

FIRST KEYSTONE CORP  
Form 10-Q  
November 09, 2011

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10Q

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

For the quarterly period ended September 30, 2011

or

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

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

Commission File Number: 2-88927

FIRST KEYSTONE CORPORATION  
(Exact name of registrant as specified in its charter)

Pennsylvania  
(State or other jurisdiction of  
incorporation or organization)

23-2249083  
(I.R.S. Employer  
Identification No.)

111 West Front Street, Berwick, PA  
(Address of principal executive offices)

18603  
(Zip Code)

Registrant's telephone number, including area code: (570) 752-3671

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes  No

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

Large accelerated filer  Accelerated filer   
Non-accelerated filer  Smaller reporting company

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Act). Yes  No

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

Common Stock, \$2 Par Value, 5,445,042 shares as of November 4, 2011.

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## PART I. - FINANCIAL INFORMATION

## ITEM. 1 Financial Statements

FIRST KEYSTONE CORPORATION AND SUBSIDIARY  
CONSOLIDATED BALANCE SHEETS

(Amounts in thousands, except per share data)

	September 2011 (Unaudited)	December 2010
<b>ASSETS</b>		
Cash and due from banks	\$7,040	\$4,346
Interest-bearing deposits in other banks	10,958	4,559
Federal funds sold	3,000	3,000
Total cash and cash equivalents	\$20,998	\$11,905
Investment securities available-for-sale	328,827	303,902
Investment securities held-to-maturity estimated fair value of \$3,297 in 2011 and \$6,191 in 2010	3,241	6,266
Restricted securities at cost - available-for-sale	5,460	6,363
Loans, net of unearned income	410,381	409,651
Allowance for loan losses	(5,474 )	(5,701 )
Net loans	\$404,907	\$403,950
Premises and equipment, net	12,191	11,842
Accrued interest receivable	4,274	4,589
Cash surrender value of bank owned life insurance	18,958	18,388
Investment in limited partnerships	1,513	1,600
Goodwill	19,133	19,133
Core deposit intangible	1,023	1,240
Prepaid FDIC insurance	1,485	2,005
Foreclosed assets held for resale	1,000	1,149
Deferred income taxes	0	2,742
Other assets	1,745	1,527
<b>TOTAL ASSETS</b>	<b>\$824,755</b>	<b>\$796,601</b>
<b>LIABILITIES</b>		
Deposits:		
Non-interest bearing	\$79,192	\$69,080
Interest bearing	554,615	557,815
<b>TOTAL DEPOSITS</b>	<b>633,807</b>	<b>626,895</b>
Short-term borrowings	22,349	20,977
Long-term borrowings	69,355	66,400
Accrued interest and other expenses	2,944	2,976
Deferred income taxes	2,078	0
Other liabilities	2,226	293
<b>TOTAL LIABILITIES</b>	<b>\$732,759</b>	<b>\$717,541</b>
<b>STOCKHOLDERS' EQUITY</b>		
Common stock, par value \$2.00 per share	11,375	11,375
Surplus	30,161	30,175

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Retained earnings	49,042	45,246
Accumulated other comprehensive income (loss)	7,493	(1,633 )
Less treasury stock, at cost, 242,725 shares in 2011 and 243,540 shares in 2010	(6,075 )	(6,103 )
<b>TOTAL STOCKHOLDERS' EQUITY</b>	<b>\$91,996</b>	<b>\$79,060</b>
<b>TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY</b>	<b>\$824,755</b>	<b>\$796,601</b>

See Accompanying Notes to Consolidated Financial Statements

FIRST KEYSTONE CORPORATION AND SUBSIDIARY  
CONSOLIDATED STATEMENTS OF INCOME  
FOR THE THREE MONTHS ENDED SEPTEMBER 30, 2011 AND 2010  
(Unaudited)

(Amounts in thousands except per share data)

	2011	2010
<b>INTEREST INCOME</b>		
Interest and fees on loans	\$5,848	6,205
Interest and dividend income on investment securities	3,388	3,371
Deposits in banks	0	9
Interest on federal funds sold	1	0
Total interest income	\$9,237	\$9,585
<b>INTEREST EXPENSE</b>		
Deposits	\$1,657	\$2,208
Short-term borrowings	36	61
Long-term borrowings	647	823
Total interest expense	\$2,340	\$3,092
Net interest income	\$6,897	\$6,493
Provision for loan losses	500	1,075
Net interest income after provision for loan losses	\$6,397	\$5,418
<b>NON-INTEREST INCOME</b>		
Trust department	\$153	\$153
Service charges and fees	335	372
Bank owned life insurance income	187	193
ATM fees and debit card income	238	204
Gain on sale of loans	117	336
Investment securities gains (losses) - net	218	(11 )
Recovery on loss due to defalcation	0	800
Other	95	26
Total non-interest income	\$1,343	\$2,073
<b>NON-INTEREST EXPENSE</b>		
Salaries and employee benefits	\$2,394	\$2,281
Occupancy, net	335	291
Furniture and equipment	120	108
Computer expenses	268	200
Professional services	197	315
State shares tax	227	177
FDIC Insurance	127	213
ATM and debit card fees	98	86
Other	665	617
Total non-interest expenses	\$4,431	\$4,288
Income before income taxes	\$3,309	\$3,203
Income tax expense	632	713

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Net Income	\$2,677	\$2,490
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PER SHARE DATA

Net Income Per Share:

Basic	\$.49	\$.45
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Diluted	.49	.45
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Cash dividends per share	.24	.23
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See Accompanying Notes to Consolidated Financial Statements

FIRST KEYSTONE CORPORATION AND SUBSIDIARY  
CONSOLIDATED STATEMENTS OF INCOME  
FOR THE NINE MONTHS ENDED SEPTEMBER 30, 2011 AND 2010  
(Unaudited)

(Amounts in thousands except per share data)

	2011	2010
<b>INTEREST INCOME</b>		
Interest and fees on loans	\$17,572	\$18,290
Interest and dividend income on investment securities	10,338	10,235
Deposits in banks	3	21
Interest on federal funds sold	1	0
Total interest income	\$27,914	\$28,546
<b>INTEREST EXPENSE</b>		
Deposits	\$5,263	\$6,991
Short-term borrowings	129	169
Long-term borrowings	1,927	2,725
Total interest expense	\$7,319	\$9,885
Net interest income	\$20,595	\$18,661
Provision for loan losses	1,100	1,675
Net interest income after provision for loan losses	\$19,495	\$16,986
<b>NON-INTEREST INCOME</b>		
Trust department	\$440	\$500
Service charges and fees	983	1,140
Bank owned life insurance income	569	573
ATM fees and debit card income	678	597
Gain on sale of loans	211	532
Investment securities gains (losses) - net	143	198
Recovery on loss due to defalcation	0	800
Other	341	224
Total non-interest income	\$3,365	\$4,564
<b>NON-INTEREST EXPENSE</b>		
Salaries and employee benefits	\$7,027	\$6,719
Occupancy, net	1,015	983
Furniture and equipment	328	363
Computer expenses	745	638
Professional services	523	665
State shares tax	548	531
FDIC Insurance	564	634
ATM and debit card fees	279	261
Other	2,178	1,893
Total non-interest expenses	\$13,207	\$12,687
Income before income taxes	\$9,653	\$8,863
Income tax expense	1,937	1,873

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Net Income	\$7,716	\$6,990
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PER SHARE DATA

Net Income Per Share:

Basic	\$1.42	\$1.28
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Diluted	1.42	1.28
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Cash dividends per share	.72	.69
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See Accompanying Notes to Consolidated Financial Statements

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FIRST KEYSTONE CORPORATION AND SUBSIDIARY  
CONSOLIDATED STATEMENT OF CHANGES IN STOCKHOLDERS' EQUITY  
(Unaudited)

(Amounts in thousands, except per share data)

	Common Stock	Surplus	Comprehensive Income	Retained Earnings	Accumulated Other Comprehensive (Loss)	Treasury Stock	Total
Balance at December 31, 2009	\$ 11,375	\$ 30,269		\$ 41,346	\$ (2,583 )	\$ (6,240 )	\$ 74,167
Comprehensive Income:							
Net Income			\$ 6,990	6,990			6,990
Change in net unrealized gain (loss) on investment securities available-for- sale, net of reclassification adjustment and tax effects			9,282		9,282		9,282
Total comprehensive income			\$ 16,272				
Issuance of 4,051 shares of treasury stock upon exercise of employee stock options		(94 )				136	42
Cash dividends - \$.69 per share				(3,754 )			(3,754 )
Balance at September 30, 2010	\$ 11,375	\$ 30,175		\$ 44,582	\$ 6,699	\$ (6,104 )	\$ 86,727
Balance at December 31, 2010	\$ 11,375	\$ 30,175		\$ 45,246	\$ (1,633 )	\$ (6,103 )	\$ 79,060
Comprehensive Income:							
Net Income			\$ 7,716	7,716			7,716
Change in unrealized gain (loss) on investment securities available-for sale, net of reclassification adjustment and tax effects			9,126		9,126		9,126
Total Comprehensive income			\$ 16,842				
Issuance of 815 shares of treasury stock upon exercise of employee stock options		(14 )				28	14

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Cash dividends - \$.72 per share			(3,920 )			(3,920 )
Balance at September 30, 2011	\$ 11,375	\$ 30,161	\$ 49,042	\$ 7,493	\$ (6,075 )	\$ 91,996

See accompanying notes to consolidated financial statements.

FIRST KEYSTONE CORPORATION AND SUBSIDIARY  
CONSOLIDATED STATEMENTS OF CASH FLOWS  
FOR THE NINE MONTHS ENDED SEPTEMBER 30, 2011 AND 2010  
(Unaudited)

(Amounts in thousands)

	2011	2010
<b>OPERATING ACTIVITIES</b>		
Net income	\$7,716	\$6,990
Adjustments to reconcile net income to net cash provided by operating activities:		
Provision or loan losses	1,100	1,675
Provision for depreciation and amortization	721	742
Premium amortization on investment securities	760	531
Core deposit amortization	217	214
Discount accretion on investment securities	(860 )	(1,025 )
Gain on sale of mortgage loans	(211 )	(532 )
Proceeds from sale of mortgage loans for resale	14,270	15,860
Originations of mortgage loans for resale	(12,756 )	(11,635 )
Loss (gain) on sale and valuation adjustments on foreclosed assets held for sale	137	(20 )
Gain on sales of investment securities	(143 )	(198 )
Deferred income tax provision	141	73
Decrease (increase) in interest receivable and other assets	97	(1,072 )
Decrease in prepaid FDIC insurance	520	564
Increase in cash surrender value of bank owned life insurance	(569 )	(573 )
Increase/(decrease) in interest payable, accrued expenses and other liabilities	(292 )	47
<b>NET CASH PROVIDED BY OPERATING ACTIVITIES</b>	<b>\$10,848</b>	<b>\$11,641</b>
<b>INVESTING ACTIVITIES</b>		
Purchase of investment securities	\$(87,501 )	\$(57,994 )
Proceeds from sales of investment securities available for sale	53,564	18,216
Proceeds from maturities and redemptions of investment securities available for sale	26,229	14,297
Proceeds from the redemption of restricted securities	903	0
Proceeds from maturities and redemption of investment securities held to maturity	2,048	2,733
Net (decrease) in loans	(3,632 )	(12,715 )
Purchase of premises and equipment	(1,047 )	(1,160 )
Proceeds from sale of foreclosed assets	348	200
Purchase of investment in real estate venture	0	(1,084 )
<b>NET CASH (USED IN) INVESTING ACTIVITIES</b>	<b>\$(9,088 )</b>	<b>\$(37,507 )</b>
<b>FINANCING ACTIVITIES</b>		
Net increase in deposits	\$6,912	\$47,032
Net increase in short-term borrowings	1,372	5,562
Proceeds from long-term borrowings	5,000	7,000
Repayment of long-term borrowings	(2,045 )	(16,541 )
Proceeds from issuance of treasury stock under stock option plan	14	42
Cash dividends	(3,920 )	(3,754 )
<b>NET CASH PROVIDED BY FINANCING ACTIVITIES</b>	<b>\$7,333</b>	<b>\$39,341</b>
<b>INCREASE IN CASH AND CASH EQUIVALENTS</b>	<b>\$9,093</b>	<b>\$13,475</b>
<b>CASH AND CASH EQUIVALENTS, BEGINNING</b>	<b>11,905</b>	<b>11,426</b>

CASH AND CASH EQUIVALENTS, ENDING	\$20,998	\$24,901
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SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION

Cash paid during period for

Interest	\$7,484	\$10,144
Income taxes	1,572	1,436
Loans transferred to foreclosed assets held for resale	336	821
Investment securities purchased - \$2,192 less settlement obligation \$2,192 in 2011	0	0

See Accompanying Notes to Consolidated Financial Statements

FIRST KEYSTONE CORPORATION AND SUBSIDIARY  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
September 30, 2011  
(Unaudited)

NOTE 1 — SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

The accounting policies of First Keystone Corporation and Subsidiary (the “Corporation”) are in accordance with accounting principles generally accepted in the United States of America and conform to common practices within the banking industry. The more significant policies follow:

Principles of Consolidation

The consolidated financial statements include the accounts of First Keystone Corporation and its wholly-owned Subsidiary, First Keystone Community Bank (the “Bank”). All significant inter-company balances and transactions have been eliminated in consolidation.

Nature of Operations

The Corporation, headquartered in Berwick, Pennsylvania, provides a full range of banking, trust and related services through its wholly-owned Bank subsidiary and is subject to competition from other financial institutions in connection with these services. The Bank serves a customer base which includes individuals, businesses, public and institutional customers primarily located in the Northeast Region of Pennsylvania. The Bank has 16 full service offices and 18 ATMs located in Columbia, Luzerne, Montour and Monroe Counties. The Corporation and its subsidiary must also adhere to certain federal banking laws and regulations and are subject to periodic examinations made by various federal agencies.

Segment Reporting

The Corporation’s banking subsidiary acts as an independent community financial services provider, and offers traditional banking and related financial services to individual, business and government customers. Through its branch and automated teller machine network, the Bank offers a full array of commercial and retail financial services, including the taking of time, savings and demand deposits; the making of commercial, consumer and mortgage loans; and the providing of other financial services. The Bank also performs personal, corporate, pension and fiduciary services through its Trust Department.

Management does not separately allocate expenses, including the cost of funding loan demand, between the commercial, retail, trust and mortgage banking operations of the Corporation. Currently, management measures the performance and allocates the resources of First Keystone Corporation as a single segment.

Use of Estimates

The preparation of these consolidated financial statements in conformity with accounting principles generally accepted in the United States of America, requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of these consolidated financial statements and the reported amounts of income and expenses during the reporting periods. Actual results could significantly differ from those estimates.

Material estimates that are particularly susceptible to significant changes include the assessment for impairment of certain investment securities, the allowance for loan losses, deferred tax assets and liabilities, impairment of other intangible assets and foreclosed real estate. Assumptions and factors used in the estimates are evaluated on an annual basis or whenever events or changes in circumstance indicate that the previous assumptions and factors have changed. The result of the analysis could result in adjustments to the estimates.

## Investment Securities

The Corporation classifies its investment securities as either “Held-to-Maturity” or “Available-for-Sale” at the time of purchase. Debt securities are classified as Held-to-Maturity when the Corporation has the ability and positive intent to hold the securities to maturity. Investment securities Held-to-Maturity are carried at cost adjusted for amortization of premium and accretion of discount to maturity.

Debt securities not classified as Held-to-Maturity and equity securities are included in the Available-for-Sale category and are carried at fair value. The amount of any unrealized gain or loss, net of the effect of deferred income taxes, is reported as other comprehensive income (loss) in the Consolidated Statement of Changes in Stockholders’ Equity. Management’s decision to sell Available-for-Sale securities is based on changes in economic conditions controlling the sources and applications of funds, terms, availability of and yield of alternative investments, interest rate risk and the need for liquidity.

The cost of debt securities classified as Held-to-Maturity or Available-for-Sale is adjusted for amortization of premiums and accretion of discounts to expected maturity. Such amortization and accretion, as well as interest and dividends is included in interest income from investments. Realized gains and losses are included in net investment securities gains and losses. The cost of investment securities sold, redeemed or matured is based on the specific identification method.

## Restricted Securities

Restricted equity securities consist of stock in Federal Home Loan Bank of Pittsburgh (“FHLB-Pittsburgh”), Atlantic Central Bankers Bank (“ACBB”) and Federal Reserve Bank and do not have a readily determinable fair value because their ownership is restricted, and they can be sold back only to the FHLB-Pittsburgh, ACBB, the Federal Reserve Bank or to another member institution. Therefore, these securities are classified as restricted equity investment securities, carried at cost, and evaluated for impairment. At September 30, 2011, the Corporation held \$5,425,000 in stock of FHLB-Pittsburgh and \$35,000 in stock of ACBB. At December 31, 2010, the Corporation held \$6,328,000 in stock of the FHLB-Pittsburgh, and \$35,000 in stock of ACBB.

The Corporation evaluated its holding of restricted stock for impairment and deemed the stock to not be impaired due to the expected recoverability of cost, which equals the value reflected within the Corporation’s consolidated financial statements. The decision was based on several items ranging from the estimated true economic losses embedded within FHLB’s mortgage portfolio to the FHLB’s liquidity position and credit rating. The Corporation utilizes the impairment framework outlined in GAAP to evaluate stock for impairment. The following factors were evaluated to determine the ultimate recoverability of the cost of the Corporation’s restricted stock holdings; (i) the significance of the decline in net assets of the FHLB as compared to the capital stock amount for the FHLB and the length of time this situation has persisted; (ii) commitments by the FHLB to make payments required by law or regulation and the level of such payments in relation to the operating performance of the FHLB; (iii) the impact of legislative and regulatory changes on the institutions and, accordingly, on the customer base of the FHLB; (iv) the liquidity position of the FHLB; and (v) whether a decline is temporary or whether it affects the ultimate recoverability of the FHLB stock based on (a) the materiality of the carrying amount to the member institution and (b) whether an assessment of the institution’s operational needs for the foreseeable future allow management to dispose of the stock. Based on the analysis of these factors, the Corporation determined that its holdings of restricted stock were not impaired at September 30, 2011 and December 31, 2010.

## Loans

Loans are stated at their outstanding unpaid principal balances, net of deferred fees or costs, unearned income and the allowance for loan losses. Interest on installment loans is recognized as income over the term of each loan, generally, by the actuarial or accrual methods. Interest on all other loans is primarily recognized based upon the principal amount outstanding on an actual day basis. Loan origination fees and certain direct loan origination costs have been deferred with the net amount amortized using the interest method over the contractual life of the related loans as an interest yield adjustment.

Mortgage loans held for resale are carried at the lower of cost or market on an aggregate basis determined by independent pricing from appropriate federal or state agency investors. These loans are sold without recourse to the Corporation.



**Past-Due Loans** — Generally, a loan is considered to be past-due when scheduled loan payments are in arrears 15 days or more. Delinquent notices are generated automatically when a loan is 15 days past-due. Collection efforts continue on loans past-due beyond 60 days that have not been satisfied, when it is believed that some chance exists for improvement in the status of the loan. Past-due loans are continually evaluated with the determination for charge-off being made when no reasonable chance remains that the status of the loan can be improved.

**Non-Accrual Loans** — Generally, a loan is classified as non-accrual and the accrual of interest on such a loan is discontinued when the contractual payment of principal or interest has become 90 days past due or management has serious doubts about further collectibility of principal or interest, even though the loan currently is performing. A loan may remain on accrual status if it is in the process of collection and is either guaranteed or well secured. When a loan is placed on non-accrual status, unpaid interest credited to income in the current year is reversed and unpaid interest accrued in prior years is charged against the allowance for loan losses. Certain non-accrual loans may continue to perform, that is, payments are still being received. Generally, the payments are applied to principal. These loans remain under constant scrutiny and if performance continues, interest income may be recorded on a cash basis based on management's judgement as to collectibility of principal.

**Impaired Loans** — A loan is considered impaired when, based on current information and events, it is probable that the Corporation will be unable to collect all amounts due according to the contractual terms of the loan agreement. Under current accounting standards, the allowance for loan losses related to impaired loans is based on discounted cash flows using the loan's effective interest rate or the fair value of the collateral for certain collateral dependent loans. The recognition of interest income on impaired loans is the same as for non-accrual loans discussed above.

**Allowance for Loan Losses** — The allowance for loan losses is established through provisions for loan losses charged against income. Loans deemed to be uncollectible are charged against the allowance for loan losses and subsequent recoveries, if any, are credited to the allowance.

The allowance for loan losses is maintained at a level estimated by management to be adequate to absorb potential loan losses. Management's periodic evaluation of the adequacy of the allowance for loan losses is based on the Corporation's past loan loss experience, known and inherent risks in the portfolio, adverse situations that may affect the borrower's ability to repay (including the timing of future payments), the estimated value of any underlying collateral, composition of the loan portfolio, current economic conditions, and other relevant factors. This evaluation is inherently subjective as it requires material estimates including the amounts and timing of future cash flows expected to be received on impaired loans that may be susceptible to significant change.

In addition, the Corporation is subject to periodic examination by its federal and state examiners, and may be required by such regulators to recognize additions to the allowance for loan losses based on their assessment of credit information available to them at the time of their examinations.

In addition, an allowance is provided for possible credit losses on off-balance sheet credit exposures. The allowance is estimated by management and is classified in other liabilities.

The allowance consists of specific and general components. The specific component relates to loans that are individually classified as impaired. At the present time, select loans are not aggregated for collective impairment evaluation, as such; all loans are subject to individual impairment evaluation should the facts and circumstances pertinent to a particular loan suggest that such evaluation is necessary. Factors considered by management in determining impairment include payment status and the probability of collecting scheduled principal and interest payments when due. Loans that experience insignificant payment delays and payment shortfalls generally are not classified as impaired. A loan is considered impaired when, based on current information and events, it is probable that the Corporation will be unable to collect the scheduled payments of principal or interest when due according to

the contractual terms of the loan agreement. Management determines the significance of payment delays and payment shortfalls on a case-by-case basis, taking into consideration all of the circumstances surrounding the loan and the borrower, including the length of the delay, the reasons for the delay, the borrower's prior payment record, and the amount of the shortfall in relation to the principal and interest owed. If a loan is impaired, a portion of the allowance is allocated so that the loan is reported net, at the present value of estimated future cash flows using the loan's existing rate or at the fair value of collateral if repayment is expected solely from collateral. Troubled debt restructurings are separately identified for impairment disclosures and are measured at the present value of estimated future cash flows using the loan's effective rate at inception. If a troubled debt restructuring is considered to be a collateral dependent loan, the loan is reported, net, at the fair value of the collateral. For troubled debt restructurings that subsequently default, the Corporation determines the amount of reserve in accordance with the accounting policy for the allowance for loan losses.

The general component covers all other loans not identified as impaired and is based on historical losses adjusted for current factors. The historical loss component of the allowance is determined by losses recognized by portfolio segment over the preceding two years. In calculating the historical component of our allowance, we aggregate loans into one of four portfolio segments: Commercial, Commercial Real Estate, Consumer and Residential. Risk factors impacting loans in each of the portfolio segments include broad deterioration of property values, reduced consumer and business spending as a result of continued high unemployment and reduced credit availability and lack of confidence in a sustainable recovery. Actual loss experience is supplemented with other economic factors based on the risks present for each portfolio segment. These economic factors include consideration of the following: the concentration of watch and substandard loans as a percentage of total loans, levels of loan concentration within the portfolio segment or division of a portfolio segment and broad economic conditions.

#### Premises and Equipment

Premises, improvements, and equipment are stated at cost less accumulated depreciation computed principally utilizing the straight-line method over the estimated useful lives of the assets. Long-lived assets are reviewed for impairment whenever events or changes in business circumstances indicate that the carrying value may not be recovered. Maintenance and minor repairs are charged to operations as incurred. The cost and accumulated depreciation of the premises and equipment retired or sold are eliminated from the property accounts at the time of retirement or sale, and the resulting gain or loss is reflected in current operations.

#### Mortgage Servicing Rights

The Corporation originates and sells real estate loans to investors in the secondary mortgage market. After the sale, the Corporation may retain the right to service these loans. When originated mortgage loans are sold and servicing is retained, a servicing asset is capitalized based on relative fair value at the date of sale. Servicing assets are amortized as an offset to other fees in proportion to, and over the period of, estimated net servicing income. The unamortized cost is included in other assets in the accompanying consolidated balance sheet. The servicing rights are periodically evaluated for impairment based on their relative fair value.

#### Foreclosed Assets Held for Resale

Real estate properties acquired through, or in lieu of, loan foreclosure are held for sale and are initially recorded at fair value on the date of foreclosure establishing a new cost basis. After foreclosure, valuations are periodically performed by management and if fair value declines subsequent to foreclosure, a valuation allowance is recorded through expense. The real estate is carried at the lower of carrying amount or fair value less cost to sell. Revenues derived from and costs to maintain the assets and subsequent gains and losses on sales are included in other non-interest income and expense.

#### Bank Owned Life Insurance

The Corporation invests in Bank Owned Life Insurance (BOLI) with split dollar life provisions. Purchase of BOLI provides life insurance coverage on certain employees with the Corporation being owner and beneficiary of the policies.

#### Investments in Real Estate Ventures

The Bank is a limited partner in real estate ventures that own and operate affordable residential low-income housing apartment buildings for elderly residents. The investments are accounted for under the effective yield method. Under the effective yield method, the Bank recognizes tax credits as they are allocated and amortizes the initial cost of the

investment to provide a constant effective yield over the period that the tax credits are allocated to the Bank. Under this method, the tax credits allocated, net of any amortization of the investment in the limited partnerships, are recognized in the consolidated statements of income as a component of income tax expense. The amount of tax credits allocated to the Bank were \$187,000 in 2011 and \$187,000 in 2010, and the amortization of the investments in the limited partnerships were \$88,000 and \$120,000 for the nine months ended September 30, 2011 and 2010, respectively. The carrying value of the investments as of September 30, 2011 and December 31, 2010 were \$1,513,000 and \$1,600,000, respectively. During 2010, the Bank purchased an interest in a low income housing partnership in the amount of \$1,084,000.

## Income Taxes

The provision for income taxes is based on the results of operations, adjusted primarily for tax-exempt income. Certain items of income and expense are reported in different periods for financial reporting and tax return purposes. Deferred tax assets and liabilities are determined based on the differences between the consolidated financial statement and income tax bases of assets and liabilities measured by using the enacted tax rates and laws expected to be in effect when the timing differences are expected to reverse. Deferred tax expense or benefit is based on the difference between deferred tax asset or liability from period to period.

In assessing the realizability of deferred tax assets, management considers whether it is more likely than not that some portion or all of the deferred tax assets will not be realized. The ultimate realization of deferred tax assets is dependent upon the generation of future taxable income during the periods in which those temporary differences become deductible. Management considers the scheduled reversal of deferred tax liabilities, the projected future taxable income and tax planning strategies in making this assessment. A valuation allowance, if needed, reduces deferred tax assets to the amount expected to be realized.

A tax position is recognized as a benefit only if it is “more likely than not” that the tax position would be sustained in a tax examination, with a tax examination being presumed to occur. The amount recognized is the largest amount of tax benefit that is greater than 50% likely of being realized on examination. For tax positions not meeting the “more likely than not” test, no tax benefit is recorded.

The Corporation and the Bank are subject to U.S. federal income tax and Commonwealth of Pennsylvania tax. The Corporation is no longer subject to examination by Federal or State taxing authorities for the years before 2007. At September 30, 2011 and 2010 the Corporation did not have any unrecognized tax benefits. The Corporation does not expect the amount of any unrecognized tax benefits to significantly increase in the next twelve months. The Corporation recognizes interest related to income tax matters as interest expense and penalties related to income tax matters as other noninterest expense. At September 30, 2011 and December 31, 2010, the Corporation does not have any amounts accrued for interest and/or penalties.

## Goodwill, Other Intangible Assets, and Premium Discount

Goodwill resulted from the acquisition of the Pocono Community Bank in November 2007 and of certain fixed and operating assets acquired and deposit liabilities assumed of the branch of another financial institution in Danville, Pennsylvania, in January 2004. Such goodwill represents the excess cost of the acquired assets relative to the assets fair value at the dates of acquisition. The amount was comprised of the finalization of severance agreements and contract terminations related to the acquisition. In accordance with current accounting standards, goodwill is not amortized. Management performs an annual evaluation for impairment. Any impairment of goodwill results in a charge to income. The Corporation periodically assesses whether events or changes in circumstances indicate that the carrying amounts of goodwill and other intangible assets may be impaired. Goodwill is tested for impairment at the reporting unit level and an impairment loss is recorded to the extent that the carrying amount of goodwill exceeds its implied fair value. The Corporation has tested the goodwill included in its consolidated balance sheet at December 31, 2010, and has determined there was no impairment as of that date or as of September 30, 2011. No assurance can be given that future impairment tests will not result in a charge to earnings.

Intangible assets are comprised of core deposit intangibles and premium discount (negative premium) on certificates of deposit acquired. The core deposit intangible is being amortized over the average life of the deposits acquired as determined by an independent third party. Premium discount (negative premium) on acquired certificates of deposit resulted from the valuation of certificate of deposit accounts by an independent third party. The book value of certificates of deposit acquired was greater than their fair value at the date of acquisition which resulted in a negative

premium due to higher cost of the certificates of deposit compared to the cost of similar term financing. The Corporation has tested the core deposit intangible included in its consolidated balance sheet at December 31, 2010 and has determined there was no impairment as of that date or as of September 30, 2011. No assurance can be given that future impairment tests will not result in a charge to earnings.

#### Stock Based Compensation

The Corporation sponsored a stock option plan which expired on April 21, 2008. Compensation cost is recognized for stock options to employees based on the fair value of these awards at the date of grant. A Black-Scholes model is utilized to estimate the fair value of stock options. Compensation expense is recognized over the requisite service period. There were 20,245 outstanding options that may be exercised as of September 30, 2011.

#### Per Share Data

FASB ASC 260-10 Earnings Per Share ((SFAS) No. 128, "Earnings Per Share"), requires dual presentation of basic and fully diluted earnings per share. Basic earnings per share is calculated by dividing net income by the weighted average number of shares of common stock outstanding at the end of each period. Diluted earnings per share is calculated by increasing the denominator for the assumed conversion of all potentially dilutive securities. The Corporation's dilutive securities are limited to stock options. The most recent options issued were in December 2007.

#### Cash Flow Information

For purposes of reporting consolidated cash flows, cash and cash equivalents include cash on hand and due from other banks and interest bearing deposits in other banks and federal funds sold. The Corporation considers cash classified as interest bearing deposits with other banks as a cash equivalent since they are represented by cash accounts essentially on a demand basis. Federal funds are also included as a cash equivalent because they are generally purchased and sold for one-day periods.

#### Treasury Stock

The purchase of the Corporation's common stock is recorded at cost. At the date of subsequent reissue, the treasury stock account is reduced by the cost of such stock on a last-in-first-out basis.

#### Trust Assets and Income

Property held by the Corporation in a fiduciary or agency capacity for its customers is not included in the accompanying consolidated financial statements since such items are not assets of the Corporation. Trust Department income is generally recognized on a cash basis and is not materially different than if it were reported on an accrual basis.

#### Accumulated Other Comprehensive Income

The Corporation is required to present accumulated other comprehensive income in a full set of general-purpose financial statements for all periods presented. Accumulated other comprehensive income is comprised of net unrealized holding gains on the available for sale investment securities portfolio. The Corporation has elected to report the effects of other comprehensive income as part of the Consolidated Statement of Changes in Stockholders' Equity.

#### Recent Accounting Pronouncements

FASB ASU 2010-20 - Receivables (Topic 310), Disclosures about the Credit Quality of Financial Receivables and the Allowance for Credit Losses — ASU 2010-20 requires new and enhanced disclosures about the credit quality of an entity's financing receivables and its allowance for credit losses. The new and amended disclosure requirements focus on such areas as nonaccrual and past-due financing receivables, allowance for credit losses related to financing receivable, impaired loans, credit quality information and modifications. The ASU requires an entity to disaggregate new and existing disclosures based on how it develops its allowance for credit losses and how it manages credit exposures. For public entities, the disclosures as of the end of a reporting period are effective for interim and annual reporting periods ending on or after December 15, 2010. The disclosures about activity that occurs during a reporting period are effective for interim and annual reporting periods beginning on or after December 15, 2010. See Note 3.

FASB ASU 2010-09 - Subsequent Events (Topic 855): Amendments to Certain Recognition and Disclosure requirements. This accounting standard update modifies the requirement to disclose the date that subsequent events

are considered through for SEC filers. An entity that is an SEC filer is not required to disclose the date through which subsequent events have been evaluated. This change alleviates potential conflicts between Subtopic 855-10 and the SEC=s requirements.

FASB ASC 860 - In September 2009, the FASB issued new guidance impacting FASB ASC 860, Transfers and servicing (Statement No. 166 — Accounting for Transfers of Financial Assets — and amendment of FASB Statement No. 140). The new guidance removes the concept of a qualifying special-purpose entity and limits the circumstances in which a financial asset, or portion of a financial asset, should be derecognized when the transferor has not transferred the entire financial asset to an entity that is not consolidated with the transferor in the financial statements being presented and/or when the transferor has continuing involvement with the transferred financial asset. The new guidance became effective for the Corporation on January 1, 2010. The implementation of this new guidance did not have a material impact on the Corporation=s consolidated financial statements.



FASB ASC 820-10 - In January 2010, the FASB issued an updated (ASC No. 2010-06, Improving Disclosures about Fair Value Measurements) impacting FASB ASC 210-10, Fair Value Measurements and Disclosures. The amendments in this update require new disclosures about significant transfers in and out of Level 1 and Level 2 fair value measurements. The amendments also require a reporting entity to provide information about activity for purchases, sales issuances and settlements in Level 3 fair value measurements and clarify disclosures about the level of disaggregation and disclosures about inputs and valuation techniques. This update became effective for the Corporation on January 1, 2010. The implementation of this new guidance did not have a material impact on the Corporation's consolidated financial statements.

#### Advertising Costs

It is the Corporation's policy to expense advertising costs in the period in which they are incurred. Advertising expense for the nine months ended September 30, 2011 and 2010, was approximately \$201,000 and \$172,000, respectively.

#### Reclassifications

Certain amounts in the consolidated financial statements of prior periods have been reclassified to conform with presentation used in the 2011 consolidated financial statements. Such reclassifications have no effect on the Corporation's consolidated financial condition or net income.

#### NOTE 2 — INVESTMENT SECURITIES

The amortized cost, related estimated fair value, and unrealized gains and losses for investment securities classified as "Available-For-Sale" or "Held-to-Maturity" were as follows at September 30, 2011 and December 31, 2010:

(Amounts in thousands)	Available-for-Sale Securities			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
<b>September 30, 2011:</b>				
Obligations of U.S. Government Corporations and Agencies:				
Mortgage-backed	\$69,248	\$3,165	\$(15 )	\$72,398
Other	13,208	109	(25 )	13,292
Obligations of state and political subdivisions	176,011	11,052	(2,362 )	184,701
Corporate securities	57,294	470	(928 )	56,836
Marketable equity securities	1,725	203	(328 )	1,600
Restricted equity securities	5,460	—	—	5,460
<b>Total</b>	<b>\$322,946</b>	<b>\$14,999</b>	<b>\$(3,658 )</b>	<b>\$334,287</b>

(Amounts in thousands)	Held-to-Maturity Securities			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
<b>September 30, 2011:</b>				
Obligations of U.S. Government Corporations and Agencies:				
Mortgage-backed	\$128	\$4	\$0	\$132
Other	2,016	41	0	2,057
Obligations of state and political subdivisions	1,097	11	0	1,108

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Total	\$3,241	\$56	\$0	\$3,297
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(Amounts in thousands)	Available-for-Sale Securities			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
December 31, 2010:				
Obligations of U.S. Government Corporations and Agencies:				
Mortgage-backed	\$43,673	\$1,250	\$(146 )	\$44,777
Other	7,079	47	(30 )	7,096
Obligations of state and political subdivisions	182,181	2,617	(7,546 )	177,252
Corporate securities	71,708	1,497	(253 )	72,952
Marketable equity securities	1,725	256	(156 )	1,825
Restricted equity securities	6,363	0	0	6,363
<b>Total</b>	<b>\$312,729</b>	<b>\$5,667</b>	<b>\$(8,131 )</b>	<b>\$310,265</b>

(Amounts in thousands)	Held-to-Maturity Securities			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
December 31, 2010:				
Obligations of U.S. Government Corporations and Agencies:				
Mortgage-backed	\$142	\$3	\$0	\$145
Other	5,027	19	(81 )	4,965
Obligations of state and political subdivisions	1,097	0	(16 )	1,081
<b>Total</b>	<b>\$6,266</b>	<b>\$22</b>	<b>\$(97 )</b>	<b>\$6,191</b>

Securities Available-for-Sale with an aggregate fair value of \$180,993,000 at September 30, 2011 and \$186,735,000 at December 31, 2010; and securities Held-to-Maturity with an aggregate book value of \$2,774,000 at September 30, 2011 and \$5,799,000 at December 31, 2010, were pledged to secure public funds, trust funds, securities sold under agreements to repurchase, FHLB advances and other balances of \$113,470,000 at September 30, 2011 and \$109,283,000 at December 31, 2010.

The amortized cost, estimated fair value and weighted average yield of debt securities, by contractual maturity, are shown below at September 30, 2011 and December 31, 2010. Expected maturities will differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

(Amounts in thousands)

September 30, 2011

	U.S. Government Agency & Corporation Obligations <sup>1</sup>	Obligations of State & Political Subdivisions <sup>2</sup>	Marketable Equity Securities <sup>3</sup>	Restricted Equity Securities <sup>3</sup>	Corporate Securities
<b>Available-For-Sale:</b>					
<b>Within 1 Year:</b>					
Amortized cost	\$ 1,018	\$ —	\$—	\$—	\$14,268
Estimated fair value	1,023	—	—	—	14,502
Weighted average yield	1.05	% —	—	—	3.81 %
<b>1 - 5 Years:</b>					
Amortized cost	10,195	2,929	—	—	42,025
Estimated fair value	10,228	3,084	—	—	41,411
Weighted average yield	.99	% 4.53	% —	—	2.77 %
<b>5 - 10 Years:</b>					
Amortized cost	12,138	11,699	—	—	1,000
Estimated fair value	12,600	13,037	—	—	923
Weighted average yield	3.35	% 5.33	% —	—	3.10 %
<b>After 10</b>					
Amortized cost	59,106	161,383	1,725	5,460	—
Estimated fair value	61,839	168,580	1,600	5,460	—
Weighted average yield	3.89	% 6.23	% 3.33	% —	—
<b>Total:</b>					
Amortized cost	\$ 82,457	\$ 176,011	\$1,725	\$5,460	\$57,293
Estimated fair value	85,690	184,701	1,600	5,460	56,836
Weighted average yield	3.42	% 6.14	% 3.33	% —	3.04 %

<sup>1</sup>Mortgage-backed securities are allocated for maturity reporting at their original maturity date.

<sup>2</sup>Average yields on tax-exempt obligations of state and political subdivisions have been computed on a tax-equivalent basis using a 34% tax rate.

<sup>3</sup>Marketable equity securities and restricted equity securities are not considered to have defined maturities and are included in the after ten year category.

(Amounts in thousands)

September 30, 2011

	U.S. Government Agency & Corporation Obligations <sup>1</sup>	Obligations of State & Political Subdivisions <sup>2</sup>	Marketable Equity Securities <sup>3</sup>	Restricted Equity Securities <sup>3</sup>	Corporate Securities
<b>Held-To-Maturity:</b>					
<b>Within 1 Year:</b>					
Amortized cost	\$ —	\$ 630	\$—	\$—	\$—
Estimated fair value	—	630	—	—	—
Weighted average yield	—	—	—	—	—
<b>1 - 5 Years:</b>					
Amortized cost	2,016	—	—	—	—
Estimated fair value	2,057	—	—	—	—
Weighted average yield	1.31	% —	—	—	—
<b>5 - 10 Years:</b>					
Amortized cost	128	—	—	—	—
Estimated fair value	132	—	—	—	—
Weighted average yield	2.56	% —	—	—	—
<b>After 10 Years:</b>					
Amortized cost	—	467	—	—	—
Estimated fair value	—	478	—	—	—
Weighted average yield	—	7.04	% —	—	—
<b>Total:</b>					
Amortized cost	\$ 2,144	\$ 1,097	\$—	\$—	\$—
Estimated fair value	2,189	1,108	—	—	—
Weighted average yield	1.38	% 3.00	% —	—	—

1 Mortgage-backed securities are allocated for maturity reporting at their original maturity date.

2Average yields on tax-exempt obligations of state and political subdivisions have been computed on a tax-equivalent basis using a 34% tax rate.

3Marketable equity securities and restricted equity securities are not considered to have defined maturities and are included in the after ten year category.

(Amounts in thousands)

December 31, 2010

	U.S. Government Agency & Corporation Obligations <sup>1</sup>	Obligations of State & Political Subdivisions <sup>2</sup>	Marketable Equity Securities <sup>3</sup>	Restricted Equity Securities <sup>3</sup>	Corporate Securities
<b>Available-For-Sale:</b>					
<b>Within 1 Year:</b>					
Amortized cost	\$ —	\$ —	\$—	\$—	\$10,746
Estimated fair value	—	—	—	—	10,843
Weighted average yield	—	—	—	—	4.32 %
<b>1 - 5 Years:</b>					
Amortized cost	4,056	452	—	—	57,902
Estimated fair value	4,064	467	—	—	59,069
Weighted average yield	1.25 %	5.78 %	—	—	3.22 %
<b>5 - 10 Years:</b>					
Amortized cost	10,682	1,734	—	—	3,060
Estimated fair value	11,149	1,823	—	—	3,040
Weighted average yield	4.08 %	6.05 %	—	—	3.19 %
<b>After 10</b>					
Amortized cost	36,014	179,995	1,725	6,363	—
Estimated fair value	36,660	174,962	1,825	6,363	—
Weighted average yield	4.03 %	6.14 %	2.54 %	.95 %	—
<b>Total:</b>					
Amortized cost	\$ 50,752	\$ 182,181	\$1,725	\$6,363	\$71,708
Estimated fair value	51,873	177,252	1,825	6,363	72,952
Weighted average yield	3.82 %	6.14 %	2.54 %	.95 %	3.38 %

1 Mortgage-backed securities are allocated for maturity reporting at their original maturity date.

2 Average yields on tax-exempt obligations of state and political subdivisions have been computed on a tax-equivalent basis using a 34% tax rate.

3 Marketable equity securities and restricted equity securities are not considered to have defined maturities and are included in the after ten year category.

(Amounts in thousands)

December 31, 2010

	U.S. Government Agency & Corporation Obligations <sup>1</sup>	Obligations of State & Political Subdivisions <sup>2</sup>	Marketable Equity Securities <sup>3</sup>	Restricted Equity Securities <sup>3</sup>	Corporate Securities
<b>Held-To-Maturity:</b>					
<b>Within 1 Year:</b>					
Amortized cost	\$ —	\$ 630	\$—	\$—	\$—
Estimated fair value	—	628	—	—	—
Weighted average yield	—	4.49	% —	—	—
<b>1 - 5 Years:</b>					
Amortized cost	3,027	—	—	—	—
Estimated fair value	3,030	—	—	—	—
Weighted average yield	3.83	% —	—	—	—
<b>5 - 10 Years:</b>					
Amortized cost	2,142	—	—	—	—
Estimated fair value	2,080	—	—	—	—
Weighted average yield	2.37	% —	—	—	—
<b>After 10 Years:</b>					
Amortized cost	—	467	—	—	—
Estimated fair value	—	453	—	—	—
Weighted average yield	—	7.04	% —	—	—
<b>Total:</b>					
Amortized cost	\$ 5,169	\$ 1,097	\$—	\$—	\$—
Estimated fair value	5,110	1,081	—	—	—
Weighted average yield	3.22	% 5.58	% —	—	—

1 Mortgage-backed securities are allocated for maturity reporting at their original maturity date.

2 Average yields on tax-exempt obligations of state and political subdivisions have been computed on a tax-equivalent basis using a 34% tax rate.

3 Marketable equity securities and restricted equity securities are not considered to have defined maturities and are included in the after ten year category.

There were no aggregate investments with a single issuer (excluding the U.S. Government and its agencies) which exceeded ten percent of consolidated shareholders' equity at September 30, 2011. The quality rating of the obligations of state and political subdivisions are generally investment grade, as rated by Moody's, Standard and Poors or Fitch. The typical exceptions are local issues which are not rated, but are secured by the full faith and credit obligations of the communities that issued these securities. The state and political subdivision investments are actively traded in a liquid market.

Proceeds from sale of investments in Available-for-Sale debt and equity securities during the third quarter of 2011 and 2010 were \$9,721,000 and \$0, respectively. Gross gains realized on these sales were \$407,000 and \$0, respectively. Gross losses on these sales were \$188,000 and \$0, respectively. There were no impairment losses in 2011 and 2010.

There were no proceeds from sale of investments in Held-To-Maturity debt and equity securities during 2011 and 2010. There were no gains or losses realized during these periods.

Management evaluates securities for other-than-temporary impairment (“OTTI”) at least on a quarterly basis, and more frequently when economic or market conditions warrant such an evaluation. Investment securities classified as available-for-sale or held-to-maturity are generally evaluated for OTTI under FASB ASC 320 (SFAS No. 115, Accounting for Certain Investments in Debt and Equity Securities). In determining OTTI under the FASB 320 (SFAS No. 115) model, management considers many factors, including (1) the length of time and the extent to which the fair value has been less than cost, (2) the financial condition and near-term prospects of the issuer, (3) whether the market decline was affected by macroeconomic conditions; and (4) whether the entity has the intent to sell the debt security or more likely than not will be required to sell the debt security before its anticipated recovery. The assessment of whether an other-than-temporary decline exists involves a high degree of subjectivity and judgment and is based on the information available to management at a point in time.



When other-than-temporary impairment occurs, the amount of the other-than-temporary impairment recognized in earnings depends on whether an entity intends to sell the security or more likely than not will be required to sell the security before recovery of its amortized cost basis less any current-period credit loss. If an entity intends to sell or more likely than not will be required to sell the security before recovery of its amortized cost basis less any current-period credit loss, the other-than-temporary impairment shall be recognized in earnings equal to the entire difference between the investment's amortized cost basis and its fair value at the balance sheet date. If an entity does not intend to sell the security and it is not more likely than not that the entity will be required to sell the security before recovery of its amortized cost basis less any current-period loss, the other-than-temporary impairment shall be separated into the amount representing the credit loss and the amount related to all other factors. The amount of the total other-than-temporary impairment related to the credit loss is determined based on the present value of cash flows expected to be collected and is recognized in earnings. The amount of the total other-than-temporary impairment related to the other factors shall be recognized in other comprehensive income, net of applicable taxes. The previous amortized cost basis less the other-than-temporary impairment recognized in earnings shall become the new amortized cost basis of the investment.

The fair market value of the equity securities tends to fluctuate with the overall equity markets as well as the trends specific to each institution. The equity securities portfolio is reviewed in a similar manner as that of the debt securities with greater emphasis placed on the length of time the market value has been less than the carrying value and the financial sector outlook. The Corporation also reviews dividend payment activities, levels of non-performing assets and loan loss reserves, and whether or not the issuer is participating in the TARP Capital Purchase Program. The starting point for the equity analysis is the length and severity of market value decline. The Corporation and an independent consultant monitor the entire portfolio monthly with particular attention given to securities in a continuous loss position of at least ten percent for over twelve months. Securities with an unrealized loss that were determined to be other-than-temporary were written down to fair value, with the write-down recorded as a realized loss included in security (losses) gains. The Corporation evaluated the near-term prospects of the issuer in relation the severity and duration of the market value decline as well as the other attributes listed above. Based on that evaluation and the Corporation's ability and intent to hold these equity securities for a reasonable period of time sufficient for a forecasted recovery of fair value, the Corporation does not consider these equity securities to be other-than-temporary impaired at September 30, 2011.

In accordance with disclosures required by FASB ASC 320-10-50 Investments-Debt and Equity Securities Disclosures (EITF No. 03-1), the summary below shows the gross unrealized losses and fair value of the Bank's investments, aggregated by investment category, that individual securities have been in a continuous unrealized loss position for less than 12 months or more than 12 months as of September 30, 2011 and December 31, 2010:

September 30, 2011

(Amounts in thousands)	Less Than 12 Months		12 Months or More		Total	
	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss
Direct obligations of the U.S.						
Government	\$6,108	\$25	\$—	\$—	\$6,108	\$25
Federal Agency Backed Securities	5,200	15	—	—	5,200	15
Municipal Bonds	4,191	24	10,914	2,338	15,105	2,362
Corporate Securities	28,101	891	463	37	28,564	928
Equities	389	69	501	259	890	328
	\$43,989	\$1,024	\$11,878	\$2,634	\$55,867	\$3,658



December 31, 2010

(Amounts in thousands)	Less Than 12 Months		12 Months or More		Total	
	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss
Direct obligations of the U.S.						
Government	\$7,925	\$111	\$—	\$—	\$7,925	\$111
Federal Agency Backed Securities	4,859	146	—	—	4,859	146
Municipal Bonds	90,995	3,239	13,160	4,323	104,155	7,562
Corporate Securities	18,414	253	—	—	18,414	253
Equities	98	27	645	129	743	156
	\$122,291	\$3,776	\$13,805	\$4,452	\$136,096	\$8,228

The Corporation invests in various forms of agency debt including mortgage backed securities and callable debt. The mortgage backed securities are issued by FHLMC (Federal Home Loan Mortgage Corporation) of FNMA (Federal National Mortgage Association). The municipal securities consist of general obligations and revenue bonds. The equity securities consist of stocks in other bank holding companies. The fair market value of the above securities is influenced by market interest rates, prepayment speeds on mortgage securities, bid to offer spreads in the market place and credit premiums for various types of agency debt. These factors change continuously and therefore the market value of these securities may be higher or lower than the Corporation's carrying value at any measurement date. Management does not believe any of their 71 securities in an unrealized position as of September 30, 2011 represents an other-than-temporary impairment. The Corporation has the ability to hold the remaining securities contained in the above table for a time necessary to recover the cost.

Securities with an unrealized loss that are determined to be other-than-temporary are written down to fair value, with the write-down recorded as a realized loss included in securities gains (losses).

## NOTE 3 — LOANS

Major classifications of loans at September 30, 2011 and December 31, 2010 consisted of:

(Amounts in thousands)

	September 30, 2011	December 31, 2010
Commercial, Financial, and Agricultural	\$ 21,786	\$ 29,693
Tax-exempt	19,346	12,450
Real estate mortgages - Held-for-sale	3,646	4,950
Real estate mortgages - Consumer	122,904	127,031
Real estate mortgages - Commercial	235,186	227,147
Consumer	7,688	8,781
Gross loans	\$ 410,556	\$ 410,052
Add (deduct): Unearned discount	(453 )	(675 )
Net deferred loan fees and costs	278	274
Loans, net of unearned income	\$ 410,381	\$ 409,651

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Activity in the allowance for loan losses for the quarter ended September 30, 2011 and the year ended December 31, 2010:

(Amounts in thousands)

	September 30, 2011	December 31, 2010
Balance, January 1	\$ 5,701	\$ 5,322
Provision charged to operations	1,100	2,575
Loans charged off	(1,392 )	(2,262 )
Recoveries	65	66
Current period and year-end balance	\$ 5,474	\$ 5,701

The credit quality indicators by loan segment are summarized below at September 30, 2011 and December 31, 2010:

	Commercial & Industrial		Commercial Real Estate Construction	
	September 30, 2011	December 31, 2010	September 30, 2011	December 31, 2010
<b>Grade:</b>				
1-6 Pass	\$39,662	\$ 37,991	\$5,763	\$ 5,111
7 Special Mention	557	1,330	—	—
8 Substandard	913	991	—	433
9 Doubtful	—	227	—	—
Add (deduct): Unearned discount	—	—	—	—
Net deferred loan fees & costs	91	74	(9 )	(13 )
Loans, net of unearned income	\$41,223	\$ 40,613	\$5,754	\$ 5,531

	Commercial Real Estate Other		Residential Real Estate Including Home Equity	
	September 30, 2011	December 31, 2010	September 30, 2011	December 31, 2010
<b>Grade:</b>				
1-6 Pass	\$216,642	\$ 205,941	\$125,383	\$ 130,477
7 Special Mention	4,551	8,308	—	191
8 Substandard	8,230	8,958	1,167	1,313
9 Doubtful	—	—	—	—
Add (deduct): Unearned discount	—	—	—	—
Net deferred loan fees & costs	23	35	93	82
Loans, net of unearned income	\$229,446	\$ 223,242	\$126,643	\$ 132,063

	Consumer Loans	
	September 30, 2011	December 31, 2010
<b>Grade:</b>		
1-6 Pass	\$ 7,661	\$ 8,781
7 Special Mention	—	—
8 Substandard	27	—
9 Doubtful	—	—
Add (deduct): Unearned discount	(453 )	(675 )

Net deferred loan fees & costs	80	96
Loans, net of unearned income	\$ 7,315	\$ 8,202

Commercial C & I and Commercial Real Estate Other include loans categorized as tax free loans.

Loan risk grading is a management tool designed to identify and measure risk in the Bank's loan portfolio. Its purpose is to provide a uniform framework and common language to assess and monitor risk, primarily in the Bank's commercial loan/commercial real estate loan portfolios.

The grading system focuses on a borrower's financial strength and performance, experience and depth of management, primary and secondary sources of repayment, the nature of the business and the outlook for the particular industry. Primary emphasis will be on the financial condition and trends. The grade also reflects current economic and industry conditions; as well as other variables such as liquidity, cash flow, revenue/earnings trends, management strengths or weaknesses, quality of financial information, and credit history.

The reduction in C & I loans rated Special Mention was primarily due to the payoff of one loan. The reduction in Substandard C & I loans was due to one loan being charged-off, and payments made on several other loans. The reduction in C & I loans rated doubtful was due to the charge-off of one unsecured loan.

The Substandard Commercial Real Estate Construction category was decreased due to the upgrade of one relationship.

The reduction in Special Mention Commercial Real Estate Other was due to upgrades of 5 relationships. Commercial Real Estate Other rated Substandard remained relatively level from December 31, 2010 to September 30, 2011.

The reduction in Special Mention Residential Real Estate was due entirely to the upgrade of one relationship.

Consumer loans had a downgrade of 1 relationship from Pass to Substandard.

The Bank utilizes a risk grading matrix to assign a risk rating to commercial loans, on a scale of 1 to 9. Risk grades in the residential real estate and consumer loan portfolios are assigned based on payment activity. Risk rating grade characteristics are as follows:

Risk Grade 1 - Cash Secured - Pass through and including Risk Grade 6 B Watch- Pass 6

At the low end of the rating scale, a risk grade of 1 has virtually no risk of loss or default. This grade is reserved for credit evidenced by 100% cash, or other liquid collateral, properly margined and monitored. This grade reflects excellent credit quality with virtually no risk of loss.

Loan ratings then progress through escalating ratings of 2 through 6 based upon risk. Risk is evaluated via examination of several attributes including but not limited to financial trends and strengths and weaknesses, likelihood of repayment when considering both cash flow and collateral, sources of repayment, leverage position, management expertise, and repayment history. A risk rating of 2 reflects excellent credit quality with low risk, while a rating of 3 is considered moderate risk, 4 is a loan with average risk, and 5 is acceptable risk.

At the high end of the Pass ratings is a Risk Grade of 6 - Watch - Pass. A 6 rated credit represents borderline risk reflecting higher than normal risk of loss or default, and serves as an early warning system that the credit needs to be monitored more closely. Loans in this category are performing according to terms, but present some type of potential concern.

Risk Grade 7 - SPECIAL MENTION

Generally, these loans or assets are currently protected, but are "Potentially Weak". They constitute an undue and unwarranted credit risk but not to the point of justifying a classification of substandard.

Assets in this category are currently protected but have potential weakness which may, if not checked or corrected, weaken the asset or inadequately protect the Bank's credit position at some future date. No loss of principal or interest is envisioned, however they constitute an undue credit risk that may be minor but is unwarranted in light of the circumstances surrounding a specific asset. Risk is increasing beyond that at which the loan originally would have been granted. Historically, cash flows are inconsistent; financial trends show some deterioration. Liquidity and leverage are above industry averages. Financial information could be incomplete or inadequate. A Special Mention asset has potential weaknesses that deserve management's close attention.

## Risk Grade 8:- SUBSTANDARD

Generally, these assets are inadequately protected by the current sound worth and paying capacity of the obligor or of the collateral pledged, if any. Assets so classified must have “well-defined” weaknesses that jeopardize the full liquidation of the debt. There is a distinct possibility that the Bank will sustain some loss.

They are characterized by the distinct possibility that the Bank will sustain some loss if in the aggregate amount of substandard assets, is not fully covered by the liquidation of the collateral used as security. Substandard loans are inadequately protected by current sound net worth, paying capacity of the borrower, or pledged collateral, and have a high probability of payment default, or they have other well-defined weaknesses. Such assets require more intensive supervision by Bank Management.

## Risk Grade 9:- DOUBTFUL

Generally, all the weaknesses inherent in a substandard loan with the added factor that the weaknesses are pronounced to a point where the basis of current information, conditions, and values, collection or liquidation in full is highly improbable. The possibility of loss is extremely high, but because of certain important and reasonably specific pending factors that may work to strengthen the asset, its classification is deferred until, for example, a proposed merger, acquisition, liquidation procedures, capital injection, perfection of liens on additional collateral and refinancing plans are completed. Loans are graded doubtful if they contain weaknesses so serious that collection or liquidation in full is questionable.

The activity in the allowance for loan losses, by loan segment, is summarized below for the periods indicated.

(Amounts in thousands)	Commercial	Commercial Real Estate	Consumer	Residential	Unallocated	Total
Nine months ended September 30, 2011:						
Allowance for Credit Losses:						
Beginning balance	\$ 565	\$ 2,769	\$ 123	\$ 1,501	\$ 743	\$ 5,701
Charge-offs	(483 )	(712 )	(71 )	(126 )	—	(1,392 )
Recoveries	23	31	10	1	—	65
Provision	342	726	89	88	(145 )	1,100
Ending Balance	\$ 447	\$ 2,814	\$ 151	\$ 1,464	\$ 598	\$ 5,474
Ending balance: individually evaluated for impairment	—	372	—	38	—	410
Ending balance: collectively evaluated for impairment	\$ 447	\$ 2,442	\$ 151	\$ 1,426	\$ 598	\$ 5,064
Financing Receivables:						
Ending Balance	\$ 41,223	\$ 235,200	\$ 7,315	\$ 126,643	\$ —	\$ 410,381
Ending balance: individually evaluated for impairment	43	3,747	—	852	—	4,642
Ending balance: collectively evaluated for impairment	\$ 41,180	\$ 231,453	\$ 7,315	\$ 125,791	\$ —	\$ 405,739



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(Amounts in thousands)	Commercial					Total
	Commercial	Real Estate	Consumer	Residential	Unallocated	
Year ended December 31, 2010:						
Allowance for Credit Losses:						
Beginning balance	\$ 970	\$ 2,213	\$ 99	\$ 1,734	\$ 306	\$ 5,322
Charge-offs	(389 )	(1,585 )	(95 )	(193 )	—	(2,262 )
Recoveries	38	13	14	1	—	66
Provision	(54 )	2,128	105	(41 )	437	2,575
Ending Balance	\$ 565	\$ 2,769	\$ 123	\$ 1,501	\$ 743	\$ 5,701
Ending balance: individually evaluated for impairment	296	309	—		C —	605
Ending balance: collectively evaluated for impairment	\$ 269	\$ 2,460	\$ 123	\$ 1,501	\$ 743	\$ 5,096
Financing Receivables:						
Ending Balance	\$ 20,969	\$ 199,878	\$ 7,357	\$ 181,447	\$ —	\$ 409,651
Ending balance: individually evaluated for impairment	381	3,108	—	787	—	4,276
Ending balance: collectively evaluated for impairment	\$ 20,588	\$ 196,770	\$ 7,357	\$ 180,660	\$ —	\$ 405,375

Impaired loans at September 30, 2011 and December 31, 2010 were \$4,642,000 and \$4,276,000, respectively. The gross interest that would have been recorded if these loans had been current in accordance with their original terms and the amounts actually recorded in income were as follows:

(Amounts in thousands)	September 30, 2011	December 31, 2010
Gross interest due under terms	\$ 536	\$ 316
Amount included in income	(62 )	(63 )
Interest income not recognized	\$ 474	\$ 253

The Corporation's impaired loans are summarized below for the periods ended September 30, 2011 and December 31, 2010.

(Amounts in thousands)	Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Recorded Investment	Interest Income Recognized
September 30, 2011:					
With no related allowance recorded:					
Commercial	\$43	\$187	\$—	\$253	\$—
Commercial real estate	1,779	2,402	—	2,513	62
Residential	584	654	—	657	—
With an allowance recorded:					
Commercial	—	—	—	—	—
Commercial real estate	1,968	2,236	372	2,272	—
Residential	268	268	38	269	—
Total	\$4,642	\$5,747	\$410	\$5,964	\$62

Total consists of:

Commercial	\$43	\$187	\$—	\$253	\$—
Commercial real estate	\$3,747	\$4,638	\$372	\$4,785	\$62
Residential	\$852	\$922	\$38	\$926	\$—

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(Amounts in thousands)	Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Recorded Investment	Interest Income Recognized
December 31, 2010:					
With no related allowance recorded:					
Commercial	\$29	\$29	\$—	\$29	\$—
Commercial real estate	907	942	—	937	14
Residential	787	866	—	785	19
With an allowance recorded:					
Commercial	352	352	296	356	7
Commercial real estate	2,201	2,641	309	2,398	23
Residential	—	—	—	—	—
Total	\$4,276	\$4,830	\$605	\$4,505	\$63
Total consists of:					
Commercial	\$381	\$381	\$296	\$385	\$7
Commercial real estate	\$3,108	\$3,583	\$309	\$3,335	\$37
Residential	\$787	\$866	\$—	\$785	\$19

The recorded investment represents the loan balance reflected on the consolidated balance sheets net of any charge-offs. The unpaid balance is equal to the gross amount due on the loan. The average recorded investment is calculated on the daily loan balance during the period of impairment.

Financing receivables on non-accrual status and foreclosed assets as of September 30, 2011 and December 31, 2010 were as follows:

(Amounts in thousands)	September 30, 2011	December 31, 2010
Commercial – Real Estate	\$ 3,747	\$ 3,108
Commercial - other	43	381
Residential	852	787
Consumer	—	—
Total impaired/non-accruing loans	\$ 4,642	\$ 4,276
Restructured loans	—	—
Total impaired loans	\$ 4,642	\$ 4,276
Loans past-due 90 days or more and still accruing	28	—
Foreclosed assets	1,000	1,149
Total non-performing assets	\$ 5,670	\$ 5,425

At September 30, 2011 and December 31, 2010, the recorded investment in impaired loans as defined by FASB ASC 310-10-35 Receivables Subsequent Measurements was \$4,642,000 and \$4,276,000 and the impaired loans allowances were \$410,000 and \$605,000, respectively at September 30, 2011 and December 31, 2010. The average recorded balance in impaired loans during the quarter ended September 30, 2011 and the year ended December 31, 2010 was approximately \$5,964,000 and \$4,505,000, respectively.

The following tables present the aging of past-due loans by class of loans at September 30, 2011:

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(Amounts in thousands)

	30-59 Days Past Due	60-89 Days Past Due	Greater Than 90 Days	Total Past Due	Current	Total Financing Receivables
September 30, 2011:						
Commercial	\$ 199	\$ 79	\$ 28	\$ 306	\$40,917	\$41,223
Commercial real estate	3,297	483	—	3,780	231,420	235,200
Consumer	122	30	—	152	7,163	7,315
Residential	1,059	399	—	1,458	125,185	126,643
Total	\$4,677	\$991	\$ 28	\$5,696	\$404,685	\$410,381

(Amounts in thousands)

	30-59 Days Past Due	60-89 Days Past Due	Greater Than 90 Days	Total Past Due	Current	Total Financing Receivables
<b>December 31, 2010:</b>						
Commercial	\$740	\$102	\$ —	\$842	\$34,758	\$35,600
Commercial real estate	999	2,149	—	3,148	230,638	233,786
Consumer	75	1	—	76	8,127	8,203
Residential	1,212	155	—	1,367	130,695	132,062
Total	\$3,026	\$2,407	\$ —	\$5,433	\$404,218	\$409,651

Loans past-due 90 days or more and still accruing interest was \$28 and \$0 at September 30, 2011 and December 31, 2010, respectively.

At September 30, 2011, there were no commitments to lend additional funds with respect to non-accrual and restructured loans.

From time to time, the Bank may agree to modify the contractual terms of a borrower's loan. In cases where such modifications represent a concession to a borrower experiencing financial difficulty, the modification is considered a troubled debt restructuring. Loans modified in a troubled debt restructuring are placed on non-accrual status until the Bank determines the future collection of principal and interest is reasonably assured, which generally requires that the borrower demonstrate a period of performance according to the restructured terms of six months. At September 30, 2011 and December 31, 2010, there were no loans classified as troubled debt restructurings.

#### NOTE 4 — SHORT-TERM BORROWINGS

Federal funds purchased, securities sold under agreements to repurchase and Federal Home Loan Bank advances generally represent overnight or less than 30-day borrowings. U.S. Treasury tax and loan notes for collections made by the Bank are payable on demand.

#### NOTE 5 — LONG-TERM BORROWINGS

Long-term borrowings are comprised of advances from the Federal Home Loan Bank (FHLB). Under terms of a blanket agreement, collateral for the loans are secured by certain qualifying assets of the Corporation's banking subsidiary which consist principally of first mortgage loans and certain investment securities.

#### NOTE 6 — FINANCIAL INSTRUMENTS WITH OFF-BALANCE SHEET RISK AND CONCENTRATIONS OF CREDIT RISK

The Corporation 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. These financial instruments include commitments to extend credit and standby letters of credit. Those instruments involve, to varying degrees, elements of credit and interest rate risk in excess of the amount recognized in the consolidated balance sheets. The contract or notional amounts of those instruments reflect the extent of involvement the Corporation has in particular classes of financial instruments. The Corporation does not engage in trading activities with respect to any of its financial instruments with off-balance sheet risk.

The Corporation's exposure to credit loss in the event of nonperformance by the other party to the financial instrument for commitments to extend credit and standby letters of credit is represented by the contractual notional amount of those instruments.

The Corporation uses the same credit policies in making commitments and conditional obligations as it does for on-balance sheet instruments.

The Corporation may require collateral or other security to support financial instruments with off-balance sheet credit risk. The contract or notional amounts at September 30, 2011, and December 31, 2010, were as follows:

(amounts in thousands)	September 30, 2011	December 31, 2010
<b>Financial instruments whose contract amounts represent credit risk:</b>		
Commitments to extend credit	\$ 62,222	\$ 55,551
Financial standby letters of credit	\$ 1,189	\$ 805
Performance standby letters of credit	\$ 4,614	\$ 5,315

Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Commitments generally have fixed expiration dates or other termination clauses that may require payment of a fee. Since many of the commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. The Corporation evaluates each customer's creditworthiness on a case-by-case basis. The amount of collateral obtained, if deemed necessary by the Corporation upon extension of credit, is based on management's credit evaluation of the counter-party. Collateral held varies but may include accounts receivable, inventory, property, plant and equipment, and income-producing commercial properties.

Standby letters of credit are conditional commitments issued by the Corporation to guarantee the performance of a customer to a third party. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending loan facilities to customers. The Corporation may hold collateral to support standby letters of credit for which collateral is deemed necessary.

The Corporation grants commercial, agricultural, real estate mortgage and consumer loans to customers primarily in the counties of Columbia, Luzerne, Montour, and Monroe, Pennsylvania. It is management's opinion that the loan portfolio was well balanced and diversified at September 30, 2011, to the extent necessary to avoid any significant concentration of credit risk. However, its debtors' ability to honor their contracts may be influenced by the region's economy.

#### NOTE 7 — FAIR VALUES OF FINANCIAL INSTRUMENTS

##### Assets Measured at Fair Value on a Recurring Basis

The Corporation measures certain assets at fair value on a recurring basis. Fair value is defined as a price that would be received to sell an asset in an orderly transaction between market participants at the measurement date. FASB ASC 820-10 establishes a framework for measuring fair value that includes a hierarchy used to classify the inputs used in measuring fair value. The hierarchy prioritizes the inputs used in determining valuations into three levels. The level in the fair value hierarchy within which the fair value measurement falls is determined based on the lowest level input that is significant to the fair value measurement. The levels of the fair value hierarchy are as follows:

- A. Level 1: Fair value is based on unadjusted quoted prices in active markets that are accessible to the Bank for identical assets. These generally provide the most reliable evidence and are used to measure fair value whenever available.
- B. Level 2: Fair value is based on significant inputs, other than Level 1 inputs, that are observable either directly or indirectly for substantially the full term of the asset through corroboration with observable market data. Level 2 inputs include quoted market prices in active markets for similar assets, quoted market prices that are not active for identical or similar assets and other observable inputs.
- C.

Level 3: Fair value is based on significant unobservable inputs. Examples of valuation methodologies that would result in Level 3 classification include option pricing models, discounted cash flows and other similar techniques.



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At September 30, 2011 and December 31, 2010 investments measured at fair value on a recurring basis and the valuation methods used are as follows:

September 30, 2011	Level 1	Level 2	Level 3	Total
Available for Sale Securities				
Obligations of US Government Agencies				
Mortgaged-backed	\$—	\$72,398	\$—	\$72,398
Other	—	13,292	—	13,292
Obligations of state and political subdivisions	—	184,701	—	184,701
Corporate securities	—	56,836	—	56,836
Equity securities	1,600	—	—	1,600
Restricted equity securities	—	5,460	—	5,460
	\$1,600	\$332,687	\$—	\$334,287
December 31, 2010	Level 1	Level 2	Level 3	Total
Available for Sale Securities				
Obligations of US Government Agencies				
Mortgaged-backed	\$—	\$44,777	\$—	\$44,777
Other	—	7,096	—	7,096
Obligations of state and political subdivisions	—	177,252	—	177,252
Corporate securities	—	72,952	—	72,952
Equity securities	1,825	—	—	1,825
Restricted equity securities	—	6,363	—	6,363
	\$1,825	\$308,440	\$—	\$310,265

The estimated fair values of equity securities classified as Level 1 are derived from quoted market prices in active markets; these assets consist mainly of stocks held in other banks. The estimated fair values of all debt securities classified as Level 2 are obtained from nationally-recognized third-party pricing agencies. The estimated fair values are derived primarily from cash flow models, which include assumptions for interest rates, credit losses, and prepayment speeds. The significant inputs utilized in the cash flow models are based on market data obtained from sources independent of the Bank (observable inputs), and are therefore classified as Level 2 within the fair value hierarchy.

FASB ASC 825-10-50 Fair Value Measurement Disclosure (“Disclosures about Fair Value of Financial Instruments”), requires disclosure of fair value information about financial instruments, whether or not required to be recognized in the consolidated balance sheets, for which it is practicable to estimate such fair value. In cases where quoted market prices are not available, fair values are based on estimates using present value or other valuation techniques. These techniques are significantly affected by the assumptions used, including the discount rate and estimates of future cash flows. Fair value estimates derived through these techniques cannot be substantiated by comparison to independent markets and, in many cases, could not be realized in immediate settlement of the instrument. FASB ASC 825-10-50 excludes certain financial instruments and all nonfinancial instruments from its disclosure requirements. Accordingly, the aggregate fair value amounts presented do not represent the underlying value of the Corporation.

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

Cash and Due From Banks, Short-Term Investments, Accrued Interest Receivable and Accrued Interest Payable

The fair values are equal to the current carrying values.

Investment Securities

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

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## Loans

Fair values are estimated for categories of loans with similar financial characteristics. Loans were segregated by type such as commercial, tax-exempt, real estate mortgages and consumer. For estimation purposes each loan category was further segmented into fixed and adjustable rate interest terms and also into performing and non-performing classifications.

The fair value of each category of performing loans is calculated by discounting future cash flows using the current rates at which similar loans would be made to borrowers with similar credit ratings and for the same remaining maturities.

Fair value for non-performing loans is based on management's estimate of future cash flows discounted using a rate commensurate with the risk associated with the estimated future cash flows. The assumptions used by management are judgmentally determined using specific borrower information.

## Non-Performing Assets

The banks' impaired loan valuation procedure for any loans greater than \$250,000 requires an appraisal to be obtained and reviewed annually at year end. A quarterly collateral evaluation is performed which may include a site visit, property pictures and discussions with realtors and other similar business professionals to ascertain current values.

For impaired loans less than \$250,000 upon classification and annually at year end, the bank completes a Certificate of Inspection (approved by the State Dept. of Banking and the FDIC examiners) which includes the results of an onsite inspection, insured values, tax assessed values, recent sales comparisons and a review of the previous evaluations.

The banks' foreclosed asset valuation procedure requires an appraisal to be completed with the exception of those cases which the bank has obtained a sales agreement.

## Cash Surrender Value of Bank Owned Life Insurance

Fair value is equal to the cash surrender value of life insurance policies.

## Deposits

Under FASB ASC 825-10-50, the fair value of deposits with no stated maturity, such as Demand Deposits, Savings Accounts and Money Market Accounts is equal to the amount payable on demand at September 30, 2011 and December 31, 2010.

Fair values for fixed-rate certificates of deposit are estimated using a discounted cash flow calculation that applies interest rates currently being offered on similar term borrowings, to a schedule of aggregated expected monthly maturities on time deposits.

## Short-Term and Long-Term Borrowings

The fair values of short-term and long-term borrowings are estimated using discounted cash flow analyses based on the Corporation's incremental borrowing rate for similar instruments.

Commitments to Extend Credit and Standby Letters of Credit

Management estimates that there are no material differences between the notional amount and the estimated fair value of those off-balance sheet items since they are primarily composed of unfunded loan commitments which are generally priced at market at the time of funding.

Assets and liabilities measured at fair value on a non-recurring basis are summarized below:

September 30, 2011	Level 1	Level 2	Level 3	Total
Impaired loans	\$—	\$—	\$4,642	\$4,642
Foreclosed assets held for sale	—	—	1,000	1,000
Loans held for sale	—	—	3,646	3,646

  

December 31, 2010	Level 1	Level 2	Level 3	Total
Impaired loans	\$—	\$—	\$4,276	\$4,276
Foreclosed assets held for sale	—	—	1,149	1,149
Loans held for sale	—	—	4,950	4,950

There were no transfers amongst valuation levels September 30, 2011 and December 31, 2010. At September 30, 2011 and December 31, 2010, the carrying values and estimated fair values of financial instruments of the Corporation are presented in the table below:

(Amounts in thousands)	September 30, 2011		December 31, 2010	
	Carrying Amount	Estimated Fair Value	Carrying Amount	Estimated Fair Value
<b>FINANCIAL ASSETS:</b>				
Cash and cash equivalents	\$7,040	\$7,040	\$4,346	\$4,346
Short-term investments	13,958	13,958	7,559	7,559
Investment securities - available for sale	334,287	334,287	310,265	310,265
Investment securities - held to maturity	3,241	3,297	6,266	6,191
Net loans	404,907	427,811	403,950	408,984
Accrued interest receivable	4,274	4,274	4,589	4,589
Cash surrender value of life insurance	18,958	18,958	18,388	18,388
<b>FINANCIAL LIABILITIES:</b>				
Deposits	633,807	636,275	626,895	610,632
Short-term borrowings	22,349	22,349	20,977	20,977
Long-term borrowings	69,355	73,579	66,400	69,869
Accrued interest and other expenses	2,944	2,944	2,976	2,976
<b>OFF-BALANCE SHEET FINANCIAL INSTRUMENTS:</b>				
Commitments to extend credit		62,222		55,551
Financial standby letters of credit		1,189		805
Performance standby letters of credit		4,614		5,315

NOTE8 —MANAGEMENT’S ASSERTIONS AND COMMENTS REQUIRED TO BE PROVIDED WITH FORM 10Q FILING

In management’s opinion, the consolidated interim financial statements reflect fair presentation of the consolidated financial position of First Keystone Corporation and Subsidiary, and the results of their operations and their cash flows for the interim periods presented. Further, the consolidated interim financial statements are unaudited; however they reflect all adjustments, which are in the opinion of management, necessary to present fairly the consolidated financial condition and consolidated results of operations and cash flows for the interim periods presented and that all such adjustments to the consolidated financial statements are of a normal recurring nature. The independent registered public accounting firm, J. H. Williams & Co., LLP, reviewed these consolidated financial statements as stated in their accompanying review report.

The results of operations for the nine-month period ended September 30, 2011, are not necessarily indicative of the results to be expected for the full year.

These consolidated interim financial statements have been prepared in accordance with requirements of Form 10Q and therefore do not include all disclosures normally required by accounting principles generally accepted in the United States of America applicable to financial institutions as included with consolidated financial statements included in the Corporation’s annual Form 10K filing. The reader of these consolidated interim financial statements may wish to refer to the Corporation’s annual report or Form 10K for the period ended December 31, 2010, filed with the Securities and Exchange Commission.

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

Board of Directors and Stockholders of First Keystone Corporation:

We have reviewed the accompanying consolidated balance sheet of First Keystone Corporation and Subsidiary as of September 30, 2011, and the related consolidated statements of income for the three and nine month periods ended September 30, 2011 and 2010 and changes in stockholders' equity and cash flows for the nine-month periods ended September 30, 2011, and 2010. These consolidated interim financial statements are the responsibility of the management of First Keystone Corporation and Subsidiary.

We conducted our reviews in accordance with the standards of the Public Company Accounting Oversight Board (United States). A review of interim financial information consists principally of applying analytical procedures and making inquiries of persons responsible for financial and accounting matters. It is substantially less in scope than an audit conducted in accordance with the standards of the Public Company Accounting Oversight Board (United States), the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, we do not express such an opinion.

Based on our reviews, we are not aware of any material modifications that should be made to the consolidated interim financial statements referred to above for them to be in conformity with accounting principles generally accepted in the United States of America.

We have previously audited, in accordance with the auditing standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheet of First Keystone Corporation and Subsidiary as of December 31, 2010, and the related consolidated statements of income, changes in stockholders' equity, and cash flows for the year then ended (not presented herein); and in our report dated March 15, 2011, we expressed an unqualified opinion on those consolidated financial statements. In our opinion, the information set forth in the accompanying consolidated balance sheet as of December 31, 2010, is fairly stated, in all material respects, in relation to the consolidated balance sheet from which it has been derived.

/s/ J.H. Williams & Co., LLP  
J. H. Williams & Co., LLP

Kingston, Pennsylvania  
November 7, 2011

ITEM 2. First Keystone Corporation Management's Discussion and Analysis of Financial Condition and Results of Operation as of September 30, 2011

This quarterly report contains certain forward-looking statements (as defined in the Private Securities Litigation Reform Act of 1995), which reflect management's beliefs and expectations based on information currently available. These forward-looking statements are inherently subject to significant risks and uncertainties, including changes in general economic and financial market conditions, the Corporation's ability to effectively carry out its business plans and changes in regulatory or legislative requirements. Other factors that could cause or contribute to such differences are changes in competitive conditions, and pending or threatened litigation. Although management believes the expectations reflected in such forward-looking statements are reasonable, actual results may differ materially.

### RESULTS OF OPERATIONS

First Keystone Corporation realized earnings for the third quarter of 2011 of \$2,677,000, an increase of \$187,000, or 7.51% from the third quarter of 2010. The increase in net income for 2011 was primarily the result of an increased net interest margin and an increase in net interest income of \$404,000 from the third quarter of 2010. On a per share basis, net income per share was \$1.42 for the first nine months of 2011 up from \$1.28 for the first nine months of 2010, an increase of 10.9%. Cash dividends increased to \$.72 per share up from \$.69 in the first half of 2010, an increase of 4.3%.

Year-to-date net income annualized as of September 30, 2011, amounts to a return on average common equity of 12.38%, a return on tangible equity of 16.07% and a return on assets of 1.26%. For the nine months ended September 30, 2010, these measures were 11.63%, 15.62%, and 1.14%, respectively on an annualized basis.

### NET INTEREST INCOME

The major source of operating income for the Corporation is net interest income, defined as interest income less interest expense. In the third quarter of 2011, interest income amounted to \$9,237,000, a decrease of \$348,000 or 3.6% from the third quarter of 2010, while interest expense amounted to \$2,340,000 in the third quarter of 2011, a decrease of \$752,000, or 24.3% from the third quarter of 2010. As a result, net interest income increased \$404,000 or 6.2% in the third quarter of 2011 to \$6,897,000 from \$6,493,000 in third quarter of 2010.

Our net interest margin for the quarter ended September 30, 2011 was 3.97% compared to 3.73% for the quarter ended September 30, 2010.

### PROVISION FOR LOAN LOSSES

The provision for loan losses for the quarter ended September 30, 2011, was \$500,000, compared to \$1,075,000 for the third quarter of 2010. The decrease in the provision for loan losses resulted from our analysis of our current loan portfolio, including non performing loans. Net charge-offs amounted to \$1,363,000 for the nine months ending September 30, 2011. For the nine months ended September 30, 2010, net charge-offs amounted to \$1,781,000. The allowance for loan losses as a percentage of loans, net of unearned interest, was 1.33% as of September 30, 2011, as compared to 1.39% as of December 31, 2010 and 1.26% as of September 30, 2010. See Allowance for Loan Losses on Page 35 for further discussion.

### NON-INTEREST INCOME

Total non-interest income or other income was \$1,343,000 for the quarter ended September 30, 2011, as compared to \$2,073,000 for the quarter ended September 30, 2010, a —decrease of \$730,000, or 35.2%. In the third quarter of



2010 the bank recorded income of \$800,000 as a recovery on loss due to defalcation. Adjusting for that one time income indicates that other non-interest income was \$1,273,000.

Securities gains in the third quarter of 2011 were \$218,000 versus a loss of \$11,000 in the third quarter of 2010. After adjusting for the one-time recovery on loss due to defalcation and the securities gains and losses, non-interest income from operations for the third quarter of 2011 was \$1,125,000 versus \$1,284,000 in 2010. This is a reduction of \$159,000 or 12.4%. The main component of this decline was gains on sale of residential mortgage loans. The reduction in gains on sale of loans from 2010 to 2011 was \$219,000, which represented 93% of the decline.

## NON-INTEREST EXPENSES

Total non-interest expenses, or other expenses, was \$4,431,000 for the quarter ended September 30, 2011, as compared to \$4,288,000 for the quarter ended September 30, 2010. The increase of \$143,000, or 3.3% is comprised of salary and benefits, increasing \$113,000, occupancy, furniture and equipment and computer expense increasing \$124,000. The increases reflect additional employees and benefit costs related to information technology security and greater regulatory compliance.

Expenses associated with employees (salaries and employee benefits) continue to be the largest category of non-interest expenses. Salaries and benefits amounted to \$7,027,000, or 53.2% of total non-interest expense for the nine months ended September 30, 2011, as compared to 53.0% for the nine months ended September 30, 2010. Net occupancy, furniture and equipment, and computer expense amounted to \$2,088,000 for the nine months ended September 30, 2011, an increase of \$104,000, or 5.2%. Other non-interest expenses, including FDIC insurance, professional services and state shares tax amounted to \$1,635,000 for the nine months ended September 30, 2011, a decrease of \$195,000, or 10.7% from the first nine months of 2010. Our non-interest expense for the nine months ended September 30, 2011 is approximately 2.15% of average assets on an annualized basis, which places us among the leaders of our peer financial institutions at controlling total non-interest expense.

## INCOME TAXES

Effective tax planning has helped produce favorable net income. Income tax amounted to \$1,937,000 for the nine months ended September 30, 2011, as compared to \$1,873,000 for 2010, an increase of \$64,000. The effective total income tax rate was 20.1% and 21.1% for the nine months ended September 30, 2011 and 2010, respectively.

## ANALYSIS OF FINANCIAL CONDITION

### ASSETS

Total assets increased to \$824,755,000 as of September 30, 2011, an increase of \$28,154,000 from year-end 2010. Net loans decreased by just less than 1% as loan demand remains weak and borrowers are generally paying down debt. An increase in deposits led to a similar size increase in the investment portfolio.

During the third quarter of 2011 the Corporation decreased short-term borrowings to \$22,349,000 as of September 30, 2011, as compared to \$23,130,000 as of June 30, 2011. Long-term borrowings were \$69,355,000 as of September 30, 2011, a decrease of \$2,375,000 from the \$71,730,000 reported June 30, 2011.

### EARNING ASSETS

Our primary earning asset, loans, net of unearned income increased to \$404,907,000 as of September 30, 2011, up \$957,000 since year-end 2010. The loan portfolio continues to be diversified. Overall asset quality has remained consistent with non-performing assets increasing only slightly since year-end 2010. Total non-performing assets were \$5,670,000 as of September 30, 2011, an increase of \$245,000, or 4.5% from the \$5,425,000 reported in non-performing assets as of December 31, 2010. Total allowance for loan losses to total non-performing loans was 117.9% as of September 30, 2011 and 133.3% at December 31, 2010.

Besides loans, another primary earning asset is our overall investment portfolio, which increased in size from December 31, 2010, to September 30, 2011. Held-to-maturity securities amounted to \$3,241,000 as of September 30, 2011, a decrease of \$3,025,000 from December 31, 2010. Available-for-sale securities amounted to \$334,287,000 as of September 30, 2011, an increase of \$24,022,000 from year-end 2010. Interest bearing deposits in other banks and

federal funds sold increased as of September 30, 2011, to \$13,958,000 from \$7,559,000 at year-end 2010.

## LOANS

Total loans, net of unearned income and the allowance for loan losses, increased to \$404,907,000 as of September 30, 2011, as compared to a balance of \$403,950,000 as of December 31, 2010. The table on page 35 provides data relating to the composition of the Corporation's loan portfolio on the dates indicated. Total loans, net of unearned income and the allowance for loan losses, increased \$957,000, or 0.2% as of September 30, 2011.

The economy and the resultant decline in loan demand account for the slow growth in loans in 2010 and continued into 2011. Residential real estate loans declined from December 31, 2010 a total of \$131,981,000 to \$126,550,000 as of September 30, 2011. The decline is attributed to the weak housing market, unstable employment and consumer's reluctance to take on debt. The Corporation did not change its underwriting standards in 2010 or 2011, rather opportunities to originate commercial and consumer loans declined because of the economy and the increased unemployment in our market area.

The loan portfolio is well diversified. The total commercial portfolio is \$276,318,000 of which \$235,186,000 or 85.1% of gross loans is secured by commercial real estate. The largest relationship is an \$8,500,000 tax-free loan to a municipality founded in 1816 consisting of 35 square miles, which is located in the eastern region of our market area. According to the township it has experienced 17% growth in population over the past 9 years and future job growth is projected to be 29% over the next 10 years. The township is currently involved in a \$70,000,000 sewer expansion project. Our loan is secured by project receivables and the full faith, credit and taxing power of the township.

The second largest relationship of \$6,839,476 is comprised of loans to individuals and their related companies involved in the ownership and operation of gas stations, convenience stores, and truck stops located in northern, central, and eastern Pennsylvania. The borrowers are well experienced in the industry and have been operating various locations since 1988. The loans are secured by commercial real estate, and perfected security interest in all business assets.

The next largest relationship is a real estate holding LLC established in 2006, and its related medical service companies. The LLC was formed to construct and provide medical office space for a group of closely related medical entities and outside services and is located in the corporation's immediate central market area. The relationship had outstanding loan balances of \$6,702,555 at September 30, 2011, secured primarily by commercial real estate and perfected security interest in all business assets of the various related entities. A small portion of the relationship is to an individual, \$40,000, secured by vehicles, and a \$277,000 residential mortgage secured by real estate.

The fourth largest commercial relationship is the net balance of \$5,977,358, after participations sold of \$3,365,000 and letters of credit of \$2,331,000. This relationship is comprised of a \$5,000,000 revolving line of credit and related \$2,331,000 letters of credit to develop a Planned Residential Community in the eastern portion of our market area, several commercial investment properties totaling \$3,921,000, a \$450,000 revolving line of credit for working capital and a \$78,000 residential mortgage. The borrowers and their related companies have been involved in real estate development since 1974, and have developed residential communities, and medical and professional office space. The entire relationship is secured by a combination of real estate and marketable securities.

The fifth largest relationship of \$4,803,489 is located in our central market area and is involved in construction and ownership of a 60 room hotel. Loans consist of mortgages on the commercial real estate and perfected interest in all business assets.

Each of the aforementioned loans are paying as agreed and none of the loans are considered criticized or classified. The property securing each of the loans was appraised at the time the loan was originated. Appraisals are ordered independently of the loan approval process from appraisers on an approved list. All appraisals are reviewed internally for conformity with accepted standards of the Bank.

All loan relationships in excess of \$1,500,000 are reviewed internally and through an external loan review process on an annual basis. Such review is based upon analysis of current financial statements of the borrower, co-borrowers/guarantors, payment history, and economic conditions.

The Corporation continues to internally underwrite each of its loans to comply with prescribed policies and approval levels established by its Board of Directors.

## Loans Outstanding, Net of Unearned Income

(Amounts in thousands)	September 30, 2011	December 31, 2010
<b>Commercial, financial and agricultural:</b>		
Commercial secured by real estate	\$ 235,186	\$ 227,147
Commercial - other	21,786	29,693
Tax exempt - real estate and other	19,346	12,450
Real estate (primarily residential mortgage loans)	126,550	131,981
Consumer loans	7,688	8,781
<b>Total Gross Loans</b>	<b>\$ 410,556</b>	<b>\$ 410,052</b>
Add (deduct): Unearned income	(453 )	(675 )
Unamortized loan fees net of costs	278	274
<b>Total Loans, net of unearned income</b>	<b>\$ 410,381</b>	<b>\$ 409,651</b>

## ALLOWANCE FOR LOAN LOSSES

The allowance for loan losses constitutes the amount available to absorb losses within the loan portfolio. As of September 30, 2011 the allowance for loan loss was \$5,474,000 as compared to \$5,701,000 as of December 31, 2010. The allowance for loan losses is established through a provision for loan losses charged to expenses. Loans are charged against the allowance for possible loan losses when management believes that the collectibility of the principal is unlikely. The risk characteristics of the loan portfolio are managed through the various control processes, including credit evaluations of individual borrowers, periodic reviews, and diversification by industry. Risk is further mitigated through the application of lending procedures such as the holding of adequate collateral and the establishment of contractual guarantees.

Management performs a quarterly analysis to determine the adequacy of the allowance for loan losses. The methodology in determining adequacy incorporates specific and general allocations together with a risk/loss analysis on various segments of the portfolio according to an internal loan review process. This assessment results in an allocated allowance. Management maintains its loan review and loan classification standards consistent with those of its regulatory supervisory authority.

Management considers, based upon its methodology, that the allowance for loan losses is adequate to cover foreseeable future losses. However, there can be no assurance that the allowance for loan losses will be adequate to cover significant losses, if any that might be incurred in the future.

The Analysis of Allowance for Loan Losses table contains an analysis of our Allowance for Loan Losses indicating charge-offs and recoveries by the year and annual additional provisions charged to operations. In the third quarter of 2011, net charge-offs as a percentage of average loans were 0.32%, as compared to 0.43% in the third quarter of 2010. Net charge-offs amounted to \$1,327,000 and \$1,781,000 for the first nine months of 2011 and 2010, respectively. Commercial loan charge-offs for third quarter 2011 resulted primarily from \$711,000 for 2 commercial-real estate secured loans. Net charge-offs in 2010 relates primarily to increased losses of commercial loans secured by real estate. The largest relationship, representing 45.7% of net charge-offs in 2010, is located in the eastern portion of our market area and was directly related to the housing industry. The downturn in the economy resulted in a drastic reduction in the number of housing starts in that region. The second largest loan relationship, representing 17.8%, of net charge-offs in 2010 was related to residential investment real estate which was also negatively affected with the downturn in the economy resulting in increased vacancy rates. The resulting charge-offs versus the specific allocations for these two relationships required an additional provision in the third quarter of 2010.

For the first three quarters of 2011, the provision for loan losses was \$1,100,000 as compared to \$1,675,000 for the first three quarters of 2010. As of September 30, 2011, the majority of the reserve was related to commercial real estate loans of \$2,814,000 and residential real estate loans of \$1,464,000. The Corporation determined that the reserve for loan losses as of September 30, 2011 was sufficient to adequately fund the reserve to account for probable future losses in the loan portfolio. At December 31, 2010, \$4,270,000 of the reserve was related to commercial and real estate loans. Net charge-offs of commercial and real estate loans in 2010 were \$2,115,000 and this impacted the historical loss component factor for the allowance for loan loss valuation. The Corporation determined that the provision for loan losses made during 2010 was sufficient to maintain the allowance for loan losses at a level necessary for the probable losses inherent in the loan portfolio as of December 31, 2010.

## Analysis of Allowance for Loan Losses

(Amounts in thousands)

	September 30, 2011	December 31, 2010	September 30, 2010			
Balance at beginning of period	\$ 5,701	\$ 5,322	\$ 5,322			
Charge-offs:						
Commercial, financial, and agricultural	483	389	243			
Real estate	838	1,778	1,506			
Consumer	71	95	77			
	1,392	2,262	1,826			
Recoveries:						
Commercial, financial, and agricultural	23	39	31			
Real estate	32	13	1			
Consumer	10	14	13			
	65	66	45			
Net charge-offs	1,327	2,196	1,781			
Additions charged to operations	1,100	2,575	1,675			
Allowance purchased	—	—	—			
Balance at end of period	\$ 5,474	\$ 5,701	\$ 5,216			
Ratio of net charge-offs during the period to average loans outstanding during the period	0.32	%	0.54	%	0.43	%
Allowance for loan losses to average loans outstanding during the period	1.33	%	1.39	%	1.26	%

It is the policy of management and the Corporation's Board of Directors to provide for losses on both identified and unidentified losses inherent in its loan portfolio. A provision for loan losses is charged to operations based upon an evaluation of the potential losses in the loan portfolio. This evaluation takes into account such factors as portfolio concentrations, delinquency, trends, trends of non-accrual and classified loans, economic conditions, and other relevant factors.

The loan review process, which is conducted quarterly, is an integral part of our evaluation of the loan portfolio. A detailed quarterly analysis to determine the adequacy of the Corporation's allowance for loan losses is reviewed by our Board of Directors.

With our manageable level of net charge-offs and the additions to the reserve from our provision out of operations, the allowance for loan losses as a percentage of average loans amounted to 1.33% at September 30, 2011, 1.39% at December 31, 2010 and 1.26% at September 30, 2010.

The following table sets forth the allocation of the Bank's allowance for loan losses by loan category and the percentage of loans in each category to total loans receivable at the dates indicated. The portion of the allowance for loan losses allocated to each loan category does not represent the total available for future losses that may occur within the loan category, since the total loan loss allowance is a valuation reserve applicable to the entire loan portfolio.

## Allocation of Allowance for Loan Losses



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(Amounts in thousands)	September 30, 2011			December 31, 2010		
Commercial, financial, and agricultural	\$ 447	9.2	%*	\$ 565	11.4	%*
Real estate - mortgage	4,278	87.7	%*	4,270	86.1	%*
Consumer and other loans	151	3.1	%*	123	2.5	%*
Unallocated	598	N/A	*	743	N/A	*
	\$ 5,474	100.0	%*	\$ 5,701	100.0	%*

\*Percentage of loans in each category to total loans in the Allowance for Loan Loss Analysis.

## NON-PERFORMING ASSETS

The Non-Performing Assets table on page 38 details the Corporation's non-performing assets as of the dates indicated. Generally, a loan is classified as non-accrual and the accrual of interest on such a loan is discontinued when the contractual payment of principal or interest has become 90 days past due or management has serious doubts about further collectibility of principal or interest, even though the loan currently is performing. A loan may remain on accrual status if it is in the process of collection and is either guaranteed or well secured. When a loan is placed on non-accrual status, unpaid interest credited to income in the current year is reversed and unpaid interest accrued in prior years is charged against the allowance for loan losses. Restructured loans are loans where the borrower has been granted a concession in the interest rate or payment amount because of financial problems. Foreclosed assets held for sale represent property acquired through foreclosure, or considered to be an in-substance foreclosure.

The total of non-performing assets increased \$245,000 to \$5,670,000 in the third quarter of 2011 after increasing to \$5,425,000 as of December 31, 2010. The economy, in particular increased unemployment and the downturn of the housing industry, had a direct effect of increasing our non-performing assets at December 31, 2010. The Corporation is closely monitoring its commercial real estate portfolio because of the current economic environment. In particular, vacancy rates are rising and rents and property values in some markets have fallen. Losses on commercial real estate, which increased in 2010, are projected to continue somewhat higher than normal into 2011. Impaired loans increased to \$4,642,000 in the third quarter of 2011, after increasing to \$4,276,000 in 2010 from \$2,948,000 in 2009. Foreclosed assets decreased to \$1,000,000 in the third quarter of 2011 from \$1,149,000 in 2010. Loans past-due 90 days or more and still accruing were \$28,000 for the third quarter of 2011 and \$0 in 2010. Non-performing assets to period end loans and foreclosed assets was 1.4% in the third quarter of 2011 and 1.3% in 2010. Total non-performing assets to total assets is 0.7% at September 30, 2011 and December 31, 2010. Our allowance for loan losses to total non-performing assets were 96.5% at September 30, 2011 and 105.1% at December 31, 2010. Additional detail can be found on page 38, Non-Performing Assets Table and page 24 in the Financing Receivables on non-accrual status table. Asset quality is a priority and the Corporation retains a full-time loan review officer to closely track and monitor overall loan quality, and a full-time workout specialist to manage collection efforts.

Impaired loans increased to \$4,642,000 at September 30, 2011 from \$4,276,000 at December 31, 2010. Four relationships in 2011 carried aggregate balances of \$500,000 or greater. The largest relationship is represented by two loans carrying a balance of \$1,000,000 secured by commercial real estate. The September 30, 2011 valuation carried a net realizable value of \$1,200,000, after an estimated 10% cost to sell. The next largest relationship is represented by two loans carrying a balance of \$600,000 secured by leasehold mortgages. The September 30, 2011 valuations carried a net realizable value of \$492,000, after an estimated 10% cost to sell, resulting in a specific allocation of \$108,000, which was increased from \$49,000 at December 31, 2010. The next largest relationship is represented by three loans carrying a balance of \$532,000 secured by two commercial real estate properties. The September 30, 2011 valuations carried a net realizable value of \$502,000 after an estimated 10% cost to sell, resulting in a specific allocation of \$30,000 at September 30, 2011 compared to \$141,000 at December 31, 2010. A portion of this relationship, \$91,000, was charged-off during the quarter ended June 30, 2011. The next largest relationship is represented by three loans carrying a balance of \$500,000 secured by residential real estate. The December 31, 2010 and September 30, 2011 valuations indicated a maximum sales price of \$721,000 and a liquidation value of \$556,000. The Corporation charged off \$70,000 prior to year end bringing the loan balances to \$500,000 equaling the net realizable value after an estimated 10% cost to sell. Of the \$4,642,000, \$600,000 is located outside of our primary market area. None of the impaired loans were participation loans.

The Corporation's impaired loan valuation procedure for any loans greater than \$250,000 requires an appraisal to be obtained and reviewed annually at year end. A quarterly collateral evaluation is performed which may include a site visit, property pictures and discussions with realtors and other similar business professionals to ascertain current

values.

For impaired loans less than \$250,000 upon classification and annually at year end, the Corporation completes a Certificate of Inspection (approved by the State Department of Banking and the FDIC examiners) which includes the results of an onsite inspection, insured values, tax assessed values, recent sales comparisons and a review of the previous evaluations.

Improving loan quality is a priority, and we actively work with borrowers to resolve credit problems and we continue our close monitoring efforts in 2011. As of September 30, 2011, the Corporation did not have any troubled debt restructurings in its loan portfolio. Excluding the assets disclosed in the Non-Performing Assets Table, management is not aware of any information about borrowers' possible credit problems which cause serious doubt as to their ability to comply with present loan repayment terms.

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Should the economic climate no longer continue to be stable or deteriorate further, borrowers may experience difficulty, and the level of non-performing loans and assets, charge-offs and delinquencies could rise and possibly require additional increases in our allowance for loan losses.

In addition, regulatory authorities, as an integral part of their examinations, periodically review the allowance for possible loan and lease losses. They may require additions to allowances based upon their judgements about information available to them at the time of examination.

Interest income received on non-performing loans as of September 30, 2011 and September 30, 2010 was \$62,000 and \$36,000, respectively. Interest income, which would have been recorded on these loans under the original terms was \$536,000 as of September 30, 2011 and \$261,000 as of September 30, 2010. At September 30, 2011 and December 31, 2010, the Corporation had no outstanding commitments to advance additional funds with respect to these non-performing loans.

A concentration of credit exists when the total amount of loans to borrowers, who are engaged in similar activities that are similarly impacted by economic or other conditions, exceed 10% of total loans. As of September 30, 2011 and December 31, 2010 and 2009, management is of the opinion that there were no loan concentrations exceeding 10% of total loans.

#### Non-Performing Assets

(Amounts in thousands)

	September 30, 2011	December 31, 2010		
<b>Non-performing assets</b>				
Impaired/non-accrual loans	\$ 4,642	\$ 4,276		
Foreclosed assets held for resale	1,000	1,149		
Loans past-due 90 days or more and still accruing interest	28	—		
<b>Total non-performing assets</b>	<b>\$ 5,670</b>	<b>\$ 5,425</b>		
<b>Impaired loans</b>				
Non-performing loans	\$ 4,642	\$ 4,276		
Allocated allowance for loan losses	(410 )	(605 )		
<b>Net investment in impaired loans</b>	<b>\$ 4,232</b>	<b>\$ 3,671</b>		
Impaired loans with a valuation allowance	\$ 2,236	\$ 2,553		
Impaired loans without a valuation allowance	2,406	1,723		
<b>Total impaired loans</b>	<b>\$ 4,642</b>	<b>\$ 4,276</b>		
Valuation allowance related to impaired loans	\$ 410	\$ 605		
Valuation allowance as a percent of impaired loans	8.8	%	14.2	%
Impaired loans to loans net of unearned discount	1.1	%	1.0	%
Non-performing assets to period-end loans and foreclosed assets	1.4	%	1.3	%
Total non-performing assets to total assets	0.7	%	0.7	%
Allowance for loan losses to impaired loans	117.9	%	133.3	%
Allowance for loan losses to total non-performing assets	96.5	%	105.1	%

Real estate mortgages comprise 88.5% of the loan portfolio as of September 30, 2011, as compared to 89.2% as of December 31, 2010. Real estate mortgages consist of both residential and commercial real estate loans. The real estate loan portfolio is well diversified in terms of borrowers, collateral, interest rates, and maturities. Also, the residential real estate loan portfolio is largely fixed rate mortgages. The real estate loans are concentrated primarily in our marketing area and are subject to risks associated with the local economy. The commercial real estate loans typically reprice approximately each three to five years and are also concentrated in our marketing area. The Corporation's loss exposure on its non-performing loans continues to be mitigated by collateral positions on these loans. The allocated allowance for loan losses associated with impaired loans is generally computed based upon the related collateral value of the loans. The collateral values are determined by recent appraisals, but are generally discounted by management based on historical dispositions, changes in market conditions since the last valuation and management's expertise and knowledge of the borrower and the borrower's business.

## DEPOSITS AND OTHER BORROWED FUNDS

As indicated previously, total deposits increased by \$6,912,000 as non-interest bearing deposits increased by \$10,112,000 and interest bearing deposits decreased by \$3,200,000 as of September 30, 2011, from year-end 2010. Total short-term and long-term borrowings increased \$4,327,000 as of September 30, 2011 to \$91,704,000, as compared to \$87,377,000 in total borrowings as of year-end 2010.

## CAPITAL STRENGTH

Normal increases in capital are generated by net income, less cash dividends paid out. Also, accumulated other comprehensive income or loss derived from unrealized gains or losses on investment securities available-for-sale can have a positive or negative impact on capital.

At September 30, 2011, total stockholders' equity was \$91,996,000, an increase of \$12,936,000 or 16.4% over December 31, 2010. During the nine month period ended September 30, 2011, the Corporation retained earnings in excess of dividends in the amount of \$3,796,000. Also, the accumulated other comprehensive income from unrealized gains in the available-for-sale investment portfolio was \$7,493,000, an increase of \$9,126,000 from a loss of \$1,633,000 as of December 31, 2010.

The Corporation had 242,725 shares of common stock as treasury stock as of September 30, 2011 compared to 243,540 on December 31, 2010. This had the effect of decreasing our Stockholders' Equity by \$6,075,000 on September 30, 2011 and by \$6,103,000 on December 31, 2010.

Total stockholders' equity was \$91,996,000 as of September 30, 2011 and \$79,060,000 as of December 31, 2010. Leverage ratio and risk based capital ratios remain very strong. As of September 30, 2011, our leverage ratio was 7.95% compared to 7.44% as of December 31, 2010. In addition, Tier I risk based capital and total risk based capital ratio as of September 30, 2011, were 11.88% and 12.89%, respectively. The same ratios as of December 31, 2010 were 10.85% and 11.87%, respectively.

## LIQUIDITY

The liquidity position of the Corporation remains adequate to meet customer loan demand and deposit fluctuation. Managing liquidity remains an important segment of asset liability management. Our overall liquidity position is maintained by an active asset liability management committee.

Management feels its current liquidity position is satisfactory, given a very stable core deposit base which has generally increased annually. Secondly, our loan payments and principal paydowns on our mortgage backed securities provide a steady source of funds. Also, short-term investments and maturing investment securities represent additional sources of liquidity. Finally, short-term borrowings are readily accessible at the Federal Reserve Bank discount window, Atlantic Central Bankers Bank, or the Federal Home Loan Bank.

## ITEM 3 Quantitative and Qualitative Disclosures About Market Risk

There have been no material changes in the Company's quantitative and qualitative market risks since December 31, 2010. The composition of rate sensitive assets and rate sensitive liabilities as of September 30, 2011 is very similar to December 31, 2010.



ITEM 4. Controls and Procedures

a)Evaluation of Disclosure Controls and Procedures. First Keystone Corporation maintains disclosure controls and procedures (as defined in Rule 13a-15(e) under the Securities Exchange Act of 1934, as amended) designed to ensure that information required to be disclosed in the reports that the Corporation files or submits under the Securities Exchange Act of 1934 is recorded, processed, summarized and reported within the time periods specified in the rules and forms of the Securities and Exchange Commission. Based upon their evaluation of those disclosure controls and procedures performed as of the end of the period covered by this report, the chief executive officer and chief financial officer of the Corporation concluded that the Corporation's disclosure controls and procedures were effective. The Corporation believes that a control system, no matter how well designed and operated, cannot provide absolute assurance that the objectives of the control system are met, and no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, within a corporation have been detected.

b)Changes in internal control over financial reporting. The Corporation made no changes in its internal control over financial reporting or in other factors that has materially affected, or is reasonably likely to materially affect, the Corporation's internal control over financial reporting during the last fiscal quarter.



PART II - OTHER INFORMATION

Item 1. Legal Proceedings

None.

Item 1A. There have been no material changes in our “Risk Factors” as previously disclosed in our Annual Report on Form 10-K for the year ended December 31, 2010.

Item 2. Changes in Securities, Use of Proceeds and Issuer Purchases of Equity Securities

Period	Total Number of Shares Purchased	Average Price Paid per Share	Total Number of Shares	Maximum Number of
			Purchased as Part of Publicly Announced Plans or Programs	Shares that May Yet Be Purchased Under the Plans or Programs
July 1 — July 31, 2011	—	—	—	112,098
August 1 — August 31, 2011	—	—	—	112,098
Sept 1 — Sept 30, 2011	—	—	—	112,098
Total	—	—	—	112,098

Item 3. Defaults Upon Senior Securities

None.

Item 4. Removed and Reserved

Item 5. Other Information

The Company made no material changes to the procedures by which shareholders may recommend nominees to the Company’s Board of Directors.

Item 6.Exhibits and Reports on Form 8-K

(a) Exhibits required by Item 601 Regulation S-K

Exhibit Number	Description of Exhibit
3i	Articles of Incorporation, as amended (Incorporated by reference to Exhibit 3(i) to the Registrant's Report on Form 10-Q for the quarter ended March 31, 2006).
3ii	By-Laws, as amended (Incorporated by reference to Exhibit 3(ii) to the Registrant's Report on Form 10-Q for the quarter ended March 31, 2006).
10.1	Supplemental Employee Retirement Plan (Incorporated by reference to Exhibit 10 to the Registrant's Report on Form 10-Q for the quarter ended September 30, 2005).
10.2	Management Incentive Compensation Plan (Incorporated by reference to Exhibit 10 to the Registrant's Annual Report on Form 10-K for the year ended December 31, 2010).
10.3	Profit Sharing Plan (Incorporated by reference to Exhibit 10 to the Registrant's Report on Form 10-Q for the quarter ended September 30, 2006).
10.4	First Keystone Corporation 1998 Stock Incentive Plan (Incorporated by reference to Exhibit 10 to the Registrant's Report on Form 10-Q for the quarter ended September 30, 2006).
14	Code of Ethics (Incorporated by reference to Exhibit 14 to the Registrant's Report on Form 8-K dated January 9, 2007).
31.1	Rule 13a-15(e) and 15d-15(e) Certification of Chief Executive Officer.
31.2	Rule 13a-15(e) and 15d-15(e) Certification of Chief Financial Officer.
32.1	Section 1350 Certification of Chief Executive Officer.
32.2	Section 1350 Certification of Principal Financial Officer.

FIRST KEYSTONE CORPORATION

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

FIRST KEYSTONE CORPORATION  
Registrant

November 7, 2011

/s/ Matthew P. Prosseda  
Matthew P. Prosseda  
Chief Executive Officer  
(Principal Executive Officer)

November 7, 2011

/s/ Diane C.A. Rosler  
Diane C.A. Rosler  
Chief Financial Officer  
(Principal Accounting Officer)

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