FIRST KEYSTONE CORP
Form 10-Q
May 11, 2011

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10Q

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

For the quarterly period ended March 31, 2011

or

¨ TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the transition period from ________ to ________

Commission File Number: 2-88927

FIRST KEYSTONE CORPORATION

(Exact name of registrant as specified in its charter)

Pennsylvania (State or other jurisdiction of incorporation or organization)	23-2249083 (I.R.S. Employer identification No.)
111 West Front Street, Berwick, PA (Address of principal executive offices)	18603 (Zip Code)

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

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

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

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

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Act). Yes ¨ No x

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

Common Stock, $2 Par Value, 5,444,292 shares as of May 9, 2011.

PART I. - FINANCIAL INFORMATION

Item. 1 Financial Statements

FIRST KEYSTONE CORPORATION AND SUBSIDIARY
CONSOLIDATED BALANCE SHEETS

(Amounts in thousands)	March 2011 (Unaudited)	December 2010
ASSETS		
Cash and due from banks	$ 8,072	$ 4,346
Interest-bearing deposits in other banks	22,340	4,559
Federal funds sold	0	3,000
Total cash and cash equivalents	$ 30,412	$ 11,905
Investment securities available-for-sale	296,963	303,902
Investment securities held-to-maturity estimated fair value of $6,199 in 2011 and $6,191 in 2010	6,257	6,266
Restricted securities at cost - available-for-sale	6,046	6,363
Loans, net of unearned income	409,997	409,651
Allowance for loan losses	(5,861)	(5,701)
Net loans	$ 404,136	$ 403,950
Premises and equipment, net	12,011	11,842
Accrued interest receivable	4,278	4,589
Cash surrender value of bank owned life insurance	18,578	18,388
Investment in limited partnerships	1,571	1,600
Goodwill	19,133	19,133
Core deposit intangible	1,168	1,240
Prepaid FDIC insurance	1,799	2,005
Foreclosed assets held for resale	1,472	1,149
Deferred income taxes	3,241	2,742
Other assets	2,218	1,527
TOTAL ASSETS	$ 809,283	$ 796,601
LIABILITIES		
Deposits:		
Non-interest bearing	$ 77,147	$ 69,080
Interest bearing	549,202	557,815
TOTAL DEPOSITS	626,349	626,895
Short-term borrowings	24,734	20,977
Long-term borrowings	71,385	66,400
Accrued interest and other expenses	3,258	2,976
Other liabilities	4,362	293
TOTAL LIABILITIES	$ 730,088	$ 717,541
STOCKHOLDERS' EQUITY		
Common stock, par value $2.00 per share	11,375	11,375
Surplus	30,173	30,175
Retained earnings	46,435	45,246

Accumulated other comprehensive (loss)	(2,687)	(1,633)
Less treasury stock, at cost, 243,475 shares in 2011 and 243,540 shares in 2010	(6,101)	(6,103)
TOTAL STOCKHOLDERS' EQUITY	$79,195	$79,060
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	$809,283	$796,601

See Accompanying Notes to Consolidated Financial Statements

FIRST KEYSTONE CORPORATION AND SUBSIDIARY
CONSOLIDATED STATEMENTS OF INCOME
FOR THE THREE MONTHS ENDED March 31, 2011 AND 2010
(Unaudited)

(Amounts in thousands except per share data)

	2011	2010
INTEREST INCOME		
Interest and fees on loans	$5,845	$5,999
Interest and dividend income on securities	3,500	3,431
Deposits in banks	2	3
Total interest income	$9,347	$9,433
INTEREST EXPENSE		
Deposits	$1,839	$2,464
Short-term borrowings	50	51
Long-term borrowings	627	954
Total interest expense	$2,516	$3,469
Net interest income	$6,831	$5,964
Provision for loan losses	300	200
Net interest income after provision for loan losses	$6,531	$5,764
NON-INTEREST INCOME		
Trust department	$140	$172
Service charges and fees	316	367
Bank owned life insurance income	190	188
ATM fees and debit card income	210	185
Gain on sale of mortgage loans	40	99
Investment securities losses - net	(75)	(36)
Other	142	121
Total non-interest income	$963	$1,096
NON-INTEREST EXPENSE		
Salaries and employee benefits	$2,283	$2,210
Occupancy, net	354	342
Furniture and equipment	100	104
Computer expenses	234	225
Professional services	153	184
State shares tax	183	177
FDIC insurance	245	202
Other	752	677
Total non-interest expenses	$4,304	$4,121
Income before income taxes	$3,190	$2,739
Income tax expense	694	552
Net Income	$2,496	$2,187
PER SHARE DATA		

Net Income Per Share:		
Basic	$ .46	$ .40
Diluted	.46	.40
Cash dividends per share	.24	.23

See Accompanying Notes to Consolidated Financial Statements

FIRST KEYSTONE CORPORATION AND SUBSIDIARY
CONSOLIDATED STATEMENT OF CHANGES IN STOCKHOLDERS' EQUITY
(Unaudited)

(Amounts in thousands, except per share data)

	Common Stock	Surplus	Comprehensive Income	Retained Earnings	Accumulated Other Comprehensive (Loss)	Treasury Stock	Total
Balance at December 31, 2009	$ 11,375	$ 30,269		$ 41,346	$ (2,583)	$ (6,240)	$ 74,167
Comprehensive Income:							
Net Income			$ 2,187	2,187			2,187
Change in net unrealized gain (loss) on investment securities available-for-sale, net of reclassification adjustment and tax effects			1,670		1,670		1,670
Total comprehensive income			$ 3,857				
Issuance of 4,101 shares of treasury stock upon exercise of employee stock options		(11)				16	5
Cash dividends - $.23 per share				(1,251)			(1,251)
Balance at March 31, 2010	$ 11,375	$ 30,258		$ 42,282	$ (913)	$ (6,224)	$ 76,778
Balance at December 31, 2010	$ 11,375	$ 30,175		$ 45,246	$ (1,633)	$ (6,103)	$ 79,060
Comprehensive Income:							
Net Income			$ 2,496	2,496			2,496
Change in unrealized gain (loss) on investment securities available-sale, net of reclassification							

adjustment and tax effects			(1,054)		(1,054)		(1,054)
Total Comprehensive income			$ 1,442				
Issuance of 65 of treasury stock upon exercise of employee stock options		(2)				2	
Cash dividends - $.24 per share				(1,307)			(1,307)
Balance at March 31, 2011	$ 11,375	$ 30,173		$ 46,435	$ (2,687)	$ (6,101)	$ (79,195)

See accompanying notes to consolidated financial statements.

FIRST KEYSTONE CORPORATION AND SUBSIDIARY
CONSOLIDATED STATEMENTS OF CASH FLOWS
FOR THE THREE MONTHS ENDED March 31, 2011 AND 2010
(Unaudited)

(Amounts in thousands)	2011	2010
OPERATING ACTIVITIES		
Net income	$2,496	$2,187
Adjustments to reconcile net income to net cash provided by operating activities:		
Provision for loan losses	300	200
Provision for depreciation and amortization	228	240
Core deposit amortization	72	69
Premium amortization on investment securities	278	146
Discount accretion on investment securities	(294)	(334)
Gain on sale of mortgage loans	(40)	(99)
Proceeds from sale of mortgage loans	4,697	3,529
Originations of mortgage loans for resale	(4,252)	(1,824)
Loss on sales of investment securities	75	36
Deferred income tax provision	40	34
Increase in interest receivable and other assets	(380)	(505)
Decrease in prepaid FDIC insurance	206	186
Increase in cash surrender bank owned life insurance	(190)	(188)
Increase (decrease) in interest payable, accrued expenses and other liabilities	181	(26)
NET CASH PROVIDED BY OPERATING ACTIVITIES	$2,417	$3,651
INVESTING ACTIVITIES		
Purchases of investment securities held-to-maturity	0	(1,028)
Purchases of investment securities available-for-sale	(42,169)	(18,637)
Proceeds from sales of investment securities available-for-sale	44,129	4,966
Proceeds from the redemption of restricted securities	317	0
Proceeds from maturities and redemptions of investment securities available for sale	7,467	6,485
Proceeds from maturities and redemption of investment securities held-to-maturity	39	724
Net increase (decrease) in loans	(1,193)	48
Purchase of premises and equipment	(389)	(610)
NET CASH PROVIDED BY (USED IN) INVESTING ACTIVITIES	$8,201	$(8,052)
FINANCING ACTIVITIES		
Net increase (decrease) in deposits	$(546)	$24,161
Net increase (decrease) in short-term borrowings	3,757	(2,558)
Proceeds from long-term borrowings	5,000	7,000
Repayment of long-term borrowings	(15)	(14)
Proceeds from the exercise of stock options	0	5
Cash dividends	(1,307)	(1,251)
NET CASH PROVIDED BY FINANCING ACTIVITIES	$6,889	$27,343
INCREASE IN CASH AND CASH EQUIVALENTS	18,507	$22,942
CASH AND CASH EQUIVALENTS, BEGINNING	11,905	11,426
CASH AND CASH EQUIVALENTS, ENDING	$30,412	$34,368

SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION		
Cash paid during period for interest	$2,614	$3,572
Loans transferred to foreclosed assets held for resale	323	0
Investment securities purchased - $4,170 less settlement obligation $4,170 in 2011	0	0

See Accompanying Notes to Consolidated Financial Statements

FIRST KEYSTONE CORPORATION AND SUBSIDIARY
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
March 31, 2011
(Unaudited)

NOTE 1 — SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

The accounting policies of First Keystone Corporation and Subsidiary (the "Corporation") are in accordance with accounting principles generally accepted in the United States of America and conform to common practices within the banking industry. The more significant policies follow:

Principles of Consolidation

The consolidated financial statements include the accounts of First Keystone Corporation and its wholly-owned Subsidiary, 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, public and institutional customers primarily located in the Northeast Region of Pennsylvania. The Bank has 15 full service offices and 17 ATMs located in Columbia, Luzerne, Montour and Monroe Counties. The Corporation and its subsidiary must also adhere to certain federal banking laws and regulations and are subject to periodic examinations made by various federal agencies.

Segment Reporting

The Corporation's banking subsidiary acts as an independent community financial services provider, and offers traditional banking and related financial services to individual, business and government customers. Through its branch and automated teller machine network, the Bank offers a full array of commercial and retail financial services, including the taking of time, savings and demand deposits; the making of commercial, consumer and mortgage loans; and the providing of other financial services. The Bank also performs personal, corporate, pension and fiduciary services through its Trust Department.

Management does not separately allocate expenses, including the cost of funding loan demand, between the commercial, retail, trust and mortgage banking operations of the Corporation. Currently, management measures the performance and allocates the resources of First Keystone Corporation as a single segment.

Use of Estimates

The preparation of these consolidated financial statements in conformity with accounting principles generally accepted in the United States of America, requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of these consolidated financial statements and the reported amounts of income and expenses during the reporting periods. Actual results could 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 other intangible assets and foreclosed real estate. 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. Debt securities are classified as Held-to-Maturity when the Corporation has the ability and positive intent to hold the securities to maturity. Investment securities Held-to-Maturity are carried at cost adjusted for amortization of premium and accretion of discount to maturity.

Debt securities not classified as Held-to-Maturity and equity securities are included in the Available-for-Sale category and are carried at fair value. The amount of any unrealized gain or loss, net of the effect of deferred income taxes, is reported as other comprehensive income (loss) in the Consolidated Statement of Changes in Stockholders’ Equity. Management's decision to sell Available-for-Sale securities is based on changes in economic conditions controlling the sources and applications of funds, terms, availability of and yield of alternative investments, interest rate risk and the need for liquidity.

The cost of debt securities classified as Held-to-Maturity or Available-for-Sale is adjusted for amortization of premiums and accretion of discounts to expected maturity. Such amortization and accretion, as well as interest and dividends is included in interest income from investments. Realized gains and losses are included in net investment securities gains and losses. The cost of investment securities sold, redeemed or matured is based on the specific identification method.

Restricted Securities

Restricted equity securities consist of stock in Federal Home Loan Bank of Pittsburgh (“FHLB-Pittsburgh”), Atlantic Central Bankers Bank (“ACBB”) and Federal Reserve Bank and 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, the Federal Reserve Bank or to another member institution. Therefore, these securities are classified as restricted equity investment securities, carried at cost, and evaluated for impairment. At March 31, 2011, the Corporation held $6,011,000 in stock of FHLB-Pittsburgh and $35,000 in stock of ACBB. At December 31, 2010, the Corporation held $6,328,000 in stock of the FHLB-Pittsburgh, and $35,000 in stock of ACBB.

The Corporation evaluated its holding of restricted stock for impairment and deemed the stock to not be impaired due to the expected recoverability of cost, which equals the value reflected within the Corporation’s consolidated financial statements. The decision was based on several items ranging from the estimated true economic losses embedded within FHLB’s mortgage portfolio to the FHLB’s liquidity position and credit rating. The Corporation utilizes the impairment framework outlined in GAAP to evaluate stock for impairment. The following factors were evaluated to determine the ultimate recoverability of the cost of the Corporation’s restricted stock holdings; (i) the significance of the decline in net assets of the FHLB as compared to the capital stock amount for the FHLB and the length of time this situation has persisted; (ii) commitments by the FHLB to make payments required by law or regulation and the level of such payments in relation to the operating performance of the FHLB; (iii) the impact of legislative and regulatory changes on the institutions and, accordingly, on the customer base of the FHLB; (iv) the liquidity position of the FHLB; and (v) whether a decline is temporary or whether it affects the ultimate recoverability of the FHLB stock based on (a) the materiality of the carrying amount to the member institution and (b) whether an assessment of the institution’s operational needs for the foreseeable future allow management to dispose of the stock. Based on the analysis of these factors, the Corporation determined that its holdings of restricted stock were not impaired at March 31, 2011 and December 31, 2010.

Loans

Loans are stated at their outstanding unpaid principal balances, net of deferred fees or costs, unearned income and the allowance for loan losses. Interest on installment loans is recognized as income over the term of each loan, generally, by the actuarial or accrual methods. Interest on all other loans is primarily recognized based upon the principal amount outstanding on an actual day basis. Loan origination fees and certain direct loan origination costs have been deferred with the net amount amortized using the interest method over the contractual life of the related loans as an interest yield adjustment.

Mortgage loans held for resale are carried at the lower of cost or market on an aggregate basis determined by independent pricing from appropriate federal or state agency investors. These loans are sold without recourse to the Corporation.

Past-Due Loans — Generally, a loan is considered to be past-due when scheduled loan payments are in arrears 15 days or more. Delinquent notices are generated automatically when a loan is 15 days past-due. Collection efforts continue on loans past-due beyond 60 days that have not been satisfied, when it is believed that some chance exists for improvement in the status of the loan. Past-due loans are continually evaluated with the determination for charge-off being made when no reasonable chance remains that the status of the loan can be improved.

Non-Accrual Loans — Generally, a loan is classified as non-accrual and the accrual of interest on such a loan is discontinued when the contractual payment of principal or interest has become 90 days past due or management has serious doubts about further collectibility of principal or interest, even though the loan currently is performing. A loan may remain on accrual status if it is in the process of collection and is either guaranteed or well secured. When a loan is placed on non-accrual status, unpaid interest credited to income in the current year is reversed and unpaid interest accrued in prior years is charged against the allowance for loan losses. Certain non-accrual loans may continue to perform, that is, payments are still being received. Generally, the payments are applied to principal. These loans remain under constant scrutiny and if performance continues, interest income may be recorded on a cash basis based on management's judgement as to collectibility of principal.

Impaired Loans — A loan is considered impaired when, based on current information and events, it is probable that the Corporation will be unable to collect all amounts due according to the contractual terms of the loan agreement. Under current accounting standards, the allowance for loan losses related to impaired loans is based on discounted cash flows using the loan’s effective interest rate or the fair value of the collateral for certain collateral dependent loans. The recognition of interest income on impaired loans is the same as for non-accrual loans discussed above.

Allowance for Loan Losses — The allowance for loan losses is established through provisions for loan losses charged against income. Loans deemed to be uncollectible are charged against the allowance for loan losses and subsequent recoveries, if any, are credited to the allowance.

The allowance for loan losses is maintained at a level estimated by management to be adequate to absorb potential loan losses. Management's periodic evaluation of the adequacy of the allowance for loan losses is based on the Corporation's past loan loss experience, known and inherent risks in the portfolio, adverse situations that may affect the borrower's ability to repay (including the timing of future payments), the estimated value of any underlying collateral, composition of the loan portfolio, current economic conditions, and other relevant factors. This evaluation is inherently subjective as it requires material estimates including the amounts and timing of future cash flows expected to be received on impaired loans that may be susceptible to significant change.

In addition, the Corporation is subject to periodic examination by its federal and state examiners, and may be required by such regulators to recognize additions to the allowance for loan losses based on their assessment of credit information available to them at the time of their examinations.

In addition, an allowance is provided for possible credit losses on off-balance sheet credit exposures. The allowance is estimated by management and is classified in other liabilities.

The allowance consists of specific and general components. The specific component relates to loans that are individually classified as impaired. At the present time, select loans are not aggregated for collective impairment evaluation, as such; all loans are subject to individual impairment evaluation should the facts and circumstances pertinent to a particular loan suggest that such evaluation is necessary. Factors considered by management in determining impairment include payment status and the probability of collecting scheduled principal and interest payments when due. Loans that experience insignificant payment delays and payment shortfalls generally are not classified as impaired. A loan is considered impaired when, based on current information and events, it is probable that the Corporation will be unable to collect the scheduled payments of principal or interest when due according to the contractual terms of the loan agreement. Management determines the significance of payment delays and payment shortfalls on a case-by-case basis, taking into consideration all of the circumstances surrounding the loan and the borrower, including the length of the delay, the reasons for the delay, the borrower's prior payment record, and the amount of the shortfall in relation to the principal and interest owed. If a loan is impaired, a portion of the allowance is allocated so that the loan is reported, net, at the present value of estimated future cash flows using the loan's existing rate or at the fair value of collateral if repayment is expected solely from collateral. Troubled debt restructurings are separately identified for impairment disclosures and are measured at the present value of estimated future cash flows using the loan's effective rate at inception. If a trouble debt restructuring is considered to be a collateral dependent loan, the loan is reported, net, at the fair value of the collateral. For troubled debt restructurings that subsequently default, the Corporation determines the amount of reserve in accordance with the accounting policy for the allowance for loan losses.

The general component covers all other loans not identified as impaired and is based on historical losses adjusted for current factors. The historical loss component of the allowance is determined by losses recognized by portfolio segment over the preceding two years. In calculating the historical component of our allowance, we aggregate loans into one of four portfolio segments: Commercial, Commercial Real Estate, Consumer and Residential. Risk factors impacting loans in each of the portfolio segments include broad deterioration of property values, reduced consumer and business spending as a result of continued high unemployment and reduced credit availability and lack of confidence in a sustainable recovery. Actual loss experience is supplemented with other economic factors based on the risks present for each portfolio segment. These economic factors include consideration of the following: the concentration of watch and substandard loans as a percentage of total loans, levels of loan concentration within the portfolio segment or division of a portfolio segment and broad economic conditions.

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 accompanying consolidated balance sheet. The servicing rights are periodically evaluated for impairment based on their relative fair value.

Foreclosed Assets Held for Resale

Real estate properties acquired through, or in lieu of, loan foreclosure are held for sale and are initially recorded at fair value on the date of foreclosure establishing a new cost basis. After foreclosure, valuations are periodically performed by management and if fair value declines subsequent to foreclosure, a valuation allowance is recorded through expense. The real estate is carried at the lower of carrying amount or fair value less cost to sell and is included in other assets. Revenues derived from and costs to maintain the assets and subsequent gains and losses on sales are included in other non-interest income and expense. The total of foreclosed real estate properties amounted to $1,472,000 at March 31, 2011 and $1,149,000 at December 31, 2010.

Bank Owned Life Insurance

The Corporation invests in Bank Owned Life Insurance (BOLI) with split dollar life provisions. Purchase of BOLI provides life insurance coverage on certain employees with the Corporation being owner and beneficiary of the policies.

Investments in Real Estate Ventures

The Bank is a limited partner in real estate ventures that own and operate affordable residential low-income housing apartment buildings for elderly residents. The investments are accounted for under the effective yield method. Under the 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 $187,000 in 2011 and 2010, and the amortization of the investments in the limited partnerships were $29,000 in the first quarter of 2011 and 2010. The carrying value of the investments as of March 31, 2011 and December 31, 2010 were $1,571,000 and $1,600,000, respectively, and is included in other assets in the accompanying consolidated balance sheets. During 2010, the Bank purchased an interest in a low income housing partnership in the amount of $1,084,000.

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 realizability 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 2007. At December 31, 2010 and 2009 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 other noninterest expense. At December 31, 2010 and December 31, 2009, 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. The amount was comprised of the finalization of severance agreements and contract terminations related to the acquisition. In accordance with current accounting standards, goodwill is not amortized. Management performs an annual evaluation for impairment. Any impairment of goodwill results in a charge to income. The Corporation periodically assesses whether events or changes in circumstances indicate that the carrying amounts of goodwill and other intangible assets may be impaired. Goodwill is tested for impairment at the reporting unit level and an impairment loss is recorded to the extent that the carrying amount of goodwill exceeds its implied fair value. The Corporation has tested the goodwill included in its consolidated balance sheet at December 31, 2010, and has determined there was no impairment as of that date or as of March 31, 2011. No assurance can be given that future impairment tests will not result in a charge to earnings.

Intangible assets are comprised of core deposit intangibles and premium discount (negative premium) on certificates of deposit acquired. The core deposit intangible is being amortized over the average life of the deposits acquired as determined by an independent third party. Premium discount (negative premium) on acquired certificates of deposit resulted from the valuation of certificate of deposit accounts by an independent third party. The book value of certificates of deposit acquired was greater than their fair value at the date of acquisition which resulted in a negative premium due to higher cost of the certificates of deposit compared to the cost of similar term financing. The Corporation has tested the core deposit intangible included in its consolidated balance sheet at December 31, 2010 and has determined there was no impairment as of that date or as of March 31, 2011. No assurance can be given that future impairment tests will not result in a charge to earnings.

Stock Based Compensation

The Corporation sponsored a stock option plan which expired on April 21, 2008. 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 model is utilized to estimate the fair value of stock options. Compensation expense is recognized over the requisite service period. There were 26,588 outstanding options that may be exercised as of March 31, 2011.

Per Share Data

FASB ASC 260-10 Earnings Per Share ((SFAS) No. 128, "Earnings Per Share"), requires dual presentation of basic and fully diluted earnings per share. Basic earnings per share is calculated by dividing net income by the weighted average number of shares of common stock outstanding at the end of each period. Diluted earnings per share is calculated by increasing the denominator for the assumed conversion of all potentially dilutive securities. The Corporation's dilutive securities are limited to stock options. 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 other banks and 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 last-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

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

Recent Accounting Pronouncements

FASB ASU 2010-20 - "Receivable (Topic 310), Disclosures about the Credit Quality of Financial Receivables and the Allowance for Credit Losses" — ASU 2010-20 requires new and enhanced disclosures about the credit quality of an entity's financing receivables and its allowance for credit losses. The new and amended disclosure requirements focus on such areas as nonaccrual and past-due financing receivables, allowance for credit losses related to financing receivable, impaired loans, credit quality information and modifications. The ASU requires an entity to disaggregate new and existing disclosures based on how it develops its allowance for credit losses and how it manages credit exposures. For public entities, the disclosures as of the end of a reporting period are effective for interim and annual reporting periods ending on or after December 15, 2010. The disclosures about activity that occurs during a reporting period are effective for interim and annual reporting periods beginning on or after December 15, 2010. See Note 4.

FASB ASU 2010-09 - Subsequent Events (Topic 855): Amendments to Certain Recognition and Disclosure requirements. This accounting standard update modifies the requirement to disclose the date that subsequent events are considered through for SEC filers. An entity that is an SEC filer is not required to disclose the date through which subsequent events have been evaluated. This change alleviates potential conflicts between Subtopic 855-10 and the SEC's requirements.

FASB ASC 860 - In June 2009, the FASB issued new guidance impacting FASB ASC 860, Transfers and servicing (Statement No. 166 — Accounting for Transfers of Financial Assets — and amendment of FASB Statement No. 140). The new guidance removes the concept of a qualifying special-purpose entity and limits the circumstances in which a financial asset, or portion of a financial asset, should be derecognized when the transferor has not transferred the entire financial asset to an entity that is not consolidated with the transferor in the financial statements being presented and/or when the transferor has continuting involvement with the transferred financial asset. The new guidance became effective for the Corporation on January 1, 2010. The implementation of this new guidance did not have a material impact on the Corporation's consolidated financial statements.

FASB ASC 820-10 - In January 2010, the FASB issued an updated (ASC No. 2010-06, Improving Disclosures about Fair Value Measurements) impacting FASB ASC 210-10, Fair Value Measurements and Disclosures. The amendments in this update require new disclosures about significant transfers in and out of Level 1 and Level 2 fair value measurements. The amendments also require a reporting entity to provide information about activity for purchases, sales issuances and settlements in Level 3 fair value measurements and clarify disclosures about the Level of disaggregation and disclosures abut inputs and valuation techniques. This update became effective for the Corporation on January 1, 2010. The implementation of this new guidance 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 at March 31, 2011 and 2010, was approximately $58,000 and $58,000, respectively.

Reclassifications

Certain amounts in the consolidated financial statements of prior periods have been reclassified to conform with presentation used in the 2011 consolidated financial statements. Such reclassifications have no effect on the Corporation's consolidated financial condition or net income.

NOTE 2. INVESTMENT SECURITIES

The amortized cost, related estimated fair value, and unrealized gains and losses for investment securities classified as "Available-For-Sale" or "Held-to-Maturity" were as follows at March 31, 2011 and December 31, 2010:

	Available-for-Sale Securities			
(Amounts in thousands) March 31, 2011:	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
Obligations of U.S. Government Corporations and Agencies:				
Mortgage-backed	$66,349	$1,201	$(148)	$67,402
Other	8,118	36	(30)	8,124
Obligations of state and political subdivisions	175,057	1,672	(7,784)	168,945
Corporate securities	49,772	1,000	(143)	50,629
Marketable equity securities	1,725	271	(133)	1,863
Restricted equity securities	6,046	—	—	6,046
Total	$307,067	$4,180	$(8,238)	$303,009

Held-to-Maturity Securities

(Amounts in thousands) March 31, 2011:	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
Obligations of U.S. Government Corporations and Agencies:				
Mortgage-backed	$137	$3	$—	$140
Other	5,023	19	(67)	4,975
Obligations of state and political subdivisions	1,097	—	(13)	1,084
Total	$6,257	$22	$(80)	$6,199

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(Amounts in thousands) December 31, 2010:	Available-for-Sale Securities Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
Obligations of U.S. Government Corporations and Agencies:				
Mortgage-backed	$43,673	$1,250	$(146)	$44,777
Other	7,079	47	(30)	7,096
Obligations of state and political subdivisions	182,181	2,617	(7,546)	177,252
Corporate securities	71,708	1,497	(253)	72,952
Marketable equity securities	1,725	256	(156)	1,825
Restricted equity securities	6,363	0	0	6,363
Total	$312,729	$5,667	$(8,131)	$310,265

(Amounts in thousands) December 31, 2010:	Held-to-Maturity Securities Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
Obligations of U.S. Government Corporations and Agencies:				
Mortgage-backed	$142	$3	$0	$145
Other	5,027	19	(81)	4,965
Obligations of state and political subdivisions	1,097	0	(16)	1,081
Total	$6,266	$22	$(97)	$6,191

Securities Available-for-Sale with an aggregate fair value of $178,648,000 at March 31, 2011 and $186,735,000 at December 31, 2010; and securities Held-to-Maturity with an aggregate book value of $5,790,000 at March 31, 2011 and $5,799,000 at December 31, 2010, were pledged to secure public funds, trust funds, securities sold under agreements to repurchase, FHLB advances and other balances of $89,580,000 at March 31, 2011 and $109,283,000 at December 31, 2010.

The amortized cost, estimated fair value and weighted average yield of debt securities, by contractual maturity, are shown below at March 31, 2011 and December 31, 2010. Expected maturities will differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

(Amounts in thousands)

	March 31, 2011				
	U.S. Government Agency & Corporation Obligations1	Obligations of State & Political Subdivisions2	Marketable Equity Securities3	Restricted Equity Securities3	Corporate Securities
Available-For-Sale:					
Within 1 Year:					
Amortized cost	$—	$ 4,002	$—	$—	$13,829
Estimated fair value	—	4,013	—	—	14,065
Weighted average yield	—	6.00 %	—	—	3.60 %
1 - 5 Years:					
Amortized cost	5,099	2,470	—	—	32,886
Estimated fair value	5,099	2,458	—	—	33,525
Weighted average yield	1.30 %	4.11 %	—	—	3.28 %
5 - 10 Years:					
Amortized cost	10,002	11,271	—	—	3,057
Estimated fair value	10,431	11,528	—	—	3,040
Weighted average yield	4.03 %	5.35 %	—	—	3.19 %
After 10					
Amortized cost	59,367	157,313	1,725	6,046	—
Estimated fair value	59,995	150,946	1,863	6,046	—
Weighted average yield	3.90 %	6.23 %	3.27 %	.01 %	—
Total:					
Amortized cost	$74,468	$ 175,056	$1,725	$6,046	$49,772
Estimated fair value	75,525	168,945	1,863	6,046	50,630
Weighted average yield	3.74 %	6.14 %	3.27 %	.01 %	3.36 %

1Mortgage-backed securities are allocated for maturity reporting at their original maturity date.
2Average yields on tax-exempt obligations of state and political subdivisions have been computed on a tax-equivalent basis using a 34% tax rate.
3Marketable equity securities and restricted equity securities are not considered to have defined maturities and are included in the after ten year category.

(Amounts in thousands)

	March 31, 2011				
	U.S. Government Agency & Corporation Obligations1	Obligations of State & Political Subdivisions2	Marketable Equity Securities3	Restricted Equity Securities3	Corporate Securities
Held-To-Maturity:					
Within 1 Year:					
Amortized cost	$—	$ 630	$—	$—	$—
Estimated fair value	—	628	—	—	—
Weighted average yield	—	4.50 %	—	—	—
1 - 5 Years:					
Amortized cost	3,023	—	—	—	—
Estimated fair value	3,028	—	—	—	—
Weighted average yield	1.35 %	—	—	—	—
5 - 10 Years:					
Amortized cost	2,137	—	—	—	—
Estimated fair value	2,088	—	—	—	—
Weighted average yield	2.36 %	—	—	—	—
After 10 Years:					
Amortized cost	—	467	—	—	—
Estimated fair value	—	456	—	—	—
Weighted average yield	—	7.04 %	—	—	—
Total:					
Amortized cost	$5,160	$ 1,097	$—	$—	$—
Estimated fair value	5,116	1,084	—	—	—
Weighted average yield	1.77 %	5.58 %	—	—	—

1Mortgage-backed securities are allocated for maturity reporting at their original maturity date.
2Average yields on tax-exempt obligations of state and political subdivisions have been computed on a tax-equivalent basis using a 34% tax rate.
3Marketable 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, 2010				
	U.S. Government Agency & Corporation Obligations1	Obligations of State & Political Subdivisions2	Marketable Equity Securities3	Restricted Equity Securities3	Corporate Securities
Available-For-Sale:					
Within 1 Year:					
Amortized cost	$—	$ —	$—	$—	$10,746
Estimated fair value	—	—	—	—	10,845
Weighted average yield	—	—	—	—	4.32 %
1 - 5 Years:					
Amortized cost	4,056	452	—	—	57,902
Estimated fair value	4,064	467	—	—	59,069
Weighted average yield	1.25 %	5.78 %	—	—	3.22 %
5 - 10 Years:					
Amortized cost	10,682	1,734	—	—	3,060
Estimated fair value	11,149	1,823	—	—	3,040
Weighted average yield	4.08 %	6.05 %	—	—	3.19 %
After 10					
Amortized cost	36,014	179,995	1,725	6,363	—
Estimated fair value	36,660	174,962	1,825	6,363	—
Weighted average yield	4.03 %	6.14 %	2.54 %	.95 %	—
Total:					
Amortized cost	$50,752	$ 182,181	$1,725	$6,363	$71,708
Estimated fair value	51,873	177,252	1,825	6,363	72,952
Weighted average yield	3.82 %	6.14 %	2.54 %	.95 %	3.38 %

1Mortgage-backed securities are allocated for maturity reporting at their original maturity date.
2Average yields on tax-exempt obligations of state and political subdivisions have been computed on a tax-equivalent basis using a 34% tax rate.
3Marketable 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, 2010				
	U.S. Government Agency & Corporation Obligations1	Obligations of State & Political Subdivisions2	Marketable Equity Securities3	Restricted Equity Securities3	Corporate Securities
Held-To-Maturity:					
Within 1 Year:					
Amortized cost	$—	$ 630	$—	$—	$—
Estimated fair value	—	628	—	—	—
Weighted average yield	—	4.49 %	—	—	—
1 - 5 Years:					
Amortized cost	3,027	—	—	—	—
Estimated fair value	3,030	—	—	—	—
Weighted average yield	3.83 %	—	—	—	—
5 - 10 Years:					
Amortized cost	2,142	—	—	—	—
Estimated fair value	2,080	—	—	—	—
Weighted average yield	2.37 %	—	—	—	—
After 10 Years:					
Amortized cost	—	467	—	—	—
Estimated fair value	—	453	—	—	—
Weighted average yield	—	7.04 %	—	—	—
Total:					
Amortized cost	$5,169	$ 1,097	$—	$—	$—
Estimated fair value	5,110	1,081	—	—	—
Weighted average yield	3.22 %	5.58 %	—	—	—

1Mortgage-backed securities are allocated for maturity reporting at their original maturity date.
2Average yields on tax-exempt obligations of state and political subdivisions have been computed on a tax-equivalent basis using a 34% tax rate.
3Marketable 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 March 31, 2011. The quality rating of the obligations of state and political subdivisions are generally investment grade, as rated by Moody's, Standard and Poors 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 first quarter of 2011 and 2010 were $44,129,000 and $4,966,000, respectively. Gross gains realized on these sales were $650,000 and $601,000, respectively. Gross losses on these sales were $725,000 and $637,000, respectively. There were no impairment losses in 2011 and 2010.

There were no proceeds from sale of investments in Held-To-Maturity debt and equity securities during 2011 and 2010. 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 (SFAS No. 115, Accounting for Certain Investments in Debt and Equity Securities). In determining OTTI under the FASB 320 (SFAS No. 115) 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, and whether or not the issuer is participating in the TARP Capital Purchase Program. The starting point for the equity analysis is the length and severity of market value decline. The Corporation and an independent consultant 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. Securities with an unrealized loss that were determined to be other-than-temporary were written down to fair value, with the write-down recorded as a realized loss included in security (losses) gains. The Corporation evaluated the near-term prospects of the issuer in relation the severity and duration of the market value decline as well as the other attributes listed above. Based on that evaluation and the Corporation's ability and intent to hold these equity securities for a reasonable period of time sufficient for a forecasted recovery of fair value, the Corporation does not consider these equity securities to be other-than-temporary impaired at March 31, 2011.

In accordance with disclosures required by FASB ASC 320-10-50 Investments-Debt and Equity Securities Disclosures (EITF No. 03-1), the summary below shows the gross unrealized losses and fair value of the Bank's investments, aggregated by investment category, that individual securities have been in a continuous unrealized loss position for less than 12 months or more than 12 months as of March 31, 2011 and December 31, 2010:

March 31, 2011

	Less Than 12 Months		12 Months or More		Total	
(Amounts in thousands)	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss
Direct obligations of the U.S. Government	$6,984	$97	$—	$—	$6,984	$97
Federal Agency Backed Securities	27,422	148	—	—	27,422	148
Municipal Bonds	88,649	3,651	12,797	4,146	101,446	7,797
Corporate Securities	12,871	143	—	—	12,871	143
Equities	288	22	618	111	906	133
	$136,214	$4,061	$13,415	$4,257	$149,629	$8,318

December 31, 2010

(Amounts in thousands)	Less Than 12 Months Fair Value	Less Than 12 Months Unrealized Loss	12 Months or More Fair Value	12 Months or More Unrealized Loss	Total Fair Value	Total Unrealized Loss
Direct obligations of the U.S. Government	$7,925	$111	$—	$—	$7,925	$111
Federal Agency Backed Securities	4,859	146	—	—	4,859	146
Municipal Bonds	90,995	3,239	13,160	4,323	104,155	7,562
Corporate Securities	18,414	253	—	—	18,414	253
Equities	98	27	645	129	743	156
	$122,291	$3,776	$13,805	$4,452	$136,096	$8,228

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) of FNMA (Federal National Mortgage Association). The municipal securities consist of general obligations and revenue bonds. The 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 to 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 166 securities in an unrealized position as of March 31, 2011 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 securities gains (losses).

NOTE 4 — LOANS

Major classifications of loans at March 31, 2011 and December 31, 2010 consisted of:

(Amounts in thousands)

	March 31, 2011	December 31, 2010
Commercial, Financial, and Agricultural	$28,714	$ 29,693
Tax-exempt	13,928	12,450
Real estate mortgages - Held-for-sale	4,545	4,950
Real estate mortgages - Consumer	126,515	127,031
Real estate mortgages - Commercial	227,719	227,147
Consumer	8,892	8,781
Gross loans	$410,313	$ 410,052
Add (deduct): Unearned discount	(601)	(675)
Net deferred loan fees and costs	285	274
Loans, net of unearned income	$409,997	$ 409,651

Activity in the allowance for loan losses for the quarter ended March 31, 2011 and the year ended December 31, 2010:

(Amounts in thousands)

	March 31, 2011	December 31, 2010
Balance, January 1	$ 5,701	$ 5,322
Provision charged to operations	300	2,575
Loans charged off	(151)	(2,262)
Recoveries	11	66
Balance, December 31	$ 5,861	$ 5,701

The credit quality indicators by loan segment are summarized below at March 31, 2011 and December 31, 2010:

	Commercial & Industrial		Commercial Real Estate Construction	
	March 31, 2011	December 31, 2010	March 31, 2011	December 31, 2010
Grade:				
1-6 Pass	$39,265	$ 37,991	$5,203	$ 5,111
7 Special Mention	610	1,330	—	—
8 Substandard	947	991	578	433
9 Doubtful	224	227	—	—
Add (deduct): Unearned discount	—	—	—	—
Net deferred loan fees & costs	83	74	(10)	(13)
Loans, net of unearned income	$41,129	$ 40,603	$5,771	$ 5,531

	Commercial Real Estate Other		Residential Real Estate Including Home Equity	
	March 31, 2011	December 31, 2010	March 31, 2011	December 31, 2010
Grade:				
1-6 Pass	$209,933	$ 205,941	$129,689	$ 130,477
7 Special Mention	2,943	8,308	—	191
8 Substandard	10,658	8,958	1,371	1,313
9 Doubtful	—	—	—	—
Add (deduct): Unearned discount	—	—	—	—
Net deferred loan fees & costs	51	35	71	82
Loans, net of unearned income	$223,585	$ 223,252	$131,131	$ 132,063

	Consumer Loans	
	March 31, 2011	December 31, 2010
Grade:		
1-6 Pass	$ 8,885	$ 8,781
7 Special Mention		—
8 Substandard	7	—
9 Doubtful	—	—
Add (deduct): Unearned discount	(601)	(675)
Net deferred loan fees & costs	90	96

Loans, net of unearned income	$	8,381	$	8,202

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

Loan risk grading is a management tool designed to identify and measure risk in the Bank's loan portfolio. Its purpose is to provide a uniform framework and common language to assess and monitor risk, primarily in the Bank's commercial loan/commercial real estate loan portfolios.

The grading system focuses on a borrower's financial strength and performance, experience and depth of management, primary and secondary sources of repayment, the nature of the business and the outlook for the particular industry. Primary emphasis will be on the financial condition and trends. The grade also reflects current economic and industry conditions; as well as other variables such as liquidity, cash flow, revenue/earnings trends, management strengths or weaknesses, quality of financial information, and credit history.

The reduction in C & I loans rated Special Mention was primarily due to the payoff of one loan.

The Substandard Commercial Real Estate Construction category was increased due to construction draws for the same project as listed at December 31, 2010. This project is performing as agreed, and nearing the final stages of construction.

The reduction in Special Mention Commercial Real Estate Other was due to upgrades of 5 relationships totaling $3,388,000 to Pass categories, and downgrade of one relationship totaling $1,977,000 to Substandard. The downgraded relationship is related to the hotel industry, and paying as agreed.

The reduction in Special Mention Residential Real Estate was due entirely to the upgrade of one relationship.

The Bank utilizes a risk grading matrix to assign a risk rating to commercial loans, on a scale of 1 to 9. Risk grades in the residential real estate and consumer loan portfolios are assigned based on payment activity. Risk rating grade characteristics are as follows:

Risk Grade 1 - Cash Secured - Pass through and including Risk Grade 6 – Watch- Pass 6

At the low end of the rating scale, a risk grade of 1 has virtually no risk of loss or default. This grade is reserved for credit evidenced by 100% cash, or other liquid collateral, properly margined and monitored. This grade reflects excellent credit quality with virtually no risk of loss.

Loan ratings then progress through escalating ratings of 2 through 6 based upon risk. Risk is evaluated via examination of several attributes including but not limited to financial trends and strengths and weaknesses, likelihood of repayment when considering both cash flow and collateral, sources of repayment, leverage position, management expertise, and repayment history. A risk rating of 2 reflects excellent credit quality with low risk, while a rating of 3 is considered moderate risk, 4 is a loan with average risk, and 5 is acceptable risk.

At the high end of the Pass ratings is a Risk Grade of 6 - Watch - Pass. A 6 rated credit represents borderline risk reflecting higher than normal risk of loss or default, and serves as an early warning system that the credit needs to be monitored more closely. Loans in this category are performing according to terms, but present some type of potential concern.

Risk Grade 7 - SPECIAL MENTION

Generally, these loans or assets are currently protected, but are "Potentially Weak". They constitute an undue and unwarranted credit risk but not to the point of justifying a classification of substandard.

Assets in this category are currently protected but have potential weakness which may, if not checked or corrected, weaken the asset or inadequately protect the Bank's credit position at some future date. No loss of principal or interest is envisioned, however they constitute an undue credit risk that may be minor but is unwarranted in light of the circumstances surrounding a specific asset. Risk is increasing beyond that at which the loan originally would have been granted. Historically, cash flows are inconsistent; financial trends show some deterioration. Liquidity and leverage are above industry averages. Financial information could be incomplete or inadequate. A Special Mention asset has potential weaknesses that deserve management's close attention.

Risk Grade 8:- SUBSTANDARD

Generally, these assets are inadequately protected by the current sound worth and paying capacity of the obligor or of the collateral pledged, if any. Assets so classified must have "well-defined" weaknesses that jeopardize the full liquidation of the debt. There is a distinct possibility that the Bank will sustain some loss.

They are characterized by the distinct possibility that the Bank will sustain some loss if in the aggregate amount of substandard assets, is not fully covered by the liquidation of the collateral used as security. Substandard loans are inadequately protected by current sound net worth, paying capacity of the borrower, or pledged collateral, and have a high probability of payment default, or they have other well-defined weaknesses. Such assets require more intensive supervision by Bank Management.

Risk Grade 9:- DOUBTFUL

Generally, all the weaknesses inherent in a substandard loan with the added factor that the weaknesses are pronounced to a point where the basis of current information, conditions, and values, collection or liquidation in full is highly improbable. The possibility of loss is extremely high, but because of certain important and reasonably specific pending factors that may work to strengthen the asset, its classification is deferred until, for example, a proposed merger, acquisition, liquidation procedures, capital injection, perfection of liens on additional collateral and refinancing plans are completed. Loans are graded doubtful if they contain weaknesses so serious that collection or liquidation in full is questionable.

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

(Amounts in thousands)	Commercial	Commercial Real Estate	Consumer	Residential	Unallocated	Total
March 31, 2011:						
Allowance for Credit Losses:						
Beginning balance	$ 565	$ 2,769	$ 123	$ 1,501	$ 743	$ 5,701
Charge-offs	(128)	—	(23)	—	—	(151)
Recoveries	6	—	4	1	—	11
Provision	175	(317)	73	471	(102)	300
Ending Balance	$ 618	$ 2,452	$ 177	$ 1,973	$ 641	$ 5,861
Ending balance: individually evaluated for impairment	224	512	—	22	—	758
Ending balance: collectively evaluated for impairment	$ 394	$ 1,939	$ 177	$ 1,952	$ 641	$ 5,103
Financing Receivables:						
Ending Balance	$ 41,128	$ 180,798	$ 8,382	$ 179,689	$ —	$ 409,997
Ending balance: individually evaluated for impairment	224	2,570	—	1,301	—	4,095
Ending balance: collectively evaluated for impairment	$ 40,904	$ 178,228	$ 8,382	$ 178,388	$ —	$ 405,902

(Amounts in thousands)

	Commercial	Commercial Real Estate	Consumer	Residential	Unallocated	Total
December 31, 2010:						
Allowance for Credit Losses:						
Beginning balance	$970	$2,213	$99	$1,734	$306	$5,322
Charge-offs	(389)	(1,585)	(95)	(193)	—	(2,262)
Recoveries	38	13	14	1	—	66
Provision	(54)	2,128	105	(41)	437	2,575
Ending Balance	$565	$2,769	$123	$1,501	$743	$5,701
Ending balance: individually evaluated for impairment	296	309	—	—	—	605
Ending balance: collectively evaluated for impairment	$269	$2,460	$123	$1,501	$743	$5,096
Financing Receivables:						
Ending Balance	$20,969	$199,878	$7,357	$181,447	$	$409,651
Ending balance: individually evaluated for impairment	381	3,109	—	787	—	4,276
Ending balance: collectively evaluated for impairment	$20,588	$196,769	$7,357	$180,660	$—	$405,375

Impaired loans at March 31, 2011 and December 31, 2010 were $4,095,000 and $4,276,000, respectively. The gross interest that would have been recorded if these loans had been current in accordance with their original terms and the amounts actually recorded in income were as follows:

(Amounts in thousands)

	March 31, 2011	December 31, 2010
Gross interest due under terms	$ 369	$ 316
Amount included in income	—	(63)
Interest income not recognized	$ 369	$ 253

The Corporation's impaired loans are summarized below for the periods ended March 31, 2011 and December 31, 2010.

(Amounts in thousands)

	Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Recorded Investment	Interest Income Recognized
March 31, 2011:					
With no related allowance recorded:					
Commercial	$—	$—	$—	$—	$—
Commercial real estate	665	708	—	673	—
Residential	734	804	—	736	—
With an allowance recorded:					
Commercial	224	224	224	229	—
Commercial real estate	2,382	2,754	526	2,571	—
Residential	90	90	8	90	—
Total	$4,095	$4,580	$758	$4,299	$—

Total consists of:					
Commercial	$224	$224	$224	$229	$—
Commercial real estate	$3,047	$3,462	$526	$3,244	$—
Residential	$824	$894	$8	$826	$—

(Amounts in thousands)	Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Recorded Investment	Interest Income Recognized
December 31, 2010:					
With no related allowance recorded:					
Commercial	$29	$29	$—	$29	$—
Commercial real estate	907	942	—	937	14
Residential	787	866	—	785	19
With an allowance recorded:					
Commercial	352	352	296	356	7
Commercial real estate	2,201	2,641	309	2,398	23
Residential	—	—	—	—	—
Total	$4,276	$4,830	$605	$4,505	$63
Total consists of:					
Commercial	$381	$381	$296	$385	$7
Commercial real estate	$3,108	$3,583	$309	$3,335	$37
Residential	$787	$866	$—	$785	$19

The recorded investment represents the loan balance reflected on the consolidated balance sheets net of any charge-offs. The unpaid balance is equal to the gross amount due on the loan. The average recorded investment is calculated on the daily loan balance during the period of impairment.

Financing receivables on non-accrual status and foreclosed assets as of March 31, 2011 and December 31, 2010 were as follows:

(Amounts in thousands)	March 31, 2011	December 31, 2010
Commercial - R/E	$ 3,047	$ 3,108
Commercial - other	224	381
Residential	824	787
Consumer	—	—
Total non-accruing loans	$ 4,095	$ 4,276
Restructured loans	—	—
Total impaired loans	$ 4,095	$ 4,276
Loans past-due 90 days or more and still accruing	7	—
Foreclosed assets	1,472	1,149
Total non-performing assets	$ 5,574	$ 5,425

At March 31, 2011 and December 31, 2010, the recorded investment in impaired loans as defined by FASB ASC 310-10-35 Receivables Subsequent Measurements (SFAS 114) was $4,095,000 and $4,276,000 and the impaired loans allowances were $758,000 and $605,000, respectively at March 31, 2011 and December 31, 2010. The average recorded balance in impaired loans during the quarter ended March 31, 2011 and the year ended December 31, 2010 was approximately $4,299,000 and $4,505,000, respectively.

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

(Amounts in thousands)	30-59 Days Past Due	60-89 Days Past Due	Greater Than 90 Days	Total Past Due	Current	Total Financing Receivables
March 31, 2011:						
Commercial	$89	$49	$ —	$138	$40,990	$41,128
Commercial real estate	1,405	512	—	1,917	178,881	180,798
Consumer	90	4	7	101	8,281	8,382
Residential	1,028	135	—	1,163	178,526	179,689
Total	$2,612	$700	$ 7	$3,319	$406,678	$409,997

(Amounts in thousands)	30-59 Days Past Due	60-89 Days Past Due	Greater Than 90 Days	Total Past Due	Current	Total Financing Receivables
December 31, 2010:						
Commercial	$740	$101	$ —	$842	$34,758	$35,600
Commercial real estate	999	2,149				