

FIRST KEYSTONE CORP  
Form 10-Q  
November 07, 2013

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10Q

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(D) OF THE SECURITIES EXCHANGE ACT OF  
<sup>x</sup> 1934

For the quarterly period ended September 30, 2013

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**

Edgar Filing: FIRST KEYSTONE CORP - Form 10-Q

(State or other jurisdiction of incorporation or organization) (I.R.S. Employer Identification No.)

**111 West Front Street, Berwick, PA 18603**  
(Address of principal executive offices) (Zip Code)

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

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

Yes  No

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

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

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

Yes  No

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

Common Stock, \$2 Par Value, 5,511,239 shares as of November 5, 2013.

## PART I - FINANCIAL INFORMATION

## Item 1. Financial Statements

## FIRST KEYSTONE CORPORATION AND SUBSIDIARY

## CONSOLIDATED BALANCE SHEETS

(Amounts in thousands)	September 30, 2013 (Unaudited)	December 31, 2012
<b>ASSETS</b>		
Cash and due from banks	\$ 8,331	\$ 10,038
Interest-bearing deposits in other banks	1,358	10,882
Total cash and cash equivalents	9,689	20,920
Investment securities available-for-sale	315,275	296,312
Investment securities held-to-maturity (estimated fair value 2013- \$1,560; 2012 - \$2,599)	1,546	2,561
Restricted securities at cost - available-for-sale	3,480	4,883
Loans, net of unearned income	445,652	432,896
Allowance for loan losses	(6,000 )	(5,772 )
Net loans	439,652	427,124
Premises and equipment, net	21,026	19,363
Accrued interest receivable	3,868	4,060
Cash surrender value of bank owned life insurance	20,387	19,869
Investments in real estate ventures	1,334	1,480
Goodwill	19,133	19,133
Core deposit intangible, net	463	668
Prepaid FDIC insurance	0	1,002
Foreclosed assets held for resale	480	468
Deferred income taxes	1,271	5
Other assets	2,088	2,118
<b>TOTAL ASSETS</b>	<b>\$ 839,692</b>	<b>\$ 819,966</b>
<b>LIABILITIES</b>		
Deposits:		
Non-interest bearing	\$ 82,279	\$ 76,418
Interest bearing	583,804	532,416
Total deposits	666,083	608,834
Short-term borrowings	24,553	55,069
Long-term borrowings	47,453	44,520
Accrued interest and other expenses	3,511	2,902

Edgar Filing: FIRST KEYSTONE CORP - Form 10-Q

Deferred income taxes	36	4,612
Other liabilities	563	699
<b>TOTAL LIABILITIES</b>	<b>\$ 742,199</b>	<b>\$ 716,636</b>
<b>STOCKHOLDERS' EQUITY</b>		
Preferred stock, par value \$2.00 per share; authorized 1,000,000 shares in 2013 and 2012; issued 0 in 2013 and 2012	\$ 0	\$ 0
Common stock, par value \$2.00 per share; authorized 20,000,000 shares in 2013 and 2012; issued 5,746,388 in 2013 and 5,717,400 in 2012	11,493	11,435
Surplus	31,397	30,725
Retained earnings	58,802	54,532
Accumulated other comprehensive income	1,640	12,528
Treasury stock, at cost, 235,646 in 2013 and 237,183 in 2012	(5,839 )	(5,890 )
<b>TOTAL STOCKHOLDERS' EQUITY</b>	<b>97,493</b>	<b>103,330</b>
<b>TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY</b>	<b>\$ 839,692</b>	<b>\$ 819,966</b>

See accompanying notes to consolidated financial statements.

## FIRST KEYSTONE CORPORATION AND SUBSIDIARY

## CONSOLIDATED STATEMENTS OF INCOME

FOR THE THREE MONTHS ENDED SEPTEMBER 30, 2013 AND 2012

(Unaudited)

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

	2013	2012
<b>INTEREST INCOME</b>		
Interest and fees on loans	\$5,182	\$5,534
Interest and dividend income on investment securities	2,486	2,987
Interest on deposits in banks	0	1
Total interest income	\$7,668	\$8,522
<b>INTEREST EXPENSE</b>		
Interest on deposits	\$920	\$1,065
Interest on short-term borrowings	34	29
Interest on long-term borrowings	293	382
Total interest expense	\$1,247	\$1,476
Net interest income	\$6,421	\$7,046
Provision for loan losses	133	400
Net interest income after provision for loan losses	\$6,288	\$6,646
<b>NON-INTEREST INCOME</b>		
Trust department	\$213	\$193
Service charges and fees	353	313
Bank owned life insurance income	171	179
ATM fees and debit card income	258	239
Gains on sales of mortgage loans	77	332
Investment securities gains (losses) - net	264	477
Other	61	153
Total non-interest income	\$1,397	\$1,886
<b>NON-INTEREST EXPENSE</b>		
Salaries and employee benefits	\$2,822	\$2,602
Occupancy, net	368	398
Furniture and equipment	131	202
Computer expense	264	277
Professional services	134	135
State shares tax	204	193
FDIC insurance	108	120
ATM and debit card fees	129	121

Edgar Filing: FIRST KEYSTONE CORP - Form 10-Q

Other	759	1,128
Total non-interest expense	\$4,919	\$5,176

Income before income tax expense	\$2,766	\$3,356
Income tax expense	611	592
NET INCOME	\$2,155	\$2,764

PER SHARE DATA

Net income per share:		
Basic	\$.39	\$.51
Diluted	.39	.51
Cash dividends per share	.26	.25

See accompanying notes to consolidated financial statements.

## FIRST KEYSTONE CORPORATION AND SUBSIDIARY

## CONSOLIDATED STATEMENTS OF INCOME

FOR THE NINE MONTHS ENDED SEPTEMBER 30, 2013 AND 2012

(Unaudited)

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

	2013	2012
<b>INTEREST INCOME</b>		
Interest and fees on loans	\$15,488	\$16,833
Interest and dividend income on investment securities	7,845	9,456
Interest on deposits in banks	3	1
Total interest income	\$23,336	\$26,290
<b>INTEREST EXPENSE</b>		
Interest on deposits	\$2,716	\$3,528
Interest on short-term borrowings	83	88
Interest on long-term borrowings	923	1,482
Total interest expense	\$3,722	\$5,098
Net interest income	\$19,614	\$21,192
Provision for loan losses	733	1,200
Net interest income after provision for loan losses	\$18,881	\$19,992
<b>NON-INTEREST INCOME</b>		
Trust department	\$625	\$561
Service charges and fees	1,030	885
Bank owned life insurance income	518	546
ATM fees and debit card income	744	730
Gains on sale of mortgage loans	517	738
Investment securities gains (losses) - net	2,944	1,484
Other	306	339
Total non-interest income	\$6,684	\$5,283
<b>NON-INTEREST EXPENSE</b>		
Salaries and employee benefits	\$8,250	\$7,794
Occupancy, net	1,145	1,072
Furniture and equipment	491	445
Computer expense	766	800
Professional services	375	447
State shares tax	612	564
FDIC insurance	317	375
ATM and debit card fees	384	348

Edgar Filing: FIRST KEYSTONE CORP - Form 10-Q

FHLB prepayment penalties	345	811
Other	2,238	2,912
Total non-interest expense	\$14,923	\$15,568

Income before income tax expense	\$10,642	\$9,707
Income tax expense	2,089	1,709
NET INCOME	\$8,553	\$7,998

PER SHARE DATA

Net Income Per Share:

Basic	\$1.56	\$1.47
Diluted	1.56	1.47
Cash dividends per share	.78	.75

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			Compre- hensive Income	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Treasury Stock	Total
	Shares	Amount	Surplus					
Balance at December 31, 2012	5,717,400	\$ 11,435	\$ 30,725		\$ 54,532	\$ 12,528	\$(5,890 )	\$ 103,330
Comprehensive Income:								
Net Income				\$ 8,553	8,553			8,553
Change in net unrealized gains (losses) on investment securities available-for- sale, net of reclassification adjustment and tax effects				(10,888)		(10,888 )		(10,888 )
Total comprehensive income				\$ (2,335 )				
Issuance of common stock under dividend reinvestment and stock purchase plans	28,988	58	690		(666 )			82
Issuance of 1,537 shares of treasury stock upon exercise of employee stock options			(18 )				51	33
Cash dividends - \$.78 per share					(3,617 )			(3,617 )
Balance at September 30, 2013	5,746,388	\$ 11,493	\$ 31,397		\$ 58,802	\$ 1,640	\$(5,839 )	\$ 97,493
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				4,715		4,715		4,715

available-for- sale, net of reclassification adjustment and tax effects							
Total comprehensive income				\$ 12,713			
Issuance of common stock under dividend reinvestment and stock purchase plans	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

## CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(Unaudited)

(Amounts in thousands)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2013	2012	2013	2012
Net Income	\$ 2,155	\$ 2,764	\$8,553	\$7,998
Other comprehensive income (losses):				
Unrealized holding gains (losses) on available-for-sale investment securities arising during the period	(2,317 )	3,088	(13,512)	8,651
Less reclassification adjustment for net gains (losses) realized in income	264	477	2,944	1,484
Change in unrealized gains (losses) before tax effect	(2,581 )	2,611	(16,456)	7,167
Tax effects	867	(897 )	5,568	(2,452 )
Net change in unrealized gains (losses)	(1,714 )	1,714	(10,888)	4,715
Comprehensive Income	\$ 441	\$ 4,478	\$(2,335 )	\$12,713

See accompanying notes to consolidated financial statements.

## FIRST KEYSTONE CORPORATION AND SUBSIDIARY

## CONSOLIDATED STATEMENTS OF CASH FLOWS

FOR THE NINE MONTHS ENDED SEPTEMBER 30, 2013 AND 2012

(Unaudited)

(Amounts in thousands)	2013	2012
<b>OPERATING ACTIVITIES</b>		
Net income	\$8,553	\$7,998
Adjustments to reconcile net income to net cash provided by operating activities:		
Provision for loan losses	733	1,200
Depreciation and amortization	924	837
Premium amortization on investment securities	1,615	913
Discount accretion on investment securities	(282 )	(676 )
Core deposit discount amortization net of accretion	205	212
Deferred (benefit) income tax provision	(274 )	(434 )
(Gains) losses on sales of mortgage loans originated for resale	(517 )	(738 )
Proceeds from sales of mortgage loans originated for resale	22,737	23,301
Originations of mortgage loans originated for resale	(22,576 )	(24,499 )
(Gains) losses on sales of investment securities	(2,680 )	(1,484 )
(Gains) losses on sales of foreclosed assets held for resale	(70 )	195
Decrease (increase) in accrued interest receivable	192	156
(Increase) decrease in cash surrender value of bank owned life insurance	(518 )	(546 )
Losses (gains) on disposal of premises and equipment	138	0
Decrease (increase) in other assets – net	56	(327 )
Decrease (increase) in prepaid FDIC insurance	1,002	325
Increase (decrease) in accrued interest and other expenses	609	131
(Decrease) increase in other liabilities - net	(239 )	(408 )
<b>NET CASH PROVIDED BY (USED IN) OPERATING ACTIVITIES</b>	<b>\$9,608</b>	<b>\$6,156</b>
<b>INVESTING ACTIVITIES</b>		
Proceeds from sales of investment securities available-for-sale	\$56,680	\$36,737
Proceeds from maturities and redemptions of investment securities available-for-sale	30,215	27,894
Purchases of investment securities available-for-sale	(120,964)	(25,473)
Proceeds from maturities and redemptions of investment securities held-to-maturity	1,012	14
Proceeds from the redemption of restricted securities	3,954	968
Purchases of restricted securities	(2,551 )	(206 )
Net (increase) decrease in loans	(13,251 )	(15,007)
Purchases of premises and equipment	(2,540 )	(5,795 )
Proceeds from sales of foreclosed assets held for resale	468	852
<b>NET CASH (USED IN) PROVIDED BY INVESTING ACTIVITIES</b>	<b>\$(46,977 )</b>	<b>\$19,984</b>
<b>FINANCING ACTIVITIES</b>		
Net increase (decrease) in deposits	\$57,249	\$5,883

Edgar Filing: FIRST KEYSTONE CORP - Form 10-Q

Net (decrease) increase in short-term borrowings	(30,516 )	(14,118)
Proceeds from long-term borrowings	10,000	10,000
Repayment of long-term borrowings	(7,067 )	(23,799)
Proceeds from issuance of common stock	56	65
Proceeds from issuance of treasury stock	33	246
Cash dividends paid	(3,617 )	(3,879 )
<b>NET CASH PROVIDED BY (USED IN) FINANCING ACTIVITIES</b>	<b>\$26,138</b>	<b>\$(25,602)</b>
<b>(DECREASE) INCREASE IN CASH AND CASH EQUIVALENTS</b>	<b>\$(11,231 )</b>	<b>\$538</b>
<b>CASH AND CASH EQUIVALENTS, BEGINNING</b>	<b>20,920</b>	<b>10,179</b>
<b>CASH AND CASH EQUIVALENTS, ENDING</b>	<b>\$9,689</b>	<b>\$10,717</b>
<b>SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION</b>		
Cash paid during period for:		
Cash paid during period for interest	\$3,819	\$5,355
Cash paid for income taxes	1,086	1,726

See accompanying notes to consolidated financial statements.

FIRST KEYSTONE CORPORATION AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

September 30, 2013

(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, governments, and public and institutional customers primarily located in the Northeast Region of Pennsylvania. The Bank has 17 full service offices and 19 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 state and 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, 2013, the Corporation held \$3,445,000 in stock of FHLB-Pittsburgh and \$35,000 in stock of ACBB. At December 31, 2012, the Corporation held \$4,848,000 in stock of 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, 2013 and December 31, 2012.

## **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.



*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 brought current, 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.

*Charge-Offs* — Commercial real estate loans are charged off in whole or in part when they become sufficiently delinquent based upon the terms of the underlying loan contract and when a collateral deficiency exists. Because all or part of the contractual cash flows are not expected to be collected, the loan is considered to be impaired, and the Bank estimates the impairment based on its analysis of the cash flows and collateral estimated at fair value less cost to sell.

Consumer loans are charged off when they become non-performing assets, or when the value of the underlying collateral is not sufficient to support the loan balance and a loss is expected. At that time, the amount of estimated collateral deficiency, if any, is charged off for loans secured by collateral, and all other loans are charged off in full. Loans in which the borrower is in bankruptcy are considered on a case by case basis and are either charged off by the Bank or reaffirmed by the borrower. Loans with collateral are charged down to the estimated fair value of the collateral less cost to sell.

*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.

*Troubled Debt Restructurings ("TDRs")* — The restructuring of a loan is considered a "troubled debt restructuring" if both the following conditions are met: (i) the borrower is experiencing financial difficulties, and (ii) the Bank has granted a concession. The most common concessions granted include one or more modifications to the terms of the debt, such as (a) a reduction in the interest rate for the remaining life of the debt, (b) an extension of the maturity date at an

interest rate lower than the current market rate for new debt with similar risk, (c) a temporary period of interest-only payments, and (d) a reduction in the contractual payment amount for either a short period or remaining term of the loan. A less common concession is the forgiveness of a portion of the principal.

The determination of whether a borrower is experiencing financial difficulties takes into account not only the current financial condition of the borrower, but also the potential financial condition of the borrower were a concession not granted. Similarly, the determination of whether a concession has been granted is very subjective in nature. For example, simply extending the term of a loan at its original interest rate or even at a higher interest rate could be interpreted as a concession unless the borrower could readily obtain similar credit terms from a different lender.

*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, 2013 and December 31, 2012, 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 troubled debt restructuring is considered to be a collateral dependent loan, the loan is reported, net, at the fair value of the collateral. For troubled debt restructurings that subsequently default, the Corporation determines the amount of reserve in accordance with the accounting policy for the allowance for loan losses.

The general component covers all other loans not identified as impaired and is based on historical losses adjusted for current factors. The historical loss component of the allowance is determined by losses recognized by portfolio segment over the preceding two years. In calculating the historical component of our allowance, we aggregate loans into one of four portfolio segments: Commercial and Industrial, Commercial real estate, Residential real estate and Consumer. 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 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 \$480,000 at September 30, 2013 and \$468,000 at December 31, 2012.

### **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 \$284,000 in 2013 and \$277,000 in 2012, and the amortization of the investments in the limited partnerships were \$146,000 for the nine months ended September 30, 2013 and \$138,000 for the nine months ended September 30, 2012.

### **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, 2013 and December 31, 2012, 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, 2013 and December 31, 2012, 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 evaluated 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 evaluated the goodwill included in its consolidated balance sheet at December 31, 2012, and has determined there was no impairment as of that date or as of September 30, 2013. 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 evaluated the core deposit intangible included in its consolidated balance sheet at December 31, 2012 and has determined there was no impairment as of that date or as of September 30, 2013. 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 4,823 exercisable options issued and outstanding as of September 30, 2013.

### **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. Federal funds are also included as a cash equivalent because they are generally purchased and sold for one-day periods.

### **Treasury Stock**

The purchase of the Corporation's common stock is recorded at cost. At the date of subsequent reissue, the treasury stock account is reduced by the cost of such stock on a 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 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 adoption of this standard did not have a material impact on the Corporation's consolidated financial statements.

In October 2012, the FASB issued ASU 2012-06, *Business Combinations (Topic 805): Subsequent Accounting for an Indemnification Asset Recognized at the Acquisition Date as a Result of a Government-Assisted Acquisition of a Financial Institution*. The ASU clarifies the applicable guidance for subsequently measuring an indemnification asset recognized as a result of a government-assisted (Federal Deposit Insurance Corporation) acquisition of a financial institution. The guidance was effective for fiscal years, and interim periods within those years, beginning on or after December 15, 2012, with early adoption permitted. The adoption of this standard did not have a material impact on the Corporation's consolidated financial statements.

### **Advertising Costs**

It is the Corporation's policy to expense advertising costs in the period in which they are incurred. Advertising expense for the nine months ended September 30, 2013 and 2012, was \$279,000 and \$216,000, respectively.

### **Reclassifications**

The Corporation reclassified certain immaterial amounts in the consolidated statements of income. Such reclassifications have no effect on the Corporation's consolidated financial condition or net income.

## NOTE 2 — INVESTMENT SECURITIES

The amortized cost, related estimated fair value, and unrealized gains and losses for investment securities classified as "Available-For-Sale" or "Held-to-Maturity" were as follows at September 30, 2013 and December 31, 2012:

(Amounts in thousands)	Available-for-Sale Securities			Estimated Fair Value
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	
September 30, 2013:				
Obligations of U.S. Government Corporations and Agencies:				
Mortgage-backed	\$81,496	\$ 1,044	\$ (1,230 )	\$81,310
Other	23,494	228	(18 )	23,704
Obligations of state and political subdivisions	155,574	5,100	(2,597 )	158,077
Corporate securities	50,608	449	(1,257 )	49,800
Marketable equity securities	1,533	851	0	2,384
Restricted equity securities	3,480	0	0	3,480
Total	\$316,185	\$ 7,672	\$ (5,102 )	\$318,755

(Amounts in thousands)	Held-to-Maturity Securities			Estimated Fair Value
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	
September 30, 2013:				
Obligations of U.S. Government Corporations and Agencies:				
Mortgage-backed	\$76	\$ 3	\$ 0	\$ 79
Other	1,000	10	0	1,010
Obligations of state and political subdivisions	470	1	0	471
Total	\$1,546	\$ 14	\$ 0	\$ 1,560

(Amounts in thousands)	Available-for-Sale Securities			Estimated Fair Value
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	
December 31, 2012:				
Obligations of U.S. Government Corporations and Agencies:				
Mortgage-backed	\$41,946	\$ 2,090	\$ (193 )	\$43,843
Other	29,076	159	(203 )	29,032
Obligations of state and political subdivisions	160,829	16,163	(39 )	176,953
Corporate securities	43,902	673	(68 )	44,507
Marketable equity securities	1,533	454	(10 )	1,977
Restricted equity securities	4,883	0	0	4,883
Total	\$282,169	\$ 19,539	\$ (513 )	\$301,195

(Amounts in thousands)	Held-to-Maturity Securities			Estimated Fair Value
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	
December 31, 2012:				
Obligations of U.S. Government Corporations and Agencies:				
Mortgage-backed	\$88	\$ 4	\$ 0	\$ 92
Other	2,006	24	0	2,030
Obligations of state and political subdivisions	467	10	0	477
Total	\$2,561	\$ 38	\$ 0	\$ 2,599

Securities Available-for-Sale with an aggregate fair value of \$195,467,000 at September 30, 2013 and \$165,810,000 at December 31, 2012; and securities Held-to-Maturity with an aggregate book value of \$1,077,000 at September 30, 2013 and \$1,094,000 at December 31, 2012, were pledged to secure public funds, trust funds, securities sold under agreements to repurchase, FHLB advances and other balances of \$146,427,000 at September 30, 2013 and \$94,101,000 at December 31, 2012.

The amortized cost, estimated fair value and weighted average yield of debt securities, by contractual maturity, are shown below at September 30, 2013 and December 31, 2012. 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, 2013							
	U.S. Government Obligations		Corporations & State Agencies & Political Subdivisions <sup>2</sup>		Marketable Equity Securities <sup>3</sup>	Restricted Equity Securities <sup>3</sup>	Corporate Securities	
Available-For-Sale:								
Within 1 Year:								
Amortized cost	\$4,521	\$ 446			\$ 0	\$ 0		\$ 14,056
Estimated fair value	4,554	451			0	0		14,110
Weighted average yield	0.96 %	5.83 %			0	0		1.75 %
1 - 5 Years:								
Amortized cost	3,561	6,025			0	0		13,074
Estimated fair value	3,593	6,326			0	0		13,418
Weighted average yield	0.87 %	4.39 %			0	0		2.67 %
5 - 10 Years:								
Amortized cost	11,666	43,893			0	0		23,478
Estimated fair value	11,854	43,128			0	0		22,272
Weighted average yield	2.27 %	3.52 %			0	0		3.10 %
After 10 Years:								
Amortized cost	85,242	105,210			1,533	3,480		0
Estimated fair value	85,013	108,172			2,384	3,480		0
Weighted average yield	1.98 %	6.11 %			3.85 %	0.53 %		0
Total:								
Amortized cost	\$104,990	\$ 155,574			\$ 1,533	\$ 3,480		\$ 50,608
Estimated fair value	105,014	158,077			2,384	3,480		49,800
Weighted average yield	1.93 %	5.31 %			3.85 %	0.53 %		2.62 %

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

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

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



(Amounts in thousands)

	September 30, 2013				
	U.S. Government Obligations	State Obligations	Marketable Equity Securities <sup>3</sup>	Restricted Equity Securities <sup>3</sup>	Corporate Securities
	Corporations	Agencies & Political Subdivisions <sup>2</sup>			
<b>Held-To-Maturity:</b>					
<b>Within 1 Year:</b>					
Amortized cost	\$0	\$ 0	\$ 0	\$ 0	\$ 0
Estimated fair value	0	0	0	0	0
Weighted average yield	0	0	0	0	0
<b>1 - 5 Years:</b>					
Amortized cost	1,076	0	0	0	0
Estimated fair value	1,089	0	0	0	0
Weighted average yield	0.88 %	0	0	0	0
<b>5 - 10 Years:</b>					
Amortized cost	0	0	0	0	0
Estimated fair value	0	0	0	0	0
Weighted average yield	0	0	0	0	0
<b>After 10 Years:</b>					
Amortized cost	0	470	0	0	0
Estimated fair value	0	471	0	0	0
Weighted average yield	0	8.69 %	0	0	0
<b>Total:</b>					
Amortized cost	\$1,076	\$ 470	\$ 0	\$ 0	\$ 0
Estimated fair value	1,089	471	0	0	0
Weighted average yield	0.88 %	8.69 %	0	0	0

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

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

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

*(Amounts in thousands)*

	December 31, 2012					
	U.S. Government	Obligations		Marketable	Restricted	
	Corporations	of State		Equity	Equity	Corporate
	Agencies	& Political		Securities <sup>3</sup>	Securities <sup>3</sup>	Securities
	Obligations	Subdivisions <sup>2</sup>				
Available-For-Sale:						
Within 1 Year:						
Amortized cost	\$ 0	\$ 200		\$ 0	\$ 0	\$ 17,150
Estimated fair value	0	201		0	0	17,238
Weighted average yield	0	6.83	%	0	0	3.09 %
1 - 5 Years:						
Amortized cost	12,120	3,237		0	0	25,261
Estimated fair value	12,233	3,452		0	0	25,720
Weighted average yield	1.03 %	4.65	%	0	0	2.28 %
5 - 10 Years:						
Amortized cost	3,677	10,948		0	0	1,491
Estimated fair value	3,954	12,279		0	0	1,549
Weighted average yield	4.66 %	5.52	%	0	0	5.76 %
After 10 Years:						
Amortized cost	55,225	146,444		1,533	4,883	0
Estimated fair value	56,688	161,021		1,977	4,883	0
Weighted average yield	3.04 %	6.30	%	3.93 %	0.19 %	0
Total:						
Amortized cost	\$ 71,022	\$ 160,829		\$ 1,533	\$ 4,883	\$ 43,902
Estimated fair value	72,875	176,953		1,977	4,883	44,507
Weighted average yield	2.78 %	6.21	%	3.93 %	0.19 %	2.72 %

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

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

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

*(Amounts in thousands)*

	December 31, 2012				
	U.S. Government Obligations	State & Political Obligations	Marketable Equity Securities <sup>3</sup>	Restricted Equity Securities <sup>3</sup>	Corporate Securities
Held-to-Maturity:					
Within 1 Year:					
Amortized cost	\$1,006	\$ 0	\$ 0	\$ 0	\$ 0
Estimated fair value	1,017	0	0	0	0
Weighted average yield	1.78 %	0	0	0	0
1 - 5 Years:					
Amortized cost	1,088	0	0	0	0
Estimated fair value	1,105	0	0	0	0
Weighted average yield	0.93 %	0	0	0	0
5 - 10 Years:					
Amortized cost	0	0	0	0	0
Estimated fair value	0	0	0	0	0
Weighted average yield	0	0	0	0	0
After 10 Years:					
Amortized cost	0	467	0	0	0
Estimated fair value	0	477	0	0	0
Weighted average yield	0	7.14 %	0	0	0
Total:					
Amortized cost	\$2,094	\$ 467	\$ 0	\$ 0	\$ 0
Estimated fair value	2,122	477	0	0	0
Weighted average yield	1.34 %	7.14 %	0	0	0

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

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

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

There were no aggregate investments with a single issuer (excluding the U.S. Government and its agencies) which exceeded ten percent of consolidated shareholders' equity at September 30, 2013. 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 2013 and 2012 were \$12,114,000 and \$9,829,000, respectively. Gross gains realized on these sales were \$332,000 and \$477,000, respectively. Gross losses on these sales were \$68,000 and \$0, respectively. There were no impairment losses in 2013 and 2012.

There were no proceeds from sale of investments in Held-to-Maturity debt and equity securities during the third quarter of 2013 and 2012. 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, 2013 and December 31, 2012.

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, 2013 and December 31, 2012:

September 30, 2013

(Amounts in thousands)	Less Than 12 Months		12 Months or More		Total	
	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss
Direct obligations of the U.S. Government	\$ 5,255	\$ 18	\$ 0	\$ 0	\$5,255	\$ 18
Mortgage-backed securities	37,086	1,128	3,675	102	40,761	1,230
Municipal bonds	48,534	2,514	292	83	48,826	2,597
Corporate securities	20,729	1,257	0	0	20,729	1,257
Marketable equity securities	0	0	0	0	0	0
	\$ 111,604	\$ 4,917	\$ 3,967	\$ 185	\$ 115,571	\$ 5,102

December 31, 2012

(Amounts in thousands)	Less Than 12 Months		12 Months or More		Total	
	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss
Direct obligations of the U.S. Government	\$ 12,519	\$ 203	\$ 0	\$ 0	\$12,519	\$ 203
Mortgage-backed securities	10,174	193	0	0	10,174	193
Municipal bonds	1,651	14	338	25	1,989	39
Corporate securities	1,924	48	1,480	20	3,404	68
Marketable equity securities	312	10	0	0	312	10
	\$ 26,580	\$ 468	\$ 1,818	\$ 45	\$28,398	\$ 513

18

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 77 securities in an unrealized loss position as of September 30, 2013 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, 2013 and December 31, 2012 consisted of:

*(Amounts in thousands)*

	September 30, 2013	December 31, 2012
Commercial and Industrial	\$ 26,498	\$ 28,714
Tax-exempt – real estate and other	39,923	29,192
Commercial real estate	221,204	221,338
Residential real estate	151,273	143,002
Real estate mortgages - Held-for-sale	511	4,009
Consumer	5,884	6,473
Gross loans	445,293	432,728
Add (deduct): Unearned discount and	(102 )	(170 )
Net deferred loan fees and costs	461	338
Total loans, net of unearned income	\$ 445,652	\$ 432,896

Activity in the allowance for loan losses for the nine months ended September 30, 2013 and the year ended December 31, 2012:

*(Amounts in thousands)*

	September 30, 2013	December 31, 2012
Balance at beginning of period	\$ 5,772	\$5,929
Provision charged to operations	733	1,600
Loans charged off	(538 )	(1,832 )
Recoveries	33	75
Balance at end of period	\$ 6,000	\$ 5,772

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 Industrial, and Commercial Real Estate borrowing relationships. An asset quality rating is assigned using the guidance provided in the Bank's loan policy. 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 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.

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, 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 upon analysis 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.

Edgar Filing: FIRST KEYSTONE CORP - Form 10-Q

The credit quality indicators by loan segment are summarized below at September 30, 2013 and December 31, 2012:

(Amounts in thousands)	Commercial and Industrial		Commercial Real Estate Construction	
	September 30, 2013	December 31, 2012	September 30, 2013	December 31, 2012
Grade:				
1-6 Pass	\$61,574	\$ 53,154	\$ 5,010	\$ 4,387
7 Special Mention	511	617	0	0
8 Substandard	24	299	0	0
9 Doubtful	0	0	0	0
Add (deduct): Unearned discount and Net deferred loan fees and costs	0	0	0	0
	140	116	3	(2 )
Loans, net of unearned income	\$62,249	\$ 54,186	\$ 5,013	\$ 4,385
	Commercial Real Estate		Residential Real Estate Including Home Equity	
	September 30, 2013	December 31, 2012	September 30, 2013	December 31, 2012
Grade:				
1-6 Pass	\$214,071	\$ 214,545	\$ 150,206	\$ 145,700
7 Special Mention	2,355	2,129	287	136
8 Substandard	4,080	4,112	1,291	1,176
9 Doubtful	0	0	0	0
Add (deduct): Unearned discount and Net deferred loan fees and costs	0	0	0	0
	(33 )	(15 )	261	156
Loans, net of unearned income	\$220,473	\$ 220,771	\$ 152,045	\$ 147,168
	Consumer Loans		Loans, Net of Unearned Income	
	September 30, 2013	December 31, 2012	September 30, 2013	December 31, 2012
Grade:				
1-6 Pass	\$5,881	\$ 6,458	\$ 436,742	\$ 424,244
7 Special Mention	3	2	3,156	2,884
8 Substandard	0	13	5,395	5,600
9 Doubtful	0	0	0	0
Add (deduct): Unearned discount and Net deferred loan fees and costs	(102 )	(170 )	(102 )	(170 )
	90	83	461	338
Loans, net of unearned income	\$5,872	\$ 6,386	\$ 445,652	\$ 432,896

Commercial and Industrial and Commercial Real Estate include loans categorized as tax free loans.





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

(Amounts in thousands)	Commercial and Industrial	Commercial Real Estate	Residential Real Estate	Consumer	Unallocated	Total
Nine months ended September 30, 2013:						
Allowance for Loan Losses:						
Beginning balance	\$ 573	\$ 2,837	\$ 1,524	\$ 80	\$ 758	\$ 5,772
Charge-offs	(12 )	(175 )	(321 )	(30 )	0	(538 )
Recoveries	19	0	5	9	0	33
Provision	217	176	355	15	(30 )	733
Ending Balance	797	2,838	1,563	74	728	6,000
Ending balance: individually evaluated for impairment	0	177	15	0	0	192
Ending balance: collectively evaluated for impairment	\$ 797	\$ 2,661	\$ 1,548	\$ 74	\$ 728	\$ 5,808
Financing Receivables:						
Ending Balance	\$ 62,249	\$ 225,486	\$ 152,045	\$ 5,872	\$ 0	\$ 445,652
Ending balance: individually evaluated for impairment	24	2,889	888	0	0	3,801
Ending balance: collectively evaluated for impairment	\$ 62,225	\$ 222,597	\$ 151,157	\$ 5,872	\$ 0	\$ 441,851

(Amounts in thousands)	Commercial and Industrial	Commercial Real Estate	Residential Real Estate	Consumer	Unallocated	Total
Year ended December 31, 2012:						
Allowance for Loan Losses:						
Beginning balance	\$ 489	\$ 3,507	\$ 1,228	\$ 137	\$ 568	\$ 5,929
Charge-offs	(264 )	(1,077 )	(404 )	(87 )	0	(1,832 )
Recoveries	23	22	1	29	0	75
Provision	325	385	699	1	190	1,600
Ending Balance	573	2,837	1,524	80	758	5,772
Ending balance: individually evaluated for impairment	0	111	112	0	0	223
Ending balance: collectively evaluated for impairment	\$ 573	\$ 2,726	\$ 1,412	\$ 80	\$ 758	\$ 5,549
Financing Receivables:						
Ending Balance	\$ 54,186	\$ 225,156	\$ 147,168	\$ 6,386	\$ 0	\$ 432,896
Ending balance: individually evaluated for impairment	248	1,312	803	0	0	2,363
Ending balance: collectively evaluated for impairment	\$ 53,938	\$ 223,844	\$ 146,365	\$ 6,386	\$ 0	\$ 430,533

From time to time, the Bank may agree to modify the contractual terms of a borrower's loan. In cases where the modifications represent a concession to a borrower experiencing financial difficulty, the modification is considered a troubled debt restructuring ("TDR"). Loans classified in troubled debt restructurings may or may not be placed on non-accrual status.

The outstanding balance of TDRs as of September 30, 2013 and December 31, 2012 was \$4,128,000 and \$0, respectively. The increase in TDRs was attributable to deterioration in the respective borrowers' financial position, and in some cases a declining collateral value, along with the Bank's proactive monitoring of the loan portfolio. As of September 30, 2013, there were no unfunded commitments on any TDRs.

During the third quarter of 2013, three loans with a combined post modification balance of \$811,000 were classified as TDRs, as compared to the third quarter of 2012, when no loans were classified as TDRs. For the nine months ended September 30, 2013, twelve loans were classified as TDRs as compared to September 30, 2012 when no loans were classified as TDRs. The loan modifications for the third quarter of 2013 consisted of one term modification beyond the original stated term, one interest rate modification, and one payment modification. The loan modifications for the nine months ended September 30, 2013 consisted of three interest rate modifications, two term modifications, and seven payment modifications.

The following table presents the unpaid balance of TDRs at the dates indicated:

*(Amounts in thousands)*

	September 30, 2013	September 30, 2012
TDRs included in nonperforming loans	\$ 1,735	\$ 0
TDRs in compliance with modified terms and performing	2,393	0
Total	\$ 4,128	\$ 0

The following tables present information regarding the loan modifications categorized as TDRs during the three months and nine months ended September 30, 2013 and September 30, 2012:

*(Amounts in thousands, except number of contracts)*

	Three Months Ended September 30, 2013			Three Months Ended September 30, 2012		
	Pre- Modification Number of Contracts	Outstanding Recorded Investment	Post- Modification Outstanding Recorded Investment	Pre- Modification Number of Contracts	Outstanding Recorded Investment	Post- Modification Outstanding Recorded Investment
Commercial and Industrial	0	\$ 0	\$ 0	0	\$ 0	\$ 0
Commercial real estate	3	806	811	0	0	0
Residential real estate	0	0	0	0	0	0
Total	3	\$ 806	\$ 811	0	\$ 0	\$ 0

*(Amounts in thousands, except number of contracts)*

Edgar Filing: FIRST KEYSTONE CORP - Form 10-Q

	Nine Months Ended September 30, 2013			Nine Months Ended September 30, 2012		
	Pre- Modification Number of Contracts	Outstanding Recorded Investment	Post- Modification Outstanding Recorded Investment	Pre- Modification Number of Contracts	Outstanding Recorded Investment	Post- Modification Outstanding Recorded Investment
Commercial and Industrial	0	\$ 0	\$ 0	0	\$ 0	\$ 0
Commercial real estate	12	4,445	4,305	0	0	0
Residential real estate	0	0	0	0	0	0
Total	12	\$ 4,445	\$ 4,305	0	\$ 0	\$ 0

Edgar Filing: FIRST KEYSTONE CORP - Form 10-Q

The following table provides detail regarding the types of loan modifications made for loans categorized as TDRs during the three months and nine months ended September 30, 2013 and September 30, 2012 with the total number of each type of modification performed.

	Three Months Ended September 30, 2013				Three Months Ended September 30, 2012			
	Rate Modification	Term Modification	Payment Modification	Number Modified	Rate Modification	Term Modification	Payment Modification	Number Modified
Commercial and Industrial	0	0	0	0	0	0	0	0
Commercial real estate	1	1	1	3	0	0	0	0
Residential real estate	0	0	0	0	0	0	0	0
Total	1	1	1	3	0	0	0	0

	Nine Months Ended September 30, 2013				Nine Months Ended September 30, 2012			
	Rate Modification	Term Modification	Payment Modification	Number Modified	Rate Modification	Term Modification	Payment Modification	Number Modified
Commercial and Industrial	0	0	0	0	0	0	0	0
Commercial real estate	3	2	7	12	0	0	0	0
Residential real estate	0	0	0	0	0	0	0	0
Total	3	2	7	12	0	0	0	0

Impaired loans at September 30, 2013 and December 31, 2012 were \$3,801,000 and \$2,363,000, 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, 2013	December 31, 2012
Gross interest due under terms to date	\$ 375	\$ 279
Amount included in income year-to-date	(21 )	(34 )
Interest income not recognized to date	\$ 354	\$ 245

The Corporation's impaired loans are summarized below for the periods ended September 30, 2013 and December 31, 2012.

(Amounts in thousands)

	Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Recorded Investment	Interest Income Recognized
September 30, 2013:					
With no related allowance recorded:					

Edgar Filing: FIRST KEYSTONE CORP - Form 10-Q

Commercial and Industrial	\$ 24	\$ 170	\$ 0	\$ 175	\$ 0
Commercial real estate	2,510	3,038	0	3,102	16
Residential real estate	825	1,154	0	1,163	1

With an allowance recorded:

Commercial and Industrial	0	0	0	0	0
Commercial real estate	379	379	177	380	4
Residential real estate	63	63	15	65	0
Total	\$ 3,801	\$ 4,804	\$ 192	\$ 4,885	\$ 21

Total consists of:

Commercial and Industrial	\$ 24	\$ 170	\$ 0	\$ 175	\$ 0
Commercial real estate	\$ 2,889	\$ 3,417	\$ 177	\$ 3,482	\$ 20
Residential real estate	\$ 888	\$ 1,217	\$ 15	\$ 1,228	\$ 1

Loans classified as TDRs on non-accrual status were included in the table on the previous page. At September 30, 2013, \$1,735,000 of loans classified as TDRs were on non-accrual status with a total allocated allowance of \$0.

(Amounts in thousands)	Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Recorded Investment	Interest Income Recognized
December 31, 2012:					
With no related allowance recorded:					
Commercial and Industrial	\$ 248	\$ 547	\$ 0	\$ 785	\$ 4
Commercial real estate	1,108	1,495	0	1,529	7
Residential real estate	544	737	0	748	13
With an allowance recorded:					
Commercial and Industrial	0	0	0	0	0
Commercial real estate	204	322	111	322	0
Residential real estate	259	259	112	261	10
Total	\$ 2,363	\$ 3,360	\$ 223	\$ 3,645	\$ 34
Total consists of:					
Commercial and Industrial	\$ 248	\$ 547	\$ 0	\$ 785	\$ 4
Commercial real estate	\$ 1,312	\$ 1,817	\$ 111	\$ 1,851	\$ 7
Residential real estate	\$ 803	\$ 996	\$ 112	\$ 1,009	\$ 23

As of December 31, 2012, there were no loans classified as TDRs.

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.

Financing receivables on non-accrual status and foreclosed assets as of September 30, 2013 and December 31, 2012 were as follows:

(Amounts in thousands)

	September 30, 2013	December 31, 2012
Commercial and Industrial	\$ 24	\$ 248
Commercial real estate	2,889	1,312
Residential real estate	888	803



Edgar Filing: FIRST KEYSTONE CORP - Form 10-Q

Total impaired (including non-accrual TDRs)	3,801	2,363
Loans past-due 90 days or more and still accruing	0	952
Foreclosed assets	480	468
Total non-performing assets	\$ 4,281	\$ 3,783
Total TDRs in compliance with modified terms and performing	\$ 2,393	\$ 0

Non-performing assets consist of non-accrual loans, loans past-due 90 days or more and still accruing, and foreclosed assets held for resale.

At September 30, 2013 and December 31, 2012, the recorded investment in impaired loans as defined by FASB ASC 310-10-35, *Receivables Subsequent Measurements*, was \$3,801,000 and \$2,363,000, and the impaired loans allowances were \$192,000 and \$223,000, respectively. The average recorded balance in impaired loans during the period ended September 30, 2013 and December 31, 2012 was approximately \$4,885,000 and \$3,645,000, respectively.

The following tables present the aging of past-due loans by major classification of loans at September 30, 2013 and December 31, 2012:

*(Amounts in thousands)*

	30-59 Days Past Due	60-89 Days Past Due	90 Days or Greater Past Due	Total Past Due	Impaired Loans	Current	Total Financing Receivables
September 30, 2013:							
Commercial and Industrial	\$ 212	\$ 5	\$ 0	\$ 217	\$ 24	\$62,008	\$ 62,249
Commercial real estate	1,379	41	0	1,420	2,889	221,177	225,486
Residential real estate	1,713	239	0	1,952	888	149,205	152,045
Consumer	82	0	0	82	0	5,790	5,872
Total	\$ 3,386	\$ 285	\$ 0	\$ 3,671	\$ 3,801	\$438,180	\$ 445,652

*(Amounts in thousands)*

	30-59 Days Past Due	60-89 Days Past Due	90 Days or Greater Past Due	Total Past Due	Impaired Loans	Current	Total Financing Receivables
December 31, 2012:							
Commercial and Industrial	\$ 10	\$ 136	\$ 0	\$ 146	\$ 248	\$53,792	\$ 54,186
Commercial real estate	760	605	952	2,317	1,312	221,527	225,156
Residential real estate	1,060	584	0	1,644	803	144,721	147,168
Consumer	56	0	0	56	0	6,330	6,386
Total	\$ 1,886	\$ 1,325	\$ 952	\$ 4,163	\$ 2,363	\$426,370	\$ 432,896

Loans past due 90 days or more and still accruing interest were \$0 at September 30, 2013 and \$952,000 at December 31, 2012. The decrease was the result of the payoff of the two Commercial Real Estate loans previously classified as 90 days or greater past due with a combined balance of \$952,000.

At September 30, 2013 and December 31, 2012, there were no commitments to lend additional funds with respect to non-accrual and restructured loans.

#### **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.

**NOTE 5 — LONG-TERM BORROWINGS**

Long-term borrowings are comprised of advances from FHLB and a capital lease assumed as a result of the acquisition of Pocono Community Bank in the amount of \$811,000. Under terms of a blanket agreement, collateral for the FHLB loans is certain qualifying assets of the Corporation's banking subsidiary. The principal assets are real estate mortgages and certain investment securities.

**NOTE 6 — COMMITMENTS AND CONTINGENCIES**

In 2011, the Bank began work to expand its main headquarters in Berwick, Pennsylvania. The renovation and construction project was completed in the second quarter of 2013.

On July 26, 2012, the Bank acquired property consisting of a parcel of land in the amount of \$423,000 in Shickshinny, Pennsylvania. This branch is expected to open in late 2013. The Bank has committed to spend \$1,466,000 on this facility, of which \$792,000 has been spent.

On November 30, 2012, the Bank acquired property consisting of a parcel of land and a building in the amount of \$311,000 in Dallas, Pennsylvania. The branch opened on March 18, 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 FINANCIAL INSTRUMENTS WITH OFF-BALANCE SHEET RISK AND CONCENTRATIONS**  
**7 — 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, 2013 and December 31, 2012, were as follows:

*(Amounts in thousands)*

	September 30, 2013	December 31, 2012
--	-----------------------	----------------------

Edgar Filing: FIRST KEYSTONE CORP - Form 10-Q

Financial instruments whose contract amounts represent credit risk:

Commitments to extend credit	\$ 61,266	\$ 63,653
Financial standby letters of credit	\$ 418	\$ 720
Performance standby letters of credit	\$ 3,979	\$ 3,714

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. The concentrations of credit by type of loan are set forth in Note 3 – Loans. It is management's opinion that the loan portfolio was well balanced and diversified at September 30, 2013, 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:

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

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

Level 3: Fair value is based on significant unobservable inputs that reflect a reporting entity's own assumptions C. 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, 2013 and December 31, 2012, investments measured at fair value on a recurring basis and the valuation methods used are as follows:

*(Amounts in thousands)*

September 30, 2013

Edgar Filing: FIRST KEYSTONE CORP - Form 10-Q

	Level 1	Level 2	Level 3	Total
Available-for-Sale Securities:				
Obligations of U.S. Government Corporations and Agencies:				
Mortgaged-backed	\$0	\$81,310	\$ 0	\$81,310
Other	0	23,704	0	23,704
Obligations of state and political subdivisions	0	158,077	0	158,077
Corporate securities	0	49,800	0	49,800
Marketable equity securities	2,384	0	0	2,384
Restricted equity securities	0	3,480	0	3,480
Total	\$2,384	\$316,371	\$ 0	\$318,755

*(Amounts in thousands)*

December 31, 2012

	Level 1	Level 2	Level 3	Total
Available-for-Sale Securities:				
Obligations of U.S. Government Corporations and Agencies:				
Mortgaged-backed	\$0	\$43,843	\$ 0	\$43,843
Other	0	29,032	0	29,032
Obligations of state and political subdivisions	0	176,953	0	176,953
Corporate securities	0	44,507	0	44,507
Marketable equity securities	1,977	0	0	1,977
Restricted equity securities	0	4,883	0	4,883
Total	\$1,977	\$299,218	\$ 0	\$301,195

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 2013 and 2012.

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

At September 30, 2013 and December 31, 2012, impaired loans measured at fair value on a non-recurring basis and the valuation methods used are as follows:

*(Amounts in thousands)*

	Level 1	Level 2	Level 3	Total
Assets at September 30, 2013				
Impaired loans:				
Commercial and Industrial	\$ 0	\$ 0	\$24	\$24
Commercial real estate	0	0	2,889	2,889
Residential real estate	0	0	888	888
Total impaired loans	\$ 0	\$ 0	\$3,801	\$3,801

*(Amounts in thousands)*

	Level 1	Level 2	Level 3	Total
Assets at December 31, 2012				
Impaired loans:				
Commercial and Industrial	\$ 0	\$ 0	\$248	\$248
Commercial real estate	0	0	1,312	1,312
Residential real estate	0	0	803	803
Total impaired loans	\$ 0	\$ 0	\$2,363	\$2,363

The Bank's impaired and TDR loan valuation procedure for any loans greater than \$250,000 requires an evaluation to be conducted 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 and TDR 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 2013 and 2012.

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

At September 30, 2013 and December 31, 2012, foreclosed assets held for resale measured at fair value on a non-recurring basis and the valuation methods used are as follows:

*(Amounts in thousands)*

	Level 1	Level 2	Level 3	Total
Assets at September 30, 2013				
Other foreclosed assets held for resale:				
Commercial real estate	\$ 0	\$ 0	\$ 480	\$480
Total foreclosed assets held for resale	\$ 0	\$ 0	\$ 480	\$480

*(Amounts in thousands)*

	Level 1	Level 2	Level 3	Total
Assets at December 31, 2012				
Other foreclosed assets held for resale:				
Commercial real estate	\$ 0	\$ 0	\$ 95	\$95
Residential real estate	0	0	373	373
Total foreclosed assets held for resale	\$ 0	\$ 0	\$ 468	\$468

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 2013 and 2012.

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:

*(Amounts in thousands)*

Assets at September 30, 2013	Quantitative Information about Level 3 Fair Value Measurements			Range
	Fair Value	Estimate Valuation Technique	Unobservable Input	
Impaired loans	\$3,801	Appraisal of collateral <sup>1,3</sup>	Appraisal adjustments <sup>2</sup>	10% - 35%
Other foreclosed assets held for sale	480	Appraisal of collateral <sup>1,3</sup>	Appraisal adjustments <sup>2</sup>	10% - 35%

<sup>1</sup>Fair value is generally determined through independent appraisals of the underlying collateral, as defined by Bank regulators.

<sup>2</sup>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.

<sup>3</sup>Includes qualitative adjustments by management and estimated liquidation expenses.

## **Fair Value of Financial Instruments**

*(Amounts in thousands)*

	Carrying Amount	Fair Value Level 1	Measurements at Level 2	September 30, 2013 Level 3	Total
<b>FINANCIAL ASSETS:</b>					
Cash and due from banks	\$8,331	\$8,331	\$0	\$0	\$8,331
Short-term investments	1,358	1,358	0	0	1,358
Investment securities – available-for-sale	318,755	2,384	316,371	0	318,755
Investment securities – held-to-maturity	1,546	0	1,560	0	1,560
Net loans	439,652	0	0	446,995	446,995
Mortgage servicing rights	522	0	0	522	522
Accrued interest receivable	3,868	3,868	0	0	3,868
Cash surrender value of bank owned life insurance	20,387	20,387	0	0	20,387
<b>FINANCIAL LIABILITIES:</b>					
Deposits	666,083	416,925	0	250,093	667,018
Short-term borrowings	24,553	24,553	0	0	24,553
Long-term borrowings	47,453	0	0	48,163	48,163
Accrued interest payable	431	431	0	0	431
<b>OFF-BALANCE SHEET FINANCIAL INSTRUMENTS:</b>					
Commitments to extend credit					61,266
Financial standby letters of credit					418
Performance standby letters of credit					3,979

*(Amounts in thousands)*

	Carrying Amount	Fair Value Level 1	Measurements at Level 2	December 31, 2012 Level 3	Total
<b>FINANCIAL ASSETS:</b>					
Cash and due from banks	\$ 10,038	\$ 10,038	\$ 0	\$ 0	\$ 10,038
Short-term investments	10,882	10,882	0	0	10,882
Investment securities – available-for-sale	301,195	1,977	299,218	0	301,195
Investment securities – held-to-maturity	2,561	0	2,599	0	2,599
Net loans	427,124	0	0	423,873	423,873
Mortgage servicing rights	478	0	0	478	478
Accrued interest receivable	4,060	4,060	0	0	4,060
Cash surrender value of bank owned life insurance	19,869	19,869	0	0	19,869
<b>FINANCIAL LIABILITIES:</b>					
Deposits	608,834	361,071	0	250,618	611,689
Short-term borrowings	55,069	55,069	0	0	55,069
Long-term borrowings	44,520	0	0	47,696	47,696
Accrued interest payable	528	528	0	0	528
<b>OFF-BALANCE SHEET FINANCIAL INSTRUMENTS:</b>					
Commitments to extend credit					63,653
Financial standby letters of credit					720
Performance standby letters of credit					3,714

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, 2013 and December 31, 2012.

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.



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, 2013 and the related consolidated statements of income, changes in stockholders' equity and comprehensive income for the three-month and nine-month periods ended September 30, 2013 and 2012 and the consolidated statements of cash flows for the nine-month periods ended September 30, 2013 and 2012. 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 and subsidiary as of December 31, 2012, and the related consolidated statements of income, changes in stockholders' equity, comprehensive income and cash flows for the year then ended (not presented herein); and in our report dated March 18, 2013, 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, 2012, is fairly stated, in all material respects, in relation to the consolidated balance sheet from which it has been derived.

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

J. H. Williams & Co., LLP

Kingston, Pennsylvania



November 7, 2013

33

Item 2. First Keystone Corporation Management's Discussion and Analysis of Financial Condition and Results of Operation as of September 30, 2013

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 2013 of \$2,155,000, a decrease of \$609,000, or 22.0% from the third quarter of 2012. The decrease in net income for the third quarter of 2013 was due to several factors, including a decrease in non-interest income and a decrease in net interest income. For the nine months ended September 30, 2013, net income was \$8,553,000, which exceeded the same period in 2012 by \$555,000, or 6.9%. While net interest income was lower in the nine months ended September 30, 2013, the provision for loan losses declined, non-interest income was higher and non-interest expense was lower.

On a per share basis, for the three months ended September 30, 2013, net income was \$.39 versus \$.51 in the third quarter of 2012. Net income per share was \$1.56 for the first nine months of 2013, up from \$1.47 for the first nine months of 2012, an increase of 6.1%. Cash dividends increased to \$.78 per share, up from \$.75 in the first nine months of 2012, an increase of 4.0%.

Year-to-date net income annualized as of September 30, 2013, amounted to a return on average common equity of 11.14%, a return on tangible equity net of goodwill of 13.69% and a return on assets of 1.39%. For the nine months ended September 30, 2012, these measures were 10.83%, 13.44%, and 1.30%, respectively, on an annualized basis.

## NET INTEREST INCOME

The major source of operating income for the Corporation is net interest income, defined as interest income less interest expense. In the third quarter of 2013, interest income amounted to \$7,668,000, a decrease of \$854,000 or 10.0% from the third quarter of 2012, while interest expense amounted to \$1,247,000 in the third quarter of 2013, a

decrease of \$229,000, or 15.5% from the third quarter of 2012. As a result, net interest income decreased \$625,000 or 8.9% in the third quarter of 2013 to \$6,421,000 from \$7,046,000 in the third quarter of 2012.

For the nine months ended September 30, 2013, interest income declined by 11.2%, or \$2,954,000. Interest expense declined by 27.0%, or \$1,376,000. The net effect was a decline in net interest income for the nine months ended September 30, 2013 of \$1,578,000, or 7.5%

Our net interest margin for the nine months ended September 30, 2013 was 3.81% compared to 4.12% for the nine months ended September 30, 2012.

#### PROVISION FOR LOAN LOSSES

The provision for loan losses for the quarter ended September 30, 2013 was \$133,000 as compared to \$400,000 for the quarter ended September 30, 2012. The decrease 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 months ended September 30, 2013 and 2012 were \$505,000 and \$1,224,000, respectively. See Allowance for Loan Losses on Page 38 for further discussion.

## NON-INTEREST INCOME

Total non-interest income was \$1,397,000 for the quarter ended September 30, 2013, as compared to \$1,886,000 for the quarter ended September 30, 2012, a decrease of \$489,000, or 25.9%. Net gains on sales of mortgage loans decreased \$255,000 over the third quarter of 2012 to \$77,000. Mortgage originations fell as rates began to rise during the third quarter. Net gains on sales of investment securities also decreased \$213,000 to \$264,000 as compared to the third quarter of 2012. The Bank has taken gains and losses in the portfolio, primarily in municipal securities, to reduce market risk and protect from further changes in value in the face of increases in long-term interest rates.

Excluding investment securities gains and losses, non-interest income was \$1,133,000 for the third quarter of 2013, a decrease of \$276,000, or 19.6% from the third quarter of 2012.

For the nine months ended September 30, 2013, non-interest income was \$6,684,000, which increased \$1,401,000 over the same period in 2012. The primary reason for the increase was the net investment securities gains of \$2,944,000. These gains exceeded those taken in 2012 by \$1,460,000. Excluding net securities gains, non-interest income declined by \$59,000. While Trust Department income and service charges and fees both increased, they were not large enough to offset the \$221,000 reduction in gains on sales of residential mortgage loans.

## NON-INTEREST EXPENSE

Total non-interest expense was \$4,919,000 for the quarter ended September 30, 2013, as compared to \$5,176,000 for the quarter ended September 30, 2012. Non-interest expense was down \$257,000, or 5.0%. Salaries and employee benefits rose by \$220,000, or 8.5%. These increases reflect additional employee and benefit costs associated with several new employees including a Residential Mortgage Consultant, Training Director, and the salaries associated with staffing the Dallas Branch, which opened on March 18, 2013. Also, medical insurance costs have risen for the period. Other non-interest expense was lower due to decreased 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 \$8,250,000, or 55.3% of total non-interest expense for the nine months ended September 30, 2013, as compared to 50.1% for the nine months of 2012. Net occupancy, furniture and equipment, and computer expense amounted to \$2,402,000 for the nine months ended September 30, 2013, an increase of \$85,000, or 3.7%. Other non-interest expense, including the FHLB prepayment penalties, ATM and debit card fees, FDIC insurance, professional services and state shares tax amounted to \$4,271,000 for the nine months ended September 30, 2013, a decrease of \$1,186,000, or 21.7% as compared to the nine months of 2012.

Non-interest expense was \$14,923,000 for the nine months ended September 30, 2013, which was a \$645,000, or 4.1% decrease from the same period in 2012. During the nine months ended September 30, 2013, salaries and employee benefits increased by 5.9%. A contributing factor was a 16.2% increase in hospital insurance overhead. Occupancy, furniture and equipment and computer expense increased by 3.7%. Professional services and FDIC insurance both declined, however, the biggest change is attributed to reductions in collections and OREO related expenses.

#### INCOME TAXES

Effective tax planning has helped produce favorable net income. Income tax expense amounted to \$2,089,000 for the nine months ended September 30, 2013, as compared to \$1,709,000 for the nine months ended September 30, 2012, an increase of \$380,000. The effective total income tax rate was 22.1% for the third quarter of 2013 as compared to 17.6% for the third quarter of 2012. The increase in the effective tax rate was due to the increase in net gains on sales of investment securities. The Corporation looks to maximize its tax-exempt income derived from both tax-free loans and tax-free municipal securities.

#### ANALYSIS OF FINANCIAL CONDITION

##### ASSETS

Total assets increased to \$839,692,000 as of September 30, 2013, an increase of \$19,726,000, or 2.4% from year-end 2012. As of September 30, 2013, total deposits amounted to \$666,083,000, an increase of 9.4% from year-end 2012.

Net loans increased by \$12,528,000 or 2.9%. Loan demand continues to be weak; however, the Bank has seen an increase in loan originations. Several large loan payoffs have impacted balances during the first nine months of the year.

Cash balances decreased compared to year-end 2012 due to the timing of collections of outstanding cash items from other institutions.

The Corporation continues to maintain and manage its asset growth. The Corporation's strong equity capital position provides an opportunity to further leverage its asset growth. Total borrowings decreased in the first nine months of 2013 by \$27,583,000 to \$72,006,000 from \$99,589,000 as of December 31, 2012. Borrowings decreased as a result of increases in deposits and the sales of investments during the year.

## EARNING ASSETS

Earning assets are defined as those assets that produce interest income. By maintaining a healthy asset utilization rate, i.e., the volume of earning assets as a percentage of total assets, the Corporation maximizes income. The earning asset ratio (average interest earning assets divided by average total assets) equaled 91.48% at September 30, 2013, compared to 91.40% at September 30, 2012. This indicates that the management of earning assets is a priority and non-earning assets, primarily cash and due from banks, fixed assets and other assets, are maintained at minimal levels. The primary earning assets are loans and investment securities.

Our primary earning asset, loans, net of unearned income, increased to \$445,652,000 as of September 30, 2013, up \$12,756,000, or 3.0% since year-end 2012. The loan portfolio continues to be diversified. Overall asset quality has remained consistent with non-performing assets increasing slightly since year-end 2012. Total non-performing assets were \$4,281,000 as of September 30, 2013, an increase of \$498,000, or 13.2% from the \$3,783,000 reported in non-performing assets as of December 31, 2012. Total allowance for loan losses to total non-performing assets was 140.0% as of September 30, 2013 and 152.6% at December 31, 2012.

In addition to loans, another primary earning asset is our overall investment portfolio, which increased in size from December 31, 2012, to September 30, 2013. Held-to-maturity securities amounted to \$1,546,000 as of September 30, 2013, a decrease of \$1,015,000 from December 31, 2012. Available-for-sale securities amounted to \$318,755,000 as of September 30, 2013, an increase of \$17,560,000 from year-end 2012. Interest-bearing deposits in other banks decreased as of September 30, 2013, to \$1,358,000 from \$10,882,000 at year-end 2012.

## LOANS

Total loans, net of unearned income, increased to \$445,652,000 as of September 30, 2013 as compared to \$432,896,000 as of December 31, 2012. The table on page 19 provides data relating to the composition of the corporation's loan portfolio on the dates indicated. Total net loans increased by \$12,528,000 or 2.9%.

The generally weak economy and resultant decline in loan demand accounted for marginal growth in the loan portfolio from December 31, 2012 to September 30, 2013. The Commercial and Industrial portfolio decreased \$2,216,000 to \$26,498,000 as of September 30, 2013 as compared to \$28,714,000 as of December 31, 2012. The decrease is attributed to weak loan demand, which were offset by loan payoffs along with typical loan amortizations. The Tax-exempt portfolio, including tax-exempt real estate, increased \$10,731,000 to \$39,923,000 as of September 30, 2013 as compared to \$29,192,000 as of December 31, 2012. The increase was attributed to new originations totaling \$11,400,000, which were impacted by payoffs of \$2,900,000, along with typical amortizations. The Residential Real Estate portfolio increased 3.2% to \$151,784,000 as of September 30, 2013, as compared to \$147,011,000 as of December 31, 2012. The growth was attributed to originations of \$33,300,000 in Residential Real Estate loans, which were offset by \$22,200,000 in sales of new originations to the secondary market during the nine months ended September 30, 2013. The Corporation expects to continue originating and selling certain long-term fixed rate residential mortgage loans which conform to secondary market requirements, as the Corporation derives ongoing income from servicing of mortgages sold in the secondary market. The Commercial Real Estate portfolio decreased \$134,000 to \$221,204,000 as of September 30, 2013, as compared to \$221,338,000 as of December 31, 2012. The decrease was primarily the result of sluggish loan originations being offset by \$24,400,000 in loan payoffs, plus typical portfolio amortizations. Other than the payoffs mentioned above, the competition for available loans further hinders loan originations. The Consumer portfolio decreased \$589,000 to \$5,884,000 as of September 30, 2013, as compared to \$6,473,000 as of December 31, 2012. The decrease was primarily the result of portfolio amortizations and loan payoffs being greater than new loan originations. During the first nine months of 2013, 367 new consumer loans were originated while 483 payoffs were recorded. The Corporation continues its efforts to lend to creditworthy borrowers despite the continued slow economic conditions.

Management believes that the loan portfolio is well diversified. The total Commercial portfolio was \$287,625,000 of which \$225,516,000 or 50.6% of gross loans is secured by commercial real estate.

The largest relationship is a manufacturing/fabrication company and its related entities. The company has a long history of successful operations dating back to 1980. The relationship had outstanding loan balances and unused commitments of \$8,828,000 at September 30, 2013. The debt consists of approximately \$6,333,000 in term debt secured by various real estate holdings and approximately \$2,495,000 in operating lines of credit secured by business assets and guaranties.

The second largest relationship is a real estate development company and its related entities, specializing in the design, construction, and management of multi-tenant residential housing. The company was established in the late 1980s. The relationship had outstanding loan balances and unused commitments of \$8,424,000 at September 30, 2013. The debt consists of approximately \$5,712,000 in term debt secured by various real estate holdings and approximately \$2,700,000 in lines of credit secured by various real estate holdings. The loans are secured primarily by income producing multi-tenant real estate.

The third largest relationship is an \$8,387,000 tax free loan to a municipality founded in 1816 consisting of 35 square miles. According to township officials, the population has been increasing steadily since 2001 and is currently in excess of 11,000 people. In 2012, the township completed its \$74,000,000 sewer expansion project. The Bank's loan is secured by project receivables and the full faith, credit, and taxing power of the township.

The fourth largest relationship consists of net outstanding balances of \$8,157,000 after participation shares sold of \$2,851,000. 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. 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 fifth largest relationship is a real estate holding company established in 2006 and its related entities. The company was formed to construct and manage a multi-tenant medical complex, housing offices of medical practitioners, social services providers, and other related services. The relationship is located in the Corporation's immediate central market area. The relationship had outstanding loan balances and unused commitments of \$7,601,000 as of September 30, 2013. This relationship is comprised of approximately \$7,151,000 in term debt and approximately \$450,000 in lines of credit. The loans are secured primarily by income producing commercial real estate and perfected by security interest in business assets.



Each of the aforementioned relationships is located within the Corporation's market area.

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.

Overall, the portfolio risk profile as measured by loan grade is considered low risk, as \$436,742,000 or 98.1% of gross loans are graded Pass; \$3,156,000 or 0.7% are graded Special Mention; \$5,395,000 or 1.2% are graded Substandard; and \$0 are graded Doubtful. The rating is intended to 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 the Bank, credit history and lender knowledge of the borrower. See Note 3 — Loans for risk grading tables.

Overall, non-pass grades increased at September 30, 2013 to \$8,551,000 as compared to year-end December 31, 2012 of \$8,484,000. Commercial and Industrial non-pass grades decreased to \$535,000 as of September 30, 2013 as compared to \$916,000 as of December 31, 2012. Commercial Real Estate non-pass grades increased to \$6,435,000 as of September 30, 2013 as compared to \$6,241,000 as of December 31, 2012. The Residential Real Estate and Consumer Loans non-pass grades increased to \$1,581,000 as of September 30, 2013 as compared to \$1,327,000 as of December 31, 2012.

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, 2013	December 31, 2012
Commercial and Industrial	\$ 26,498	\$ 28,714
Tax exempt - real estate and other	39,923	29,192
Commercial real estate	221,204	221,338
Residential real estate	151,784	147,011
Consumer	5,884	6,473
Gross loans	445,293	432,728
Add (deduct): Unearned discount and	(102 )	(170 )
Net deferred loan fees and costs	461	338
Total loans, net of unearned income	\$ 445,652	\$ 432,896

**ALLOWANCE FOR LOAN LOSSES**

The allowance for loan losses constitutes the amount available to absorb losses within the loan portfolio. As of September 30, 2013, the allowance for loan losses was \$6,000,000 as compared to \$5,772,000 as of December 31, 2012. 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 the allowance for loan losses indicating charge-offs and recoveries for the nine month period and the year. In the first nine months of 2013, net charge-offs as a percentage of average loans was 0.1%. For the twelve month period ended December 31, 2012, net charge-offs as a percentage of average loans was 0.4%. Net charge-offs amounted to \$505,000 for the first nine months of 2013 as compared to \$1,757,000 for the twelve months ended December 31, 2012, and \$1,224,000 for the first nine months of 2012. The decrease in net charge-offs in the first nine months of 2013 as compared to the first nine months of 2012 related primarily to decreased losses in Commercial and Residential Real Estate loans. During the first nine months of 2013, \$496,000 in Commercial and Residential Real Estate loans were charged off as compared to \$973,000 for the first nine months of 2012. Also, for the first nine months of 2013, \$12,000 in Commercial and Industrial loans were charged off as compared to \$264,000 in the first nine months of 2012.

For the first nine months of 2013, the provision for loan losses was \$733,000 as compared to \$1,200,000 for the first nine months of 2012. The provision, net of charge-offs and recoveries, increased the quarter end Allowance for Loan Losses to \$6,000,000 of which 13.3% was attributed to the Commercial and Industrial component; 47.3% attributed to the Commercial Real Estate component; 26.1% attributed to the Residential Real Estate component (primarily residential mortgages); 1.2% attributed to the Consumer component; and 12.1% being the unallocated component (refer to the activity in the allowance for loan losses table in Note 3 – Loans on page 19). 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 the probable losses inherent in the loan portfolio as of September 30, 2013.

## Analysis of Allowance for Loan Losses

(Amounts in thousands)	September 30, 2013	December 31, 2012	September 30, 2012			
Balance at beginning of period	\$ 5,772	\$ 5,929	\$ 5,929			
Charge-offs:						
Commercial and Industrial	12	264	264			
Real estate – commercial and residential	496	1,481	973			
Consumer	30	87	54			
	538	1,832	1,291			
Recoveries:						
Commercial and Industrial	19	23	23			
Real estate – commercial and residential	5	23	22			
Consumer	9	29	22			
	33	75	67			
Net charge-offs	505	1,757	1,224			
Additions charged to operations	733	1,600	1,200			
Balance at end of period	\$ 6,000	\$ 5,772	\$ 5,905			
Ratio of net charge-offs during the period to average loans outstanding during the period	0.12	%	0.40	%	0.29	%
Allowance for loan losses to average loans outstanding during the period	1.39	%	1.36	%	1.40	%

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 the Bank's manageable level of net charge-offs and the additions to the reserve from the provision out of operations, the allowance for loan losses as a percentage of average loans amounted to 1.39% at September 30, 2013, 1.36% at December 31, 2012 and 1.40% at September 30, 2012.

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, 2013			December 31, 2012		
Commercial and Industrial	\$797	15.1	%*	\$573	11.4	%*
Real estate – commercial and residential	4,401	83.5	%*	4,361	87.0	%*
Consumer	74	1.4	%*	80	1.6	%*
Unallocated	728	<u>N/A</u>	*	758	<u>N/A</u>	*
	\$6,000	100.0	%*	\$5,772	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 41 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. A modification of a loan constitutes a troubled debt restructuring ("TDR") when a borrower is experiencing financial difficulty and the modification constitutes a concession that we would not otherwise consider. Modifications to loans classified as a TDR generally include reductions in contractual interest rates, principal deferment and extensions of maturity dates at a stated interest rate lower than the current market for a new loan with similar risk characteristics. While unusual, there may be instances of loan principal forgiveness. Foreclosed assets held for resale represent property acquired through foreclosure, or considered to be an in-substance foreclosure.

Total non-performing assets increased \$498,000 to \$4,281,000 as of September 30, 2013 as compared to \$3,783,000 as of December 31, 2012. The economy, in particular, high unemployment, weak job markets, unsettled fuel prices, rising energy costs, lack of disposable income, and the continued slowness in the housing industry had a direct effect on 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 loans, which increased in 2012, have slowed through the third quarter of 2013. Impaired loans increased \$1,438,000 to \$3,801,000 as of September 30, 2013 as compared to \$2,363,000 as of December 31, 2012. Foreclosed assets held for resale increased to \$480,000 as of September 30, 2013 as compared to \$468,000 as of December 31, 2012. The increase was the result of the sale of two residential properties and one commercial real estate property, which was offset by the addition of a commercial real estate property. Loans past-due 90 days or more and still accruing interest decreased to \$0 as of September 30, 2013 as compared to \$952,000 as of December 31, 2012. The decrease was a result of the payoff of two related commercial real estate loans previously classified as 90 days or more past-due with a combined balance of \$952,000. Non-performing assets to period-end loans and foreclosed assets was 1.0% at September 30, 2013 and 0.9% at December 31, 2012. Total non-performing assets to total assets was 0.5% as of September 30, 2013 and 0.5% as of December 31, 2012. Additional detail can be found on page 41 Non-Performing Assets table and page 25 in the Financing Receivables on non-accrual status table. Asset quality is a priority and the Corporation retains a full-time loan review officer to closely track and monitor overall loan quality, along with a full-time workout specialist to manage collection and liquidation efforts.

Impaired loans were \$3,801,000 at September 30, 2013 and \$2,363,000 at December 31, 2012. The largest relationship is represented by one loan carrying a balance of \$1,432,000, secured by three commercial real estate properties and a personal residence. This is a participation facility that was purchased in 2006. The quarter-end valuation carried a net realizable value of \$7,450,000, after estimated average appraisal adjustments and costs to sell of 23%, resulting in a specific allocation of \$0. The second largest relationship is represented by four loans carrying a balance of \$516,000 secured by commercial real estate. The quarter-end valuation carried a net realizable value of

\$563,000, after average estimated appraisal adjustments and costs to sell of 27%, resulting in a specific allocation of \$0. The third largest relationship is represented by two loans carrying a balance of \$201,000, secured by commercial real estate. The quarter-end valuation carried a net realizable value \$358,000, after average estimated appraisal adjustments and costs to sell of 33%, resulting in a specific allocation of \$0. The estimated appraisal adjustments and costs to sell percentages are determined based upon the market area in which the real estate securing the loan is located and therefore can differ from one loan to another. Of the \$3,801,000 in impaired loans, none are located outside of our primary market area.

Loans categorized as TDRs carried an unpaid balance of \$4,128,000 as of September 30, 2013 as compared to \$0 as of December 31, 2012. The increase was attributable to deterioration in the respective borrowers' financial position, and in some cases a declining collateral value, along with the Bank's proactive monitoring of the loan portfolio. All of the restructured loans were classified in the commercial real estate portfolio. Seven loans are performing under the terms of the debt restructurings, four loans are non-performing under the terms of the debt restructurings, and one loan was paid off during the second quarter of 2013. The troubled debt restructuring modifications consisted of two term modifications beyond the original stated term, three interest rate modifications, and seven payment modifications. TDRs are separately identified for impairment disclosures, and if necessary, a specific allocation is established. As of September 30, 2013, no specific allocations were attributable to the TDRs. For TDRs that default, the Bank determines a reserve amount in accordance with the Bank's policy for allowance for loan losses.

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. We actively work with borrowers to resolve credit problems and will continue our close monitoring efforts through the remainder of 2013. Excluding the assets disclosed below in the Non-Performing Assets table and the Troubled Debt Restructurings section in Note 3 – Loans, 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 losses. They may require additions to allowances based upon their judgments about information available to them at the time of examination.

Interest income received on non-performing loans for the first nine months of 2013 and for the year ended December 31, 2012 was \$21,000 and \$34,000, respectively. Interest income, which would have been recorded on these loans under the original terms as of September 30, 2013 and December 31, 2012, was \$375,000 and \$279,000, respectively. At September 30, 2013 and December 31, 2012, 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, 2013 and December 31, 2012, management is of the opinion that there were no loan concentrations exceeding 10% of total loans.



**Non-performing Assets**

(Amounts in thousands)	September 30, 2013	December 31, 2012		
Non-performing assets				
Impaired loans	\$ 3,801	\$ 2,363		
Foreclosed assets held for resale	480	468		
Loans past-due 90 days or more and still accruing interest	0	952		
Total non-performing assets	\$ 4,281	\$ 3,783		
Impaired loans				
Non-performing loans	\$ 3,801	\$ 2,363		
Allocated allowance for loan losses	(192 )	(223 )		
Net investment in impaired loans	\$ 3,609	\$ 2,140		
Impaired loans with a valuation allowance	\$ 442	\$ 463		
Impaired loans without a valuation allowance	3,359	1,900		
Total impaired loans	\$ 3,801	\$ 2,363		
Allocated valuation allowance related to impaired loans	\$ 192	\$ 223		
Allocated valuation allowance as a percent of impaired loans	5.1	%	9.4	%
Impaired loans to loans net of unearned income	0.9	%	0.6	%
Non-performing assets to period-end loans and foreclosed assets	1.0	%	0.9	%
Total non-performing assets to total assets	0.5	%	0.5	%
Allowance for loan losses to impaired loans	157.9	%	244.3	%
Allowance for loan losses to total non-performing assets	140.2	%	152.6	%

Real estate mortgages comprise 84.7% of the loan portfolio as of September 30, 2013, as compared to 86.0% as of December 31, 2012. Real estate mortgages consist of both residential and commercial real estate loans. The real estate loan portfolio is well diversified in terms of borrowers, collateral, interest rates, and maturities. Also, the residential real estate loan portfolio is largely fixed rate mortgages. The real estate loans are concentrated primarily in our market area and are subject to risks associated with the local economy. The commercial real estate loans typically reprice approximately each three to five years and are also concentrated in our market area. The Corporation's loss exposure on its non-performing loans continues to be mitigated by collateral positions on these loans. The allocated allowance for loan losses associated with impaired loans is generally computed based upon the related collateral value of the loans. The collateral values are determined by recent appraisals, but are generally discounted by management based on historical dispositions, changes in market conditions since the last valuation and management's expertise and knowledge of the borrower and the borrower's business.

#### DEPOSITS AND OTHER BORROWED FUNDS

Total deposits increased \$57,249,000 to \$666,083,000 as of September 30, 2013 as non-interest bearing deposits increased by \$5,861,000 and interest bearing deposits increased by \$51,388,000 from year-end 2012. Total short-term and long-term borrowings decreased to \$72,006,000 as of September 30, 2013, from \$99,589,000 at year-end 2012, a decrease of \$27,583,000, or 27.7%.

#### CAPITAL STRENGTH

Normal increases in capital are generated by net income, less cash dividends paid out. During the first nine months of the year, net income less dividends paid increased capital by \$4,270,000. Accumulated other comprehensive income derived from net unrealized gains (losses) on investment securities available-for-sale also impacts capital. At December 31, 2012, accumulated other comprehensive income was \$12,528,000. Accumulated other comprehensive income stood at \$1,640,000 at September 30, 2013, a decline of \$10,888,000. Fluctuations in interest rates have regularly impacted the gain/loss position in the Bank's investment portfolio, as well as its decision to sell securities at a gain or loss. In order to protect the Bank from market risk in the event of further interest rate increases, the Bank chose to sell a portion of its securities during the third quarter of 2013 at an overall net gain of \$264,000. These fluctuations from net unrealized gains (losses) on investment securities available-for-sale do not affect regulatory capital.

The Corporation held 235,646 and 237,183 shares of common stock at September 30, 2013 and December 31, 2012, as treasury stock. This had an effect of reducing our total stockholders' equity by \$5,839,000 as of September 30, 2013, and \$5,890,000 as of December 31, 2012. Beginning in June 2012, the Corporation began issuing common stock for new shares purchased by participants in the Corporation's Dividend Reinvestment Program ("DRIP"). Prior to that, shares needed to fill purchase orders through the DRIP were acquired on the open market. This change was made to reduce the volatility in stock price, which occurred because of large quarterly purchases and to augment capital

formation.

Total stockholders' equity was \$97,493,000 as of September 30, 2013, and \$103,330,000 as of December 31, 2012. Leverage ratio and risk based capital ratios remain very strong. As of September 30, 2013, our leverage ratio was 9.37% compared to 8.97% as of December 31, 2012. In addition, Tier I risk based capital and total risk based capital ratio as of September 30, 2013, were 13.73% and 14.88%, respectively. The same ratios as of December 31, 2012 were 13.33% and 14.46%, respectively.

## LIQUIDITY

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

Management believes its current liquidity position is satisfactory given the fact that the Corporation has a very stable core deposit base which has increased annually. The Corporation's loan payments and principal paydowns on its mortgage-backed securities provide a steady source of funds. Short-term investments and maturing investments represent additional sources of liquidity.

Edgar Filing: FIRST KEYSTONE CORP - Form 10-Q

The following tables represent scheduled maturities of the Corporation's contractual obligations by time remaining until maturity as of September 30, 2013 and December 31, 2012.

(Amounts in thousands)

Contractual Obligations September 30, 2013	Less than 1 Year	1 - 3 Years	3 - 5 Years	Over 5 Years	Total
Time deposits	\$166,246	\$51,018	\$28,667	\$3,228	\$249,159
Securities sold under agreement to repurchase	22,516	0	0	0	22,516
FHLB borrowings	14,037	5,000	18,000	12,000	49,037
Commitments to grant loans <sup>1</sup>	7,992	0	0	0	7,992
Commitments to fund loans for secondary market mortgages <sup>1</sup>	879	0	0	0	879
Unfunded commitments on lines of credit <sup>1</sup>	50,123	3,151	0	0	53,274
Financial standby letters of credit <sup>1</sup>	418	0	0	0	418
Performance standby letters of credit <sup>1</sup>	3,979	0	0	0	3,979
Purchase and building commitments	694	0	0	0	694
Operating lease obligations	114	141	117	2,722	3,094
Capital lease obligations	132	264	140	0	536
	\$267,130	\$59,574	\$46,924	\$17,950	\$391,578

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

(Amounts in thousands)

Contractual Obligations December 31, 2012	Less than 1 Year	1 - 3 Years	3 - 5 Years	Over 5 Years	Total
Time deposits	\$144,283	\$73,785	\$29,695	\$0	\$247,763
Securities sold under agreement to repurchase	17,059	0	0	0	17,059
FHLB borrowings	45,010	12,000	5,000	20,000	82,010
Commitments to grant loans <sup>1</sup>	11,242	0	0	0	11,242
Commitments to fund loans for secondary market mortgages <sup>1</sup>	2,828	0	0	0	2,828
Unfunded commitments on lines of credit <sup>1</sup>	46,110	3,473	0	0	49,583
Financial standby letters of credit <sup>1</sup>	720	0	0	0	720
Performance standby letters of credit <sup>1</sup>	3,714	0	0	0	3,714
Purchase and building commitments	840	0	0	0	840
Operating lease obligations	142	186	112	2,766	3,206
Capital lease obligations	132	264	240	0	636
	\$272,080	\$89,708	\$35,047	\$22,766	\$419,601

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

## MARKET RISK

Market risk is the risk of loss arising from adverse changes in the fair value of financial instruments due to changes in interest rates, exchange rates and equity prices. The Corporation's market risk is composed primarily of interest rate risk. The Corporation's interest rate risk results from timing differences in the repricing of assets, liabilities, off-balance sheet instruments, and changes in relationships between rate indices and the potential exercise of explicit or embedded options.

Increases in the level of interest rates also may adversely affect the fair value of the Corporation's securities and other earning assets. Generally, the fair value of fixed-rate instruments fluctuates inversely with changes in interest rates. As a result, increases in interest rates could result in decreases in the fair value of the Corporation's interest-earning assets, which could adversely affect the Corporation's results of operations if sold, or, in the case of interest-earning assets classified as available-for-sale, the Corporation's stockholders' equity, if retained. Under FASB ASC 320-10, *Investment Debt and Equity Securities*, changes in the unrealized gains and losses, net of taxes, on securities classified as available-for-sale are reflected in the Corporation's stockholders' equity. The Corporation does not own any trading assets.

### ***Asset/Liability Management***

The principal objective of asset/liability management is to manage the sensitivity of the net interest margin to potential movements in interest rates and to enhance profitability through returns from managed levels of interest rate risk. The Corporation actively manages the interest rate sensitivity of its assets and liabilities. The following table presents an interest sensitivity analysis of assets and liabilities as of September 30, 2013. Several techniques are used for measuring interest rate sensitivity. Interest rate risk arises from the mismatches in the repricing of assets and liabilities within a given time period, referred to as a rate sensitivity gap. If more assets than liabilities mature or reprice within the time frame, the Corporation is asset sensitive. This position would contribute positively to net interest income in a rising rate environment. Conversely, if more liabilities mature or reprice, the Corporation is liability sensitive. This position would contribute positively to net interest income in a falling rate environment.

Limitations of interest rate sensitivity gap analysis as illustrated in the following table include: a) assets and liabilities which contractually reprice within the same period may not, in fact, reprice at the same time or to the same extent; b) changes in market interest rates do not affect all assets and liabilities to the same extent or at the same time, and c) interest rate sensitivity gaps reflect the Corporation's position on a single day (September 30, 2013 in the case of the following schedule) while the Corporation continually adjusts its interest sensitivity throughout the year. The Corporation's cumulative gap at one year indicates the Corporation is liability sensitive.

### **Interest Rate Sensitivity Analysis**

*(Amounts in thousands)*

	September 30, 2013				
	One Year	1 - 5 Years	Beyond 5 Years	Not Rate Sensitive	Total
Assets	\$172,945	\$339,208	\$240,691	\$86,848	\$839,692

Liabilities/Stockholders' Equity	230,109	360,177	150,137	99,269	839,692
Interest Rate Sensitivity Gap	\$(57,164)	\$(20,969)	\$90,554	\$(12,421)	
Cumulative Gap	\$(57,164)	\$(78,133)	\$12,421	0	

***Earnings at Risk***

The Bank's Asset/Liability Committee ("ALCO") is responsible for reviewing the interest rate sensitivity position and establishing policies to monitor and limit exposure to interest rate risk. The guidelines established by ALCO are reviewed by the Corporation's Board of Directors. The Corporation recognizes that more sophisticated tools exist for measuring the interest rate risk in the balance sheet beyond interest rate sensitivity gap. Although the Corporation continues to measure its interest rate sensitivity gap, the Corporation utilizes additional modeling for interest rate risk in the overall balance sheet. Earnings at risk and economic values at risk are analyzed.

Earnings simulation modeling addresses earnings at risk and net present value estimation addresses economic value at risk. While each of these interest rate risk measurements has limitations, taken together they represent a reasonably comprehensive view of the magnitude of interest rate risk in the Corporation.

### ***Earnings Simulation Modeling***

The Corporation's net income is affected by changes in the level of interest rates. Net income is also subject to changes in the shape of the yield curve. For example, a flattening of the yield curve would result in a decline in earnings due to the compression of earning asset yields and increased liability rates, while a steepening would result in increased earnings as earning asset yields widen.

Earnings simulation modeling is the primary mechanism used in assessing the impact of changes in interest rates on net interest income. The model reflects management's assumptions related to asset yields and rates paid on liabilities, deposit sensitivity, size and composition of the balance sheet. The assumptions are based on what management believes at that time to be the most likely interest rate environment. Earnings at risk is the change in net interest income from a base case scenario under various scenarios of rate shock increases and decreases in the interest rate earnings simulation model.

The table on page 46 presents an analysis of the changes in net interest income and net present value of the balance sheet resulting from various increases or decreases in the level of interest rates, such as two percentage points (200 basis points) in the level of interest rates. The calculated estimates of change in net interest income and net present value of the balance sheet are compared to current limits approved by ALCO and the Board of Directors. The earnings simulation model projects net interest income would decrease 3.1%, 7.4% and 12.2% in the 100, 200 and 300 basis point increasing rate scenarios presented. In addition, the earnings simulation model projects net interest income would decrease 3.6% and 8.6% in the 100 and 200 basis point decreasing rate scenarios presented. All of these forecasts are within the Corporation's one year policy guidelines.

The analysis and model used to quantify the sensitivity of net interest income becomes less reliable in a decreasing rate scenario given the current unprecedented low interest rate environment with federal funds trading in the 0 – 25 basis point range. Results of the declining scenarios are affected by the fact that many of the Corporation's interest-bearing liabilities are at rates below 1% and therefore cannot decline 100 or more basis points. However, the Corporation's interest-sensitive assets are able to decline by these amounts. For the nine months ended September 30, 2013, the cost of interest-bearing liabilities averaged 0.79%, and the yield on average interest-earning assets, on a fully taxable equivalent basis, averaged 4.49%.

### ***Net Present Value Estimation***

The net present value measures economic value at risk and is used to help determine levels of risk at a point in time present in the balance sheet that might not be taken into account in the earnings simulation model. The net present value of the balance sheet is defined as the discounted present value of asset cash flows minus the discounted present



value of liability cash flows. At September 30, 2013, the 100 and 200 basis point immediate decreases in rates are estimated to affect net present value with a decrease of 2.6% and 9.8%, respectively. Additionally, net present value is projected to decrease 6.9%, 18.7% and 34.8% in the 100, 200 and 300 basis point immediate increase scenarios, respectively. All scenarios presented are below the Corporation's policy limits.

The computation of the effects of hypothetical interest rate changes are based on many assumptions. They should not be relied upon solely as being indicative of actual results, since the computations do not contemplate actions management could undertake in response to changes in interest rates.

**Effect of Change in Interest Rates**

	Projected Change	
Effect on Net Interest Income		
1-Year Net Income Simulation Projection		
+300 bp Shock vs. Stable Rate	(12.2	)%
+200 bp Shock vs. Stable Rate	(7.4	)%
+100 bp Shock vs. Stable Rate	(3.1	)%
Flat rate	0.0	%
-100 bp Shock vs. Stable Rate	(3.6	)%
-200 bp Shock vs. Stable Rate	(8.6	)%
Effect on Net Present Value of Balance Sheet		
Static Net Present Value Change		
+300 bp Shock vs. Stable Rate	(34.8	)%
+200 bp Shock vs. Stable Rate	(18.7	)%
+100 bp Shock vs. Stable Rate	(6.9	)%
Flat rate	0.0	%
-100 bp Shock vs. Stable Rate	(2.6	)%
-200 bp Shock vs. Stable Rate	(9.8	)%

**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 2012 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, 2012.

### Item 3. Quantitative and Qualitative Disclosures about Market Risk

Information with respect to quantitative and qualitative disclosures about market risk is included in the information under Management's Discussion and Analysis in Item 2.

### Item 4. Controls and Procedures

Evaluation of Disclosure Controls and Procedures. First Keystone Corporation maintains disclosure controls and procedures (as defined in Rule 13a-15(e) under the Securities Exchange Act of 1934, as amended) designed to ensure that information required to be disclosed in the reports that the Corporation files or submits under the Securities Exchange Act of 1934 is recorded, processed, summarized and reported within the time periods specified a) in the rules and forms of the Securities and Exchange Commission. Based upon their evaluation of those disclosure controls and procedures performed as of the end of the period covered by this report, the Chief Executive Officer and Chief Financial Officer of the Corporation concluded that the Corporation's disclosure controls and procedures were effective as of September 30, 2013.

Changes in internal control over financial reporting. There were no changes in the Corporation's internal control b) over financial reporting during the fiscal quarter ended September 30, 2013, 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, 2012.

## 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, 2013	0	0	0	120,000
August 1 — August 31, 2013	0	0	0	120,000
Sept. 1 — Sept. 30, 2013	0	0	0	120,000
Total	0	0	0	120,000

## Item 3. Defaults Upon Senior Securities

None.

## Item 4. Mine Safety Disclosures

Not applicable.

Item 5. Other Information

None.

48

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 February 14, 2013).
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 11, 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 7, 2013 /s/ Matthew P. Prosseda  
Matthew P. Prosseda  
President and Chief Executive Officer  
(Principal Executive Officer)

November 7, 2013 /s/ Diane C.A. Rosler  
Diane C.A. Rosler  
Senior Vice President and Chief Financial Officer  
(Principal Financial Officer)



INDEX TO EXHIBITS

Exhibit	Description
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 February 14, 2013).
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 11, 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.