

Edgar Filing: FIRST KEYSTONE CORP - Form 10-Q

FIRST KEYSTONE CORP  
Form 10-Q  
November 08, 2006

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, 2006

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, or a non-accelerated filer. See definition of "accelerated filer and large accelerated filer" in Rule 12b-2 of the Exchange Act). (Check one):

Large accelerated filer   
Accelerated Filer   
Non-accelerated filer

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

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Yes [ ]                      No [X]

On November 1, 2006 there were 4,323,746 shares of the Registrant's common stock outstanding.

## PART I. - FINANCIAL INFORMATION

### Item. 1 Financial Statements

#### FIRST KEYSTONE CORPORATION AND SUBSIDIARY CONSOLIDATED BALANCE SHEETS

| (Amounts in thousands)   | September<br>2006<br>(Unaudited) | December<br>2005 |
|--|----------------------------------|------------------|
| <b>ASSETS</b>  |                                  |                  |
| Cash and due from banks  | \$ 6,737                         | \$ 7,098         |
| Interest bearing deposits in<br>other banks  | 83                               | 58               |
| Investment securities, available-<br>for-sale securities carried at<br>estimated fair value          | 236,428                          | 247,288          |
| Investment securities, held-to-<br>maturity securities, estimated<br>fair value of \$6,906 and 4,217 | 6,932                            | 4,248            |
| Loans, net of unearned income  | 251,257                          | 234,593          |
| Allowance for loan losses  | (3,622)                          | (3,676)          |
| Net loans  | \$247,635                        | \$230,917        |
| Premises and equipment-net   | 4,909                            | 5,091            |
| Accrued interest receivable  | 3,002                            | 2,604            |
| Cash surrender value of bank<br>owned life insurance   | 11,817                           | 11,470           |
| Goodwill   | 1,224                            | 1,224            |
| Other assets   | 2,898                            | 2,401            |
| TOTAL ASSETS   | \$521,665                        | \$512,399        |
| <b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>  |                                  |                  |
| <b>LIABILITIES</b>   |                                  |                  |
| Deposits   |                                  |                  |
| Non-interest bearing   | \$ 38,844                        | \$ 39,664        |
| Interest bearing   | 347,526                          | 323,132          |
| TOTAL DEPOSITS   | \$386,370                        | \$362,796        |
| Short-term borrowings  | 18,511                           | 28,151           |
| Long-term borrowings   | 60,535                           | 65,535           |
| Accrued interest and other expenses  | 2,653                            | 2,372            |
| Other liabilities  | 116                              | 102              |
| TOTAL LIABILITIES  | \$468,185                        | \$458,956        |

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|  |                           |                           |
|--|---------------------------|---------------------------|
| STOCKHOLDERS' EQUITY   |                           |                           |
| Common stock, par value \$2 per share  | \$ 9,079                  | \$ 9,079                  |
| Surplus  | 12,322                    | 12,387                    |
| Retained earnings  | 37,365                    | 35,714                    |
| Accumulated other comprehensive income                                       | 371                       | 807                       |
| Less treasury stock at cost 215,827<br>shares in 2006 and<br>153,624 in 2005 | (5,657)                   | (4,544)                   |
| TOTAL STOCKHOLDERS' EQUITY   | <u>\$ 53,480</u>          | <u>\$ 53,443</u>          |
| TOTAL LIABILITIES AND<br>STOCKHOLDERS' EQUITY                                | <u>\$521,665</u><br>===== | <u>\$512,399</u><br>===== |

See Accompanying Notes to Consolidated Financial Statements

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FIRST KEYSTONE CORPORATION AND SUBSIDIARY  
CONSOLIDATED STATEMENTS OF INCOME  
FOR THE THREE MONTHS ENDED SEPTEMBER 30, 2006 AND 2005  
(Unaudited)

(Amounts in thousands except per share data)

|  | 2006           | 2005           |
|--|----------------|----------------|
| INTEREST INCOME  |                |                |
| Interest and fees on loans                             | \$4,223        | \$3,746        |
| Interest and dividend income<br>on securities          | 3,012          | 2,887          |
| Deposits in banks                                      | 1              | 4              |
| TOTAL INTEREST INCOME                                  | <u>\$7,236</u> | <u>\$6,637</u> |
| INTEREST EXPENSE                                       |                |                |
| Deposits   | \$2,951        | \$2,080        |
| Short-term borrowings                                  | 250            | 164            |
| Long-term borrowings                                   | 709            | 737            |
| TOTAL INTEREST EXPENSE                                 | <u>\$3,910</u> | <u>\$2,981</u> |
| Net interest income                                    | <u>\$3,326</u> | <u>\$3,656</u> |
| Provision for loan losses                              | 100            | 150            |
| NET INTEREST INCOME AFTER<br>PROVISION FOR LOAN LOSSES | <u>\$3,226</u> | <u>\$3,506</u> |
| NON-INTEREST INCOME                                    |                |                |
| Trust department                                       | \$ 122         | \$ 106         |
| Service charges and fees                               | 537            | 552            |
| Bank owned life insurance income                       | 121            | 109            |

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|   |         |         |
|---|---------|---------|
| Gain on sale of loans                         | 10      | 14      |
| Investment securities gains<br>(losses) - net | 74      | 89      |
| Other   | 88      | 45      |
|   | <hr/>   | <hr/>   |
| TOTAL NON-INTEREST INCOME                     | \$ 952  | \$ 915  |
|   | <hr/>   | <hr/>   |
| NON-INTEREST EXPENSES                         |         |         |
| Salaries and employee benefits                | \$1,279 | \$1,144 |
| Occupancy, net                                | 154     | 152     |
| Furniture and equipment                       | 187     | 148     |
| Professional services                         | 115     | 99      |
| State shares tax                              | 131     | 121     |
| Other   | 514     | 581     |
|   | <hr/>   | <hr/>   |
| TOTAL NON-INTEREST EXPENSES                   | \$2,380 | \$2,245 |
|   | <hr/>   | <hr/>   |
| Income before income taxes                    | \$1,798 | \$2,176 |
| Income tax expense                            | 295     | 372     |
|   | <hr/>   | <hr/>   |
| Net Income                                    | \$1,503 | \$1,804 |
|   | =====   | =====   |
| PER SHARE DATA                                |         |         |
| Basic   | \$ .35  | \$ .41  |
| Diluted                                       | .35     | .41     |
| Cash dividends per share                      | .22     | .20     |

See Accompanying Notes to Consolidated Financial Statements

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FIRST KEYSTONE CORPORATION AND SUBSIDIARY  
CONSOLIDATED STATEMENTS OF INCOME  
FOR THE NINE MONTHS ENDED SEPTEMBER 30, 2006 AND 2005  
(Unaudited)

(Amounts in thousands except per share data)

|   | 2006     | 2005     |
|---|----------|----------|
| INTEREST INCOME                               |          |          |
| Interest and fees on loans                    | \$12,171 | \$10,985 |
| Interest and dividend income<br>on securities | 8,968    | 8,537    |
| Deposits in banks                             | 6        | 44       |
| Interest on federal funds sold                | 0        | 3        |
|   | <hr/>    | <hr/>    |
| TOTAL INTEREST INCOME                         | \$21,145 | \$19,569 |
|   | <hr/>    | <hr/>    |
| INTEREST EXPENSE                              |          |          |
| Deposits                                      | \$ 8,028 | \$ 5,804 |
| Short-term borrowings                         | 684      | 324      |
| Long-term borrowings                          | 2,167    | 2,265    |

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|  |          |          |
|--|----------|----------|
| TOTAL INTEREST EXPENSE                                 | \$10,879 | \$ 8,393 |
| Net interest income                                    | \$10,266 | \$11,176 |
| Provision for loan losses                              | 400      | 500      |
| NET INTEREST INCOME AFTER<br>PROVISION FOR LOAN LOSSES | \$ 9,866 | \$10,676 |
| NON-INTEREST INCOME                                    |          |          |
| Trust department                                       | \$ 385   | \$ 358   |
| Service charges and fees                               | 1,538    | 1,502    |
| Bank owned life insurance income                       | 347      | 324      |
| Gain on sale of loans                                  | 13       | 54       |
| Investment securities gains<br>(losses) - net          | 269      | 232      |
| Other  | 168      | 164      |
| TOTAL NON-INTEREST INCOME                              | \$ 2,720 | \$ 2,634 |
| NON-INTEREST EXPENSE                                   |          |          |
| Salaries and employee benefits                         | \$ 3,955 | \$ 3,669 |
| Occupancy, net   | 452      | 431      |
| Furniture and equipment                                | 561      | 499      |
| Professional services                                  | 298      | 300      |
| State shares tax                                       | 389      | 360      |
| Other  | 1,580    | 1,706    |
| TOTAL NON-INTEREST EXPENSES                            | \$ 7,235 | \$ 6,965 |
| Income before income taxes                             | \$ 5,351 | \$ 6,345 |
| Income tax expense                                     | 823      | 1,089    |
| Net Income   | \$ 4,528 | \$ 5,256 |
| PER SHARE DATA   |          |          |
| Basic  | \$ 1.04  | \$ 1.20  |
| Diluted  | 1.04     | 1.19     |
| Cash Dividends   | .66      | .60      |

See Accompanying Notes to Consolidated Financial Statements

FIRST KEYSTONE CORPORATION AND SUBSIDIARY  
CONSOLIDATED STATEMENTS OF CASH FLOWS  
FOR THE NINE MONTHS ENDED September 30, 2006 AND 2005  
(Unaudited)

(Amounts in thousands)

2006

2005

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|  |             |              |
|--|-------------|--------------|
| OPERATING ACTIVITIES   |             |              |
| Net income   | \$ 4,528    | \$ 5,256     |
| Adjustments to reconcile net income to net cash provided by operating activities:    |             |              |
| Provision for loan losses  | 400         | 500          |
| Stock option expense   | 8           | 0            |
| Provision for depreciation and amortization  | 404         | 409          |
| Premium amortization on investment securities  | 125         | 318          |
| Accretion of core deposit net discount   | 1           | (65)         |
| Discount accretion on investment securities  | (379)       | (522)        |
| Gain on sale of mortgage loans   | (13)        | (54)         |
| Proceeds from sale of mortgage loans   | 5,658       | 3,930        |
| Originations of mortgage loans for resale  | (3,713)     | (4,512)      |
| (Gain) loss on sale of foreclosed real estate  | 13          | 0            |
| (Gain) loss on sales of investment securities  | (269)       | (232)        |
| Deferred income tax (benefit)  | (216)       | (6)          |
| (Increase) decrease in interest receivable and other assets                          | (609)       | 664          |
| Increase in cash surrender value of bank owned life insurance                        | (347)       | (324)        |
| Increase (decrease) in interest payable, accrued expenses and other liabilities      | 216         | 210          |
|  | <hr/>       | <hr/>        |
| Net Cash Provided by Operating Activities  | \$ 5,807    | \$ 5,572     |
| INVESTING ACTIVITIES   |             |              |
| Purchases of investment securities available-for-sale                                | \$ 52,266   | \$ (105,676) |
| Purchase of investment securities held-to-maturity                                   | (2,005)     | 0            |
| Proceeds from sales of investment securities available-for-sale                      | (64,345)    | 71,423       |
| Proceeds from sales of investment securities held to maturity                        | 201         | 0            |
| Proceeds from maturities and redemptions of investment securities available-for-sale | 21,790      | 29,858       |
| Proceeds from maturities and redemption of investment securities held-to-maturity    | 107         | 104          |
| Net (increase) decrease in loans   | (19,078)    | 1,486        |
| Purchase of premises and equipment   | (147)       | (97)         |
| Proceeds from sale of foreclosed assets  | 198         | 0            |
|  | <hr/>       | <hr/>        |
| Net Cash Used by Investing Activities  | \$ (11,013) | \$ (2,902)   |
| FINANCING ACTIVITIES   |             |              |
| Net increase (decrease) in deposits  | \$ 23,574   | \$ 17,657    |
| Net increase (decrease) in   |             |              |

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|                                 |           |           |
|---------------------------------|-----------|-----------|
| short-term borrowings           | (9,640)   | (3,022)   |
| Net increase (decrease) in      |           |           |
| long-term borrowings            | (5,000)   | (1,375)   |
| Acquisition of treasury stock   | (1,255)   | (112)     |
| Proceeds from sale of treasury  |           |           |
| stock                           | 69        | 95        |
| Cash dividends                  | (2,877)   | (2,637)   |
|                                 | <hr/>     | <hr/>     |
| Net Cash Provided by Financing  |           |           |
| Activities                      | \$ 4,871  | \$ 10,606 |
|                                 | <hr/>     | <hr/>     |
| Increase (Decrease) in Cash and |           |           |
| Cash Equivalents                | (335)     | 13,276    |
| Cash and Cash Equivalents,      |           |           |
| Beginning                       | 7,156     | 6,186     |
|                                 | <hr/>     | <hr/>     |
| Cash and Cash Equivalents,      |           |           |
| Ending                          | \$ 6,821  | \$ 19,462 |
|                                 | =====     | =====     |
| SUPPLEMENTAL DISCLOSURE OF CASH |           |           |
| FLOW INFORMATION                |           |           |
| Cash paid during period for:    |           |           |
| Interest                        | \$ 10,890 | \$ 8,233  |
| Income Taxes                    | 1,065     | 556       |

See Accompanying Notes to Consolidated Financial Statements

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FIRST KEYSTONE CORPORATION  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
September 30, 2006  
(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, The First National Bank of Berwick (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

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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 10 full service offices and 12 ATMs located in Columbia, Luzerne and Montour 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 differ from those estimates.

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### 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) (See Note 6). Management's decision to sell Available for Sale securities is based on changes in economic

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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.

### 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 method. 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. 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, depending on the type of loan. 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.

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.

A principal factor in estimating the allowance for loan losses is the measurement of 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 effective interest rate of the loan or the fair value of the collateral for certain collateral dependent loans.

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.

#### DERIVATIVES

The Bank has outstanding loan commitments that relate to the origination of mortgage loans that will be held for resale. Pursuant to Statement of Financial Accounting Standards (SFAS) No. 133, "Accounting for Derivative Instruments and Hedging Activities" as amended by SFAS No. 138, "Accounting for Certain Derivative Instruments and Certain Hedging Activities" and the guidance contained within the Derivatives Implementation Group Statement 133 Implementation Issue No. C 13, the Bank has accounted for such loan commitments as derivative instruments. The outstanding loan commitments in this category did not give rise to any losses for the nine-month period ended September 30, 2006 and the year ended December 31, 2005, as the fair market value of each outstanding loan commitment exceeded the Bank's cost basis in each outstanding loan commitment.

#### PREMISES AND EQUIPMENT

Premises, improvements and equipment are stated at cost less accumulated depreciation computed principally on 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.

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### 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 REAL ESTATE

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 the real estate is carried at the lower of carrying amount or fair value less cost to sell and is included in other assets. 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.

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### 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 Emerging Issues Task Force (EITF) 94-1, "Accounting for Tax Benefits Resulting from Investments in Affordable Housing Projects". 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 \$128,000 in 2006 and \$128,000 in 2005. The amortization of the investments in the limited partnerships were \$75,000 and \$72,000 for the nine months ended September 30, 2006 and 2005, respectively. The carrying value of the investments as of September 30, 2006 and December 31, 2005, was \$620,000 and \$695,000, respectively, and is carried in other assets in the accompanying consolidated balance sheets.

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### 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.

### GOODWILL, OTHER INTANGIBLE ASSETS, AND PREMIUM DISCOUNT

Goodwill resulted from the acquisition 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 date of acquisition. The Corporation accounts for goodwill pursuant to the Statement of Financial Accounting Standards (SFAS) No. 142, "Goodwill and Intangible Assets". SFAS No. 142 includes requirements to test goodwill for impairments rather than to amortize goodwill. The Corporation has tested the goodwill included in its consolidated balance sheet at December 31, 2005, and has determined there was no impairment as of that date.

Intangible assets are comprised of core deposit intangibles and premium discount (negative premium) on acquired certificates of deposit acquired in January 2004 when the Bank assumed deposit accounts of the branch of another financial institution. 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 which were part of the deposit accounts assumed of the branch by another financial institution. 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.

### STOCK BASED COMPENSATION

The Corporation had accounted for stock options and shares issued under the Stock Option Incentive Plan through December 31, 2002 in accordance with Accounting Principles Board Opinion (APB) No. 25, "Accounting for Stock Issued to Employees". Under this method no compensation expense is recognized for stock options when the exercise price equals the fair value of the options at the grant date. Under provisions of Statement of Financial Accounting Standards (SFAS) No. 123, "Accounting for Stock Based Compensation",

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the fair value of a stock option is required to be recognized as compensation expense over the service period (generally the vesting period). As permitted under SFAS No. 123 the Corporation had elected to continue to account for its stock option plan in accordance with APB No. 25.

As of the first quarter 2003, the Corporation adopted Statement of Financial Accounting Standards (SFAS) No. 148, "Accounting for Stock Based Compensation - Transition and Disclosures - an amendment of FASB Statement No. 123". The Corporation elected to use the "prospective method" of accounting for stock options as allowed by the Standard. Accordingly, compensation expense for the nine month period ended September 30, 2006 in the amount of \$8,000 is attributed to the vested portion of stock options granted in 2005.

### PER SHARE DATA

Statement of Financial Accounting Standards (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.

### 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. 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.

### 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.

### RECENT ACCOUNTING PRONOUNCEMENTS

In November 2005, the Financial Accounting Standards Board (FASB) issued FASB Staff Position (FSP) 115 - "The Meaning of Other Than Temporary Impairment and Its Application to Certain Investments". This FSP provides additional guidance on when an investment in a debt or equity security should be considered impaired and when that impairment should be considered other than temporary and recognized as a loss in the consolidated statement of income. Specifically, this guidance clarifies that an investor should recognize an impairment loss no later than when an impairment is deemed other than temporary, even if the decision to sell has not been made. The FSP also requires certain disclosures about unrealized losses that have not been recognized as other than temporary impairments. The Corporation has followed the guidance of this FSP in 2005 and 2006.

In May 2005, the FASB issued Statement of Financial Accounting Standards ("SFAS") No. 154, "Accounting Charges and Error Corrections", which modifies the accounting for and reporting of a change in an accounting principle. This statement applies to all voluntary changes in accounting principles and changes required by an accounting pronouncement in the unusual instance that the pronouncement does not include specified transition provisions. This statement also requires retrospective application to prior period financial statements of changes in accounting principles, unless it is impractical to determine either the period specific or cumulative effects of the accounting change. SFAS No. 154 is effective for accounting changes made in fiscal years beginning after December 15, 2005. The adoption of SFAS No. 154 is not expected to have a material impact on the Corporation's consolidated financial condition or results of operations.

In December 2004, the FASB issued Statement of Financial Accounting Standards ("SFAS") No. 153, "Exchanges of Nonmonetary Assets", which amends APB Opinion No. 29, "Accounting for Nonmonetary Transactions". SFAS No. 153 eliminates the exception from fair value measurement for nonmonetary exchanges of similar productive assets in Opinion No. 29 and replaces it with an exception for exchanges that do not have commercial substance. SFAS No. 153 specifies that a nonmonetary exchange has commercial substance if the future cash flows of the entity are expected to change significantly as a result of the exchange. SFAS No. 153 is effective for nonmonetary exchanges occurring in fiscal periods beginning after June 15, 2005. The adoption of SFAS No. 153 is not expected to have a material impact on the Corporation's consolidated financial condition or results of operations.

In December 2004, the FASB issued Statement of Financial Accounting Standards ("SFAS") No. 123 (revised 2004), "Share Based Payment". This Statement is a revision of SFAS No. 123, "Accounting for Stock Based Compensation", and supercedes APB Opinion No. 25, "Accounting for Stock Issued to Employees", and its related guidance. SFAS No. 123 (revised 2004) established standards for the accounting for transactions in which an entity exchanges its equity instruments for goods and services. This Statement requires that the cost resulting from all share based payment transactions be recognized in the financial statements. This Statement establishes fair value as the measurement objective in accounting for share based payment arrangements and requires all entities to apply a fair value based measurement method in accounting for share based payment transactions with employees, except for equity instruments held by employee share ownership plans.

In addition, this statement amends SFAS No. 95 "Statement of Cash Flows" to require that excess tax benefits be reported as financing cash inflow rather than as a reduction of taxes paid. The Corporation has adopted these statements as of January 1, 2006.

In January 2003, the Corporation adopted the provisions of SFAS No. 123 and began recognizing the compensation expense ratably in the consolidated statement of income, based on the estimated fair value of all awards granted after that date. SFAS No. 123R will

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require the Corporation to change its method of accounting for share based awards to include estimated forfeitures in the initial estimate of compensation expense and to accelerate the recognition of compensation expense for retiree eligible employees. The adoption of these standards is not expected to have a material effect on the Corporation's consolidated financial condition or results of operations.

### 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 month period ended September 30, 2006 and 2005 was approximately \$193,000 and \$173,000, respectively.

### RECLASSIFICATIONS

Certain amounts in the consolidated financial statements of prior periods have been reclassified to conform with presentation used in the 2006 consolidated financial statements. Such reclassifications have no effect on the Corporation's consolidated financial condition or net income.

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### Note 2. ALLOWANCE FOR LOAN LOSSES

Changes in the allowance for loan losses for the periods ended September 30, 2006, and September 30, 2005, were as follows:

| (amounts in thousands)          | 2006    | 2005    |       |
|---------------------------------|---------|---------|-------|
|                                 | _____   | _____   |       |
| Balance, January 1              | \$3,676 | \$3,828 |       |
| Provision charged to operations | 460     | 500     |       |
| Loans charged off               | (492)   | (678)   |       |
| Recoveries                      | 38      | 27      |       |
| Balance, September 30           | \$3,622 | \$3,677 | _____ |
|                                 |         | =====   | ===== |

At September 30, 2006, the total recorded investment in loans that are considered to be impaired as defined by SFAS No. 114 was \$2,088,000. These impaired loans had a related allowance for loan losses of \$143,000. No additional charge to operations was required to provide for the impaired loans since the total allowance for loan losses is estimated by management to be adequate to provide for the loan loss allowance required by SFAS No. 114 along with any other potential losses.

At September 30, 2006, there were no significant commitments to

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lend additional funds with respect to non accrual and restructured loans.

Non accrual loans at September 30, 2006 and December 31, 2005 were \$2,088,000 and \$1,734,000, respectively, all of which were considered impaired.

Loans past due 90 days or more and still accruing interest amounted to \$393,00 and \$64,000 on September 30, 2006 and December 31, 2005, respectively.

### Note 3. 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 4. LONG-TERM BORROWINGS

Long term borrowings are comprised of advances from the Federal Home Loan Bank. 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 5. 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.

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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, 2006, and December

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31, 2005, were as follows:

(amounts in thousands)

|   | September 30,<br>2006 | December 31,<br>2005 |
|---|-----------------------|----------------------|
|   | ———                   | ———                  |
| Financial instruments whose contract amounts represent credit risk: |                       |                      |
| Commitments to extend credit  | \$33,280              | \$29,228             |
| Financial standby letters of credit                                 | 1,170                 | 1,151                |
| Performance standby letters of credit                               | 2,355                 | 1,170                |

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, and Montour, Pennsylvania. It is management's opinion that the loan portfolio was well balanced and diversified at September 30, 2006, 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.

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### Note 6. STOCKHOLDERS' EQUITY

Changes in Stockholders' Equity for the period ended September

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30, 2006, were are follows:

(Amounts in thousands, except common share data)

|   | Common<br>Shares          | Common<br>Stock       | Surplus                |
|---|---------------------------|-----------------------|------------------------|
|   | <u>          </u>         | <u>          </u>     | <u>          </u>      |
| Balance at January 1, 2006  | 4,539,573                 | \$9,079               | \$12,387               |
| Comprehensive Income:   |                           |                       |                        |
| Net Income  |                           |                       |                        |
| Change in unrealized<br>gain (loss) on<br>investment securities<br>available-for-sale,<br>net of reclassification<br>adjustment and tax effects |                           |                       |                        |
| Total comprehensive<br>income (loss)  |                           |                       |                        |
| Purchase of 66,428<br>shares of treasury stock  |                           |                       |                        |
| Sale of 4,225 shares<br>treasury stock  |                           |                       | (73)                   |
| Recognition of stock option<br>expense in excess of<br>forfeitures  |                           |                       | 8                      |
| Cash dividends -<br>\$.66 per share   |                           |                       |                        |
| Balance at September 30, 2006   | <u>4,539,573</u><br>===== | <u>9,079</u><br>===== | <u>12,322</u><br>===== |

(Amounts in thousands, except common share data)

|   | Compre-<br>hensive<br>Income | Retained<br>Earnings | Accumulated<br>Other<br>Comprehensive<br>Income (Loss) |
|---|------------------------------|----------------------|--|
|   | <u>          </u>            | <u>          </u>    | <u>          </u>                                      |
| Balance at January 1, 2006  |                              | \$35,714             | \$ 807   |
| Comprehensive Income:   |                              |                      |  |
| Net Income  | \$4,528                      | 4,528                |  |
| Change in unrealized<br>gain (loss) on<br>investment securities<br>available-for-sale,<br>net of reclassification<br>adjustment and tax effects | (436)                        |                      | (436)  |
| Total comprehensive<br>income (loss)  | <u>\$4,092</u><br>=====      |                      |  |

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|  |                          |                        |
|--|--------------------------|------------------------|
| Purchase of 66,428<br>shares of treasury stock                     |                          |                        |
| Sale of 4,225 shares<br>treasury stock                             |                          |                        |
| Recognition of stock option<br>expense in excess of<br>forfeitures |                          |                        |
| Cash dividends -<br>\$.66 per share                                | (2,877)                  |                        |
| Balance at September 30, 2006                                      | <u>\$37,365</u><br>===== | <u>\$ 371</u><br>===== |

(Amounts in thousands, except common share data)

|   | Treasury<br>Stock         | Total                    |
|---|---------------------------|--------------------------|
|   | -----                     | -----                    |
| Balance at January 1, 2006  | \$(4,544)                 | \$53,443                 |
| Comprehensive Income:   |                           |                          |
| Net Income  |                           | 4,528                    |
| Change in unrealized<br>gain (loss) on<br>investment securities<br>available-for-sale,<br>net of reclassification<br>adjustment and tax effects |                           | (436)                    |
| Total comprehensive<br>income (loss)  |                           |                          |
| Purchase of 66,428<br>shares of treasury stock  | (1,255)                   | (1,255)                  |
| Sale of 4,225 shares<br>treasury stock  | 142                       | 69                       |
| Recognition of stock option<br>expense in excess of<br>forfeitures  |                           | 8                        |
| Cash dividends -<br><br>\$.66 per share   |                           | (2,877)                  |
| Balance at September 30, 2006   | <u>\$(5,657)</u><br>===== | <u>\$53,480</u><br>===== |

On October 24, 2006 the Corporation declared a 5% stock dividend to shareholders of record on November 14, 2006, payable on December 5, 2006.

NOTE 7. 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

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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 accountants, 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, 2006, 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 generally accepted accounting principles 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, 2005, filed with the Securities and Exchange Commission.

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### 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, 2006, and the related consolidated statements of income for the three and nine-month periods ended September 30, 2006 and 2005 and the consolidated statements of cash flows for the nine month periods ended September 30, 2006 and 2005. 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.

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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, 2005, 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 January 20, 2006, 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, 2005, 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  
October 19, 2006

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### Item 2. First Keystone Corporation Management's Discussion and Analysis of Financial Condition and Results of Operation as of September 30, 2006

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 2006 of \$1,503,000, a decrease of \$301,000 or 16.7% from the third quarter of 2005. Nine months net income for the period ended September 30, 2006, amounted to \$4,528,000, a decrease of 13.9% from the \$5,256,000 net income reported September 30, 2005. Net interest income declined in both the third quarter of 2006 and for the first nine months of 2006. The lower net interest income was due to a flatten yield curve and continued compression in our net interest margin. The reduced net interest income was partially

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offset by a lower loan loss provision, increased non interest income, and continued excellent control over non interest expense. On a per share basis, net income per share was \$1.04 for the nine months of 2006, as compared to \$1.20 for the first nine months of 2005, while dividends increased to \$.66 per share up from \$.60 in 2005, or an increase of 10.0%.

Year to date net income annualized amounts to a return on average common equity of 11.54% and a return on assets of 1.16%. For the nine months ended September 30, 2005, these measures were 12.95% and 1.39%, 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 2006, interest income amounted to \$7,236,000, an increase of \$599,000 or 9.0% from the third quarter of 2005. Interest expense amounted to \$3,910,000 in the third quarter of 2006, an increase of \$929,000 or 31.2% over the third quarter of 2005. Accordingly, net interest income amounted to \$3,326,000 in the third quarter of 2006, a decrease of \$330,000, or 9.0% from the third quarter of 2005. Year to date for the nine months ended September 30, 2006, total interest income increased \$1,576,000, or 8.1% to \$21,145,000 from \$19,569,000 in the first nine months of 2005. Total interest expense increased \$2,486,000, or 29.6% to \$10,879,000 for the first nine months of 2006 from \$8,393,000 in the first nine months of 2005. This resulted in net interest income decreasing \$910,000 to \$10,266,000 as of September 30, 2006 from \$11,176,000 as of September 30, 2005.

Our net interest margin for the quarter ended September 30, 2006, was 3.08% compared to 3.46% for the quarter ended September 30, 2005. For the nine months ended September 30, 2006, our net interest margin was 3.17% compared to 3.49% for the first nine months of 2005.

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### PROVISION FOR LOAN LOSSES

The provision for loan losses for the quarter ended September 30, 2006, was \$100,000 compared to \$150,000 for the third quarter of 2005. Year to date, the provision for loan losses amounts to \$400,000 in 2006 as compared to the \$500,000 provision for the period ended September 30, 2005. Net charge offs amounted to \$454,000 for the nine months ended September 30, 2006, as compared to \$651,000 for the first nine months of 2005.

The allowance for loan losses as a percentage of loans, net of unearned interest was 1.44% as of September 30, 2006, and 1.57% as of December 31, 2005.

### NON-INTEREST INCOME

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Total non interest or other income was \$952,000 for the quarter ended September 30, 2006, as compared to \$915,000 for the quarter ended September 30, 2005. Excluding investment security gains and losses, non interest income was \$878,000 for the third quarter of 2006, as compared to \$826,000 in the third quarter of 2005, an increase of 6.3%. For the nine months ended September 30, 2006, total non interest income was \$2,720,000, as compared to \$2,634,000, or a 3.3% increase from the first nine months of 2005. In both the third quarter of 2006 and for the nine months ended September 30, 2006, the increase in non interest income was primarily the result of an increase in trust department revenue, an increase in bank owned life insurance income, and an increase in other non interest income.

### NON-INTEREST EXPENSES

Total non interest, or other expenses, was \$2,380,000 for the quarter ended September 30, 2006, as compared to \$2,245,000 for the quarter ended September 30, 2005, an increase of \$135,000 or 6.0%.

For the nine months ended September 30, 2006, total non interest expense was \$7,235,000, an increase of \$270,000, or 3.9% over the first nine months of 2005. Expenses associated with employees (salaries and employee benefits) continue to be the largest category of non interest expenses. Salaries and benefits amount to 54.7% of total non interest expense for the nine months ended September 30, 2006, as compared to 52.7% for the first nine months of 2005. Salaries and benefits amounted to \$3,955,000 for the nine months ended September 30, 2006, an increase of \$286,000, or 7.8% over the first nine months of 2005. Net occupancy expense, along with furniture and equipment expense, increased for the nine months ended September 30, 2006, from 2005. Professional services expense declined slightly in 2006. Other non interest expense decreased moderately in 2006 and state shares tax has increased slightly. Our overall non interest expense continues at less than 2% of average assets on an annualized basis. This places us among the leaders of our peer financial institutions at controlling non interest expense.

### INCOME TAXES

Effective tax planning has helped produce favorable net income. The effective total income tax rate was 16.4% for the third quarter of 2006 as compared to 17.1% for the third quarter of 2005. For the nine months ended September 30, 2006, our tax liability amounted to \$823,000 for an effective tax rate of 15.4% as compared to an effective tax rate of 17.2% for the first nine months of 2005. The decrease in our effective tax rate was due primarily to the tax savings derived from our investment in bank owned life insurance and additional investment in municipal securities.

### ANALYSIS OF FINANCIAL CONDITION

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### ASSETS

Total assets increased to \$521,665,000 as of September 30, 2006, an increase of \$9,266,000, or 1.8% over year end 2005. Total deposits increased to \$386,370,000 as of September 30, 2006, an increase of \$23,574,000, or 6.5% over year end 2005.

The Corporation used the increase in total deposits to fund primarily an increase in loans and reduced borrowings. Borrowings decreased \$14,640,000 from December 31, 2005. Short term borrowings decreased to \$18,511,000 as of September 30, 2006, down \$9,640,000 from year end 2005. Long term borrowings decreased to \$60,535,000 as of September 30, 2006, down \$5,000,000 from year end 2005.

### EARNING ASSETS

Our primary earning asset, loans, net of unearned income increased to \$251,257,000 as of September 30, 2006, an increase of \$16,664,000, or 7.1% from year end 2005. The loan portfolio is well diversified and the increases in the portfolio has been primarily from increased originations of commercial real estate loans.

In addition to loans, another primary earning asset is our investment portfolio which has decreased in size from December 31, 2005, to September 30, 2006. Available for sale securities amounted to \$236,428,000 as of September 30, 2006, a decrease of \$10,860,000, or 4.4% from year end 2005. However, held to maturity securities increased to \$6,932,000 as of September 30, 2006, an increase of \$2,684,000, or 63.2% since year end 2005. Interest bearing deposits with banks increased to \$83,000 on September 30, 2006, as compared to \$58,000 as of December 31, 2005.

### ALLOWANCE FOR LOAN LOSSES

Management performs a quarterly analysis to determine the adequacy of the allowance for loan losses. The methodology in determining adequacy incorporates specific allocations together with a risk/loss analysis on various segments of the portfolio according to an internal loan review process. Management maintains its loan review and loan classification standards consistent with those of its regulatory supervisory authority. Management feels, considering the conservative portfolio composition, which is largely composed of small retail loans (mortgages and installments) with minimal classified assets, low delinquencies, and favorable loss history, that the allowance for loan loss is adequate to cover foreseeable future losses.

Any loans classified for regulatory purposes as loss, doubtful, substandard, or special mention that have not been disclosed under Industry Guide 3 do not (i) represent or result from trends or uncertainties which management reasonably expects will materially impact future operating results, liquidity, or capital resources, or (ii) represent material credits about which management is aware of any information which causes management to have serious doubts as to the ability of such borrowers to comply with the loan repayment terms.

The company was required to adopt Financial Accounting Standards Board Statement No. 114, "Accounting by Creditors for Impairment of a Loan" - Refer to Note 5 above for details.

#### NON-PERFORMING ASSETS

Non performing assets consist of non accrual and restructured loans, other real estate and foreclosed assets, together with the loans past due 90 days or more and still accruing. As of September 30, 2006, total non performing assets were \$2,675,000 as compared to \$2,530,000 on December 31, 2005. Non performing assets to total loans and foreclosed assets was 1.07% as of September 30, 2006, and 1.08% as of December 31, 2005.

Interest income received on non performing loans as of September 30, 2006, was \$8,000 compared to \$57,000 as of December 31, 2005. Interest income, which would have been recorded on these loans under the original terms as of September 30, 2006, and December 31, 2005, was \$130,000 and \$149,000, respectively. As of September 30, 2006 and December 31, 2005, there was no outstanding commitments to advance additional funds with respect to these non performing loans.

#### DEPOSITS AND OTHER BORROWED FUNDS

As indicated previously, total deposits increased by \$23,574,000 as non interest bearing deposits decreased by \$820,000 and interest bearing deposits increased by \$24,394,000 as of September 30, 2006, from year end 2005. Total short term and long term borrowings decreased by \$14,640,000 from year end 2005.

#### CAPITAL STRENGTH

Normal increases in capital are generated by net income, less cash dividends paid out. Also, accumulated other comprehensive income derived from unrealized gains on investment securities available for sale increased shareholders' equity, or capital net of taxes, by \$371,000 as of September 30, 2006, and \$807,000 as of December 31, 2005. Our stock repurchase plan repurchased 215,827 shares as treasury stock as of September 30, 2006 and 153,624 shares as treasury stock as of December 31, 2005. This had an effect of our reducing our total stockholders' equity by \$5,657,000 on September 30, 2006, and \$4,544,000 as of December 31, 2005.

Total stockholders' equity was \$53,480,000 as of September 30, 2006, and \$53,443,000 as of December 31, 2005. Leverage ratio and risk based capital ratios remain very strong. As of September 30, 2006, our leverage ratio was 10.00% compared to 10.04% as of December 31, 2005. In addition, Tier I risk based capital and total risk based capital ratio as of September 30, 2006, were 17.48% and 18.83%, respectively. The same ratios as of December 31, 2005, were 17.74% and 19.16%, respectively.

#### LIQUIDITY

The liquidity position of the Corporation remains adequate to

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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 satisfactorily given a very stable core deposit base which has 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.

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### 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, 2005. The composition of rate sensitive assets and rate sensitive liabilities as of September 30, 2006 is very similar to December 31, 2005.

### ITEM 4. Controls and Procedures

a) Evaluation of disclosure controls and procedures. The company maintains controls and procedures designed to ensure that information required to be disclosed in the reports that the company 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 controls and procedures performed within 90 days of the filing date of this report, the chief executive and chief financial officers of the company concluded that the company's disclosure controls and procedures were adequate.

b) Changes in internal controls. The Company made no significant changes in its internal controls or in other factors that could significantly affect these controls subsequent to the date of the evaluation of the controls by the Chief Executive and Chief Financial officers.

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## PART II - OTHER INFORMATION

### Item 1. Legal Proceedings

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None.

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

| Period                                 | Total<br>Number<br>of Shares<br>Purchased | Average<br>Price Paid<br>per Share | Total<br>Number<br>of Shares<br>Purchased<br>as Part of<br>Publicly<br>Announced<br>Plans or<br>Programs | Maximum<br>Number of<br>Shares That<br>May Yet Be<br>Purchased<br>Under the<br>Plans or<br>Programs |
|--|---|------------------------------------|--|---|
| July 1 -<br>July 31,<br>2006           |   | --                                 | --   | --<br><br>67,001  |
| August 1 -<br>August 31,<br>2006       |   | 45,000                             | 18.50  | 45,000<br><br>22,001  |
| September 1 -<br>September 30,<br>2006 |   | --                                 | --   | --<br><br>22,001  |
| Total                                  | 45,000                                    | 18.50                              | 45,000   | 22,001  |

Item 3. Defaults Upon Senior Securities

None.

Item 4. Submission of Matters to a Vote of Security Holders

Annual Meeting of Shareholders of First Keystone Corporation held on Tuesday, April 18, 2006 at 10:00 a.m.

| Directors Elected         | Votes For | Votes<br>Against | Votes<br>Withheld |
|---------------------------|-----------|------------------|-------------------|
| Budd L. Beyer             | 3,086,287 | 42,145           | 0                 |
| Frederick E. Crispin, Jr. | 3,087,349 | 41,073           | 0                 |
| Jerome F. Fabian          | 3,088,009 | 40,413           | 0                 |
| Robert J. Wise            | 3,011,164 | 117,258          | 0                 |

Broker

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| <u>Directors Elected</u>  | <u>Abstentions</u> | <u>Non-Votes</u> |
|---------------------------|--------------------|------------------|
| Budd L. Beyer             | 0                  | 0                |
| Frederick E. Crispin, Jr. | 0                  | 0                |
| Jerome F. Fabian          | 0                  | 0                |
| Robert J. Wise            | 0                  | 0                |

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Directors Continuing:

John E. Arndt, term expires in 2007  
J. Gerald Bazewicz, term expires in 2007  
Robert E. Bull, term expires in 2007  
Don E. Bower, term expires in 2008  
John L. Coates, term expires in 2008  
Dudley P. Cooley, term expires in 2008

Matters Voted Upon:

Selection of J. H. Williams & Co. LLP, as auditors for the Corporation.

Votes For - 3,126,328  
Votes Against - 2,034  
Votes Withheld - 0  
Abstentions - 60  
Broker Non-Votes - 0

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.

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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 |

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(Incorporated by reference to Exhibit 3(i) to the Registrant's Report on Form 10Q 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 10Q for the quarter ended March 31, 2006).
- 10.1 Supplemental Employee Retirement Plan  
(Incorporated by reference to Exhibit 10 to Registrant's Report on Form 10Q for the quarter ended September 30, 2005).
- 10.2 Management Incentive Compensation Plan
- 10.3 Profit Sharing Plan
- 10.4 First Keystone Corporation 1998 Stock Incentive Plan
- 14 Code of Ethics (Incorporated by reference to Exhibit 14 to the Registrant's Annual Report on 10K for the year ended December 31, 2003).
- 31.1 Rule 13a-14(a)/15d-14(a) Certification of Chief Executive Officer.
- 31.2 Rule 13a-14(a)/15d-14(a) Certification of Chief Financial Officer.
- 32.1 Section 1350 Certification of Chief Executive Officer.
- 32.2 Section 1350 Certification of Chief Financial Officer.

(b) During the quarter ended September 30, 2006, the registrant filed the following reports on Form 8-K:

| <u>Date of Report</u> | <u>Item</u> | <u>Description</u>  |
|-----------------------|-------------|---|
| July 28, 2006         | 5           | On July 27, 2006, the Registrant issued a press release announcing its earnings for the quarter ended September 30, 2006. |
| August 30, 2006       | 5           | On August 28, 2006, the Registrant issued a press release announcing the declaration of it's third quarter dividend.      |

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### SIGNATURES

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

FIRST KEYSTONE CORPORATION  
Registrant

November 7, 2006                    /s/ J. Gerald Bazewicz  
J. Gerald Bazewicz  
President and  
Chief Executive Officer  
(Principal Executive Officer)

November 7, 2006                    /s/ Diane C.A. Rosler  
Diane C.A. Rosler  
Principal Financial Officer  
(Principal Accounting Officer)

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### INDEX TO EXHIBITS

| <u>Exhibit</u> | <u>Description</u>   |
|----------------|--|
| 3i             | Articles of Incorporation, as amended (Incorporated by reference to Exhibit 3(i) to the Registrant's Report on Form 10Q for the quarter ended March 31, 2006). |
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