

FIRST KEYSTONE CORP  
Form 10-Q  
May 10, 2012

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 March 31, 2012

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 23-2249083  
(State or other jurisdiction of (I.R.S. Employer

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incorporation or organization) identification No.)

111 West Front Street, Berwick, PA 18603  
(Address of principal executive offices) (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 has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

Yes  No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See 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

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, 5,446,037 shares as of May 4, 2012.

## PART I - FINANCIAL INFORMATION

## Item 1. Financial Statements

## FIRST KEYSTONE CORPORATION AND SUBSIDIARY

## CONSOLIDATED BALANCE SHEETS

(Amounts in thousands)	March 31, 2012 (Unaudited)	December 31, 2011
<b>ASSETS</b>		
Cash and due from banks	\$ 6,964	\$ 8,403
Interest-bearing deposits in other banks	3,958	1,776
Total cash and cash equivalents	10,922	10,179
Investment securities available-for-sale	327,456	328,824
Investment securities held-to-maturity (estimated fair value of \$2,656 in 2012 and \$2,666 in 2011)	2,598	2,605
Restricted securities at cost - available-for-sale	4,931	5,189
Loans, net of unearned income	420,187	415,995
Allowance for loan losses	(5,964 )	(5,929 )
Net loans	414,223	410,066
Premises and equipment, net	14,311	12,725
Accrued interest receivable	4,467	4,375
Cash surrender value of bank owned life insurance	19,329	19,145
Investment in limited partnerships	1,430	1,484
Goodwill	19,133	19,133
Core deposit intangible	880	951
Prepaid FDIC insurance	1,314	1,427
Foreclosed assets held for resale	780	780
Deferred income taxes	14	30
Other assets	1,905	1,633
<b>TOTAL ASSETS</b>	<b>\$ 823,693</b>	<b>\$ 818,546</b>
<b>LIABILITIES</b>		
Deposits:		
Non-interest bearing	\$ 84,131	\$ 75,489
Interest bearing	554,674	548,860
Total Deposits	638,805	624,349
Short-term borrowings	18,586	30,882
Long-term borrowings	64,323	64,339
Accrued interest and other expenses	3,175	2,857

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Deferred income taxes	2,852	2,350
Other liabilities	334	677
<b>TOTAL LIABILITIES</b>	<b>\$ 728,075</b>	<b>\$ 725,454</b>
<b>STOCKHOLDERS' EQUITY</b>		
Common stock, par value \$2.00 per share; authorized 10,000,000 shares; issued 5,687,767 in 2012 and 2011	\$ 11,375	\$ 11,375
Surplus	30,142	30,157
Retained earnings	51,167	49,872
Accumulated other comprehensive income	8,976	7,757
Treasury stock, at cost, 241,730 shares in 2012 and 242,517 shares in 2011	(6,042 )	(6,069 )
<b>TOTAL STOCKHOLDERS' EQUITY</b>	<b>95,618</b>	<b>93,092</b>
<b>TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY</b>	<b>\$ 823,693</b>	<b>\$ 818,546</b>

See accompanying notes to consolidated financial statements.

## FIRST KEYSTONE CORPORATION AND SUBSIDIARY

## CONSOLIDATED STATEMENTS OF INCOME

FOR THE THREE MONTHS ENDED MARCH 31, 2012 AND 2011

(Unaudited)

*(Amounts in thousands, except per share data)*

	2012	2011
<b>INTEREST INCOME</b>		
Interest and fees on loans	\$5,671	\$5,845
Interest and dividend income on investment securities	3,256	3,500
Deposits in banks	0	2
Total interest income	\$8,927	\$9,347
<b>INTEREST EXPENSE</b>		
Deposits	\$1,305	\$1,839
Short-term borrowings	29	50
Long-term borrowings	573	627
Total interest expense	\$1,907	\$2,516
Net interest income	\$7,020	\$6,831
Provision for loan losses	400	300
Net interest income after provision for loan losses	\$6,620	\$6,531
<b>NON-INTEREST INCOME</b>		
Trust department	\$190	\$140
Service charges and fees	286	316
Bank owned life insurance income	183	190
ATM fees and debit card income	243	210
Gain on sale of mortgage loans	160	40
Investment securities gains (losses) - net	30	(75 )
Other	112	142
Total non-interest income	\$1,204	\$963
<b>NON-INTEREST EXPENSE</b>		
Salaries and employee benefits	\$2,622	\$2,283
Occupancy, net	345	354
Furniture and equipment	111	100
Computer expense	252	234
Professional services	170	153
State shares tax	180	183

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FDIC insurance	126	245
ATM and debit card fees	110	144
Other	669	608
Total non-interest expense	\$4,585	\$4,304
Income before income taxes expense	\$3,239	\$3,190
Income tax expense	583	694
NET INCOME	\$2,656	\$2,496

PER SHARE DATA

Net Income Per Share:

Basic	\$.49	\$.46
Diluted	.49	.46
Cash dividends per share	.25	.24

See accompanying notes to consolidated financial statements.

## FIRST KEYSTONE CORPORATION AND SUBSIDIARY

## CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY

(Unaudited)

(Amounts in thousands, except per share data)

	Common		Comprehensive Income	Retained Earnings	Accumulated		Total
	Stock	Surplus			Other Comprehensive Income (Loss)	Treasury Stock	
Balance at December 31, 2010	\$ 11,375	\$ 30,175		\$ 45,246	\$ (1,633 )	\$ (6,103 )	\$ 79,060
Comprehensive Income:							
Net Income			\$ 2,496	2,496			2,496
Change in net unrealized gains (losses) on investment securities available-for- sale, net of reclassification adjustment and tax effects			(1,054 )		(1,054 )		(1,054 )
Total comprehensive income			\$ 1,442				
Issuance of 65 shares treasury stock upon exercise of employee stock options		(2 )				2	
Cash dividends - \$.24 per share				(1,307 )			(1,307 )
Balance at March 31, 2011	\$ 11,375	\$ 30,173		\$ 46,435	\$ (2,687 )	\$ (6,101 )	\$ (79,195)
Balance at December 31, 2011	\$ 11,375	\$ 30,157		\$ 49,872	\$ 7,757	\$ (6,069 )	\$ 93,092
Comprehensive Income:							
Net Income			\$ 2,656	2,656			2,656
Change in net unrealized gains (losses) on investment securities available-for- sale, net of reclassification adjustment and tax effects			1,219		1,219		1,219
Total comprehensive income			\$ 3,875				
Issuance of 787 shares treasury stock upon exercise of employee stock options		(15 )				27	12
Cash dividends - \$.25 per share	(1,361 )			(1,361 )			
Balance at March 31, 2012	\$ 11,375	\$ 30,142		\$ 51,167	\$ 8,976	\$ (6,042 )	\$ 95,618

## CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(Unaudited)

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(Amounts in thousands)	Three Months Ended	
	March 31, 2012	March 31, 2011
Net Income	\$ 2,656	\$ 2,496
Other comprehensive income (losses):		
Unrealized holding gains (losses) on available-for-sale investment securities arising during the period	1,893	(1,669 )
Less reclassification adjustment for net gains (losses) realized in income	30	(75 )
Change in unrealized gains (losses) before tax effect	1,863	(1,594 )
Tax effects	(644 )	(540 )
Net change in unrealized gains (losses)	1,219	(1,054 )
Comprehensive Income	\$ 3,875	\$ 1,442

See accompanying notes to consolidated financial statements.



## FIRST KEYSTONE CORPORATION AND SUBSIDIARY

## CONSOLIDATED STATEMENTS OF CASH FLOWS

FOR THE THREE MONTHS ENDED March 31, 2012 AND 2011

(Unaudited)

(Amounts in thousands)	2012	2011
<b>OPERATING ACTIVITIES</b>		
Net income	\$2,656	\$2,496
Adjustments to reconcile net income to net cash provided by operating activities:		
Provision for loan losses	400	300
Depreciation and amortization	275	228
Premium amortization on investment securities	323	278
Discount accretion on investment securities	(231 )	(294 )
Core deposit discount amortization net of accretion	71	72
Deferred income tax (benefit) provision	(116 )	40
(Gain) loss on sale of mortgage loans originated for resale	(159 )	(40 )
Proceeds from sale of mortgage loans originated for resale	5,092	4,697
Originations of mortgage loans originated for resale	(6,726 )	(4,252 )
(Gain) loss on sales of investment securities	(30 )	75
(Gain) loss on sale of foreclosed real estate held for resale	(12 )	0
(Increase) decrease in accrued interest receivable	(92 )	311
(Increase) decrease in cash surrender value of bank owned life insurance	(184 )	(190 )
(Increase) decrease in other assets – net	(272 )	(691 )
Decrease (increase) in prepaid FDIC insurance	113	206
Increase (decrease) in accrued interest and other expenses	318	282
(Decrease) increase in other liabilities	(343 )	(101 )
<b>NET CASH PROVIDED BY OPERATING ACTIVITIES</b>	<b>\$1,083</b>	<b>\$3,417</b>
<b>INVESTING ACTIVITIES</b>		
Proceeds from sales of investment securities available-for-sale	8,711	44,129
Proceeds from maturities and redemptions of investment securities available-for-sale	8,559	7,467
Purchases of investment securities available-for-sale	(14,109)	(42,169)
Proceeds from maturities and redemption of investment securities held-to-maturity	5	39
Proceeds from the redemption of restricted securities	258	317
Net (increase) decrease in loans	(2,791 )	(1,193 )
Purchases of premises and equipment	(1,829 )	(389 )
Proceeds from sale of foreclosed assets held for resale	61	0
<b>NET CASH (USED IN) PROVIDED BY INVESTING ACTIVITIES</b>	<b>\$(1,135 )</b>	<b>\$8,201</b>
<b>FINANCING ACTIVITIES</b>		
Net increase (decrease) in deposits	\$14,456	\$(546 )
Net (decrease) increase in short-term borrowings	(12,296)	3,757

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Proceeds from long-term borrowings	0	5,000
Repayment of long-term borrowings	(16 )	(15 )
Proceeds from issuance of treasury stock	12	0
Cash dividends paid	(1,361 )	(1,307 )
NET CASH PROVIDED BY FINANCING ACTIVITIES	\$795	\$6,889
INCREASE IN CASH AND CASH EQUIVALENTS	743	18,507
CASH AND CASH EQUIVALENTS, BEGINNING	10,179	11,905
CASH AND CASH EQUIVALENTS, ENDING	\$10,922	\$30,412
SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION		
Cash paid during period for:		
Cash paid during period for interest	\$1,997	\$2,614
Income taxes paid	0	0

See accompanying notes to consolidated financial statements.

FIRST KEYSTONE CORPORATION AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

March 31, 2012

(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 accounting 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, government, and public and institutional customers primarily located in the Northeast Region of Pennsylvania. The Bank has 16 full service offices and 18 Automated Teller Machines (“ATM”) located in Columbia, Luzerne, Montour and Monroe counties. The Corporation and its subsidiary must also adhere to certain federal and state banking laws and regulations and are subject to periodic examinations made by various federal agencies.

**Segment Reporting**

The Corporation's subsidiary acts as an independent community financial services provider, and offers traditional banking and related financial services to individual, business, government, and public and institutional customers. Through its branch and ATM 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 the 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 goodwill and other intangible assets and foreclosed assets held for resale. 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. Investment securities are accounted for on a trade date basis. 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 classified as 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 accumulated other comprehensive income (loss) in the Consolidated Statements 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, are 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”) and Atlantic Central Bankers Bank (“ACBB”). These securities 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 or to another member institution. Therefore, these securities are classified as restricted equity investment securities, carried at cost, and evaluated for impairment. At March 31, 2012, the Corporation held \$4,896,000 in stock of FHLB-Pittsburgh and \$35,000 in stock of ACBB. At December 31, 2011, the Corporation held \$5,154,000 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 March 31, 2012 and December 31, 2011.

## **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 loans is recognized as income over the term of each loan, generally, by the accrual method. Loan origination fees and certain direct loan origination costs have been deferred with the net amount amortized using the straight line method or the interest method over the contractual life of the related loans as an interest yield adjustment.

Residential 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 past-due loans 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 collectability 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 interest income. 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 judgment as to collectability 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. This allowance is estimated by management and if deemed necessary, the allowance would be classified in other liabilities on the consolidated balance sheets. As of March 31, 2012 and December 31, 2011, an allowance for possible credit losses on off-balance sheet credit exposures was not recorded.

The allowance consists of specific and general components. The specific component relates to loans that are individually classified as impaired. 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 trouble 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 special mention, substandard and doubtful loans as a percentage of total loans, levels of loan concentration within the portfolio segment or division of a portfolio segment, broad economic conditions, delinquency trends, volume trends and terms, and policy and management changes.

### **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 consolidated balance sheets. 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 and is included in other

assets on the consolidated balance sheets. Revenues derived from and costs to maintain the assets and subsequent gains and losses on sales are included in non-interest income and expense on the consolidated statements of income. The total of foreclosed real estate properties amounted to \$780,000 at March 31, 2012 and December 31, 2011.

### **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 and mentally challenged adult 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 \$277,000 in 2012 and \$160,000 in 2011, and the amortization of the investments in the limited partnerships were \$53,000 in the first quarter of 2012 and \$29,000 in the first quarter of 2011.

## **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 ultimate realization 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 2008. At March 31, 2012 and December 31, 2011, 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 non-interest expense. At March 31, 2012 and December 31, 2011, 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. During the first quarter of 2008, \$152,000 of liabilities related to the Pocono acquisition were recorded as a purchase accounting adjustment resulting in an increase in the excess purchase price.

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, 2011, and has determined there was no impairment as of that date or as of March 31, 2012. 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, 2011 and has determined there was no impairment as of that date or as of March 31, 2012. No assurance can be given that future impairment tests will not result in a charge to earnings.

### **Stock Based Compensation**

The Corporation adopted a stock option incentive plan in 1998. 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 Option Pricing Model is utilized to estimate the fair value of stock options. Compensation expense is recognized over the requisite service period. The Plan expired in 2008, and therefore, no stock options are available for issuance. After adjustments for the effects of stock dividends, options exercised and options forfeited, there remains 19,250 exercisable options issued and outstanding as of March 31, 2012.

### **Per Share Data**

FASB ASC 260-10, *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 banks, 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.

### **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 first-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 (Loss)**

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

### **Accounting Policies Recently Adopted and Pending Accounting Pronouncements**

In May 2011, the FASB issued ASU 2011-04, *Fair Value Measurement: Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs*. The primary purpose of the ASU is to improve the comparability between U.S. GAAP fair value accounting and reporting requirements and International Financial Reporting Standards ("IFRS") fair value and reporting requirements. The ASU also requires additional disclosures about transfers between level 1 and 2 of the fair value hierarchy, quantitative information for level 3 inputs, and the level of the fair value measurement hierarchy for items that are not measured at fair value in the statement of financial position but for which the fair value is required to be disclosed. The ASU was effective for the interim and annual periods beginning after December 15, 2011. The adoption of the standard did not have a material impact on the Corporation's consolidated financial statements. See Notes 2 and 8 for further information.

In June 2011, the FASB issued ASU 2011-05, *Comprehensive Income: Presentation of Comprehensive Income*. The ASU requires presentation of the components of other comprehensive income (“OCI”) in either a continuous statement of comprehensive income or two separate but consecutive statements. The update does not change the items presented in OCI and does not affect the calculation or reporting of earnings per share (“EPS”). In December 2011, the FASB issued ASU 2011-12, *Comprehensive Income: Deferral of the Effective Date for Amendments to the Presentation of Reclassification of Items out of Accumulated Other Comprehensive Income in Accounting Standards update No. 2011-05*, which deferred the effective date for the amendments to the reclassification of items out of accumulated other comprehensive income (“AOCI”). The guidance was effective for fiscal years and interim periods within those years beginning after December 15, 2011, and must be applied retrospectively for all periods presented. Upon adoption of this standard, the Corporation presented total other comprehensive income and the components of other comprehensive income in a separate statement of comprehensive income.

In September 2011, the FASB issued ASU 2011-08, *Intangibles - Goodwill and Other: Testing Goodwill for Impairment*, to simplify the current two-step goodwill impairment test in FASB ASC Topic 350-20, *Intangibles – Goodwill and Other: Goodwill*. The update permits entities to first perform a qualitative assessment to determine whether or not it is more likely than not (a likelihood of more than 50 percent) that the fair value of a reporting unit is less than its carrying amount. If the entity determines that it is more likely than not that the fair value of a reporting unit is less than its carrying amount, it would then perform the first step of the goodwill impairment test; otherwise, no further impairment test would be required. The guidance was effective for annual and interim goodwill impairment tests performed for fiscal years beginning after December 15, 2011. The Corporation adopted the standard as of January 1, 2012 and will apply the new guidance to future goodwill impairment testing. The adoption of the standard did not have a material impact on the Corporation’s consolidated financial statements or its goodwill impairment evaluation.

In December 2011, the FASB issued ASU 2011-11, *Balance Sheet: Disclosures about Offsetting Assets and Liabilities*, to increase the disclosure requirements surrounding derivative instruments that are offset within the balance sheet pursuant to the provisions of current U.S. GAAP. The objective of the update is to provide greater comparability between issuers reporting under U.S. GAAP versus IFRS and provide users the ability to evaluate the effect of netting arrangements on a company’s financial statements. The ASU is effective for annual reporting periods beginning on or after January 1, 2013, and interim periods within those annual periods with retrospective disclosure for all comparative periods presented. The Corporation is evaluating the impact of the ASU; however, the Corporation does not anticipate this update will have a material impact on its 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 three months ended March 31, 2012 and 2011, was approximately \$80,000 and \$58,000, respectively.

**Reclassifications**

The Corporation reclassified certain immaterial amounts in the consolidated statements of income. 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 March 31, 2012 and December 31, 2011:

(Amounts in thousands)	Available-for-Sale Securities			Estimated Fair Value
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	
<i>March 31, 2012:</i>				
Obligations of U.S. Government Corporations and Agencies:				
Mortgage-backed	\$59,381	\$ 2,782	\$ (14 )	\$62,149
Other	16,369	111	(1 )	16,479
Obligations of state and political subdivisions	176,950	11,803	(1,377 )	187,376
Corporate securities	59,550	650	(647 )	59,553
Marketable equity securities	1,574	367	(42 )	1,899
Restricted equity securities	4,931	0	0	4,931
Total	\$318,755	\$ 15,713	\$ (2,081 )	\$332,387



(Amounts in thousands)	Held-to-Maturity Securities			Estimated Fair Value
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	
<i>March 31, 2012:</i>				
Obligations of U.S. Government Corporations and Agencies:				
Mortgage-backed	\$ 119	\$ 4	\$ 0	\$ 123
Other	2,012	42	0	2,054
Obligations of state and political subdivisions	467	12	0	479
Total	\$2,598	\$ 58	\$ 0	\$ 2,656

(Amounts in thousands)	Available-for-Sale Securities			Estimated Fair Value
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	
<i>December 31, 2011:</i>				
Obligations of U.S. Government Corporations and Agencies:				
Mortgage-backed	\$64,892	\$ 2,930	\$ (41 )	\$67,781
Other	13,187	94	(6 )	13,275
Obligations of state and political subdivisions	177,139	11,846	(2,200 )	186,785
Corporate securities	60,263	373	(1,394 )	59,242
Marketable equity securities	1,574	292	(125 )	1,741
Restricted equity securities	5,189	0	0	5,189
Total	\$322,244	\$ 15,535	\$ (3,766 )	\$334,013

(Amounts in thousands)	Held-to-Maturity Securities			Estimated Fair Value
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	
<i>December 31, 2011:</i>				
Obligations of U.S. Government Corporations and Agencies:				
Mortgage-backed	\$ 124	\$ 4	\$ 0	\$ 128
Other	2,014	46	0	2,060
Obligations of state and political subdivisions	467	11	0	478
Total	\$2,605	\$ 61	\$ 0	\$ 2,666

Securities Available-for-Sale with an aggregate fair value of \$184,654,000 at March 31, 2012 and \$182,478,000 at December 31, 2011; and securities Held-to-Maturity with an aggregate book value of \$1,131,000 at March 31, 2012 and \$2,138,000 at December 31, 2011, were pledged to secure public funds, trust funds, securities sold under agreements to repurchase, FHLB advances and other balances of \$101,743,000 at March 31, 2012 and \$106,647,000 at December 31, 2011.

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The amortized cost, estimated fair value and weighted average yield of debt securities, by contractual maturity, are shown below at March 31, 2012 and December 31, 2011. 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)

	March 31, 2012						
	U.S. Government Obligations		Corporations & Agencies of State & Political Subdivisions <sup>2</sup>		Marketable Equity Securities <sup>3</sup>	Restricted Equity Securities <sup>3</sup>	Corporate Securities
Available-For-Sale:							
Within 1 Year:							
Amortized cost	\$2,008	\$ 0			\$ 0	\$ 0	\$ 13,505
Estimated fair value	2,017	0			0	0	13,747
Weighted average yield	1.20 %	0			0	0	4.53 %
1 - 5 Years:							
Amortized cost	12,160	3,417			0	0	42,131
Estimated fair value	12,255	3,625			0	0	42,011
Weighted average yield	1.03 %	4.77 %			0	0	2.33 %
5 - 10 Years:							
Amortized cost	6,271	11,981			0	0	3,914
Estimated fair value	6,647	13,356			0	0	3,795
Weighted average yield	3.93 %	5.33 %			0	0	3.52 %
After 10 Years:							
Amortized cost	55,311	161,552			1,574	4,931	0
Estimated fair value	57,709	170,395			1,899	4,931	0
Weighted average yield	3.53 %	6.30 %			3.52 %	0.04 %	0
Total:							
Amortized cost	\$75,750	\$ 176,950			\$ 1,574	\$ 4,931	\$ 59,550
Estimated fair value	78,628	187,376			1,899	4,931	59,553
Weighted average yield	3.10 %	6.20 %			3.52 %	0.04 %	2.91 %

<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)

	March 31, 2012				
	U.S. Government Obligations		Marketable	Restricted	
	Corporations & Agencies	of State & Political Subdivisions <sup>2</sup>	Equity Securities <sup>3</sup>	Equity Securities <sup>3</sup>	Corporate Securities
Held-to-Maturity:					
Within 1 Year:					
Amortized cost	\$0	\$ 0	\$ 0	\$ 0	\$ 0
Estimated fair value	0	0	0	0	0
Weighted average yield	0	0	0	0	0
1 - 5 Years:					
Amortized cost	2,012	0	0	0	0
Estimated fair value	2,054	0	0	0	0
Weighted average yield	1.38 %	0	0	0	0
5 - 10 Years:					
Amortized cost	119	0	0	0	0
Estimated fair value	123	0	0	0	0
Weighted average yield	2.56 %	0	0	0	0
After 10 Years:					
Amortized cost	467	0	0	0	0
Estimated fair value	479	0	0	0	0
Weighted average yield	7.14 %	0	0	0	0
Total:					
Amortized cost	\$2,598	\$ 0	\$ 0	\$ 0	\$ 0
Estimated fair value	2,656	0	0	0	0
Weighted average yield	2.47 %	0	0	0	0

<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)

	December 31, 2011							
	U.S. Government Obligations		Marketable		Restricted		Corporate	
	Corporations of State & Political		Equity Securities <sup>3</sup>		Equity Securities <sup>3</sup>		Securities	
	Obligations	Subdivisions <sup>2</sup>	Equity Securities <sup>3</sup>	Equity Securities <sup>3</sup>	Equity Securities <sup>3</sup>	Equity Securities <sup>3</sup>	Equity Securities <sup>3</sup>	Securities
Available-For-Sale:								
Within 1 Year:								
Amortized cost	\$2,016	\$ 0	\$ 0	\$ 0	\$ 0	\$ 0	\$ 10,757	
Estimated fair value	2,030	0	0	0	0	0	10,928	
Weighted average yield	1.20	% 0	0	0	0	0	4.70	%
1 - 5 Years:								
Amortized cost	11,175	3,411	0	0	0	0	48,506	
Estimated fair value	11,250	3,614	0	0	0	0	47,444	
Weighted average yield	1.17	% 4.77	% 0	0	0	0	2.59	%
5 - 10 Years:								
Amortized cost	6,905	11,475	0	0	0	0	1,000	
Estimated fair value	7,285	12,826	0	0	0	0	870	
Weighted average yield	4.04	% 5.33	% 0	0	0	0	3.10	%
After 10 Years:								
Amortized cost	57,983	162,253	1,574	1,574	5,189	5,189	0	
Estimated fair value	60,491	170,345	1,741	1,741	5,189	5,189	0	
Weighted average yield	3.66	% 6.30	% 3.37	% 3.37	% 0.01	% 0.01	% 0	%
Total:								
Amortized cost	\$78,079	\$ 177,139	\$ 1,574	\$ 1,574	\$ 5,189	\$ 5,189	\$ 60,263	
Estimated fair value	81,056	186,785	1,741	1,741	5,189	5,189	59,242	
Weighted average yield	3.27	% 6.21	% 3.37	% 3.37	% 0.01	% 0.01	% 2.98	%

<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)

	December 31, 2011				
	U.S. Government Obligations				
	Corporations & Agencies of State & Political Subdivisions <sup>2</sup>		Marketable Equity Securities <sup>3</sup>	Restricted Equity Securities <sup>3</sup>	Corporate Securities
Held-to-Maturity:					
Within 1 Year:					
Amortized cost	\$0	\$ 0	\$ 0	\$ 0	\$ 0
Estimated fair value	0	0	0	0	0
Weighted average yield	0	0	0	0	0
1 - 5 Years:					
Amortized cost	2,014	0	0	0	0
Estimated fair value	2,060	0	0	0	0
Weighted average yield	1.41 %	0	0	0	0
5 - 10 Years:					
Amortized cost	124	0	0	0	0
Estimated fair value	128	0	0	0	0
Weighted average yield	2.56 %	0	0	0	0
After 10 Years:					
Amortized cost	0	467	0	0	0
Estimated fair value	0	478	0	0	0
Weighted average yield	0	7.14 %	0	0	0
Total:					
Amortized cost	\$2,138	\$ 467	\$ 0	\$ 0	\$ 0
Estimated fair value	2,188	478	0	0	0
Weighted average yield	1.48 %	7.14 %	0	0	0

<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.

There were no aggregate investments with a single issuer (excluding the U.S. Government and its agencies) which exceeded ten percent of consolidated stockholders' equity at March 31, 2012. The quality rating of the obligations of state and political subdivisions are generally investment grade, as rated by Moody's, Standard and Poor's 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 the sale of investments in Available-for-Sale debt and equity securities during the first quarter of 2012 and 2011 were \$8,711,000 and \$44,129,000, respectively. Gross gains realized on these sales were \$35,000 and \$650,000, respectively. Gross losses on these sales were \$5,000 and \$725,000, respectively. There were no impairment losses in the first quarter of 2012 and 2011.

There were no proceeds from sale of investments in Held-to-Maturity debt and equity securities during the first quarter of 2012 and 2011. 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, *Investments - Debt and Equity Securities*. In determining OTTI under the FASB ASC 320 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. The starting point for the equity analysis is the length and severity of market value decline. The Corporation and its investment advisors 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. Based on the factors described above, management did not consider any equity securities to be other-than-temporarily impaired at March 31, 2012 and December 31, 2011.

In accordance with disclosures required by FASB ASC 320-10-50, *Investments - Debt and Equity Securities*, the summary below shows the gross unrealized losses and fair value of the Corporation’s investments, aggregated by investment category, that individual securities have been in a continuous unrealized loss position for less than 12 months or 12 months or more as of March 31, 2012 and December 31, 2011:



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March 31, 2012

(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	\$ 1,997	\$ 1	\$ 0	\$ 0	\$ 1,997	\$ 1
Federal agency backed securities	5,084	14	0	0	5,084	14
Municipal bonds	1,755	22	9,949	1,356	11,704	1,378
Corporate securities	17,505	342	4,753	305	22,258	647
Marketable equity securities	14	2	380	39	394	41
	\$ 26,355	\$ 381	\$ 15,082	\$ 1,700	\$ 41,437	\$ 2,081

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December 31, 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	\$6,118	\$ 6	\$0	\$ 0	\$6,118	\$ 6
Federal agency backed securities	7,806	41	0	0	7,806	41
Municipal bonds	2,455	11	10,518	2,189	12,973	2,200
Corporate securities	32,162	1,185	1,791	209	33,953	1,394
Marketable equity securities	82	20	754	105	836	125
	\$48,623	\$ 1,263	\$13,063	\$ 2,503	\$61,686	\$ 3,766

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”) or FNMA (“Federal National Mortgage Association”). The municipal securities consist of general obligations and revenue bonds. The marketable 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 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 42 securities in an unrealized loss position as of March 31, 2012 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 investment securities gains (losses) expense-net on the consolidated statements of income.

### 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, *Fair Value Measures and Disclosures*, 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:

Level 1: Fair value is based on unadjusted quoted prices in active markets that are accessible to the Corporation for identical assets. These generally provide the most reliable evidence and are used to measure fair value whenever available.

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.

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.

At March 31, 2012 and December 31, 2011, investments measured at fair value on a recurring basis and the valuation methods used are as follows:

March 31, 2012

	Level 1	Level 2	Level 3	Total
Available-for-Sale Securities:				
Obligations of U.S. Government Corporations & Agencies:				
Mortgaged-backed	\$ 0	\$62,149	\$ 0	\$62,149
Other	0	16,479	0	16,479
Obligations of state and political subdivisions	0	187,376	0	187,376
Corporate securities	0	59,553	0	59,553
Marketable equity securities	1,899	0	0	1,899
Restricted equity securities	0	4,931	0	4,931
Total	\$1,899	\$330,488	\$ 0	\$332,387

December 31, 2011

	Level 1	Level 2	Level 3	Total
Available-for-Sale Securities:				
Obligations of U.S. Government Corporations & Agencies:				
Mortgaged-backed	\$ 0	\$67,781	\$ 0	\$67,781
Other	0	13,275	0	13,275
Obligations of state and political subdivisions	0	186,785	0	186,785
Corporate securities	0	59,242	0	59,242
Marketable equity securities	1,741	0	0	1,741
Restricted equity securities	0	5,189	0	5,189
Total	\$1,741	\$332,272	\$ 0	\$334,013

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 Corporation (observable inputs), and are therefore classified as Level 2 within the fair value hierarchy. The Corporation does not have any Level 3 inputs. There were no transfers between Level 1 and Level 2 during the quarter ended March 31, 2012.

### NOTE 3 — LOANS

Major classifications of loans at March 31, 2012 and December 31, 2011 consisted of:

(Amounts in thousands)

	March 31, 2012	December 31, 2011
Commercial, Financial and Agricultural	\$ 23,152	\$ 21,448
Tax-exempt - Real Estate and Other	21,368	19,779
Real estate mortgages - Held-for-sale	2,915	1,356
Real estate mortgages - Consumer	132,428	129,362
Real estate mortgages - Commercial	233,376	236,645
Consumer	6,942	7,429
Gross loans	420,181	416,019
Add (deduct): Unearned discount and	(286 )	(331 )
Net deferred loan fees and costs	292	307
Total loans, net of unearned income	\$ 420,187	\$ 415,995

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Activity in the allowance for loan losses for the quarter ended March 31, 2012 and the year ended December 31, 2011:

(Amounts in thousands)

	March 31, 2012	December 31, 2011
Balance at beginning of period	\$ 5,929	\$ 5,701
Provision charged to operations	400	1,900
Loans charged off	(394 )	(1,769 )
Recoveries	29	97
Balance at end of period	\$ 5,964	\$ 5,929

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.

Overall, the portfolio risk profile as measured by loan grade is considered low risk, as \$409,375,000 or 97.4% of gross loans are graded Pass; \$2,487,000 or 0.6% are graded Special Mention; \$8,319,000 or 2.0% are graded Substandard; and \$0 are graded Doubtful.

Commercial & Industrial non-pass grades increased to \$1,541,000 as of March 31, 2012, as compared to \$1,436,000 as of December 31, 2011. Commercial Real Estate non-pass grades decreased to \$8,191,000 as of March 31, 2012, as compared to \$10,375,000 as of December 31, 2011. The \$2,184,000 decrease was the result of \$1,057,000 in loans being upgraded, no new additions to the substandard category, with the balance attributed to the charge-down of several assets. The Residential Real Estate and Consumer Loans non-pass grades decreased to \$1,074,000 as of March 31, 2012 compared to \$1,115,000 as of December 31, 2011. The reduction in Special Mention Residential Real Estate was due entirely to the upgrade of one relationship.

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 credit quality indicators by loan segment are summarized below at March 31, 2012 and December 31, 2011:

	Commercial & Industrial		Commercial Real Estate Construction	
	March 31, 2012	December 31, 2011	March 31, 2012	December 31, 2011
Grade:				
1-6 Pass	\$40,986	\$ 38,250	\$ 11,586	\$ 3,781
7 Special Mention	605	556	0	0
8 Substandard	936	880	0	0
9 Doubtful	0	0	0	0
Add (deduct): Unearned discount	0	0	0	0
Net deferred loan fees & costs	93	100	(2 )	(8 )
Loans, net of unearned income	\$42,620	\$ 39,786	\$ 11,584	\$ 3,773

	Commercial Real Estate Other		Residential Real Estate Including Home Equity	
	March 31, 2012	December 31, 2011	March 31, 2012	December 31, 2011
Grade:				
1-6 Pass	\$ 215,591	\$ 224,030	\$ 134,291	\$ 129,627
7 Special Mention	1,882	3,269	0	0
8 Substandard	6,309	7,106	1,052	1,091
9 Doubtful	0	0	0	0
Add (deduct): Unearned discount	0	0	0	0
Net deferred loan fees & costs	(8 )	3	135	133
Loans, net of unearned income	\$ 223,774	\$ 234,408	\$ 135,478	\$ 130,851

	Consumer Loans	
	March 31, 2012	December 31, 2011
Grade:		
1-6 Pass	\$6,921	\$ 7,405
7 Special Mention	0	0
8 Substandard	22	24
9 Doubtful	0	0
Add (deduct): Unearned discount	(286 )	(331 )
Net deferred loan fees & costs	74	79
Loans, net of unearned income	\$6,731	\$ 7,177

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

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

(Amounts in thousands)

	Commercial					Unallocated	Total
	Commercial Real Estate	Consumer	Residential				
Three months ended March 31, 2012:							
Allowance for Loan Losses:							
Beginning balance	\$ 489	\$ 3,507	\$ 137	\$ 1,228	\$ 568	\$ 5,929	
Charge-offs	(5 )	(369 )	(18 )	(2 )	0	(394 )	
Recoveries	15	1	13	0	0	29	
Provision	36	209	0	69	86	400	
Ending Balance	535	3,348	132	1,295	654	5,964	

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Ending balance: individually evaluated for impairment	101	651	0	138	0	890
Ending balance: collectively evaluated for impairment	\$ 434	\$ 2,697	\$ 132	\$ 1,157	\$ 654	\$ 5,074
Financing Receivables:						
Ending Balance	\$ 42,620	\$ 235,358	\$ 6,731	\$ 135,478	\$ 0	\$ 420,187
Ending balance: individually evaluated for impairment	219	2,589	0	842	0	3,650
Ending balance: collectively evaluated for impairment	\$ 42,401	\$ 232,769	\$ 6,731	\$ 134,636	\$ 0	\$ 416,537

(Amounts in thousands)

	Commercial					Total
	Commercial	Real Estate	Consumer	Residential	Unallocated	
December 31, 2011:						
Allowance for Loan Losses:						
Beginning balance	\$ 565	\$ 2,769	\$ 123	\$ 1,501	\$ 743	\$ 5,701
Charge-offs	(485 )	(968 )	(98 )	(218 )	0	(1,769 )
Recoveries	28	51	16	2	0	97
Provision	381	1,655	96	(57 )	(175 )	1,900
Ending Balance	489	3,507	137	1,228	568	5,929
Ending balance: individually evaluated for impairment	80	756	0	111	0	947
Ending balance: collectively evaluated for impairment	\$ 409	\$ 2,751	\$ 137	\$ 1,117	\$ 568	\$ 4,982
Financing Receivables:						
Ending Balance	\$ 39,786	\$ 238,181	\$ 7,177	\$ 130,851	\$ 0	\$ 415,995
Ending balance: individually evaluated for impairment	122	3,211	0	855	0	4,188
Ending balance: collectively evaluated for impairment	\$ 39,664	\$ 234,970	\$ 7,177	\$ 129,996	\$ 0	\$ 411,807

Impaired loans at March 31, 2012 and December 31, 2011 were \$3,650,000 and \$4,188,000, 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)

	March 31, 2012	December 31, 2011
Gross interest due under terms year-to-date	\$ 92	\$ 342
Amount included in income	0	(54 )
Interest income not recognized	\$ 92	\$ 288

The Corporation's impaired loans are summarized below for the periods ended March 31, 2012 and December 31, 2011.

(Amounts in thousands)

	Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Recorded Investment	Interest Income Recognized
March 31, 2012:					
With no related allowance recorded:					
Commercial	\$ 39	\$ 185	\$ 0	\$ 187	\$ 0

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Commercial real estate	914	1,164	0	1,240	0
Residential	300	322	0	322	0
With an allowance recorded:					
Commercial	180	370	101	370	0
Commercial real estate	1,675	2,736	651	2,742	0
Residential	542	678	138	678	0
Total	\$ 3,650	\$ 5,455	\$ 890	\$ 5,539	\$ 0
Total consists of:					
Commercial	\$ 219	\$ 555	\$ 101	\$ 557	\$ 0
Commercial real estate	\$ 2,589	\$ 3,900	\$ 651	\$ 3,982	\$ 0
Residential	\$ 842	\$ 1,000	\$ 138	\$ 1,000	\$ 0

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(Amounts in thousands)	Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Recorded Investment	Interest Income Recognized
December 31, 2011:					
With no related allowance recorded:					
Commercial	\$ 43	\$ 188	\$ 0	\$ 239	\$ 0
Commercial real estate	1,319	1,505	0	1,554	12
Residential	270	280	0	286	1
With an allowance recorded:					
Commercial	80	80	80	89	3
Commercial real estate	1,891	2,932	756	2,947	34
Residential	585	733	111	736	4
Total	\$ 4,188	\$ 5,718	\$ 947	\$ 5,851	\$ 54
Total consists of:					
Commercial	\$ 123	\$ 268	\$ 80	\$ 328	\$ 3
Commercial real estate	\$ 3,210	\$ 4,437	\$ 756	\$ 4,501	\$ 46
Residential	\$ 855	\$ 1,013	\$ 111	\$ 1,022	\$ 5

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 March 31, 2012 and December 31, 2011 were as follows:

(Amounts in thousands)	March 31, 2012	December 31, 2011
Commercial – real estate	\$ 2,589	\$ 3,211
Commercial - other	219	122
Residential	842	855
Consumer	0	0
Total non-accruing loans	3,650	4,188
Restructured loans	0	0
Total impaired loans	3,650	4,188
Loans past-due 90 days or more and still accruing	1,009	0
Foreclosed assets	780	780
Total non-performing assets	\$ 5,439	\$ 4,968

At March 31, 2012 and December 31, 2011, the recorded investment in impaired loans as defined by FASB ASC 310-10-35, *Receivables Subsequent Measurements*, was \$3,650,000 and \$4,188,000, and the impaired loans

allowances were \$890,000 and \$947,000, respectively at March 31, 2012 and December 31, 2011. The average recorded balance in impaired loans during the quarter ended March 31, 2012 and December 31, 2011 was approximately \$5,539,000 and \$5,851,000, respectively.

The following tables present the aging of past-due loans by class of loans at March 31, 2012 and December 31, 2011:

(Amounts in thousands)

	30-59 Days Past Due	60-89 Days Past Due	90 Days or Greater Past Due	Total Past Due	Non- Performing Assets	Current	Total Financing Receivables
March 31, 2012:							
Commercial	\$ 165	\$ 670	\$ 58	\$ 893	\$ 219	\$41,415	\$ 42,527
Commercial real estate	1,071	674	615	2,360	2,589	230,425	235,374
Consumer	38	45	19	102	0	6,841	6,943
Residential	1,517	359	317	2,193	842	132,308	135,343
Total	\$ 2,791	\$ 1,748	\$ 1,009	\$ 5,548	\$ 3,650	\$410,989	\$ 420,187

(Amounts in thousands)

	30-59 Days Past Due	60-89 Days Past Due	90 Days or Greater Past Due	Total Past Due	Non- Performing Assets	Current	Total Financing Receivables
December 31, 2011:							
Commercial	\$ 166	\$ 21	\$ 0	\$ 187	\$ 123	\$39,476	\$ 39,786
Commercial real estate	1,427	785	0	2,212	3,210	232,759	238,181
Consumer	64	62	0	126	0	7,051	7,177
Residential	1,473	353	0	1,826	855	128,170	130,851
Total	\$ 3,130	\$ 1,221	\$ 0	\$ 4,351	\$ 4,188	\$407,456	\$ 415,995

Loans past-due 90 days or more and still accruing interest were \$1,009,000 and \$0 at March 31, 2012 and December 31, 2011, respectively. Loans 90 days or greater past-due remained on accrual status as these assets were deemed to be in the process of collection, and guaranteed or well secured.

At March 31, 2012, 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 March 31, 2012, there were no loans classified as troubled debt restructurings.



**NOTE 4 — SHORT-TERM BORROWINGS**

Federal funds purchased, securities sold under agreements to repurchase, Federal Discount Window, 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”) and a capital lease assumed as a result of the acquisition of Pocono Community Bank in the amount of \$811,000 at November 1, 2007. Under terms of a blanket agreement, collateral for the loans are secured by certain qualifying assets of the Corporation’s banking subsidiary with FHLB, which consist principally of first mortgage loans and certain investment securities.

## **NOTE 6 — COMMITMENTS AND CONTINGENCIES**

In August 2011, the Bank entered into an agreement with a seller to acquire property consisting of three parcels of vacant land in the amount of \$504,000 in Kingston, Pennsylvania. The property was acquired on February 15, 2012. As of March 31, 2012, the Bank has committed to build a new facility at an approximate cost of \$1,429,000, of which \$163,000 has been spent.

In 2011, the Bank began work to expand its main headquarters in Berwick, Pennsylvania. As of March 31, 2012, the Bank has committed to spend \$5.4 million on this facility, of which \$2.1 million has been spent.

In February 2012, the Bank entered into an agreement with a seller to acquire property consisting of a parcel of land and a building in the amount of \$400,000 in Shickshinny, Pennsylvania. This property is expected to be acquired in the second quarter of 2012.

In the normal course of business, there are various pending legal actions and proceedings that are not reflected in the consolidated financial statements. Management does not believe the outcome of these actions and proceedings will have a material effect on the consolidated financial position of the Corporation.

## **NOTE 7 — 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 March 31, 2012 and December 31, 2011, were as follows:

(Amounts in thousands)

	March 31, 2012	December 31, 2011
Financial instruments whose contract amounts represent credit risk:		
Commitments to extend credit	\$ 63,005	\$ 62,459
Financial standby letters of credit	\$ 842	\$ 789
Performance standby letters of credit	\$ 4,330	\$ 4,370

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 some of the commitments may 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 borrower. Collateral held varies but may include accounts receivable, inventory, property, plant and equipment, owner-occupied income-producing commercial properties, and residential real estate.

Standby letters of credit are conditional commitments issued by the Corporation to guarantee payment to a third party when a customer either fails to repay an obligation or fails to perform some non-financial obligation. 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 March 31, 2012, to the extent necessary to avoid any significant concentration of credit risk. However, its debtor's ability to honor their contracts may be influenced by the region's economy.

#### **NOTE 8 — FAIR VALUES OF FINANCIAL INSTRUMENTS**

FASB ASC 825-10-50, *Financial Instruments - Overall - Disclosure*, 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.

### **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 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 (the format was 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.

The Corporation's foreclosed asset valuation procedure requires an appraisal to be completed periodically with the exception of those cases which the Corporation 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 March 31, 2012 and December 31, 2011.

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 approval.

There were no transfers amongst valuation levels in the first quarter of 2012 and in the year ended 2011. At March 31, 2012 and December 31, 2011, the carrying values and estimated fair values of financial instruments of the Corporation are presented in the table below:

(Amounts in thousands)	March 31, 2012		December 31, 2011	
	Carrying Amount	Estimated Fair Value	Carrying Amount	Estimated Fair Value
<b>FINANCIAL ASSETS:</b>				
Cash and due from banks	\$6,964	\$ 6,964	\$8,403	\$ 8,403
Short-term investments	3,958	3,958	1,776	1,776
Investment securities – available-for-sale	332,387	332,387	334,013	334,013
Investment securities – held-to-maturity	2,598	2,656	2,605	2,666
Net loans	414,223	413,425	410,066	410,033
Accrued interest receivable	4,467	4,467	4,375	4,375
Cash surrender value of bank owned life insurance	19,329	19,329	19,145	19,145
<b>FINANCIAL LIABILITIES:</b>				
Deposits	638,805	635,372	624,349	624,758
Short-term borrowings	18,586	18,586	30,882	30,882
Long-term borrowings	64,323	68,773	64,339	69,055
Accrued interest and other expenses	3,175	3,175	2,857	2,857
<b>OFF-BALANCE SHEET FINANCIAL INSTRUMENTS:</b>				
Commitments to extend credit		63,005		62,459
Financial standby letters of credit		842		789
Performance standby letters of credit		4,330		4,370

**NOTE 9 MANAGEMENT'S ASSERTIONS AND COMMENTS REQUIRED TO BE PROVIDED WITH FORM 10-Q 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 three-month period ended March 31, 2012, 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 10-Q 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 Report on Form 10-K filing. The reader of these consolidated interim financial statements may wish to refer to the Corporation's Annual Report on Form 10-K for the period ended December 31, 2011, filed with the Securities and Exchange Commission.

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Stockholders of First Keystone Corporation:

We have reviewed the consolidated balance sheet of First Keystone Corporation and Subsidiary as of March 31, 2012 and the related consolidated statements of income, changes in stockholders' equity, comprehensive income and cash flows for the three-month periods ended March 31, 2012 and 2011. These consolidated interim financial statements are the responsibility of the management of First Keystone Corporation and Subsidiary.

We conducted our review 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 standards of the Public Company Accounting Standards 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 accompanying 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 auditing standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheet of First Keystone Corporation as of December 31, 2011, 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, 2012, 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, 2011, 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

May 9, 2012

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Item First Keystone Corporation Management's Discussion and Analysis of Financial Condition and Results of  
2. Operation as of March 31, 2012

This quarterly report contains certain forward-looking statements, which are included pursuant to the "safe harbor" provisions of the Private Securities Litigation Reform Act of 1995, and 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 first quarter of 2012 of \$2,656,000, an increase of \$160,000, or 6.4% from the first quarter of 2011. The increase in net income for 2012 was primarily the result of an increased net interest margin and an increase in net interest income of \$189,000 from the first quarter of 2011. On a per share basis, net income per share was \$.49 for the first three months of 2012 up from \$.46 for the first three months of 2011, an increase of 6.5%. Cash dividends increased to \$.25 per share up from \$.24 in the first quarter of 2011, an increase of 4.2%.

Year-to-date net income annualized as of March 31, 2012, amounts to a return on average common equity of 11.11%, a return on tangible equity of 15.70% and a return on assets of 1.29%. For the three months ended March 31, 2011, these measures were 12.20%, 15.24%, and 1.23%, 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 first quarter of 2012, interest income amounted to \$8,927,000, a decrease of \$420,000 or 4.5% from the first quarter of 2011, while interest expense amounted to \$1,907,000 in the first quarter of 2012, a decrease of \$609,000, or 24.2% from the first quarter of 2011. As a result, net interest income increased \$189,000 or 2.8% in the first quarter of 2012 to \$7,020,000 from \$6,831,000 in first quarter of 2011.

Our net interest margin for the quarter ended March 31, 2012 was 4.09% compared to 3.96% for the quarter ended March 31, 2011.

## PROVISION FOR LOAN LOSSES

The provision for loan losses for the quarter ended March 31, 2012, was \$400,000, compared to \$300,000 for the first quarter of 2011. The increase in the provision for loan losses resulted from our analysis of our current loan portfolio, including non-performing loans. Net charge-offs for the period ended March 31, 2012 were \$365,000, compared to \$140,000 for the first quarter of 2011. The allowance for loan losses as a percentage of average loans outstanding, net of unearned interest, was 1.43% as of March 31, 2012, as compared to 1.44% as of December 31, 2011. See Allowance for Loan Losses on Page 35 for further discussion.

## NON-INTEREST INCOME

Total non-interest income was \$1,204,000 for the quarter ended March 31, 2012, as compared to \$963,000 for the quarter ended March 31, 2011, an increase of \$241,000, or 25.0%. Excluding investment securities gains and losses, non-interest income was \$1,174,000 for the first quarter of 2012, an increase of \$136,000, or 13.1% from the first quarter of 2011. The increase in non-interest income was driven by an increase in gains on sale of residential mortgage loans of \$120,000 and an increase in Trust Department income of \$50,000 as compared to the first quarter of 2011.

## NON-INTEREST EXPENSE

Total non-interest expense was \$4,585,000 for the quarter ended March 31, 2012, as compared to \$4,304,000 for the quarter ended March 31, 2011. The increase of \$281,000, or 6.5% is comprised of salary and employee benefits expense increasing \$339,000, net occupancy, furniture and equipment and computer expense increasing \$20,000, and other non-interest expense, including FDIC insurance, professional services and state shares tax decreasing \$78,000. These increases reflect additional employee and benefit costs associated with a new office opening, and additions to the accounting and the information security areas.

Expenses associated with employees (salaries and employee benefits) continue to be the largest category of non-interest expense. Salaries and benefits amounted to \$2,622,000, or 57.2% of total non-interest expense for the three months ended March 31, 2012, as compared to 53.0% for the first three months of 2011. Net occupancy, furniture and equipment, and computer expense amounted to \$708,000 for the three months ended March 31, 2012, an increase of \$20,000, or 2.9%. Other non-interest expense, including FDIC insurance, professional services and state shares tax amounted to \$1,255,000 for the three months ended March 31, 2012, a decrease of \$78,000, or 5.9% from the first three months of 2011. Non-interest expense in the first quarter of 2012 is approximately 2.2% 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 \$583,000 for the three months ended March 31, 2012, as compared to \$694,000 for 2011, a decrease of \$111,000. The effective total income tax rate was 18.0% for the first quarter of 2012 as compared to 21.8% for the first quarter of 2011. The decrease in the effective tax rate was due to an additional tax credit taken as a result of a low-income housing investment partnership acquired in 2010.

## ANALYSIS OF FINANCIAL CONDITION

### ASSETS

Total assets increased to \$823,693,000 as of March 31, 2012, an increase of \$5,147,000 from year-end 2011. Net loans increased by \$4,157,000 or 1.0%, reflecting continued weak demand. Cash balances remained nearly the same from year-end, as excess cash continues to be used in the investment portfolio.

During the first quarter of 2012, the Corporation decreased short-term borrowings to \$18,586,000 as of March 31, 2012, as compared to \$30,882,000 as of December 31, 2011. Long-term borrowings were \$64,323,000 as of March 31, 2012, basically unchanged from the \$64,339,000 as of December 31, 2011.

## EARNING ASSETS

Our primary earning asset, loans, net of unearned income, increased to \$420,187,000 as of March 31, 2012, up \$4,192,000, or 1.0% since year-end 2011. The loan portfolio continues to be diversified. Overall asset quality has remained consistent with non-performing assets increasing slightly since year-end 2011. Total non-performing assets were \$5,439,000 as of March 31, 2012, an increase of \$471,000, or 9.5% from the \$4,968,000 reported in non-performing assets as of December 31, 2011. Total allowance for loan losses to total non-performing assets was 109.7% as of March 31, 2012 and 119.3% at December 31, 2011.

In addition to loans, another primary earning asset is our overall investment portfolio, which decreased in size from December 31, 2011, to March 31, 2012. Held-to-maturity securities amounted to \$2,598,000 as of March 31, 2012, a decrease of \$7,000 from December 31, 2011. Available-for-sale securities amounted to \$332,387,000 as of March 31, 2012, a decrease of \$1,626,000 from year-end 2011. Interest-bearing deposits in other banks increased as of March 31, 2012, to \$3,958,000 from \$1,776,000 at year-end 2011.

## LOANS

Total loans, net of unearned income, increased to \$420,187,000 as of March 31, 2012, as compared to a balance of \$415,995,000 as of December 31, 2011. The table on page 20 provides data relating to the composition of the Corporation's loan portfolio on the dates indicated. Total loans, net of unearned income, increased \$4,192,000, or 1.0% in the first quarter of 2012.

The economy and the resultant decline in loan demand account for the slow growth in the loan portfolio in the first quarter of 2012. Residential real estate loans increased to \$135,343,000 as of March 31, 2012, as compared to \$130,718,000 as of December 31, 2011. The majority of the increase was the result of new originations and refinances held in the Bank's portfolio. The Corporation did not change its underwriting standards in the first quarter of 2012 and expects to maintain these underwriting standards in the future.

The loan portfolio is well diversified. The total commercial portfolio was \$277,896,000 at March 31, 2012 and \$277,872,000 at December 31, 2011, of which \$235,369,000 or 56.0% at March 31, 2012 and \$238,186,000 or 57.3% at December 31, 2011, 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 township officials, the township experienced 17% growth in population from 2001 through 2010 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. The Bank's loan is secured by project receivables and the full faith, credit and taxing power of the township.

The second largest relationship of \$7,395,000 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 third largest relationship consisted of the net balance of \$7,160,000 after participations sold of \$3,234,000. This relationship is comprised of a \$5,000,000 revolving line of credit with related letters of credit to develop a Planned Residential Community in the eastern portion of our market area; a \$68,000 residential mortgage; the unsold principal balance of several commercial mortgages secured by investment properties totaling \$435,000; and a \$450,000 revolving line of credit for working capital. 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 fourth largest relationship is a real estate development company and its related entities, specializing in the design, construction and management of student housing units. The company was established in the late 1980s and its primary market is our immediate central market. The relationship had outstanding loan balances of \$7,077,000 at March 31, 2012, and is secured primarily by income producing real estate.

The fifth 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 \$7,012,000 at March 31, 2012, secured primarily by commercial real estate and perfected security interest in all business assets of the various related entities.

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.

Increases in the portfolio in the first quarter of 2012 were primarily in residential mortgage real estate loans. There was an increase in commercial loans – other; these are loans to corporations and businesses not secured by real estate. The Corporation continued to originate and sell certain long-term fixed rate residential mortgage loans which conform to secondary market requirements. The Corporation derives ongoing income from the servicing of mortgages sold in the secondary market.

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)	March 31, 2012	December 31, 2011
Commercial, financial and agricultural:		
Commercial secured by real estate	\$ 233,376	\$ 236,645
Commercial - other	23,152	21,448
Tax exempt - real estate and other	21,368	19,779
Real estate (primarily residential mortgage loans)	135,343	130,718
Consumer loans	6,942	7,429
Total Gross Loans	420,181	416,019
Add (deduct): Unearned discount and Net deferred loan fees and costs	6	(24 )
Total Loans, net of unearned income	\$ 420,187	\$ 415,995

### ALLOWANCE FOR LOAN LOSSES

The allowance for loan losses constitutes the amount available to absorb losses within the loan portfolio. As of March 31, 2012, the allowance for loan loss was \$5,964,000 as compared to \$5,929,000 as of December 31, 2011. 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 collectability 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 quarter and the year and additional provisions charged to operations. In the first quarter of 2012, net charge-offs as a percentage of average loans were 0.09%, as compared to net charge-offs as a percentage of average loans of 0.41% in 2011. Net charge-offs amounted to \$365,000 for the first quarter of 2012 as compared to \$1,672,000 at year-end 2011, and \$140,000 for the first quarter of 2011. The increase in net charge-offs in the first quarter of 2012 as compared to the first quarter of 2011 relates primarily to two commercial real estate relationships that were charged down. The largest of these, \$159,000, represents 43.6% of net charge-offs for the first quarter of 2012. This borrower is related to the residential construction business and experienced a significant decrease in his business related to the downturn of the housing market which continued into 2012. The second largest chargedown of \$150,000, or 41.1% of net charge-offs is related to a commercial real estate investor whose income stream has been negatively impacted by decreased consumer disposable income. The balance of net charge-offs is comprised of two small commercial relationships and five small consumer loans.

For the first quarter of 2012, the provision for loan losses was \$400,000 as compared to \$300,000 for the first quarter of 2011. The provision, net of charge-offs and recoveries, increased the quarter end Allowance for Loan Losses to \$5,964,000 of which \$535,000 or 9.0% is attributed to Commercial, financial and agriculture loans; \$4,643,000 or 77.8% is attributed to Real Estate loans; \$132,000 or 2.2% is attributed to Consumer loans, and \$654,000 or 11.0% being the unallocated component (refer to the activity in the allowance for loan losses by loan segment table in Note 3 — Loans on page 20). The Allowance for Loan Losses increased to \$5,964,000 as of March 31, 2012, as compared to \$5,929,000 as of December 31, 2011. The Corporation determined that the provision for loan losses made during the current quarter was sufficient to maintain the allowance for loan losses at a level necessary for probable losses inherent in the loan portfolio as of March 31, 2012.

### Analysis of Allowance for Loan Losses

(Amounts in thousands)

	March 31, 2012	December 31, 2011	March 31, 2011			
Balance at beginning of period	\$ 5,929	\$ 5,701	\$ 5,701			
Charge-offs:						
Commercial, financial and agricultural	5	485	128			
Real estate	371	1,186	0			
Consumer	18	98	23			
	394	1,769	151			
Recoveries:						
Commercial, financial and agricultural	15	28	6			
Real estate	1	53	1			
Consumer	13	16	4			
	29	97	11			
Net charge-offs	365	1,672	140			
Additions charged to operations	400	1,900	300			
Balance at end of period	\$ 5,964	\$ 5,929	\$ 5,861			
Ratio of net charge-offs during the period to average loans outstanding during the period	0.09	%	0.41	%	0.03	%
Allowance for loan losses to average loans outstanding during the period	1.43	%	1.44	%	1.43	%

It is the policy of management and the Corporation's Board of Directors to make a provision for 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 the Bank's evaluation of the loan portfolio. A detailed quarterly analysis to determine the adequacy of the Corporation's allowance for loan losses is reviewed by the 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 1.43% at March 31, 2012, 1.44% at December 31, 2011 and 1.43% at March 31, 2011.

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**

(Amounts in thousands)	March 31, 2012			December 31, 2011		
Commercial, financial and agricultural	\$535	10.1	%*	\$489	9.1	%*
Real estate - mortgage	4,643	87.4	%*	4,735	88.3	%*
Consumer and other loans	132	2.5	%*	137	2.6	%*
Unallocated	654	N/A	*	568	N/A	*
	\$5,964	100.0	%*	\$5,929	100.0	%*

\*Percentage of allocation in each category to total in the Allowance for Loan Loss Analysis, excluding unallocated.

**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 collectability 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 income. 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.

Total non-performing assets increased \$471,000 to \$5,439,000 in the first quarter of 2012 as compared to \$4,968,000 as of December 31, 2011. The economy, in particular, high unemployment, weak job market, rising cost of fuel, and the continued slowness in the housing industry had a direct effect of increasing the Corporation's non-performing assets. 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 2011, are projected to continue at higher than average levels into 2012. Impaired loans decreased to \$3,650,000 for the quarter ending March 31, 2012, as compared to \$4,188,000 as of December 31, 2011. Foreclosed assets remained the same at \$780,000 for March 31, 2012 and December 31, 2011. Loans past-due 90 days or more and still accruing interest increased to \$1,009,000 as of March 31, 2012, as compared to \$0 as of December 31, 2011. These loans are deemed to be well secured and in the process of collection. Non-performing assets to period end loans and foreclosed assets was 1.3% in the first quarter of 2012 and 1.2% on December 31, 2011. Total non-performing assets to total assets was 0.7% as of March 31, 2012 and 0.6% on December 31, 2011. Our allowance for loan losses to total non-performing assets was 109.7% as of March 31, 2012

and 119.3% at December 31, 2011. Additional detail can be found on page 38, “Non-Performing Assets Table” and page 25 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, along with a full-time workout specialist to manage collection and liquidation efforts.

Impaired loans decreased to \$3,650,000 at March 31, 2012 from \$4,188,000 at December 31, 2011. Three relationships carried aggregate balances of \$250,000 or greater. The largest relationship is represented by two loans carrying a balance of \$988,000 secured by commercial real estate and business assets. The March 31, 2012 valuation carried a net realizable value of \$595,000, after an estimated \$105,000 cost to sell, resulting in a specific allocation of \$393,000. The second largest relationship is represented by two loans carrying a balance of \$436,000 secured by leasehold mortgages. The March 31, 2012 valuation carried a net realizable value of \$298,000, after an estimated \$53,000 cost to sell, resulting in a specific allocation of \$139,000. The third largest relationship is represented by three loans carrying a balance of \$431,000 secured by residential real estate and a bare land track. The March 31, 2012 valuation carried a net realizable value of \$386,000, after an estimated \$43,000 cost to sell, resulting in a specific allocation of \$46,000. Of the \$3,650,000 in impaired loans, \$436,000 is located outside of our primary market area. None of the impaired loans are participated facilities.

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 (the format was 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 will continue our close monitoring efforts in 2012. As of March 31, 2012, 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.

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 the Corporation's 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 judgments about information available to them at the time of examination.

Interest income received on non-performing loans in the first quarter of 2012 and for the year ended December 31, 2011 was \$0 and \$54,000, respectively. Interest income, which would have been recorded on these loans under the original terms as of March 31, 2012 and December 31, 2011 was \$92,000 and \$342,000, respectively. At March 31, 2012 and December 31, 2011, 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 March 31, 2012 and December 31, 2011, management is of the opinion that there were no loan concentrations exceeding 10% of total loans.

### **Non-performing Assets**

(Amounts in thousands)



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	March 31, 2012	December 31, 2011		
Non-performing assets				
Impaired loans	\$ 3,650	\$ 4,188		
Foreclosed assets held for resale	780	780		
Loans past-due 90 days or more and still accruing interest	1,009	0		
Total non-performing assets	\$ 5,439	\$ 4,968		
Impaired loans				
Non-performing loans	\$ 3,650	\$ 4,188		
Allocated allowance for loan losses	(890 )	(947 )		
Net investment in impaired loans	\$ 2,760	\$ 3,241		
Impaired loans with a valuation allowance	\$ 2,397	\$ 2,556		
Impaired loans without a valuation allowance	1,253	1,632		
Total impaired loans	\$ 3,650	\$ 4,188		
Allocated valuation allowance related to impaired loans	\$ 890	\$ 947		
Allocated valuation allowance as a percent of impaired loans	24.4	%	22.6	%
Impaired loans to loans net of unearned discount	0.9	%	1.0	%
Non-performing assets to period-end loans and foreclosed assets	1.3	%	1.2	%
Total non-performing assets to total assets	0.7	%	0.6	%
Allowance for loan losses to impaired loans	163.4	%	141.6	%
Allowance for loan losses to total non-performing assets	109.7	%	119.3	%

Real estate mortgages comprise 88.2% of the net loan portfolio as of March 31, 2012, as compared to 88.7% as of December 31, 2011. 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 market 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 market 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

Total deposits increased \$14,456,000 to \$638,805,000 as of March 31, 2012 as non-interest bearing deposits increased by \$8,642,000 and interest bearing deposits increased by \$5,814,000 as of March 31, 2012, from year-end 2011. Total short-term and long-term borrowings decreased to \$82,909,000 as of March 31, 2012, from \$95,221,000 at year-end 2011, a decrease of \$12,312,000, or 12.9%.

#### 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 stockholders' equity, or capital net of taxes, by \$1,219,000 for the three months ended March 31, 2012. The Corporation had 241,730 shares of common stock on March 31, 2012 and 242,517 on December 31, 2011, as treasury stock. This had an effect of our reducing our total stockholders' equity by \$6,042,000 as of March 31, 2012, and \$6,069,000 as of December 31, 2011.

Total stockholders' equity was \$95,618,000 as of March 31, 2012, and \$93,092,000 as of December 31, 2011. Leverage ratio and risk based capital ratios remain very strong. As of March 31, 2012, our leverage ratio was 8.25% compared to 8.07% as of December 31, 2011. In addition, Tier I risk based capital and total risk based capital ratio as of March 31, 2012, were 12.14% and 13.25%, respectively. The same ratios as of December 31, 2011 were 11.99% and 13.09%, 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 the fact that the Corporation has a very stable core deposit base which has increased annually. Secondly, the Corporation's loan payments and principal paydowns on its mortgage backed securities provide a steady source of funds. Also, short-term investments and maturing investments represent additional sources of liquidity.

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The following table represents scheduled maturities of the Corporation's contractual obligations by time remaining until maturity as of March 31, 2012 and December 31, 2011.

(Amounts in thousands)

Contractual Obligations March 31, 2012	Less than 1 Year	1 - 3 Years	3 -5 Years	Over 5 Years	Total
Time deposits	\$ 152,323	\$ 76,224	\$ 28,443	\$ 0	\$ 256,990
Securities sold under agreement to repurchase	18,586	0	0	0	18,586
FHLB borrowings	16,000	32,750	13,000	2,000	63,750
Commitments to grant loans <sup>1</sup>	7,965	0	0	0	7,965
Commitments to fund loans for secondary market mortgages	2,231	0	0	0	2,231
Unfunded commitments on lines of credit <sup>1</sup>	44,809	0	0	0	44,809
Purchase obligations of loan participations <sup>1</sup>	8,000	0	0	0	8,000
Financial standby letters of credit <sup>1</sup>	842	0	0	0	842
Performance standby letters of credit <sup>1</sup>	4,330	0	0	0	4,330
Purchase and building commitments	4,959	0	0	0	4,959
Operating lease obligations	209	297	193	2,376	3,075
Capital lease obligations	131	448	270	0	849
	\$ 260,385	\$ 109,719	\$ 41,906	\$ 4,376	\$ 416,386

<sup>1</sup>The Corporation does not expect all of the commitments and letters of credit to be fully funded. The total commitments amount related to these contractual obligations does not necessarily represent future cash requirements.

(Amounts in thousands)

Contractual Obligations December 31, 2011	Less than 1 Year	1 - 3 Years	3 -5 Years	Over 5 Years	Total
Time deposits	\$ 135,711	\$ 90,269	\$ 26,151	\$ 0	\$ 252,131
Securities sold under agreement to repurchase	18,132	0	0	0	18,132
FHLB borrowings	28,750	32,750	13,000	2,000	76,500
Commitments to grant loans <sup>1</sup>	5,703	0	0	0	5,703
Commitments to fund loans for secondary market mortgages	1,311	0	0	0	1,311
Unfunded commitments on lines of credit <sup>1</sup>	47,445	0	0	0	47,445
Purchase obligations of loan participations <sup>1</sup>	8,000	0	0	0	8,000
Financial standby letters of credit <sup>1</sup>	789	0	0	0	789
Performance standby letters of credit <sup>1</sup>	4,370	0	0	0	4,370
Purchase and building commitments	6,080	0	0	0	6,080
Operating lease obligations	187	305	189	2,394	3,075
Capital lease obligations	108	406	290	0	804
	\$ 256,586	\$ 123,730	\$ 39,630	\$ 4,394	\$ 424,340

<sup>1</sup>The Corporation does not expect all of the commitments and letters of credit to be fully funded. The total commitments amount related to these contractual obligations does not necessarily represent future cash requirements.

### **Critical Accounting Estimates**

The Corporation has chosen accounting policies that it believes are appropriate to accurately and fairly report its operating results and financial position, and the Corporation applies those accounting policies in a consistent manner. The Significant Accounting Policies are summarized in Note 1 to the consolidated financial statements included in the 2011 Annual Report on Form 10-K. There have been no changes to the Critical Accounting Estimates since the Corporation filed its Annual Report on Form 10-K for the year ended December 31, 2011.

Item 3. Quantitative and Qualitative Disclosures about Market Risk

There have been no material changes in the Corporation's quantitative and qualitative market risks since December 31, 2011. The composition of rate sensitive assets and rate sensitive liabilities as of March 31, 2012 is very similar to December 31, 2011. For more information, please refer to Part II - Item 7A of the Corporation's Annual Report on Form 10-K for the year ended December 31, 2011.

Item 4. Controls and Procedures

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 a) 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 as of March 31, 2012.

Changes in internal control over financial reporting. There were no changes in the Corporation's internal control b) over financial reporting during the fiscal quarter ended March 31, 2012, that materially affected, or are reasonably likely to materially affect, the Corporation's internal control over financial reporting.

## PART II - OTHER INFORMATION

## Item 1. Legal Proceedings

Although the Corporation is subject to various claims and legal actions that occur from time to time in the ordinary course of business, the Corporation is not party to any pending legal proceedings that management believes could have a material adverse effect on its business, results of operations, financial condition or cash flows.

## Item 1A. Risk Factors

There have been no material changes to the risk factors disclosed in Item 1A “Risk Factors” in the Corporation’s Annual Report on Form 10-K for the year ended December 31, 2011.

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

Period	(a) Total Number of Shares Purchased	(b) Average Price Paid per Share	(c) Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs	(d) Maximum Number of Shares that May Yet Be Purchased Under the Plans or Programs
January 1 — January 31, 2012	—	—	—	120,000
February 1 — February 29, 2012	—	—	—	120,000
March 1 — March 31, 2012	—	—	—	120,000
Total	—	—	—	120,000

## Item 3. Defaults Upon Senior Securities

None.

## Item 4. Mine Safety Disclosures

Not applicable.

Item 5. Other Information

None.

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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 (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 and restated (Incorporated by reference to Exhibit 3(ii) to the Registrant's Report on Form 8-K dated January 14, 2011).
10.1	Supplemental Employee Retirement Plan (Incorporated by reference to Exhibit 10 to 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 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 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 Registrant's Report on Form 10-Q for the quarter ended September 30, 2006).
14	First Keystone Corporation Directors and Senior Management Code of Ethics (Incorporated by reference to Exhibit 14 to Registrant's Report on Form 8-K dated January 9, 2007).
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.*
101.INS	XBRL Instance Document.*
101.SCH	XBRL Taxonomy Extension Schema Document.*
101.CAL	XBRL Taxonomy Extension Calculation Linkbase Document.*
101.DEF	XBRL Taxonomy Extension Definition Linkbase Document.*
101.LAB	XBRL Taxonomy Extension Label Linkbase Document.*

101.PRE XBRL Taxonomy Extension Presentation Linkbase Document.\*

\*Filed herewith.

The Corporation will provide a copy of any exhibit upon receipt of a written request for the particular exhibit or exhibits desired. All requests should be addressed to the Corporation's principal executive offices.

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FIRST KEYSTONE CORPORATION

SIGNATURES

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

FIRST KEYSTONE CORPORATION  
Registrant

May 9, 2012 /s/ Matthew P. Prosseda  
Matthew P. Prosseda  
Chief Executive Officer  
(Principal Executive Officer)

May 9, 2012 /s/ Diane C.A. Rosler  
Diane C.A. Rosler  
Senior Vice President and Chief Financial Officer  
(Principal Financial Officer)

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