

Edgar Filing: FIRST KEYSTONE CORP - Form 10-Q

FIRST KEYSTONE CORP  
Form 10-Q  
November 09, 2010

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10Q

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

For the quarterly period ended September 30, 2010

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  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).

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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:

On November 5, 2010 there were 5,444,177 shares of the Registrant's common stock outstanding.

## PART I. - FINANCIAL INFORMATION

### Item. 1 Financial Statements

#### FIRST KEYSTONE CORPORATION AND SUBSIDIARY CONSOLIDATED BALANCE SHEETS

(Amounts in thousands)

	September 2010 (Unaudited)	December 2009
<b>ASSETS</b>		
Cash and due from banks	\$ 4,742	\$ 4,199
Interest-bearing deposits in other banks	17,159	7,227
Federal funds sold	3,000	0
Investment securities available- for-sale carried at estimated fair value	304,901	269,685
Investment securities, held-to- maturity securities estimated fair value of \$7,322 and \$4,936	7,274	4,974
Restricted securities at cost	8,139	8,139
Loans, net of unearned income	413,193	406,697
Allowance for loan losses	(5,217)	(5,322)
Net loans	\$407,976	\$401,375
Premises and equipment, net	11,919	11,465
Accrued interest receivable	4,420	4,213
Cash surrender value of bank owned life insurance	18,195	17,622
Goodwill	19,133	19,133
Prepaid FDIC insurance	2,216	2,780
Other assets	6,247	7,518
TOTAL ASSETS	\$815,321	\$758,330
<b>LIABILITIES AND STOCKHOLDERS EQUITY</b>		
<b>LIABILITIES</b>		
Deposits		
Non-interest bearing	\$ 65,466	\$ 61,779
Interest bearing	562,133	518,790

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TOTAL DEPOSITS	\$627,599	\$580,569
Short-term borrowings	23,024	17,462
Long-term borrowings	73,415	82,976
Accrued interest and other expenses	2,934	3,101
Other liabilities	1,622	55
TOTAL LIABILITIES	<u>\$728,594</u>	<u>\$684,163</u>
STOCKHOLDERS' EQUITY		
Common stock, par value \$2.00 per share	11,375	11,375
Surplus	30,175	30,269
Retained earnings	44,582	41,346
Accumulated other comprehensive income (loss)	6,699	(2,583)
Less treasury stock, at cost, 243,641 shares in 2010 and 247,641 shares in 2009	(6,104)	(6,240)
TOTAL STOCKHOLDERS' EQUITY	<u>\$ 86,727</u>	<u>\$ 74,167</u>
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	<u>\$815,321</u> =====	<u>\$758,330</u> =====

See Accompanying Notes to Consolidated Financial Statements

1

FIRST KEYSTONE CORPORATION AND SUBSIDIARY  
CONSOLIDATED STATEMENTS OF INCOME  
FOR THE THREE MONTHS ENDED SEPTEMBER 30, 2010 AND 2009  
(Unaudited)

(Amounts in thousands except per share data)

	2010	2009
INTEREST INCOME		
Interest and fees on loans	\$6,205	\$6,216
Interest and dividend income on securities	3,371	3,213
Deposits in banks	9	4
Total Interest Income	<u>\$9,585</u>	<u>\$9,433</u>
INTEREST EXPENSE		
Deposits	\$2,208	\$2,823
Short-term borrowings	61	85
Long-term borrowings	823	990

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Total Interest Expense	\$3,092	\$3,898
Net interest income	\$6,493	\$5,535
Provision for loan losses	1,075	150
Net interest income after provision for loan losses	\$5,418	\$5,385
NON-INTEREST INCOME		
Trust department	\$ 153	\$ 112
Service charges and fees	372	433
Bank owned life insurance income	193	184
ATM fees and debit card income	204	178
Gain on sale of loans	336	57
Investment securities gains (losses) - net	(11)	(11)
Recovery on loss due to defalcation	800	0
Other	26	120
Total non-interest income	\$2,073	\$1,073
NON-INTEREST EXPENSES		
Salaries and employee benefits	\$2,281	\$2,023
Occupancy, net	291	307
Furniture and equipment	308	283
Professional services	315	132
State shares tax	177	177
FDIC Insurance	213	204
Other	703	762
Total non-interest expenses	\$4,288	\$3,888
Income before income taxes	\$3,203	\$2,570
Income tax expense	713	484
Net Income	\$2,490	\$2,086
	=====	=====
PER SHARE DATA		
Basic	\$ .45	\$ .39
Diluted	.45	.39
Cash dividends	.23	.23

See Accompanying Notes to Consolidated Financial Statements

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(Amounts in thousands except per share data)

	2010	2009
<b>INTEREST INCOME</b>		
Interest and fees on loans	\$18,290	\$18,621
Interest and dividend income on securities	10,235	9,574
Deposits in banks	21	7
Total interest income	\$28,546	\$28,202
<b>INTEREST EXPENSE</b>		
Deposits	\$ 6,991	\$ 8,650
Short-term borrowings	169	286
Long-term borrowings	2,725	2,947
Total interest expense	\$ 9,885	\$11,883
Net interest income	\$18,661	\$16,319
Provision for loan losses	1,675	600
Net interest income after provision for loan losses	\$16,986	\$15,719
<b>NON-INTEREST INCOME</b>		
Trust department	\$ 500	\$ 338
Service charges and fees	1,140	1,241
Bank owned life insurance income	573	557
ATM fees and debit card income	597	504
Gain on sale of loans	532	153
Investment securities gains (losses) - net	198	122
Recovery on loss due to defalcation	800	0
Other	224	504
Total non-interest income	\$ 4,564	\$ 3,419
<b>NON-INTEREST EXPENSE</b>		
Salaries and employee benefits	\$ 6,719	\$ 5,890
Occupancy, net	983	877
Furniture and equipment	1,001	827
Professional services	665	303
State shares tax	531	523
FDIC Insurance	634	979
Other	2,154	2,165
Total non-interest expenses	\$12,687	\$11,564
Income before income taxes	\$ 8,863	\$ 7,574
Income tax expense	1,873	1,223
Net Income	\$ 6,990	\$ 6,351
<b>PER SHARE DATA</b>		
Basic	\$ 1.28	\$ 1.17
Diluted	1.28	1.17
Cash Dividends	.69	.69

See Accompanying Notes to Consolidated Financial Statements

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3

FIRST KEYSTONE CORPORATION AND SUBSIDIARY  
CONSOLIDATED STATEMENTS OF CASH FLOWS  
FOR THE NINE MONTHS ENDED September 30, 2010 AND 2009  
(Unaudited)

(Amounts in thousands)

	2010	2009
OPERATING ACTIVITIES		
Net income	\$ 6,990	\$ 6,351
Adjustments to reconcile net income to net cash provided by operating activities:		
Provision for loan losses	1,675	600
Provision for depreciation and amortization	742	526
Premium amortization on investment securities	531	199
Accretion of core deposit net discount	214	200
Discount accretion on investment securities	(1,025)	(891)
Gain on sale of mortgage loans	(532)	(153)
Proceeds from sale of mortgage loans	15,860	14,751
Originations of mortgage loans for resale	(11,635)	(19,300)
Gain(loss) on sale of foreclosed real estate	(20)	5
Gain on sales of investment securities	(198)	(122)
Deferred income tax (benefit)	73	(145)
(Increase) decrease in interest receivable and other assets	(1,072)	113
Decrease in prepaid FDIC Insurance	564	0
Increase in cash surrender value of bank owned life insurance	(573)	(557)
Increase (decrease) in interest payable, accrued expenses and other liabilities	47	(173)
Net Cash Provided by Operating Activities	\$ 11,641	\$ 1,404
INVESTING ACTIVITIES		
Purchases of investment securities available-for-sale	\$ (52,958)	\$ (87,155)
Purchase of investment securities held-to-maturity	(5,036)	(2,000)
Proceeds from sales of investment securities available-for-sale	18,216	53,932

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Proceeds from maturities and redemptions of investment securities available-for-sale	14,297	17,440
Proceeds from bank owned life insurance	0	530
Proceeds from maturities and redemption of investment securities held-to-maturity	2,733	12
Net (increase) decrease in loans	(12,715)	4,394
Purchase of premises and equipment	(1,160)	(2,685)
Proceeds from sale of foreclosed assets	200	155
Purchase of investment in real estate venture	(1,084)	0
<b>Net Cash Used by Investing Activities</b>	<b><u>\$(37,507)</u></b>	<b><u>\$(15,377)</u></b>
<b>FINANCING ACTIVITIES</b>		
Net increase in deposits	\$ 47,032	\$ 71,797
Net increase (decrease) in short-term borrowings	5,562	(32,049)
Proceeds from long-term borrowings	7,000	0
Repayment of long-term borrowings	(16,541)	(7,038)
Proceeds from sale of treasury stock	42	0
Cash dividends	(3,754)	(3,753)
<b>Net Cash Provided by Financing Activities</b>	<b><u>\$ 39,341</u></b>	<b><u>\$ 28,957</u></b>
Increase in Cash and Cash Equivalents	13,475	14,984
Cash and Cash Equivalents, Beginning	11,426	9,951
<b>Cash and Cash Equivalents, Ending</b>	<b><u>\$ 24,901</u></b>	<b><u>\$ 24,935</u></b>
	=====	=====
<b>SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION</b>		
Cash paid during period for:		
Interest	\$ 10,144	\$ 11,975
Income Taxes	1,436	1,151

See Accompanying Notes to Consolidated Financial Statements

4

FIRST KEYSTONE CORPORATION  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
September 30, 2010  
(Unaudited)

Note 1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

The accounting policies of First Keystone Corporation and

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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 differ from those 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



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securities to maturity. Investment securities Held to Maturity are carried at cost adjusted for amortization of premium and accretion of discount to maturity.

5

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 September 30, 2010 and December 31, 2009, the Corporation held \$6,661,000 in stock of FHLB Pittsburgh, \$35,000 in stock of ACBB and \$1,443,000 in stock of Federal Reserve Bank.

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

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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, 2010 and December 31, 2009.

### 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 method. 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. These loans are sold without recourse to the Corporation.

6

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.

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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.

A principal factor in estimating the allowance for loan losses is the measurement of 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 effective interest rate of the loan or the fair value of the collateral for certain collateral dependent loans.

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.

### 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.

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### FORECLOSED REAL ESTATE

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 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 included in other assets amounted to \$960,000 at September 30, 2010 and \$330,000 at December 31, 2009.

### 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 2010 and 2009. The amortization of the investments in the limited partnerships were \$120,000 and \$116,000 for the nine months ended September 30, 2010 and 2009. The carrying value of the investments as of September 30, 2010 and December 31, 2009 were \$1,653,000 and \$690,000, respectively, and is included in other assets in the accompanying consolidated balance sheets.

### 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.

### 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

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

8

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.

### STOCK BASED COMPENSATION

The Corporation sponsors a stock option plan. 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.

### 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

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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. The Corporation considers cash classified as interest bearing deposits with other banks and federal funds sold as a cash equivalent since they are represented by cash accounts essentially on a demand 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.

### RECENT ACCOUNTING PRONOUNCEMENTS

FASB ASC 820-10 - In February 2008, the FASB issued new guidance impacting FASB ASC 820-10, Fair Value Measurements and Disclosures (FASB Staff Position No. 157-2). The staff position delays the effective date of FASB ASC 820-10 (SFAS No. 157) for nonfinancial assets and nonfinancial liabilities, except for items that are recognized or disclosed at fair value in the financial statements on a recurring basis. The delay expired January 1, 2009, and the expiration of the delay did not have a material impact on the Corporation's consolidated financial positions or results of operations.

FASB ASC 805 - In December 2007, the FASB issued new guidance impacting FASB ASC 805, Business Combinations (SFAS No 141R - Business Combinations). The new guidance establishes principles and requirements for how an acquiring company (1) recognizes and measures in its financial statements the identifiable assets acquired, the liabilities assumed and any noncontrolling interest in the acquiree, (2) recognizes and measures the goodwill acquired in the business combination or a gain from a bargain purchase, and (3) determines what

9

information to disclose to enable users of the financial statements to evaluate the nature and financial effects of the business combination. The new standard became effective for the Corporation on January 1, 2009. The adoption of this standard did not have a material impact on the Corporation's consolidated financial position or results of operations.

FASB ASC 810-10 - In December 2007, the FASB issued FASB ASC 810-10, Consolidation (Statement No. 160 - Noncontrolling Interests in Consolidated Financial Statements - an amendment of ARB No. 51). FASB ASC 810-10 requires the ownership interests in subsidiaries held by parties other than the parent be clearly identified, labeled and presented in the consolidated balance sheet within equity, but separate from the parent's equity. It also requires the amount of consolidated net income attributable to the parent and the

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noncontrolling interest to be clearly identified and presented on the face of the consolidated statement of income. The new standard became effective for the Corporation on January 1, 2009. The adoption of this standard did not have a material impact on the Corporation's consolidated financial position or results of operations.

FASB ASC 815-10 - In March 2008, the FASB issued FASB ASC 815-10, Derivatives and Hedging (Statement No. 161 - Disclosures about Derivative Instruments and Hedging Activities - an amendment of FASB Statement No. 133). FASB ASC 815-10 requires enhanced disclosures about how and why an entity uses derivative instruments, how derivative instruments and related items are accounted for and how derivative instruments and related hedged items affect an entity's financial position, financial performance and cash flows. The new standard became effective for the Corporation on January 1, 2009. The adoption of this standard did not have a material impact on the Corporation's consolidated financial position or results of operations.

FASB ASC 855 - In May 2009, the FASB issued FASB ASC 855, Subsequent Events (Statement No. 165 - Subsequent Events). FASB ASC 855 establishes the period after the balance sheet date during which management shall evaluate events or transactions that may occur for potential recognition or disclosure in financial statements and the circumstances under which an entity shall recognize events or transactions that occur after the balance sheet date. FASB ASC 855 also requires disclosure of the date through which subsequent events have been evaluated. The Corporation adopted this standard for the interim reporting period ending June 30, 2009. The adoption of this standard did not have a material impact on the Corporation's consolidated financial position or results of operations.

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, an 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 continuing involvement with the transferred financial asset. The new standard will become effective for the Corporation on January 1, 2010. The Corporation is currently evaluating the impact of adopting the new standard on the consolidated financial statements.

FASB ASC 810-10 - In June 2009, the FASB issued new guidance impacting FASB ASC 810-10, Consolidation (Statement No. 167 - Amendments to FASB Interpretation No. 46R). The new guidance amends tests for variable interest entities to determine whether a variable interest entity must be consolidated. FASB ASC 810-10 requires an entity to perform an analysis to determine whether an entity's variable interest or interests give it a controlling financial interest in a variable interest entity. This standard requires ongoing reassessments of whether an entity is the primary beneficiary of a variable interest entity and enhanced disclosures that provide more transparent information about an entity's involvement with a variable interest entity. The new guidance will become effective for the Corporation on January 1, 2010 and the Corporation is currently evaluating the impact of adopting the

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standard on the consolidated financial statements.

FASB ASC 105-10 - In June 2009, the FASB issued FASB ASC 105-10, Generally Accepted Accounting Principles (Statement No. 168 - The FASB Accounting Standards Codification and the Hierarchy of Generally Accepted Accounting Principles). The new guidance replaces SFAS No. 162 and establishes the FASB Accounting Standards Codification as the source of authoritative accounting principles recognized by the FASB to be applied by nongovernmental entities in the preparation of financial statements in conformity with generally accepted accounting

10

principles ("GAAP"). Rules and interpretative releases of the Securities and Exchange Commission under federal securities laws are also sources of authoritative GAAP for SEC registrants. The new standard became effective for financial statements issued for interim and annual periods ending after September 15, 2009. The adoption of this statement did not have a material impact on the Corporation's consolidated financial position or results of operations. Technical references to generally accepted accounting principles included in the Notes to Consolidated Financial Statements are provided under the new FASB ASC structure with the prior terminology included parenthetically.

FASB ASC 715-20-50 - In December 2008, the FASB issued new guidance impacting FASB ASC 715-20-50, Compensation Retirement Benefits - Defined Benefit Plans - General (FASB Staff Position No. 132R- 1, Employers' Disclosures about Postretirement Benefit Plan Assets). This provides guidance on an employer's disclosures about plan assets of a defined benefit pension or other postretirement plan. The guidance requires disclosure of the fair value of each major category of plan assets for pension plans and other postretirement benefit plans. This standard becomes effective for the Corporation on January 1, 2010. The Corporation is currently evaluating the impact of adopting the new guidance on the consolidated financial statements, but it is not expected to have a material impact.

FASB ASC 825-10-50 - In April 2009, the FASB issued new guidance impacting FASB ASC 825-10-50, Financial Instruments (FASB Staff Position No. FAS 107-1 and APB 28-1, Interim Disclosures about Fair Value of Financial Instruments). This guidance amends existing GAAP to require disclosures about fair values of financial instruments for interim reporting periods as well as in annual financial statements. The guidance also amends existing GAAP to require those disclosures in summarized financial information at interim reporting periods. The Corporation adopted this standard for the interim reporting period ending March 31, 2009.

FASB ASC 320-10 - In April 2009, the FASB issued new guidance impacting FASB ASC 320-10, Investments - Debt and Equity Securities (FASB Staff Position No. FAS 115-2, Recognition and Presentation of Other Than Temporary Impairments). This guidance amends the other than temporary impairment guidance in U.S. generally accepted accounting principles for debt securities. If an entity determines



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that it has an other than temporary impairment on a security, it must recognize the credit loss on the security in the income statement. The credit loss is defined as the difference between the present value of the cash flows expected to be collected and the amortized cost basis. FASB ASC 320-10 expands disclosures about other than temporary impairment and requires that the annual disclosures in existing generally accepted accounting principles be made for interim reporting periods. The Corporation adopted this guidance for the interim reporting period ending March 31, 2009.

FASB ASC 820 - In April 2009, the FASB issued new guidance impacting FASB ASC 820, Fair Value Measurements and Disclosures (FASB Staff Position No. FAS 157-4, Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly). This provides additional guidance on determining fair value when the volume and level of activity for the asset or liability have significantly decreased when compared with normal market activity for the asset or liability. A significant decrease in the volume or level of activity for the asset or liability is an indication that transactions or quoted prices may not be determinative of fair value because transactions may not be orderly. In that circumstance, further analysis of transactions or quoted prices is needed, and an adjustment to the transactions or quoted prices may be necessary to estimate fair value. The Corporation adopted this guidance for the interim reporting period ending March 31, 2009 and it did not have a material impact on the Corporation's consolidated financial position or results of operations.

SAB 111 - In April 2009, the Securities and Exchange Commission issued Staff Accounting Bulletin No. 111 ("SAB 111"). SAB 111 amends Topic 5.M in the Staff Accounting Bulletin series entitled Other Than Temporary Impairment of Certain Investments in Debt and Equity Securities. On April 9, 2009, the FASB issued new guidance impacting FASB ASC 320-10, Investments - Debt and Equity Securities (FASB Staff Position No. FAS 115-2 and FAS 124-2, Recognition and Presentation of Other Than Temporary Impairments). SAB 111 maintains the previous views related to equity securities and amends Topic 5.M to exclude debt securities from its scope. SAB 111 was effective for the Corporation as of March 31, 2009. There was no material impact to the Corporation's consolidated financial position or results of operations upon adoption.

11

SAB 112 - In June 2009, the Securities and Exchange Commission issued Staff Accounting Bulletin No. 112 ("SAB 112"). SAB 112 revises or rescinds portions of the interpretative guidance included in the Staff Accounting Bulletin series in order to make the interpretative guidance consistent with the recent pronouncements by the FASB, specifically FASB ASC 805 and FASB ASC 810-10 (SFAS No. 141R and SFAS No. 160). SAB 112 was effective for the Corporation as of June 30, 2009. There was no material impact to the Corporation's consolidated financial position or results of operations upon adoption.

FASB ASC 323 - In November 2008, the FASB Emerging Issues Task

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Force reached a consensus on FASB ASC 323, Investments - Equity Method and Joint Ventures (Issue No. 08-6, Equity Method Investment Accounting Considerations). The new guidance clarifies the accounting for certain transactions and impairment considerations involving equity method investments. An equity investor shall not separately test an investee's underlying assets for impairment but will recognize its share of any impairment charge recorded by an investee in earnings and consider the effect of the impairment on its investment. An equity investor shall account for a share issuance by an investee as if the investor had sold a proportionate share of its investment, with any gain or loss recognized in earnings. The new guidance became effective for the Corporation on January 1, 2009 and did not have a material impact on the Corporation's consolidated financial position or results of operations.

FASB ASC 350 - In November 2008, the FASB Emerging Issues Task Force reached a consensus on FASB ASC 350, Intangibles - Goodwill and Other (Issue No. 08-7, Accounting for Defensive Intangible Assets). The new guidance clarifies how to account for defensive intangible assets subsequent to initial measurement. The guidance applies to acquired intangible assets in situations in which an entity does not intend to actively use an asset but intends to hold the asset to prevent others from obtaining access to the asset. A defensive intangible asset should be accounted for as a separate unit of accounting with an expected life that reflects the consumption of the expected benefits related to the asset. The benefit from holding a defensive intangible asset is the direct and indirect cash flows resulting from the entity preventing others from using the asset. The new guidance was effective for intangible assets acquired on or after January 1, 2009 and did not have a material impact on the Corporation's consolidated financial position or results of operations.

FASB ASC 260-10 - In June 2008, the FASB issued new guidance impacting FASB ASC 260-10, Earnings Per Share (FSP No. EITF 03-06-1, Determining Whether Instruments Granted in Share Based Payment Transactions are Participating Securities). This new guidance concluded that all outstanding unvested share based payment awards that contain rights to nonforfeitable dividends participate in undistributed earnings with common shareholders and therefore are considered participating securities for purposes of computing earnings per share. Entities that have participating securities that are not convertible into common stock are required to use the "two class" method of computing earnings per share. The two class method is an earnings allocation formula that determines earnings per share for each class of common stock and participating security according to dividends declared (or accumulated) and participation rights in undistributed earnings. This new guidance was effective for fiscal years beginning after December 15, 2008 and interim periods within those fiscal years. This new guidance became effective for the Corporation on January 1, 2009 and did not have a material impact on the Corporation's consolidated financial position or results of operations.

FASB ASC 820-10 - In August 2009, the FASB issued an update (ASC No. 2009-05, Measuring Liabilities at Fair Value) impacting FASB ASC 820-10, Fair Value Measurements and Disclosures. The update provides clarification about measuring liabilities at fair value in circumstances where a quoted price in an active market for an identical liability is not available and the valuation techniques that should be used. The update also clarifies that when estimating

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the fair value of a liability, a reporting entity is not required to include a separate input or adjustment to other inputs relating to the existence of a restriction that prevents the transfer of the liability. This update became effective for the Corporation for the reporting period ending September 30, 2009 and did not have a material impact on the Corporation's consolidated financial position or results of operations.

FASB ASC 820-10 - In September 2009, the FASB issued an update (ASC No. 2009-12, Investments in Certain Entities That Calculate Net Asset Value per Share (or its equivalent)) impacting FASB ASC 820-10, Fair Value Measurements and Disclosures. The amendments in this update permit, as a practical expedient, a reporting entity to measure the fair value of an investment that is within the scope of the amendments in this update on the

12

basis of the net asset value per share of the investment (or its equivalent) if the net asset value of the investment is calculated in a manner consistent with the measurement principles of Topic 946, Financial Services Investment Companies. The amendments in this update also require disclosures by major category of investment about the attributes of investments within the scope of the amendments in this update, such as the nature of any restrictions on the ability to redeem an investment on the measurement date. This update becomes effective for the Corporation for interim and annual reporting periods ending after December 15, 2009. The Corporation is currently evaluating the impact of adopting the new guidance on the consolidated financial statements, but it is not expected to have a material impact.

FASB ASC 505-20 - In January 2010, the FASB issued an update (ASC No. 2010-01, Accounting for Distributions to Shareholders with Components of Stock and Cash) impacting FASB ASC 505-20, Equity, Stock Dividends and Stock Splits. The amendments in this update clarify that the stock portion of a distribution to shareholders that allows them to elect to receive cash or stock with a potential limitation on the total amount of cash that all shareholders can elect to receive in the aggregate is considered a share issuance that is reflected in earnings per share and is not a stock dividend. This update became effective for the Corporation for interim and annual periods ending after December 15, 2009 and did not have a material impact on the Corporation's consolidated financial position or results of operations.

FASB ASC 810-10 - In January 2010, the FASB issued an update (ASC No. 2010-02, Accounting and Reporting for Decreases in Ownership of a Subsidiary - a Scope Clarification) impacting FASB ASC 810-10, Consolidation. The amendments in this update address implementation issues related to the changes of ownership provisions originally issued as FASB Statement 160. It also improves the disclosures related to retained investments in a deconsolidated subsidiary or a preexisting interest held by an acquirer in a business combination. This update became effective for the Corporation for interim and annual periods ending after December 15, 2009 and did not have a material impact on the Corporation's

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consolidated financial position or results of operations.

FASB ASC 820-10 - In January 2010, the FASB issued an update (ASC No. 2010-06, Improving Disclosures about Fair Value Measurements) impacting FASB ASC 820-10, 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 about inputs and valuation techniques. This update becomes effective for the Corporation for interim and annual reporting periods beginning after December 15, 2009. The Corporation is currently evaluating the impact of adopting the new guidance on the 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, 2010 and 2009 was approximately \$172,000 and \$190,000, respectively.

### RECLASSIFICATIONS

Certain amounts in the consolidated financial statements of prior periods have been reclassified to conform with presentation used in the 2010 consolidated financial statements. Such reclassifications have no effect on the Corporation's consolidated financial condition or net income.

13

### Note 2. ALLOWANCE FOR LOAN LOSSES

Changes in the allowance for loan losses for the periods ended September 30, 2010, and September 30, 2009, were as follows:

(amounts in thousands)

	September 30, 2010	September 30, 2009
	-----	-----
Balance, January 1	\$5,322	\$5,195
Provision charged to operations	1,675	600
Loans charged off	(1,826)	(559)
Recoveries	46	39
	-----	-----
Balance, September 30	\$5,217	\$5,275
	=====	=====

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At September 30, 2010, the total recorded investment in loans that are considered to be impaired as defined by FASB ASC 310-10-35 Receivable Subsequent Measurement (SFAS No. 114) was \$3,975,000. No additional charge to operations was required to provide for the impaired loans since the total allowance for loan losses is estimated by management to be adequate to provide for the loan loss allowance required by the standard along with any other potential losses.

At September 30, 2010, there were no significant commitments to lend additional funds with respect to non accrual and restructured loans.

Non accrual loans at September 30, 2010 and December 31, 2009 were \$3,975,000 and \$2,948,000, respectively, all of which were considered impaired.

Loans past due 90 days or more and still accruing interest amounted to \$437,000 and \$140,000 on September 30, 2010 and December 31, 2009, respectively.

### Note 3. SHORT-TERM BORROWINGS

Federal funds purchased, securities sold under agreements to repurchase and Federal Home Loan Bank advances generally represent overnight or less than 30 day borrowings. U.S. Treasury tax and loan notes for collections made by the Bank are payable on demand.

### Note 4. LONG-TERM BORROWINGS

Long-term borrowings are comprised of advances from the Federal Home Loan Bank. Under terms of a blanket agreement, collateral for the loans are secured by certain qualifying assets of the Corporation's banking subsidiary which consist principally of first mortgage loans and certain investment securities.

### Note 5. FINANCIAL INSTRUMENTS WITH OFF-BALANCE SHEET RISK AND CONCENTRATIONS OF CREDIT RISK

The Corporation is a party to financial instruments with off balance sheet risk in the normal course of business to meet the financing needs of its customers. These financial instruments include commitments to extend credit and standby letters of credit. Those instruments involve, to varying degrees, elements of credit and interest rate risk in excess of the amount recognized in the consolidated balance sheets. The contract or notional amounts of those instruments reflect the extent of involvement the Corporation has in particular classes of financial instruments. The Corporation does not engage in trading activities with respect to any of its financial instruments with off-balance sheet risk.

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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, 2010 and December 31, 2009 were as follows:

(amounts in thousands)

	September 30, 2010	December 31, 2009
	—	—
Financial instruments whose contract amounts represent credit risk:		
Commitments to extend credit	\$57,462	\$63,247
Financial standby letters of credit	804	843
Performance standby letters of credit	5,707	5,806

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 many of the commitments are expected to 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 counter party. Collateral held varies but may include accounts receivable, inventory, property, plant and equipment, and income producing commercial properties.

Standby letters of credit are conditional commitments issued by the Corporation to guarantee the performance of a customer to a third party. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending loan facilities to customers. The Corporation may hold collateral to support standby letters of credit for which collateral is deemed necessary.

The Corporation grants commercial, agricultural, real estate mortgage and consumer loans to customers primarily in the counties of Columbia, Luzerne, Montour, and Monroe Pennsylvania. It is management's opinion that the loan portfolio was well balanced and diversified at September 30, 2010, to the extent necessary to avoid any significant concentration of credit risk. However, its debtors

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ability to honor their contracts may be influenced by the region's economy.

15

Note 6. STOCKHOLDERS' EQUITY

Changes in Stockholders' Equity for the period ended September 30, 2010, were as follows:

(Amounts in thousands, except common share data)

	Common Stock	Surplus	Compre- hensive Income
	<u>          </u>	<u>          </u>	<u>          </u>
Balance at January 1, 2010	\$11,375	\$30,269	
Comprehensive Income:			
Net Income			\$ 6,990
Change in unrealized gain (loss) on investment securities available-for-sale, net of reclassification adjustment and tax effects			9,282
Total Comprehensive income (loss)			<u>\$16,272</u> =====
Issuance of 4,051 shares of treasury stock upon exercise of employee stock options		(94)	
Cash dividends - \$.69 per share			
	<u>          </u>	<u>          </u>	
Balance at September 30, 2010	\$11,375	\$30,175	
	=====	=====	

(Amounts in thousands, except common share data)

	Retained Earnings	Accumulated Other Comprehensive Income (Loss)
	<u>          </u>	<u>          </u>

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Balance at January 1, 2010	\$41,346	\$ (2,583)
Comprehensive Income:		
Net Income	6,990	
Change in unrealized gain (loss) on investment securities available-for-sale, net of reclassification adjustment and tax effects		9,282
Total Comprehensive income (loss)		
Issuance of 4,051 shares of treasury stock upon exercise of employee stock options		
Cash dividends - \$.69 per share	(3,754)	
Balance at September 30, 2010	<u>\$44,582</u> =====	<u>\$6,699</u> =====

(Amounts in thousands, except common share data)

	Treasury Stock	Total
	-----	-----
Balance at January 1, 2010	\$ (6,240)	\$74,167
Comprehensive Income:		
Net Income		6,990
Change in unrealized gain (loss) on investment securities available-for-sale, net of reclassification adjustment and tax effects		9,282
Total Comprehensive income (loss)		
Issuance of 4,051 shares of treasury stock upon exercise of employee stock options	136	42
Cash dividends - \$.69 per share		(3,754)
Balance at September 30, 2010	<u>\$ (6,104)</u> =====	<u>\$86,727</u> =====

NOTE 7. MANAGEMENT'S ASSERTIONS AND COMMENTS REQUIRED TO BE PROVIDED WITH FORM 10Q FILING

In management's opinion, the consolidated interim financial statements reflect fair presentation of the consolidated financial position of First Keystone Corporation and Subsidiary, and the



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results of their operations and their cash flows for the interim periods presented. Further, the consolidated interim financial statements are unaudited; however they reflect all adjustments, which are in the opinion of management, necessary to present fairly the consolidated financial condition and consolidated results of operations and cash flows for the interim periods presented and that all such adjustments to the consolidated financial statements are of a normal recurring nature. The independent registered public accounting firm, J. H. Williams & Co., LLP, reviewed these consolidated financial statements as stated in their accompanying review report.

The results of operations for the nine month period ended September 30, 2009, are not necessarily indicative of the results to be expected for the full year.

These consolidated interim financial statements have been prepared in accordance with requirements of Form 10Q and therefore do not include all disclosures normally required by generally accepted accounting principles applicable to financial institutions as included with consolidated financial statements included in the Corporation's annual Form 10K filing. The reader of these consolidated interim financial statements may wish to refer to the Corporation's annual report or Form 10K for the period ended December 31, 2009, filed with the Securities and Exchange Commission.

16

### REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

Board of Directors and Stockholders of First Keystone Corporation:

We have reviewed the accompanying consolidated balance sheet of First Keystone Corporation and Subsidiary as of September 30, 2010, and the related consolidated statements of income for the three and nine month periods ended September 30, 2010 and 2009 and cash flows for the nine month periods ended September 30, 2010 and 2009. These consolidated interim financial statements are the responsibility of the management of First Keystone Corporation and Subsidiary.

We conducted our reviews 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 the standards of the Public Company Accounting Oversight 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 consolidated interim financial statements referred to above for them to be in conformity with accounting principles generally accepted in the United States of America.

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We have previously audited, in accordance with the 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, 2009, and the related consolidated statements of income, changes in stockholders' equity, and cash flows for the year then ended (not presented herein); and in our report dated March 12, 2010, 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, 2009, is fairly stated, in all material respects, in relation to the consolidated balance sheet from which it has been derived.

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

Kingston, Pennsylvania  
November 8, 2010

17

### Item 2. First Keystone Corporation Management's Discussion and Analysis of Financial Condition and Results of Operation as of September 30, 2010

This quarterly report contains certain forward-looking statements (as defined in the Private Securities Litigation Reform Act of 1995), which 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.

The Dodd Frank Wall Street Reform and consumer Protection Act may affect our financial condition, results of operations, liquidity and stock price.

On July 21, 2010, the Dodd Frank Wall Street Reform and Consumer Protection Act, or the Dodd Frank Act, was signed into law. The Dodd Frank Act provisions affecting large and small financial institutions, including several provisions that will profoundly affect how community banks and bank holding companies will be regulated in the future. Among other things, these provisions relax

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rules regarding interstate branching, allow financial institutions to pay interest on business checking accounts, change the scope of federal deposit insurance coverage, and impose new capital requirements on bank holding companies. In addition, there is significant uncertainty about the full impact of the Dodd Frank Act because many of its provisions require subsequent regulatory rule making.

The Dodd Frank Act establishes the Bureau of Consumer Financial Protection as an independent entity within the Federal Reserve, which will be given authority to promulgate consumer protection regulations applicable to all entities offering financial services or products, including banks. Additionally, the Dodd Frank Act includes a series of provisions covering mortgage loan origination standards affecting, among other things, originator compensation, minimum repayment standards, and pre payments.

The Dodd Frank Act contains numerous other provisions affecting financial institutions of all types, many of which may have an impact on the Corporation's operating environment in substantial and unpredictable ways. Consequently, the Dodd Frank Act is likely to affect our cost of doing business, it may limit or expand the activities in which the Corporation permissibly may engage, and it may affect the competitive balance within the Corporation's industry and market areas.

The Dodd Frank Act and the regulations to be adopted thereunder are expected to subject the Corporation and other financial institutions to additional restrictions, oversight and costs that may have an adverse impact on its business, financial condition, results of operations or the price of the Corporation's common stock, and the Corporation's ability to continue to conduct business consistent with historical practices.

### RESULTS OF OPERATIONS

First Keystone Corporation realized earnings for the third quarter of 2010 of \$2,490,000, an increase of \$404,000 or 19.4% from the third quarter of 2009. Nine months net income for the period ended September 30, 2010, amounted to \$6,990,000, an increase of \$639,000 or 10.1% from the \$6,351,000 net income reported September 30, 2009. Net interest income increased in both the third quarter of 2010 and for the first nine months of 2010 when compared to the same period in 2009. The higher net interest income in 2010 was due to a positively sloped yield curve and an expansion of our net interest margin. Earnings in the third quarter were adversely affected by our decision to increase our provision for loan losses resulting from the write down of two commercial loans during the quarter. An increase in non interest income of \$1,000,000 was due primarily to the Recovery on loss due to defalcation. Finally, non interest expense increased during the third quarter by \$400,000 due to additional hires associated with our Mountain Top office and Professional services due to additional costs associated with regulatory compliance. Earnings for the nine months ended September 30, 2010 were positively affected by increased interest income and non interest income. The increase of 10.1% in net income during the first three

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quarters of 2010 was accomplished even though Occupancy Expense was up \$106,000 and Furniture and equipment expense was up \$174,000. On a per share basis, net income per share was \$1.28 for the first nine months of 2010, as compared to \$1.17 for the first nine months of 2009, while dividends were at \$.69 per share, unchanged from the first three quarters of 2009.

Year to date net income annualized amounts to a return on average common equity of 1.14% and a return on assets of 11.63%. For the nine months ended September 30, 2009, these measures were 1.15% and 11.97%, 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 2010, interest income amounted to \$9,585,000, an increase of \$152,000 or 1.6% from the third quarter of 2009. Interest expense amounted to \$3,092,000 in the third quarter of 2010, a decrease of \$806,000 or 20.7% from the third quarter of 2009. Accordingly, net interest income amounted to \$6,493,000 in the third quarter of 2010, an increase of \$958,000, or 17.3% from the third quarter of 2009. Year to date for the nine months ended September 30, 2010, total interest income increased \$344,000, or 1.2% to \$28,546,000 from \$28,202,000 in the first nine months of 2009. Total interest expense decreased \$1,998,000, or 16.8% to \$9,885,000 for the first nine months of 2010 from \$11,883,000 in the first nine months of 2009. This resulted in net interest income increasing \$2,342,000 to \$18,661,000 as of September 30, 2010 from \$16,319,000 as of September 30, 2009, an increase of 14.4%.

Our net interest margin for the quarter ended September 30, 2010, was 3.73% compared to 3.60% for the quarter ended September 30, 2009. For the nine months ended September 30, 2010, our net interest margin was 3.62% compared to 3.59% for the first nine months of 2009.

### PROVISION FOR LOAN LOSSES

The provision for loan losses for the quarter ended September 30, 2010, was \$1,075,000 compared to \$150,000 for the third quarter of 2009. Year to date, the provision for loan losses amounts to \$1,675,000 in 2010 as compared to the \$600,000 provision for the period ended September 30, 2009. The increased provision for loan losses came as result of increased net charge offs. Net charge offs amounted to \$1,780,000 for the nine months ended September 30, 2010, as compared to \$520,000 for the first nine months of 2009.

The allowance for loan losses as a percentage of loans, net of unearned interest was 1.26% as of September 30, 2010, and 1.31% as of December 31, 2009.

### NON-INTEREST INCOME

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Total non interest or other income was \$2,073,000 for the quarter ended September 30, 2010, as compared to \$1,073,000 for the quarter ended September 30, 2009. Excluding investment securities gains and losses, non interest income was \$2,084,000 for the third quarter of 2010, as compared to \$1,084,000 in the third quarter of 2009, an increase of 92.3% and was impacted primarily by the Recovery on loss due to defalcation. For the nine months ended September 30, 2010, total non interest income was \$4,564,000, as compared to \$3,419,000, or a 33.5% increase from the first nine months of 2009. Excluding investment securities gains and losses, non-interest income for the nine months ended September 30, 2010 was \$4,366,000, an increase of 32.4% from the \$3,297,000 reported in 2009. For the nine months ended September 30, 2010, the increase in non-interest income was primarily the result of an increase Trust Department income, Gains on sale of loans and the aforementioned Recovery on loss due to defalcation.

19

### NON-INTEREST EXPENSES

Total non interest, or other expenses, was \$4,288,000 for the quarter ended September 30, 2010, as compared to \$3,888,000 for the quarter ended September 30, 2009, an increase of \$400,000 or 10.3%. The majority of the increase in non interest expenses in the third quarter of 2010 relate to higher salaries related to our new Mountaintop Office and increases in Professional fees incurred to assist with regulatory compliance.

For the nine months ended September 30, 2010, total non interest expense was \$12,687,000, an increase of \$1,123,000, or 9.7% over the first nine months of 2009. Expenses associated with employees (salaries and employee benefits) continue to be the largest category of non interest expenses. Salaries and benefits amount to 53.0% of total non interest expense for the nine months ended September 30, 2010, as compared to 50.9% for the first nine months of 2009. Salaries and benefits amounted to \$6,719,000 for the nine months ended September 30, 2010, an increase of \$829,000, or 14.1% over the first nine months of 2009. The increase is associated with additional hires in August 2009 as well as salary and benefit increases. Net occupancy expense, including furniture and equipment, amounted to \$1,984,000 for the nine months ended September 30, 2010, an increase of \$280,000, or 16.4% from 2009. The increase reflects costs associated with a new branch opening and a new core processing system. Professional services increased \$362,000 or 119.5% from the first nine months of 2009. FDIC insurance amounted to \$634,000 as of September 30, 2010, a substantial decrease of \$345,000 compared to 2009. Other non interest expenses amounted to \$2,685,000, relatively unchanged from 2009. Even with the increase in non interest expenses in 2010, our overall non interest expense continues at slightly more than 2.1% of average assets on an annualized basis. This places us among the leaders of our peer financial institutions at controlling non interest expense.

### INCOME TAXES

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Effective tax planning has helped produce favorable net income. The effective total income tax rate was 22.3% for the third quarter of 2010 as compared to 18.8% for the third quarter of 2009. For the nine months ended September 30, 2010, our tax expense amounted to \$1,873,000 for an effective tax rate of 21.1% as compared to an effective tax rate of 16.1% for the first nine months of 2009.

### ANALYSIS OF FINANCIAL CONDITION

#### ASSETS

Total assets increased to \$815,321,000 as of September 30, 2010, an increase of \$56,991,000, or 7.5% over year end 2009. Total deposits increased to \$627,599,000 as of September 30, 2010, an increase of \$47,030,000, or 8.1% over year end 2009.

The Corporation used the increase in total deposits to fund primarily an increase in investment securities since loan demand was weak. In addition, borrowings were reduced. Total borrowings decreased \$3,999,000 from December 31, 2009. Short term borrowings increased to \$23,024,000 as of September 30, 2010, up from \$17,462,000 at year end 2009. Long term borrowings decreased to \$73,415,000 as of September 30, 2010, down \$9,561,000 from \$82,976,000 at year end 2009.

#### EARNING ASSETS

Our primary earning asset, loans, net of unearned income increased slightly to \$413,193,000 as of September 30, 2010, an increase of \$6,496,000, or 1.6% from year end 2009. The loan portfolio is well diversified and the slow increase in the portfolio has been caused primarily by reduced originations of both consumer loans and commercial loans.

20

In addition to loans, another primary earning asset is our investment portfolio which increased in size from December 31, 2009, to September 30, 2010. Available for sale securities amounted to \$304,901,000 as of September 30, 2010, an increase of \$35,216,000, or 13.1% from year end 2009. Held to maturity securities increased to \$7,274,000 as of September 30, 2010, an increase of \$2,300,000, or 46.2% since year end 2009. Interest bearing deposits with banks increased to \$17,159,000 on September 30, 2010, as compared to \$7,227,000 as of December 31, 2009. Additionally, federal funds sold increased to \$3,000,000 compared to \$0 at December 31, 2010.

#### ALLOWANCE FOR LOAN LOSSES

Management performs a quarterly analysis to determine the adequacy of the allowance for loan losses. The methodology in determining adequacy incorporates specific allocations together with a risk/loss analysis on various segments of the portfolio according

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to an internal loan review process. Management maintains its loan review and loan classification standards consistent with those of its regulatory supervisory authority. Management feels, considering the conservative portfolio composition, which is largely composed of commercial and small retail loans (mortgages and installments) with minimal classified assets, low delinquencies, and favorable loss history, that the allowance for loan loss is adequate to cover foreseeable future losses.

Any loans classified for regulatory purposes as loss, doubtful, substandard, or special mention that have not been disclosed under Industry Guide 3 do not (i) represent or result from trends or uncertainties which management reasonably expects will materially impact future operating results, liquidity, or capital resources, or (ii) represent material credits about which management is aware of any information which causes management to have serious doubts as to the ability of such borrowers to comply with the loan repayment terms.

The Corporation follows the guidance in FASB ASC 310-10-35 Receivables Subsequent Measurement SFAS No. 114, "Accounting by Creditors for Impairment of a Loan" - Refer to Note 2 above for details.

### NON-PERFORMING ASSETS

Non performing assets consist of non accrual and restructured loans, other real estate and foreclosed assets, together with the loans past due 90 days or more and still accruing. As of September 30, 2010, total non performing assets were \$5,372,000 as compared to \$3,418,000 on December 31, 2009. Non performing assets to total loans and foreclosed assets was 1.3% as of September 30, 2010, and .84% as of December 31, 2009.

The recorded investment in loans that are considered to be impaired was \$3,975,000 at September 30, 2010 and \$2,595,000 at September 30, 2009, all of which were on non accrual basis. The related reserve for loan losses for those loans was \$665,000 at September 30, 2010 and \$364,000 at September 30, 2009. At December 31, 2009 the recorded investment in loans that are considered to be impaired was \$2,948,000, all of which were on non accrual basis. The related reserve for loan losses for those loans was \$834,000.

21

Table: Non-Performing Assets

(Amounts in thousands)

	9/30/2010	12/31/2009	9/30/2009
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Non-accruing loans:

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Commercial secured			
by real estate	\$1,476	\$1,933	\$2,287
Commercial - other	625	797	0
Tax exempt	0	0	0
Real estate -			
residential	1,874	218	308
Consumer	0	0	0
	<hr/>	<hr/>	<hr/>
Total non-accruing loans	\$3,975	\$2,948	\$2,595
Restructured loans	0	0	0
	<hr/>	<hr/>	<hr/>
Total impaired loans	3,975	2,948	2,595
Loans past-due 90 days			
or more and			
still accruing	437	140	0
Other real estate owned	960	330	133
	<hr/>	<hr/>	<hr/>
Total non-performing	\$5,372	\$3,418	\$2,728
assets	<u>=====</u>	<u>=====</u>	<u>=====</u>

As of September 30, 2010, the decrease in non accruing loans since June 30, 2010 consisted of three commercial real estate borrowers with loans which totaled approximately \$3,659,000 returning to the accrual basis. In addition, loans charged off during the quarter included \$1,392,000 in commercial secured by real estate, \$2,000 in commercial other, \$11,000 residential real estate, and \$23,000 other consumer loans.

Interest income received on non performing loans as of September 30, 2010, was \$36,000 compared to \$38,000 as of September 31, 2009. Interest income, which would have been recorded on these loans under the original terms as of September 30, 2010, and September 30, 2009 was \$261,000 and \$94,000, respectively. As of September 30, 2010 and September 30, 2009, there were no outstanding commitments to advance additional funds with respect to these non performing loans.

### DEPOSITS AND OTHER BORROWED FUNDS

Total deposits increased by \$47,030,000 as non interest bearing deposits increased by \$3,687,000 and interest bearing deposits increased by \$43,343,000 as of September 30, 2010, from year end 2009. Total short term and long term borrowings decreased by \$3,999,000 from year end 2009.

### CAPITAL STRENGTH

Normal increases in capital are generated by net income, less cash dividends paid out. Also, accumulated other comprehensive income derived from unrealized gains or losses on investment securities, available for sale, increased shareholders' equity, or capital net of taxes, by \$6,699,000 as of September 30, 2010, and decreased capital by \$2,583,000 as of December 31, 2009. Treasury stock as of September 30, 2010 and December 31, 2009 had an effect of our reducing our total stockholders' equity by \$6,104,000 on



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September 30, 2010 and \$6,240,000 on December 31, 2009.

Total stockholders' equity was \$86,727,000 as of September 30, 2010, and \$74,167,000 as of December 31, 2009. Leverage ratio and risk based capital ratios remain very strong. As of September 30, 2010, our leverage ratio was 7.31% compared to 7.44% as of December 31, 2009. In addition, Tier I risk based capital and total risk based capital ratio as of September 30, 2010, were 10.97% and 11.93%, respectively. The same ratios as of December 31, 2009, were 10.86% and 11.90%, respectively.

22

### LIQUIDITY

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

Management feels its current liquidity position is satisfactorily given a very stable core deposit base which has increased annually. Secondly, our payments on loans and principal paydowns on our mortgage backed securities provide a steady source of funds. Also, short term investments and maturing investment securities represent additional sources of liquidity. Finally, short term borrowings are readily accessible at the Federal Reserve Bank discount window, Atlantic Central Bankers Bank, or the Federal Home Loan Bank.

### ITEM 3. Quantitative and Qualitative Disclosures About Market Risk

There have been no material changes in the Company's quantitative and qualitative market risks since December 31, 2009. The composition of rate sensitive assets and rate sensitive liabilities as of September 30, 2010 is very similar to December 31, 2009.

### ITEM 4. Controls and Procedures

a) Evaluation of disclosure controls and procedures. The company 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 company files or submits under the Securities Exchange Act of 1934 is recorded, processed, summarized and reported within the time periods specified in the rules and forms of the Securities and Exchange Commission. Based upon their evaluation of those disclosure controls and procedures performed as of the end of the period covered by this report, the chief executive officer and chief financial officer of the company concluded that the company's disclosure controls and procedures were adequate. The company believes that a control system, no matter how well designed

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and operated, cannot provide absolute assurance that the objectives of the control system are met, and no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, within a company have been detected.

b) Changes in internal control over financial reporting. The company made no changes in its internal control over financial reporting or in other factors that has materially affected, or is reasonably likely to materially affect, the company's internal control over financial reporting during the last fiscal quarter.

23

### PART II - OTHER INFORMATION

Item 1. Legal Proceedings

None.

Item 1A. There have been no material changes to the risk factors disclosed in Item 1A "Risk Factors" in our Annual Report on Form 10K for the year ended December 31, 2009.

Item 2. Changes in Securities, Use of Proceeds and Issuer Purchases of Equity Securities

Period	Total Number of Shares Purchased	Average Price Paid per Share	Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs	Maximum Number of Shares That May Yet Be Purchased Under the Plans or Programs
July 1 - July 31, 2010	----	----	----	112,098
August 1 - August 31, 2010	----	----	----	112,098
Sept. 1 - Sept. 30, 2010	----	----	----	112,098
Total	----	----	----	112,098

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Item 3. Defaults Upon Senior Securities

None.

Item 4. Removed and Reserved

Item 5. Other Information

The Company made no material changes to the procedures by which shareholders may recommend nominees to the Company's Board of Directors.

24

Item 6. Exhibits and Reports on Form 8-K

(a) Exhibits required by Item 601 Regulation S-K

<u>Exhibit Number</u>	<u>Description of Exhibit</u>
3i	Articles of Incorporation, as amended (Incorporated by reference to Exhibit 3(i) to the Registrant's Report on Form 10Q for the quarter ended March 31, 2006).
3ii	By-Laws, as amended (Incorporated by reference to Exhibit 3(ii) to the Registrant's Report on Form 10Q for the quarter ended March 31, 2006).
10.1	Supplemental Employee Retirement Plan (Incorporated by reference to Exhibit 10 to the Registrant's Report on Form 10Q for the quarter ended September 30, 2005).
10.2	Management Incentive Compensation Plan (Incorporated by reference to Exhibit 10 to the Registrant's Report on Form 10Q for the quarter ended March 31, 2010).
10.3	Profit Sharing Plan (Incorporated by reference to Exhibit 10 to the Registrant's Report on Form 10Q for the quarter ended September 30, 2006).
10.4	First Keystone Corporation 1998 Stock Incentive Plan (Incorporated by reference to Exhibit 10 to the Registrant's Report on Form 10Q for the quarter ended September 30, 2006).
14	Code of Ethics (Incorporated by reference to Exhibit 14 to the Registrant's Report on Form 8K

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dated January 9, 2007).

- 31.1 Rule 13a-15(a) and 15d-15(e) Certification of Chief Executive Officer.
- 31.2 Rule 13a-15(a) and 15d-15(e) Certification of Chief Financial Officer.
- 32.1 Section 1350 Certification of Chief Executive Officer.
- 32.2 Section 1350 Certification of Chief Financial Officer.

25

FIRST KEYSTONE CORPORATION

SIGNATURES

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

FIRST KEYSTONE CORPORATION  
Registrant

November 8, 2010 /s/ Matthew P. Prosseda  
Matthew P. Prosseda  
Chief Executive Officer  
(Principal Executive Officer)

November 8, 2010 /s/ Diane C.A. Rosler  
Diane C.A. Rosler  
Chief Financial Officer  
(Principal Accounting Officer)

26

INDEX TO EXHIBITS

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