FIRST KEYSTONE CORP
Form 10-Q
November 09, 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 September 30, 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, 5,469,962 shares as of November 4, 2012.

PART I - FINANCIAL INFORMATION

Item 1. Financial Statements

FIRST KEYSTONE CORPORATION AND SUBSIDIARY

CONSOLIDATED BALANCE SHEETS

| *(Amounts in thousands)* | September 30, 2012 (Unaudited) | December 31, 2011 |
|---|---|---|
| ASSETS | | |
| Cash and due from banks | $ 6,677 | $ 8,403 |
| Interest-bearing deposits in other banks | 4,040 | 1,776 |
| Total cash and cash equivalents | 10,717 | 10,179 |
| Investment securities available-for-sale | 303,244 | 328,824 |
| Investment securities held-to-maturity (estimated fair value of $2,632 in 2012 and $2,666 in 2011) | 2,585 | 2,605 |
| Restricted securities at cost - available-for-sale | 4,427 | 5,189 |
| Loans, net of unearned income | 430,977 | 415,995 |
| Allowance for loan losses | (5,905 ) | (5,929 ) |
| Net loans | 425,072 | 410,066 |
| Premises and equipment, net | 18,027 | 12,725 |
| Accrued interest receivable | 4,219 | 4,375 |
| Cash surrender value of bank owned life insurance | 19,691 | 19,145 |
| Investment in real estate ventures | 1,346 | 1,484 |
| Goodwill | 19,133 | 19,133 |
| Core deposit intangible | 739 | 951 |
| Prepaid FDIC insurance | 1,102 | 1,427 |
| Foreclosed assets held for resale | 534 | 780 |
| Deferred income taxes | 8 | 30 |
| Other assets | 1,984 | 1,633 |
| TOTAL ASSETS | $ 812,828 | $ 818,546 |
| | | |
| LIABILITIES | | |
| Deposits: | | |
| Non-interest bearing | $ 86,025 | $ 75,489 |
| Interest bearing | 544,207 | 548,860 |
| Total Deposits | 630,232 | 624,349 |
| Short-term borrowings | 16,764 | 30,882 |
| Long-term borrowings | 50,540 | 64,339 |
| Accrued interest and other expenses | 2,988 | 2,857 |

| | | |
|---|---|---|
| Deferred income taxes | 4,346 | 2,350 |
| Other liabilities | 5,697 | 677 |
| TOTAL LIABILITIES | $ 710,567 | $ 725,454 |
| | | |
| STOCKHOLDERS' EQUITY | | |
| Preferred stock, par value $2.00 per share; authorized 1,000,000 shares in 2012; issued 0 in 2012 | $ 0 | $ 0 |
| Common stock, par value $2.00 per share; authorized 20,000,000 shares in 2012 and 10,000,000 shares in 2011; issued 5,707,395 in 2012 and 5,687,767 in 2011 | 11,415 | 11,375 |
| Surplus | 30,526 | 30,157 |
| Retained earnings | 53,782 | 49,872 |
| Accumulated other comprehensive income | 12,472 | 7,757 |
| Treasury stock, at cost, 238,489 shares in 2012 and 242,517 shares in 2011 | (5,934) | (6,069) |
| | | |
| TOTAL STOCKHOLDERS' EQUITY | 102,261 | 93,092 |
| TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY | $ 812,828 | $ 818,546 |

See accompanying notes to consolidated financial statements.

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FIRST KEYSTONE CORPORATION AND SUBSIDIARY

CONSOLIDATED STATEMENTS OF INCOME

FOR THE THREE MONTHS ENDED SEPTEMBER 30, 2012 AND 2011

(Unaudited)

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

| | 2012 | 2011 |
|---|---|---|
| INTEREST INCOME | | |
| Interest and fees on loans | $5,534 | $5,848 |
| Interest and dividend income on investment securities | 2,987 | 3,388 |
| Interest on deposits in banks | 1 | 0 |
| Interest on federal funds sold | 0 | 1 |
| Total interest income | $8,522 | $9,237 |
| | | |
| INTEREST EXPENSE | | |
| Interest on deposits | $1,065 | $1,657 |
| Interest on short-term borrowings | 29 | 36 |
| Interest on long-term borrowings | 382 | 647 |
| Total interest expense | $1,476 | $2,340 |
| | | |
| Net interest income | $7,046 | $6,897 |
| Provision for loan losses | 400 | 500 |
| Net interest income after provision for loan losses | $6,646 | $6,397 |
| | | |
| NON-INTEREST INCOME | | |
| Trust department | $193 | $153 |
| Service charges and fees | 313 | 335 |
| Bank owned life insurance income | 179 | 187 |
| ATM fees and debit card income | 239 | 238 |
| Gains on sale of mortgage loans | 332 | 117 |
| Investment securities gains (losses) - net | 477 | 218 |
| Other | 153 | 95 |
| Total non-interest income | $1,886 | $1,343 |
| | | |
| NON-INTEREST EXPENSE | | |
| Salaries and employee benefits | $2,602 | $2,394 |
| Occupancy, net | 398 | 335 |
| Furniture and equipment | 202 | 122 |
| Computer expense | 277 | 266 |
| Professional services | 174 | 197 |
| State shares tax | 193 | 227 |
| FDIC insurance | 120 | 127 |

| | | |
|---|---|---|
| ATM and debit card fees | 121 | 98 |
| Other | 1,089 | 665 |
| Total non-interest expense | $5,176 | $4,431 |
| | | |
| Income before income tax expense | $3,356 | $3,309 |
| Income tax expense | 592 | 632 |
| NET INCOME | $2,764 | $2,677 |
| | | |
| PER SHARE DATA | | |
| Net Income Per Share: | | |
| Basic | $.51 | $.49 |
| Diluted | .51 | .49 |
| Cash dividends per share | .25 | .24 |

See accompanying notes to consolidated financial statements.

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FIRST KEYSTONE CORPORATION AND SUBSIDIARY

CONSOLIDATED STATEMENTS OF INCOME

FOR THE NINE MONTHS ENDED SEPTEMBER 30, 2012 AND 2011

(Unaudited)

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

| | 2012 | 2011 |
|---|---|---|
| INTEREST INCOME | | |
| Interest and fees on loans | $16,833 | $17,572 |
| Interest and dividend income on investment securities | 9,456 | 10,338 |
| Interest on deposits in banks | 1 | 3 |
| Interest on federal funds sold | 0 | 1 |
| Total interest income | $26,290 | $27,914 |
| | | |
| INTEREST EXPENSE | | |
| Interest on deposits | $3,528 | $5,263 |
| Interest on short-term borrowings | 88 | 129 |
| Interest on long-term borrowings | 1,482 | 1,927 |
| Total interest expense | $5,098 | $7,319 |
| | | |
| Net interest income | $21,192 | $20,595 |
| Provision for loan losses | 1,200 | 1,100 |
| Net interest income after provision for loan losses | $19,992 | $19,495 |
| | | |
| NON-INTEREST INCOME | | |
| Trust department | $561 | $440 |
| Service charges and fees | 885 | 983 |
| Bank owned life insurance income | 546 | 569 |
| ATM fees and debit card income | 730 | 678 |
| Gains on sale of mortgage loans | 738 | 211 |
| Investment securities gains (losses) - net | 1,484 | 143 |
| Other | 339 | 341 |
| Total non-interest income | $5,283 | $3,365 |
| | | |
| NON-INTEREST EXPENSE | | |
| Salaries and employee benefits | $7,794 | $7,027 |
| Occupancy, net | 1,072 | 1,015 |
| Furniture and equipment | 445 | 330 |
| Computer expense | 800 | 743 |
| Professional services | 514 | 523 |
| State shares tax | 564 | 548 |
| FDIC insurance | 375 | 564 |

| | | |
|---|---|---|
| ATM and debit card fees | 348 | 279 |
| FHLB prepayment penalties | 811 | 0 |
| Other | 2,845 | 2,178 |
| Total non-interest expense | $15,568 | $13,207 |
| | | |
| Income before income tax expense | $9,707 | $9,653 |
| Income tax expense | 1,709 | 1,937 |
| NET INCOME | $7,998 | $7,716 |
| | | |
| PER SHARE DATA | | |
| Net Income Per Share: | | |
| Basic | $1.47 | $1.42 |
| Diluted | 1.47 | 1.42 |
| Cash dividends per share | .75 | .72 |

See accompanying notes to consolidated financial statements.

FIRST KEYSTONE CORPORATION AND SUBSIDIARY

CONSOLIDATED STATEMENT OF CHANGES IN STOCKHOLDERS' EQUITY

(Unaudited)

*(Amounts in thousands, except shares)*

| | Common Stock Shares | Amount | Surplus | Compre-hensive Income | Retained Earnings | Accumulated Other Comprehensive Income (Loss) | Treasury Stock | Total |
|---|---|---|---|---|---|---|---|---|
| Balance at December 31, 2011 | 5,687,767 | $11,375 | $30,157 | | $49,872 | $ 7,757 | $(6,069 ) | $ 93,092 |
| Comprehensive Income: | | | | | | | | |
| Net Income | | | | $7,998 | 7,998 | | | 7,998 |
| Change in net unrealized gains (losses) on investment securities available-for- sale, net of reclassification adjustment and tax effects | | | | 4,715 | | 4,715 | | 4,715 |
| Total comprehensive income | | | | $12,713 | | | | |
| Issuance of 19,628 shares of common stock for stock dividends and stock purchase plan | 19,628 | 40 | 439 | | | | | 479 |
| Issuance of 4,028 shares of treasury stock upon exercise of employee stock options | | | (70 ) | | | | 135 | 65 |
| Cash dividends - $.75 per share | | | | | (4,088 ) | | | (4,088) |
| Balance at September 30, 2012 | 5,707,395 | $11,415 | $30,526 | | $53,782 | $ 12,472 | $(5,934 ) | $ 102,261 |
| | | | | | | | | |
| Balance at December 31, 2010 | 5,687,767 | $11,375 | $30,175 | | $45,246 | $ (1,633 ) | $(6,103 ) | $ 79,060 |
| Comprehensive Income: | | | | | | | | |
| Net Income | | | | $7,716 | 7,716 | | | 7,716 |
| Change in unrealized gains (losses) on investment securities available-for sale, net of reclassification adjustment and tax | | | | 9,126 | | 9,126 | | 9,126 |

| | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| effects | | | | | | | | |
| Total comprehensive income | | | | $16,842 | | | | |
| Issuance of 815 shares of treasury stock upon exercise of employee stock options | | | (14 ) | | | | 28 | 14 |
| Cash dividends - $.72 per share | | | | | (3,920 ) | | | (3,920) |
| Balance at September 30, 2011 | 5,687,767 | $11,375 | $30,161 | | $49,042 | $ 7,493 | $(6,075 ) | $ 91,996 |

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(Unaudited)

| *(Amounts in thousands)* | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|---|---|---|---|
| | 2012 | 2011 | 2012 | 2011 |
| Net Income | $ 2,764 | $ 2,677 | $ 7,998 | $ 7,716 |
| Other comprehensive income: | | | | |
| Unrealized holding gains on available-for-sale investment securities arising during the period | 3,088 | 9,712 | 8,651 | 13,948 |
| Less reclassification adjustment for net gains realized in income | 477 | 218 | 1,484 | 143 |
| Change in unrealized gains before tax effect | 2,611 | 9,494 | 7,167 | 13,805 |
| Tax effects | (897 ) | (3,216 ) | (2,452 ) | (4,679 ) |
| Net change in unrealized gains | 1,714 | 6,278 | 4,715 | 9,126 |
| Comprehensive Income | $ 4,478 | $ 8,955 | $ 12,713 | $ 16,842 |

See accompanying notes to consolidated financial statements.

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FIRST KEYSTONE CORPORATION AND SUBSIDIARY

CONSOLIDATED STATEMENTS OF CASH FLOWS

FOR THE NINE MONTHS ENDED SEPTMBER 30, 2012 AND 2011

(Unaudited)

| *(Amounts in thousands)* | 2012 | 2011 |
|---|---|---|
| OPERATING ACTIVITIES | | |
| Net income | $7,998 | 7,716 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Provision for loan losses | 1,200 | 1,100 |
| Depreciation and amortization | 837 | 721 |
| Premium amortization on investment securities | 913 | 760 |
| Discount accretion on investment securities | (676) | (860) |
| Core deposit discount amortization net of accretion | 212 | 217 |
| Deferred (benefit) income tax provision | (434) | 141 |
| (Gain) loss on sale of mortgage loans originated for resale | (738) | (211) |
| Proceeds from sale of mortgage loans originated for resale | 23,301 | 14,270 |
| Originations of mortgage loans originated for resale | (24,499) | (12,756) |
| (Gain) loss on sales of investment securities | (1,484) | (143) |
| Loss (gain) on sale of foreclosed assets held for resale | 195 | 137 |
| Decrease (increase) in accrued interest receivable | 156 | 315 |
| (Increase) decrease in cash surrender value of bank owned life insurance | (546) | (569) |
| (Increase) decrease in other assets - net | (327) | (218) |
| Decrease (increase) in prepaid FDIC insurance | 325 | 520 |
| Increase (decrease) in accrued interest and other expenses | 131 | (32) |
| (Decrease) increase in other liabilities | (408) | (260) |
| NET CASH PROVIDED BY OPERATING ACTIVITIES | $6,156 | $10,848 |
| | | |
| INVESTING ACTIVITIES | | |
| Proceeds from sales of investment securities available-for-sale | $36,737 | $53,564 |
| Proceeds from maturities and redemptions of investment securities available-for-sale | 27,894 | 26,229 |
| Purchases of investment securities available-for-sale | (25,473) | (87,501) |
| Proceeds from maturities and redemption of investment securities held-to-maturity | 14 | 2,048 |
| Proceeds from the redemption of restricted securities | 968 | 903 |
| Purchases of restricted securities | (206) | 0 |
| Net (increase) decrease in loans | (15,007) | (3,632) |
| Purchases of premises and equipment | (5,795) | (1,047) |
| Proceeds from sale of foreclosed assets held for resale | 852 | 348 |
| NET CASH PROVIDED BY (USED IN) INVESTING ACTIVITIES | $19,984 | $(9,088) |
| | | |
| FINANCING ACTIVITIES | | |
| Net increase (decrease) in deposits | $5,883 | $6,912 |
| Net (decrease) increase in short-term borrowings | (14,118) | 1,372 |
| Proceeds from long-term borrowings | 10,000 | 5,000 |
| Repayment of long-term borrowings | (23,799) | (2,045) |

| | | |
|---|---|---|
| Proceeds from issuance of common stock | 65 | 0 |
| Proceeds from issuance of treasury stock | 246 | 14 |
| Cash dividends paid | (3,879 ) | (3,920 ) |
| NET CASH (USED IN) PROVIDED BY FINANCING ACTIVITIES | $(25,602) | $7,333 |
| | | |
| INCREASE IN CASH AND CASH EQUIVALENTS | $538 | $9,093 |
| CASH AND CASH EQUIVALENTS, BEGINNING | 10,179 | 11,905 |
| CASH AND CASH EQUIVALENTS, ENDING | $10,717 | $20,998 |
| | | |
| SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION | | |
| Cash paid during period for: | | |
| Cash paid during period for interest | $5,355 | $7,484 |
| Cash paid for income taxes | 1,726 | 1,572 |

See accompanying notes to consolidated financial statements.

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FIRST KEYSTONE CORPORATION AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

September 30, 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 17 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 and in the Consolidated Statements of Comprehensive Income. 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 and dividend income from investment securities. 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 September 30, 2012, the Corporation held $4,392,000 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 September 30, 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 September 30, 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 $534,000 at September 30, 2012 and $780,000 at 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 $138,000 for the nine months ended September 30, 2012 and $88,000 for the nine months ended September 30, 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 September 30, 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 September 30, 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 September 30, 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 September 30, 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 13,603 exercisable options issued and outstanding as of September 30, 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 these effects on the Consolidated Statements of Comprehensive Income.

**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 Note 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. Total other comprehensive income and the components of other comprehensive income are presented in the Consolidated Statements 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.

In July 2012, the FASB issued ASU 2012-02, *Intangibles – Goodwill and Other (Topic 350)*. The primary purpose of the ASU is to simplify the impairment test for indefinite-lived intangible assets other than goodwill. The new guidance gives the Corporation the option to make a qualitative assessment about the likelihood that an indefinite-lived intangible asset is impaired to determine whether it should perform a quantitative impairment test. The ASU is effective for annual and interim impairment tests performed for fiscal years beginning after September 15, 2012. The Corporation will adopt this standard in the fourth quarter of 2012, and does not anticipate that this standard 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 nine months ended September 30, 2012 and 2011, was approximately $216,000 and $201,000, 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.

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**NOTE 2 — INVESTMENT SECURITIES**

The amortized cost, related estimated fair value, and unrealized gains and losses for investment securities classified as "Available-For-Sale" or "Held-to-Maturity" were as follows at September 30, 2012 and December 31, 2011:

| *(Amounts in thousands)* | Available-for-Sale Securities | | | |
|---|---|---|---|---|
| | | Gross | Gross | Estimated |
| | Amortized | Unrealized | Unrealized | Fair |
| *September 30, 2012:* | Cost | Gains | Losses | Value |
| Obligations of U.S. Government Corporations and Agencies: | | | | |
| Mortgage-backed | $45,928 | $ 2,484 | $ (58) | $48,354 |
| Other | 17,720 | 164 | 0 | 17,884 |
| Obligations of state and political subdivisions | 171,305 | 16,220 | (670) | 186,855 |
| Corporate securities | 47,736 | 704 | (301) | 48,139 |
| Marketable equity securities | 1,619 | 447 | (54) | 2,012 |
| Restricted equity securities | 4,427 | 0 | 0 | 4,427 |
| Total | $288,735 | $ 20,019 | $ (1,083) | $307,671 |

| *(Amounts in thousands)* | Held-to-Maturity Securities | | | |
|---|---|---|---|---|
| | | Gross | Gross | Estimated |
| | Amortized | Unrealized | Unrealized | Fair |
| *September 30, 2012:* | Cost | Gains | Losses | Value |
| Obligations of U.S. Government Corporations and Agencies: | | | | |
| Mortgage-backed | $110 | $ 5 | $ 0 | $ 115 |
| Other | 2,008 | 30 | 0 | 2,038 |
| Obligations of state and political subdivisions | 467 | 12 | 0 | 479 |
| Total | $2,585 | $ 47 | $ 0 | $ 2,632 |

| *(Amounts in thousands)* | Available-for-Sale Securities | | | |
|---|---|---|---|---|
| | | Gross | Gross | Estimated |
| | Amortized | Unrealized | Unrealized | 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 | | | |
|---|---|---|---|---|
| | | Gross | Gross | Estimated |
| | Amortized | Unrealized | Unrealized | 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 |

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Securities Available-for-Sale with an aggregate fair value of $180,422,000 at September 30, 2012 and $182,478,000 at December 31, 2011; and securities Held-to-Maturity with an aggregate book value of $1,118,000 at September 30, 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 $99,800,000 at September 30, 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 September 30, 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)*

| | September 30, 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 | $1,001 | | $ 0 | | $ 0 | | $ 0 | | $ 12,282 | |
| Estimated fair value | 1,002 | | 0 | | 0 | | 0 | | 12,412 | |
| Weighted average yield | 1.35 | % | 0 | % | 0 | % | 0 | % | 3.78 | % |
| 1 - 5 Years: | | | | | | | | | | |
| Amortized cost | 12,134 | | 3,430 | | 0 | | 0 | | 30,993 | |
| Estimated fair value | 12,264 | | 3,626 | | 0 | | 0 | | 31,357 | |
| Weighted average yield | 1.03 | % | 4.77 | % | 0 | % | 0 | % | 2.29 | % |
| 5 - 10 Years: | | | | | | | | | | |
| Amortized cost | 9,116 | | 10,946 | | 0 | | 0 | | 4,461 | |
| Estimated fair value | 9,436 | | 12,350 | | 0 | | 0 | | 4,370 | |
| Weighted average yield | 4.62 | % | 5.52 | % | 0 | % | 0 | % | 3.30 | % |
| After 10 | | | | | | | | | | |
| Amortized cost | 41,397 | | 156,929 | | 1,619 | | 4,427 | | 0 | |
| Estimated fair value | 43,536 | | 170,879 | | 2,012 | | 4,427 | | 0 | |
| Weighted average yield | 3.23 | % | 6.30 | % | 3.63 | % | 0.09 | % | 0 | % |
| Total: | | | | | | | | | | |
| Amortized cost | $63,648 | | $ 171,305 | | $ 1,619 | | $ 4,427 | | $ 47,736 | |
| Estimated fair value | 66,238 | | 186,855 | | 2,012 | | 4,427 | | 48,139 | |
| Weighted average yield | 2.98 | % | 6.22 | % | 3.63 | % | 0.09 | % | 2.78 | % |

[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)*

| | September 30, 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 | 1,008 | 0 | 0 | 0 | 0 |
| Estimated fair value | 1,023 | 0 | 0 | 0 | 0 |
| Weighted average yield | 1.78 % | 0 % | 0 % | 0 % | 0 % |
| 5 - 10 Years: | | | | | |
| Amortized cost | 1,110 | 0 | 0 | 0 | 0 |
| Estimated fair value | 1,130 | 0 | 0 | 0 | 0 |
| Weighted average yield | 1.07 % | 0 % | 0 % | 0 % | 0 % |
| After 10 Years: | | | | | |
| Amortized cost | 0 | 467 | 0 | 0 | 0 |
| Estimated fair value | 0 | 479 | 0 | 0 | 0 |
| Weighted average yield | 0 % | 7.14 % | 0 % | 0 % | 0 % |
| Total: | | | | | |
| Amortized cost | $2,118 | $ 467 | $ 0 | $ 0 | $ 0 |
| Estimated fair value | 2,153 | 479 | 0 | 0 | 0 |
| Weighted average yield | 1.41 % | 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.

*(Amounts in thousands)*

| | December 31, 2011 | | | | |
|---|---|---|---|---|---|
| | U.S. Government Agency & Corporation 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 shareholders’ equity at September 30, 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 sale of investments in Available-for-Sale debt and equity securities during the third quarter of 2012 and 2011 were $9,829,000 and $9,435,000, respectively. Gross gains realized on these sales were $477,000 and $407,000, respectively. Gross losses on these sales were $0 and $188,000, respectively. There were no impairment losses in 2012 and 2011.

There were no proceeds from sale of investments in Held-to-Maturity debt and equity securities during the third 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 September 30, 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 September 30, 2012 and December 31, 2011:

September 30, 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 | $ 0 | $ 0 | $ 0 | $ 0 | $0 | $ 0 |
| Federal agency backed securities | 5,656 | 58 | 0 | 0 | 5,656 | 58 |
| Municipal bonds | 578 | 9 | 7,085 | 661 | 7,663 | 670 |
| Corporate securities | 1,919 | 51 | 6,277 | 250 | 8,196 | 301 |
| Marketable equity securities | 134 | 9 | 297 | 45 | 431 | 54 |
| | $ 8,287 | $ 127 | $ 13,659 | $ 956 | $21,946 | $ 1,083 |

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 26 securities in an unrealized loss position as of September 30, 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.

**NOTE 3 — LOANS**

Major classifications of loans at September 30, 2012 and December 31, 2011 consisted of:

*(Amounts in thousands)*

| | September 30, 2012 | December 31, 2011 |
|---|---|---|
| Commercial, Financial and Agricultural | $ 23,730 | $ 21,448 |
| Tax-exempt - Real Estate and Other | 31,601 | 19,779 |
| Real estate mortgages - Held-for-sale | 1,904 | 1,356 |
| Real estate mortgages - Consumer | 141,868 | 129,362 |
| Real estate mortgages - Commercial | 225,100 | 236,645 |
| Consumer | 6,651 | 7,429 |
| Gross loans | 430,854 | 416,019 |
| Add (deduct): Unearned discount and | (202) | (331) |
| Net deferred loan fees and costs | 325 | 307 |
| Total loans, net of unearned income | $ 430,977 | $ 415,995 |

Activity in the allowance for loan losses for the nine months ended September 30, 2012 and the year ended December 31, 2011:

*(Amounts in thousands)*

| | September 30, 2012 | December 31, 2011 |
|---|---|---|
| Balance at beginning of period | $ 5,929 | $ 5,701 |
| Provision charged to operations | 1,200 | 1,900 |
| Loans charged off | (1,291 ) | (1,769 ) |
| Recoveries | 67 | 97 |
| Balance at end of period | $ 5,905 | $ 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 $420,949,000 or 97.7% of gross loans are graded Pass; $3,372,000 or 0.8% are graded Special Mention; $6,533,000 or 1.5% are graded Substandard; and $0 are graded Doubtful.

Commercial & Industrial non-pass grades decreased to $1,198,000 as of September 30, 2012, as compared to $1,436,000 as of December 31, 2011. Commercial Real Estate non-pass grades decreased to $7,203,000 as of September 30, 2012, as compared to $10,375,000 as of December 31, 2011. The $3,172,000 decrease in Commercial Real Estate was the result of $1,172,000 in loans upgraded, $771,000 in loans charged-down, and $381,000 in loans transferred into foreclosed assets held for resale, with the balance attributed to borrower repayments. The Residential Real Estate and Consumer Loans non-pass grades increased to $1,504,000 as of September 30, 2012, compared to $1,115,000 as of December 31, 2011. The increase was due to the net of down-grading several residential assets and the transfer of one large residential property to foreclosed assets held for resale.

The Bank utilizes a risk grading matrix as a tool for managing credit risk in the loan portfolio and assigns an Asset Quality Rating (risk grade) to all retail, commercial and commercial real estate borrowing relationships. An asset quality rating is assigned using the guidance provided in the Bank’s loan policy, which was revised in the second quarter of 2012. Primary responsibility for assigning the asset quality rating rests with the lender. The asset quality rating is validated periodically by both an internal and external loan review process. The rating will always represent the best assessment of risk available at a given point in time, based upon a review of the borrower’s financial statements, credit analysis, payment history with our Bank, credit history and lender knowledge of the borrower. Risk grade characteristics are as follows:

*Risk Grade 1 – MINIMAL RISK through Risk Grade 6 – MANAGEMENT ATTENTION (Pass Grade Categories)*

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.

At the low-risk end of the rating scale, a risk grade of 1 - Minimal Risk is the grade reserved for loans with exceptional credit fundamentals and virtually no risk of default or loss. Loan grades then progress through escalating ratings of 2 through 6 based upon risk. Risk Grade 2 - Modest Risk are loans with sufficient cash flows; Risk Grade 3 - Average Risk are loans with key balance sheet ratios slightly above the borrower’s peers; Risk Grade 4 - Acceptable Risk are loans with key balance sheet ratios usually near the borrower’s peers, but one or more ratios may be higher; and Risk Grade 5 – Marginally Acceptable are loans with strained cash flow, increasing leverage and/or weakening markets. Risk Grade 6 - Management Attention are loans with weaknesses resulting from declining performance trends and the borrower’s cash flows may be temporarily strained. Loans in this category are performing according to terms, but present some type of potential concern.

*Risk Grade 7 – SPECIAL MENTION (Non-Pass Category)*

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 (Non-Pass Category)*

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 (Non-Pass Category)*

Generally, loans graded doubtful have 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/or 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 September 30, 2012 and December 31, 2011:

| | Commercial & Industrial | | Commercial Real Estate Construction | |
|---|---|---|---|---|
| | September 30, 2012 | December 31, 2011 | September 30, 2012 | December 31, 2011 |
| Grade: | | | | |
| 1-6 Pass | $51,341 | $ 38,250 | $ 5,470 | $ 3,781 |
| 7 Special Mention | 642 | 556 | 0 | 0 |
| 8 Substandard | 556 | 880 | 0 | 0 |
| 9 Doubtful | 0 | 0 | 0 | 0 |
| Add (deduct): Unearned discount | 0 | 0 | 0 | 0 |
| Net deferred loan fees & costs | 119 | 100 | (2) | (8) |
| Loans, net of unearned income | $52,658 | $ 39,786 | $ 5,468 | $ 3,773 |

| | Commercial Real Estate Other | | Residential Real Estate Including Home Equity | |
|---|---|---|---|---|
| | September 30, 2012 | December 31, 2011 | September 30, 2012 | December 31, 2011 |
| Grade: | | | | |
| 1-6 Pass | $ 215,218 | $ 224,030 | $ 142,285 | $ 129,627 |
| 7 Special Mention | 2,590 | 3,269 | 137 | 0 |
| 8 Substandard | 4,613 | 7,106 | 1,350 | 1,091 |

| | | | | |
|---|---|---|---|---|
| 9 Doubtful | 0 | 0 | 0 | 0 |
| Add (deduct): Unearned discount | 0 | 0 | 0 | 0 |
| Net deferred loan fees & costs | (26) | 3 | 156 | 133 |
| Loans, net of unearned income | $ 222,395 | $ 234,408 | $ 143,928 | $ 130,851 |

| | Consumer Loans | | Loans, Net of Unearned Income | |
|---|---|---|---|---|
| | September 30, 2012 | December 31, 2011 | September 30, 2012 | December 31, 2011 |
| Grade: | | | | |
| 1-6 Pass | $ 6,635 | $ 7,405 | $ 420,949 | $ 403,093 |
| 7 Special Mention | 3 | 0 | 3,372 | 3,825 |
| 8 Substandard | 14 | 24 | 6,533 | 9,101 |
| 9 Doubtful | 0 | 0 | 0 | 0 |
| Add (deduct): Unearned discount | (202) | (331) | (202) | (331) |
| Net deferred loan fees & costs | 78 | 79 | 325 | 307 |
| Loans, net of unearned income | $ 6,528 | $ 7,177 | $ 430,977 | $ 415,995 |

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 |
|---|---|---|---|---|---|---|
| Nine months ended September 30, 2012: | | | | | | |
| Allowance for Loan Losses: | | | | | | |
| Beginning balance | $ 489 | $ 3,507 | $ 137 | $ 1,228 | $ 568 | $ 5,929 |
| Charge-offs | (264) | (708) | (54) | (265) | 0 | (1,291) |
| Recoveries | 23 | 21 | 22 | 1 | 0 | 67 |
| Provision | 308 | 164 | (24) | 557 | 195 | 1,200 |
| Ending Balance | 556 | 2,984 | 81 | 1,521 | 763 | 5,905 |
| Ending balance: individually evaluated for impairment | 0 | 390 | 0 | 158 | 0 | 548 |
| Ending balance: collectively evaluated for impairment | $ 556 | $ 2,594 | $ 81 | $ 1,363 | $ 763 | $ 5,357 |
| Financing Receivables: | | | | | | |
| Ending Balance | $ 52,658 | $ 227,863 | $ 6,528 | $ 143,928 | $ 0 | $ 430,977 |
| Ending balance: individually evaluated for impairment | 502 | 1,894 | 0 | 951 | 0 | 3,347 |
| Ending balance: collectively evaluated for impairment | $ 52,156 | $ 225,969 | $ 6,528 | $ 142,977 | $ 0 | $ 427,630 |

| *(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 |

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Impaired loans at September 30, 2012 and December 31, 2011 were $3,347,000 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)*

| | September 30, 2012 | December 31, 2011 |
|---|---|---|
| Gross interest due under terms year-to-date | $ 201 | $ 342 |
| Amount included in income year-to-date | (20) | (54) |
| Interest income not recognized year-to-date | $ 181 | $ 288 |

The Corporation's impaired loans are summarized below for the periods ended September 30, 2012 and December 31, 2011.

| *(Amounts in thousands)*<br>September 30, 2012: | Recorded Investment | Unpaid Principal Balance | Related Allowance | Average Recorded Investment | Interest Income Recognized |
|---|---|---|---|---|---|
| With no related allowance recorded: | | | | | |
| Commercial | $ 502 | $ 801 | $ 0 | $ 811 | $ 3 |
| Commercial real estate | 865 | 1,326 | 0 | 1,364 | 0 |
| Residential | 108 | 173 | 0 | 177 | 0 |
| With an allowance recorded: | | | | | |
| Commercial | 0 | 0 | 0 | 0 | 0 |
| Commercial real estate | 1,029 | 1,298 | 390 | 1,302 | 7 |
| Residential | 843 | 926 | 158 | 940 | 10 |
| Total | $ 3,347 | $ 4,524 | $ 548 | $ 4,594 | $ 20 |
| Total consists of: | | | | | |
| Commercial | $ 502 | $ 801 | $ 0 | $ 811 | $ 3 |
| Commercial real estate | $ 1,894 | $ 2,624 | $ 390 | $ 2,666 | $ 7 |
| Residential | $ 951 | $ 1,099 | $ 158 | $ 1,117 | $ 10 |

| *(Amounts in thousands)*<br>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 September 30, 2012 and December 31, 2011 were as follows:

*(Amounts in thousands)*

| | September 30, 2012 | December 31, 2011 |
|---|---|---|
| Commercial - real estate | $ 1,894 | $ 3,210 |
| Commercial - other | 502 | 123 |
| Residential | 951 | 855 |
| Consumer | 0 | 0 |
| Total non-accruing loans | 3,347 | 4,188 |
| Restructured loans | 0 | 0 |
| Total impaired loans | 3,347 | 4,188 |
| Loans past-due 90 days or more and still accruing | 2,016 | 0 |
| Foreclosed assets | 534 | 780 |
| Total non-performing assets | $ 5,897 | $ 4,968 |

At September 30, 2012 and December 31, 2011, the recorded investment in impaired loans as defined by FASB ASC 310-10-35, *Receivables Subsequent Measurements,* was $3,347,000 and $4,188,000, and the impaired loans allowances were $548,000 and $947,000, respectively at September 30, 2012 and December 31, 2011. The average year-to-date recorded balance in impaired loans during the period ended September 30, 2012 and December 31, 2011 was approximately $4,594,000 and $5,851,000, respectively.

The following tables present the aging of past-due loans by class of loans at September 30, 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 |
|---|---|---|---|---|---|---|---|
| September 30, 2012: | | | | | | | |
| Commercial | $ 81 | $ 0 | $ 0 | $ 81 | $ 502 | $52,075 | $ 52,658 |
| Commercial real estate | 2,027 | 437 | 1,544 | 4,008 | 1,894 | 221,961 | 227,863 |
| Consumer | 63 | 15 | 0 | 78 | 0 | 6,450 | 6,528 |
| Residential | 1,126 | 91 | 472 | 1,689 | 951 | 141,288 | 143,928 |
| Total | $ 3,297 | $ 543 | $ 2,016 | $ 5,856 | $ 3,347 | $421,774 | $ 430,977 |

| *(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 $2,016,000 and $0 at September 30, 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, guaranteed, or well secured. The loans consist of a participation loan with a balance of approximately $1,000,000 that is a well secured property with a loan-to-value of 25%; approximately $500,000 in commercial retail properties that are in the process of collection and deemed to be well secured; and two residential mortgages with a balance of $500,000, both of which are in the process of collection with the borrowers making payments.

At September 30, 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 September 30, 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 on 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 real estate mortgages and certain investment securities.

**NOTE 6 — COMMITTMENTS AND CONTINGENCIES**

In February 2012, the Bank acquired three parcels of vacant land in the amount of $504,000 in Kingston, Pennsylvania. This location opened on August 20, 2012 with a new branch building at a cost of $1.3 million.

In 2011, the Bank began work to expand its main headquarters in Berwick, Pennsylvania. As of September 30, 2012, the Bank has committed to spend $5.3 million on this facility, of which $4.3 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 was acquired on July 26, 2012, and is expected to open in the second quarter of 2013.

In September 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 $311,000 in Dallas, Pennsylvania. The property is to be acquired by the end of the fourth quarter of 2012, and is expected to be open by the end of the first quarter of 2013.

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 September 30, 2012 and December 31, 2011, were as follows:

*(Amounts in thousands)*

| | September 30, 2012 | December 31, 2011 |
|---|---|---|
| Financial instruments whose contract amounts represent credit risk: | | |
| Commitments to extend credit | $ 58,631 | $ 62,459 |
| Financial standby letters of credit | $ 724 | $ 789 |
| Performance standby letters of credit | $ 3,783 | $ 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 September 30, 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**

Fair value is the exchange price that would be received for an asset or paid to transfer (exit price) in the principal or most advantageous market for the asset and liability in an orderly transaction between market participants on the measurement date. There are three levels of inputs that may be used to measure fair value:

A. Level 1: Fair value is based on unadjusted quoted prices in active markets that are accessible to the Corporation for identical, unrestrictive 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 other observable 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 that reflect a reporting entity's own assumptions about the assumptions that market participants would use in pricing an asset or liability. Examples of valuation methodologies that would result in Level 3 classification include option pricing models, discounted cash flows and other similar techniques.

A financial instrument's level within the fair value hierarchy is based on the lowest level of input that is significant to the fair value measurement. Transfers of financial instruments between levels within the fair value hierarchy are recognized on the date management determines that the underlying circumstances or assumptions have changed.

**Financial Assets Measured at Fair Value on a Recurring Basis**

At September 30, 2012 and December 31, 2011, investments measured at fair value on a recurring basis and the valuation methods used are as follows:

September 30, 2012

| | Level 1 | Level 2 | Level 3 | Total |
|---|---|---|---|---|
| Available-for-Sale Securities: | | | | |
| Obligations of U.S. Government Corporations and Agencies: | | | | |
| Mortgaged-backed | $0 | $48,354 | $ 0 | $48,354 |
| Other | 0 | 17,884 | 0 | 17,884 |
| Obligations of state and political subdivisions | 0 | 186,855 | 0 | 186,855 |
| Corporate securities | 0 | 48,139 | 0 | 48,139 |
| Marketable equity securities | 2,012 | 0 | 0 | 2,012 |
| Restricted equity securities | 0 | 4,427 | 0 | 4,427 |
| Total | $2,012 | $305,659 | $ 0 | $307,671 |

December 31, 2011

| | Level 1 | Level 2 | Level 3 | Total |
|---|---|---|---|---|
| Available-for-Sale Securities: | | | | |
| Obligations of U.S. Government Corporations and 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 for investments. There were no transfers between Level 1 and Level 2 during 2012 and 2011.

**Financial Assets Measured at Fair Value on a Nonrecurring Basis**

At September 30, 2012 and December 31, 2011, impaired loans measured at fair value on a non-recurring basis and the valuation methods used are as follows:

| | Level 1 | Level 2 | Level 3 | Total |
|---|---|---|---|---|
| Assets at September 30, 2012 | | | | |
| Impaired loans: | | | | |
| Commercial, Financial and Agricultural | $ 0 | $ 0 | $ 502 | $ 502 |
| Commercial real estate mortgages | 0 | 0 | 1,894 | 1,894 |
| Residential real estate mortgages | 0 | 0 | 951 | 951 |
| Total impaired loans | $ 0 | $ 0 | $ 3,347 | $ 3,347 |

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| | Level 1 | Level 2 | Level 3 | Total |
|---|---|---|---|---|
| Assets at December 31, 2011 | | | | |
| Impaired loans: | | | | |
| Commercial, Financial and Agricultural | $ 0 | $ 0 | $123 | $123 |
| Commercial real estate mortgages | 0 | 0 | 3,210 | 3,210 |
| Residential real estate mortgages | 0 | 0 | 855 | 855 |
| Total impaired loans | $ 0 | $ 0 | $4,188 | $4,188 |

The Bank'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 Bank completes a Certificate of Inspection, which includes an onsite inspection, insured values, tax assessed values, recent sales comparisons and a review of the previous evaluations. These assets are included as Level 3 fair values, based upon the lowest level that is significant to the fair value measurements. There were no transfers between valuation levels in 2012 and 2011.

**Nonfinancial Assets Measured at Fair Value on a Nonrecurring Basis**

At September 30, 2012 and December 31, 2011, foreclosed assets held for resale measured at fair value on a non-recurring basis and the valuation methods used are as follows:

| | Level 1 | Level 2 | Level 3 | Total |
|---|---|---|---|---|
| Assets at September 30, 2012 | | | | |
| Other foreclosed assets held for resale: | | | | |
| Residential real estate mortgages | $ 0 | $ 0 | $ 474 | $474 |
| Commercial real estate mortgages | 0 | 0 | 60 | 60 |
| Total foreclosed assets held for resale | $ 0 | $ 0 | $ 534 | $534 |

| | Level 1 | Level 2 | Level 3 | Total |
|---|---|---|---|---|
| Assets at December 31, 2011 | | | | |
| Other foreclosed assets held for resale: | | | | |
| Commercial real estate mortgages | $ 0 | $ 0 | $ 780 | $780 |
| Total foreclosed assets held for resale | $ 0 | $ 0 | $ 780 | $780 |

The Bank's foreclosed asset valuation procedure requires an appraisal to be completed periodically with the exception of those cases which the Bank has obtained a sales agreement. These assets are included as Level 3 fair values, based upon the lowest level that is significant to the fair value measurements. There were no transfers between valuation levels in 2012 and 2011.

The following table presents additional quantitative information about assets measured at fair value on a nonrecurring basis and for which the Bank has utilized Level 3 inputs to determine the fair value:

| | Quantitative Information about Level 3 Fair Value Measurements | | | |
|---|---|---|---|---|
| | Fair Value Estimate | Valuation Technique | Unobservable Input | Range |
| Assets at September 30, 2012 | | | | |
| Impaired loans | $3,347 | Appraisal of collateral[1,3] | Appraisal adjustments[2] | 10% - 35% |
| Foreclosed assets held for sale | 534 | Appraisal of collateral[1,3] | Appraisal adjustments[2] | 10% - 35% |

[1]Fair value is generally determined through independent appraisals of the underlying collateral, as defined by Bank regulators.

[2]Appraisals may be adjusted by management for qualitative factors such as economic conditions and estimated liquidation expenses. The typical range of appraisal adjustments are presented as a percent of the appraisal value.

[3]Includes qualitative adjustments by management and estimated liquidation expenses.

**Fair Value of Financial Instruments**

*(Amounts in thousands)*

| | Carrying | Fair Value Measurements at September 30, 2012 | | | |
|---|---|---|---|---|---|
| | Amount | Level 1 | Level 2 | Level 3 | Total |
| FINANCIAL ASSETS: | | | | | |
| Cash and due from banks | $6,677 | $6,677 | $0 | $0 | $6,677 |
| Short-term investments | 4,040 | 4,040 | 0 | 0 | 4,040 |
| Investment securities – available-for-sale | 307,671 | 2,012 | 305,659 | 0 | 307,671 |
| Investment securities – held-to-maturity | 2,585 | 0 | 2,632 | 0 | 2,632 |
| Net loans | 425,072 | 0 | 0 | 425,579 | 425,579 |
| Mortgage servicing rights | 459 | 0 | 0 | 459 | 459 |
| Accrued interest receivable | 4,219 | 4,219 | 0 | 0 | 4,219 |
| Cash surrender value of bank owned life insurance | 19,691 | 19,691 | 0 | 0 | 19,691 |
| FINANCIAL LIABILITIES: | | | | | |
| Deposits | 630,232 | 381,925 | 0 | 251,663 | 633,588 |
| Short-term borrowings | 16,764 | 16,764 | 0 | 0 | 16,764 |
| Long-term borrowings | 50,540 | 0 | 0 | 54,083 | 54,083 |
| Accrued interest payable | 529 | 529 | 0 | 0 | 529 |
| OFF-BALANCE SHEET FINANCIAL INSTRUMENTS: | | | | | |
| Commitments to extend credit | | | | | 58,631 |
| Financial standby letters of credit | | | | | 724 |
| Performance standby letters of credit | | | | | 3,783 |

*(Amounts in thousands)*

| | Carrying | Fair Value Measurements at December 31, 2011 | | | |
|---|---|---|---|---|---|
| | Amount | Level 1 | Level 2 | Level 3 | Total |
| FINANCIAL ASSETS: | | | | | |
| Cash and due from banks | $8,403 | $8,403 | $0 | $0 | $8,403 |
| Short-term investments | 1,776 | 1,776 | 0 | 0 | 1,776 |
| Investment securities – available-for-sale | 334,013 | 1,741 | 332,272 | 0 | 334,013 |
| Investment securities – held-to-maturity | 2,605 | 0 | 2,666 | 0 | 2,666 |
| Net loans | 410,066 | 0 | 0 | 410,033 | 410,033 |
| Mortgage servicing rights | 421 | 0 | 0 | 421 | 421 |
| Accrued interest receivable | 4,375 | 4,375 | 0 | 0 | 4,375 |
| Cash surrender value of bank owned life insurance | 19,145 | 19,145 | 0 | 0 | 19,145 |
| FINANCIAL LIABILITIES: | | | | | |
| Deposits | 624,349 | 368,831 | 0 | 255,962 | 624,793 |
| Short-term borrowings | 30,882 | 30,882 | 0 | 0 | 30,882 |

| | | | | | |
|---|---|---|---|---|---|
| Long-term borrowings | 64,339 | 0 | 0 | 69,055 | 69,055 |
| Accrued interest payable | 785 | 785 | 0 | 0 | 785 |
| | | | | | |
| OFF-BALANCE SHEET FINANCIAL INSTRUMENTS: | | | | | |
| Commitments to extend credit | | | | | 62,459 |
| Financial standby letters of credit | | | | | 789 |
| Performance standby letters of credit | | | | | 4,370 |

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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.

**Cash Surrender Value of Bank Owned Life Insurance**

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

**Deposits**

Under FASB ASC 825-10-50, the fair value of deposits with no stated maturity, such as demand deposits, savings accounts and money market accounts, is equal to the amount payable on demand at September 30, 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 borrowings are equal to the current carrying values, 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.

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**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 nine-month period ended September 30, 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

Board of Directors and Stockholders of First Keystone Corporation:

We have reviewed the consolidated balance sheet of First Keystone Corporation and Subsidiary as of September 30, 2012 and the related consolidated statements of income and comprehensive income for the three and nine month periods ended September 30, 2012 and 2011 and changes in stockholders' equity and cash flows for the nine month periods ended September 30, 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

November 8, 2012

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Item 2. First Keystone Corporation Management's Discussion and Analysis of Financial Condition and Results of Operation as of September 30, 2012

This quarterly report contains certain forward-looking statements, which are included pursuant to the "safeharbor" 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 third quarter of 2012 of $2,764,000, an increase of $87,000, or 3.3% from the third quarter of 2011. The increase in net income for the third quarter of 2012 was due to several factors, including an increase in net interest income, an increase in gains on sale of mortgage loans and an increase in gains on the sale of investment securities. On a per share basis, net income per share was $1.47 for the first nine months of 2012, up from $1.42 for the first nine months of 2011, an increase of 3.5%. Cash dividends increased to $.75 per share up from $.72 in the first nine months of 2011, an increase of 4.2%.

Year-to-date net income annualized as of September 30, 2012, amounted to a return on average common equity of 10.83%, a return on tangible equity of 15.47% and a return on assets of 1.30%. For the nine months ended September 30, 2011, these measures were 12.38%, 16.07%, and 1.26%, respectively, on an annualized basis.

In July 2012, the Corporation completed transactions designed to improve net interest income. Investment securities with a market value of $15,941,000 and having a yield of 2.95% were sold for a gain of $946,000. In addition, term borrowings with the Federal Home Loan Bank of Pittsburgh in the amount of $13,750,000 with a weighted average cost of 4.29% were prepaid, resulting in a prepayment penalty of $811,000. The impact of these transactions was an annualized increase in net interest income of $150,000. The deleveraging of the balance sheet also improved Tier 1 leverage and improved sensitivity to rising interest rates.

NET INTEREST INCOME

The major source of operating income for the Corporation is net interest income, defined as interest income less interest expense. In the third quarter of 2012, interest income amounted to $8,522,000, a decrease of $715,000 or 7.7% from the third quarter of 2011, while interest expense amounted to $1,476,000 in the third quarter of 2012, a decrease of $864,000, or 36.9% from the third quarter of 2011. As a result, net interest income increased $149,000 or 2.2% in the third quarter of 2012 to $7,046,000 from $6,897,000 in third quarter of 2011. Net interest income increased $597,000 or 2.9% for the nine months ended September 30, 2012 to $21,192,000 from $20,595,000 for the same period in 2011.

Our net interest margin for the nine months ended September 30, 2012 was 4.12% compared to 3.97% for the nine months ended September 30, 2011.

PROVISION FOR LOAN LOSSES

The provision for loan losses for the quarter ended September 30, 2012, was $400,000, compared to $500,000 for the quarter ended September 30, 2011. The year-to-date provision for loan losses amounted to $1,200,000 as of September 30, 2012, as compared to $1,100,000 as of September 30, 2011. The increase in the provision for loan losses resulted from the Bank's analysis of the current loan portfolio, including historic losses, past-due trends, current economic conditions, and other relevant factors. Net charge-offs for the nine month period ended September 30, 2012 was $1,224,000, compared to $1,327,000 for the nine month period ended September 30, 2011. The allowance for loan losses as a percentage of average loans outstanding, net of unearned interest, was 1.40% for the nine months ended September 30, 2012, as compared to 1.33% for the nine months ended September 30, 2011, and 1.44% for the year ended December 31, 2011. See Allowance for Loan Losses on Page 36 for further discussion.

NON-INTEREST INCOME

Total non-interest income was $1,886,000 for the quarter ended September 30, 2012, as compared to $1,343,000 for the quarter ended September 30, 2011, an increase of $543,000, or 40.4%. Excluding investment securities gains and losses, non-interest income was $1,409,000 for the third quarter of 2012, an increase of $284,000, or 25.2% from the third quarter of 2011. The increase in non-interest income was driven by an increase in net gains on the sale of investment securities of $259,000, an increase in gains on sale of residential mortgage loans of $215,000 and an increase in Trust Department income of $40,000 as compared to the third quarter of 2011.

NON-INTEREST EXPENSE

Total non-interest expense was $5,176,000 for the quarter ended September 30, 2012, as compared to $4,431,000 for the quarter ended September 30, 2011. Non-interest expense was up $745,000, or 16.8%. Salaries and employee benefits rose by $208,000, or 8.7%. These increases reflect additional employee and benefit costs associated with staffing additions in the accounting and information security areas. Also, medical insurance costs have risen for the period. Further, non-interest expense was impacted by increased costs related to collections and other real estate owned.

Expenses associated with employees (salaries and employee benefits) continue to be the largest category of non-interest expense. Salaries and benefits amounted to $7,794,000, or 50.1% of total non-interest expense for the nine months ended September 30, 2012, as compared to 53.2% for the nine months of 2011. Net occupancy, furniture and equipment, and computer expense amounted to $2,317,000 for the nine months ended September 30, 2012, an increase of $229,000, or 11.0%. Other non-interest expense, including the FHLB prepayment penalty, FDIC insurance, professional services and state shares tax amounted to $5,457,000 for the nine months ended September 30, 2012, an increase of $1,365,000, or 33.4% from the first nine months of 2011. Non-interest expense in the first nine months of 2012 is approximately 2.6% 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 expense amounted to $1,709,000 for the nine months ended September 30, 2012, as compared to $1,937,000 for the nine months ended September 30, 2011, a decrease of $228,000. The effective total income tax rate was 17.6% for the third quarter of 2012 as compared to 19.1% for the third quarter of 2011. The effective total income tax rate was 17.6% for the first nine months of 2012 as compared to 20.1% for the first nine months of 2011. The decrease in the effective tax rate was due to additional tax exempt income received and an additional low-income housing tax credit recognized during the period.

ANALYSIS OF FINANCIAL CONDITION

ASSETS

Total assets decreased to $812,828,000 as of September 30, 2012, a decrease of $5,718,000 from year-end 2011. Net loans increased by $15,006,000 or 3.7%, reflecting a slight pickup in activity. Cash balances decreased compared to year-end.

During the first nine months of 2012, the Corporation decreased short-term borrowings to $16,764,000 as of September 30, 2012, as compared to $30,882,000 as of December 31, 2011. Long-term borrowings decreased to $50,540,000 as of September 30, 2012, down from the $64,339,000 as of December 31, 2011.

The decreases in total assets and long-term borrowings were attributable to a program in which investments were sold to pay-off several long-term borrowings to further improve net interest margin.

EARNING ASSETS

Our primary earning asset, loans, net of unearned income, increased to $430,977,000 as of September 30, 2012, up $14,982,000, or 3.6% since year-end 2011. The loan portfolio continues to be diversified. Overall asset quality has remained consistent with non-performing assets increasing since year-end 2011. Total non-performing assets were $5,897,000 as of September 30, 2012, an increase of $929,000, or 18.7% 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 100.1% as of September 30, 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 September 30, 2012. Held-to-maturity securities amounted to $2,585,000 as of September 30, 2012, a decrease of $20,000 from December 31, 2011. Available-for-sale securities amounted to $307,671,000 as of September 30, 2012, a decrease of $26,342,000 from year-end 2011. Interest-bearing deposits in other banks increased as of September 30, 2012, to $4,040,000 from $1,776,000 at year-end 2011.

LOANS

Total loans, net of unearned income, increased to $430,977,000 as of September 30, 2012, as compared to a balance of $415,995,000 as of December 31, 2011. The table on page 19 provides data relating to the composition of the Corporation's loan portfolio on the dates indicated. Total loans, net of unearned income, increased $14,982,000, or 3.6% in the first nine months of 2012.

The economy and the resultant decline in loan demand accounted for slow growth in the loan portfolio in the first nine months of 2012. The Residential Real Estate loan portfolio increased $13,054,000 to $143,772,000 as of September 30, 2012, as compared to $130,718,000 as of December 31, 2011. The majority of the increase was the result of new originations and, to a lesser extent, refinances held in the Bank's portfolio. The Commercial Secured by Real Estate loan portfolio decreased $11,545,000 to $225,100,000 as of September 30, 2012, as compared to $236,645,000 as of December 31, 2011. The decrease was the result of weak new loan originations; a $6,405,000 pay-off of one large commercial mortgage; pay-offs of four commercial mortgages with balances of $450,000 or more (all of which were income-producing properties); and typical portfolio run-off.

The loan portfolio is well diversified. The total commercial portfolio was $280,431,000 at September 30, 2012 and $277,872,000 at December 31, 2011, of which $227,891,000 or 52.9% of gross loans were secured by commercial real estate at September 30, 2012, and $238,186,000 or 57.3% at December 31, 2011.

The largest relationship is an $8,387,000 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 consisted of the net balance of $8,256,000 after participation shares sold of $3,166,000. This relationship is comprised of several first lien mortgages relating to office and professional rental properties and a $5,000,000 line of credit to a planned residential community in the Corporation's eastern market area. The principal and related companies have been involved in real estate development since 1974, and have successfully developed residential communities, medical office facilities, and professional office facilities. The entire relationship is secured by a combination of real estate and marketable securities.

The third 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 $7,518,000 at September 30, 2012, and is secured primarily by income producing real estate.

The fourth largest relationship of $7,261,000 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 fifth largest relationship is a real estate holding LLC established in 2006 along with its related medical service companies. The LLC was formed to construct and provide medical office space for a group of closely related medical entities and outside services and is located in the Corporation's immediate central market area. The relationship had outstanding loan balances of $6,993,000 at September 30, 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 nine months 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) | September 30, 2012 | December 31, 2011 |
|---|---|---|
| Commercial, financial and agricultural: | | |
| Commercial secured by real estate | $ 225,100 | $ 236,645 |
| Commercial - other | 23,730 | 21,448 |
| Tax exempt - real estate and other | 31,601 | 19,779 |
| Real estate (primarily residential mortgage loans) | 143,772 | 130,718 |
| Consumer loans | 6,651 | 7,429 |
| Total Gross Loans | 430,854 | 416,019 |
| Add (deduct): Unearned discount and | (202 ) | (331 ) |

| | | |
|---|---|---|
| Net deferred loan fees and costs | 325 | 307 |
| Total Loans, net of unearned income | $ 430,977 | $ 415,995 |

ALLOWANCE FOR LOAN LOSSES

The allowance for loan losses constitutes the amount available to absorb losses within the loan portfolio. As of September 30, 2012, the allowance for loan loss was $5,905,000 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 for the nine month period and the year and additional provisions charged to operations. In the first nine months of 2012, net charge-offs as a percentage of average loans were 0.29%, as compared to net charge-offs as a percentage of average loans of 0.41% during the twelve months of 2011, and 0.32% for the first nine months of 2011. Net charge-offs amounted to $1,224,000 for the first nine months of 2012 as compared to $1,672,000 for the twelve months ended December 31, 2011, and $1,327,000 for the first nine months of 2011. The decrease in net charge-offs in the first nine months of 2012 as compared to the first nine months of 2011 relates primarily to one commercial real estate relationship that was charged down $400,000 or 32.7% of net charge-offs; one Commercial/Financial relationship that was written down $153,000 or 12.5% of net charge-offs; and two Residential Mortgages that were charged down $169,000 or 13.8% of net charge-offs. The remaining balance of net charge-offs was comprised of small commercial relationships and small consumer loans.

For the first nine months of 2012, the provision for loan losses was $1,200,000 as compared to $1,100,000 for the first nine months of 2011. The provision, net of charge-offs and recoveries, increased the quarter end Allowance for Loan Losses to $5,905,000 of which $556,000 or 9.4% is attributed to Commercial, financial and agriculture loans; $4,505,000 or 76.3% is attributed to Real Estate loans; $81,000 or 1.4% is attributed to Consumer loans; and $763,000 or 12.9% being the unallocated component (refer to the activity in the allowance for loan losses by loan segment table in Note 3 — Loans on page 19). The Allowance for Loan Losses decreased to $5,905,000 as of September 30, 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 September 30, 2012.

Analysis of Allowance for Loan Losses

*(Amounts in thousands)*

| | September 30, 2012 | December 31, 2011 | September 30, 2011 |
|---|---|---|---|
| Balance at beginning of period | $ 5,929 | $ 5,701 | $ 5,701 |
| Charge-offs: | | | |
| Commercial, financial and agricultural | 264 | 485 | 483 |
| Real estate | 973 | 1,186 | 838 |
| Consumer | 54 | 98 | 71 |
| | 1,291 | 1,769 | 1,392 |
| Recoveries | | | |
| Commercial, financial and agricultural | 23 | 28 | 23 |
| Real estate | 22 | 53 | 32 |
| Consumer | 22 | 16 | 10 |
| | 67 | 97 | 65 |
| Net charge-offs | 1,224 | 1,672 | 1,327 |
| Additions charged to operations | 1,200 | 1,900 | 1,100 |

| | | | |
|---|---|---|---|
| Balance at end of period | $ 5,905 | $ 5,929 | $ 5,474 |
| Ratio of net charge-offs during the period to average loans outstanding during the period | 0.29 % | 0.41 % | 0.32 % |
| Allowance for loan losses to average loans outstanding during the period | 1.40 % | 1.44 % | 1.33 % |

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 1.40% at September 30, 2012, 1.44% at December 31, 2011 and 1.33% at September 30, 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) | September 30, 2012 | | | December 31, 2011 | | |
|---|---|---|---|---|---|---|
| Commercial, financial and agricultural | $556 | 10.8 | %* | $489 | 9.1 | %* |
| Real estate - mortgage | 4,505 | 87.6 | %* | 4,735 | 88.3 | %* |
| Consumer and other loans | 81 | 1.6 | %* | 137 | 2.6 | %* |
| Unallocated | 763 | N/A | * | 568 | N/A | * |
| | $5,905 | 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 40 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 resale represent property acquired through foreclosure, or considered to be an in-substance foreclosure.

Total non-performing assets increased $929,000 to $5,897,000 as of September 30, 2012 as compared to $4,968,000 as of December 31, 2011. The economy, in particular, high unemployment, weak job markets, unsettled fuel prices,

rising energy costs, 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 through 2012 and into early 2013. Impaired loans decreased to $3,347,000 as of September 30, 2012, as compared to $4,188,000 as of December 31, 2011. Foreclosed assets held for resale decreased to $534,000 as of September 30, 2012 as compared to $780,000 as of December 31, 2011. Loans past-due 90 days or more and still accruing interest increased to $2,016,000 as of September 30, 2012, as compared to $0 as of December 31, 2011. These loans are deemed to be well secured and in the process of collection. They consist of a participation loan with a balance of approximately $1,000,000 that is a well secured property with a loan-to-value of 25%; approximately $500,000 in commercial retail properties that are in the process of collection and deemed to be well secured; and two residential mortgages with a balance of approximately $500,000, both of which are in the process of collection with the borrowers making payments. Non-performing assets to period end loans and foreclosed assets was 1.4% as of September 30, 2012 and 1.2% as of December 31, 2011. Total non-performing assets to total assets was 0.7% as of September 30, 2012 and 0.6% as of December 31, 2011. Our allowance for loan losses to total non-performing assets was 100.1% as of September 30, 2012 and 119.3% as of December 31, 2011. Additional detail can be found on page 40, "Non-Performing Assets Table" and page 24 in the "Financing Receivables on Non-Accrual Status Table". Asset quality is a priority and the Corporation retains a full-time Loan Review Officer to closely track and monitor overall loan quality, along with a full-time workout specialist to manage collection and liquidation efforts.

Impaired loans decreased to $3,347,000 at September 30, 2012 from $4,188,000 at December 31, 2011. Two relationships carried aggregate balances of $250,000 or greater. The largest relationship is represented by five loans carrying a balance of $1,135,000 secured by rental residential real estate. The September 30, 2012 valuation carried a net realizable value of $1,008,000, after an estimated $130,000 cost to sell, resulting in a specific allocation of $138,000. The second largest relationship is represented by one loan carrying a balance of $285,000 secured by residential property. The September 30, 2012 valuation carried a net realizable value of $226,000, after an estimated $25,000 cost to sell, resulting in a specific allocation of $59,000. Of the $3,347,000 in impaired loans, one is located outside of our primary market area carrying a balance of $186,000. 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, 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 September 30, 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 and accrued on non-performing loans in the first nine months of 2012 and for the year ended December 31, 2011 was $20,000 and $54,000, respectively. Interest income, which would have been recorded on these loans under the original terms as of September 30, 2012 and December 31, 2011, was $201,000 and $342,000,

respectively. At September 30, 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 September 30, 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)

| | September 30, 2012 | December 31, 2011 |
|---|---|---|
| Non-performing assets | | |
| Impaired loans | $ 3,347 | $ 4,188 |
| Foreclosed assets held for resale | 534 | 780 |
| Loans past-due 90 days or more and still accruing interest | 2,016 | 0 |
| Total non-performing assets | $ 5,897 | $ 4,968 |
| | | |
| Impaired loans | | |
| Non-performing loans | $ 3,347 | $ 4,188 |
| Allocated allowance for loan losses | (548) | (947) |
| Net investment in impaired loans | $ 2,799 | $ 3,241 |
| | | |
| Impaired loans with a valuation allowance | $ 1,872 | $ 2,556 |
| Impaired loans without a valuation allowance | 1,475 | 1,632 |
| Total impaired loans | $ 3,347 | $ 4,188 |
| | | |
| Allocated valuation allowance related to impaired loans | $ 548 | $ 947 |
| | | |
| Allocated valuation allowance as a percent of impaired loans | 16.4 % | 22.6 % |
| Impaired loans to loans net of unearned discount | 0.8 % | 1.0 % |
| Non-performing assets to period-end loans and foreclosed assets | 1.4 % | 1.2 % |
| Total non-performing assets to total assets | 0.7 % | 0.6 % |
| Allowance for loan losses to impaired loans | 176.4 % | 141.6 % |
| Allowance for loan losses to total non-performing assets | 100.1 % | 119.3 % |

Real estate mortgages comprise 86.2% of the net loan portfolio as of September 30, 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 re-price 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 $5,883,000 to $630,232,000 as of September 30, 2012 as non-interest bearing deposits increased by $10,536,000 and interest bearing deposits decreased by $4,653,000 as of September 30, 2012, from year-end 2011. Total short-term and long-term borrowings decreased to $67,304,000 as of September 30, 2012, from $95,221,000 at year-end 2011, a decrease of $27,917,000, or 29.3%.

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 $4,715,000 for the nine months ended September 30, 2012. The Corporation had 238,489 and 242,517 shares of common stock on September 30, 2012 and December 31, 2011, respectively, as treasury stock. This had an effect of reducing our total stockholders' equity by $5,934,000 as of September 30, 2012, and $6,069,000 as of December 31, 2011.

Total stockholders' equity was $102,261,000 as of September 30, 2012, and $93,092,000 as of December 31, 2011. Leverage ratio and risk based capital ratios remain very strong. As of September 30, 2012, our leverage ratio was 9.01% compared to 8.07% as of December 31, 2011. In addition, Tier I risk based capital and total risk based capital ratio as of September 30, 2012, were 13.24% and 14.38%, respectively. The same ratios as of December 31, 2011 were 11.99% and 13.09%, respectively.

At its Annual Shareholders' Meeting on May 10, 2012, the Corporation's Articles of Incorporation were amended to increase the number of authorized common shares with a par value of $2.00 from 10,000,000 to 20,000,000 shares. Additionally, the Corporation was authorized to issue up to 1,000,000 shares of preferred stock on terms to be determined by the Board of Directors.

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.

The following table represents scheduled maturities of the Corporation's contractual obligations by time remaining until maturity as of September 30, 2012 and December 31, 2011.

*(Amounts in thousands)*

| Contractual Obligations September 30, 2012 | Less than 1 Year | 1 - 3 Years | 3 - 5 Years | Over 5 Years | Total |
|---|---|---|---|---|---|
| Time deposits | $137,960 | $80,378 | $29,970 | $0 | $248,308 |
| Securities sold under agreement to repurchase | 16,764 | 0 | 0 | 0 | 16,764 |
| FHLB borrowings | 6,000 | 19,000 | 5,000 | 20,000 | 50,000 |
| Commitments to grant loans[1] | 6,712 | 0 | 0 | 0 | 6,712 |
| Commitments to fund loans for secondary market mortgages | 2,016 | 0 | 0 | 0 | 2,016 |
| Unfunded commitments on lines of credit[1] | 49,903 | 0 | 0 | 0 | 49,903 |

| | | | | | |
|---|---|---|---|---|---|
| Financial standby letters of credit[1] | 724 | 0 | 0 | 0 | 724 |
| Performance standby letters of credit[1] | 3,783 | 0 | 0 | 0 | 3,783 |
| Purchase and building commitments | 1,400 | 0 | 0 | 0 | 1,400 |
| Commitment for investment in real estate venture | 180 | 0 | 0 | 0 | 180 |
| Commitments to purchase investment securities | 5,158 | 0 | 0 | 0 | 5,158 |
| Operating lease obligations | 155 | 255 | 194 | 2,360 | 2,964 |
| Capital lease obligations | 130 | 395 | 143 | 0 | 668 |
| | $230,885 | $100,028 | $35,307 | $22,360 | $388,580 |

[1]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[1] | 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[1] | 47,445 | 0 | 0 | 0 | 47,445 |
| Purchase obligations of loan participations[1] | 8,000 | 0 | 0 | 0 | 8,000 |
| Financial standby letters of credit[1] | 789 | 0 | 0 | 0 | 789 |
| Performance standby letters of credit[1] | 4,370 | 0 | 0 | 0 | 4,370 |
| Purchase and building commitments | 6,080 | 0 | 0 | 0 | 6,080 |
| Commitment for investment in real estate venture | 180 | 0 | 0 | 0 | 180 |
| Operating lease obligations | 187 | 305 | 189 | 2,394 | 3,075 |
| Capital lease obligations | 108 | 406 | 290 | 0 | 804 |
| | $256,766 | $123,730 | $39,630 | $4,394 | $424,520 |

[1]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 September 30, 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

a) Evaluation of Disclosure Controls and Procedures. First Keystone Corporation maintains disclosure controls and procedures (as defined in Rule 13a-15(e) under the Securities Exchange Act of 1934, as amended) designed to ensure that information required to be disclosed in the reports that the Corporation files or submits under the Securities Exchange Act of 1934 is recorded, processed, summarized and reported within the time periods specified in the rules and forms of the Securities and Exchange Commission. Based upon their evaluation of those disclosure controls and procedures performed as of the end of the period covered by this report, the Chief Executive Officer and Chief Financial Officer of the Corporation concluded that the Corporation's disclosure controls and procedures were effective as of September 30, 2012.

b) Changes in internal control over financial reporting. There were no changes in the Corporation's internal control over financial reporting during the fiscal quarter ended September 30, 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 |
|---|---|---|---|---|
| July 1 — July 31, 2012 | — | — | — | 120,000 |
| August 1 — August 31, 2012 | — | — | — | 120,000 |
| Sept. 1 — Sept. 30, 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.

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 Registrant's Report on Form 10-Q for the quarter ended June 30, 2012). |
| 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.

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

November 8, 2012 /s/ Matthew P. Prosseda
Matthew P. Prosseda
President and Chief Executive Officer
(Principal Executive Officer)

November 8, 2012 /s/ Diane C.A. Rosler
Diane C.A. Rosler
Senior Vice President and Chief Financial Officer
(Principal Accounting Officer)

INDEX TO EXHIBITS

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