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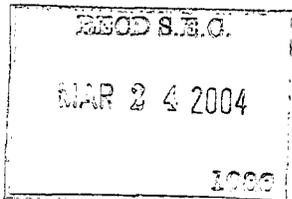
2003 ANNUAL REPORT

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**FIRST NILES FINANCIAL, INC.**  
*Niles, Ohio*

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# *First Niles Financial, Inc.*

*55 North Main Street  
P.O. Box 311  
Niles, Ohio 44446-0311*

*Ph. (330) 652-2539 ~ Fax: (330) 652-0911*

March 19, 2004

To Our Stockholders:

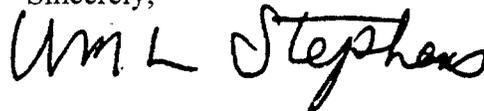
It is a pleasure to present the Annual Report to Stockholders of First Niles Financial, Inc. This past year has been one of improving economic growth and continued low interest rates. Fortunately, this low interest rate environment has been beneficial to the earnings of our industry and specifically to our Company. First Niles recorded net income of \$1,058,000 in 2003 and diluted earnings per share of \$.79, record results for the Company since becoming a public company in 1998. Additionally, our assets exceeded the \$100 million level for the second consecutive year, and only the second time in our Company's history dating back to 1897.

Providing value to our stockholders was, as always, the continued focus of our attention during 2003. During the past year we paid dividends on our common stock of \$0.57 per share, an increase of 7.5% from the \$0.53 per share paid in 2002. I am both proud and pleased that we have been able to raise our dividend, on an annual basis, every year since we first started paying a dividend in 1999.

During the second and fourth quarters of 2003 we announced programs to repurchase up to 71,612 shares and 69,865 of our outstanding shares in the open market, respectively. Each program represented 5.0% of our outstanding shares at that time. The first repurchase program was completed, while the second program is still in progress. Combined with shares from a previously announced repurchase program initiated in 2002, we repurchased 105,112 of our common shares during 2003. Our company's strong financial condition provides flexibility concerning the management of our capital, while still leaving ample capital for future growth. At December 31, 2003, stockholders' equity totaled approximately \$16.6 million, or 16.6% of total assets.

As always, your Board of Directors, management and employees are committed to building shareholder value, while continuing the commitment to serve our customers and community in the best way possible. We are dedicated to making your investment in First Niles a rewarding one. Thank you for your past support and continued faith in our future.

Sincerely,



WILLIAM L. STEPHENS  
*Chairman of the Board, President  
and Chief Executive Officer*

## SELECTED CONSOLIDATED FINANCIAL INFORMATION

<b><u>Selected Financial Condition Data:</u></b>	<b>December 31,</b>		
	<b>2003</b>	<b>2002</b>	<b>2001</b>
	(In thousands)		
Total assets .....	\$100,033	\$100,635	\$96,107
Loans receivable, net .....	38,778	40,205	39,508
Securities - held to maturity .....	295	3,349	8,866
Securities - available for sale and FHLB stock .....	52,506	45,787	40,085
Deposits .....	61,936	60,895	57,061
Total borrowings .....	20,500	19,500	19,500
Shareholders' equity .....	16,630	18,333	17,966

<b><u>Selected Operations Data:</u></b>	<b>Years Ended December 31,</b>		
	<b>2003</b>	<b>2002</b>	<b>2001</b>
	(In thousands, except per share amounts)		
Total interest income .....	\$5,220	\$5,754	\$5,915
Total interest expense .....	<u>2,119</u>	<u>2,592</u>	<u>2,893</u>
Net interest income .....	3,101	3,162	3,022
Provision for loan losses .....	---	<u>78</u>	<u>120</u>
Net interest income after provision for loan losses .....	3,101	3,084	2,902
Fees and service charges .....	28	30	32
Gain on sales of investment securities .....	187	165	277
Other non-interest income .....	<u>7</u>	<u>21</u>	<u>6</u>
Total non-interest income .....	222	216	315
Total non-interest expense .....	<u>1,810</u>	<u>1,908</u>	<u>2,081</u>
Income before taxes and extraordinary item .....	1,513	1,392	1,136
Income tax provision .....	<u>455</u>	<u>410</u>	<u>315</u>
Net income .....	<u>\$1,058</u>	<u>\$ 982</u>	<u>\$ 821</u>
Earnings per share - basic .....	\$0.80	\$0.71	\$0.57
Earnings per share - diluted .....	\$0.79	\$0.71	\$0.57
Dividends per share .....	\$0.57	\$0.53	\$0.46

	<u>Years Ended December 31,</u>		
	<u>2003</u>	<u>2002</u>	<u>2001</u>
<b><u>Selected Financial Ratios and Other Data:</u></b>			
<b>Performance Ratios:</b>			
Return on assets (ratio of net income to average total assets) .....	1.06%	1.01%	0.91%
Return on equity (ratio of net income to average equity) .....	6.13	5.54	4.45
Interest rate spread:			
Average during year .....	2.70	2.73	2.55
End of year .....	2.84	2.73	2.60
Net interest margin (net interest income divided by average interest-earning assets) .....	3.15	3.33	3.41
Ratio of operating expense to average total assets .....	1.78	1.91	2.25
Ratio of average interest-earning assets to average interest-bearing liabilities .....	1.21	1.22	1.26
<b>Quality Ratios:</b>			
Non-performing assets to total assets at end of year ...	1.00%	1.51%	1.50%
Non-performing loans to loans receivable, net, end of year .....	2.58	3.78	3.55
Allowance for loan losses to non-performing loans, end of year .....	75.82	50.18	48.15
Allowance for loan losses to loans receivable, net, end of year .....	1.96	1.90	1.71
<b>Capital Ratios:</b>			
Equity to total assets at end of year .....	16.62%	18.21%	18.69%
Average equity to average assets .....	17.24	18.21	20.48
<b>Other Data:</b>			
Book value per common share outstanding .....	\$11.88	\$12.51	\$11.85
Dividend payout ratio <sup>(1)</sup> .....	71.25%	74.65%	80.70%
Number of full-service offices .....	1	1	1

<sup>(1)</sup> Dividends per share divided by earnings per common share and common share equivalent.

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

### General

On October 26, 1998, Home Federal Savings and Loan Association of Niles converted from the mutual to stock form of ownership, and First Niles acquired 100% of the stock of Home Federal. First Niles has no significant operations outside those of Home Federal. All references to First Niles prior to October 26, 1998, except where otherwise indicated, are to Home Federal. References in this Annual Report to "we", "us", and "our" refer to First Niles and/or Home Federal as the context requires.

Home Federal was established in Niles, Ohio in 1897. We are a community-oriented financial institution serving primarily the Niles, Ohio area through our one office located in Niles. We provide financial services to individuals, families and small businesses. Our principal business consists of attracting retail deposits from the general public and investing those funds primarily in permanent and construction loans secured by first mortgages on one- to four-family residences. We also originate permanent and construction loans secured by first mortgages on commercial and multi-family real estate. To a much lesser extent, we originate consumer and commercial business loans. Competition from other financial institutions has, however, limited the volume of loans we have been able to originate and place in our portfolio. As a result, our excess funds are invested in short-term, lower-yielding investment and mortgage-backed and related securities. Additionally, we borrow funds from the FHLB and reinvest the proceeds in investment securities at favorable interest rate spreads.

The level of competition in our market area is strong and dominated by commercial banks, with financial institutions of varying sizes and characteristics. In addition, our market area is projected to experience a continuing decrease in population and no meaningful increase in households over the next several years. Niles and Trumbull County have per capita income and median household income lower than Ohio and the United States and in December 2003, Trumbull County also had an unemployment rate higher than both, Ohio and the United States. These economic conditions and strong competition have resulted in reduced loan demand which, in turn, has resulted in a high concentration of investment securities and mortgage-backed and related securities in our portfolio compared to typical savings institutions. In the event current economic and market conditions persist or worsen, and loan demand remains weak, we cannot give any assurances that we will be able to maintain or increase our mortgage loan portfolio, which could adversely affect our operations and financial results.

To stay competitive, during 2003, we continued our aggressive pricing policy on deposits, which was aimed at long-term deposit retention. Additionally, we also increased our level of wholesale borrowings by \$1.0 million in order to maintain our investment securities portfolio and provide added income. All other borrowings were obtained before 2002 and only when they could be invested in investment securities at favorable interest rate spreads.

## Financial Condition

Assets totaled \$100.0 million at December 31, 2003, a decrease of \$602,000, or 0.6%, from total assets of \$100.6 million at December 31, 2002. Cash and cash equivalents decreased \$2.7 million and net loans receivable decreased \$1.4 million during 2003. Additionally, securities held to maturity decreased \$3.1 million. These decreases were partially offset by a \$6.7 million increase in securities available for sale. Management's intention is to have all new security purchases categorized as available for sale.

The loan portfolio decreased \$1.4 million, or 3.5%, to \$38.8 million at December 31, 2003, as compared to \$40.2 million at December 31, 2002. Management believes that strong local competition from lenders that sell mortgages into the secondary market and low historical interest rates were the primary contributing factors to the decline in the loan portfolio. Home Federal retains all mortgages it originates and during the past year decided not to match the mortgage rates offered by some of the local competition, many of which are active sellers to the secondary market. During the past year, real estate loans decreased by \$1.3 million. Specifically, loans secured by residential properties decreased \$990,000 and commercial real estate loans decreased \$929,000, ending the year with balances of \$28.7 million and \$6.1 million, respectively. Home equity lines of credit ended the year at \$1.9 million, \$207,000 less than at December 31, 2002. These decreases were partially offset by a \$785,000 increase in loans for construction or development, which ended the year with a balance of \$2.2 million. The allowance for loan losses decreased from \$762,000 at December 31, 2002 to \$759,000 at December 31, 2003.

Deposits totaled \$61.9 million at December 31, 2003, compared to \$60.9 million at December 31, 2002, representing a 1.7% increase. During the year ended December 31, 2003, certificates of deposit increased \$1.3 million. This increase was partially offset by a collective decrease in passbook, statement savings accounts, NOW accounts and money market deposit accounts of \$231,000. The overall increase in deposits was primarily attributable to an aggressive pricing policy by management. In addition, continued weakness in the equity sector of the financial markets has led to increased deposit levels as depositors have moved funds out of stocks or otherwise avoided purchasing stocks.

Accounts payable and other liabilities were \$662,000 at December 31, 2003, as compared to \$1.3 million at December 31, 2002, a decrease of \$620,000, or 48.4%. This decrease was primarily due to the payout of deferred compensation to an executive officer who retired during 2003. FHLB advances increased \$1.0 million during the year to \$20.5 million. These advances were comprised of 12 different contracts, 11 of which have initial fixed rates, followed by variable rate conversion options, exercisable by the FHLB. Maturities of the advances range from December 2010 through August 2011. At any conversion date, and quarterly thereafter, the advances can be prepaid without penalty. The other advance has a fixed rate and a remaining term as of December 31, 2003 of approximately 32 months. The advances from the FHLB were used to purchase investment securities at a favorable interest rate spread.

Total equity at December 31, 2003 was \$16.6 million, or 16.6% of total assets. This compares to total equity of \$18.3 million, or 18.2% of total assets at December 31, 2002. The decrease in total equity during the year was attributable to \$1.2 million in repurchases of common stock and a \$1.0 million decrease in net unrealized gains on securities available for sale, partially offset by a collective \$382,000 increase in retained earnings and paid in capital, and a \$117,000

change in the balance of unallocated common stock attributable to the Employee Stock Ownership Plan.

During 2003, the Company repurchased 105,112 shares of its common stock at an average price of \$16.09. A portion of the repurchase of the aforementioned shares completed the 5.0% share repurchase program originally authorized in July 2002. During May 2003, the Company's Board of Directors authorized another 12-month share repurchase program, up to a maximum of 5.0%, or 71,612 shares, of the total outstanding shares of the Company. This repurchase program was completed during the third quarter of 2003. In November 2003, the Company's Board of Directors authorized another 12-month share repurchase program, up to a maximum of 5.0%, or 69,865 shares, of the total outstanding shares of the Company. As of December 31, 2003 this most recent repurchase program was still in progress.

The Company also issued 38,652 shares of common stock during 2003 in connection with the exercise of stock options by directors, officers and employees. The net effect of the repurchases and issuance of new shares was an increase in treasury shares of 66,460, from 288,641 shares at December 31, 2002 to 355,101 shares at December 31, 2003.

Book value per common share was \$11.88 at December 31, 2003, compared to \$12.51 at December 31, 2002. The dividend paid during each of the first three quarters of 2003 was equivalent to \$0.14 per common share. During the fourth quarter of 2003 the dividend was raised to \$0.15 per common share. At December 31, 2003 and December 31, 2002 there were 1,399,310 shares and 1,465,770 shares of common stock outstanding, respectively.

## **Results of Operations**

**General.** Our results of operations depend primarily on net interest income, which is determined by (i) the difference between rates of interest we earn on interest-earning assets, consisting primarily of mortgage loans, collateralized mortgage obligations and other investments, and the rates we pay on interest-bearing liabilities, consisting primarily of deposits and borrowings, and (ii) the relative amounts of our interest-earning assets and interest-bearing liabilities. The level of non-interest income, such as fees received from customer deposit account service charges and gains on sales of investments, and the level of non-interest expense, such as federal deposit insurance premiums, salaries and benefits, office occupancy costs, and data processing costs, also affect our results of operations. Finally, our results of operations may also be affected significantly by general economic and competitive conditions, particularly changes in market interest rates, government policies and actions of regulatory authorities, all of which are beyond our control.

**Net Income.** We recorded net income of \$1.1 million for the year ended December 31, 2003, an increase of \$76,000 or 7.7% from the \$982,000 recorded for the year ended December 31, 2002, as further explained below.

Our return on average assets was 1.06% for the year ended 2003, compared to 1.01% for the year ended 2002. Return on average equity was 6.13% for 2003, compared to 5.54% for 2002. Average equity to average assets was 17.24% for the year ended 2003, compared to 18.21% for the year ended 2002. During 2003, we paid aggregate, regular quarterly dividends on common stock totaling \$746,000, or \$0.57 per share. During 2002, we paid \$722,000 in aggregate dividends on common stock, or \$0.53 per share.

**Net Interest Income.** Net interest income for the year-ended December 31, 2003 was \$3.1 million, a \$61,000 decrease from net interest income of \$3.2 million for the year-ended December 31, 2002. Our net interest spread during 2003 was 2.70%, a three basis point decrease from the 2.73% realized during 2002. Net interest margin decreased to 3.15% during 2003 from 3.33% in 2002, a decline of 18 basis points.

The decrease in net interest margin was effected by a decrease in total interest income of \$534,000, or 9.3% during 2003 as compared to 2002. Average interest-earning assets increased from \$94.9 million in 2002 to \$98.6 million during 2003, an increase of \$3.7 million, or 3.9%. Most of the increase in interest-earning assets was comprised of a \$12.8 million increase in mortgage backed and related securities, partially offset by a \$9.0 million decrease in investment securities. This shift in asset composition was due to management's attempt to shorten the duration of the Company investment securities by shifting funds from securities that return principal only at maturity or call to securities that have monthly principal reductions.

The average balance of loans receivable decreased \$1.0 million on a year to year basis. The average balance of interest bearing deposits increased \$842,000 from 2002 to 2003. Despite the increase in average earning assets, total interest income declined from year to year, primarily because of a 76 basis point decrease in the yield on earning assets from 6.06% in 2002 to 5.30% in 2003. The decline in asset yield was primarily related to a general decline in market interest rates during 2003. Declining market rates resulted in lower interest rates on originations of fixed rate loans and adjustable rate loans repricing at lower interest rates. Adjustable rate loans comprised approximately 34.0% of our gross loan portfolio at December 31, 2003.

The yield on our portfolio of loans receivable declined 50 basis points during 2003. Additionally, the yields on the purchase of new investment securities and mortgage-backed and related securities were significantly lower in 2003 than in 2002. As a result, the average yield on mortgage backed and related securities and investment securities declined 96 basis points and 41 basis points, respectively, during 2003.

The increase in interest-earnings assets was funded by a \$3.3 million increase in average deposits and a \$340,000 increase in average borrowings. Total interest expense decreased \$473,000, or 18.3%, from \$2.6 million last year to \$2.1 million for the year ended December 31, 2003. A significant decrease in market interest rates, partially offset by a moderate increase in deposits was the primary reason for the decrease in interest expense. Overall, our cost of funds decreased 73 basis points from 3.33% during 2002 to 2.60% during 2003. During 2003 the weighted average interest rate of our FHLB advances was 4.56%, two basis points lower than during 2002. Additionally, our cost of deposits decreased 94 basis points, from 2.91% during 2002 to 1.97% during 2003. The average rate paid on our certificate of deposit accounts, our largest category of deposit accounts, declined from 3.71% for the year ended December 31, 2002 to 2.84% for the year ended December 31, 2003.

See the tables below captioned "Average Balances, Interest Rates and Yields" and "Rate/Volume Analysis of Net Interest Income" for more detailed information regarding our net interest income.

## Average Balances, Interest Rates and Yields

The following table presents for the periods indicated the total dollar amount of interest income from average interest-earning assets and the resultant yields, as well as the interest expense on average interest-bearing liabilities, expressed both in dollars and rates. No tax equivalent adjustments were made. All average balances are computed using monthly average balances.

	Year Ended December 31,					
	2003		2002			
	Average Outstanding Balance	Interest Earned/ Paid	Yield/ Rate	Average Outstanding Balance	Interest Earned/ Paid	Yield/ Rate
(Dollars in Thousands)						
<b>Interest-Earning Assets:</b>						
Loans receivable <sup>(1)</sup>	\$ 39,654	\$ 2,541	6.41%	\$40,616	\$ 2,807	6.91%
Mortgage-backed and related securities	23,879	1,037	4.34	11,108	589	5.30
Investment securities	26,304	1,525	5.80	35,324	2,194	6.21
FHLB stock	1,068	43	4.03	1,023	47	4.59
Interest-bearing deposits	7,645	74	0.97	6,803	117	1.72
Total interest-earning assets <sup>(1)</sup>	98,550	5,220	5.30	94,874	5,754	6.06
Noninterest earnings assets	2,380			3,124		
Allowance for loan losses	(762)			(726)		
<b>Total Assets</b>	<b>\$100,168</b>			<b>\$97,272</b>		
<b>Interest-Bearing Liabilities:</b>						
Savings deposits	\$ 23,908	236	0.99%	\$ 23,000	470	2.04%
Demand and NOW deposits	4,482	34	0.76	4,248	75	1.77
Certificate accounts	33,235	945	2.84	31,115	1,154	3.71
Borrowings	19,840	904	4.56	19,500	893	4.58
Total interest-bearing liabilities	81,465	2,119	2.60	77,863	2,592	3.33
Noninterest-bearing liabilities	1,439			1,692		
<b>Total Liabilities</b>	<b>82,904</b>			<b>79,555</b>		
Shareholders' equity	17,264			17,717		
<b>Total Liabilities and Shareholders' Equity</b>	<b>\$100,168</b>			<b>\$97,272</b>		
Net interest income		\$3,101			\$3,162	
Net interest rate spread			2.70%			2.73%
Net earning assets	\$17,085			\$17,011		
Net yield on average interest-earning assets			3.15%			3.33%
<b>Average interest-earning assets to average interest-bearing liabilities</b>		1.21x			1.22x	

<sup>(1)</sup> Calculated net of deferred loan fees, loan discounts and loans in process. Includes non-accrual loans.

## Rate/Volume Analysis of Net Interest Income

The following schedule presents the dollar amount of changes in interest income and interest expense for major components of interest-earning assets and interest-bearing liabilities. It distinguishes between the changes related to outstanding balances and that due to the changes in interest rates. For each category of interest-earning assets and interest-bearing liabilities, information is provided on changes attributable to (i) changes in volume (i.e., changes in volume/ multiplied by old rate) and (ii) changes in rate (i.e., changes in rate multiplied by old volume). For purposes of this table, changes attributable to both rate and volume, which cannot be segregated, have been allocated proportionately to the change due to volume and the change due to rate.

	Years Ended December 31,		
	2003 vs. 2002		
	Increase/(Decrease) Due to		Total Increase
Volume	Rate	(Decrease)	
(Dollars in Thousands)			
<b>Interest-earning assets:</b>			
Loans receivable	\$ (65)	\$(201)	\$(266)
Mortgage-backed and related securities	532	(84)	448
Investment securities and FHLB stock	(529)	(144)	(673)
Interest-bearing deposits and other	17	(60)	(43)
Total interest-earning assets	<u>\$ (45)</u>	<u>\$(489)</u>	<u>\$(534)</u>
<b>Interest-bearing liabilities:</b>			
Savings deposits	\$ 19	\$(253)	\$(234)
Demand and NOW deposits	4	(45)	41
Certificate accounts	86	(295)	(209)
Borrowings	16	(5)	11
Total interest-bearing liabilities	<u>125</u>	<u>(598)</u>	<u>(473)</u>
Net interest income	<u>\$(170)</u>	<u>\$109</u>	<u>\$(61)</u>

**Provision for Loan Losses.** We did not book any provision for loan losses for the year ended December 31, 2003 compared to a \$78,000 provision for the year ended December 31, 2002. The decrease in the provision for loan losses of \$78,000 from year to year was primarily related to the overall level of the allowance for loan losses and a stabilization in the overall asset quality of the loan portfolio. Our level of nonperforming loans, consisting of nonaccruing loans and loans delinquent more than 90 days, decreased by \$517,000 to \$1.0 million at December 31, 2003 from \$1.5 million at December 31, 2002. Our nonperforming loans totaled 2.6% of net loans receivable at December 31, 2003, compared to 3.8% of net loans receivable at December 31, 2002. Our allowance for loan losses was \$759,000 at December 31, 2003, representing 75.8% of nonperforming loans and 2.0% of net loans receivable. At December 31, 2002, the allowance for loan losses was \$762,000, representing 50.2% of non-performing loans and 1.9% of net loans receivable. At December 31, 2003 and December 31, 2002, we did not have any real estate owned or other nonperforming assets.

It is our policy to provide valuation allowances for estimated losses on loans based upon past loss experience, current trends in the level of delinquent and specific problem loans, loan concentrations to single borrowers, adverse situations that may affect the borrower's ability to repay, the estimated value of any underlying collateral, and current and anticipated economic conditions in our market area. Accordingly, the calculation of the adequacy of the allowance for loan losses is not based directly on the level of non-performing assets.

We will continue to monitor our allowance for loan losses and make future additions to the allowance through the provision for loan losses as economic conditions dictate. Although we maintain our allowance for loan losses at a level which we consider to be adequate to provide for losses, there can be no assurance that future losses will not exceed estimated amounts or that additional provisions for loan losses will not be required in future periods. In addition, our determination as to the amount of the allowance for loan losses is subject to review by the Office of Thrift Supervision and the Federal Deposit Insurance Corporation, as part of their examination process, which may result in the establishment of an additional allowance.

**Non-interest Income.** Non-interest income increased \$6,000 to \$222,000 for the year ended December 31, 2003. However, service fee and other income totaled \$35,000 in 2003, as compared to \$51,000 in 2002, a decrease of \$16,000, or 31.4%. Gain on sale of investments was the primary contributor to non-interest income in both 2003 and 2002, contributing \$187,000 and \$165,000 to non-interest income in each respective year. The \$22,000 increase was mostly attributable to the amount of Freddie Mac shares sold in the respective periods. During 2003, we sold 1,500 shares of Freddie Mac stock, contributing \$81,000 to gain on sale of investments. During 2002, we sold 500 shares of Freddie Mac stock, contributing \$33,000 to gain on sale of investments. As of December 31, 2003 we owned 29,000 shares of Freddie Mac stock, with an aggregate market value of \$1.7 million. The remaining gain on sale of investments in each period was derived from the sale of selected mortgage backed and related securities and callable U.S. Agency debentures.

**Non-interest Expense.** Non-interest expense decreased \$98,000, or 5.1%, for the year ended December 31, 2003 as compared to the same period in 2002. Compensation and benefit expense experienced the largest decline of any non-interest expense item, decreasing \$57,000 on a comparative year to year basis. This decrease was primarily attributable to the retirement of two officers during 2003. The duties of these officers have generally been absorbed by existing staff, assisted by the addition of one new employee. Further staff additions are possible, as the overall staffing level of the Company is assessed. The other significant factor contributing to the decline in non-interest expense on a year to year basis was a \$52,000 reduction in legal and audit expense. The decline in legal and audit expense was attributable to cost containment measures implemented by management in these areas. Equity in loss of limited partnership also declined \$18,000 in 2003 as compared to 2002.

Partially offsetting the items contributing to the decrease in non-interest expense were an increase in franchise taxes and other operating expense. Franchise taxes increased \$9,000 in 2003 as compared to 2002 because of increased capital levels at the subsidiary. The franchise tax rate remained unchanged in each comparative year. Other operating expense was \$22,000 higher in 2003 as compared to 2002. Most of these increase was due to a \$16,000 loss associated with the sale of a company owned automobile.

**Federal Income Taxes.** The provision for federal income taxes totaled \$455,000 for the year ended December 31, 2003, an increase of \$45,000, or 11.1% from the \$410,000 provision for 2002. The increase in the provision for federal income taxes was primarily due to pre-tax income being \$121,000 higher in 2003 than in 2002. Additionally, the effective tax rate increased to 30.1% for 2003 as compared to 29.5% for 2002. The above effective tax rates differ from the statutory rate of 34% primarily due to our ownership interest in a low income housing tax credit program. The tax credits from this program are expected to last through 2006.

### **Asset and Liability Management; Market Risk Analysis**

As stated above, we derive our income primarily from the excess of interest collected over interest paid. The rates of interest we earn on assets and pay on liabilities generally are established contractually for a period of time. However, market interest rates change over time and our results of operations, like those of many financial institutions, are impacted by these and the interest rate sensitivity of our assets and liabilities. The risk associated with changes in interest rates and our ability to adapt to these changes is known as interest rate risk and is Home Federal's most significant market risk.

Our operations are also affected by our level of income and expenses. Non-interest income includes service charges and fees, and gain on sale of investments. Non-interest expenses primarily include compensation and benefits, occupancy and equipment expenses, deposit insurance premiums and data processing expenses. Our results of operations are also significantly affected by general economic and competitive conditions, particularly changes in market interest rates, government legislation and regulation and monetary and fiscal policy.

In an attempt to manage our exposure to changes in interest rates and comply with applicable regulations, we monitor Home Federal's interest rate risk. In monitoring interest rate risk we continually analyze and manage assets and liabilities based on their payment streams and interest rates, the timing of their maturities, and their sensitivity to actual or potential changes in market interest rates.

An asset or liability is interest rate sensitive within a specific time period if it will mature or reprice within that time period. If our assets mature or reprice more rapidly or to a greater extent than our liabilities, then the market value of our portfolio equity and our net interest income would tend to increase during periods of rising interest rates and decrease during periods of falling interest rates. Conversely, if our assets mature or reprice more slowly or to a lesser extent than our liabilities, then the market value of our portfolio equity and our net interest income would tend to decrease during periods of rising interest rates and increase during periods of falling interest rates. Our policy has been to address the interest rate risk inherent in our business of originating long-term loans funded by short-term deposits by maintaining sufficient liquid assets for material and prolonged changes in interest rates. We believe that our liquidity position and capital levels, which are well in excess of regulatory requirements, assist us in reasonably limiting the effects of our interest rate risk exposure.

Our Board of Directors is responsible for reviewing our asset and liability position. The Board performs a quarterly review of interest rate risk and trends, liquidity and capital ratios and related regulatory requirements. In addition, the Board reviews simulations of the effect of interest rates on Home Federal's capital, net interest income and net income under various interest rate

scenarios. Management of Home Federal is responsible for implementing the policies and decisions of the Board of Directors with respect to our asset and liability goals and strategies.

To manage the interest rate risk, we attempt to originate adjustable-rate loans; however, due to the low interest rate environment over the past several years, customer demand for fixed-rate loans has been strong. At December 31, 2003, adjustable-rate mortgage loans totaled \$14.0 million or 34.0% of our total gross loan portfolio. We also maintain a large portfolio of liquid assets which includes investment securities. Maintaining liquid assets, however, tends to reduce potential net income because liquid assets usually provide a lower yield than other interest-earning assets. Despite these strategies we are still more vulnerable to increases in interest rates than to decreases in interest rates given current market interest rate levels, as illustrated in the table on the following page. Net portfolio value is the present value of expected cash flows from assets, liabilities and off-balance sheet contracts. The calculation is intended to illustrate the change in net portfolio value that will occur upon an immediate change in interest rates of at least 200 basis points with no effect given to any steps that management might take to counter the effect of that interest rate movement.

The following table sets forth the change in Home Federal's net portfolio value at December 31, 2003, based on Office of Thrift Supervision models, and to a lesser extent, internal assumptions, that would occur upon an immediate change in interest rates, with no effect given to any steps that management might take to counteract that change.

Change in Rate	December 31, 2003				
	Net Portfolio Value			Net Portfolio Value as % of Portfolio Value of Total Asset	
	Amount	\$ Change (Dollars in Thousands)	% Change	NPV Ratio	BP Change
+300	\$8,014	\$(8,261)	(50.8)%	8.74%	(416)
+200	11,080	(5,195)	(31.9)	11.63	(179)
+100	14,613	(1,662)	(10.2)	14.69	(14)
---	16,275	---	---	15.96	---
-100	16,068	207	(1.3)	15.63	(83)
-200	NM	NM	NM	NM	NM
-300	NM	NM	NM	NM	NM

NM = not meaningful because some market interest rates would compute to a rate less than zero.

In the above table, the first column on the left presents the basis point increments of yield curve shifts. The second column presents the overall dollar amount of net portfolio value at each basis point increment. The third and fourth columns present Home Federal's actual position in dollar change and percentage change in net portfolio value at each basis point increment. The remaining columns present Home Federal's percentage change and basis point change in its net portfolio value as a percentage of portfolio value of total assets. At December 31, 2003, the Association was within interest rate risk policy limits established by its board of directors, except at a scenario of interest rates rising 300 basis points. At this scenario, Home Federal's NPV ratio is below policy guidelines by 76 basis points. This difference is being monitored by management and is expected to improve as management aims at shortening the duration of some of Home Federal's investment securities over the coming months.

Computations of prospective effects of hypothetical interest rate changes are based on numerous assumptions, including interest rates, loan prepayments, deposit decay rates, and the market values of certain assets under the various interest rate scenarios and should not be relied upon as indicative of actual results. Certain shortcomings are inherent in the method of analysis presented in the computation of net portfolio value. Although certain assets and liabilities may have similar maturities or periods within which they reprice, they may react differently to changes in market interest rates. The interest rates on certain types of assets and liabilities may fluctuate in advance of changes in market interest rates, while interest rates on other types may lag behind changes in market rates. In the event of a change in interest rates, prepayments and early withdrawal levels could deviate significantly from those assumed in making the calculations set forth above.

### **Liquidity and Commitments**

Home Federal's primary sources of funds are deposits, repayments and prepayments of loans and securities and interest income. Although maturity and scheduled amortization of loans and securities are relatively predictable sources of funds, deposit flows and prepayments on loans and securities are influenced significantly by general interest rates, economic conditions and competition. Historically, we have been able to generate sufficient cash through our deposits and have only utilized borrowings to a limited degree. The increase in borrowings during the past year resulted from an opportunity to reinvest the proceeds at favorable interest rate spreads and was not related to liquidity needs.

Liquidity management is an ongoing and long-term function of our asset/liability management strategy. Excess funds generally are invested in interest-bearing overnight deposits at other financial institutions and in short-term investment securities. If we require funds beyond our ability to generate deposits, additional sources of funds are available. Our most liquid assets are cash and cash equivalents. At December 31, 2003, cash and cash equivalents totaled \$7.3 million compared to \$10.0 million at December 31, 2002. We monitor and review liquidity regularly and maintain a \$3.2 million line of credit with a commercial bank which can be accessed immediately. Additionally, we have the ability to borrow funds from the FHLB of Cincinnati. However, at December 31, 2003, due to existing outstanding advances, we had no unused borrowing capacity from the FHLB of Cincinnati.

At December 31, 2003, we had \$472,000 in loan origination and \$1.0 million in investment security purchase commitments outstanding, respectively. At the same date, the unadvanced portion of construction and other loans was \$1.5 million. Additionally, the unused portion of home equity lines of credit at December 31, 2003 was \$2.0 million. Certificates of deposit scheduled to mature in one year or less at December 31, 2003, totaled \$22.6 million. We did not have any investment or mortgage-related securities scheduled to mature in one year or less at December 31, 2003. Based on historical experience, we believe that a significant portion of maturing deposits will remain with us. We believe, based on our current balance sheet structure and our ability to acquire funds from various sources, that our liquidity is adequate.

## **Capital**

Total equity was \$16.6 million at December 31, 2003, or 16.6% of total assets on that date. Consistent with our goals to operate a sound and profitable financial organization, we actively seek to maintain a "well capitalized" institution in accordance with regulatory standards. As of December 31, 2003, Home Federal exceeded all capital requirements of the Office of Thrift Supervision. Our regulatory capital ratios at December 31, 2003 were as follows: Tier I (leverage) capital, 14.3%; Tier I risk-based capital, 35.5%; and Total risk-based capital, 38.6%. The regulatory capital requirements to be considered well capitalized are 5.0%, 6.0%, and 10.0%, respectively.

## **Recent Accounting Pronouncements**

Please see Note A of the Consolidated Financial Statements regarding recent accounting pronouncements.

## **Impact of Inflation and Changing Prices**

The financial statements and related data presented herein have been prepared in accordance with generally accepted accounting principles which require the measurement of financial position and operating results in terms of historical dollars without considering changes in the relative purchasing power of money over time due to inflation. The primary impact of inflation on our operations is reflected in increased operating costs. Unlike most industrial companies, virtually all of the assets and liabilities of a financial institution are monetary in nature. As a result, interest rates, generally, have a more significant impact on a financial institution's performance than does inflation. Interest rates do not necessarily move in the same direction or to the same extent as the prices of goods and services.

## **Disclosure Regarding Forward-Looking Statements**

This document, including information included or incorporated by reference, contains, and future filings by First Niles on Form 10-KSB, 10-QSB and Form 8-K and future oral and written statements by First Niles and our management may contain, forward-looking statements about First Niles and its subsidiary which we believe are within the meaning of the Private Securities Litigation Reform Act of 1995. These forward-looking statements include, without limitation, statements with respect to anticipated future operating and financial performance, growth opportunities, interest rates, cost savings and funding advantages expected or anticipated to be realized by management. Words such as may, could, should, would, believe, anticipate, estimate, expect, intend, plan and similar expressions are intended to identify these forward-looking statements. Forward-looking statements by First Niles and its management are based on beliefs, plans, objectives, goals, expectations, anticipations, estimates and intentions of management and are not guarantees of future performance. We disclaim any obligation to update or revise any forward-looking statements based on the occurrence of future events, the receipt of new information, or otherwise. The important factors we discuss below and elsewhere in this document, as well as other factors discussed under the caption "Management's Discussion and Analysis of Financial Condition and Results of Operations" included in this Annual Report to Stockholders and identified in our filings with the SEC and those presented

elsewhere by our management from time to time, could cause actual results to differ materially from those indicated by the forward-looking statements made in this document:

The following factors, many of which are subject to change based on various other factors beyond our control, could cause our financial performance to differ materially from the plans, objectives, expectations, estimates and intentions expressed in such forward-looking statements:

- the strength of the United States economy in general and the strength of the local economies in which we conduct our operations;
- the effects of, and changes in, trade, monetary and fiscal policies and laws; including interest rate policies of the Federal Reserve Board;
- financial market, monetary and interest rate fluctuations, particularly the relative relationship of short-term interest rates to long-term interest rates;
- the timely development of and acceptance of new products and services of Home Federal and the perceived overall value of these products and services by users, including the features, pricing and quality compared to competitors' products and services;
- the willingness of users to substitute competitors' products and services for our products and services;
- the impact of changes in financial services' laws and regulations (including laws concerning taxes, accounting standards, banking, securities and insurance);
- the impact of technological changes;
- acquisitions;
- changes in consumer spending and saving habits; and
- our success at managing the risks involved in the foregoing.

**REPORT OF INDEPENDENT CERTIFIED PUBLIC ACCOUNTANTS**

Board of Directors  
First Niles Financial, Inc.  
Niles, Ohio

We have audited the consolidated statements of financial condition of First Niles Financial, Inc. and subsidiary as of December 31, 2003 and 2002, and the related consolidated statements of income, stockholders' equity, and cash flows for each of the two years in the period ended December 31, 2003. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of First Niles Financial, Inc. and subsidiary as of December 31, 2003 and 2002, and the consolidated results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.



Youngstown, Ohio  
January 30, 2004

CONSOLIDATED STATEMENTS OF FINANCIAL CONDITION

FIRST NILES FINANCIAL, INC. AND SUBSIDIARY

(In thousands, except share data)

	<u>Year Ended December 31</u>	
	<u>2003</u>	<u>2002</u>
<b>ASSETS</b>		
Cash and cash equivalents:		
Noninterest bearing	\$ 860	\$ 766
Interest bearing	<u>6,428</u>	<u>9,214</u>
TOTAL CASH AND CASH EQUIVALENTS	7,288	9,980
Securities:		
Available-for-sale - at market	51,411	44,734
Held-to-maturity - at cost	295	3,349
Loans receivable	38,778	40,205
Accrued interest receivable	703	758
Federal Home Loan Bank stock, at cost (restricted)	1,095	1,053
Real estate investment - limited partnership, at equity	135	163
Prepaid expenses and other assets	33	46
Prepaid federal income taxes	-	13
Premises and equipment, at cost less accumulated depreciation	<u>295</u>	<u>334</u>
TOTAL ASSETS	<u>\$ 100,033</u>	<u>\$ 100,635</u>
<b>LIABILITIES</b>		
Deposits	\$ 61,936	\$ 60,895
Accrued interest payable	132	145
Accounts payable and other liabilities	662	1,282
Federal Home Loan Bank advances	20,500	19,500
Federal income tax payable	20	-
Deferred federal income tax liability	<u>153</u>	<u>480</u>
TOTAL LIABILITIES	83,403	82,302
<b>STOCKHOLDERS' EQUITY</b>		
Stockholders' equity:		
Preferred stock, \$.01 par value, authorized 500,000 shares, none outstanding	-	-
Common stock, \$.01 par value, authorized 6,000,000 shares; issued 1,754,411 shares	18	18
Additional paid-in capital	6,879	6,818
Retained earnings	14,078	13,766
Accumulated other comprehensive income:		
Net unrealized gains on securities available for sale, net of related tax	1,003	2,013
Common stock purchased by the Employee Stock Ownership Plan	(623)	(749)
Treasury stock - 355,101 shares in 2003 and 288,641 shares in 2002 at cost	<u>(4,725)</u>	<u>(3,533)</u>
TOTAL STOCKHOLDERS' EQUITY	<u>16,630</u>	<u>18,333</u>
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	<u>\$ 100,033</u>	<u>\$ 100,635</u>

THE ACCOMPANYING NOTES ARE AN INTEGRAL PART  
OF THESE CONSOLIDATED FINANCIAL STATEMENTS.

CONSOLIDATED STATEMENTS OF INCOME  
FIRST NILES FINANCIAL, INC. AND SUBSIDIARY

(In thousands, except share data)

	Year Ended December 31	
	2003	2002
Interest income:		
Loans receivable:		
First mortgage loans	\$ 2,404	\$ 2,651
Consumer and other loans	137	156
Mortgage-backed and related securities	1,037	589
Investments	1,568	2,241
Interest-bearing deposits	74	117
TOTAL INTEREST INCOME	5,220	5,754
Interest expense:		
Deposits	1,215	1,699
Borrowings	904	893
TOTAL INTEREST EXPENSE	2,119	2,592
NET INTEREST INCOME	3,101	3,162
Provision for loan losses	-	78
NET INTEREST INCOME AFTER PROVISION FOR LOAN LOSSES	3,101	3,084
Noninterest income:		
Gain on sale of securities	187	165
Service fees and other	35	51
TOTAL NONINTEREST INCOME	222	216
Noninterest expense:		
Equity in loss of limited partnership	28	46
General and administrative:		
Compensation and benefits	1,078	1,135
Occupancy and equipment	85	87
Federal deposit insurance premiums	10	10
State franchise taxes	179	170
Other operating expense	430	460
TOTAL NONINTEREST EXPENSE	1,810	1,908
INCOME BEFORE INCOME TAXES	1,513	1,392
Federal income taxes	455	410
NET INCOME	\$ 1,058	\$ 982
EARNINGS PER SHARE - BASIC	\$ 0.80	\$ 0.71
- DILUTED	\$ 0.79	\$ 0.71

THE ACCOMPANYING NOTES ARE AN INTEGRAL PART OF THESE CONSOLIDATED FINANCIAL STATEMENTS.

CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY

FIRST NILES FINANCIAL, INC. AND SUBSIDIARY

For the years ended December 31, 2003 and 2002

(In thousands, except share data)

	Common Stock	Additional Paid-in Capital	Retained Earnings	Net Unrealized Gains on Securities Available for Sale	Common Stock Purchased by the Employee Stock Ownership Plan	Treasury Stock	Total
Balance January 1, 2002	\$ 18	\$ 6,742	\$ 13,506	\$ 1,337	\$ (880)	\$ (2,757)	\$ 17,966
Comprehensive income:							
Net income	-	-	982	-	-	-	982
Other comprehensive income, net of tax:							
Change in unrealized gains on securities of \$785, net of reclassification adjustment for gains included in net income of \$109	-	-	-	676	-	-	676
Total comprehensive income	-	-	982	676	-	-	1,658
Cash dividends - \$.53 per share	-	-	(722)	-	-	-	(722)
ESOP shares allocated to employees	-	63	-	-	131	-	194
Purchase of shares for treasury	-	-	-	-	-	(878)	(878)
Exercised stock options	-	13	-	-	-	102	115
BALANCE							
DECEMBER 31, 2002	18	6,818	13,766	2,013	(749)	(3,533)	18,333
Comprehensive income:							
Net income	-	-	1,058	-	-	-	1,058
Other comprehensive income, net of tax:							
Change in unrealized gains on securities of \$(887), net of reclassification adjustment for gains included in net income of \$123	-	-	-	(1,010)	-	-	(1,010)
Total comprehensive income	-	-	1,058	(1,010)	-	-	48
Cash dividends - \$.57 per share	-	-	(746)	-	-	-	(746)
ESOP shares allocated to employees	-	77	-	-	126	-	203
Purchase of shares for treasury	-	-	-	-	-	(1,692)	(1,692)
Exercised stock options	-	(16)	-	-	-	500	484
BALANCE							
DECEMBER 31, 2003	\$ 18	\$ 6,879	\$ 14,078	\$ 1,003	\$ (623)	\$ (4,725)	\$ 16,630

THE ACCOMPANYING NOTES ARE AN INTEGRAL PART  
OF THESE CONSOLIDATED FINANCIAL STATEMENTS

CONSOLIDATED STATEMENTS OF CASH FLOWS

FIRST NILES FINANCIAL, INC. AND SUBSIDIARY

(In thousands)

	Year Ended December 31	
	2003	2002
<b>CASH FLOWS FROM OPERATING ACTIVITIES</b>		
Net income	\$ 1,058	\$ 982
Adjustments to reconcile net income to net cash provided by operating activities:		
Deferred income taxes	193	(35)
Depreciation	27	35
Amortization of deferred loan fees and costs	(26)	(14)
Amortization of discounts and premiums on investments and mortgage-backed and related securities, net	67	(27)
Gain on sale of securities	(187)	(165)
ESOP shares allocated	203	194
Equity in loss of limited partnership	28	46
Loss on sale of fixed asset	11	-
Provision for loan losses	-	78
Federal Home Loan Bank stock dividends	(42)	(47)
	<u>1,332</u>	<u>1,047</u>
Decrease in accrued interest receivable and prepaid expenses and other assets	81	31
Increase (decrease) in accrued interest payable, accounts payable and other liabilities	(613)	13
<b>NET CASH PROVIDED BY OPERATING ACTIVITIES</b>	<u>800</u>	<u>1,091</u>
<b>CASH FLOWS FROM INVESTING ACTIVITIES</b>		
Activity in available- for- sale securities:		
Sales	5,220	7,334
Maturities, prepayments and calls	31,878	13,226
Purchases	(45,187)	(25,010)
Activity in held- to- maturity securities:	3,055	5,530
Maturities, prepayments and calls		
(Increase) decrease in interest- bearing deposits with banks	2,787	(3,358)
(Increase) decrease in loans receivable	1,452	(760)
Sale of fixed asset	7	-
Additions to premises and equipment	(5)	(21)
<b>NET CASH USED IN INVESTING ACTIVITIES</b>	<u>(793)</u>	<u>(3,059)</u>
<b>CASH FLOWS FROM FINANCING ACTIVITIES</b>		
Purchases of treasury stock	(1,692)	(878)
Dividends paid	(746)	(722)
Increase (decrease) in savings accounts	(353)	3,129
Increase in certificates of deposit	1,394	704
Proceeds of Federal Home Loan Bank advances	1,000	-
Proceeds from exercise of stock options	484	110
<b>NET CASH PROVIDED BY FINANCING ACTIVITIES</b>	<u>87</u>	<u>2,343</u>
<b>NET INCREASE IN CASH</b>	<u>94</u>	<u>375</u>
<b>CASH AT BEGINNING OF YEAR</b>	<u>766</u>	<u>391</u>
<b>CASH AT END OF YEAR</b>	<u>\$ 860</u>	<u>\$ 766</u>
Cash paid during the period for:		
Interest	\$ 2,131	\$ 2,620
Income taxes	\$ 230	\$ 451

THE ACCOMPANYING NOTES ARE AN INTEGRAL PART OF THESE CONSOLIDATED FINANCIAL STATEMENTS.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

FIRST NILES FINANCIAL, INC. AND SUBSIDIARY

December 31, 2003 and 2002

NOTE A - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

First Niles Financial, Inc. (the "Company") is a savings and loan holding company whose activities are primarily limited to holding the stock of the Home Federal Savings and Loan Association of Niles (the "Association"). The Association conducts a general banking business in Niles, Ohio which consists of attracting deposits from the general public and applying those funds to the origination of loans for residential, consumer and nonresidential purposes. The Association's profitability is significantly dependent on its net interest income, which is the difference between interest income generated from interest-earning assets (i.e. loans and investments) and the interest expense paid on interest-bearing liabilities (i.e. customer deposits and borrowed funds). Net interest income is affected by the relative amount of interest-earning assets and interest-bearing liabilities and the interest received or paid on these balances. The level of interest rates paid or received by the Association can be significantly influenced by a number of environmental factors, such as governmental monetary policy, that are outside of management's control.

The consolidated financial information presented herein has been prepared in accordance with accounting principles generally accepted in the United States of America ("U.S. GAAP") and general accounting practices within the financial services industry. In preparing consolidated financial statements in accordance with U.S. GAAP, management is required to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the date of the financial statements and revenues and expenses during the reporting period. Actual results could differ from such estimates. A material estimate that is particularly susceptible to significant change in the near term relates to the determination of the allowance for loan losses.

The following is a summary of significant accounting policies which have been consistently applied in the preparation of the accompanying consolidated financial statements.

Principles of Consolidation:

The consolidated financial statements include the accounts of the Company and the Association. All significant intercompany balances and transactions have been eliminated in consolidation.

## FIRST NILES FINANCIAL, INC. AND SUBSIDIARY

December 31, 2003 and 2002

## NOTE A - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

## Investment Securities and Mortgage-Backed and Related Securities:

The Company accounts for investment securities and mortgage-backed and related securities in accordance with Statement of Financial Accounting Standards ("SFAS") No. 115, "Accounting for Certain Investments in Debt and Equity Securities." SFAS No. 115 requires that investments be categorized as held-to-maturity, trading or available-for-sale. Securities classified as held-to-maturity are carried at cost, adjusted for amortization of premiums and accretion of discount using methods that approximate the interest method over the remaining period to contractual maturity, adjusted for anticipated prepayments, only if the Association has the positive intent and ability to hold these securities to maturity. Trading securities and securities designated as available-for-sale are carried at fair value with resulting unrealized gains or losses recorded to operations or equity, respectively. At December 31, 2003 and 2002, the Company's equity accounts reflected net unrealized gains of \$1.0 million and \$2.0 million, respectively, on securities designated as available-for-sale. Realized gains or losses on sales of securities are recognized using the specific identification method.

## Loans Receivable:

Loans held in portfolio are stated at the principal amount outstanding, adjusted for the allowance for loan losses and unearned income. Interest is accrued as earned, unless the collectibility of the loan is in doubt. Uncollectible interest on loans that are contractually past due is charged off, or an allowance is established based on management's periodic evaluation. The allowance is established by a charge to interest income equal to all interest previously accrued, and income is subsequently recognized only to the extent that cash payments are received until, in management's judgment, the borrower's ability to make periodic interest and principal payments has returned to normal, in which case the loan is returned to accrual status. If the ultimate collectibility of the loan is in doubt, in whole or in part, all payments received on nonaccrual loans are applied to reduce principal until such doubt is eliminated.

At such time that management believes loan collection can only be effected through collateral liquidation, the estimated loan loss is charged off and the residual value is carried as an other asset.

## Loan Origination Fees and Costs:

The Association accounts for loan origination fees and costs in accordance with SFAS No. 91, "Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases." Pursuant to the provisions of SFAS No. 91, all loan origination fees received net of direct origination costs, are deferred and amortized to interest income over the contractual lives of the loans using the level-yield method, giving effect to actual loan prepayments. Additionally, SFAS No. 91 generally limits the definition of loan origination costs to the direct costs attributable to originating a loan. Total unamortized fees and costs of \$192,000 and \$104,000, respectively, are carried with outstanding loan balances at December 31, 2003.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

FIRST NILES FINANCIAL, INC. AND SUBSIDIARY

December 31, 2003 and 2002

NOTE A - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

Allowance for Losses on Loans:

It is the Association's policy to provide valuation allowances for estimated losses on loans based on past loss experience, current trends in the level of delinquent and specific problem loans, loan concentrations to single borrowers, adverse situations that may affect the borrower's ability to repay, the estimated value of any underlying collateral and current and anticipated economic conditions in the primary market area. When the collection of a loan becomes doubtful, or otherwise troubled, the Association records a loan loss provision equal to the difference between the fair value of the property securing the loan and the loan's carrying value. Major loans and major lending areas are reviewed periodically to determine potential problems at an early date. The allowance for loan losses is increased by charges to earnings and decreased by charge-offs (net of recoveries).

The Association accounts for impaired loans in accordance with SFAS No. 114, "Accounting by Creditors for Impairment of a Loan." SFAS No. 114 requires that impaired loans be measured based upon the present value of expected future cash flows discounted at the loan's effective interest rate or, as an alternative, at the loan's observable market price or fair value of the collateral.

A loan is defined under SFAS No. 114 as impaired when, based on current information and events, it is probable that a creditor will be unable to collect all amounts due according to the contractual terms of the loan agreement. In applying the provisions of SFAS No. 114, the Association considers its investment in one to four-family residential loans and consumer installment loans to be homogeneous and therefore excluded from separate identification for evaluation of impairment. With respect to the Association's investment in commercial real estate loans, and its evaluation of impairment thereof, such loans are collateral dependent and, as a result, are carried as a practical expedient at the lower of cost or fair value.

Loans which are more than ninety days contractually delinquent are considered to constitute more than a minimum delay in repayment and are evaluated for impairment under SFAS No. 114 at that time. The Association evaluates each impaired loan as to its circumstances to determine if interest recognition is appropriate when payments are received.

At December 31, 2003, the Association identified seven loans with a carrying value of \$954,000 as impaired due to uncertain conditions and delinquent payments. Accrual of interest on these loans has been suspended. Contractual interest not recognized for 2003 was \$62,000. The portion of the allowance for loan loss relating to the impaired loans at December 31, 2003 totaled \$332,000. The average recorded investment in these loans for 2003 was \$797,000. The carrying value of loans 90 days past due and still accruing was \$47,339 at December 31, 2003.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

FIRST NILES FINANCIAL, INC. AND SUBSIDIARY

December 31, 2003 and 2002

NOTE A - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

At December 31, 2002, the Association identified five loans with a carrying value of \$639,000 as impaired due to uncertain conditions and delinquent payments. Accrual of interest on these loans has been suspended. Contractual interest not recognized for 2002 was \$32,000. The portion of the allowance for loan loss relating to the impaired loans at December 31, 2002 totaled \$199,000. The average recorded investment in these loans for 2002 was \$549,000. The carrying value of loans 90 days past due and still accruing was \$879,000 at December 31, 2002.

Premises and Equipment:

Premises and equipment are recorded at cost and include expenditures which extend the useful lives of existing assets. Maintenance, repairs and minor renewals are expensed as incurred. For financial reporting, depreciation is provided on the straight-line and accelerated methods over the estimated useful lives of the assets, estimated to be forty to fifty years for buildings and three to ten years for furniture and equipment.

Federal Income Taxes:

The Company accounts for federal income taxes pursuant to SFAS No. 109, "Accounting for Income Taxes." SFAS No. 109 established financial accounting and reporting standards for the effects of income taxes that result from the Company's activities within the current and previous years. In accordance with SFAS No. 109, a deferred tax liability or deferred tax asset is computed by applying the current statutory tax rates to net taxable or deductible temporary differences between the tax basis of an asset or liability and its reported amount in the financial statements that will result in net taxable or deductible amounts in future periods. Deferred tax assets are recorded only to the extent that the amount of net deductible temporary differences or carryforward attributes may be utilized against current period earnings, carried back against prior years' earnings, offset against taxable temporary differences reversing in future periods, or utilized to the extent of management's estimate of future taxable income. A valuation allowance is provided for deferred tax assets to the extent that the value of net deductible temporary differences and carryforward attributes exceeds management's estimates of taxes payable on future taxable income. Deferred tax liabilities are provided on the total amount of net temporary differences taxable in the future.

Deferral of income taxes results primarily from deferred compensation accruals, Federal Home Loan Bank stock dividends, and book/tax differences in the allowance for loan losses.

Cash and Cash Equivalents:

For purposes of reporting cash flows, cash includes noninterest bearing cash which includes cash on hand and amounts due from correspondent banks.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

FIRST NILES FINANCIAL, INC. AND SUBSIDIARY

December 31, 2003 and 2002

NOTE A - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

Earnings Per Share:

Basic earnings per share is computed based upon the weighted-average shares outstanding during the year less weighted-average shares in the ESOP that are unallocated and not committed to be released. Diluted earnings per share is computed taking into consideration common shares outstanding and potential dilutive common shares to be issued under the Company's stock option plan.

A reconciliation of the weighted-average common shares outstanding on a basic and diluted basis for 2003 and 2002 is as follows:

	<u>2003</u>	<u>2002</u>
Basic weighted-average shares	<u>1,319,508</u>	<u>1,375,218</u>
Diluted weighted-average shares	<u>1,339,157</u>	<u>1,399,128</u>

At December 31, 2003 and 2002, there were options to purchase 110,472 and 149,124 shares, respectively, of common stock at an exercise price of \$12.53.

Recent Accounting Pronouncements:

The Company's management has reviewed newly issued but not yet effective accounting pronouncements all of which pertain to specialized areas which do not have application to the Company. Accordingly, management believes they will not have a material impact on First Niles Financial, Inc.'s consolidated financial condition or results of operations.

In December 2002, the FASB issued SFAS No. 148, "Accounting for Stock-Based Compensation - Transition and Disclosure." SFAS No. 148 amended SFAS No. 123, "Accounting for Stock-Base Compensation," to provide alternative methods of transition for a voluntary change to the fair value based method of accounting for stock-based employee compensation. In addition, SFAS No. 148 amends the disclosure requirements of SFAS No. 123 to require prominent disclosures in both annual and interim financial statements about the method of accounting for stock-based employee compensation and the effect of the method used on reported results. SFAS No. 148 is effective for fiscal years beginning after December 15, 2002. The expanded annual disclosure requirements and the transition provisions are effective for fiscal years ending after December 15, 2002. The interim disclosure provisions are effective for financial reports containing financial statements for interim periods beginning after December 15, 2002. SFAS No. 148 did not have a material effect on the Company's financial position or results of operations.

Reclassifications:

Certain amounts in 2002 have been reclassified to conform with the 2003 presentation.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

FIRST NILES FINANCIAL, INC. AND SUBSIDIARY

December 31, 2003 and 2002

NOTE B - INVESTMENT SECURITIES

Available-for-Sale:

The amortized cost, gross unrealized gains, gross unrealized losses and estimated fair values for available-for-sale securities are summarized as follows:

	December 31, 2003			
	Amortized	Gross	Gross	Estimated
	Cost	Unrealized	Unrealized	Fair
		Gains	Losses	Value
	(In thousands)			
FHLMC common stock	\$ 28	\$ 1,663	\$ -	\$ 1,691
Federal National Mortgage Association:				
Participation certificates	469	15	-	484
Federal Home Loan Mortgage Corporation:				
Collateralized mortgage obligations	25,384	33	(583)	24,834
U.S. Agencies - callable:				
Due after one year to five years	2,000	30	-	2,030
Due after five to ten years	8,000	111	(63)	8,048
Due after ten years	13,996	320	(7)	14,309
Other	15	-	-	15
TOTALS	<u>\$ 49,892</u>	<u>\$ 2,172</u>	<u>\$ (653)</u>	<u>\$ 51,411</u>
	December 31, 2002			
	Amortized	Gross	Gross	Estimated
	Cost	Unrealized	Unrealized	Fair
		Gains	Losses	Value
	(In thousands)			
FHLMC common stock	\$ 30	\$ 1,771	\$ -	\$ 1,801
Federal National Mortgage Association:				
Participation certificates	1,821	55	-	1,876
Federal Home Loan Mortgage Corporation:				
Participation certificates	679	33	-	712
Collateralized mortgage obligations	9,150	80	-	9,230
U.S. Agencies - callable:				
Due after one year to five years	2,000	8	-	2,008
Due after five to ten years	7,000	257	-	7,257
Due after ten years	21,000	835	-	21,835
Other	15	-	-	15
TOTALS	<u>\$ 41,695</u>	<u>\$ 3,039</u>	<u>\$ -</u>	<u>\$ 44,734</u>

FIRST NILES FINANCIAL, INC. AND SUBSIDIARY

December 31, 2003 and 2002

NOTE B - INVESTMENT SECURITIES (CONTINUED)

Unrealized losses on securities have not been recognized into income because management has the intent and the Company has the ability to hold the securities for the foreseeable future and the decline in fair value is due to increases in market interest rates. The fair value is expected to recover as the securities approach their maturity date and/or market interest rates decline.

Held-to-Maturity:

The amortized cost, gross unrealized gains, gross unrealized losses and estimated fair values for securities held-to-maturity are summarized as follows:

	December 31, 2003			Estimated Fair Value
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	
	(In thousands)			
Mortgage-backed and related securities:				
Federal Home Loan Mortgage Corporation:				
Collateralized mortgage obligations	\$ 295	\$ 4	\$ -	\$ 299
TOTALS	<u>\$ 295</u>	<u>\$ 4</u>	<u>\$ -</u>	<u>\$ 299</u>
	December 31, 2002			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
	(In thousands)			
Mortgage-backed and related securities:				
Federal Home Loan Mortgage Corporation:				
Collateralized mortgage obligations	\$ 3,349	\$ 53	\$ -	\$ 3,402
TOTALS	<u>\$ 3,349</u>	<u>\$ 53</u>	<u>\$ -</u>	<u>\$ 3,402</u>

During 2003, the Association sold available-for-sale securities for total proceeds of \$5.2 million resulting in gross realized gains of \$187,000.

During 2002, the Association sold available-for-sale securities for total proceeds of \$7.3 million resulting in gross realized gains of \$166,000 and gross realized losses of \$1,000.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

FIRST NILES FINANCIAL, INC. AND SUBSIDIARY

December 31, 2003 and 2002

NOTE C - LOANS RECEIVABLE

The composition of the loan portfolio is as follows:

	<u>December 31</u>	
	<u>2003</u>	<u>2002</u>
	(In thousands)	
Real estate mortgage (primarily one-to-four family residential)	\$ 28,729	\$ 29,719
Construction and development	2,189	1,404
Commercial real estate	6,136	7,065
Consumer and other	421	531
Home equity lines of credit	1,947	2,154
Loans on deposits	<u>115</u>	<u>94</u>
	39,537	40,967
Less allowance for loan losses	<u>759</u>	<u>762</u>
TOTALS	<u>\$ 38,778</u>	<u>\$ 40,205</u>

In the ordinary course of business, the Association has granted loans to some of its officers, directors and their related interests. Related party loans are made on substantially the same terms, including interest rates and collateral, as those prevailing at the time for comparable transactions with unrelated persons and do not involve more than normal risk of collectibility. The aggregate dollar amount of these loans was approximately \$1.8 million and \$1.6 million at December 31, 2003 and 2002, respectively. During the years ended December 31, 2003 and 2002, loans of \$794,000 and \$628,000, respectively, were made to officers, directors and their related interests, while principal repayments of \$611,000 and \$505,000 were received from related parties during 2003 and 2002, respectively.

The Association's lending efforts have historically focused on one-to-four family residential real estate loans and construction loans, which comprise approximately \$29.1 million, or 74%, of the total loan portfolio at December 31, 2003, and \$28.3 million, or 69% of the total portfolio at December 31, 2002. Historically, such loans have been conservatively underwritten with cash down payments sufficient to provide the Association with adequate collateral coverage in the event of default. Nevertheless, the Association, as with any lending institution, is subject to the risk that real estate values or economic conditions could deteriorate in its primary lending areas within Ohio, thereby impairing collateral values.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

FIRST NILES FINANCIAL, INC. AND SUBSIDIARY

December 31, 2003 and 2002

NOTE C - LOANS RECEIVABLE (CONTINUED)

The activity in the allowance for loan losses is summarized as follows:

	<u>December 31</u>	
	<u>2003</u>	<u>2002</u>
	(In thousands)	
Balance at beginning of year	\$ 762	\$ 676
Provision reflected in operations	-	78
Less loans charged off	(3)	-
Recovery	<u>-</u>	<u>8</u>
BALANCE AT END OF YEAR	<u>\$ 759</u>	<u>\$ 762</u>

NOTE D - REAL ESTATE INVESTMENT - LIMITED PARTNERSHIP

The Association holds an interest in a limited partnership formed to construct and operate multi-family housing units. Due to the ability to exercise significant control over operations, the Association accounts for the investment in the limited partnership using the equity method. Under the terms of the limited partnership agreement, the Association made a capital contribution of \$500,000 and is allocated tax losses and affordable housing federal income tax credits based upon that investment.

Condensed financial information extracted from preliminary accounting information for year 2003 and audited information for year 2002 for the entire partnership is summarized as of and for the years ended December 31, 2003 and 2002 as follows:

	<u>2003</u>	<u>2002</u>
	(In thousands)	
Balance Sheet:		
Investment in real estate	\$ 3,966	\$ 4,167
Total assets	4,069	4,270
Mortgage payable	2,744	2,779
Partners' equity	586	748
Operations:		
Rental income	552	572
Net loss	169	266

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

FIRST NILES FINANCIAL, INC. AND SUBSIDIARY

December 31, 2003 and 2002

NOTE E - PREMISES AND EQUIPMENT

Premises and equipment are summarized as follows:

	<u>December 31</u>	
	<u>2003</u>	<u>2002</u>
	(In thousands)	
Land	\$ 32	\$ 32
Building and building improvements	508	508
Furniture, equipment and vehicles	<u>367</u>	<u>401</u>
	907	941
Less accumulated depreciation	<u>612</u>	<u>607</u>
TOTALS	<u>\$ 295</u>	<u>\$ 334</u>

NOTE F - DEPOSITS

Substantially all deposits are interest bearing. The type of deposit accounts are summarized as follows:

	<u>December 31</u>	
	<u>2003</u>	<u>2002</u>
	(In thousands)	
Savings and transaction accounts	\$ 28,401	\$ 28,632
Certificates of deposit	<u>33,535</u>	<u>32,263</u>
TOTALS	<u>\$ 61,936</u>	<u>\$ 60,895</u>

Deposits in excess of \$100,000 are not federally insured. At December 31, 2003 and 2002, the aggregate amount of individual deposits in excess of \$100,000 was \$15.8 million and \$14.7 million, respectively.

Scheduled maturities of certificates of deposit are as follows:

	<u>December 31</u>	
	<u>2003</u>	<u>2002</u>
	(In thousands)	
Within one year	\$ 22,595	\$ 23,819
One to two years	4,467	4,203
Two to three years	2,953	2,422
Three to four years	2,314	27
Four to five years	<u>1,206</u>	<u>1,792</u>
TOTALS	<u>\$ 33,535</u>	<u>\$ 32,263</u>

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

FIRST NILES FINANCIAL, INC. AND SUBSIDIARY

December 31, 2003 and 2002

NOTE G - FEDERAL INCOME TAXES

	<u>Year Ended December 31</u>	
	<u>2003</u>	<u>2002</u>
	(In thousands)	
Income tax expense is summarized as follows:		
Federal:		
Current	\$ 262	\$ 445
Deferred	<u>193</u>	<u>(35)</u>
TOTALS	<u>\$ 455</u>	<u>\$ 410</u>

The provision for federal income taxes on earnings differ from that computed at the statutory rate of 34% as follows:

	<u>Year Ended December 31</u>	
	<u>2003</u>	<u>2002</u>
	(In thousands)	
Federal taxes computed at statutory rate	\$ 514	\$ 473
Increase (decrease) resulting from:		
Limited partnership tax credits	(78)	(78)
Dividends received deduction	(7)	(6)
Other	<u>26</u>	<u>21</u>
FEDERAL INCOME TAX PROVISION	<u>\$ 455</u>	<u>\$ 410</u>
Effective federal income tax rate	<u>30.1%</u>	<u>29.5%</u>

The components of the net deferred tax liability are as follows:

	<u>December 31</u>	
	<u>2003</u>	<u>2002</u>
	(In thousands)	
Deferred tax liabilities:		
Federal Home Loan Bank stock dividends	\$ (136)	\$ (122)
Unrealized gains on securities available for sale	<u>(516)</u>	<u>(1,037)</u>
TOTAL DEFERRED TAX LIABILITIES	(652)	(1,159)
Deferred tax assets:		
Deferred compensation	134	351
Allowance for loan losses	258	259
Imputed loan interest	48	27
ESOP	26	24
Loan fees	29	18
Depreciation	<u>4</u>	<u>-</u>
TOTAL DEFERRED TAX ASSETS	<u>499</u>	<u>679</u>
NET DEFERRED FEDERAL INCOME TAX LIABILITY	<u>\$ (153)</u>	<u>\$ (480)</u>

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

FIRST NILES FINANCIAL, INC. AND SUBSIDIARY

December 31, 2003 and 2002

NOTE G - FEDERAL INCOME TAXES (CONTINUED)

The Association was previously allowed a special bad debt deduction based on a percentage of earnings, generally limited to 8% of otherwise taxable income, or the amount of qualifying and nonqualifying loans outstanding and subject to certain limitations based on aggregate loans and savings account balances at the end of the calendar year. If the amounts that qualified as deductions for federal income tax purposes are later used for purposes other than for bad debt losses, including distributions in liquidation, such distributions will be subject to federal income taxes at the then current corporate income tax rate. Retained earnings at December 31, 2003, includes approximately \$2.5 million for which federal income taxes have not been provided. The amount of the unrecognized deferred tax liability relating to the cumulative percentage of earnings bad debt deduction totaled approximately \$863,000 at December 31, 2003.

The Association's tax credits arise from an investment in a qualified low-income housing limited partnership. The credit is subject to partial recapture in the event the project fails to comply with regulations pertaining to qualifying basis. At December 31, 2003, the partnership had maintained its qualifying basis. In the event of recapture, the Association would have to repay \$193,000 of credits used plus nondeductible interest.

NOTE H - FEDERAL HOME LOAN BANK ADVANCES AND OTHER DEBT

Federal Home Loan Bank (FHLB) advances, collateralized at December 31, 2003 by pledge of all qualifying one-to-four family residential and multi-family mortgage loans and \$1,000,000 of interest-bearing time deposits, are issued by FHLB at either a fixed rate of interest or at a fixed rate for an initial period until a quarterly option exercisable by the FHLB may convert the issue to a variable rate. The following table summarizes the advances.

<u>Interest Rate</u>	<u>Maturity</u>	<u>Convertible to Variable Rate</u>	<u>Amount (in thousands)</u>
3.12%	August, 2006	N/A	\$ 1,000
5.01%	December, 2010	March, 2002	3,000
5.20%	December, 2010	December, 2003	2,000
4.60%	January, 2011	January, 2002	2,000
4.93%	February, 2011	February, 2004	2,000
4.71%	February, 2011	February, 2002	1,000
5.20%	March, 2011	March, 2006	1,000
3.78%	March, 2011	June, 2001	2,000
4.08%	April, 2011	April, 2002	2,000
4.16%	May, 2011	May, 2002	2,000
4.09%	May, 2011	May, 2002	1,000
4.52%	August, 2011	August, 2004	1,500
Weighted - average 4.51%		TOTAL	<u>\$ 20,500</u>

At December 31, 2002, the outstanding advances from FHLB totaled \$19.5 million at a weighted-average rate of 4.58%.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

FIRST NILES FINANCIAL, INC. AND SUBSIDIARY

December 31, 2003 and 2002

NOTE H - FEDERAL HOME LOAN BANK ADVANCES AND OTHER DEBT  
(CONTINUED)

The Association maintains a \$3.2 million unsecured line of credit with another financial institution. At December 31, 2003 and 2002, the line of credit was not used and fully available.

NOTE I - EMPLOYEE BENEFIT PLANS

Stock Option Plan:

The Board of Directors adopted a Stock Option Plan that provided for the issuance of 175,440 shares of authorized, but unissued shares of common stock at fair value at the date of grant. During 1999, the Company granted options to purchase 157,896 shares at an exercise price of \$12.53 per share.

A summary of the status of the Company's stock option plan as of December 31, 2003 and 2002 and changes during the period ended on those dates is presented below:

	2003		2002	
	Shares	Weighted-Average Exercise Price	Shares	Weighted-Average Exercise Price
Outstanding at beginning of year	149,124	\$12.53	157,896	\$12.53
Granted	-	-	-	-
Exercised	38,652	12.53	8,772	12.53
Forfeited	-	-	-	-
Outstanding at end of year	<u>110,472</u>	<u>\$12.53</u>	<u>149,124</u>	<u>\$12.53</u>
Options exercisable at year-end	<u>110,472</u>	<u>\$12.53</u>	<u>149,124</u>	<u>\$12.53</u>

The following information applies to options outstanding at December 31, 2003:

Number outstanding	110,472
Weighted-average exercise price	\$12.53
Weighted-average remaining contractual life	7.9 years

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

FIRST NILES FINANCIAL, INC. AND SUBSIDIARY

December 31, 2003 and 2002

NOTE I - EMPLOYEE BENEFIT PLANS (CONTINUED)

Pro Forma Disclosure of the Effect of Stock-Based Compensation:

The Company accounts for its stock option plan in accordance with SFAS No. 123, "Accounting for Stock-Based Compensation," which contains a fair value-based method for valuing stock-based compensation that entities may use, which measures compensation cost at the grant date based on the fair value of the award. Compensation is then recognized over the service period, which is usually the vesting period. Alternatively, SFAS No. 123 permits entities to continue to account for stock options and similar equity instruments under Accounting Principles Board ("APB") Opinion No. 25, "Accounting for Stock Issued to Employees." Entities that continue to account for stock options using APB Opinion No. 25 are required to make pro forma disclosures of net earnings and earnings per share, as if the fair value-based method of accounting defined in SFAS No. 123 had been applied.

Pro forma effects on earnings arising from stock based compensation have been omitted for 2003 and 2002 in that no options have been granted in those years.

Employee Stock Ownership Plan:

The Company has an Employee Stock Ownership Plan ("ESOP") which provides retirement benefits for all employees who have completed one year of service and have attained the age of 21. The Company accounts for the ESOP in accordance with Statement of Position ("SOP") 93-6, "Employers' Accounting for Employee Stock Ownership Plans." SOP 93-6 requires the measure of compensation expense recorded by employers to equal the average fair value of ESOP shares allocated to participants during a given fiscal year. The shares released to participant accounts are based upon the principal and interest payments of the underlying debt. As shares are committed to be released, the Company reports compensation expense equal to the current market price of the shares and the shares become outstanding for earnings per share computation. The expense related to the ESOP totaled \$203,000 and \$194,000 for years 2003 and 2002, respectively. Dividends paid on unallocated shares are used to pay debt service. At December 31, 2003 and 2002, the ESOP held 91,488 and 109,987 unallocated shares with a fair market value of \$1.6 million and \$1.8 million, respectively, for each year. Allocated shares at December 31, 2003 and 2002 were 110,097 and 91,598, respectively. The remaining unpaid cost of the original unallocated shares at December 31, 2003 and 2002 is \$623,000 and \$749,000, respectively, which is presented as common stock purchased by the Employee Stock Ownership Plan in stockholders' equity.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

FIRST NILES FINANCIAL, INC. AND SUBSIDIARY

December 31, 2003 and 2002

NOTE I - EMPLOYEE BENEFIT PLANS (CONTINUED)

Nonqualified Deferred Compensation Plan:

The Directors of the Association had approved a nonqualified deferred compensation plan for certain officers which provided for retirement benefits of specified amounts for each executive. The agreements had been subject to annual renewal, however, the Directors elected to terminate this agreement at the conclusion of the plan year ended August 31, 1998. Accrued deferred compensation amounts of \$396,000 and \$1,032,000 at December 31, 2003 and 2002 are payable in a lump sum upon the executives' death, disability, voluntary resignation, or termination by the Association without cause.

NOTE J - TREASURY STOCK

During 2003 and 2002, the Board of Directors authorized the repurchase of up to 141,477 and 75,382 shares, respectively, of its common stock in the open market or private transaction. The repurchased shares are to be held in the treasury and used for general corporate purposes including use in the Company's benefit plans. During 2003 and 2002, the Company purchased 105,112 and 59,070 shares at a cost of \$1.7 million and \$0.9 million, respectively.

NOTE K - COMMITMENTS AND CONTINGENCIES

The Association is a party to financial instruments with off-balance sheet risk in the normal course of business to meet the financing needs of its customers including commitments to extend credit. Such commitments involve, to varying degrees, elements of credit and interest-rate risk in excess of the amount recognized in the statement of financial condition. The contract or notional amounts of the commitments reflect the extent of the Association's involvement in such financial instruments.

The Association's exposure to credit loss in the event of nonperformance by the other party to the financial instrument for commitments to extend credit is represented by the contractual notional amount of those instruments. The Association uses the same credit policies in making commitments and conditional obligations as those utilized for on-balance sheet instruments.

At December 31, 2003, the Association had outstanding commitments of approximately \$1.9 million to originate fixed and variable rate residential real estate loans and \$2.0 million of variable rate home equity lines of credit. The average interest rate of loan commitments and home equity lines of credit was 6% at December 31, 2003. In the opinion of management, the outstanding loan commitments equaled or exceeded prevalent market interest rates and such loans were underwritten in accordance with normal underwriting policies, and all commitments will be funded via cash flow from operations and existing excess liquidity.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

FIRST NILES FINANCIAL, INC. AND SUBSIDIARY

December 31, 2003 and 2002

NOTE K - COMMITMENTS AND CONTINGENCIES (CONTINUED)

From time to time, and in the ordinary course of business, the Company becomes a party to matters of litigation. In the opinion of the Company's counsel, there are no claims, asserted or unasserted, the resolution of which would have a material effect on the Company's consolidated financial statements.

NOTE L - FAIR VALUES OF FINANCIAL INSTRUMENTS

The following table shows carrying values and the related estimated fair values of financial instruments at December 31, 2003 and 2002.

	December 31			
	2003		2002	
	Carrying Amounts	Estimated Fair Value	Carrying Amounts	Estimated Fair Value
	(In thousands)			
Cash and equivalents	\$ 7,288	\$ 7,288	\$ 9,980	\$ 9,980
Securities:				
Available-for-sale	51,411	51,411	44,734	44,734
Held-to-maturity	295	299	3,349	3,402
Federal Home Loan Bank stock	1,095	1,095	1,053	1,053
Loans	38,778	39,643	40,205	41,329
Accrued interest receivable	703	703	758	758
Deposits:				
Checking, savings and money market	(28,401)	(28,401)	(28,632)	(28,632)
Certificates of deposit	(33,535)	(33,943)	(32,263)	(32,525)
Accrued interest payable	(132)	(132)	(145)	(145)
Federal Home Loan Bank advances	(20,500)	(22,077)	(19,500)	(21,446)

For purposes of the above disclosures of estimated fair value, the following assumptions were used: the estimated fair value for cash and equivalents and accrued interest was considered to approximate cost; the estimated fair value for securities was based on quoted market values for the individual securities or for equivalent securities; the estimated fair value for loans was based on estimates of the rate the Association would charge for similar loans at December 31, 2003 and 2002, respectively, applied over estimated payment periods; the estimated fair value for demand and savings deposits was based on their carrying value; the estimated fair value for certificates of deposit was based on estimates of the rate the Company would pay on such obligations at December 31, 2003 and 2002, respectively, applied for the time period until maturity; the fair value of the advances at December 31, 2003 and December 31, 2002 was determined with reference to rates in effect for similar lending arrangements; and the estimated fair value of commitments was not material.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

### FIRST NILES FINANCIAL, INC. AND SUBSIDIARY

December 31, 2003 and 2002

#### NOTE L - FAIR VALUES OF FINANCIAL INSTRUMENTS (CONTINUED)

While these estimates of fair values are based on management's judgment of appropriate factors, there is no assurance that, if the Company had disposed of such items at December 31, 2003 or 2002, the estimated fair values would necessarily have been achieved at that date, since market values may differ depending on various circumstances. The estimated fair values at December 31, 2003 should not be considered to apply at any subsequent date.

#### NOTE M - REGULATORY CAPITAL

The Association is subject to minimum capital requirements promulgated by the Office of Thrift Supervision ("OTS"). 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 Company's financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the Association must meet specific capital guidelines that involve quantitative measures of the Association's assets, liabilities, and certain off-balance-sheet items as calculated under regulatory accounting practices. The Association's capital amounts and classifications are also subject to qualitative judgments by the regulators about components, risk weightings, and other factors. Such minimum capital standards generally require the maintenance of regulatory capital sufficient to meet each of three tests, hereinafter described as the tangible capital requirement, the tier 1 core capital requirement and the total risk-based capital requirement. The tangible capital requirement provides for minimum tangible capital (defined as stockholders' equity less all intangible assets) equal to 1.5% of adjusted total assets. The tier 1 core capital requirement provides for minimum core capital (tangible capital plus certain forms of supervisory goodwill and other qualifying intangible assets) generally equal to 4.0% of adjusted total assets except for those associations with the highest examination rating and acceptable levels of risk.

The total risk-based capital requirement currently provides for the maintenance of core capital plus general loan loss allowances equal to 8.0% of risk-weighted assets. In computing risk-weighted assets, the Association multiplies the value of each asset on its statement of financial condition by a defined risk-weighting factor, e.g., one-to four-family residential loans carry a risk-weighted factor of 50%.

During the year 2002, the Association was notified by the OTS that it was categorized as "well capitalized" under the framework for prompt corrective action. To be categorized as "well capitalized," the Association must maintain capital ratios as set forth in the following schedule.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

FIRST NILES FINANCIAL, INC. AND SUBSIDIARY

December 31, 2003 and 2002

NOTE M - REGULATORY CAPITAL (CONTINUED)

As of December 31, 2003 and 2002, management believes that the Association met all capital adequacy requirements to which it was subject.

	<u>Actual</u>		<u>For Capital Adequacy Purposes</u>		<u>To be "Well-Capitalized" under Prompt Corrective Action Provisions</u>	
	<u>Amount</u>	<u>Ratio</u>	<u>Amount</u>	<u>Ratio</u>	<u>Amount</u>	<u>Ratio</u>
			(Dollars in thousands)			
<b>2003:</b>						
Tangible capital	\$ 13,948	14.3%	≥\$1,460	≥1.5%	*	*
Tier 1 core capital	\$ 13,948	14.3%	≥\$3,893	≥4.0%	≥\$4,866	≥ 5.0%
Total risk-based capital	\$ 15,191	38.6%	≥\$3,147	≥8.0%	≥\$3,934	≥10.0%
<b>2002:</b>						
Tangible capital	\$ 14,267	14.9%	≥\$1,439	≥1.5%	*	*
Tier 1 core capital	\$ 14,267	14.9%	≥\$3,838	≥4.0%	≥\$4,798	≥ 5.0%
Total risk-based capital	\$ 15,573	38.5%	≥\$3,236	≥8.0%	≥\$4,046	≥10.0%

\*Ratio is not required under regulations

The Association's management believes that, under the current regulatory capital regulations, the Association will continue to meet its minimum capital requirements in the foreseeable future. However, events beyond the control of the Association, such as increased interest rates or a downturn in the economy in the primary market area, could adversely affect future earnings and, consequently, the ability to meet future minimum regulatory capital requirements.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

FIRST NILES FINANCIAL, INC. AND SUBSIDIARY

December 31, 2003 and 2002

NOTE M - REGULATORY CAPITAL (CONTINUED)

The Association is subject to regulations imposed by the OTS regarding the amount of capital distributions payable to the Company. Generally, the Association's payment of dividends is limited, without prior OTS approval, to net earnings for the current calendar year plus the two preceding calendar years, less capital distributions paid over the comparable time period. Insured institutions are required to file an application with the OTS for capital distributions in excess of this limitation.

NOTE N - CONDENSED FINANCIAL STATEMENTS OF FIRST NILES FINANCIAL, INC.

The following condensed financial statements summarize the financial position of First Niles Financial, Inc. as of December 31, 2003 and 2002, and the results of its operations and its cash flows for the years then ended.

First Niles Financial, Inc.  
STATEMENTS OF FINANCIAL CONDITION  
December 31, 2003 and 2002  
(In thousands)

	<u>2003</u>	<u>2002</u>
<b>ASSETS</b>		
Cash and cash equivalents:		
Noninterest bearing	\$ 21	\$ 9
Interest bearing	<u>877</u>	<u>983</u>
	898	992
Available-for-sale securities - at market	-	327
Mortgage loan receivable	294	298
Account receivable from Home Federal Savings and Loan Association of Niles	523	220
Investment in Home Federal Savings and Loan Association of Niles	14,951	16,278
Accrued interest and prepaid expense	<u>2</u>	<u>258</u>
<b>TOTAL ASSETS</b>	<u><b>\$16,668</b></u>	<u><b>\$18,373</b></u>
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
Accrued expenses	\$ 18	\$ 39
Accrued federal income tax	20	-
Deferred federal income tax liability	<u>-</u>	<u>1</u>
<b>TOTAL LIABILITIES</b>	<u>38</u>	<u>40</u>
Stockholders' equity	<u>16,630</u>	<u>18,333</u>
<b>TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY</b>	<u><b>\$16,668</b></u>	<u><b>\$18,373</b></u>

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

FIRST NILES FINANCIAL, INC. AND SUBSIDIARY

December 31, 2003 and 2002

NOTE N - CONDENSED FINANCIAL STATEMENTS OF FIRST NILES FINANCIAL, INC.  
(CONTINUED)

First Niles Financial, Inc.  
CONDENSED STATEMENTS OF INCOME  
For the years ended December 31, 2003 and 2002  
(In thousands)

	<u>2003</u>	<u>2002</u>
Revenue:		
Interest income	\$ 32	\$ 76
	32	76
	TOTAL REVENUE	
General and administrative expenses	<u>218</u>	<u>240</u>
	LOSS BEFORE INCOME TAX CREDITS AND EQUITY IN EARNINGS OF SUBSIDIARY	
	(186)	(164)
Income tax credits	<u>(63)</u>	<u>(56)</u>
	LOSS BEFORE EQUITY IN EARNINGS OF SUBSIDIARY	
	(123)	(108)
Equity in earnings of subsidiary	<u>1,181</u>	<u>1,090</u>
	NET INCOME	
	<u>\$ 1,058</u>	<u>\$ 982</u>

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

FIRST NILES FINANCIAL, INC. AND SUBSIDIARY

December 31, 2003 and 2002.

NOTE N - CONDENSED FINANCIAL STATEMENTS OF FIRST NILES FINANCIAL, INC.  
(CONTINUED)

First Niles Financial, Inc.  
CONDENSED STATEMENTS OF CASH FLOWS  
For the years ended December 31, 2003 and 2002  
(In thousands)

	<u>2003</u>	<u>2002</u>
Cash flows from operating activities:		
Net income for the period	\$ 1,058	\$ 982
Adjustments to reconcile net income to net cash provided by operating activities:		
Excess distributions from (undistributed income of) consolidated subsidiary	319	(1,090)
Net decrease in due from subsidiary, accrued interest and prepaid expenses	176	183
Decrease in accounts payable and accrued expense	<u>(21)</u>	<u>(1)</u>
NET CASH PROVIDED BY OPERATING ACTIVITIES	1,532	74
Cash flows from investing activities:		
Net (increase) decrease in loans receivable	4	(298)
Purchase of securities available-for-sale	-	(1,471)
Maturities of securities available-for-sale	324	1,147
Net decrease in interest bearing deposits	<u>106</u>	<u>2,027</u>
NET CASH PROVIDED BY INVESTING ACTIVITIES	434	1,405
Cash flows from financing activities:		
Exercise of options	484	110
Dividends paid	(746)	(722)
Purchase of treasury stock	<u>(1,692)</u>	<u>(878)</u>
NET CASH USED IN FINANCING ACTIVITIES	<u>(1,954)</u>	<u>(1,490)</u>
NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	12	(11)
Cash and cash equivalents at beginning of period	<u>9</u>	<u>20</u>
CASH AND CASH EQUIVALENTS AT END OF PERIOD	<u>\$ 21</u>	<u>\$ 9</u>
Noncash transaction:		
Employee stock benefit plan transactions	<u>\$ 203</u>	<u>\$ 195</u>

# FIRST NILES FINANCIAL, INC. SHAREHOLDER INFORMATION

## ANNUAL MEETING

The annual meeting of shareholders will be held at 2:00 p.m. local time, Wednesday, April 21, 2004, at the main office of First Niles, located at 55 North Main Street, Niles, Ohio.

## COMMON STOCK AND DIVIDENDS

First Niles Financial, Inc.'s common stock trades on The Nasdaq SmallCap Market under the symbol "FNFI". At December 31, 2003, there were 1,754,411 shares of common stock issued, 1,399,310 shares of common stock outstanding and 446 shareholders of record.

The table below presents the quarterly range of high and low sales prices of First Niles' common stock for 2002 and 2003, as well as the amount of cash distributions declared during the stated periods. The price information set forth in the table below was provided by the Nasdaq Stock Market.

	<u>HIGH</u>	<u>LOW</u>	<u>CASH DIVIDENDS DECLARED</u>
First Quarter (ended March 31, 2002)	\$14.60	\$12.80	\$0.13
Second Quarter (ended June 30, 2002)	\$15.75	\$13.75	\$0.13
Third Quarter (ended September 30, 2002)	\$16.00	\$14.25	\$0.13
Fourth Quarter (ended December 31, 2002)	\$16.20	\$15.02	\$0.14
First Quarter (ended March 31, 2003)	\$16.60	\$15.60	\$0.14
Second Quarter (ended June 30, 2003)	\$16.43	\$15.19	\$0.14
Third Quarter (ended September 30, 2003)	\$17.25	\$15.19	\$0.14
Fourth Quarter (ended December 31, 2003)	\$17.90	\$16.43	\$0.15

Dividend payment decisions are made with consideration of a variety of factors including earnings, financial condition, market considerations and regulatory restrictions. Restrictions on dividend payments are described in Note M of the Notes to Consolidated Financial Statements included in this Annual Report.

## SHAREHOLDER AND GENERAL INQUIRIES

Lawrence Safarek, Vice President  
First Niles Financial, Inc.  
55 North Main Street  
Niles, Ohio 44446  
(330) 652-2539

## TRANSFER AGENT

Computershare Investor  
Services LLC  
2 North LaSalle Street  
Chicago, IL 60602  
(888) 294-8217 (toll free)

## ANNUAL AND OTHER REPORTS

Copies of the Company's Annual Report on Form 10-KSB filed with the Securities and Exchange Commission, can be obtained, without cost, by writing or calling: First Niles Financial, Inc. Investor Relations, Attn: Lawrence Safarek, Vice President and Treasurer, 55 North Main Street, Niles, Ohio 44446: (330) 652-2539.

**FIRST NILES FINANCIAL, INC.  
CORPORATE INFORMATION**

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**COMPANY AND BANK ADDRESS**

55 North Main Street  
Niles, Ohio 44446

Telephone: (330) 652-2539  
Fax: (330) 652-0911

**BOARD OF DIRECTORS**

WILLIAM L. STEPHENS  
*Chairman, President and Chief Executive  
Officer of First Niles Financial, Inc. and  
Home Federal Savings and Loan  
Association of Niles*

LEONARD GANTLER  
*CPA and sole shareholder, Leonard T.  
Gantler Co., Inc.*

P. JAMES KRAMER  
*President, William Kramer & Son*

WILLIAM EDDY  
*President, Clinic of Osteopathic  
Medicine, Inc.*

RALPH A. ZUZOLO, SR.  
*Partner, Law Firm of Zuzolo, Zuzolo  
& Zuzolo*

**INDEPENDENT AUDITORS**

ANNESS, GERLACH & WILLIAMS,  
a Professional Corporation  
Certified Public Accountants  
1275 Boardman-Canfield Road  
Youngstown, Ohio 44513

**EXECUTIVE OFFICERS**

WILLIAM L. STEPHENS  
*Chairman, President and Chief Executive  
Officer of First Niles Financial, Inc. and  
Home Federal Savings and Loan  
Association of Niles*

LAWRENCE SAFAREK  
*Vice President and Treasurer of First  
Niles Financial, Inc. and Home Federal  
Savings and Loan Association of Niles*

**SPECIAL COUNSEL**

SILVER, FREEDMAN & TAFF, L.L.P.  
1700 Wisconsin Avenue, N.W.  
Washington, D.C. 20007