

SUPERVISION AND REGULATION

The business in which the Company is engaged is subject to extensive supervision, regulation and examination by various bank regulatory authorities and other governmental agencies. State and federal banking laws have as their principal objective either the maintenance of the safety and soundness of financial institutions and the federal deposit insurance system or the protection of consumers or classes of consumers, and depositors in particular, rather than the specific protection of stockholders of a bank or its parent company.

Set forth below is a brief description of certain laws and regulations that relate to the regulation of the Company. To the extent the following material describes statutory or regulatory provisions, it is qualified in its entirety by reference to the particular statute or regulation.

Regulation of the Company

General. As a registered bank holding company, the Company is subject to regulation under the Bank Holding Company Act of 1956, as amended ("BHCA") and to inspection, examination and supervision by the Board of Governors of the Federal Reserve System ("FRB"). The Company is also subject to the laws of the State of New Hampshire.

The FRB has the authority to issue orders to bank holding companies to cease and desist from unsound banking practices and violations of conditions imposed by, or violations of agreements with, the FRB. The FRB is also empowered to assess civil money penalties against companies or individuals who violate the BHCA or orders or regulations thereunder, to order termination of non-banking activities of non-banking subsidiaries of bank holding companies, and to order termination of ownership and control of a non-banking subsidiary by a bank holding company. Under the BHCA, the Company may not generally engage in activities or acquire more than 5% of any class of voting securities of any company engaged in activities other than banking or activities that are closely related to banking. Under certain circumstances, the Company may be required to give notice to or seek approval of the FRB before engaging in activities other than banking.

Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994 ("Riegle-Neal"). Riegle-Neal permits adequately capitalized and adequately managed bank holding companies, as determined by the FRB, to acquire banks in any state subject to certain concentration limits and other conditions. Riegle-Neal also generally authorizes the interstate merger of banks. In addition, among other things, Riegle-Neal permits banks to establish new branches on an interstate basis provided that the law of the host state specifically authorizes such action. However, as a bank holding company, the Company is required to obtain prior FRB approval before acquiring more than 5% of a class of voting securities, or substantially all of the assets of a bank holding company, bank or savings association.

Control Acquisitions. The Change in Bank Control Act prohibits a person or group of persons from acquiring "control" of a bank holding company, such as the Company, unless the FRB has been notified and has not objected to the transaction. Under a rebuttable presumption established by the FRB, the acquisition of 10% or more of a class of voting securities of a bank holding company with a class of securities registered under Section 12 of the Securities Exchange Act of 1934, as amended, would, under the circumstances set forth in the presumption, constitute acquisition of control of the bank holding company. In addition, a company is required to obtain the approval of the FRB under the BHCA before acquiring 25% (5% in the case of an acquirer that is a

bank holding company) or more of any class of outstanding voting securities of a bank holding company, or otherwise obtaining control or a "controlling influence" over that bank holding company.

Bank Holding Company Dividends. The FRB has authority to prohibit bank holding companies from paying dividends if such payment is deemed to be unsafe or unsound. The FRB has indicated generally that it may be an unsafe or unsound practice for bank holding companies to pay dividends unless the bank holding company's net income over the preceding year is sufficient to fund the dividends and the expected rate of earnings retention is consistent with the organization's capital needs, asset quality and overall financial condition. The Company depends in part upon dividends received from its subsidiary banks to fund its activities. As described below, the Federal Deposit Insurance Corporation ("FDIC") and the Banks' regulatory agencies may regulate the amount of dividends payable by the subsidiary banks. The inability of the Bank to pay a dividend may have an adverse effect on the Company.

Regulation of the Banks

General. PNB is a national banking association, organized under the National Bank Act. As such, its primary regulatory authority is the OCC. The OCC regularly examines national banks and their operations. In addition, operations of national banks are subject to federal statutes and regulations. Such statutes and regulations relate to required capital and reserves, investments, loans, mergers, payment of dividends, issuance of securities and many other aspects of operations. Capital requirements applicable to PNB are substantially similar to those adopted by the FRB regarding bank holding companies as described above.

The OCC's approval is required for a national bank to pay dividends if the total dividends declared by a national bank in any year will exceed the total of its net profits for that year combined with its retained net profits for the preceding two years, less any required transfer to surplus. The OCC has the authority to approve or disapprove mergers, consolidations, the establishment of branches and similar corporate actions. The OCC also has the power to prevent a national bank from engaging in unsafe or unsound practices or violating applicable laws in conducting its business.

Under the Gramm-Leach-Bliley Act (1999) ("GLBA"), the OCC permits national banks, to the extent permitted under state law, to engage in certain new activities which are permissible for subsidiaries of a financial holding company. Further, it expressly preserves the ability of national banks to retain all existing subsidiaries.

PNB is also subject to applicable provisions of New Hampshire law to the extent that such laws do not conflict with, or are not otherwise preempted by federal banking law.

BCB is organized under New Hampshire law and is subject to the regulations of the Commissioner and the FDIC, including requirements and restrictions related to the maintenance of adequate levels of capital, the payment of dividends, investments, the nature and amount of loans which can be originated and the rate of interest that can be charged thereon, and other activities. Capital requirements applicable to BCB are substantially similar to those adopted by the FRB regarding bank holding companies as described above.

Insurance of Accounts and FDIC Regulation. The Banks pay deposit insurance premiums to the FDIC based on an assessment rate established by the FDIC for Bank Insurance Fund-member institutions. The FDIC has established a risk-based premium system under which the FDIC classifies institutions based on their capital ratios and on other relevant factors and generally assesses higher rates on those institutions that tend to pose greater risks to the federal

deposit insurance funds. The Federal Deposit Insurance Act ("FDIA") does not require the FDIC to charge all banks deposit insurance premiums when the ratio of deposit insurance reserves to insured deposits is maintained above specified levels. However, as a result of general economic conditions and bank failures, it is possible that the ratio of deposit insurance reserves to insured deposits could fall below the minimum ratio that FDIA requires, which would result in the FDIC setting deposit insurance assessment rates sufficient to increase deposit insurance reserves to the required ratio. We cannot predict whether the FDIC will be required to increase deposit insurance assessments on the Banks above their current levels.

Bank Holding Company Support of Subsidiary Banks. Under FRB policy, a bank holding company is expected to act as a source of financial and managerial strength to each of its subsidiary banks and to commit resources to their support. This support may be required at times when the bank holding company may not have the resources to provide it. Similarly, under the cross-guarantee provisions of FDIA, the FDIC can hold any FDIC-insured depository institution liable for any loss suffered or anticipated by the FDIC in connection with (1) the "default" of a commonly controlled FDIC-insured depository institution; or (2) any assistance provided by the FDIC to a commonly controlled FDIC-insured depository institution "in danger of default." Both BCB and PNB are FDIC-insured depository institutions.

Regulatory Capital Requirements. The FRB and the FDIC have issued substantially similar risk-based and leverage capital guidelines applicable to United States banking organizations. In addition, these regulatory agencies may from time to time require that a banking organization maintain capital above the minimum levels, whether because of its financial condition or actual or anticipated growth.

The FRB risk-based guidelines define a three-tier capital framework. Tier 1 capital includes common stockholders' equity and qualifying preferred stock, less goodwill and other adjustments. Tier 2 capital consists of preferred stock not qualifying as Tier 1 capital, mandatory convertible debt, limited amounts of subordinated debt, other qualifying term debt and the allowance for loan losses up to 1.25 percent of risk-weighted assets. Tier 3 capital includes subordinated debt that is unsecured, fully paid, has an original maturity of at least two years, is not redeemable before maturity without prior approval by the FRB and includes a lock-in clause precluding payment of either interest or principal if the payment would cause the issuing bank's risk-based capital ratio to fall or remain below the required minimum. The sum of Tier 1 and Tier 2 capital less investments in unconsolidated subsidiaries represents qualifying total capital. Risk-based capital ratios are calculated by dividing Tier 1 and total capital by risk-weighted assets. Assets and off-balance sheet exposures are assigned to one of four categories of risk-weights, based primarily on relative credit risk. The minimum Tier 1 capital ratio is four percent and the minimum total capital ratio is eight percent. The Company's tier 1 calculation equals 11.80% and its total capital ratio is 13.94%.

The leverage ratio is determined by dividing Tier 1 capital by adjusted average total assets. Although the stated minimum ratio is 100 to 200 basis points above three percent, banking organizations are required to maintain a ratio of at least five percent to be classified as "well capitalized". The Company's leverage ratio is 8.43%.

The Federal Deposit Insurance Corporation Improvement Act of 1991 ("FDICIA"), among other things, identifies five capital categories for insured depository institutions (well capitalized, adequately capitalized, undercapitalized, significantly undercapitalized and critically undercapitalized) and requires the federal bank regulatory agencies to implement systems for "prompt corrective action" for insured depository institutions that do not meet minimum capital requirements within such categories. FDICIA imposes progressively more

restrictive constraints on operations, management and capital distributions, depending on the category in which an institution is classified. Failure to meet the capital guidelines could also subject a banking institution to capital raising requirements. An "undercapitalized" bank must develop a capital restoration plan and its parent holding company must guarantee that bank's compliance with the plan. The liability of the parent holding company under any such guarantee is limited to the lesser of five percent of the bank's assets at the time it became "undercapitalized" or the amount needed to comply with the plan. Furthermore, in the event of the bankruptcy of the parent holding company, such guarantee would take priority over the parent's general unsecured creditors. In addition, FDICIA requires the various regulatory agencies to prescribe certain non-capital standards for safety and soundness relating generally to operations and management, asset quality and executive compensation and permits regulatory action against a financial institution that does not meet such standards.

The various regulatory agencies have adopted substantially similar regulations that define the five capital categories identified by FDICIA, using the total risk-based capital, Tier 1 risk-based capital and leverage capital ratios as the relevant capital measures. Such regulations establish various degrees of corrective action to be taken when an institution is considered undercapitalized. Under the regulations, a "well capitalized" institution must have a Tier 1 risk-based capital ratio of at least six percent, a total risk-based capital ratio of at least ten percent and a leverage ratio of at least five percent and not be subject to a capital directive order. Regulators also must take into consideration (a) concentrations of credit risk; (b) interest rate risk (when the interest rate sensitivity of an institution's assets does not match the sensitivity of its liabilities or its off-balance-sheet position); and (c) risks from non-traditional activities, as well as an institution's ability to manage those risks, when determining the adequacy of an institution's capital. This evaluation will be made as a part of the institution's regular safety and soundness examination. In addition, the Company, and any Bank with significant trading activity, must incorporate a measure for market risk in their regulatory capital calculations. As of December 31, 2004, the most recent notification from the FDIC categorized both Banks as "well capitalized".

U.S. bank regulatory authorities and international bank supervisory organizations, principally the Basel Committee on Banking Supervision ("Basel Committee"), have proposed changes to the risk-based capital adequacy framework, which ultimately could affect the appropriate capital guidelines, including changes (such as those relating to lending to registered broker-dealers) that are of particular relevance to banks, such as the Banks, that engage in significant securities activities. Among other things, the Basel Committee rules, which were proposed formally for public comment in May 2003 and are expected to become effective around early 2007, would add operational risk as a third component to the denominator of the risk-capital calculation, which currently includes only credit and market risks.

The Community Reinvestment Act. The Community Reinvestment Act ("CRA") requires lenders to identify the communities served by the institution's offices and other deposit taking facilities and to make loans and investments and provide services that meet the credit needs of these communities. Regulatory agencies examine each of the Banks and rate such institutions' compliance with CRA as "Outstanding," "Satisfactory," "Needs to Improve," or "Substantial Noncompliance." Failure of an institution to receive at least a "Satisfactory" rating could inhibit such institution or its holding company from undertaking certain activities, including engaging in activities newly permitted as a financial holding company under the GLBA and acquisitions of other financial institutions. The FRB must take into account the record of performance of banks in meeting the credit needs of the entire community served, including low-and moderate-income neighborhoods. New Hampshire also has enacted substantially

similar community reinvestment requirements. PNB has achieved a rating of "outstanding" and BCB a rating of "satisfactory" on their most recent examinations.

Customer Information Security and Privacy. The FDIC and other bank regulatory agencies have adopted final guidelines for establishing standards for safeguarding nonpublic personal information about customers that implement provisions of GLBA, which establishes a comprehensive framework to permit affiliations among commercial banks, insurance companies, securities firms, and other financial service providers by revising and expanding the BHCA framework. Specifically, the Information Security Guidelines established by the GLBA require each financial institution, under the supervision and ongoing oversight of its board of directors or an appropriate committee thereof, to develop, implement and maintain a comprehensive written information security program designed to ensure the security and confidentiality of customer information, to protect against anticipated threats or hazards to the security or integrity of such information; and to protect against unauthorized access to or use of such information that could result in substantial harm or inconvenience to any customer.

The GLBA requires financial institutions to implement policies and procedures regarding the disclosure of nonpublic personal information about consumers to nonaffiliated third parties. In general, the statute requires financial institutions to explain to consumers their policies and procedures regarding the disclosure of such nonpublic personal information, and, unless otherwise required or permitted by law, financial institutions are prohibited from disclosing such information except as provided in their policies and procedures.

USA PATRIOT Act. The USA PATRIOT Act of 2001 (The "USA PATRIOT Act"), designed to deny terrorists and others the ability to obtain anonymous access to the U.S. financial system, has significant implications for depository institutions, broker-dealers and other businesses involved in the transfer of money. The USA PATRIOT Act, together with the implementing regulations of various federal regulatory agencies, have caused financial institutions, including banks, to adopt and implement additional, or amend existing, policies and procedures with respect to, among other things, anti-money laundering compliance, suspicious activity and currency transaction reporting, customer identity verification and customer risk analysis. The statute and its underlying regulations also permit information sharing for counter-terrorist purposes between federal law enforcement agencies and financial institutions, as well as among financial institutions, subject to certain conditions, and require the FRB (and other federal banking agencies) to evaluate the effectiveness of an applicant in combating money laundering activities when considering applications filed under Section 3 of the BHCA or under the Bank Merger Act. Management believes that the Company is in compliance with all the requirements prescribed by the USA PATRIOT Act and all applicable final implementing regulations.

COMPETITION

The banking industry in the United States, which includes commercial banks, savings and loan associations, mutual savings banks, capital stock savings banks, credit unions, and bank and savings and loan holding companies, is part of the broader financial services industry which includes insurance companies, mutual funds, and the brokerage industry, among others. In recent years, intense market demands and economic pressures have eroded once clearly defined industry classifications and have forced financial services institutions to diversify their services, increase returns on deposits, and become more cost-effective as a result of competition with one another and with new types of financial services companies, including non-bank competitors.

The Company's banking subsidiaries face significant competition in their respective markets from commercial banks, savings banks, credit unions, consumer finance companies, insurance companies, "non-bank banks," mutual funds, government agencies, investment management companies, investment advisors, brokers and investment bankers. In addition, increasing consolidation within the banking and financial services industry, as well as increased competition from larger regional and out-of-state banking organizations and non-bank providers of various financial services, may adversely affect the Company's ability to achieve its financial goals. Federal banking laws permit adequately capitalized bank holding companies to venture across state lines to offer banking services through bank subsidiaries to a wider geographic market. Consequently, it is possible for large organizations to enter many new markets including the markets served by the Company. Certain of these competitors, by virtue of their size and resources, may enjoy certain efficiencies and competitive advantages over the Company in pricing, delivery, and marketing of their products and services. The Company's long-term success depends on the ability of the Company's banking subsidiaries to compete successfully with other financial institutions in their service areas. It is not possible to assess what impact these changes in the regulatory environment will have on the Company. Many of these large competitors have significantly more financial resources, larger market share and greater name recognition in the market areas served by the Company and its banking subsidiaries.

BCB and PNB compete in this environment by providing a broad range of financial services, competitive interest rates and a personal level of service that, combined, tend to retain the loyalty of its customers in its market areas against competitors with far larger resources. To a lesser extent, convenience of branch locations and hours of operations are also considered competitive advantages of the Banks.

RISK FACTORS

The discussions set forth below contain certain statements that may be considered "forward-looking statements." Forward-looking statements involve unknown risks, uncertainties and other factors that may cause the Company's actual results to materially differ from those projected in the forward-looking statements. For further information regarding forward-looking statements, you should review the discussion under the caption "FORWARD-LOOKING STATEMENTS" on page 1 of this report.

Recent accounting changes could give rise to adverse changes in the regulatory capital treatment of junior subordinated debentures, including currently outstanding junior subordinated debentures of the Company which, in turn, could adversely affect the Company's regulatory capital position. In January 2003, the Financial Accounting Standards Board ("FASB") issued FASB Interpretation No. 46, "Consolidation of Variable Interest Entities" ("FIN 46") that addresses the consolidation rules to be applied to "variable interest entities" as defined in FIN 46. FIN 46, which applies to certain variable interest entities as of February 1, 2003 and to all variable interest entities as of December 14, 2003, provides that certain variable interest entities should not be treated as consolidated subsidiaries. Northway Capital Trust I and Northway Capital Trust II, the Company's Delaware statutory business trusts, may constitute variable interest entities. Historically, issuer trusts, such as Northway Capital Trust I and Northway Capital Trust II that issued junior subordinated debentures have been consolidated by their parent companies. In addition, junior subordinated debentures have been treated as eligible for Tier 1 capital treatment by bank holding companies under the FRB's rules and regulations relating to minority interests in equity accounts of consolidated subsidiaries. Accordingly, the Company has consolidated its existing issuer trusts in preparing its consolidated financial statements in the past, and the Company's outstanding junior subordinated debentures have been treated as Tier 1 capital.

On December 24, 2003, FASB issued a revision to FIN 46 ("FIN46R"), to clarify some of the provisions of FIN 46. Based on FIN46R, the Company deconsolidated its existing issuer trusts as of December 31, 2003, and restated their historical financial statements. The adoption of FIN46R results in the reclassification of the redeemable junior subordinated debentures from mezzanine capital to other liabilities as well as the reclassification of interest cost from minority interest to interest expense.

This deconsolidation could result in a change to the regulatory capital treatment of junior subordinated debentures issued by the Company and other U.S. bank holding companies. Specifically, it is possible that since the issuer trusts would no longer be consolidated by the Company the junior subordinated debentures issued by each such issuer trust would not be considered a minority interest in equity accounts of a consolidated subsidiary and therefore not be accorded Tier 1 capital treatment by the FRB. Trust preferred securities have historically been eligible for Tier 1 capital treatment by bank holding companies under FRB rules and regulations relating to minority interests in equity accounts of consolidated subsidiaries. Following the issuance of FIN 46, including the consolidation rules with respect to variable interest entities, the FRB requested public comment on a proposed rule that would limit trust preferred securities in the Tier 1 capital of bank holding companies, but with stricter limits and clearer qualitative standards. After considering the public comments, the FRB issued a final rule on March 1, 2005, which provides that after a five-year transition period ending on March 31, 2009, the aggregate amount of the trust preferred securities and certain other capital elements would be limited to 25% of Tier 1 capital elements, net of goodwill and intangibles. As of December 31, 2004, assuming the aggregate amount of the trust preferred securities is limited to 25% of Tier 1 capital, the Company would still exceed the regulatory required minimums for capital adequacy purposes.

The Company could be adversely impacted by changes in applicable regulations. The Company is subject to extensive federal and state laws and regulations and is subject to supervision, regulation and examination by various federal and state bank regulatory agencies. The restrictions imposed by such laws and regulations limit the manner in which the Company and its bank subsidiaries may conduct business and obtain financing. There can be no assurance that any modification of these laws and regulations, or new legislation that may be enacted, in the future will not make compliance more difficult or expensive, restrict the Company's ability to originate, broker or sell loans or otherwise adversely affect the operations of the Company. See "Supervision and Regulation" on page 5 of this report.

The Company's business is largely dependent upon the hospitality industry. A number of the Company's loan customers are in the hospitality industry. The hospitality industry is dependent on personal discretionary spending levels. As a result, the hospitality industry may be adversely impacted by economic trends, including recession and increased unemployment. Additionally, unforeseen events including acts of terrorism, war, increases in fuel prices, travel-related accidents and unusual weather patterns also may adversely affect the hospitality industry. As a result, the Company's business also is likely to be adversely affected by those events.

Interest rate volatility may adversely impact the Company's results of operations. The principal component of the Company's income stream is net interest and dividend income. Net interest and dividend income is the difference between interest and fee income on earning assets, such as loans and investments, and the interest expense paid on interest bearing liabilities, such as deposits and borrowed funds. The Company's net interest and dividend income may be significantly affected by changes in market interest rates. A decrease in interest rates could reduce the Company's net interest and dividend income as the difference between interest and fee income and interest expense

decreases. An increase in interest rates could also negatively impact the Company's results of operations by reducing borrowers' ability to repay their current loan obligations, resulting in increased loan defaults, foreclosures and write-offs and could necessitate increases to the Company's allowance for loan losses. See "Management's Discussion and Analysis of Financial Condition and Results of Operations" in Item 7 of this report.

The Company's allowance for loan losses may not be adequate to cover actual losses. The Company makes various assumptions and judgments about the collectibility of its loan portfolio and provides an allowance for potential loan losses based on several factors. If the Company's assumptions are incorrect, its allowance for loan losses may be insufficient to cover its actual losses, which would have an adverse effect on the Company's results of operations, and may cause the Company to increase the allowance in the future. See "Management's Discussion and Analysis of Financial Condition and Results of Operations" in Item 7 of this report.

Changes in the securities market may adversely impact the Company's results of operations. In recent years the securities market has experienced a significant downturn and will likely continue to experience volatility as a result of, among other things, global economic and political conditions. Continued declines in equity prices, as well as declines in the performance of certain sectors or specific companies, may result in a corresponding decline in the value of Company-held securities. The decline in the value of Company-held securities may decrease the Company's earnings. See "Management's Discussion and Analysis of Financial Condition and Results of Operations" in Item 7 of this report.

EMPLOYEES

As of December 31, 2004 the Company has 246 full-time equivalent employees. The Company considers its employee relations to be good.

WEBSITE ACCESS TO COMPANY REPORTS

The Company's annual reports on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, and all amendments to those reports are available free of charge on the Company's website at www.northwayfinancialinc.com as soon as reasonably practicable after such material is electronically filed with or furnished to the Securities and Exchange Commission. Also, copies of the Company's annual report will be made available, free of charge, upon written request.

ITEM 2. PROPERTIES

The Company operates 20 branch offices, one commercial lending and administration facility and one consumer loan origination facility that are located in the central and northern New Hampshire communities of Berlin, Conway (five offices), Gorham (two offices), Groveton, Littleton, West Ossipee, West Plymouth, Plymouth, Campton, Ashland, North Woodstock, Tilton, Franklin, Laconia, Belmont, Pittsfield and Concord. Fifteen of these offices are located on properties the Company owns. The Company leases six of its branches and the consumer loan origination facility. Two facilities are leased as tenants at will while the remaining five facilities are leased under contracts that expire between June 30, 2005 and December 12, 2008. Furthermore, two of the leases have an option to renew for an additional five years. Seventeen of the Company's branches have drive-up facilities and all are equipped with automated teller machines.

ITEM 3. LEGAL PROCEEDINGS

The Company is not a party to, nor are any of its subsidiaries the subject of,

any material pending legal proceedings, other than ordinary routine litigation incidental to the business.

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

No matters were submitted to a vote of security holders during the quarter ended December 31, 2004.

PART II

ITEM 5. MARKET FOR REGISTRANT'S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES

The Company's common stock is traded on The Nasdaq Stock Market, Inc.'s National Market under the symbol "NWFI". The following table sets forth, for the periods indicated, the high and low closing sale prices for the common stock, as reported by The Nasdaq National Market, and the dividends paid on the common stock:

		Price Per Share		Dividends
		Low	High	Per Share
2004	4th Quarter	$31.30	$34.96	$0.17
	3rd Quarter	29.30	35.12	0.17
	2nd Quarter	33.50	38.60	0.17
	1st Quarter	34.03	38.00	0.17
2003	4th Quarter	$29.99	$35.49	$0.17
	3rd Quarter	29.10	30.97	0.17
	2nd Quarter	28.01	30.65	0.17
	1st Quarter	28.81	31.25	0.17

The Company intends to continue to pay dividends on a quarterly basis subject to, among other things, the financial condition and earnings of the Company, capital requirements, and other factors, including applicable governmental regulations. No dividends will be payable unless declared by the Board of Directors and then only to the extent funds are legally available for the payment of such dividends.

On March 4, 2005, the closing sales price of the common stock on the Nasdaq National Market was $35.41 per share. As of such date, there were approximately 1,150 holders of record of the Company common stock.

ITEM 6. SELECTED FINANCIAL DATA

The following table sets forth the selected consolidated financial information of the Company for
ended December 31, 2004. This selected consolidated financial information should be read in conju
Discussion and Analysis of Financial Condition and Results of Operations" appearing under Item 7
Statements and Supplementary Data" appearing under Item 8 of this report.

At or for the years ended December 31,	2004	2003	2002
(Dollars in thousands, except per share data)			
Balance Sheet Data:			
Total assets	$638,418	$609,216	$598,945
Securities available-for-sale, at fair value	101,133	68,082	87,776

Securities held-to-maturity	--	--	--
Loans, net of unearned income	474,706	473,619	445,773
Allowance for loan losses	5,204	5,036	4,920
Other real estate owned	--	--	175
Unidentifiable intangible assets	--	--	--
Goodwill	10,152	10,152	10,152
Core deposit intangible	2,949	3,903	4,857
Deposits	475,359	463,307	476,194
Long-term debt	98,620	87,620	66,620
Stockholders' equity	49,510	47,872	44,266
Income Statement Data:			
Net interest and dividend income	$ 22,846	$ 23,050	$ 21,664
Provision for loan losses	495	805	900
Noninterest income	5,097	5,375	3,396
Noninterest expense	22,394	22,136	20,035
Net income	3,388	3,617	2,598
Per Common Share Data:			
Net income - basic	$ 2.26	$ 2.40	$ 1.71
Net income - assuming dilution	2.24	2.39	1.71
Cash dividends declared	0.68	0.68	0.68
Book value	32.93	31.92	29.19
Tangible book value	24.02	22.30	19.07
Selected Ratios:			
Return on average assets	0.54%	0.59%	0.49%
Return on average equity	6.97	7.82	5.86
Dividend payout	30.10	28.28	39.65
Average equity to average assets	7.75	7.61	8.33

ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The purpose of this discussion is to focus on significant changes in the financial condition and results of operations of the Company. It is intended to supplement and highlight information contained in the accompanying consolidated financial statements and the selected financial data presented elsewhere in this report. The discussion set forth below contains certain statements that may be considered "forward-looking statements." Forward-looking statements involve risks, uncertainties and other factors that may cause the Company's actual results to materially differ from those projected in the forwarding-looking statements. For further information regarding forward-looking statements, you should review the discussion under the caption "FORWARD-LOOKING STATEMENTS" on page 1 of this report.

OVERVIEW OF PERFORMANCE

The Company derives substantially all of its revenue and income from community bank-related activities. The Banks operate as typical community banking institutions and do not engage in any specialized finance or capital markets activities. Northway functions primarily as the holder of stock of its subsidiaries and assists in the management of the operations of its subsidiaries as appropriate.

The principal components of the Company's income sources are net interest and dividend income. Net interest and dividend income is the difference between interest and fee income received on income earning assets, such as loans and investments, and the interest expense paid on interest bearing liabilities, such as deposits and borrowed funds. Our other sources of income include revenues from fee-based services, such as debit card and ATM fees and sales of securities.

Economic and industry factors that could cause the Company's financial

performance to differ from expected results include changes in applicable federal and state regulations, changes in the hospitality industry on which the Company's business is largely dependent, interest rate volatility, significant changes in loan losses which may affect the Company's allowance for loan losses and the related provision for loan losses, and changes in the securities market that would affect the performance of the Company's investment portfolio. Management evaluates each of these factors on an ongoing basis to determine their impact and to effect any strategies necessary to mitigate these risks.

The Company reported net income of $3,388,000, or $2.26 per common share, in 2004 compared to net income of $3,617,000, or $2.40 per common share, in 2003 and $2,598,000, or $1.71 per common share, in 2002. Return on average equity was 6.97% in 2004, compared to 7.82% in 2003 and 5.86% in 2002. Return on average assets was 0.54% in 2004, compared to 0.59% in 2003 and 0.49% in 2002.

During 2004, the Company recorded a decrease in interest and dividend income of $1,230,000, as a decrease in the average yield on earning assets of 0.40% was only partially offset by an increase in average earning assets of $18,885,000. This was partially offset by the fact that the continuation of a low interest rate environment provided the Company further opportunity to reduce its average cost of interest bearing liabilities. During 2004, the cost of interest bearing liabilities decreased 0.25%, resulting in a decrease in interest expense of $1,026,000. The Company recorded a reduction in the provision for loan losses of $310,000 as the total provision for 2004 was $495,000 compared to $805,000 for 2003. The decrease in the provision for loan losses was the result of an ongoing review of the adequacy of the allowance for loan losses. Noninterest income, excluding securities gains, increased $491,000 from last year. This reflects, in part, the impact of a new non-deposit product line introduced earlier in 2004, in addition to our continuing efforts to maximize all components of noninterest income, including the introduction of Bounce Protection(TM) in 2004. Less favorable market conditions for investment securities resulted in lower securities gains for the year than in 2003, as realized gains decreased $769,000 to $753,000. Noninterest expense increased $258,000 to $22,394,000 in 2004 compared to $22,136,000 in 2003 due primarily to an increase in salaries and benefits expense.

During 2003, the Company took advantage of the improved market conditions for investment securities and realized securities gains totaling $1,522,000 compared to $151,000 for the prior year. The low interest rate environment resulted in significant mortgage refinancing activity. The Company decided to sell a portion of this loan volume in the secondary market based on the Company's underwriting standards. The result of these sales was an increase in gain on sale of loans of $163,000 to $422,000 in 2003. The current low interest rate environment also provided the Company an opportunity to reduce its average cost of interest bearing liabilities by 0.59%. In addition, this rate environment allowed the Company to increase its average outstanding borrowings at very attractive rates and use the proceeds to fund increases in both average loans and investments.

NET INTEREST AND DIVIDEND INCOME ANALYSIS

Fluctuations in interest rates as well as changes in volume and mix of income earning assets and interest-bearing liabilities can materially impact net interest and dividend income, the principal source of our income. The discussion of net interest and dividend income is presented on a taxable equivalent basis, unless otherwise noted, to facilitate performance comparisons among various taxable and tax-exempt assets.

The table below under the caption "Consolidated Average Balances, Interest and Dividend Income/Expense and Average Yields/Rates," presents the average balances, income earned or interest paid, and average yields earned or rates paid on our assets and liabilities for the years ended December 31, 2004, 2003,

and 2002.

Net interest and dividend income for 2004 decreased $162,000, or 1%, compared to 2003. Interest and dividend income decreased $1,188,000, or 4%, in 2004 compared to 2003. The continued suppression of market interest rates during 2004 resulted in a 0.39% decrease in the yield on average earning assets. A 0.48% decrease in the yield on loans was partially offset by an increase in average loan balances of $17,105,000. This resulted in a net decrease of $1,294,000, or 5%, in interest and fees on loans. The decrease in interest and fees on loans was partially offset by an increase in interest and dividend income on securities of $100,000, which was the result of an increase in average balances of $6,450,000 partially offset by a decrease in average yield of 0.22%.

Interest expense decreased $1,026,000, or 12%, in 2004 compared to 2003. The decrease in interest expense was due primarily to a 0.25% decrease in rates paid on interest bearing liabilities partially offset by an increase in average balances of $11,061,000. The increase in average balances is primarily the result of increases in average Federal Home Loan Bank ("FHLB") advances of $17,473,000. Total average deposits, including noninterest bearing DDA, decreased $1,373,000 but a shift in the mix of deposits resulted in a decrease in time deposits of $20,791,000 partially offset by higher average balances in demand deposits, NOW accounts and savings accounts, which are all lower cost sources of funds for the Company.

Net interest and dividend income for 2003 increased $1,466,000, or 7%, compared to 2002. Interest and dividend income increased $85,000 in 2003 compared to 2002. This was due to an increase in average earning assets of $66,220,000 which increase was partially offset by a 0.74% decrease in the yield on average earning assets. Interest income and fees on loans increased $124,000 which increase was primarily due to an increase in the average balance of $57,193,000 partially offset by a decrease in the average yield of 0.81%. Furthermore, interest and dividend income on securities increased $114,000 as an increase in average securities of $12,846,000 was partially offset by a decrease in the average yield on securities of 0.69%. These increases in interest and dividend income were partially offset by a decrease in interest income on federal funds sold of $153,000 as the average balance decreased $3,818,000 and was accompanied by a decrease in the average yield of 0.65%.

Interest expense decreased $1,381,000, or 14%, in 2003 compared to 2002. The decrease in net interest expense was due primarily to a 0.59% decrease in the average rate paid on interest bearing liabilities partially offset by an increase in average interest bearing liability balances of $65,798,000. The decrease in the rate paid on interest bearing liabilities was a function of both the acquisition of long-term debt at attractive rates as well as a decision by management to lower rates on interest bearing deposits. The increase in the average liability balance is the result of increases in average FHLB advances of $16,570,000 as the Company took advantage of the current low rate environment to borrow $28,000,000 in medium-term advances at an average rate of 2.74%. Furthermore, the average balance in junior subordinated debentures increased $8,971,000 as a result of the inclusion of this debt, which was issued during 2002, for the full 2003 fiscal year as compared to six months in fiscal 2002. Average interest bearing deposits increased $40,527,000 due primarily to the fact that deposits acquired in October 2002 were recorded for the full 2003 fiscal year.

The trend in net interest and dividend income is commonly evaluated in terms of average rates using net interest margin and interest rate spread. The net interest margin is computed by dividing fully taxable equivalent net interest and dividend income by average total earning assets. This ratio represents the difference between the average yield returned on average earning assets and the average rate paid for all funds used to support those earning assets, including

both interest bearing and noninterest bearing sources of funds. The net interest margin decreased 0.17% to 3.99% in 2004 after having decreased 0.26% to 4.16% in 2003. The decrease in the net interest margin for 2004 was a direct result of the decrease in the yield on earning assets, which decrease was only partially offset by the decrease in the cost of funds.

The interest rate spread measures the difference between the average yield on earning assets and the average rate paid on interest bearing liabilities. The interest rate spread eliminates the impact of noninterest bearing funds and gives a direct perspective on the effect of interest rate fluctuations. During 2004, the net interest rate spread decreased 0.14% to 3.78% as the yield on earning assets declined 0.39% and was only partially offset by a decrease in the cost of interest bearing liabilities of 0.25%. During 2003, the net interest rate spread decreased 0.15% to 3.92% as the yield on earning assets declined 0.74% and was only partially offset by a decrease in the cost of interest bearing liabilities of 0.59%.

See the tables below under the captions "Consolidated Average Balances, Interest and Dividend Income/Expense and Average Yields/Rates" and "Consolidated Rate/Volume Variance Analysis" for more information.

CONSOLIDATED AVERAGE BALANCES, INTEREST INCOME/EXPENSE AND AVERAGE YIEL

($000 Omitted)

For the Year Ended December 31,

	2004			2003		
	Average Balance	Income/ Expense	Average Yield/ Rate	Average Balance	Income/ Expense	Average Yield/ Rate
Assets						
Interest earning assets:						
Federal funds sold	$ 10,564	$ 125	1.18%	$ 15,153	$ 118	0.78%
Interest bearing deposits	143	1	0.70	224	2	0.89
Securities (1) (2)	86,236	3,684	4.27	79,786	3,584	4.49
Loans, net (3) (4)	483,865	26,821	5.54	466,760	28,115	6.02
Total interest earning assets (5)	580,808	30,631	5.27	561,923	31,819	5.66
Cash and due from banks	15,637			14,907		
Allowance for loan losses	(5,104)			(4,983)		
Premises and equipment, net	13,444			12,447		
Other assets	22,574			23,753		
Total assets	$627,359			$608,047		
Liabilities						
Interest bearing liabilities:						
Regular savings	$ 85,319	220	0.26	$ 80,741	338	0.42
NOW and super NOW	97,170	334	0.34	87,212	285	0.33
Money market accounts	65,286	460	0.70	66,159	495	0.75
Certificates of deposit	140,614	2,136	1.52	161,405	3,304	2.05
Securities sold under agreements to repurchase	8,611	87	1.01	7,895	123	1.56
FHLB advances	80,744	3,115	3.86	63,271	2,876	4.55
Junior subordinated						

debentures	20,620	1,079	5.23	20,620	1,036	5.02
Total interest bearing liabilities	498,364	7,431	1.49	487,303	8,457	1.74
Noninterest bearing deposits	76,915			71,160		
Other liabilities	3,475			3,307		
Total liabilities	578,754			561,770		
Stockholders' equity	48,605			46,277		
Total liabilities and stockholders' Equity	$627,359			$608,047		
Net interest and dividend income(6)		$23,200			$23,362	
Interest rate spread (7)			3.78%			3.92%
Net interest margin (8)			3.99%			4.16%

(1) Reported on a tax equivalent basis. Reported interest on securities of $3,582,000, $3,470,000
$102,000, $114,000 and $173,000, for 2004, 2003 and 2002, respectively, to reflect the tax eq
(2) Average balances are calculated using the adjusted cost basis.
(3) Reported on a tax equivalent basis. Reported interest and fees on loans of $26,569,000, $27,9
adjusted by $252,000, $198,000 and $79,000 for 2004, 2003 and 2002, respectively, to reflect
(4) Net of unearned income. Includes loans held for sale and nonperforming loans.
(5) Reported on a tax equivalent basis. Reported interest and dividend income of $30,277,000, $31
adjusted by $354,000, $312,000 and $252,000 for 2004, 2003 and 2002, respectively, to reflect
(6) Reported on a tax equivalent basis. Reported net interest and dividend income of $22,846,000,
adjusted by $354,000, $312,000 and $252,000 for 2004, 2003 and 2002, respectively, to reflect
(7) Interest rate spread equals the yield on interest earning assets minus the rate paid on inter
(8) The net interest margin equals net interest income divided by total average interest earning

CONSOLIDATED RATE/VOLUME VARIANCE ANALYSIS(1)

($000 Omitted)

	2004 Compared to 2003 Increase (Decrease) Due to Change In				20 Increase (
	Volume	Rate	Mix	Total	Volume
Interest and dividend income:					
Federal funds sold	$ (36)	$ 61	$ (18)	$ 7	$ (55)
Interest bearing deposits	(1)	--	--	(1)	--
Securities	290	(176)	(14)	100	666
Loans	1,030	(2,242)	(82)	(1,294)	3,909
Total interest and dividend income	1,283	(2,357)	(114)	(1,188)	4,520
Interest expense:					
Regular savings	19	(130)	(7)	(118)	103
NOW and super NOW	32	15	2	49	83
Money market accounts	(6)	(29)	--	(35)	188

Certificates of deposit	(426)	(852)	110	(1,168)	(46)	(
Securities sold under agreements to repurchase	11	(43)	(4)	(36)	(4)	
FHLB advances	794	(435)	(120)	239	890	
Junior subordinated debentures	--	43	--	43	512	
Total interest expense	424	(1,431)	(19)	(1,026)	1,726	(
Net interest and dividend income	$ 859	$ (926)	$ (95)	$ (162)	$ 2,794	$(

(1) Reported on a tax equivalent basis.

PROVISION FOR LOAN LOSSES

The provision for loan losses represents the annual cost of providing an allowance for losses inherent in the loan portfolio. The size of the provision for each year is determined by management based upon many factors, including loan growth, net charge-offs, changes in the composition of the loan portfolio, delinquencies, management's assessment of loan portfolio quality, the value of collateral and general economic factors.

The provision for loan losses was $495,000 in 2004, a decrease of $310,000 from the provision recorded in 2003. The 2003 provision of $805,000 decreased $95,000 from the provision recorded in 2002. The provision for each of the three years was based upon a review of the adequacy of the allowance for loan losses, which is conducted on a quarterly basis. These reviews are based upon many factors including the risk characteristics of the portfolio, trends in loan delinquencies, and an assessment of existing economic conditions. In addition, various regulatory agencies, as part of their examination process, review the banks' allowances for loan losses and such review may result in changes to the allowance based on judgments different from those of management.

The decrease in the 2004 provision was due in part to a reduction in average impaired loans of $1,100,000 as well as the fact that the Company realized significant recoveries during 2004, which allowed the company to maintain its coverage ratio. The decrease in the 2003 provision was due in large part to the recording of $70,000 to other expense for a provision for losses related to unfunded loan commitments such as unused lines of credit and unused portions of home-equity loans. This provision had previously been calculated as part of the allowance for loan losses.

Although management utilizes its best judgment in providing for losses, there can be no assurance that the Company will not have to change its provision for loan losses in subsequent periods. Management will continue to monitor the allowance for loan losses and modify the provision to the allowance for loan losses as appropriate. For additional information regarding estimates in the assessment of the allowance for loan losses see "Application of Critical Accounting Policies" below.

NONINTEREST INCOME

Noninterest income consists of revenues generated from a broad range of financial services and activities, including fee-based services and income earned through securities sales.

The following table sets forth the components of the Company's noninterest income:

($000 Omitted)
Years Ended December 31,

	2004	2003	2002
Service charges and fees on deposit accounts	$2,229	$1,673	$1,473
Gain on sales of securities available-for-sale, net	753	1,522	151
Gain on sales of loans, net	374	422	259
Other	1,741	1,758	1,513
Total noninterest income	$5,097	$5,375	$3,396

Fee income from service charges and fees on deposit accounts increased 33% in 2004, 14% in 2003 and 26% in 2002. The improvement in 2004 is due principally to increases in overdraft fee income as the Company introduced new fee schedules in December 2003. In addition, the Company introduced Bounce Protection(TM), an overdraft privilege program, in April 2004 and this has led to increased overdraft income. The improvement in 2003 is due principally to increases in overdraft fee income and service charge income resulting from the full year impact of the branch acquisitions completed in October 2002. The improvement in 2002 is due principally to the introduction of new overdrawn account procedures and fee schedules introduced in January 2002 as well as the impact of the branch purchases during the fourth quarter 2002.

Net gains on sales of securities were $753,000 in 2004 compared to $1,522,000 in 2003 and $151,000 in 2002. Securities gains in 2004 and 2003 were the result of improved market conditions for investment securities. Securities gains, net, in 2004 included $253,000 of net gains on sales of equity securities compared to net losses of $147,000 in 2003 and net losses of $410,000 in 2002. Net gains on the sales of debt securities totaled $500,000 in 2004 compared to $1,669,000 in 2003 and $561,000 in 2002.

Gains on sales of loans, net, decreased $48,000 in 2004 compared to 2003. Gains on sales of mortgage loans decreased $228,000 as the Company opted to retain a greater portion of fixed rate mortgages in portfolio in 2004 compared to 2003. This was partially offset by the fact that during 2004, the Company sold a portfolio of commercial loans guaranteed by the Small Business Administration for a gain of $178,000. The low interest rate environment in 2003 resulted in significant mortgage refinancing activity. Therefore, during 2003 the Company decided to sell a portion of this loan volume in the secondary market based on our underwriting standards. The result of these sales was an increase in gain on sale of loans of $163,000 to $422,000 in 2003. During 2002, the Company recorded a gain on sale of loans of $259,000 which resulted from the sale of mortgage loans to the secondary market.

Other noninterest income (sources of which include debit card interchange fees, credit card merchant and fee income, automated teller machine fees, loan fees, safe deposit fees and commissions on alternative investment products) decreased $17,000, or 1%, to $1,741,000 in 2004 following an increase of $245,000, or 16%, to $1,758,000 in 2003 and $339,000, or 29%, to $1,513,000 in 2002. The decrease in 2004 was due to the fact that in 2003 the Company recognized approximately $191,000 in other loan fees resulting from transactions with Federal Home Loan Mortgage Corporation ("FHLMC"). This decrease was partially offset by the introduction of alternative investment products offered by the Company, which increased fee income by approximately $126,000. The increase in 2003 compared to 2002 was due primarily to the increase in other loan fees.

NONINTEREST EXPENSE

Total noninterest expense increased $258,000, or 1%, during 2004 following an increase of $2,101,000, or 10%, during 2003 and an increase of $2,866,000, or 17%, during 2002. The increase in expenses during 2004 is due primarily to an

increase in salaries and employee benefits. The increase in expenses during 2003 is due in large part to the full year impact of the October 2002 branch purchases, which contributed to the overall in increase in salaries and benefits expense, office occupancy and equipment expense and increased expenses associated with the amortization of core deposit intangibles. The increase in expenses during 2002 is due in large part to the $910,000 write-down of equity securities, expenses related to the acquisition of three branches during the fourth quarter, staff additions and technology initiatives.

The following table sets forth information relating to the Company's noninterest expense during the periods indicated:

	($000 Omitted) Years Ended December 31,		
	2004	2003	2002
Salaries and employee benefits	$11,981	$11,426	$ 9,758
Office occupancy and equipment	3,731	3,753	3,298
Amortization of core deposit intangible	954	954	476
Write-down of equity securities available-for-sale	--	184	910
Professional fees	1,234	1,166	1,096
Stationery and supplies	429	556	596
Telephone	595	571	505
Postage and shipping	348	378	378
ATM expense	295	442	366
Other	2,827	2,706	2,652
Total noninterest expense	$22,394	$22,136	$20,035

Salaries and employee benefits increased $555,000, or 5%, from 2003 to 2004 and $1,668,000 or 17%, from 2002 to 2003. These increases reflect staff additions in connection with the expansion of the retail franchise, increased lending activities and normal salary and wage increases. Also, during 2004 and 2003, the Company recorded a liability to deferred compensation related to a Supplemental Employee Retirement Plan ("SERP"). Refer to Note 14 to the Consolidated Financial Statements for a further discussion regarding the SERP.

Office occupancy and equipment expense decreased $22,000 from 2003 to 2004 after increasing $455,000, or 14%, from 2002 to 2003. The 2003 increase was due to increases in depreciation expense associated with technology purchases made in the latter part of 2002 as well as the expansion of the retail franchise.

The amortization of core deposit intangibles, net, remained unchanged from 2003 to 2004 after increasing $478,000 from 2002 to 2003 due to the full year impact of the October 2002 branch purchases.

During 2004, the Company recorded no write-down of equity securities compared to $184,000 in 2003 and $910,000 in 2002. During 2003, five equity securities were determined to be other than temporarily impaired due to sustained weakness in their sector as well as weaknesses related to the individual companies. During 2002, the sustained overall weakness in the equity market as well as significant declines in certain sectors and specific companies within those sectors, resulted in the Company determining that the market values of certain of its marketable equity securities were other than temporarily impaired. As a result, during 2002 the Company recorded a write-down of equity securities of $910,000.

INCOME TAX EXPENSE

The Company recognized $1,666,000, $1,867,000 and $1,507,000 in income tax expense for the years ended December 31, 2004, 2003 and 2002, respectively. The effective tax rate was 33.0% for 2004, 34.1% for 2003 and 36.7% for 2002. For additional information relating to income taxes, see Note 13 to the Consolidated Financial Statements.

ASSETS

Total assets increased $29,202,000, or 5%, to $638,418,000 at December 31, 2004 compared to $609,216,000 at December 31, 2003. The following is a summary of significant balance sheet changes.

	($000 Omitted) Years Ended December 31,			
	2004	2003	Change	% Change
Total assets	$638,418	$609,216	$29,202	4.8%
Earning assets	592,971	562,311	30,660	5.5
Federal funds sold	10,975	16,470	(5,495)	(33.4)
Securities available-for-sale, at fair value (1)	107,013	73,152	33,861	46.3
Loans, net of unearned income	474,706	473,619	1,087	0.2
Deposits	475,359	463,307	12,052	2.6
Borrowings	109,888	95,021	14,867	15.7
Stockholders' equity	49,510	47,872	1,638	3.4

(1) Includes Federal Home Loan Bank stock and Federal Reserve Bank stock.

The increase in earning assets of $30,660,000 was due primarily to an increase in securities available-for-sale partially offset by a decrease in federal funds sold. The increase in earning assets was funded by an increase in both deposits and borrowings.

SECURITIES AVAILABLE-FOR-SALE

The Company's securities are classified into one of two categories based on management's intent to hold the securities: (i) "held-to-maturity" securities, or (ii) securities "available-for-sale." Securities designated to be held-to-maturity are reported at amortized cost. Securities classified as available-for-sale are required to be reported at fair value with unrealized gains and losses, net of taxes, excluded from earnings and shown separately as a component of stockholders' equity. At December 31, 2004 and 2003 the Company had no securities designated as held-to-maturity.

The following table summarizes the Company's securities portfolio at December 31, 2004 and 2003, showing amortized cost and fair value for each category:

	($000 Omitted) December 31,			
	2004		2003	
	Amortized Cost	Fair Value	Amortized Cost	Fair Value
Securities available-for-sale:				
US Treasury and US government agencies	$ 54,914	$ 54,563	$37,945	$37,840
Mortgage-backed securities	29,447	29,291	2,803	2,888
Collateralized mortgage obligations	10	10	15	15

Marketable equity securities	1,827	1,931	2,589	2,766
Corporate bonds	12,001	12,287	20,857	21,983
State and political subdivisions	2,966	3,051	2,432	2,590
Total securities available-for-sale	$101,165	$101,133	$66,641	$68,082

Total securities increased $33,051,000 during 2004 to $101,133,000. One of the primary functions of the investment portfolio is to provide liquidity to the Company. During 2004, the Company deployed a leverage strategy whereby $20,000,000 in FHLB advances were offset by the purchase of mortgage-backed securities providing the Company an attractive spread. The remainder of the increase in securities was due to the increase in deposits.

The net unrealized loss on securities available-for-sale was $32,000 at December 31, 2004 compared to a net unrealized gain of $1,441,000 at December 31, 2003. At December 31, 2004, the net unrealized loss on debt securities was $136,000 and the net unrealized gain on marketable equity securities was $104,000. At December 31, 2003, the net unrealized gain on debt securities was $1,264,000 and the net unrealized gain on marketable equity securities was $177,000. The net unrealized gain on debt securities for 2003 is primarily the result of the low interest rate environment during 2003, which resulted in an appreciation in value of existing debt holdings.

Due to the decline in the performance of securities in certain sectors and specific companies within those sectors, the Company determined, through the evaluations described in Note 1 to the Consolidated Financial Statements, that the market values of certain of its marketable equity securities were other than temporarily impaired. As a result, during 2003 net losses on sales of marketable equity securities amounted to $147,000 and write-downs of marketable equity securities amounted to $184,000. During 2002 net losses on sales of marketable equity securities amounted to $410,000 and write-downs of marketable equity securities amounted to $910,000.

At December 31, 2004, the Company's investment in equity securities totaled $1,931,000. This amount is net of a market value adjustment of $104,000, of which the full amount was reflected as a gain in accumulated other comprehensive loss in stockholders' equity.

The Company has a general policy of purchasing investment grade securities and U.S. government securities to minimize credit risk. All securities, however, carry interest rate risk, which affect their market values such that as market yields increase, the value of the Company's securities decline and vice versa. Additionally, mortgage-backed securities carry prepayment risk whereby expected yields may not be achieved due to the inability to reinvest proceeds from prepayment at comparable yields. Moreover, such mortgage-backed securities may not benefit from price appreciation in periods of declining rates to the same extent as the remainder of the portfolio.

A portion of the securities portfolio is pledged to secure public deposits, short-term securities sold under agreements to repurchase and treasury, tax and loan accounts. Refer to Note 3 to the Consolidated Financial Statements for a further discussion of pledging of securities.

LOANS

Gross loans remained relatively unchanged in 2004, increasing $946,000 due primarily to increases in residential real estate, commercial real estate and commercial loans, partially offset by a decrease in indirect installment loans. At December 31, 2003 loans increased 6% with the most significant increases occurring in residential real estate, commercial real estate and indirect installment loans. The following table presents the composition of the loan

portfolio as of December 31, 2004 and 2003:

	($000 Omitted)			
	2004	Percent of Total	2003	Percent of Total
Real estate:				
Residential	$147,333	31.0%	$129,493	27.3%
Commercial	130,334	27.5	120,366	25.4
Construction	5,366	1.1	3,851	0.8
Commercial	27,013	5.7	24,528	5.2
Installment	29,345	6.2	30,291	6.4
Indirect installment	116,520	24.5	150,807	31.8
Other	18,901	4.0	14,530	3.1
	$474,812	100.0%	$473,866	100.0%

The loan portfolio mix shifted during the year. Indirect installment loans, which are fixed-rate loans secured by automobiles originated through automobile dealers with an average term of 60 months, comprised 24.5% of the loan portfolio at December 31, 2004 as compared to 31.8% at the end of 2003. Effective August 31, 2004, the Company discontinued the origination of indirect installment loans; therefore, this portfolio will continue to amortize going forward. Residential real estate loans increased to account for 31.0% of the portfolio from 27.3% at December 31, 2003 due in part to the decision to retain high credit quality fixed-rate mortgages in the portfolio rather than sell in the secondary market.

Commercial real estate loans consist of loans secured by income producing commercial real estate and commercial loans consist of loans that are either unsecured or are secured by inventories, receivables or other corporate assets, and some are additionally secured by a guarantee of the federal Small Business Administration. Commercial real estate and commercial loans increased by $12,453,000 in 2004 as compared to 2003. The Company continues to emphasize commercial real estate and commercial loans in order to enhance earnings and maintain the balance of its portfolio.

Residential real estate loans increased by $17,840,000 in 2004, a 14% increase from 2003, compared to an increase of $14,967,000, or 13%, in 2003 compared to 2002. The Company originates both fixed-rate and adjustable-rate residential loans for its portfolio. Some fixed-rate residential loans are originated for sale to investors in the secondary market. The increase in residential real estate loans in 2004 and 2003 resulted primarily from the Company's decision to retain a greater percentage of fixed-rate residential mortgage loans.

During 2004, installment loan balances decreased $946,000, or 3%, from 2003, compared to a decrease of $9,878,000, or 25%, in 2003 compared to 2002. Indirect installment loans decreased by $34,287,000, or 23%, in 2004 compared to an increase of $11,330,000, or 8%, in 2003. As previously mentioned, indirect installment originations ceased on August 31, 2004.

NONPERFORMING ASSETS

Nonperforming assets were $2,949,000, or 0.46% of total assets, at December 31, 2004 compared to $4,180,000, or 0.69% of total assets, at December 31, 2003, a decrease of $1,321,000, or 29%. Nonperforming assets are comprised primarily of nonaccrual loans, other chattels owned and real estate acquired by foreclosure or a similar conveyance of title. The accrual of interest on a loan is discontinued when there is reasonable doubt as to its collectibility or whenever the payment of principal or interest is more than 90 days past due. However, there are loans within this nonaccrual classification that provide periodic payments, but which have a weakness with respect to the collateral

securing the loan.

At December 31, 2004, nonaccrual loans totaled $2,867,000, or 0.60% of total loans, compared to $4,089,000, or 0.86% of total loans, in 2003. There was no other real estate owned at either December 31, 2004 or 2003. Other chattels owned decreased $9,000 to $82,000 at December 31, 2004 compared to $91,000 at December 31, 2003.

ALLOWANCE FOR LOAN LOSSES

The Company maintains an allowance for loan losses to absorb losses inherent in the existing loan portfolio. When a loan, or portion thereof, is considered uncollectible, it is charged against the allowance. Recoveries of amounts previously charged-off are added to the allowance when collected. The adequacy of the allowance for loan losses is evaluated on a regular basis by management. Factors considered in evaluating the adequacy of the allowance include previous loss experience, current economic conditions and their effect on borrowers and the market area in general, and the performance of individual credits in relation to the contract terms. In addition various federal and state regulatory agencies, as an integral part of their examination process, periodically review the adequacy of the Company's allowance for loan losses. For additional information regarding estimates in the assessment of the allowance for loan losses see "Application of Critical Accounting Policies-Allowance for Loan Losses" below.

The Company's allowance for loan losses increased $168,000 from December 31, 2003 to $5,204,000, or 1.10% of total loans, at December 31, 2004.

The following table sets forth the composition of the allowance for loan losses for the periods indicated:

	($000 Omitted) Years Ended December 31,		
	2004	2003	2002
Beginning allowance	$5,036	$4,920	$4,642
Provision for loan losses	495	805	900
Loans charged-off	(665)	(870)	(824)
Recoveries of loans previously charged-off	338	181	202
Net charge-offs	(327)	(689)	(622)
Ending allowance	$ 5,204	$ 5,036	$ 4,920
Allowance as a percentage of loans outstanding	1.10%	1.06%	1.10%
Allowance as a percentage of nonperforming loans	181.51	123.16	135.95
Net charge-offs as a percentage of average loans	0.07	0.15	0.15

DEPOSITS

Total deposits at December 31, 2004 were $475,359,000, an increase of $12,052,000, or 3%, compared to $463,307,000 at December 31, 2003. The increase in deposits was due primarily to an increase in demand deposits, NOW accounts and regular savings partially offset by a decrease in time deposits.

The following table sets forth the components of deposits for the periods indicated:

	($000 Omitted) December 31,	
	2004	2003
Demand	$ 78,669	$ 69,599
Regular savings, NOW and money market	263,685	244,766
Time	133,005	148,942
Total deposits	$475,359	$463,307

At December 31, 2004, time deposits of $100,000 or more are scheduled to mature as follows:

	($000 Omitted)
3 months or less	$ 4,360
Over 3 to 6 months	2,868
Over 6 to 12 months	4,109
Over 12 months	7,598
	$18,935

BORROWINGS

At December 31, 2004 short-term borrowings consisted of securities sold under agreements to repurchase of $11,268,000 compared to $7,401,000 for 2003.

Long-term debt in 2004 consists of FHLB term advances of $78,000,000 as well as $20,620,000 of junior subordinated debentures, compared to $67,000,000 of FHLB term advances and $20,620,000 of junior subordinated debentures in 2003. Seven of the long-term term FHLB advances are callable quarterly with call dates in January, February and March 2005. The increase in FHLB advances is the result of new advances totaling $20,000,000, which was partially offset by the maturity of $9,000,000 in advances.

Junior subordinated debentures consist of two issues of floating rate trust preferred securities acquired during April and July 2002 in the amount of $7,217,000 and $13,403,000, respectively, due in 2032. These trust preferred securities were offered for the purpose of providing capital to the subsidiary banks to ensure adequate capital following the recent branch acquisitions and for general corporate purposes. As of December 31, 2004, of the $20,620,000 principal amount outstanding, $16,338,000 qualified as Tier 1 capital and $4,282,000 was allocated to Tier 2 capital.

See Notes 8 and 9 to the Consolidated Financial Statements for additional information regarding the Company's borrowings.

The following table sets forth certain information concerning the Company's borrowings at the dates indicated:

	($000 Omitted) December 31,	
	2004	2003
Short-term borrowings	$ 11,268	$ 7,401
Long-term debt	98,620	87,620
	$109,888	$ 95,021

	========	========

At December 31, 2004, long-term debt is scheduled to mature as follows:

	($000 Omitted)
Less than one year	$ 2,000
One to three years	44,000
Three to five years	23,000
Over five years	29,620
	$98,620

OFF-BALANCE SHEET ARRANGEMENTS

The Company is party to financial instruments with off-balance sheet risk in the normal course of business to meet the financing needs of its customers and to reduce its own exposure to fluctuations in interest rates. These financial instruments include commitments to originate loans and standby letters of credit. The instruments involve, to varying degrees, elements of credit and interest rate risk in excess of the amount recognized in the balance sheet. The amounts of those instruments reflect the extent of involvement the Company has in particular classes of financial instruments.

The Company's exposure to credit loss in the event of nonperformance by the other party to the financial instrument for loan commitments and standby letters of credit is represented by the contractual amount of those instruments. The Company uses the same credit policies in making commitments and conditional obligations as it does for balance sheet instruments.

Financial instruments with off-balance sheet credit risk at December 31, 2004 and 2003 totaled $48,199,000 and $45,276,000, respectively.

See Note 15 to the Consolidated Financial Statements for additional information regarding off-balance sheet arrangements.

CAPITAL

The Company's stockholders' equity serves to support growth and provide depositors and other creditors protection against loss. Equity capital represents the stockholders' investment in the Company. Management strives to maintain an optimal level of capital on which an attractive return to the stockholders will be realized over both the short-term and long-term, while serving depositors' and creditors' needs.

The Company must also observe the minimum requirements enforced by the federal banking regulators. There are three capital requirements that banks and bank holding companies must meet: Tier 1 capital, total capital (combination of Tier 1 capital and Tier 2 capital), and leverage (Tier 1 capital to average assets) ratios. Tier 1 capital consists of stockholders' equity, net of intangible assets as well as a portion of junior subordinated debentures. Tier 2 capital consists of a limited amount of allowance for loan losses and the portion of junior subordinated debentures not allocated to Tier 1 capital. Tier 1 capital, total capital and leverage ratios do not include any adjustments for unrealized gains and losses relating to securities available-for-sale except net unrealized losses relating to marketable equity securities. The minimum requirements for the leverage ratio, risk-based Tier 1 capital and risk-based total capital are 4%, 4% and 8%, respectively. As of December 31, 2004 and 2003, both Banks were "well capitalized" as defined under FDIC regulations.

The following table sets forth the Company's risk-based capital and leverage ratios:

	($000 Omitted) December 31,	
	2004	2003
Risk-adjusted assets	$446,807	$453,272
Tier 1 capital (to average assets)	8.43%	7.22%
Tier 1 capital (to risk weighted assets)	11.80	9.66
Total capital (to risk weighted assets)	13.94	12.81

Total stockholders' equity includes a $691,000 negative adjustment for accumulated other comprehensive loss, net of tax, at December 31, 2004 and a $149,000 adjustment for accumulated other comprehensive income, net of tax, at December 31, 2003. At December 31, 2004, this adjustment was comprised of a net unrealized loss on securities available-for-sale of $18,000, net of taxes, and an unfunded pension accumulated benefit obligation of $673,000, net of taxes. While the Company continues to contribute the maximum amount permitted by law to its pension plan, the discount rate used to calculate the future value of such contribution and the poor asset performance of investment securities has resulted in the unfunded pension accumulated benefit obligation. For additional information regarding estimates see "Application of Critical Accounting Policies" below.

The Company intends to continue to pay dividends on a quarterly basis subject to the financial condition and earnings of the Company, capital requirements, and other factors, including applicable governmental regulations. No dividends will be payable unless declared by the Board of Directors and then only to the extent funds are legally available for the payment of such dividends.

APPLICATION OF CRITICAL ACCOUNTING POLICIES

The Company's accounting policies are more fully described in Note 1 of the Consolidated Financial Statements. As disclosed in Note 1, the preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions about future events that affect the amounts reported in the financial statements and accompanying notes. Actual results could differ significantly from those estimates. The Company believes that the following discussion addresses the Company's most critical accounting policies, which are those that are most important to the portrayal of the Company's financial condition and results of operations and require management's most difficult, subjective and complex judgments.

Allowance for Loan Losses. Allowance for loan losses are estimated at the individual Banks based on estimates of losses related to customer loan balances. In establishing the appropriate provisions for customer loan balances, the Company makes assumptions with respect to their future collectibility. The Company's assumptions are based on an individual assessment of the customer's credit quality as well as subjective factors and trends, including the credit rating of the loans. Generally, these individual credit assessments occur prior to the inception of the credit exposure and at regular reviews during the life of the exposure and consider (a) the customer's ability to meet and sustain their financial commitments; (b) a customer's current and projected financial condition; (c) the positive or negative effects of the current and projected industry outlook; and (d) the economy in general. Once the Company considers all of these factors, a determination is made as to the probability of default. An appropriate provision is made, which takes into account the severity of the likely loss on the outstanding loan balances based on the Company's experience in collecting these amounts. The Company's level of allowance for loan losses fluctuates depending upon all of the factors mentioned above.

Goodwill and Core Deposit Intangible. Effective January 1, 2002, the Company adopted Statement of Financial Accounting Standards No. 142 ("SFAS No. 142"), "Goodwill and Other Intangible Assets." Under SFAS No. 142, the Company is required to perform annual impairment tests of its goodwill and intangible assets and more frequently in certain circumstances. The Company has elected to test for goodwill and intangible asset impairment in the fourth quarter of each year. In that goodwill is carried on the books of the Banks and the Company owns 100% of their outstanding stock, there is no market value for their common stock. The Company utilizes a multiple of earnings approach in analyzing the valuation of goodwill. Core deposit intangibles are carried on the books of the Banks as well. The valuation of core deposit intangibles incorporate deposits acquired compared with current deposit levels, considers deposit outflow assumptions made at acquisition as well as other factors.

The most recent impairment test of goodwill and core deposit intangible assets indicated that no adjustment was required. The Company cannot predict the occurrence of certain future events that might adversely affect the reported value of goodwill and core deposit intangible that totaled $10,152,000 and $2,949,000, respectively, at December 31 2004. Such events include, but are not limited to, strategic decisions made in response to economic and competitive conditions, the impact of the economic environment on the Company's customer base, or the impact of changes in federal and state laws and regulations.

Pension Benefits. The Company maintains a trusteed non-contributory pension plan (the "Plan") covering substantially all full-time employees. Several statistical and other factors, which attempt to anticipate future events, are used in calculating the expense and liability related to the Plan. Key factors include assumptions about the expected rates of return on plan assets and discount rates. The Company considers market conditions, including changes in investment returns and interest rates, in making these assumptions.

The Company determines the expected long-term rate of return on plan assets based on the building block method, which consists of aggregating the expected rates of return for each component of the plan's asset mix. Plan assets are comprised primarily of mutual funds including bond funds, US equity funds, international equity funds, real estate funds and short-term money market funds. The Company uses historic plan asset returns combined with current market conditions to estimate the rate of return. The expected rate of return on plan assets is a long-term assumption and generally does not change annually. The discount rate reflects the market rate for high-quality fixed income debt instruments on the Company's annual measurement date (December 31) and is subject to change each year.

Unrecognized actuarial gains and losses are being recognized over approximately a 17-year period, which represents the expected remaining service life of the employee group. Unrecognized actuarial gains and losses arise from several factors including experience and assumption changes in the obligations and from the difference between expected returns and actual returns on plan assets. These unrecognized losses will be systematically recognized as an increase in future net periodic pension expense in accordance with FAS 87, "Employers' Accounting for Pensions."

The actuarial assumptions used by the Company in determining its pension benefits may differ materially from actual results due to changing market and economic conditions, higher or lower withdrawal rates or longer or shorter life spans of the participants. While the Company believes that the assumptions used are appropriate, differences in actual experience or changes in assumptions may materially affect the Company's financial position or results of operations.

Mortgage Servicing Rights (MSR or MSRs). Servicing assets are recognized as separate assets when rights are acquired through purchase or through sale of financial assets. Capitalized servicing rights are reported in other assets and

are amortized into noninterest income in proportion to, and over the period of, the estimated future net servicing income of the underlying financial assets. Servicing assets are evaluated for impairment based upon the fair value of the rights as compared to amortized cost. Impairment is determined by stratifying rights by predominant characteristics, such as interest rates and original loan terms (primarily 15 and 30 year). Fair value is determined using prices for similar assets with similar characteristics, when available, or based upon discounted cash flows using market-based assumptions. In periods of falling market interest rates, accelerated loan prepayment speeds can adversely impact the fair value of these mortgage-servicing rights relative to their book value. In the event that the fair value of these assets were to increase in the future, the Company can recognize the increased fair value to the extent of the impairment allowance but cannot recognize an asset in excess of its amortized book value. When the book value of an individual stratum exceeds its fair value, an impairment reserve must be recognized. Future changes in management's assessment of the impairment of these servicing assets, as a result of changes in observable market data relating to market interest rates, loan prepayment speeds, and other factors, could impact the Company's financial condition and results of operations either positively or adversely.

MARKET RISK

Market risk is the risk of loss in a financial instrument arising from adverse changes in market rates and prices, such as interest rates, foreign currency exchange rates, commodity prices and equity prices. The Company's primary market risk exposure is interest rate risk. The ongoing monitoring and management of this risk is an important component of the Company's asset/liability management process which is governed by policies established by the Company's Boards of Directors that are reviewed and approved annually. The Board of Directors delegates responsibility for carrying out the asset/liability management policies to the Company's Asset Liability Committee ("ALCO"). In this capacity ALCO develops guidelines and strategies impacting the Company's asset/liability management-related activities based upon estimated market risk sensitivity, policy limits and overall market interest rate levels/trends.

Interest Rate Risk

Interest rate risk represents the sensitivity of earnings to changes in market interest rates. As interest rates change, the interest income and interest expenses associated with the Company's financial instruments also change, thereby impacting net interest income ("NII"), the primary component of the Company's earnings. ALCO utilizes the results of a detailed and dynamic simulation model to quantify the estimated exposure of NII to sustained interest rate changes. While ALCO routinely monitors simulated NII sensitivity over a rolling 2-year horizon, it also utilizes additional tools to monitor potential longer-term interest rate risk.

The simulation model captures the impact of changing interest rates on the interest income received and interest expense paid on all interest-earning assets and interest-bearing liabilities reflected on the Company's balance sheet. The Company uses computer simulations to determine the impact on net interest income of various interest rate scenarios, balance sheet trends and strategies. These simulations incorporate assumptions about balance sheet dynamics such as loan and deposit growth, loan and deposit pricing, changes in funding mix, and asset and liability repricing and maturity characteristics. Simulations based on numerous assumptions are run under various interest rate scenarios to determine the impact on net interest income and capital. From these scenarios, interest rate risk is quantified and appropriate strategies are developed and implemented.

This sensitivity analysis is compared to ALCO policy limits which specify a

maximum tolerance level for NII exposure over a 1-year horizon given both an immediate 300 basis point, or 3%, upward and downward shift in interest rates. Given the current level of interest rates, the Company has modeled an upward shift in rates of 300 basis points and a downward shift in rates of 100 basis points. Using an immediate rate shock simulation where interest rates increase 300 basis points, the December 31, 2004 earnings simulation model projects that net interest income for the twelve months ending December 31, 2005 would decrease by an amount equal to approximately 1.67%. In addition, utilizing an immediate rate shock simulation where interest rates decrease 100 basis points, the December 31, 2004 earnings simulation model projects that net interest income for the twelve months ending December 31, 2005 would decrease by an amount equal to approximately 2.63%.

Using an immediate rate shock simulation where interest rates increase 300 basis points, the December 31, 2004 earnings simulation model projected that net interest income for the twelve months ending December 31, 2006 would increase by an amount equal to approximately 0.47%. In addition, utilizing an immediate rate shock simulation where interest rates decrease 100 basis points, the December 31, 2004 earnings simulation model projected that net interest income for the twelve months ending December 31, 2006 would decrease by an amount equal to approximately 5.45%. The projected results are within Company's ALCO policy limits for both years.

The preceding sensitivity analysis does not represent a Company forecast and should not be relied upon as being indicative of expected operating results. These hypothetical estimates are based upon numerous assumptions including, among others, the nature and timing of interest rate levels, yield curve shape, prepayments on loans and securities, deposit decay rates, pricing decisions on loans and deposits, and reinvestment/replacement of asset and liability cashflows. The assumptions differed in each of the periods included in the sensitivity analysis above. While assumptions are developed based upon current economic and local market conditions, the Company cannot make any assurances as to the predictive nature of these assumptions, including how customer preferences or competitor influences might change.

The most significant factors affecting the changes in market risk exposure during 2004 compared to 2003 were the continuation of the low interest rate environment, changes in the yield curve for investment securities, the increase in the aggregate principal amount in fixed-rate loans extended by the Banks, the aggregate increase in securities available-for-sale, the increase in total deposits, and the increase in long-term debt.

LIQUIDITY RISK

Liquidity risk management involves the Company's ability to raise funds in order to meet its existing and anticipated financial obligations. These obligations are the withdrawal of deposits on demand or at contractual maturity, the repayment of debt as it matures, the ability to fund new and existing loan commitments and the ability to take advantage of new business opportunities. Liquidity may be provided through amortization, maturity or sale of assets such as loans and securities available-for-sale, liability sources such as increased deposits, utilization of the FHLB credit facility, purchased or other borrowed funds, and access to the capital markets. Liquidity targets are subject to change based on economic and market conditions and are controlled and monitored by ALCO. At the bank level, liquidity is managed by measuring the net amount of marketable assets after deducting pledged assets, plus lines of credit, primarily with the FHLB, which are available to fund liquidity requirements. Management then measures the adequacy of that aggregate amount relative to the aggregate amount of liabilities deemed to be sensitive or volatile. These include brokered deposits, deposits in excess of $100,000, term deposits with short maturities, and credit commitments outstanding.

Additionally, the Company requires cash for various operating needs including

dividends to stockholders, the purchase of treasury stock, capital injections to the Banks, and the payment of general corporate expenses. The primary sources of liquidity for the Company are dividends from the Banks and reimbursement for services performed on behalf of the banks. Additionally, the Company may utilize outside sources of funding such as the issuance of the trust preferred securities during 2002.

Cash and cash equivalents decreased by $6,316,000 during 2004. Cash used for investing activities totaled $38,450,000 with lending activities utilizing $1,112,000 and investment purchases using $34,671,000. Cash provided by financing activities totaled $26,009,000. This cash consisted of an increase in deposits of $12,052,000, an increase in repurchase agreements of $3,867,000 and $20,000,000 from FHLB advances partially offset by the repayment of maturing FHLB advances in the amount of $9,000,000. The net cash provided by operating activities totaled $6,125,000 and consisted primarily of net income of $3,388,000 and a decrease in other assets and other liabilities, net.

CAPITAL EXPENDITURES AND COMMITMENTS

During 2004, the Company incurred approximately $2,267,000 in capital expenditures. The expenditures included approximately $938,000 for the improvement of the commercial lending and administration facility in North Conway, New Hampshire and approximately $220,000 office furnishings for the facility. Approximately $142,000 was expended for an upgrade to the AS400 computer system. The remaining expenditures were for normal replacement of, or upgrades in, existing property and equipment.

During 2003, the Company incurred approximately $1,810,000 in capital expenditures. The expenditures included approximately $846,000 for the purchase and improvement of a commercial lending and administration facility in North Conway, New Hampshire. Approximately $307,000 was expended for the reengineering of the operations department of the Berlin main office facility, which included both construction and furniture costs. The remaining expenditures were for normal replacement of, or upgrades in, existing property and equipment.

The Company's estimated capital expenditures for 2005 total $1,250,000. The Company has budgeted approximately $250,000 for customer relationship management (CRM) software, $138,000 for call center expansion, and $118,000 for upgrades to the mortgage processing system. The remaining expenditures will be incurred for normal replacement of, or upgrades to, existing property and equipment. These expenditures are expected to be funded through normal Company cash flows.

CONTRACTUAL OBLIGATIONS

The table below contains information on the Company's contractual obligations as of the fiscal year ended December 31, 2004:

($000 Omitted)

Contractual Obligations	Total	Less Than One Year	1-3 Years	3-5 Years	More than Five Years
FHLB Advances	$78,000	$2,000	$44,000	$23,000	$ 9,000
Junior subordinated debentures	20,620	--	--	--	20,620
Total	$98,620	$2,000	$44,000	$23,000	$29,620

ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Information regarding quantitative and qualitative disclosures about market risk is included in "Management's Discussion and Analysis of Financial Condition and Results of Operations" appearing under Item 7 of this report and is hereby incorporated by reference in this Item 7A.

ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

CONSOLIDATED STATEMENTS OF INCOME

	($000 Omitted, Except	
FOR THE YEAR ENDED DECEMBER 31,	2004	20
Interest and dividend income		
Interest and fees on loans	$26,569	$27,9
Interest on debt securities available-for-sale:		
Taxable	3,201	3,0
Tax-exempt	142	1
Dividends	239	2
Interest on federal funds sold	125	1
Interest on interest bearing deposits	1	
Total interest and dividend income	30,277	31,5
Interest expense		
Interest on deposits	3,150	4,4
Interest on short-term borrowings	110	1
Interest on long-term debt	4,171	3,9
Total interest expense	7,431	8,4
Net interest and dividend income	22,846	23,0
Provision for loan losses	495	8
Net interest and dividend income after provision for loan losses	22,351	22,2
Noninterest income		
Service charges and fees on deposit accounts	2,229	1,6
Gain on sales of securities available-for-sale, net	753	1,5
Gain on sales of loans, net	374	4
Other	1,741	1,7
Total noninterest income	5,097	5,3
Noninterest expense		
Salaries and employee benefits	11,981	11,4
Office occupancy and equipment	3,731	3,7
Amortization of core deposit intangible	954	9
Write-down of equity securities	--	1
Other	5,728	5,8
Total noninterest expense	22,394	22,1
Income before income tax expense	5,054	5,4
Income tax expense	1,666	1,8
Net income	$ 3,388	$ 3,6

Basic earnings per common share	$ 2.26	$ 2.
Earnings per common share assuming dilution	$ 2.24	$ 2.

See Notes to Consolidated Financial Statements

CONSOLIDATED BALANCE SHEETS

AS OF DECEMBER 31,

Assets
Cash and cash equivalents
  Cash and due from banks and interest bearing deposits
  Federal funds sold

Total cash and cash equivalents

Securities available-for-sale, at fair value
Federal Home Loan Bank stock
Federal Reserve Bank stock
Loans held-for-sale
Loans, net before allowance for loan losses
Less: allowance for loan losses

Net loans

Premises and equipment, net
Goodwill
Core deposit intangible, net
Other assets

Total assets

Liabilities
Deposits
  Demand
  Regular savings, NOW and money market deposit accounts
  Certificates of deposit (in denominations of $100,000 or more)
  Other time

Total deposits

Short-term borrowings
Other liabilities
Long-term debt

Total liabilities

Stockholders' equity
Preferred stock, $1.00 par value; 1,000,000 shares authorized; none issued
Common stock, $1.00 par value; 9,000,000 shares authorized; 1,731,969 issued and 1,503,574

outstanding in 2004 and 1,499,574 outstanding in 2003
Additional paid in capital
Retained earnings
Treasury stock (228,395 shares at December 31, 2004 and 232,395 shares at December 31, 2003)
Accumulated other comprehensive (loss) income, net of tax

Total stockholders' equity

Total liabilities and stockholders' equity

See Notes to Consolidated Financial Statements

CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY

($000 Omitted)

	Common Stock	Additional Paid In Capital	Retained Earnings	Treasury Stock
Balance at December 31, 2001	$1,732	$2,101	$45,955	$(5,864)
Net income - 2002	--	--	2,598	--
Net change in unrealized loss on securities available-for-sale, net of tax	--	--	--	--
Net change in unfunded pension accumulated benefit obligation, net of tax	--	--	--	--
Exercise of stock options, net of tax benefit	--	(13)	--	153
Cash dividends declared ($0.68 per share)	--	--	(1,030)	--
Balance at December 31, 2002	1,732	2,088	47,523	(5,711)
Net income - 2003	--	--	3,617	--
Net change in unrealized loss on securities available-for-sale, net of tax	--	--	--	--
Net change in unfunded pension accumulated benefit obligation, net of tax	--	--	--	--
Treasury stock purchased	--	--	--	(502)
Cash dividends declared ($0.68 per share)	--	--	(1,024)	--
Balance at December 31, 2003	1,732	2,088	50,116	(6,213)
Net income - 2004	--	--	3,388	--
Net change in unrealized gain on securities available-for-sale, net of tax	--	--	--	--
Net change in unfunded pension accumulated benefit obligation, net of tax	--	--	--	--
Exercise of stock options, net of tax benefit	--	(13)	--	123
Treasury stock purchased	--	--	--	--
Cash dividends declared ($0.68 per share)	--	--	(1,020)	--
Balance at December 31, 2004	$1,732	$2,075	$52,484	$(6,090)

(1) Accumulated other comprehensive loss as of December 31, 2004 consists of net unrealized holdi
securities of $18, net of tax, and net unrealized holding losses on unfunded pension accumula
net of tax. Accumulated other comprehensive gain as of December 31, 2003 consists of net unre
available-for-sale securities of $870, net of tax, and net unrealized holding losses on unfun
obligation of $721, net of tax. Accumulated other comprehensive loss as of December 31, 2002

holding losses on available-for-sale securities of $240, net of tax, and net unrealized holdi
accumulated benefit obligation of $1,126, net of tax.

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

FOR THE YEAR ENDED DECEMBER 31,	200
Net income	$3,38
Other comprehensive (loss) income	
Net unrealized (losses) gains on securities available-for-sale	(72
Reclassification adjustment for realized (gains) losses in net income	(75
Net unrealized (losses) gains on securities	(1,47
Minimum pension liability adjustment	7
Other comprehensive (loss) income	(1,39
Income tax (benefit) expense	(55
Other comprehensive (loss) income, net of tax	(84
Comprehensive income	$2,54

See Notes to Consolidated Financial Statements

CONSOLIDATED STATEMENTS OF CASH FLOWS

FOR THE YEAR ENDED DECEMBER 31,	2004
Cash flows from operating activities:	
Net income	$ 3,388
Adjustments to reconcile net income to net cash provided by operating activities:	
Provision for loan losses	495
Depreciation and amortization	2,369
Deferred income tax expense (benefit)	43
Write-down of equity securities	-
Gain on sales of securities available-for-sale, net	(753)
Loss (gain) on sale, disposal and write-down of premises and equipment	9
Amortization of premiums and accretion of discounts on securities, net	90
(Decrease) increase in unearned income, net	(141)
Accretion of discount on loans acquired	(160)
Loss (gain) on sales of other real estate owned and other personal property, net	9
Net decrease in loans held-for-sale	200
Other liabilities assumed net of (other assets acquired) in branch transactions	-
Net change in other assets and other liabilities	576
Net cash provided by operating activities	6,125
Cash flows from investing activities:	
Proceeds from sales of securities available-for-sale	16,964
Proceeds from maturities of securities available-for-sale	25,690

Purchases of securities available-for-sale	(76,515)
Purchases of Federal Home Loan Bank stock	(810)
Purchases of Federal Reserve Bank stock	-
Loan originations and principal collections, net	(7,142)
Recoveries of previously charged-off loans	338
Loans acquired in branch transactions	-
Proceeds from sale of commercial loans	5,088
Proceeds from sales of and payments received on other real estate owned	-
Proceeds from sales of and payments received on other personal property	604
Premises and equipment acquired in branch transactions	-
Additions to premises and equipment	(2,267)
Purchase of company owned life insurance policies	(400)
Net cash used by investing activities	(38,450)
Cash flows from financing activities:	
Net increase (decrease) in deposits	12,052
Deposits assumed in branch transactions, net of assumption premiums	-
Advances from FHLB	20,000
Repayment of FHLB advances	(9,000)
Net increase (decrease) in securities sold under agreements to repurchase	3,867
Exercise of stock options, net of tax benefit	110
Purchases of treasury stock	-
Issuance of in junior subordinated debentures	-
Cash dividends paid	(1,020)
Net cash provided by financing activities	26,009
Net (decrease) increase in cash and cash equivalents	(6,316)
Cash and cash equivalents at beginning of year	31,085
Cash and cash equivalents at end of year	$ 24,769
Supplemental disclosure of cash flows:	
Interest paid	$7,519
Income taxes paid	2,090
Loans transferred to other real estate owned	-
Loans transferred to other personal property	603

See Notes to Consolidated Financial Statements

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 1 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

NATURE OF OPERATIONS

The Company is a bank holding company formed in 1997 under the laws of New Hampshire and is registered under the Bank Holding Company Act of 1956. The Company's only business activity has been to own all of the shares of, and provide management, capital and operational support to, The Berlin City Bank ("BCB") and The Pemigewasset National Bank of Plymouth, New Hampshire ("PNB") and its Delaware statutory business trusts Northway Capital Trust I and Northway Capital Trust II. The Company's headquarters are in Berlin, New Hampshire. The banking subsidiaries are engaged principally in the business of attracting deposits from the general public and investing those deposits in securities, commercial loans, real estate loans, and consumer loans.

BASIS OF PRESENTATION

The consolidated financial statements include the accounts of the Company and its wholly-owned subsidiaries. All significant intercompany accounts and transactions have been eliminated in the consolidation.

Northway Capital Trust I and Northway Capital Trust II, subsidiaries of the Company, were formed to sell capital securities to the public through a third party trust pool. In accordance with FASB Interpretation No. 46, "Consolidation of Variable Interest Entities" ("FIN 46"), the subsidiaries have not been included in the consolidated financial statements.

The accounting and reporting policies of the Company conform to accounting principles generally accepted in the United States of America and to general practices within the banking industry.

In preparing the financial statements, management is required to make estimates and judgments that affect the reported amounts of assets and liabilities as of the dates of the consolidated balance sheets, and income and expense for the periods. Actual results could differ from those estimates. Material estimates that are particularly susceptible to change in the near-term relate to the determination of the allowance for loan losses.

RECLASSIFICATIONS

Certain amounts in the prior years' financial statements have been reclassified to conform with the current year's presentation.

CASH AND CASH EQUIVALENTS

For purposes of the statement of cash flows, cash and cash equivalents include cash and due from banks, federal funds sold and interest bearing deposits.

SECURITIES

Debt securities that the Company has the positive intent and ability to hold to maturity are classified as held-to-maturity and reported at amortized cost; if debt and equity securities are bought and held principally for the purpose of selling in the near term they would be classified as trading and reported at fair value, with unrealized gains and losses included in earnings; and debt and equity securities not classified as either held-to-maturity or trading are classified as available-for-sale and reported at fair value, with unrealized gains and losses excluded from earnings and reported as a separate component of stockholders' equity, net of estimated income taxes. At this time, the Company has not established a trading account.

Premiums and discounts are amortized and accreted primarily on the level yield method over the contractual life of the securities adjusted for expected prepayments.

If a decline in the fair value below the adjusted cost basis of an investment is judged to be other than temporary, the cost basis of the investment is written down to fair value as the new cost basis and the amount of the write-down is included in noninterest expense.

Gains and losses on sales of securities available-for-sale are recognized at the time of the sale on a specific identification basis.

LOANS HELD-FOR-SALE

Loans held-for-sale are generally identified as such at origination and are stated at the lower of aggregate cost or market. Market value is based on outstanding investor commitments. When loans are sold, a gain or loss is

recognized to the extent that the sale proceeds exceed or are less than the carrying value of the loans. Gains and losses are determined using the specific identification method. All loans sold are without recourse to the Company.

LOANS

Loans are carried at the principal amounts outstanding, net of any unearned income, premiums on originated loans and discounts on acquired loans. Unearned income includes loan origination fees, net of direct loan origination costs. This income is deferred and recognized as adjustments to loan income over the contractual life of the related notes using a method the result of which approximates that of the interest method.

Loans are placed on nonaccrual when payment of principal or interest is considered to be in doubt or is past due 90 days or more. The Company may choose to place a loan on nonaccrual status due to payment delinquency or uncertain collectibility, while not classifying the loan as impaired, if (i) it is probable that the Company will collect all amounts due in accordance with the contractual terms of the loan or (ii) the loan is not a commercial, commercial real estate or an individually significant mortgage or consumer loan. Previously accrued income on nonaccrual loans that has not been collected is reversed from current income, and subsequent cash receipts are recorded as income. Loans are returned to accrual status when collection of all contractual principal and interest is reasonably assured and there has been sustained repayment performance.

The Company's loans are primarily secured by real estate in New Hampshire. In addition, other real estate owned is located in this market. Accordingly, the ultimate collectibility of a substantial portion of the Company's loan portfolio and the recovery of other real estate owned are susceptible to changing conditions in this market.

ALLOWANCE FOR LOAN LOSSES

The allowance for loan losses is maintained at a level considered adequate by management on the basis of many factors including the risk characteristics of the portfolio, trends in loan delinquencies and an assessment of existing economic conditions. Additions to the allowance are charged to earnings; realized losses, net of recoveries, are charged directly to the allowance.

While management uses available information in establishing the allowance for loan losses, future additions to the allowance may be necessary if economic conditions differ substantially from the estimates used in making the evaluations. In addition, various regulatory agencies, as an integral part of their examination process, periodically review the Banks' allowances for loan losses. Such agencies may require the Banks to recognize additions to the allowance based on judgments different from those of management.

Commercial, commercial real estate and individually significant mortgage and consumer loans are considered impaired, and are placed on nonaccrual, when it is probable that the Company will not be able to collect all amounts due according to the contractual terms of the loan agreement. Mortgage and consumer loans, which are not individually significant, are measured for impairment collectively. Loans that experience insignificant payment delays and insignificant shortfalls in payment amounts generally are not classified as impaired. The amount of impairment for all impaired loans is determined by the difference between the present value of the expected cash flows related to the loan, using the original contractual interest rate, and its recorded value, or, as a practical expedient in the case of collateralized loans, the difference between the fair value of the collateral and the recorded amount of the loan.

When foreclosure is probable, impairment is measured based on the fair value of

the collateral.

SERVICING ASSETS

Servicing assets are recognized as separate assets when rights are acquired through purchase or through sale of financial assets. Capitalized servicing rights are reported in other assets and are amortized into noninterest income in proportion to, and over the period of, the estimated future net servicing income of the underlying financial assets. Servicing assets are evaluated for impairment based upon the fair value of the rights as compared to amortized cost. Impairment is determined by stratifying rights by predominant characteristics, such as interest rates and terms. Fair value is determined using prices for similar assets with similar characteristics, when available, or based upon discounted cash flows using market-based assumptions. Impairment is recognized through a valuation allowance for an individual stratum, to the extent that fair value is less than the capitalized amount for the stratum.

OTHER REAL ESTATE OWNED

Other real estate owned is comprised of properties acquired either through foreclosure proceedings or acceptance of a deed in lieu of foreclosure, and for which the Company has taken physical possession. The Company classifies loans as repossessed or foreclosed if the Company receives physical possession of the debtor's assets, regardless of whether or not foreclosure proceedings take place.

Assets acquired through foreclosure or a similar conveyance of title are initially recorded at the lower of the carrying value of the loan or the fair value, less estimated costs to sell, of the property constructively or actually received. Gains and losses upon disposition are reflected in the statement of income as realized.

PREMISES AND EQUIPMENT

Premises and equipment are carried at cost less accumulated depreciation. Depreciation is computed on the straight-line method over the estimated useful lives of the respective assets. Estimated lives are 39 years for buildings, ten to fifteen years for building improvements and three to seven years for furniture and equipment.

Amortization of leasehold improvements is accumulated on a straight-line basis over the lesser of the term of the respective lease or the asset's useful life, not to exceed ten years.

ADVERTISING

The Company directly expenses costs associated with advertising as they are incurred.

INCOME TAXES

The Company uses the asset and liability method of accounting for income taxes. Under the asset and liability method, deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and the respective tax bases and operating loss and tax credit carry forwards. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date.

STOCK-BASED COMPENSATION

At December 31, 2004, the Company has a stock-based employee compensation plan which is described more fully in Note 14. The Company accounts for this plan under the recognition and measurement principles of APB Opinion No. 25, Accounting for Stock Issued to Employees, and related Interpretations. No stock-based employee compensation cost is reflected in net income, as all options granted under this plan had an exercise price equal to the market value of the underlying common stock on the date of the grant. The following table illustrates the effect on net income and earnings per share if the Company had applied the fair value recognition provisions of SFAS No. 123 (revised 2004), "Share-Based Payment", to stock-based employee compensation.

		($000 Omitt 2004
Net income	As reported	$3,388
Deduct: Total stock-based employee compensation expense determined under fair value based methods awards, net of related tax effects		--
	Pro forma	$3,388
Earnings per common share	As reported	$ 2.26
	Pro forma	2.26
Earnings per common share (assuming dilution)	As reported	$ 2.24
	Pro forma	2.24

EARNINGS PER SHARE

Basic earnings per share ("EPS") excludes dilution and is computed by dividing income available to common stockholders by the weighted-average number of common shares outstanding for the period. Diluted EPS, if applicable, reflects the potential dilution that could occur if securities or other contracts to issue common stock were exercised or converted into common stock or resulted in the issuance of common stock that then shared in the earnings of the entity.

Earnings per common share have been computed based on the following:

	($000 Omitted) Years Ended December 31,		
	2004	2003	2002
Net income	$3,388	$3,617	$2,598
Less: Preferred stock dividends	--	--	--
Net income applicable to common stock	$3,388	$3,617	$2,598
Average number of common shares outstanding	1,500.1	1,504.4	1,515.1
Effect of dilutive options	11.6	7.8	6.0
Average number of common shares outstanding used to calculate diluted earnings per common share	1,511.7	1,512.2	1,521.1

RECENT ACCOUNTING PRONOUNCEMENTS

In April 2003, the FASB issued SFAS No. 149, "Amendment of Statement No. 133 on Derivative Instruments and Hedging Activities" ("SFAS No. 149"), which amends and clarifies financial accounting and reporting for derivative instruments, including certain derivative instruments embedded in other contracts and for hedging activities under SFAS No. 133, "Accounting for Derivative Instruments and Hedging Activities." This Statement (a) clarifies under what circumstances a contract with an initial net investment meets the characteristic of a derivative, (b) clarifies when a derivative contains a financing component, (c) amends the definition of an underlying to conform to language used in FASB Interpretation No. 45, "Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others," and (d) amends certain other existing pronouncements. The provisions of SFAS No. 149 are effective for contracts entered into or modified after June 30, 2003. There was no substantial impact on the Company's consolidated financial statements on adoption of this Statement.

In May 2003, the FASB issued SFAS No. 150, "Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity" ("SFAS No. 150"). This Statement establishes standards for the classification and measurement of certain financial instruments with characteristics of both liabilities and equity. SFAS No. 150 requires that certain financial instruments that were previously classified as equity must be classified as a liability. Most of the guidance in SFAS No. 150 is effective for financial instruments entered into or modified after May 31, 2003, and otherwise is effective at the beginning of the first interim period beginning after June 15, 2003. This Statement did not have any material effect on the Company's consolidated financial statements.

In January 2003, the FASB issued Interpretation No. 46, "Consolidation of Variable Interest Entities" ("FIN 46"), in an effort to expand upon and strengthen existing accounting guidance that addresses when a company should include in its financial statements the assets, liabilities and activities of another entity. In December 2003, the FASB revised Interpretation No. 46, also referred to as Interpretation 46 (R) ("FIN 46(R)"). The objective of this interpretation is not to restrict the use of variable interest entities but to improve financial reporting by companies involved with variable interest entities. Until now, one company generally has included another entity in its consolidated financial statements only if it controlled the entity through voting interests. This interpretation changes that, by requiring a variable interest entity to be consolidated by a company only if that company is subject to a majority of the risk of loss from the variable interest entity's activities or entitled to receive a majority of the entity's residual returns or both. The Company is required to apply FIN 46, as revised, to all entities subject to it no later than the end of the first fiscal year or interim period ending after March 15, 2004. However, prior to the required application of FIN 46, as revised, the Company shall apply FIN 46 or FIN 46 (R) to those entities that are considered to be special-purpose entities as of the end of the first reporting period ending after December 15, 2003. The adoption of this interpretation did not have a material effect on the Company's consolidated financial statements.

In December 2003, the FASB issued SFAS No. 132 (revised 2003), "Employers' Disclosures about Pensions and Other Postretirement Benefits - an amendment of SFAS No. 87, SFAS No. 88 and SFAS No. 106" ("SFAS No. 132 (revised 2003)"). This Statement revises employers' disclosures about pension plans and other postretirement benefit plans. It does not change the measurement or recognition of those plans required by SFAS No. 87, "Employers' Accounting for Pensions," SFAS No. 88, "Employers' Accounting for Settlements and Curtailments of Defined Benefit Pension Plans and for Termination Benefits," and SFAS No. 106, "Employers' Accounting for Postretirement Benefits Other Than Pensions." This

Statement retains the disclosure requirements contained in SFAS No. 132, "Employers' Disclosures About Pensions and Other Postretirement Benefits," which it replaces. It requires additional disclosures to those in the original Statement 132 about assets, obligations, cash flows and net periodic benefit cost of defined benefit pension plans and other defined benefit postretirement plans. This Statement is effective for financial statements with fiscal years ending after December 15, 2003 and interim periods beginning after December 15, 2003. Adoption of this Statement did not have a material impact on the Company's consolidated financial statements.

In December 2003, the American Institute of Certified Public Accountants ("AICPA") issued Statement of Position 03-3 ("SOP 03-3") "Accounting for Certain Loans or Debt Securities Acquired in a Transfer." SOP 03-3 requires loans acquired through a transfer, such as a business combination, where there are differences in expected cash flows and contractual cash flows due in part to credit quality be recognized at their fair value. The excess of contractual cash flows over expected cash flows is not to be recognized as an adjustment of yield, loss accrual, or valuation allowance. Valuation allowances cannot be created nor "carried over" in the initial accounting for loans acquired in a transfer on loans subject to SFAS 114, "Accounting by Creditors for Impairment of a Loan." This SOP is effective for loans acquired in fiscal years beginning after December 15, 2004, with early adoption encouraged. The Company does not believe the adoption of SOP 03-3 will have a material impact on the Company's financial position or results of operations.

In December 2004, the FASB issued SFAS No. 123 (revised 2004), "Share-Based Payment" ("SFAS 123R"). This Statement revises FASB Statement No. 123, "Accounting for Stock Based Compensation" and supersedes APB Opinion No. 25, "Accounting for Stock Issued to Employees," and its related implementation guidance. SFAS 123R requires that the cost resulting from all share-based payment transactions be recognized in the financial statements. It establishes fair value as the measurement objective in accounting for share-based payment arrangements and requires all entities to apply a fair-value based measurement method in accounting for share-based payment transactions with employees except for equity instruments held by employee share ownership plans. This Statement is effective for the Company as of the beginning of the first interim or annual reporting period that begins after June 15, 2005. The Company does not believe the adoption of this Statement will have a material impact on the Company's financial position or results of operations.

NOTE 2 CASH AND DUE FROM BANKS

Cash and due from banks at December 31, 2004 and 2003 includes $3,753,000 and $3,588,000, respectively, which is subject to withdrawals and usage restrictions to satisfy the reserve requirements of the Federal Reserve Bank.

NOTE 3 SECURITIES AVAILABLE-FOR-SALE

The amortized cost, gains in accumulated other comprehensive income, losses in accumulated other comprehensive income and fair value of securities at December 31, 2004 and 2003 follows:

	($000 Omitted)			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
December 31, 2004				
US Treasury and other US government agency securities	$ 54,914	$ 1	$ 352	$54,563
Marketable equity securities	1,827	136	32	1,931
Mortgage-backed securities	29,447	92	248	29,291

Collateralized mortgage obligations	10	-	-	10
Corporate bonds	12,001	293	7	12,287
State and political subdivision bonds and notes	2,966	85	-	3,051
	$101,165	$ 607	$ 639	$101,133

	($000 Omitted)			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
December 31, 2003				
US Treasury and other US government agency securities	$37,945	$ 74	$179	$37,840
Marketable equity securities	2,589	251	74	2,766
Mortgage-backed securities	2,803	90	5	2,888
Collateralized mortgage obligations	15	-	-	15
Corporate bonds	20,857	1,126	-	21,983
State and political subdivision bonds and notes	2,432	158	-	2,590
	$66,641	$1,699	$258	$68,082

The contractual maturity distribution of investments in debt obligations at December 31, 2004 follows:

			($000 Omit
	Within One Year	One to Five Years	Five t Ten Years
US Treasury and other US government agency securities	$1,999	$47,915	$5,00
Mortgage-backed securities	2	1,158	12
Collateralized mortgage obligations	--	--	-
Corporate bonds	--	9,983	2,01
State and political subdivision bonds and notes	1,129	498	81
Total amortized cost	$3,130	$59,554	$7,95
Fair value	$3,130	$59,591	$7,96

Actual maturities of state and political subdivision bonds and notes, mortgage-backed securities and collateralized mortgage obligations will differ from the maturities presented because borrowers have the right to prepay obligations without prepayment penalties.

An analysis of gross realized gains and losses on securities available-for-sale during the years ended December 31, follows:

	($000 Omitted)			
	2004		2003	
	Realized Gains	Realized Losses	Realized Gains	Realized Losses
Equity securities	$ 402	$ 149	$ 97	$ 244
US government agency securities	5	--	15	--
Mortgage-backed securities	--	--	--	--
Corporate bonds	539	50	1,682	28
State and political subdivisions	6	--	--	--
	$ 952	$ 199	$ 1,794	$ 272

The tax provision applicable to these net realized gains amounted to $298,000, $603,000 and 60,000 for 2004, 2003, and 2002, respectively.

Securities with a carrying amount totaling $72,106,000 and $39,789,000 were pledged to secure public deposits, securities sold under agreements to repurchase, FHLB advances and treasury, tax and loan accounts at December 31, 2004 and 2003, respectively.

The aggregate fair value and unrealized losses of securities that have been in a continuous unrealized loss position for less than twelve months and for twelve months or more, and are not other than temporarily impaired, are as follows as of December 31, 2004:

	($000 Omitted)			
	Less than 12 Months		12 Months or Longer	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
US government agency securities	$41,792	$ 186	$ 9,828	$ 166
Marketable equity securities	458	32	--	--
Mortgage-backed securities	24,428	244	260	4
Corporate bonds	1,998	7	--	--
Total temporarily impaired securities	$68,676	$ 469	$10,088	$ 170

At December 31, 2004, securities with a total fair value of $78,764,000 were in a loss position. These securities included twenty-two US government agency securities with a fair value of $51,620,000 and an unrealized loss of $352,000. These securities had an unrealized loss due to the current interest rate environment. As these securities are guaranteed by US government agencies such as FHLB, FHLMC or FNMA there is no credit risk associated with them. These securities are not other-than-temporarily impaired as the Company has the ability and the intent to hold these securities until recovery.

Mortgage-backed securities with a fair value of $24,688,000 had an unrealized loss of $248,000 at December 31, 2004. As with the US government agency securities, these securities have an unrealized loss due to the current

interest rate environment. As all of these mortgage-backed securities are guaranteed by US government agencies such as FHLMC, GNMA or FNMA there is no credit risk associated with them. These securities have not been classified as other-than-temporarily impaired as the Company has the ability and intent to hold these securities until recovery.

Nine marketable equity securities with a fair value of $458,000 had an unrealized loss of $32,000 at December 31, 2004. Marketable equity securities are subject to internal testing on a quarterly basis to determine impairment. Testing includes review of industry analyst reports, credit ratings, sector analysis and earnings projections. Based upon the December 31, 2004 review, these securities were not determined to be other-than-temporarily impaired.

One corporate bond security with a fair value of $1,998,000 had an unrealized loss of $7,000 at December 31, 2004. Corporate bond securities are subject to internal testing on a quarterly basis to determine other-than-temporary-impairment. Based upon the December 31, 2004 review, this security was not determined to be other-than-temporarily-impaired.

NOTE 4 LOANS

Loan balances were comprised of the following:

December 31,	($000 Omitted) 2004	2003
Real estate:		
Residential	$147,333	$129,493
Commercial	130,334	120,366
Construction	5,366	3,851
Commercial	27,013	24,528
Installment	29,345	30,291
Indirect installment	116,520	150,807
Other	18,901	14,530
Total loans	474,812	473,866
Less:		
Unearned income	106	247
Allowance for loan losses	5,204	5,036
Total unearned income and allowance for loan losses	5,310	5,283
Net loans	$469,502	$468,583

Total loans above are net of unearned discount on loans acquired in the amount of $415,000 and $575,000 at December 31, 2004 and 2003, respectively. In addition, total loans above are net of unamortized premium on indirect installment loans originated in the amount of $2,005,000 and $3,392,000 at December 31, 2004 and 2003, respectively.

Loans are made in the ordinary course of business to directors, executive officers, and their immediate families and to organizations in which such persons have more than a 10% ownership interest. These loans are made on substantially the same terms, including interest rate and collateral, as those prevailing at the same time for comparable transactions with unrelated persons and did not involve more than the normal risk of collectibility or present other unfavorable features. Total loans to such persons and their companies amounted to $660,000 as of December 31, 2004. During 2004, principal payments were $148,000 and principal advances amounted to $498,000.

The Company's lending activities are conducted principally in New Hampshire. Although the loan portfolio is diversified, a portion of its debtors' ability to repay is dependent upon the economic conditions prevailing in New Hampshire. The Company maintains significant credit relationships with borrowers in the hotel and motel industry. The aggregate loan balances to these industries totaled $59,730,000 at December 31, 2004 and $56,200,000 at December 31, 2003.

Loans serviced for others are not included in the accompanying statements of financial condition. The unpaid principal balances of these loans total $43,979,000 and $45,967,000 at December 31, 2004 and 2003, respectively. The Company sold $15,228,000 of mortgage loans and $5,088,000 of SBA guaranteed commercial loans in 2004 and $22,483,000 of mortgage loans and $1,482,000 of indirect installment loans in 2003.

The Company capitalized $80,000 and $187,000 of servicing rights and amortized $168,000 and $137,000 of those rights in 2004 and 2003, respectively. Impairment of mortgage servicing rights of $(2,000) and $5,000 was recognized in 2004 and 2003, respectively. Impairment of mortgage servicing rights is assessed based on the fair value of those rights. Fair values are estimated using discounted cash flows based on a current market interest rate. The amount of the impairment recognized is the amount by which the capitalized mortgage servicing rights exceed their fair value. At December 31, 2004 and 2003, respectively, the carrying amount of servicing rights was $298,000 and $384,000, and is included in other assets.

Restructured, accruing loans entered into prior to the adoption of SFAS No. 114 and 118 are not required to be reported as impaired loans unless such loans are not performing in accordance with the restructured terms at adoption of SFAS No. 114. Restructured, accruing loans entered into subsequent to the adoption of these statements are reported as impaired loans. In the year subsequent to restructure these loans may be removed from the impaired loan disclosure provided that the loan bears a market rate of interest at the time of restructure and is performing under the restructured terms.

At December 31, 2004 and 2003, loans restructured in a troubled debt restructuring before January 1, 1995, the effective date of SFAS No. 114, that are not impaired based on the terms specified by the restructuring agreement totaled $838,000 and $897,000, respectively. The gross interest income that would have been recorded in the years ended December 31, 2004 and 2003 if such restructured loans had been current in accordance with their original terms was $60,000 and $65,000, respectively. The amount of interest income recognized on such restructured loans for the years ended December 31, 2004 and 2003 was $43,000 and $44,000, respectively.

At December 31, 2004 and 2003, nonperforming loans totaled $2,867,000 and $4,089,000, respectively. No nonperforming loans were past due 90 days or more and still accruing interest for both December 31, 2004 and 2003.

The recorded investment in loans that are considered to be impaired under SFAS No. 114 was $1,914,000 and $3,014,000 at December 31, 2004 and 2003, respectively, for which the related allowance for loan losses is $307,000 and $485,000 as of December 31, 2004 and 2003, respectively. All of the Company's impaired loans are collateralized and therefore all impaired loans are measured by the difference between the fair value of the collateral and the recorded amount of the loan. All of the Company's impaired loans had a related allowance for loan losses at December 31, 2004 and 2003. The average recorded investment in impaired loans during the twelve months ended December 31, 2004 and 2003 was approximately $2,305,000 and $3,001,000, respectively. For the twelve months ended December 31, 2004 and 2003 the Company recognized interest income on impaired loans of $147,000 and $217,000, respectively, which included $128,000 and $168,000 of interest income recognized using the cash-basis method of

income recognition, respectively.

NOTE 5 ALLOWANCE FOR LOAN LOSSES

Changes in the allowance for loan losses for the years ended December 31, follows:

	($000 Omitted)		
	2004	2003	2002
Balance at beginning of year	$5,036	$4,920	$4,642
Provision for loan losses	495	805	900
Recoveries on loans previously charged-off	338	181	202
Loans charged-off	(665)	(870)	(824)
Balance at end of year	$5,204	$5,036	$4,920

NOTE 6 PREMISES AND EQUIPMENT

A summary of premises and equipment follows:

	($000 Omitted) December 31,	
	2004	2003
Land	$ 2,650	$ 2,445
Buildings	11,509	9,644
Leasehold improvements	365	508
Construction in progress	36	958
Equipment	8,906	7,855
	23,466	21,410
Less accumulated depreciation and amortization	9,765	8,552
	$13,701	$12,858

Depreciation expense for the years ended December 31, 2004, 2003 and 2002 amounted to $1,415,000, $1,427,000 and $1,315,000, respectively.

The Company leases five of its locations under non-cancelable operating leases and two locations under tenant at will agreements. In addition, the Company leases two storage facilities under non-cancelable leases. Minimum lease payments in future periods under non-cancelable operating leases at December 31, 2004 are as follows:

	($000 Omitted)
2005	$ 221
2006	156
2007	123
2008	25
	$ 525

The terms of two of the leases provide that the Company can, at the end of the current five-year term, renew the lease under one five-year option. All leases contain a provision that the Company shall pay its pro-rata share of operating costs. Additionally, two of the leases require that the Company pay all real estate taxes.

Rent expense for the years ended December 31, 2004, 2003, and 2002 amounted to $404,000, $421,000 and $369,000, respectively.

NOTE 7 DEPOSITS

The aggregate amount of maturities for time deposits as of December 31, 2004, for each of the following five years ended December 31 and thereafter, are as follows:

	($000 Omitted)
2005	$ 92,555
2006	34,698
2007	5,134
2008	462
2009	136
Thereafter	20
	$133,005

Deposits from related parties held by the Banks at December 31, 2004 and 2003 amounted to $2,953,000 and $3,081,000, respectively.

NOTE 8 SHORT-TERM BORROWINGS

Short-term borrowings consist of securities sold under agreements to repurchase. The securities sold under agreements to repurchase as of December 31, 2004 and 2003 are securities sold on a short term basis by the Company that have been accounted for not as sales but as borrowings. The underlying securities associated with securities sold under agreements to repurchase are under the control of the Company. The purchasers have agreed to sell to the Company substantially identical securities at the maturity of the agreements.

NOTE 9 LONG-TERM DEBT

Long-term debt at December 31, 2004 and 2003 consisted of FHLB advances of $78,000,000 and $67,000,000, respectively, as well as $20,620,000 of junior subordinated debentures, for each year.

As of December 31, 2004, contractual principal payments due under long-term debt, which consists of FHLB advances and junior subordinated debentures, are as follows:

	($000 Omitted)
2005	$ 2,000
2006	31,000
2007	13,000
2008	4,000
2009	19,000
2010 and years thereafter	29,620
	$98,620

The FHLB long-term debt consisted of twenty five separate advances. Seven of these advances are callable with the following rates terms:

($000 Omitted)

Amount	Rate	Maturity Date	Next Call Date

$ 5,000	6.11%	03/28/07	03/28/05
7,000	5.54	11/02/09	02/01/05
7,000	5.57	11/09/09	02/09/05
5,000	5.91	12/17/09	03/17/05
2,000	4.80	12/27/10	03/28/05
3,000	4.50	01/24/11	01/24/05
1,000	4.58	02/07/11	02/07/05
$30,000			

The remaining eighteen advances, totaling $48,000,000, are at rates ranging from 1.96% to 3.85% with a weighted average rate of 2.52%.

The $20,620,000 of junior subordinated debentures consists of the following two issues:

On April 10, 2002, the Company completed the private placement of $7,217,000 aggregate liquidation amount of floating rate trust preferred securities (the "Trust I Capital Securities") issued by its Delaware statutory business trust, Northway Capital Trust I ("Capital Trust I"). The Trust I Capital Securities were sold to a pooled investment vehicle. The proceeds from the sale of the Trust I Capital Securities, which included the proceeds from the sale by Capital Trust I of its common securities to the Company, were invested in Floating Rate Junior Subordinated Debt Securities of the Company due 2032 (the "Trust I Junior Subordinated Debt"), which were issued pursuant to an Indenture, dated April 10, 2002, between the Company and Wilmington Trust Company, as Trustee. Both the Trust I Capital Securities and the Trust I Junior Subordinated Debt have a floating rate, which resets semi-annually, equal to six-month LIBOR plus 3.70%, with a ceiling of 11.00% for the first five years. Currently, the interest rate on these securities is 6.00%. Payments of distributions and other amounts due on the Trust I Capital Securities are irrevocably guaranteed by the Company, to the extent that Capital Trust I has funds available for the payments of such distributions, pursuant to a Guarantee Agreement, dated April 10, 2002, between the Company and Wilmington Trust Company, as Guarantee Trustee. The Trust I Junior Subordinated Debt and the Trust I Capital Securities may be redeemed at the option of the Company on fixed semi-annual dates beginning on April 22, 2007.

On July 11, 2002, the Company completed the private placement of $13,403,000 aggregate liquidation amount of floating rate trust preferred securities (the "Trust II Capital Securities") issued by its Delaware statutory business trust, Northway Capital Trust II (the "Capital Trust II"). The Trust II Capital Securities were sold to a pooled investment vehicle. The proceeds from the sale of the Trust II Capital Securities, which include the proceeds from the sale by Capital Trust II of its common securities to the Company, were invested in Floating Rate Junior Subordinated Debt Securities of the Company due 2032 (the "Trust II Junior Subordinated Debt"), which were issued pursuant to an Indenture, dated July 11, 2002, between the Company and Wilmington Trust Company, as Trustee. Both the Trust II Capital Securities and the Trust II Junior Subordinated Debt have a floating rate, which resets quarterly, equal to three-month LIBOR plus 3.65%, with a ceiling of 12.50% for the first five years. Currently, the interest rate on these securities is 5.72%. Payments of distributions and other amounts due on the Trust II Capital Securities are irrevocably guaranteed by the Company, to the extent that Capital Trust II has funds available for the payments of such distributions, pursuant to a Guarantee Agreement, dated July 11, 2002, between the Company and Wilmington Trust Company, as Guarantee Trustee. The Trust II Junior Subordinated Debt and the Trust II Capital Securities may be redeemed at the option of the Company on fixed quarterly dates beginning on July 7, 2007.

NOTE 10 ACQUISITIONS

On October 18, 2002, the Company acquired certain assets and assumed the deposits of three branches offices of Fleet National Bank located in Laconia, Belmont and Pittsfield, New Hampshire. This acquisition has allowed the Company to expand its market area further into Belknap and Merrimack Counties. Deposits assumed totaled $54,932,000 for which the Company paid a deposit purchase premium of 11.25%. In addition, the Company acquired certain loans associated with the branches totaling $20,192,000. As a result of this purchase the Company made the following entries to record this transaction:

	($000 Omitted)	
Cash	$26,738	
Loans	20,192	
Goodwill	4,766	
Core deposit intangible	2,639	
Land and buildings	430	
Furniture and fixtures	13	
Leasehold improvements	76	
Other assets	83	
Building lease and equipment expense	12	
Salary expense	7	
Deposits		$54,932
Other liabilities		17
Other income		7

This transaction was accounted for using the purchase method of accounting. The results of operations of the acquired branches are included in the 2002 consolidated statements of income of the Company from the date of the transaction.

The cost of the acquired branch offices exceeded the fair value of the assets acquired and liabilities assumed by $7,405,000. Of this amount, $2,639,000 was assigned to core deposit intangible and $4,766,000 was recorded as goodwill. All of the goodwill was deductible for tax purposes. The core deposit intangible of $2,639,000 is being amortized to noninterest expense over fifty months using the straight line method.

Management reviews the carrying amount of intangible assets resulting from these transactions on an ongoing basis, taking into consideration any events and circumstances that might have diminished such amount. During 2004 and 2003, the Company reviewed the carrying amount of intangible assets and determined that no impairment was required.

NOTE 11 REGULATORY MATTERS

The Company and the Banks are subject to various regulatory capital requirements administered by the federal banking agencies. Failure to meet minimum capital requirements can initiate certain mandatory, and possibly additional discretionary actions by regulators that, if undertaken, could have a direct material effect on the Banks' financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the Banks must meet specific capital guidelines that involve quantitative measures of the Banks' assets, liabilities and certain off-balance sheet items as calculated under regulatory accounting practices. The Banks' capital amounts and classifications are also subject to qualitative judgments by the regulators about components, risk weightings and other factors.

Quantitative measures established by regulation to ensure capital adequacy require the Company and the Banks to maintain minimum amounts and ratios (set forth in the table below) of total and Tier 1 capital (as defined in the regulations) to risk-weighted assets (as defined), and of Tier 1 capital (as

defined) to average assets (as defined). As of December 31, 2004, the most recent notification from the FDIC categorized both banks as "well-capitalized" under the regulatory framework for prompt corrective action. To be categorized as "well-capitalized" the Banks must maintain total risk-based, Tier 1 risk-based and Tier 1 leverage ratios above regulatory prescribed minimum levels. There are no conditions or events since that notification that management believes have changed the Company's and Banks' categories. Management believes, as of December 31, 2004 and 2003, that the Company and the Banks meet all capital adequacy requirements to which they are subject.

These minimum capital amounts and ratios, as well as the Company's and Banks' actual capital amounts and ratios, are presented in the following table:

($000 Omit

	Actual		For Capi Adequa Purpos
	Amount	Ratio	Amount
As of December 31, 2004			
Tier 1 capital (to average assets)			
Consolidated	$52,736	8.43%	$25,014
The Berlin City Bank	30,589	7.71	15,869
The Pemigewasset National Bank of Plymouth, New Hampshire	17,561	7.74	9,071
Total capital (to risk weighted assets)			
Consolidated	62,305	13.94	35,745
The Berlin City Bank	34,051	11.79	23,097
The Pemigewasset National Bank of Plymouth, New Hampshire	19,386	12.72	12,197
Tier 1 capital (to risk weighted assets)			
Consolidated	52,736	11.80	17,872
The Berlin City Bank	30,589	10.59	11,549
The Pemigewasset National Bank of Plymouth, New Hampshire	17,561	11.52	6,099
As of December 31, 2003			
Tier 1 capital (to average assets)			
Consolidated	$43,769	7.22%	$24,256
The Berlin City Bank	28,732	7.09	16,220
The Pemigewasset National Bank of Plymouth, New Hampshire	16,572	7.55	8,774
Total capital (to risk weighted assets)			
Consolidated	58,020	12.81	36,244
The Berlin City Bank	32,231	10.51	24,526
The Pemigewasset National Bank of Plymouth, New Hampshire	18,184	12.50	11,642
Tier 1 capital (to risk weighted assets)			
Consolidated	43,769	9.66	18,122
The Berlin City Bank	28,732	9.37	12,263
The Pemigewasset National Bank of Plymouth, New Hampshire	16,572	11.39	5,821

Federal regulations prohibit banking companies from paying dividends on their

stock if the effect would cause stockholders' equity to be reduced below applicable regulatory capital requirements or if such declaration and payment would otherwise violate regulatory requirements.

Under the National Bank Act, the approval of the OCC is required if dividends declared by PNB to the Company in any year exceed the net profits of that year, as defined, combined with the retained net profit for the two preceding years. At December 31, 2004 PNB could, without approval of the OCC, declare dividends aggregating $1,132,000.

As of December 31, 2004, BCB is restricted from declaring dividends to the Company in an amount greater than approximately $10,954,000, as such declaration would decrease capital below BCB's required minimum level of regulatory capital.

NOTE 12 OTHER NONINTEREST EXPENSE

The major components of other noninterest expense for the years ended December 31, are as follows:

	($000 Omitted)		
	2004	2003	2002
Professional fees	$1,234	$1,166	$1,096
Stationery and supplies	429	556	596
Telecommunications	595	571	505
Postage and shipping	348	378	378
ATM expense	295	442	366
Other	2,827	2,706	2,652
	$5,728	$5,819	$5,593

NOTE 13 FEDERAL AND STATE TAXES

The components of federal and state tax expense for the years ended December 31, are as follows:

	($000 Omitted)		
	2004	2003	2002
Current			
Federal	$1,289	$1,713	$ 985
State	334	403	327
	1,623	2,116	1,312
Deferred			
Federal	44	(181)	176
State	(1)	(37)	(12)
	43	(218)	164
Change in valuation allowance	--	(31)	31
	43	(249)	195
Total	$1,666	$1,867	$1,507

The temporary differences (the differences between the financial statement

carrying amounts of existing assets and liabilities and their respective tax bases) that give rise to significant portions of the deferred income tax asset and deferred income tax liability at December 31, are as follows:

	($000 Omitted)	
	2004	2003
Deferred income tax asset		
Allowance for loan losses	$ 1,988	$1,836
Other	10	10
Interest on nonaccrual loans	19	27
Loan origination costs, net	4	23
Unrealized holding loss on securities available-for-sale	14	--
Securities writedown	--	9
Capital loss carryforward	70	162
Minimum pension liability adjustment	345	371
Amortization of goodwill and core deposit intangible	130	257
Supplemental pension	250	136
	2,830	2,831
Deferred income liabilities		
Depreciation	(801)	(751)
Unrealized holding gain on securities available-for-sale	--	(571)
Prepaid pension	(246)	(208)
Mortgage and consumer servicing rights	(118)	(152)
	(1,165)	(1,682)
Deferred income tax asset, net	$ 1,665	$1,149

The primary sources of recovery of the deferred income tax asset are taxes paid that are available for carryback and the expectation that the deductible temporary differences will reverse during periods in which the Company generates taxable income.

Total income tax expense for the years ended December 31, 2004, 2003 and 2002 differs from the "expected" federal income tax expense at the 34% statutory rate for the following reasons:

	2004	2003	2002
Expected federal income taxes	34.0%	34.0%	34.0%
Interest on municipal securities available-for-sale and municipal loans	(4.5)	(3.3)	(3.8)
State tax expense, net of federal benefit	4.3	4.4	5.1
Valuation allowance for securities	-	(0.6)	-
Other	(0.8)	(0.4)	1.4
Effective tax rates	33.0%	34.1%	36.7%

NOTE 14 EMPLOYEE BENEFITS

Pension Plan

The Company maintains a trusteed non-contributory pension plan (the "Plan") covering substantially all full-time employees. Assuming retirement at age 65 after 30 years or more of service, the benefits are computed as the sum of one

percent of final average earnings up to a covered compensation limit, plus 0.65 percent of final average earnings in excess of covered compensation, times years of service, up to 30. Final average earnings are defined as the five consecutive years out of the employee's last ten years of employment during which compensation is highest. The amounts contributed to the Plan are determined annually on the basis of (a) the maximum amount that can be deducted for federal income tax purposes or (b) the amount certified by a consulting actuary as necessary to avoid an accumulated funding deficiency as defined by the Employee Retirement Income Security Act of 1974. Contributions are intended to provide not only benefits attributed to service to date but also for those expected to be earned in the future.

The following table sets forth information about the Plan as of December 31, and for the years then ended:

	($000 Omitted)		
	2004	2003	2002
Change in benefit obligation			
Benefit obligation at beginning of year	$ 4,901	$ 4,356	$ 3,305
Service cost	481	444	356
Interest cost	303	266	246
Actuarial loss (gain)	233	(46)	747
Benefits paid	(113)	(119)	(298)
Benefit obligation at end of year	5,805	4,901	4,356
Change in plan assets			
Fair value of plan assets at beginning of year	3,652	2,685	2,918
Actual return on plan assets	401	540	(248)
Employer contributions	661	546	313
Benefits paid	(113)	(119)	(298)
Fair value of plan assets at end of year	4,601	3,652	2,685
Funded status at end of year	(1,204)	(1,249)	(1,671)
Unrecognized transition asset	--	(1)	(5)
Unrecognized net actuarial loss	2,803	2,824	3,371
Unrecognized prior service cost	(877)	(961)	(1,046)
Net amount recognized	$ 722	$ 613	$ 649
Amounts recognized in the consolidated balance sheets consist of:			
Accrued benefit liability	$(1,018)	$(1,092)	$(1,707)
Accumulated other comprehensive loss, before income tax benefit	1,018	1,092	1,707
Prepaid benefit cost	722	613	649
Net amount recognized	$ 722	$ 613	$ 649

The accumulated benefit obligation for the plan was $4,896,000 and $4,131,000 at December 31, 2004 and 2003, respectively.

The expected long-term rate of return for the plan's total assets is based on

the expected return of asset categories identified below, weighted based on the target allocations for each class. Equity funds are expected to return 8% to 10% over the long-term and bond funds and short-term money markets are expected to return between 4% and 6%.

Components of net periodic benefit cost	2004	2003	2002
	($000 omitted)		
Service cost	$ 481	$ 444	$ 356
Interest cost	303	266	246
Expected return on plan assets	(288)	(211)	(244)
Amortization of prior service cost	(84)	(84)	(84)
Amortization of net actuarial loss	141	172	122
Recognized transition amount	(1)	(5)	(5)
Net periodic benefit cost	$ 552	$ 582	$ 391

Assumptions used to determine benefit obligations and benefit cost as of and for the years ending December 31,	2004	2003	2002
Discount rate:			
Benefit obligation	6.00%	6.25%	6.25%
Benefit cost	6.25	6.25	6.25
Long-term rate of return on plan assets	8.00	8.00	8.50
Rate of compensation increase	3.50	4.00	4.00

At December 31, 2004 and 2003, the comprehensive loss for the unfunded pension accumulated benefit obligation was $673,000 and $721,000, net of taxes, respectively. While the Company continues to contribute the maximum amount permitted by law to its pension plan, the discount rate used to calculate the future value of such contribution and the poor asset performance of the mutual funds has resulted in the unfunded pension accumulated benefit obligation.

The Company's pension plan actual asset allocations by asset category are as follows:

	Plan Assets at December 31,		
	2004	2003	2002
Asset Category			
Mutual funds:			
Bond funds	32.6%	32.3%	45.1%
Equity securities	43.6	43.9	50.8
Real estate funds	9.4	8.8	-
Short-term money market	14.4	15.0	4.1
Total	100.0%	100.0%	100.0%

The investment policy, as established by the Company, is to provide for a moderate growth of capital with a moderate level of volatility by investing assets per the target allocations as follows:

	2004	2003	2002
Asset Category			
Mutual funds:			
Bond funds	40-60%	40.0%	45.0%
Equity securities	30-50	50.0	55.0

Real estate funds	0-15	10.0	--

The assets will be re-allocated quarterly to meet the above target allocations. The investment policy is reviewed on an annual basis, under the advisement of our certified investment advisor, to determine if the policy should be changed.

The plan assets do not include any Company common stock at December 31, 2004 and 2003.

The Company expects to contribute $745,000 to its pension plan in 2005.

Estimated future benefit payments, which reflect future service, as appropriate, are as follows for the years ended December 31:

	($000 Omitted)
2005	$ 115
2006	153
2007	165
2008	195
2009	234
2010-2014	1,861

401(k) Plan

The Company offers a contributory 401(k) Plan. Under the Northway Financial, Inc. 401(k) and Profit Sharing Plan (the "401K Plan") employees must have attained age 21, completed six months of service and be credited with 1,000 hours of service in order to participate. Employees of the Company are eligible to participate. Under the 401K Plan, employers match 50 percent of the first 4 percent of employee contributions. Total 401(k) matching expense in 2004, 2003 and 2002 amounted to $143,000, $130,000 and $120,000, respectively, and Profit Sharing contribution expense for 2004, 2003, and 2002 was $38,000, $0, and $0, respectively.

Supplemental Executive Retirement Plan (SERP)

Effective May 29, 2003, the existing Executive Life program sponsored by the Company was terminated and replaced with a SERP. The existing Split Dollar Life Insurance policy designed to support the Executive Life program is now fully owned by Northway. This policy will be maintained by Northway and is used as the benchmark for the SERP.

The total retirement SERP benefit is as follows: Upon Mr. Woodward's termination of employment for reasons other than death or for cause, the account balance is paid out to him in ten (10) equal annual installments on the first day of the month following the month in which employment is terminated. Upon death after retirement, the unpaid account balance, if any, is paid out in a lump sum to the named beneficiary. During retirement, an additional retirement payment, based on the policy gains associated with the prior calendar year, will also be paid on an annual basis until the executive's death. In the event of Mr. Woodward's death while employed by the Company, the SERP permits a death benefit of $2,000,000 be paid to his beneficiary.

Stock-Based Compensation

The Board of Directors (the "Committee") administers the 1999 Stock Option and Grant Plan (the "1999 Plan") which is described below.

Under the 1999 Plan, the Committee may select the individuals to whom awards may from time to time be granted; determine the time or times of grant; and determines the extent, if any, of incentive stock options, non-qualified stock options, restricted stock awards, unrestricted stock awards, performance share

awards, or any combination of the foregoing.

The 1999 Plan expires in February 2009. The aggregate number of shares of the Company's common stock which may be issued upon the exercise of options granted under the 1999 Plan is 175,000. The option price is fixed by the Committee at the time of the grant and may not be less than 100 percent of the fair market value of the stock, as determined by the Committee, in good faith as of the grant date. Each option may be exercised at such times as shall be determined by the Committee at or after the grant date; provided, however, that no option may be exercised ten years after the date of grant. The fair value of each option granted is estimated on grant date using the Black-Scholes option pricing model.

A summary of the status of the Company's 1999 Plan as of December 31, 2004, 2003 and 2002 and changes during the years then ended is presented below:

	2004		2003		2002	
	Shares	Weighted Average Exercise Price	Shares	Weighted Average Exercise Price	Shares	W E
Outstanding, beginning of year	42,000	$ 24.93	42,000	$ 24.93	49,500	$
Granted	--	--	--	--	--	
Exercised	(4,000)	24.64	--	--	(5,250)	
Forfeited	--		--	--	(2,250)	
Outstanding, end of year	38,000	$ 24.96	42,000	$ 24.93	42,000	$
Options exercisable at year-end	38,000		42,000		36,000	

The following table summarizes information about fixed stock options outstanding as of December 31, 2004:

Options Outstanding			Options Exercisable	
Weighted Average Exercise Price	Number Outstanding as of 12/31/04	Weighted Average Remaining Contractual Life	Number Exercisable as of 12/31/04	Weighted Average Exercise Price
$28.00	16,500	4.50 years	16,500	$28.00
22.63	21,500	5.63 years	21,500	22.63
$24.96	38,000	5.14 years	38,000	$24.96

Change in Control

The Company and its subsidiaries have entered into Key Employee agreements with the specific Executive Officers as well as other Senior Officers of the Company. These agreements provide for payments, under certain circumstances, to the officer upon the officer's termination after a change in control. Payments will be made under these agreements upon the officer's termination or resignation in connection with certain specified actions adverse to the officer's employment status after a change in control. The amount of such payments ranges from 1.0 to 1.5 times such officer's annual compensation.

NOTE 15 FINANCIAL INSTRUMENTS WITH OFF-BALANCE SHEET RISK

The Company is party to financial instruments with off-balance sheet risk in the normal course of business to meet the financing needs of its customers and to reduce its own exposure to fluctuations in interest rates. These financial instruments include commitments to originate loans and standby letters of credit. The instruments involve, to varying degrees, elements of credit and interest rate risk in excess of the amount recognized in the balance sheet. The amounts of those instruments reflect the extent of involvement the Company has in particular classes of financial instruments.

The Company's exposure to credit loss in the event of nonperformance by the other party to the financial instrument for loan commitments and standby letters of credit is represented by the contractual amount of those instruments. The Company uses the same credit policies in making commitments and conditional obligations as it does for on-balance sheet instruments.

Financial instruments with off-balance sheet credit risk at December 31, are as follows:

	($000 Omitted)	
	2004	2003
Financial instrument whose contract amounts represent credit risk:		
Unadvanced portions of home equity loans	$17,748	$13,798
Unadvanced portions of lines of credit	9,216	10,535
Unadvanced portions of commercial real estate loans	1,888	2, 202
Commitments to originate all other loans	15,952	18,391
Commitments to originate municipal notes	2,995	--
Standby letters of credit	400	350

Commitments to originate loans and municipal notes, unadvanced portions of home equity loans, lines of credit and commercial real estate loans are agreements to lend to a customer provided there is no violation of any condition established in the contract. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Since many of the commitments are expected to expire without having been drawn upon, the total commitment amounts do not necessarily represent future cash requirements. The Company evaluates each customer's creditworthiness on a case-by-case basis. The amount of collateral obtained, if deemed necessary by the Company upon extension of credit, is based on management's credit evaluation of the borrower.

Standby letters of credit are conditional commitments issued by the Company to guarantee the performance by a customer to a third party. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending loan commitments to customers. As of December 31, 2004 and 2003, the maximum potential amount of the Company's obligation was $400,000 and $350,000, respectively, for financial and standby letters of credit. The Company's outstanding letters of credit generally have a term of less than one year. If a letter of credit is drawn upon, the Company may seek recourse through the customer's underlying line of credit. If the customer's line of credit is also in default, the Company may take possession of the collateral, if any, securing the line of credit.

NOTE 16 FAIR VALUE OF FINANCIAL INSTRUMENTS

The following methods and assumptions were used by the Company in estimating its fair value disclosures for financial instruments:

Cash and cash equivalents: The carrying amounts reported in the statements of financial condition for cash and cash equivalents approximates the fair value of those assets.

Securities: Fair values for securities are based on quoted market prices, where available. If quoted market prices are not available, fair values are based on quoted market prices of comparable instruments.

FHLB and Federal Reserve Bank ("FRB") Stock: The carrying amount reported in the statements of financial condition for FHLB and FRB Stock approximates their fair value. If redeemed, the Company will receive an amount equal to the par value of the stocks.

Loans held-for-sale: Fair values for loans held-for-sale are estimated based on outstanding investor commitments, or in the absence of such commitments, are based on current investor yield requirements.

Loans: For variable-rate loans that reprice frequently and with no significant change in credit risk, fair values are based on carrying values. The fair value for other loans are estimated using discounted cash flow analyses, using interest rates currently being offered for loans with similar terms to borrowers of similar credit quality. The fair value of nonaccrual loans was estimated using discounted cash flow analysis or the estimated fair value of the underlying collateral where applicable.

Accrued interest receivable: The carrying value of accrued interest receivable approximates its fair value because of the short-term nature of this financial instrument.

Deposits: The fair value of demand deposits (e.g. NOW and super NOW checking, noninterest bearing checking, regular savings, money market accounts and mortgagors' escrow accounts) are, by definition, equal to the amount payable on demand at the reporting date (i.e. their carrying amounts). Fair values for certificates of deposit are estimated using a discounted cash flow technique that applies interest rates currently being offered on certificates to a schedule of aggregated expected monthly maturities of time deposits.

Short-term borrowings: The carrying value of short-term borrowings approximates its fair value because of the short-term nature of these financial instruments.

Long-term debt: The fair values of long-term debt are determined by discounting the anticipated future cash payments by using the rates currently available to the Company for debt with similar terms and remaining maturities.

Junior subordinated debentures: The fair values of junior subordinated debentures are based on quoted market prices, where available. If quoted market prices are not available, fair values are based on quoted market prices of comparable instruments.

Off-balance sheet instruments: The fair value of commitments to originate loans is estimated using the fees currently charged to enter similar agreements, taking into account the remaining terms of the agreements and the present creditworthiness of the counterparties. For fixed-rate loan commitments and the unadvanced portion of loans, 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 obligation with the counterparties at the reporting date. See Note 15 for further information.

The estimated fair values of the Company's financial instruments are as follows:

($000 Omitted)

	December 31,			
	2004		2003	
	Carrying Amount	Estimated Fair Value	Carrying Amount	Estimated Fair Value
Financial assets:				
Cash and cash equivalents	$ 24,769	$ 24,769	$ 31,085	$ 31,085
Securities available-for-sale	101,133	101,133	68,082	68,082
FHLB stock	5,515	5,515	4,705	4,705
FRB stock	365	365	365	365
Loans held-for-sale	311	314	511	519
Loans, net	469,502	466,679	468,583	472,340
Accrued interest receivable	2,405	2,405	2, 590	2, 590
Financial liabilities:				
Deposits	$475,359	$475,952	$463,307	$464,605
Short-term borrowings	11,268	11,268	7,401	7,401
Long-term debt	78,000	78,494	67,000	68,961
Junior subordinated debentures	20,620	21,270	20,620	21,083

The carrying amounts of financial instruments shown in the above table are included in the consolidated balance sheets under the indicated captions except that accrued interest receivable is included with other assets in the statements and junior subordinated debentures is included with long-term debt in the statements.

At December 31, 2004 and 2003, all the Company's financial instruments were held for purposes other than trading.

LIMITATIONS

Fair value estimates are made at a specific point in time, based on relevant market information and information about the financial instrument. These estimates do not reflect any premium or discount that could result from offering for sale at one time the Company's entire holdings of a particular financial instrument. Because no market exists for some of the Company's financial instruments, fair value estimates are based on judgments regarding future expected loss experience, cash flows, current economic conditions, risk characteristics, and other factors. These estimates are subjective in nature and involve uncertainties and matters of significant judgment and therefore cannot be determined with precision. Changes in assumptions and changes in the loan, debt and interest rate markets could significantly affect the estimates. Further, the income tax ramifications related to the realization of the unrealized gains and losses can have a significant effect on the fair value estimates and have not been considered. The fair value amounts presented do not represent the underlying value of the Company because fair values of certain other financial instruments, assets and liabilities have not been determined.

NOTE 17 CONDENSED PARENT ONLY FINANCIAL STATEMENTS

Condensed financial statements of Northway Financial, Inc. (Parent Company only) as of December 31, 2004 and 2003 and for the three years ended December 31, 2004 follow:

BALANCE SHEETS

	($000 Omitted)	
	2004	2003

Assets		
Cash and cash equivalents	$ 3,843	$ 3,525
Investment in subsidiary, The Berlin City Bank	37,107	35,991
Investment in subsidiary, The Pemigewasset National Bank of Plymouth, New Hampshire	24,154	24,277
Investment in unconsolidated subsidiary, Northway Capital Trust I & II	620	620
Equipment, net	2,058	1,792
Due from subsidiaries	808	978
Other assets	4,117	3,400
Total assets	$72,707	$70,583
Liabilities and stockholders' equity		
Accrued expenses	$ 571	$ 480
Other liabilities	2,006	1,611
Junior subordinated debentures	20,620	20,620
Total liabilities	23,197	22,711
Stockholders' equity:		
Common stock	1,732	1,732
Additional paid-in-capital	2,075	2,088
Retained earnings	52,484	50,116
Treasury stock	(6,090)	(6,213)
Accumulated other comprehensive (loss) income	(691)	149
Total stockholders' equity	49,510	47,872
Total liabilities and stockholders' equity	$72,707	$70,583

STATEMENTS OF INCOME

	2004
Income:	
Dividends from subsidiaries	$ 2,030
Interest income	48
Management fee income from subsidiaries	9,576
Other	178
	11,832
Expense:	
Interest expense	1,079
Salaries and employee benefits	5,639
Office occupancy and equipment expense	1,204
Professional fees	925
Other	1,825
	10,672
Income before income tax benefit and equity in undistributed net income of subsidiaries	1,160
Income tax benefit	(345

Income before equity in undistributed net income of subsidiaries	1,505
Equity in undistributed net income of subsidiaries	1,883
Net income	$ 3,388

STATEMENTS OF CASH FLOWS

	2004
Cash flows from operating activities:	
Net income	$ 3,388
Adjustments to reconcile net income to net cash (used in) provided by operating activities:	
Depreciation and amortization	603
Decrease (increase) in amount due from subsidiaries	170
Increase in other assets	(316
Increase in accrued expenses and other liabilities	535
Loss on disposal of assets	-
Undistributed net income of subsidiaries	(1,883
Net cash provided by operating activities	2,497
Cash flows from investing activities:	
Capital contributions to subsidiaries:	
The Berlin City Bank	-
Pemigewasset National Bank	-
Additions to premises and equipment	(869
Purchase of company owned life insurance	(400
Net cash used in investing activities	(1,269
Cash flows from financing activities:	
Proceeds from issuance of junior subordinated debentures by subsidiaries	-
Exercise of stock options	110
Purchases of treasury stock	-
Dividends paid	(1,020
Net cash (used in) provided by financing activities	(910
Net (decrease) increase in cash and cash equivalents	318
Cash and cash equivalents at beginning of year	3,525
Cash and cash equivalents at end of year	$ 3,843

QUARTERLY RESULTS OF OPERATIONS (UNAUDITED)

Summarized quarterly financial data for 2004 and 2003 follows:

($000 Omitted, e

2004	
Mar 31	Jun

Interest and dividend income	$7,371	$7,5
Interest expense	1,827	1,8
Net interest and dividend income	5,544	5,6
Provision for loan losses	150	1
Noninterest income	1,296	1,2
Noninterest expense	5,608	5,7
Income before taxes	1,082	1,1
Income tax expense	353	3
Net income	$ 729	$ 7
Basic earnings per common share	$ 0.49	$ 0.
Earnings per common share assuming dilution	$ 0.49	$ 0.

	2003 Q	
	Mar 31	Jun
Interest and dividend income	$7,999	$8,2
Interest expense	2,199	2,2
Net interest and dividend income	5,800	5,9
Provision for loan losses	225	2
Noninterest income	1,050	9
Noninterest expense	5,347	5,4
Income before taxes	1,278	1,2
Income tax expense	467	4
Net income	$ 811	$ 8
Basic earnings per common share	$ 0.54	$ 0.
Earnings per common share assuming dilution	$ 0.54	$ 0.

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

Shatswell, MacLeod & Company, P.C.
Certified Public Accountants
83 Pine Street
West Peabody, Massachusetts 01960

The Board of Directors and Stockholders
Northway Financial, Inc.
Berlin, New Hampshire

We have audited the accompanying consolidated balance sheets of Northway Financial, Inc. and Subsidiaries as of December 31, 2004 and 2003 and the related consolidated statements of income, comprehensive income, changes in stockholders' equity and cash flows for each of the years in the three-year

period ended December 31, 2004. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the consolidated financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall consolidated financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of Northway Financial, Inc. and Subsidiaries as of December 31, 2004 and 2003 and the results of their operations and their cash flows for each of the years in the three-year period ended December 31, 2004, in conformity with accounting principles generally accepted in the United States of America.

/s/ SHATSWELL, MacLEOD & COMPANY, P.C.

SHATSWELL, MacLEOD & COMPANY, P.C.

West Peabody, Massachusetts
January 21, 2005

ITEM 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE

None.

ITEM 9A. CONTROLS AND PROCEDURES

The Company's management, with the participation of the Company's Chief Executive Officer and Chief Financial Officer, has evaluated the effectiveness of the company's disclosure controls and procedures as of December 31, 2004. Based on that evaluation, the Company's Chief Executive Officer and Chief Financial Officer concluded that the Company's disclosure controls and procedures were effective as of December 31, 2004. There were no material changes in the Company's internal control over financial reporting during the fourth quarter 2004.

PART III

ITEM 10. DIRECTORS AND EXECUTIVE OFFICERS OF THE REGISTRANT

Information required by this item is incorporated by reference to the information set forth under the captions "Information Concerning Directors and Nominees," "Executive Officers" and "Audit and Compliance Committee" in the Company's definitive proxy statement to be delivered in connection with its 2005 Annual Meeting of Stockholders.

Furthermore, the Company has adopted a code of ethics that applies to all of its directors, officers and employees. The Company has filed a copy of this Code of Ethics as Exhibit 14 to this Form 10-K. The Company has also made the Code of Ethics available on its website at www.northwayfinancialinc.com.

ITEM 11. EXECUTIVE COMPENSATION

The information required by this item is incorporated by reference to the information set forth under the caption "Executive Compensation" in the Company's definitive proxy statement to be delivered in connection with its 2005 Annual Meeting of Stockholders, provided however, that the "Report of the Human Resources, Compensation and Nominating Committee on Executive Compensation" and the "Stock Price Performance Graph" contained in such proxy statement are not incorporated by reference herein.

ITEM 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCKHOLDER MATTERS

The information required by this item is incorporated by reference to the information set forth under the captions "Security Ownership of Management and Principal Stockholders," "Information Concerning Directors and Nominees" and "Equity Compensation Plan Information" in the Company's definitive proxy statement to be delivered in connection with its 2005 Annual Meeting of Stockholders.

ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS

The information required by this item is incorporated by reference to the information set forth under the caption "Certain Relationships and Related Transactions" in the Company's definitive proxy statement to be delivered in connection with its 2005 Annual Meeting of Stockholders.

ITEM 14. PRINCIPAL ACCOUNTANT FEES AND SERVICES

The information required by this item is incorporated by reference to the information set forth under the caption "Fees Paid to Independent Auditors" in the Company's definitive proxy statement to be delivered in connection with its 2005 Annual Meeting of Stockholders.

ITEM 15 EXHIBITS, FINANCIAL STATEMENT SCHEDULES, AND REPORTS ON FORM 8-K

(a)(1) The following financial statements are incorporated by reference from Item 8 hereof:

- Auditor's Independent Report
- Consolidated Balance Sheets as of December 31, 2004 and 2003
- Consolidated Statements of Income for the years ended December 31, 2004 and 2003
- Consolidated Statements of Changes in Stockholders Equity for the years ended December 31, 2004, 2003, 2002 and 2001
- Consolidated Statements of Comprehensive Income for the years ended December 31, 2004, 2003 and 2002
- Consolidated Statements of Cash Flows for the years ended December 31, 2004, 2003 and 2002
- Notes to Consolidated Financial Statements

(2) Financial Statement Schedules:

None

(3) The Exhibits which are filed with this report or which are incorporated herein by reference are set forth in the Exhibit Index. The Exhibit Index is incorporated herein by reference.

(b) See Item 15(a)(3) above

(c) See Item 8 of this Annual Report on Form 10-K

SIGNATURES

Pursuant to requirements of Section 13 or 15(d) 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.

NORTHWAY FINANCIAL, INC.

March 23, 2005

BY: /S/ William J. Woodward
William J. Woodward
Chairman of the Board, President & Chief Executive Officer

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacities and on the dates indicated.

Signature	Title	Date
/S/ William J. Woodward William J. Woodward	Chairman of the Board, President and CEO (Principal Executive Officer)	March 23, 2005
/S/ Richard P. Orsillo Richard P. Orsillo	Senior Vice President and Chief Financial Officer (Principal Financial and Accounting Officer)	March 23, 2005
/S/ Fletcher W. Adams Fletcher W. Adams	Vice Chairman of the Board	March 29, 2005
/S/ John H. Noyes John H. Noyes	Director	March 29, 2005
/S/ Barry J. Kelley Barry J. Kelley	Director	March 23, 2005
/S/ Randall G. Labnon Randall G. Labnon	Director	March 29, 2005
/S/ Stephen G. Boucher Stephen G. Boucher	Director	March 29, 2005
/S/ Brien L. Ward	Director	March 23, 2005

Brien L. Ward

/S/ Arnold P. Hanson, Jr. --------------------------- Arnold P. Hanson, Jr.	Director	March 23, 2005
/S/ Frederick C. Anderson --------------------------- Frederick C. Anderson	Director	March 23, 2005

INDEX OF EXHIBITS

Exhibit Number	Description of Exhibit
2.1	Agreement and Plan of Merger, dated as of March 14, 1997, by and among Northway Financial, Inc., The Berlin City Bank, Pemi Bancorp, Inc. and Pemigewasset National Bank (the "Merger Agreement") (incorporated by reference to Exhibit 2.1 to Registration Statement No. 333-33033).
3.1	Amended and Restated Articles of Incorporation of Northway Financial, Inc. (incorporated by reference to Exhibit 3.1 to Registration Statement No. 333-33033).
3.2	By-laws of Northway Financial, Inc (incorporated by reference to Exhibit 3.2 to the Company's Annual Report on Form 10-K for the year ended December 31, 1997).
4	Form of Certificate representing the Company Common Stock (reference is also made to Exhibits 3.1 and 3.2) (incorporated by reference to Exhibit 4 to Registration Statement No. 333-33033).
10.1	Employment Agreement for William J. Woodward (incorporated by reference to Exhibit 10.1 to the Company's Annual Report on Form 10-K for the year ended December 31, 1997).
10.2	Employment Agreement for Fletcher W. Adams (incorporated by reference to Exhibit 10.2 to the Company's Annual Report on Form 10-K for the year ended December 31, 1997).
10.3	Amendment to the Employment Agreement for William J. Woodward. (incorporated by reference to Exhibit 10.3 to the Company's Annual Report on Form 10-K for the year ended December 31, 1998).(2)
10.4	Amendment to the Employment Agreement for Fletcher W. Adams. (incorporated by reference to Exhibit 10.4 to the Company's Annual Report on Form 10-K for the year ended December 31, 1998). (2)
10.5	Northway Financial, Inc. 1999 Stock Option and Grant Plan (incorporated by reference to Exhibit 4.1 to Registration Statement No. 333-83571 dated July 23,1999). (2)
10.7	Form of Key Employee Agreement (incorporated by reference to Exhibit 10.8 to the Company's Annual Report on Form 10-K for the year ended 1999). (2)

10.8	Supplemental Executive Retirement Plan.
11	Statement re: Computation of Per Share Earnings(1)
14	Code of Ethics(1)
21	List of Subsidiaries(1)
23	Consent of Shatswell, MacLeod & Company, P.C. (1)
31.1	Certification of President of Northway Financial, Inc., pursuant to rules 13(a)-15(e) and 15d-15(e), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.(1)
31.2	Certification of Chief Financial Officer of Northway Financial, Inc., pursuant to rules 13(a)-15(e) and 5d-15(e), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.(1)
32.1	Certification of President of Northway Financial, Inc., pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.(1)
32.2	Certification of Chief Financial Officer of Northway Financial, Inc., pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.(1)

(1) Filed herewith.
(2) Management contract or compensatory plan required to be filed as an exhibit to this form pursuant to Item 14(c) of this report.