FIRST KEYSTONE CORP
Form 10-Q
May 10, 2012

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10Q

x 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

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 x 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 x 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	x
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 x

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
ASSETS		
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
TOTAL ASSETS	$ 823,693	$ 818,546
LIABILITIES		
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

Deferred income taxes	2,852	2,350
Other liabilities	334	677
TOTAL LIABILITIES	$ 728,075	$ 725,454
STOCKHOLDERS' EQUITY		
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)
TOTAL STOCKHOLDERS' EQUITY	95,618	93,092
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	$ 823,693	$ 818,546

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
INTEREST INCOME		
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
INTEREST EXPENSE		
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
NON-INTEREST INCOME		
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
NON-INTEREST EXPENSE		
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

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 Stock	Surplus	Comprehensive Income	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Treasury Stock	Total
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)

(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
OPERATING ACTIVITIES		
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)
NET CASH PROVIDED BY OPERATING ACTIVITIES	$1,083	$3,417
INVESTING ACTIVITIES		
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
NET CASH (USED IN) PROVIDED BY INVESTING ACTIVITIES	$(1,135)	$8,201
FINANCING ACTIVITIES		
Net increase (decrease) in deposits	$14,456	$(546)
Net (decrease) increase in short-term borrowings	(12,296)	3,757

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.

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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 exerciseable 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:

	Available-for-Sale Securities			
(Amounts in thousands)		Gross	Gross	Estimated
	Amortized	Unrealized	Unrealized	Fair
March 31, 2012:	Cost	Gains	Losses	Value
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			
	Amortized	Gross Unrealized	Gross Unrealized	Estimated Fair
March 31, 2012:	Cost	Gains	Losses	Value
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			
	Amortized	Gross Unrealized	Gross Unrealized	Estimated Fair
December 31, 2011:	Cost	Gains	Losses	Value
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			
	Amortized	Gross Unrealized	Gross Unrealized	Estimated Fair
December 31, 2011:	Cost	Gains	Losses	Value
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.

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 Corporations & Agencies Obligations[1]	Obligations of State & Political Subdivisions[2]	Marketable Equity Securities[3]	Restricted Equity Securities[3]	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 %

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

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

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

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(Amounts in thousands)

	March 31, 2012				
	U.S. Government Corporations & Agencies Obligations[1]	Obligations of State & Political Subdivisions[2]	Marketable Equity Securities[3]	Restricted Equity Securities[3]	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

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

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

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

(Amounts in thousands)

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

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

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

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

(Amounts in thousands)

	December 31, 2011										
	U.S. Government Corporations & Agencies Obligations[1]		Obligations of State & Political Subdivisions[2]			Marketable Equity Securities[3]		Restricted Equity Securities[3]		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

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

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

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

There were no aggregate investments with a single issuer (excluding the U.S. Government and its agencies) which exceeded ten percent of consolidated 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-temporary 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:

March 31, 2012

	Less Than 12 Months		12 Months or More		Total	
(Amounts in thousands)	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

	Less Than 12 Months		12 Months or More		Total	
(Amounts in thousands)	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:

A. 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.

B. Level 2: Fair value is based on significant inputs, other than Level 1 inputs, that are observable either directly or indirectly for substantially the full term of the asset through corroboration with observable market data. Level 2 inputs include quoted market prices in active markets for similar assets, quoted market prices that are not active for identical or similar assets and other observable inputs.

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

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

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	Commercial Real Estate	Consumer	Residential	Unallocated	Total
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

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

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(Amounts in thousands)

	Commercial	Commercial Real Estate	Consumer	Residential	Unallocated	Total
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

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

(Amounts in thousands) December 31, 2011:	Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Recorded Investment	Interest Income Recognized
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	60-89 Days	90 Days or Greater	Total	Non-Performing	Total Financing
	Pas					