

Edgar Filing: FIRST KEYSTONE CORP - Form 10-Q

FIRST KEYSTONE CORP
Form 10-Q
November 09, 2009

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, 2009

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 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

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

Yes [] No [X]

On November 6, 2009 there were 5,440,126 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 2009 (Unaudited)	December 2008
ASSETS		
Cash and due from banks	\$ 4,650	\$ 9,945
Interest-bearing deposits in other banks	20,285	6
Investment securities available- for-sale carried at estimated fair value	267,426	240,175
Investment securities, held-to- maturity securities, estimated fair value 2009 \$4,988 and 2008 \$2,958	4,978	2,990
Loans, net of unearned income	407,953	408,367
Allowance for loan losses	(5,275)	(5,195)
Net loans	<u>\$402,678</u>	<u>\$403,172</u>
Premises and equipment - Net	11,830	9,169
Accrued interest receivable	4,043	4,228
Cash surrender value of bank owned life insurance	17,431	17,157
Goodwill	19,133	19,133
Other assets	5,061	8,923
 TOTAL ASSETS	 <u>\$757,515</u> =====	 <u>\$714,898</u> =====
 LIABILITIES AND STOCKHOLDERS' EQUITY		
LIABILITIES		
Deposits		
Non-interest bearing	\$ 61,977	\$ 58,178
Interest bearing	514,437	446,455

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TOTAL DEPOSITS	\$576,414	\$504,633
Short-term borrowings	23,283	55,332
Long-term borrowings	74,998	82,062
Accrued interest and other expenses	3,455	3,488
Other liabilities	572	236
 TOTAL LIABILITIES	 \$678,722	 \$645,751
STOCKHOLDERS' EQUITY		
Common stock, par value \$2 per share	\$ 11,375	\$ 11,375
Surplus	30,269	30,269
Retained earnings	41,012	38,414
Accumulated other comprehensive income (loss)	2,377	(4,671)
Less treasury stock at cost 247,641 shares in 2009 and 2008	(6,240)	(6,240)
 TOTAL STOCKHOLDERS' EQUITY	 \$ 78,793	 \$ 69,147
 TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	 \$757,515 =====	 \$714,898 =====

See Accompanying Notes to Consolidated Financial Statements

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FIRST KEYSTONE CORPORATION AND SUBSIDIARY
CONSOLIDATED STATEMENTS OF INCOME
FOR THE THREE MONTHS ENDED SEPTEMBER 30, 2009 AND 2008
(Unaudited)

(Amounts in thousands except per share data)

	2009	2008
INTEREST INCOME		
Interest and fees on loans	\$6,216	\$6,401
Interest and dividend income on securities	3,213	3,078
Deposits in banks	4	12
 TOTAL INTEREST INCOME	 \$9,433	 \$9,491
INTEREST EXPENSE		
Deposits	\$2,823	\$3,374
Short-term borrowings	85	164
Long-term borrowings	990	861
 TOTAL INTEREST EXPENSE	 \$3,898	 \$4,399

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Net interest income	\$5,535	\$5,092
Provision for loan losses	150	75
NET INTEREST INCOME AFTER PROVISION FOR LOAN LOSSES	\$5,385	\$5,017
NON-INTEREST INCOME		
Trust department	\$ 112	\$ 134
Service charges and fees	611	644
Bank owned life insurance income	184	177
Gain on sale of loans	57	46
Investment securities gains (losses) - net	(11)	11
Other	120	118
TOTAL NON-INTEREST INCOME	\$1,073	\$1,130
NON-INTEREST EXPENSES		
Salaries and employee benefits	\$2,023	\$1,816
Occupancy, net	307	262
Furniture and equipment	283	237
Professional services	132	101
State shares tax	177	171
FDIC Insurance	204	84
Other	762	775
TOTAL NON-INTEREST EXPENSES	\$3,888	\$3,446
Income before income taxes	\$2,570	\$2,701
Income tax expense	484	474
Net Income	\$2,086	\$2,227
	=====	=====
PER SHARE DATA		
Basic	\$.39	\$.41
Diluted	.39	.41
Cash dividends per share	.23	.22

See Accompanying Notes to Consolidated Financial Statements

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(Amounts in thousands except per share data)

	2009	2008
INTEREST INCOME		
Interest and fees on loans	\$18,621	\$19,079
Interest and dividend income		
on securities	9,574	8,938
Deposits in banks	7	78
Interest on fed funds sold	0	14
	<hr/>	<hr/>
TOTAL INTEREST INCOME	\$28,202	\$28,109
INTEREST EXPENSE		
Deposits	\$ 8,650	\$10,719
Short-term borrowings	286	490
Long-term borrowings	2,947	2,589
	<hr/>	<hr/>
TOTAL INTEREST EXPENSE	\$11,883	\$13,798
	<hr/>	<hr/>
Net interest income	\$16,319	\$14,311
Provision for loan losses	600	200
	<hr/>	<hr/>
NET INTEREST INCOME AFTER PROVISION FOR LOAN LOSSES	\$15,719	\$14,111
NON-INTEREST INCOME		
Trust department	\$ 338	\$ 418
Service charges and fees	1,745	1,830
Bank owned life insurance income	557	518
Gain on sale of loans	153	88
Investment securities gains		
(losses) - net	122	134
Other	504	245
	<hr/>	<hr/>
TOTAL NON-INTEREST INCOME	\$ 3,419	\$ 3,233
NON-INTEREST EXPENSE		
Salaries and employee benefits	\$ 5,890	\$ 5,469
Occupancy, net	877	798
Furniture and equipment	827	682
Professional services	303	297
State shares tax	523	511
FDIC Insurance	979	137
Other	2,165	2,350
	<hr/>	<hr/>
TOTAL NON-INTEREST EXPENSES	\$11,564	\$10,244
	<hr/>	<hr/>
Income before income taxes	\$ 7,574	\$ 7,100
Income tax expense	1,223	1,265
	<hr/>	<hr/>
Net Income	\$ 6,351	\$ 5,835
	=====	=====
PER SHARE DATA		
Basic	\$ 1.17	\$ 1.07
Diluted	1.17	1.07
Cash Dividends	.69	.66

See Accompanying Notes to Consolidated Financial Statements

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FIRST KEYSTONE CORPORATION AND SUBSIDIARY
CONSOLIDATED STATEMENTS OF CASH FLOWS
FOR THE NINE MONTHS ENDED September 30, 2009 AND 2008
(Unaudited)

(Amounts in thousands)

	2009	2008
OPERATING ACTIVITIES		
Net income	\$ 6,351	\$ 5,835
Adjustments to reconcile net income to net cash provided by operating activities:		
Provision for loan losses	600	200
Stock option expense	0	18
Provision for depreciation and amortization	526	733
Premium amortization on investment securities	199	84
Accretion of core deposit net discount	200	82
Discount accretion on investment securities	(891)	(496)
Gain on sale of mortgage loans	(153)	(88)
Proceeds from sale of mortgage loans	14,751	5,602
Originations of mortgage loans for resale	(19,300)	(10,096)
Gain(loss) on sale of foreclosed real estate	5	(30)
Gain on sales of investment securities	(122)	(66)
Deferred income tax (benefit)	(145)	(167)
(Increase) decrease in interest receivable and other assets	113	(467)
Increase in cash surrender value of bank owned life insurance	(557)	(518)
Decrease in interest payable, accrued expenses and other liabilities	(173)	(339)
	<hr/>	<hr/>
Net Cash Provided by Operating Activities	\$ 1,404	\$ 287
	<hr/>	<hr/>
INVESTING ACTIVITIES		
Purchases of investment securities available-for-sale	\$(87,155)	\$(75,513)
Purchase of investment securities held-to-maturity	(2,000)	(467)
Proceeds from sales of investment securities available-for-sale	53,932	32,579

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Proceeds from maturities and redemptions of investment securities available-for-sale	17,440	32,899
Proceeds from bank owned life insurance	530	0
Proceeds from maturities and redemption of investment securities held-to-maturity	12	2,011
Net (increase) decrease in loans	4,394	(17,448)
Purchase of premises and equipment	(2,685)	(461)
Proceeds from sale of foreclosed assets	155	337
Decrease in other liabilities related to acquisition	0	(133)
Net Cash Used by Investing Activities	\$ (15,377)	\$ (26,196)
FINANCING ACTIVITIES		
Net increase in deposits	\$ 71,797	\$ 20,743
Net increase (decrease) in short-term borrowings	(32,049)	284
Proceeds from long-term borrowings	0	15,000
Repayment of long-term borrowings	(7,038)	(9,065)
Proceeds from sale of treasury stock	0	1
Cash dividends	(3,753)	(3,590)
Net Cash Provided by Financing Activities	\$ 28,957	\$ 23,373
Decrease in Cash and Cash Equivalents	14,984	(2,536)
Cash and Cash Equivalents, Beginning	9,951	9,975
Cash and Cash Equivalents, Ending	\$ 24,935	\$ 7,439
SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION		
Cash paid during period for:		
Interest	\$ 11,975	\$ 14,060
Income Taxes	1,151	1,202

See Accompanying Notes to Consolidated Financial Statements

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(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 National 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. With the opening of our new Mountain Top, Pennsylvania office effective October 1, 2009, 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.

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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.

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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.

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.

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, depending on the type of loan. Collection efforts continue on loans past due beyond 60 days that have not been satisfied, when it is

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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.

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.

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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

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accumulated depreciation computed principally on 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 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 \$133,000 and \$28,000 at September 30, 2009 and December 31, 2008, respectively.

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 FASB ASC 323 Qualified Affordable Housing Project Investments (EITF) 94-1, "Accounting for Tax Benefits Resulting from Investments in Affordable Housing Projects". 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 2009 and 2008, and the amortization of the investments in the limited

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partnerships were \$116,000 and

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\$111,000 for the nine months ended September 30, 2009 and 2008, respectively. The carrying value of the investments as of September 30, 2009 and December 31, 2008 was \$729,000 and \$844,000, 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 (See Note 2) 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 Corporation accounts for goodwill pursuant to the FASB ASC 350-1- Goodwill and Other Intangibles (SFAS) No. 142, "Goodwill and Intangible Assets". 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. The standard includes requirements to test goodwill for impairments rather than to amortize goodwill. The Corporation has tested the goodwill included in its consolidated balance sheet at December 31, 2008, and has determined there was no impairment as of that date.

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.

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STOCK BASED COMPENSATION

The Corporation sponsors a stock option plan. The Corporation accounts for stock based compensation pursuant to FASB ASC 718-10 Compensation - Stock Compensation SFAS 123R, "Share Based Payment", using the modified prospective application method. The fair values of the stock awards are determined using the estimated expected life. The Corporation recognizes stock based compensation expense on the straight line basis over the period the stock award is earned by the employee. The most recent options issued were in December 2007.

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.

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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. 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.

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.

SUBSEQUENT EVENTS

Management has evaluated subsequent events through November 9, 2009, which is the date that the Corporation's financial statements were available to be issued. No material subsequent events have occurred since September 30, 2009 that required recognition or disclosures in the accompanying financial statements.

RECENT ACCOUNTING PRONOUNCEMENTS

FASB ASC 820-10 - In February 2008, the FASB issued new guidance impacting FASB ASC 820-10, (FASB Staff Position No. 157-2).

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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 141(R) 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 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 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 no 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

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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 Company 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. 46(R)). 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 Company on January 1, 2010 and the Corporation is currently evaluating the impact of adopting the 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 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

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guidance impacting FASB ASC 715-20-50, Compensation Retirement Benefits, Defined Benefit Plans, General (FASB Staff Position No. 132(R)- 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.

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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 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 quotes

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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.

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. 141(R) and SFAS No. 160). SAB 112 was effective for the Company 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 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 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 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

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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.

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, 2009 and 2008 was approximately \$190,000 and \$239,000, respectively.

RECLASSIFICATIONS

Certain amounts in the consolidated financial statements of prior periods have been reclassified to conform with presentation used in the 2009 consolidated financial statements. Such reclassifications have no effect on the Corporation's consolidated financial condition or net income.

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Note 2. ALLOWANCE FOR LOAN LOSSES

Changes in the allowance for loan losses for the periods ended September 30, 2009, and September 30, 2008, were as follows:

(amounts in thousands)

	September 30, 2009	September 30, 2008
	_____	_____
Balance, January 1	\$5,195	\$5,047
Provision charged to operations	600	200
Loans charged off	(559)	(194)
Recoveries	39	186
Balance, September 30	<u>\$5,275</u> =====	<u>\$5,239</u> =====

At September 30, 2009, the total recorded investment in loans that are considered to be impaired as defined by SFAS No. 114 was \$2,595,000. 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 SFAS No. 114 along with any other potential losses.

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At September 30, 2009, there were no significant commitments to lend additional funds with respect to non accrual and restructured loans.

Non-accrual loans at September 30, 2009 and December 31, 2008 were \$2,595,000 and \$1,718,000, respectively, all of which were considered impaired.

Loans past due 90 days or more and still accruing interest amounted to \$0 and \$15,000 on September 30, 2009 and December 31, 2008, 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.

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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, 2009 and December 31, 2008 were as follows:

(amounts in thousands)	September 30, 2009	December 31, 2008
	_____	_____
Financial instruments whose contract amounts represent credit risk:		
Commitments to extend credit	\$57,074	\$52,762
Financial standby letters of credit	843	904
Performance standby letters of credit	6,954	6,936

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, 2009, to the extent necessary to avoid any significant concentration of credit risk. However, its debtors ability to honor their contracts may be influenced by the region's economy.

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Note 6. STOCKHOLDERS' EQUITY

Changes in Stockholders' Equity for the period ended September 30, 2009, were as follows:

(Amounts in thousands, except common share data)

	Common Shares	Common Stock	Surplus
	<u> </u>	<u> </u>	<u> </u>
Balance at January 1, 2009	5,687,767	\$11,375	\$30,269
Comprehensive Income:			
Net Income			
Change in unrealized gain (loss) on investment securities available-for-sale, net of reclassification adjustment and tax effects			
Total Comprehensive income (loss)			
Cash dividends - \$.69 per share			
Balance at September 30, 2009	<u>5,687,767</u> =====	<u>\$11,375</u> =====	<u>\$30,269</u> =====

(Amounts in thousands, except common share data)

	Compre- hensive Income	Retained Earnings	Accumulated Other Comprehensive Income (Loss)
	<u> </u>	<u> </u>	<u> </u>
Balance at January 1, 2009		\$38,414	\$ (4,671)
Comprehensive Income:			
Net Income	\$6,351	6,351	
Change in unrealized gain (loss) on investment securities available-for-sale, net of reclassification adjustment and tax effects	7,048		7,048
Total Comprehensive income (loss)	<u>\$13,299</u> =====		

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Cash dividends - \$.69 per share	(3,753)	
Balance at September 30, 2009	<u>\$41,012</u> =====	<u>\$ 2,377</u> =====

(Amounts in thousands, except common share data)

	Treasury Stock	Total
	-----	-----
Balance at January 1, 2009	\$(6,240)	\$69,147
Comprehensive Income:		
Net Income		6,351
Change in unrealized gain (loss) on investment securities available-for-sale, net of reclassification adjustment and tax effects		7,048
Total Comprehensive income (loss)		
Cash dividends - \$.69 per share		(3,753)
Balance at September 30, 2009	<u>\$(6,240)</u> =====	<u>\$78,793</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 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 accountants, 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

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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, 2008, filed with the Securities and Exchange Commission.

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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, 2009, and the related consolidated statements of income for the three and nine month periods ended September 30, 2009 and 2008 and cash flows for the nine month periods ended September 30, 2009 and 2008. 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.

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, 2008, 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 9, 2009, 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, 2008, 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

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Kingston, Pennsylvania
November 9, 2009

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Item 2. First Keystone Corporation Management's Discussion and Analysis of Financial Condition and Results of Operation as of September 30, 2009

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.

RESULTS OF OPERATIONS

First Keystone Corporation realized earnings for the third quarter of 2009 of \$2,086,000, a decrease of \$141,000 or 6.3% from the third quarter of 2008. Nine months net income for the period ended September 30, 2009, amounted to \$6,351,000, an increase of 516,000 or 8.8% from the \$5,835,000 net income reported September 30, 2008. Net interest income increased in both the third quarter of 2009 and for the first nine months of 2009 when compared to the same period in 2008. The higher net interest income in 2009 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 since past dues and charged off loans increased during the quarter. A decline in non interest income of \$57,000 or 5.0% reduced third quarter net income. Finally, non interest expense increased during the third quarter due to additional hires associated with our Mountain Top office opening on October 1, 2009 and one time expenses from our conversion to a new core operating system in September 2009. Earnings for the nine months ended September 30, 2009 were positively affected by increased interest income and non interest income. The increase of 8.8% in net income during the first three quarters of 2009 was accomplished even though FDIC insurance expense increased \$842,000 to \$979,000 as of September 30, 2009. On a per basis, net income per share was \$1.17 for the first nine months of 2009, as compared to \$1.07 for the first nine months of 2009, while dividends were at \$.69 per share as compared to \$.66 at the end of the first three quarters in 2008.

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Year to date net income annualized amounts to a return on average common equity of 11.97% and a return on assets of 1.15%. For the nine months ended September 30, 2008, these measures were 11.26% and 1.12%, 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 2009, interest income amounted to \$9,433,000, a decrease of \$58,000 or 0.6% from the third quarter of 2008. Interest expense amounted to \$3,898,000 in the third quarter of 2009, a decrease of \$501,000 or 11.4% from the third quarter of 2008. Accordingly, net interest income amounted to \$5,535,000 in the third quarter of 2009, an increase of \$443,000, or 8.7% from the third quarter of 2008. Year to date for the nine months ended September 30, 2009, total interest income increased \$93,000, or 0.3% to \$28,202,000 from \$28,109,000 in the first nine months of 2008. Total interest expense decreased \$1,915,000, or 13.9% to \$11,883,000 for the first nine months of 2009 from \$13,798,000 in the first nine months of 2008. This resulted in net interest income increasing \$2,008,000 to \$16,319,000 as of September 30, 2009 from \$14,311,000 as of September 30, 2008, an increase of 14.0%.

Our net interest margin for the quarter ended September 30, 2009, was 3.60% compared to 3.49% for the quarter ended September 30, 2008. For the nine months ended September 30, 2009, our net interest margin was 3.59% compared to 3.30% for the first nine months of 2008.

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PROVISION FOR LOAN LOSSES

The provision for loan losses for the quarter ended September 30, 2009, was \$150,000 compared to \$75,000 for the third quarter of 2008. Year to date, the provision for loan losses amounts to \$600,000 in 2009 as compared to the \$200,000 provision for the period ended September 30, 2008. The increased provision for loan losses was a result of increased net charge offs. Net charge offs amounted to \$520,000 for the nine months ended September 30, 2009, as compared to \$8,000 for the first nine months of 2008.

The allowance for loan losses as a percentage of loans, net of unearned interest was 1.29% as of September 30, 2009, and 1.27% as of December 31, 2008.

NON-INTEREST INCOME

Total non interest or other income was \$1,073,000 for the quarter ended September 30, 2009, as compared to \$1,130,000 for the quarter ended September 30, 2008. Excluding investment securities gains and losses, non interest income was \$1,084,000 for the third quarter of 2009, as compared to \$1,119,000 in the third quarter of

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2008, a decrease of 3.1%. For the nine months ended September 30, 2009, total non interest income was \$3,419,000, as compared to \$3,233,000, or a 5.8% increase from the first nine months of 2008. Excluding investment securities gains and losses, non interest income for the nine months ended September 30, 2009 was \$3,297,000, an increase of 6.4% from the \$3,099,000 reported in 2008. For the nine months ended September 30, 2009, the increase in non interest income was primarily the result of an increase in bank owned life insurance income, an increase on gains on sale of loans, and an increase in other non interest income.

NON-INTEREST EXPENSES

Total non interest, or other expenses, was \$3,888,000 for the quarter ended September 30, 2009, as compared to \$3,446,000 for the quarter ended September 30, 2008, an increase of \$442,000 or 12.8%. The majority of the increase in non-interest expenses in the third quarter of 2009 relate to the opening of a new branch office, the conversion to a new core operating system, and higher FDIC insurance.

For the nine months ended September 30, 2009, total non interest expense was \$11,564,000, an increase of \$1,320,000, or 12.9% over the first nine months of 2008. Expenses associated with employees (salaries and employee benefits) continue to be the largest category of non interest expenses. Salaries and benefits amount to 50.9% of total non interest expense for the nine months ended September 30, 2009, as compared to 53.4% for the first nine months of 2008. Salaries and benefits amounted to \$5,890,000 for the nine months ended September 30, 2009, an increase of \$421,000, or 7.7% over the first nine months of 2008. The increase is associated with additional hires in 2009 as well as salary and benefit increases. Net occupancy expense, including furniture and equipment, amounted to \$1,704,000 for the nine months ended September 30, 2009, an increase of \$224,000, or 15.1% from 2008. The increase reflects costs associated with a new branch opening and a new core processing system. Professional services increased \$6,000 or 2.0% from the first nine months of 2008. State shares tax increased \$12,000 or 2.3% over the first nine months of 2008. FDIC insurance amounted to \$979,000 as of September 30, 2009, a substantial increase of \$842,000 over 2008. Other non interest expenses amounted to \$2,165,000 for the nine months ended September 30, 2009, a decrease of \$185,000, or 7.9% from the first nine months of 2008. Even with the increase in non interest expenses in 2009, our overall non interest expense continues at slightly more than 2.0% of average assets on an annualized basis. This places us among the leaders of our peer financial institutions at controlling non interest expense.

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INCOME TAXES

Effective tax planning has helped produce favorable net income. The effective total income tax rate was 18.8% for the third quarter

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of 2009 as compared to 17.5% for the third quarter of 2008. For the nine months ended September 30, 2009, our tax expense amounted to \$1,223,000 for an effective tax rate of 16.1% as compared to an effective tax rate of 17.8% for the first nine months of 2008.

ANALYSIS OF FINANCIAL CONDITION

ASSETS

Total assets increased to \$757,515,000 as of September 30, 2009, an increase of \$42,617,000, or 6.0% over year end 2008. Total deposits increased to \$576,414,000 as of September 30, 2009, an increase of \$71,781,000, or 14.2% over year end 2008.

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 \$39,113,000 from December 31, 2008. Short term borrowings decreased to \$23,283,000 as of September 30, 2009, down from \$55,332,000 at year end 2008. Long term borrowings decreased to \$74,998,000 as of September 30, 2009, down \$7,064,000 from \$82,062,000 at year end 2008.

EARNING ASSETS

Our primary earning asset, loans, net of unearned income decreased slightly to \$407,953,000 as of September 30, 2009, a decrease of \$414,000, or 0.1% from year end 2008. The loan portfolio is well diversified and the decline in the portfolio has been primarily from reduced originations of both consumer loans and commercial loans.

In addition to loans, another primary earning asset is our investment portfolio which increased in size from December 31, 2008, to September 30, 2009. Available for sale securities amounted to \$267,426,000 as of September 30, 2009, an increase of \$27,251,000, or 11.3% from year end 2008. Held to maturity securities increased to \$4,978,000 as of September 30, 2009, an increase of \$1,988,000, or 66.5% since year end 2008. Interest bearing deposits with banks increased to \$20,285,000 on September 30, 2009, as compared to \$6,000 as of December 31, 2008.

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 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 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

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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.

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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 1 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, 2009, total non performing assets were \$2,728,000 as compared to \$1,761,000 on December 31, 2008. Non performing assets to total loans and foreclosed assets was .67% as of September 30, 2009, and .43% as of December 31, 2008.

Interest income received on non performing loans as of September 30, 2009, was \$31,000 compared to \$95,000 as of December 31, 2008. Interest income, which would have been recorded on these loans under the original terms as of September 30, 2009, and December 31, 2008, was \$94,000 and \$149,000, respectively. As of September 30, 2009 and December 31, 2008, there was no outstanding commitments to advance additional funds with respect to these non performing loans.

DEPOSITS AND OTHER BORROWED FUNDS

As indicated previously, total deposits increased by \$71,781,000 as non interest bearing deposits increased by \$3,799,000 and interest bearing deposits increased by \$67,982,000 as of September 30, 2009, from year end 2008. Total short term and long term borrowings decreased by \$39,113,000 from year end 2008.

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 \$2,377,000 as of September 30, 2009, and decreased capital by \$4,671,000 as of December 31, 2008. Treasury stock as of September 30, 2009 and December 31, 2008 had an effect of our reducing our total stockholders' equity by \$6,240,000 on September 30, 2009 and December 31, 2008.

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Total stockholders' equity was \$78,793,000 as of September 30, 2009, and \$69,147,000 as of December 31, 2008. Leverage ratio and risk based capital ratios remain very strong. As of September 30, 2009, our leverage ratio was 7.89% compared to 7.59% as of December 31, 2008. In addition, Tier I risk based capital and total risk based capital ratio as of September 30, 2009, were 11.10% and 12.13%, respectively. The same ratios as of December 31, 2008, were 10.95% and 12.02%, respectively.

LIQUIDITY

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

Management feels its current liquidity position is satisfactorily given a very stable core deposit base which has increased annually. Secondly, our loan payments 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.

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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, 2008. The composition of rate sensitive assets and rate sensitive liabilities as of September 30, 2009 is very similar to December 31, 2008.

ITEM 4. Controls and Procedures

a) Evaluation of disclosure controls and procedures. The company maintains controls and procedures 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 controls and procedures performed within 75 days of the filing date of this report, the Chief Executive and Chief Financial Officers of the company concluded that the company's disclosure controls and procedures were adequate.

b) Changes in internal controls. The Company made no significant changes in its internal controls or in other factors

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that could significantly affect these controls subsequent to the date of the evaluation of the controls by the Chief Executive and Chief Financial officers.

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PART II - OTHER INFORMATION

Item 1. Legal Proceedings

None.

Item 1A. There have been no material changes in our "Risk Factors" as previously disclosed in our Annual Report on Form 10K for the year ended December 31, 2008.

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
<u>Period</u>	<u>Total Number of Shares Purchased</u>	<u>Average Price Paid per Share</u>	<u>Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs</u>	<u>Maximum Number of Shares That May Yet Be Purchased Under the Plans or Programs</u>
July 1 - July 31, 2009	----	----	----	112,098
August 1 - August 31, 2009	----	----	----	112,098
Sept. 1 - Sept. 30, 2009	----	----	----	112,098
Total	----	----	----	112,098

Item 3. Defaults Upon Senior Securities

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None.

Item 4. Submission of Matters to a Vote of Security Holders

Annual Meeting of Shareholders of First Keystone Corporation held on Tuesday, May 5, 2009 at 10:00 a.m.

<u>Directors Elected</u>	<u>Votes For</u>	<u>Votes Against</u>	<u>Votes Withheld</u>
Jerome F. Fabian	4,379,282	27,419	0
John G. Gerlach	4,206,948	199,753	0
David R. Saracino	4,206,740	199,961	0

<u>Directors Elected</u>	<u>Abstentions</u>	<u>Broker Non-Votes</u>
Jerome F. Fabian	0	0
John G. Gerlach	0	0
David R. Saracino	0	0

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Directors Continuing:

John E. Arndt, term expires in 2010
J. Gerald Bazewicz, term expires in 2010
Robert E. Bull, term expires in 2010
Joseph B. Conahan, Jr., term expires in 2010
Don E. Bower, term expires in 2011
Robert A. Bull, term expires in 2011

Matters Voted Upon:

Selection of J. H. Williams & Co. LLP, as auditors for the Corporation.

Votes For - 4,399,923
Votes Against - 2,862
Votes Withheld - 0
Abstentions - 3,916
Broker Non-Votes - 0

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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.

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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 September 30, 2006).
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 dated January 9, 2007).
31.1	Rule 13a-14(a)/15d-14(a) Certification of Chief Executive Officer.
31.2	Rule 13a-14(a)/15d-14(a) Certification of Chief Financial Officer.
32.1	Section 1350 Certification of Chief Executive

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Officer.

32.2

Section 1350 Certification of Chief Financial Officer.

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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 9, 2009

/s/ J. Gerald Bazewicz
J. Gerald Bazewicz
President and
Chief Executive Officer
(Principal Executive Officer)

November 9, 2009

/s/ Diane C.A. Rosler
Diane C.A. Rosler
Chief Financial Officer
(Principal Accounting Officer)

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INDEX TO EXHIBITS

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