FIRST KEYSTONE CORP
Form 10-K
March 17, 2008

UNITED STATES SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K

x ANNUAL REPORT UNDER SECTION 13 or 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the fiscal year ended December 31, 2007

Or

o TRANSITION REPORT UNDER SECTION 13 or 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the transition period from to

Commission file Number: 2-88927

FIRST KEYSTONE CORPORATION

(Exact name of registrant as specified in its Charter)

Pennsylvania	**23-2249083**

(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification Number)
111 West Front Street, Berwick, Pennsylvania	**18603**
(Address of principal executive offices)	(Zip Code)

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

Securities registered pursuant to Section 12(b) of the Act: **None**

Securities registered pursuant to Section 12(g) of the Act: **Common Stock, par value $2.00 per share**

Indicate by check mark if the registrant is a well-known seasoned issuer as defined in Rule 405 of the Securities Act.
Yes o No x

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Exchange Act.
Yes o No x

Indicate by check mark whether the Registrant (1) filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the past 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes x No o

Indicate by check mark if there is no disclosure of delinquent filers in response to Item 405 of Regulation S-K contained in this form, and no disclosure will be contained, to the best of registrant s knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

Yes o No x

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 o Accelerated filer x Non-accelerated filer o Smaller reporting company o

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

The aggregate market value of the registrant s outstanding voting common stock held by non-affiliates on June 30, 2007, determined by using a per share closing price on that date of $18.85, as quoted on The Over The Counter Bulletin Board, was $73,777,637.

At March 7, 2008, there were 5,440,076 shares of Common Stock, $2.00 par value, outstanding.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the Registrant s 2008 definitive Proxy Statement are incorporated by reference in Part III of this Report.

FIRST KEYSTONE CORPORATION

FORM 10-K

Table of Contents

FIRST KEYSTONE CORPORATION

FORM 10-K

PART I

Forward Looking Statements

The management of First Keystone Corporation (Corporation), has made forward-looking statements in this annual report on Form 10-K. These forward-looking statements may be subject to risks and uncertainties. Forward-looking statements include the information concerning possible or assumed future results of operations of the Corporation and its subsidiary, First Keystone National Bank (Bank). When words such as believes, expects, anticipates or similar expressions occur in this annual report, management is making forward-looking statements.

Shareholders should note that many factors, some of which are discussed elsewhere in this annual report, could affect the future financial results of the Corporation and its subsidiary, both individually and collectively, and could cause those results to differ materially from those expressed in the forward-looking statements contained in this annual report on Form 10-K. These factors include the following:

- operating, legal and regulatory risks;
- economic, political and competitive forces affecting our banking, securities, asset management and credit services businesses; and
- the risk that our analyses of these risks and forces could be incorrect and or that the strategies developed to address them could be unsuccessful.

The Corporation undertakes no obligation to publicly revise or update these forward-looking statements to reflect events or circumstances that arise after the date of this report. Readers should carefully review the risk factors described in other documents that are filed periodically with the Securities and Exchange Commission (SEC).

ITEM 1. BUSINESS

First Keystone Corporation is a Pennsylvania business corporation, and a bank holding company, registered with and supervised by the Board of Governors of the Federal Reserve System. The Corporation was incorporated on July 6, 1983, and commenced operations on July 2, 1984, upon consummation of the acquisition of all of the outstanding stock of First Keystone National Bank. The Corporation has one wholly-owned subsidiary, the Bank, which has a commercial banking operation and trust department as its major lines of business. Since commencing operations, the Corporation s business has consisted primarily of managing and supervising the Bank, and its principal source of income has been dividends paid by the Bank. Greater than 98% of the company s revenue and profit came from the commercial banking department for the years ended December 31, 2007, 2006, and 2005, and was the only reportable segment. At December 31, 2007, the Corporation had total consolidated assets, deposits and stockholders equity of approximately $681 million, $493 million and $71 million, respectively.

The Bank was organized in 1864. The Bank is a national banking association that is a member of the Federal Reserve System. Its deposits are insured by the Federal Deposit Insurance Corporation (FDIC) to the maximum extent of the law regulated by The Office of the Comptroller of the Currency (OCC). The Bank, has fourteen branch locations (five branches within Columbia County, four branches within Luzerne County, one branch in Montour County, and four branches within Monroe County, Pennsylvania), and is a full service commercial bank providing a wide range of services to individuals and small to medium sized businesses in its Northeastern and Central Pennsylvania market area. The Bank s commercial banking activities include accepting time, demand, and savings deposits and making secured and unsecured commercial, real estate and consumer loans. Additionally, the Bank also provides personal and corporate trust and agency services to individuals, corporations, and others, including trust investment accounts, investment advisory services, mutual funds, estate planning, and management of pension and profit sharing plans.

Acquisition

Effective November 1, 2007, the Corporation completed its acquisition of Pocono Community Bank through the merger of Pocono with and into the Bank. On the acquisition date, Pocono Community Bank had approximately $150 million in assets, $105 million in loans and $110 million in deposits. Headquartered in Stroudsburg, Pennsylvania and organized in 1996, Pocono had 4 banking offices located in Montour County, Pennsylvania. The acquisition expands the branch network of the Corporation and provides Pocono customers with a broader array of products and services. The Pocono branches continue to operate as a division of the Bank under the name   Pocono Community Bank, a division of First Keystone National Bank.

Supervision and Regulation

The Corporation is subject to the jurisdiction of the SEC and of state securities laws for matters relating to the offering and sale of its securities. The Corporation is currently subject to the SEC s rules and regulations relating to company s whose shares are registered under Section 12 of the Securities Exchange Act of 1934, as amended.

The Corporation is also subject to the provisions of the Bank Holding Company Act of 1956, as amended , and to supervision by the Federal Reserve Board. The Bank Holding Company Act requires the Corporation to secure the prior approval of the Federal Reserve Board before it owns or controls, directly or indirectly, more than 5% of the voting shares of substantially all of the assets of any institution, including another bank.

The Bank Holding Company Act also prohibits acquisition of control of a bank holding company, such as the Corporation, without prior notice to the Federal Reserve Board. Control is defined for this purpose as the power, directly or indirectly, to direct the management or policies of a bank holding company or to vote 25% (or 10%, if no other person or persons acting on concert, holds a greater percentage of the Common Stock) or more of the Corporation s Common Stock.

The Corporation is required to file an annual report with the Federal Reserve Board and any additional information that the Federal Reserve Board may require pursuant to the Bank Holding Company Act. The Federal Reserve Board may also make examinations of the Corporation and any or all of its subsidiaries.

The Bank is subject to federal and state statutes applicable to banks chartered under the banking laws of the United States, to members of the Federal Reserve System and to banks whose deposits are insured by the FDIC. Bank operations are also subject to regulations of the OCC, the Federal Reserve Board and the FDIC.

The primary supervisory authority of the Bank is the OCC, which regulates and examines the Bank. The OCC has the authority under the Financial Institutions Supervisory Act to prevent a national bank from engaging in an unsafe or unsound practice in conducting its business.

Federal and state banking laws and regulations govern, among other things, the scope of a bank s business, the investments a bank may make, the reserves against deposits a bank must maintain, loans a bank makes and collateral it takes, and the activities of a bank with respect to mergers and consolidations and the establishment of branches.

As a subsidiary of a bank holding company, the Bank is subject to certain restrictions imposed by the Federal Reserve Act on any extensions of credit to the bank holding company or its subsidiaries, on investments in the stock or other securities of the bank holding company or its subsidiaries and on taking such stock or securities as collateral for loans. The Federal Reserve Act and Federal Reserve Board regulations also place certain limitations and reporting requirements on extensions of credit by a bank to principal shareholders of its parent holding company, among others, and to related interests of such principal shareholders. In addition, such legislation and regulations may affect the terms upon which any person becoming a principal shareholder of a holding company may obtain credit from banks with which the subsidiary bank maintains a correspondent relationship.

Under the Federal Deposit Insurance Act , the OCC possesses the power to prohibit institutions regulated by it from engaging in any activity that would be an unsafe or unsound banking practice or would otherwise be in violation of the law.

Permitted Non-Banking Activities

The Federal Reserve Board permits bank holding companies to engage in non-banking activities so closely related to banking, managing or controlling banks as to be a proper incident thereto. The Corporation does not at this time engage in any of these non-banking activities, nor does the Corporation have any current plans to engage in any other permissible activities in the foreseeable future.

Legislation and Regulatory Changes

From time to time, various types of federal and state legislation have been proposed that could result in additional regulations of, and restrictions on, the business of the Bank. It cannot be predicted whether any such legislation will be adopted or how such legislation would affect the business of the Bank. As a consequence of the extensive regulation of commercial banking activities in the United States, the Bank s business is particularly susceptible to being affected by federal legislation and regulations that may increase the costs of doing business.

From time to time, legislation is enacted which has the effect of increasing the cost of doing business, limiting or expanding permissible activities or affecting the competitive balance between banks and other financial institutions. No prediction can be made as to the likelihood of any major changes or the impact such changes might have on the Corporation and the Bank. Certain changes of potential significance to the Corporation which have been enacted recently and others which are currently under consideration by Congress or various regulatory agencies are discussed below.

Federal Deposit Insurance Corporation Improvement Act of 1991

The FDICIA established five different levels of capitalization of financial institutions, with prompt corrective actions and significant operational restrictions imposed of institutions that are capital deficient under the categories. The five categories are:

- well capitalized
- adequately capitalized
- undercapitalized
- significantly undercapitalized, and
- critically undercapitalized.

To be considered well capitalized, an institution must have a total risk-based capital ratio of at least 10%, a Tier 1 risk-based capital ratio of at least 6%, a leverage capital ratio of at least 5%, and must not be subject to any order or directive requiring the institution to improve its capital level. An institution falls within the adequately capitalized category if it has a total risk-based capital ratio of at least 8%, a Tier 1 risk-based capital ratio of at least 4%, and a leverage capital ratio of at least 4%. Institutions with lower capital levels are deemed to be undercapitalized, significantly undercapitalized or critically undercapitalized, depending on their actual capital levels. In addition, the appropriate federal regulatory agency may downgrade an institution to the next lower capital category upon a determination that the institution is in an unsafe or unsound condition, or is engaged in an unsafe or unsound practice. Institutions are required under FDICIA to closely monitor their capital levels and to notify their appropriate regulatory agency of any basis for a change in capital category. On December 31, 2007 the Corporation and the Bank exceeded the minimum capital levels of the well capitalized category.

Regulatory oversight of an institution becomes more stringent with each lower capital category, with certain prompt corrective actions imposed depending on the level of capital deficiency.

Other Provisions of FDICIA

Each depository institution must submit audited financial statements to its primary regulator and the FDIC, which reports are made publicly available. In addition, the audit committee of each depository institution must consist of outside directors and the audit committee at large institutions (as defined by FDIC regulation) must include members with banking or financial management expertise. The audit committee at large institutions must also have access to independent outside counsel. In addition, an institution must notify the FDIC and the institution s primary regulator of any change in the institutions independent auditor, and annual management letters must be provided to the FDIC and the depository institution s primary regulator. The regulations define a large institution as one with over $500 million in assets, which does include the Bank. Also, under the rule, an institution s independent auditor must examine the institution s internal controls over financial reporting and perform agreed-upon procedures to test compliance with laws and regulations concerning safety and soundness.

Under FDICIA, each federal banking agency must prescribe certain safety and soundness standards for depository institutions and their holding companies. Three types of standards must be prescribed:

- asset quality and earnings
- operational and managerial, and
- compensation

Such standards would include a ratio of classified assets to capital, minimum earnings, and, to the extent feasible, a minimum ratio of market value to book value for publicly traded securities of such institutions and holding companies. Operational and managerial standards must relate to:

- internal controls, information systems and internal audit systems
- loan documentation
- credit underwriting
- interest rate exposure
- asset growth, and
- compensation, fees and benefits

FDICIA also sets forth Truth in Savings disclosure and advertising requirements applicable to all depository institutions.

Real Estate Lending Standards. Pursuant to the FDICIA, the OCC and other federal banking agencies adopted real estate lending guidelines which would set loan-to-value ratios for different types of real estate loans. A LTV ratio is generally defined as the total loan amount divided by the appraised value of the property at the time the loan is originated. If the institution does not hold a first lien position, the total loan amount would be combined with the amount of all senior liens when calculating the ratio. In addition to establishing the LTV ratios, the guidelines require all real estate loans to be based upon proper loan documentation and a recent appraisal of the property.

Regulatory Capital Requirements

The federal banking regulators have adopted certain risk-based capital guidelines to assist in the assessment of the capital adequacy of a banking organization s operations for both transactions reported on the balance sheet as assets and transactions, such as letters of credit, and recourse agreements, which are recorded as off balance sheet items. Under these guidelines, nominal dollar amounts of assets and credit equivalent amounts of off balance sheet items are multiplied by one of several risk adjustment percentages, which range from 0% for assets with low credit risk, such as certain U.S. Treasury securities, to 100% for assets with relatively high credit risk, such as business loans.

The following table presents the Corporation s capital ratios at December 31, 2007.

		(In Thousands)
Tier I Capital	$	49,970
Tier II Capital		5,047
Total Capital	$	55,017
Adjusted Total Average Assets	$	649,217
Total Adjusted Risk-Weighted Assets(1)		421,285
Tier I Risk-Based Capital Ratio(2)		11.86%
Required Tier I Risk-Based Capital Ratio		4.00%
Excess Tier I Risk-Based Capital Ratio		7.86%
Total Risk-Based Capital Ratio(3)		13.06%
Required Total Risk-Based Capital Ratio		8.00%
Excess Total Risk-Based Capital Ratio		5.06%
Tier I Leverage Ratio(4)		7.96%
Required Tier I Leverage Ratio		4.00%
Excess Tier I Leverage Ratio		3.96%

(1) Includes off-balance sheet items at credit-equivalent values less intangible assets.

(2) Tier I Risk-Based Capital Ratio is defined as the ratio of Tier I Capital to Total Adjusted Risk-Weighted Assets.

(3) Total Risk-Based Capital Ratio is defined as the ratio of Tier I and Tier II Capital to Total Adjusted Risk-Weighted Assets.

(4) Tier I Leverage Ratio is defined as the ratio of Tier I Capital to Adjusted Total Average Assets.

The Corporation s ability to maintain the required levels of capital is substantially dependent upon the success of Corporation s capital and business plans; the impact of future economic events on the Corporation s loan customers; and the Corporation s ability to manage its interest rate risk and investment portfolio and control its growth and other operating expenses. See also, the information under the caption Capital Strength appearing on page 25 of this 2007 Annual Report on Form 10-K.

Effect of Government Monetary Policies

The earnings of the Corporation are and will be affected by domestic economic conditions and the monetary and fiscal policies of the United States government and its agencies.

The Federal Reserve Board have had, and will likely continue to have, an important impact on the operating results of commercial banks through its power to implement national monetary policy in order to, among other things, curb inflation or combat a recession. The Federal Reserve Board has a major effect upon the levels of bank loans, investments and deposits through its open market operations in United States government securities and through its regulations of, among other things, the discount rate on borrowings of member banks and the reserve requirements against member bank deposits. It is not possible to predict the nature and impact of future changes in monetary and fiscal policies.

Effects of Inflation

Inflation has some impact on the Bank s operating costs. Unlike industrial companies, however, substantially all of the Bank s assets and liabilities are monetary in nature. As a result, interest rates have a more significant impact on the Bank s performance than the general levels of inflation. Over short periods of time, interest rates may not necessarily move in the same direction or in the same magnitude as prices of goods and services.

Environmental Regulation

There are several federal and state statutes that regulate the obligations and liabilities of financial institutions pertaining to environmental issues. In addition to the potential for attachment of liability resulting from its own actions, a bank may be held liable, under certain circumstances, for the actions of its borrowers, or third parties, when such actions result in environmental problems on properties that collateralize loans held by the bank. Further, the liability has the potential to far exceed the original amount of the loan issued by the Bank. Currently, neither the Corporation nor the Bank is a party to any pending legal proceeding pursuant to any environmental statute, nor are the Corporation and the Bank aware of any circumstances that may give rise to liability under any such statute.

Interest Rate Risk

Federal banking agency regulations specify that the Bank s capital adequacy include an assessment of the Bank s interest rate risk exposure. The standards for measuring the adequacy and effectiveness of a banking organization s Interest Rate Risk (IRR) management includes a measurement of Board of Directors and senior management oversight, and a determination of whether a banking organization s procedures for comprehensive risk management are appropriate to the circumstances of the specific banking organization. First Keystone National Bank has internal IRR models that are used to measure and monitor IRR. Additionally, the regulatory agencies have been assessing IRR on an informal basis for several years. For these reasons, the Corporation does not expect the addition of IRR evaluation to the agencies capital guidelines to result in significant changes in capital requirements for the Bank.

The Gramm-Leach-Bliley Act of 2000

In 2000, the Gramm-Leach-Bliley Act became law, which is also known as the Financial Services Modernization Act. The act repealed some Depression-era banking laws and will permit banks, insurance companies and securities firms to engage in each others businesses after complying with certain conditions and regulations. The act grants to community banks the power to enter new financial markets as a matter of right that larger institutions have managed to do on an ad hoc basis. At this time, our company has no plans to pursue these additional possibilities.

The Sarbanes-Oxley Act

In 2002, the Sarbanes-Oxley Act became law. The Act was in response to public concerns regarding corporate accountability in connection with recent high visibility accounting scandals. The stated goals of the Sarbanes-Oxley Act are:

- to increase corporate responsibility;
- to provide for enhanced penalties for accounting and auditing improprieties at publicly traded companies; and
- to protect investors by improving the accuracy and reliability of corporate disclosures pursuant to the securities laws.

The Sarbanes-Oxley Act generally applies to all companies, both U.S. and non-U.S., that file periodic reports with the SEC under the Securities Exchange Act of 1934. The legislation includes provisions, among other things:

- governing the services that can be provided by a public company s independent auditors and the procedures for approving such services;
- requiring the chief executive officer and chief financial officer to certify certain matters relating to the company s periodic filings under the Exchange Act;
- requiring expedited filings of reports by insiders of their securities transactions and containing other provisions relating to insider conflicts of interest;
- increasing disclosure requirements relating to critical financial accounting policies and their application;
- increasing penalties for securities law violations; and
- creating a public accounting oversight board, a regulatory body subject to SEC jurisdiction with broad powers to set auditing, quality control and ethics standards for accounting firms.

The American Jobs Creation Act of 2004

In 2004, the American Jobs Creation Act was enacted as the first major corporation tax act in years. The act addresses a number of areas of corporate taxation including executive deferred compensation restrictions. The impact of the act on the Corporation is unknown at this time, but management is monitoring its developments.

History and Business - Bank

The Bank s legal headquarters are located at 111 West Front Street, Berwick, Pennsylvania.

As of December 31, 2007, the Bank had total assets of $681,207,000, total shareholders equity of $70,924,000 and total deposits and other liabilities of $610,283,000.

The Bank engages in a full-service commercial banking business, including accepting time and demand deposits, and making secured and unsecured commercial and consumer loans. The Bank s business is not seasonal in nature. Its deposits are insured by the FDIC to the extent provided by law. The Bank has no foreign loans or highly leveraged transaction loans, as defined by the Federal Reserve Board. Substantially all of the loans in the Bank s portfolio have been originated by the Bank. Policies adopted by the Board of Directors are the basis by which the Bank conducts its lending activities.

At December 31, 2007, the Bank had 151 full-time employees and 27 part-time employees. In the opinion of management, the Bank enjoys a satisfactory relationship with its employees. The Bank is not a party to any collective bargaining agreement.

Competition - Bank

The Bank competes actively with other area commercial banks and savings and loan associations, many of which are larger than the Bank, as well as with major regional banking and financial institutions. The Bank s major competitors in Columbia, Luzerne, Montour, and Monroe counties are:

- First Columbia Bank & Trust Co. of Bloomsburg
- PNC Bank, N.A.
- Columbia County Farmers National Bank of Bloomsburg
- M & T Bank
- FNB Bank, NA
- Wachovia Bank
- Sovereign Bank
- Citizens Bank
- ESSA Bank & Trust
- First National Community Bank
- North Penn Bank
- Wayne Bank

Credit unions are also competitors, especially in Luzerne and Montour counties. The Bank is generally competitive with all competing financial institutions in its service area with respect to interest rates paid on time and savings deposits, service charges on deposit accounts and interest rates charged on loans.

Concentration

The Corporation and the Bank are not dependent for deposits nor exposed by loan concentrations to a single customer or to a small group of customers the loss of any one or more of whom would have a materially adverse effect on the financial condition of the Corporation or the Bank.

Available Information

The Corporation s common stock is registered under Section 12(b) of the Securities Exchange Act of 1934. The Corporation is subject to the informational requirements of the Exchange Act, and, accordingly, files reports, proxy statements and other information with the Securities and Exchange Commission. The reports, proxy statements and other information filed with the SEC are available for inspection and copying at the SEC s Public Reference Room at Judiciary Plaza, 450 Fifth Street, N.W., Washington, D.C. 20549. You may obtain information on the operation of the Public Reference Room by calling the SEC at 1-800-SEC-0330. The Corporation is an electronic filer with the SEC. The SEC maintains an Internet site that contains reports, proxy and information statements, and other information regarding issuers that file electronically with the SEC. The SEC s internet site address is www.sec.gov.

A copy of the Corporation s Annual Report on Form 10-K may be obtained without charge at www.fkyscorp.com or via email at info@fknbank.com. Information may also be obtained via written request to Investor Relations at First Keystone Corporation, Attention: Cheryl Wynings, 111 West Front Street, P.O. Box 289, Berwick, Pennsylvania 18603.

ITEM 1A. RISK FACTORS

Investments in First Keystone Corporation common stock involve risk. The market price of First Keystone common stock may fluctuate significantly in response to a number of factors, including:

The Corporation Is Subject To Interest Rate Risk

The Corporation s earnings and cash flows are largely dependent upon its net interest income. Net interest income is the difference between interest income earned on interest-earning assets such as loans and securities and interest expense paid on interest-bearing liabilities such as deposits and borrowed funds. Interest rates are highly sensitive to many factors that are beyond the Corporation s control, including general economic conditions and policies of various governmental and regulatory agencies and, in particular, the Board of Governors of the Federal Reserve System. Changes in monetary policy, including changes in interest rates, could influence not only the interest the Corporation receives on loans and securities and the amount of interest it pays on deposits and borrowings, but such changes could also affect (I) the Corporation s ability to originate loans and obtain deposits, (ii) the fair value of the Corporation s financial assets and liabilities, and (iii) the average duration of the Corporation s mortgage-backed securities portfolio. If the interest rates paid on deposits and other borrowings increase at a faster rate than the interest rates received on loans and other investments, the Corporation s net interest income, and therefore earnings, could be adversely affected. Earnings could also be adversely affected if the interest rates received on loans and other investments fall more quickly than the interest rates paid on deposits and other borrowings.

Although management believes it has implemented effective asset and liability management strategies, to reduce the potential effects of changes in interest rates on the Corporation s results of operations, any substantial, unexpected, prolonged change in market interest rates could have a material adverse effect on the Corporation s financial condition and results of operations.

The Corporation s Profitability Depends Significantly On Economic Conditions In The Commonwealth of Pennsylvania

The Corporation s success depends primarily on the general economic conditions of the Commonwealth of Pennsylvania and the specific local markets in which the Corporation operates. Unlike larger national or other regional banks that are more geographically diversified, the Corporation provides banking and financial services to customers primarily in the Columbia, Luzerne, Montour, and Monroe Counties. The local economic conditions in these areas have a significant impact on the demand for the Corporation s products and services as well as the ability of the Corporation s customers to repay loans, the value of the collateral securing loans and the stability of the Corporation s deposit funding sources. Also a significant decline in general economic conditions could impact the local economic conditions and, in turn, have a material adverse effect on the Corporation s financial condition and results of operations.

The Corporation Operates In A Highly Competitive Industry

The Corporation faces substantial competition in all areas of its operations from a variety of different competitors, many of which are larger and may have more financial resources. Such competitors primarily include national, regional, and community banks within the various markets the Corporation operates. Additionally, various out-of-state banks have begun to enter or have announced plans to enter the market areas in which the Corporation currently operates. The Corporation also faces competition from many other types of financial institutions, including, without limitation, savings and loans, credit unions, finance companies, brokerage firms, insurance companies, factoring companies and other financial intermediaries. Also, technology has lowered barriers to entry and made it possible for non-banks to offer products and services traditionally provided by banks, such as automatic transfer and automatic payment systems. Many of the Corporation s competitors have fewer regulatory constraints and may have lower cost structures.

The Corporation s ability to compete successfully depends on a number of factors, including, among other things:

- The ability to develop, maintain and build upon long-term customer relationships based on top quality service, high ethical standards and safe, sound assets.
- The ability to expand the Corporation s market position.
- The scope, relevance and pricing of products and services offered to meet customer needs and demands.
- The rate at which the Corporation introduces new products and services relative to its competitors.
- Customer satisfaction with the Corporation s level of service.
- Industry and general economic trends.

Failure to perform in any of these areas could significantly weaken the Corporation s competitive position, which could adversely affect the Corporation s growth and profitability, which, in turn, could have a material adverse effect on the Corporation s financial condition and results of operations.

The Corporation Is Subject To Extensive Government Regulation and Supervision

The Corporation, primarily through the Bank, is subject to extensive federal and state regulation and supervision. Banking regulations are primarily intended to protect depositors funds, federal deposit insurance funds and the banking system as a whole, not shareholders. These regulations affect the Corporation s lending practices, capital structure, investment practices, dividend policy and growth, among other things. Congress and federal regulatory agencies continually review banking laws, regulations and policies for possible changes. Changes to statutes, regulations or regulatory policies could affect the Corporation in substantial and unpredictable ways. Such changes could subject the Corporation to additional costs, limit the types of financial services and products the Corporation may offer and/or increase the ability of non-banks to offer competing financial services and products, among other things. Failure to comply with laws, regulations or policies could result in sanctions by regulatory agencies, civil money penalties and/or reputation damage, which could have a material adverse effect on the Corporation s business, financial condition and results of operations.

The Corporation Is Subject To Claims and Litigation Pertaining To Fiduciary Responsibility

From time to time, customers make claims and take legal action pertaining to the Corporation s performance of its fiduciary responsibilities. Whether customer claims and legal action related to the Corporation s performance of its fiduciary responsibilities are founded or unfounded, if such claims and legal actions are not resolved in a manner favorable to the Corporation they may result in significant financial liability and/or adversely affect the market perception of the Corporation and its products and services as well as impact customer demand for those products and services. Any financial liability or reputation damage could have a material adverse effect on the Corporation s financial condition and results of operations.

The Trading Volume In The Corporation s Common Stock Is Less Than That Of Other Larger Financial Services Companies

The Corporation s common stock is currently not listed but traded on the Over The Counter Bulletin Board. As a result, trading volume is less than that of other larger financial services companies. A public trading market having the desired characteristics of depth, liquidity and orderliness depends on the presence in the marketplace of willing buyers and sellers of the Corporation s common stock at any given time. This presence depends on the individual decisions of investors and general economic and market conditions over which the Corporation has no control. Given the lower trading volume of the Corporation s common stock, significant sales of the Corporation s common stock, or the expectation of these sales, could cause the Corporation s stock price to fall.

The Corporation Is Subject To Lending Risk

As of December 31, 2007, approximately 58.4% of the Corporation s loan portfolio consisted of commercial and industrial, construction and commercial real estate loans. These types of loans are generally viewed as having more risk of default than residential real estate loans or consumer loans. These types of loans are also typically larger than residential real estate loans and consumer loans. Because the Corporation s loan portfolio contains a significant number of commercial and industrial, construction and commercial real estate loans with relatively large balances, the deterioration of one or a few of these loans could cause a significant increase in non-performing loans. An increase in non-performing loans could result in a net loss of earnings from these loans, an increase in the provision for possible loan losses and an increase in loan charge-offs, all of which could have a material adverse effect on the Corporation s financial condition and results of operations.

If The Corporation s Allowance For Loan Losses Is Not Sufficient To Cover Actual Loan Losses, Its Earnings Could Decrease

The Corporation s loan customers may not repay their loans according to the terms of their loans, and the collateral securing the payment of their loans may be insufficient to assure repayment. The Corporation may experience significant credit losses, which could have a material adverse effect on its operating results. In determining the amount of the allowance for loan losses, the Corporation reviews its loans and its loss and delinquency experience, and the Corporation evaluates economic conditions. If its assumptions prove to be incorrect, its allowance for loan losses may not cover inherent losses in its loan portfolio at the date of its financial statements. Material additions to the Corporation s allowance would materially decrease its net income. At December 31, 2007, its allowance for loan losses totaled $5.05 million, representing 1.8% of its average total loans.

Although the Corporation believes it has underwriting standards to manage normal lending risks, it is difficult to assess the future performance of its loan portfolio due to the relatively recent origination of many of these loans. The Corporation cannot assure that its non-performing loans will not increase or that its non-performing or delinquent loans will not adversely affect its future performance.

In addition, federal and state regulators periodically review the Corporation s allowance for loan losses and may require it to increase its allowance for loan losses or recognize further loan charge-offs. Any increase in its allowance for loan losses or loan charge-offs as required by these regulatory agencies could have a material adverse effect on its results of operations and financial condition.

The Corporation s Ability To Pay Dividends Is Subject to Limitations

The Corporation is a bank holding company and its operations are conducted by First Keystone National Bank, which is a separate and distinct legal entity. Substantially all of the Corporation s assets are held by First Keystone National Bank.

The Corporation s ability to pay dividends depends on its receipt of dividends from First Keystone National Bank, is its primary source of dividends. Dividend payments from First Keystone National Bank are subject to legal and regulatory limitations, generally based on net profits and retained earnings, imposed by the various banking regulatory agencies. The ability of banking subsidiaries to pay dividends is also subject to their profitability, financial condition, capital expenditures and other cash flow requirements. There is no assurance that First Keystone National Bank will be able to pay dividends in the future or that the Corporation will generate adequate cash flow to pay dividends in the future. The Corporation s failure to pay dividends on its common stock could have material adverse effect on the market price of its common stock.

ITEM 1B. UNRESOLVED STAFF COMMENTS

Not Applicable.

ITEM 2. DESCRIPTION OF PROPERTIES

The Corporation and its subsidiary occupies sixteen properties in Columbia, Luzerne, Montour, and Monroe counties in Pennsylvania, which are used principally as banking offices. Properties owned are:

- Main Office located at 111 West Front Street, Berwick, Pennsylvania 18603;
- Salem Office located at 400 Fowler Avenue, Berwick, Pennsylvania 18603;

- Freas Avenue Office located at 701 Freas Avenue, Berwick, Pennsylvania 18603;
- Scott Township Office located at Central Road and Route 11, Bloomsburg, Pennsylvania 17815;
- Mifflinville Office located at Third and Race Streets, Mifflinville, Pennsylvania 18631;
- Hanover Township Office located at 1540 Sans Souci Highway, Wilkes-Barre, Pennsylvania 18706;
- Danville Office located at 1519 Bloom Road, Danville, Pennsylvania 17821;
- Mountainhome Office located at Route 390 & Price s Drive, Mountainhome, Pennsylvania 18342;
- Brodheadsville Office located at Route 209, Brodheadsville, Pennsylvania 18322;
- Swiftwater Office located at Route 611, Swiftwater, Pennsylvania 18370;
- Vacant lot held for expansion located at 117-119 West Front Street, Berwick, Pennsylvania 18603;
- Parking lot located at Second and Market Streets, Berwick, Pennsylvania 18603; and
- 16 ATM s located in Columbia, Luzerne, Montour, and Monroe counties.

Properties leased are:

- Briar Creek Office located inside the Giant Market at 50 Briar Creek Plaza, Berwick, Pennsylvania 18603;
- Nescopeck Office located at 437 West Third Street, Nescopeck, Pennsylvania 18635;
- Kingston Office located at 179 South Wyoming Avenue, Kingston, Pennsylvania 18704;
- Stroudsburg Office located at 559 Main Street, Stroudsburg, Pennsylvania 18360;
- Operations Center located at 105 Market Street, Berwick, Pennsylvania 18603;
- Operations Center located at 610 Main Street, Stroudsburg, Pennsylvania 18360; and
- Vacant lot held for expansion located at State Route 309, Mountaintop, Pennsylvania 18707.

ITEM 3. LEGAL PROCEEDINGS

The Corporation and/or the Bank are defendants in various legal proceedings arising in the ordinary course of their business. However, in the opinion of management of the Corporation and the Bank, there are no proceedings pending to which the Corporation and the Bank is a party or to which their property is subject, which, if determined adversely to the Corporation and the Bank, would be material in relation to the Corporation s and Bank s individual profits or financial condition, nor are there any proceedings pending other than ordinary routine litigation incident to the business of the Corporation and the Bank. In addition, no material proceedings are pending or are known to be threatened or contemplated against the Corporation and the Bank by government authorities or others.

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

No matter was submitted during the fourth quarter of the fiscal year covered by this report to a vote of security holders through the solicitation of proxies or otherwise.

PART II

ITEM 5. MARKET FOR REGISTRANT S COMMON EQUITY, RELATED SHAREHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES

The Corporation s Common Stock is traded in the over-the-counter market on the OTC Bulletin Board under the symbol FKYS.OB . The following table sets forth:

- The quarterly high and low prices for a share of the Corporation s Common Stock during the periods indicated as reported to the management of the Corporation and
- Quarterly dividends on a share of the Common Stock with respect to each quarter since January 1, 2006.

The following table reflects the high and low closing sale prices reported for First Keystone Corporation s common stock, and the cash dividends declared on First Keystone Corporation s common stock, for the periods indicated, after giving retroactive effect to a 5% stock dividend paid December 5, 2006.

MARKET VALUE OF COMMON STOCK

	High		Low		Per Share Dividend
2007:					
First quarter	**$**	**19.00**	**$**	**17.50**	**$**	**.22**
Second quarter	**$**	**21.75**	**$**	**17.90**	**$**	**.22**
Third quarter	**$**	**19.25**	**$**	**17.00**	**$**	**.22**
Fourth quarter	**$**	**18.25**	**$**	**15.80**	**$**	**.22**
2006:						
First quarter	$	19.91	$	18.57	$	.21
Second quarter	$	19.05	$	17.43	$	.21
Third quarter	$	19.33	$	16.81	$	.21
Fourth quarter	$	19.20	$	17.29	$	.22

As of December 31, 2007, the Corporation had approximately 820 shareholders of record.

The Corporation has paid dividends since commencement of business in 1984. It is the present intention of the Corporation s Board of Directors to continue the dividend payment policy; however, further dividends must necessarily depend upon earnings, financial condition, appropriate legal restrictions and other factors relevant at the time the Board of Directors of the

Corporation considers dividend policy. Cash available for dividend distributions to shareholders of the Corporation must initially come from dividends paid by the Bank to the Corporation. Therefore, the restrictions on the Bank s dividend payments are directly applicable to the Corporation.

Transfer Agent:

Registrar and Transfer Company	(800) 368-5948
10 Commerce Drive	
Cranford, NJ 07016-3752	

The following brokerage firms make a market in First Keystone Corporation common stock:

RBC Dain Rauscher	(800) 223-4207
Janney Montgomery Scott LLC	(800) 526-6397
Stifel, Nicolas	(800) 223-6807
Boenning & Scattergood, Inc.	(800) 842-8928
Ferris Baker Watts, Inc.	(800) 638-7411

Dividend Restrictions on the Bank

The OCC rules govern the payment of dividends by national banks. Consequently, the Bank, which is subject to these rules, may not pay dividends from capital (unimpaired common and preferred stock outstanding) but only from retained earnings after deducting losses and bad debts therefrom. To the extent that (1) the Bank has capital surplus in an amount in excess of common capital and (2) the Bank can prove that such surplus resulted from prior period earnings, the Bank, upon approval of the OCC, may transfer earned surplus to retained earnings and thereby increase its dividend capacity.

The Bank may not pay any dividends on its capital stock during a period in which it may be in default in the payment of its assessment for a deposit insurance premium due to the FDIC, nor may it pay dividends on Common Stock until any cumulative dividends on the Bank s preferred stock (if any) have been paid in full. The Bank has never been in default in the payments of its assessments to the FDIC; and the Bank has no outstanding preferred stock. In addition, under the Federal Deposit Insurance Act (912 U.S.C. Section 1818), dividends cannot be declared and paid if the OCC obtains a cease and desist order because, in the opinion of the OCC, such payment would constitute an unsafe and unsound banking practice. As of December 31, 2007, there was $439,000 in unrestricted retained earnings and net income available at the Bank that could be paid as a dividend to the Corporation under the current OCC regulations.

Dividend Restrictions on the Corporation

Under the Pennsylvania Business Corporation Law of 1988, as amended, the Corporation may not pay a dividend if, after giving effect thereto, either:

- The Corporation would be unable to pay its debts as they become due in the usual course of business or;
- The Corporation s total assets would be less than its total liabilities.

The determination of total assets and liabilities may be based upon:

- Financial statements prepared on the basis of generally accepted accounting principles,
- Financial statements that are prepared on the basis of other accounting practices and principles that are reasonable under the circumstances, or;
- A fair valuation or other method that is reasonable under the circumstances.

Equity Compensation Plan Information

Information regarding the Corporation s equity compensation plan is incorporated herein by reference from the Equity Compensation Plan Information section of the Corporation s 2008 definitive proxy statement filed on Schedule 14A.

PERFORMANCE GRAPH

The following graph and table compare the cumulative total shareholder return on the corporation s common stock during the period December 31, 2002, through and including December 31, 2007, with

- the cumulative total return on the SNL Securities Corporate Performance Index(1) for banks with less than $500 million in total assets in the Middle Atlantic area(2), and
- the cumulative total return for all United States stocks traded on the NASDAQ Stock Market.

The comparison assumes $100 was invested on December 31, 2002, in the corporation s common stock and in each of the indices below and assumes further the reinvestment of dividends into the applicable securities. The shareholder return shown on the graph and table below is not necessarily indicative of future performance.

FIRST KEYSTONE CORPORATION

Total Return Performance

	Period Ending					
	12/31/02	12/31/03	12/31/04	12/31/05	12/31/06	12/31/07
First Keystone Corporation	100.00	142.68	138.77	128.92	126.01	116.06
NASDAQ - Total US	100.00	150.01	162.89	165.13	180.85	198.60
SNL <$500M Bank Index	100.00	145.97	168.49	178.39	187.41	152.17

(1) SNL Securities is a research and publishing firm specializing in the collection and dissemination of data on the banking, thrift and financial services industries.

(2) The Middle Atlantic area comprises the states of Delaware, Pennsylvania, Maryland, New Jersey, New York, the District of Columbia and Puerto Rico.

ITEM 6. SELECTED FINANCIAL DATA

(Amounts in thousands, except per share)	2007	2006	2005	2004	2003
			Year Ended December 31,		
SELECTED FINANCIAL DATA:					
Total Assets	**$ 681,207**	$ 525,920	$ 512,399	$ 497,615	$ 481,840
Total Investment securities	**246,059**	243,938	251,536	239,053	231,272
Net loans	**371,557**	248,086	230,917	229,972	225,549
Total Deposits	**493,041**	384,020	362,796	357,956	343,020
Stockholders equity	**70,924**	53,387	53,443	53,312	51,351
SELECTED OPERATING DATA:					
Interest income	**$ 31,899**	$ 28,577	$ 26,382	$ 25,036	$ 25,063
Interest expense	**17,785**	14,972	11,621	10,006	10,200
Net interest income	**$ 14,114**	$ 13,605	$ 14,761	$ 15,030	$ 14,863
Provision for loan losses	**150**	500	750	1,750	500
Net interest income after provision for loan and lease losses	**$ 13,964**	$ 13,105	$ 14,011	$ 13,280	$ 14,363
Other income	**4,199**	3,788	3,782	4,596	3,275
Other expense	**10,645**	9,515	9,583	9,426	8,371
Income before income taxes	**$ 7,518**	$ 7,378	$ 8,210	$ 8,450	$ 9,267
Income tax expense	**1,391**	1,188	1,363	1,663	1,950
Net income	**$ 6,127**	$ 6,190	$ 6,847	$ 6,787	$ 7,317
PER COMMON SHARE DATA:					
Net income	**$ 1.31**	$ 1.35	$ 1.48	$ 1.47	$ 1.58
Cash dividends	**.88**	.85	.78	.70	.62
PERFORMANCE RATIOS:					
Return on average assets	**1.09%**	1.20%	1.35%	1.37%	1.57%
Return on average equity	**10.48%**	11.76%	12.65%	12.76%	14.27%
Dividend payout ratio	**68.25%**	62.63%	52.61%	47.41%	39.41%
Average equity to average assets ratio	**10.37%**	10.19%	10.69%	10.76%	11.00%

ITEM 7. MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The purpose of Management s Discussion and Analysis of First Keystone Corporation, a bank holding company (the Corporation), and its wholly owned subsidiary, First Keystone National Bank (the Bank), is to assist the reader in reviewing the financial information presented and should be read in conjunction with the consolidated financial statements and other financial data contained herein. Refer to Forward Looking Statements on page 1 for detailed information.

This annual 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. Although management believes the expectations reflected in such forward-looking statements are reasonable, actual results may differ materially.

ACQUISITION

On November 1, 2007, the Corporation acquired Pocono Community Bank (hereinafter referred to as Pocono) of Stroudsburg, Pennsylvania. Pocono was a $120 million bank which operated four full-service banking offices in Monroe County, Pennsylvania. Period-to-period comparisons and the Management s Discussion are impacted by this acquisition when 2007 results are compared to 2006. The tables in Management s Discussion include contributions of this acquisition as well as internal changes. Refer to Note 2 on page 43 of the Notes to Consolidated Financial Statements for detailed information.

RESULTS OF OPERATIONS

Year Ended December 31, 2007 Versus Year Ended December 31, 2006

Net income decreased to $6,127,000 for the year ended December 31, 2007, as compared to $6,190,000 for the prior year, a decrease of 1.0%. Earnings per share, both basic and diluted, for 2007 were $1.31 as compared to $1.35 in 2006. Cash dividends per share increased to $.88 in 2007 from $.85 in 2006, an increase of 3.5%. The Corporation s return on average assets was 1.09% in 2007 as compared to 1.20% in 2006. Return on average equity decreased to 10.48% in 2007 from 11.76% in 2006. An increase in earning asset levels resulted in an overall increase of interest income to $31,899,000 up $3,322,000 or 11.6% from 2006. Likewise, there was the accompanying increase in deposits and borrowings which resulted in interest expense of $17,785,000 in 2007, an increase of $2,813,000 or 18.8% from 2006. The majority of the increases in earning assets and deposits were a result of merging Pocono into the Corporation.

Net interest income, as indicated below in Table 1, increased by $509,000 or 3.7% to $14,114,000 for the year ended December 31, 2007. The Corporation s net interest income on a fully taxable equivalent basis increased by $193,000, or 1.3% to $15,493,000 in 2007 as compared to a decrease of $1,326,000, or 8.0% to $15,300,000 in 2006.

Year Ended December 31, 2006 Versus Year Ended December 31, 2005

Net income decreased to $6,190,000 for the year ended December 31, 2006, as compared to $6,847,000 for the prior year, a decrease of 9.6%. Earnings per share, both basic and diluted, for 2006 were $1.35 as compared to $1.48 in 2005. Cash dividends per share increased to $.85 in 2006 from $.78 in 2005, an increase of 9.0%.

The Corporation s return on average assets was 1.20% in 2006 as compared to 1.35% in 2005. Return on average equity decreased to 11.76% in 2006 from 12.65% in 2005. The series of increases in interest rates in 2005 ended in 2006 and resulted in an overall increase of interest income to $28,577,000 up 8.3% from 2005. Likewise, there was the accompanying increase in the cost of funds which resulted in interest expense of $14,972,000 in 2006, an increase of 28.8% from 2005. The increases in deposit rates in 2006 and the flattened yield curve resulted in interest expense increasing faster than interest income.

Table 1 Net Interest Income

(Amounts in thousands)	**2007**	**2007/2006 Increase/(Decrease) Amount**	**%**	**2006**	**2006/2005 Increase/(Decrease) Amount**	**%**	**2005**
Interest Income	**$ 31,899**	**$ 3,322**	**11.6**	$ 28,577	$ 2,195	8.3	$ 26,382
Interest Expense	**17,785**	**2,813**	**18.8**	14,972	3,351	28.8	11,621
Net Interest Income	**14,114**	**509**	**3.7**	13,605	(1,156)	(7.8)	14,761
Tax Equivalent Adjustment	**1,379**	**(316)**	**(18.6)**	1,695	(170)	(9.1)	1,865
Net Interest Income (fully tax equivalent)	**$ 15,493**	**$ 193**	**1.3**	$ 15,300	$ (1,326)	(8.0)	$ 16,626

Table 2 Distribution of Assets, Liabilities and Stockholders Equity

	2007			2006			2005		
	Average Balance	**Revenue/ Expense**	**Yield/ Rate**	**Average Balance**	**Revenue/ Expense**	**Yield/ Rate**	**Average Balance**	**Revenue/ Expense**	**Yield/ Rate**
Interest Earning Assets:									
Loans:									
Commercial(1)	**$ 21,054**	**$ 1,938**	**9.20%**	$ 28,120	$ 2,003	7.12%	$ 30,933	$ 1,953	6.31%
Real Estate(1)	**234,465**	**15,993**	**6.82%**	198,854	13,200	6.64%	182,019	11,501	6.32%
Installment Loans, Net(1),(2)	**21,097**	**1,263**	**5.99%**	17,681	1,402	7.93%	19,706	1,492	7.57%
Fees on Loans		**(31)**	**%**		(39)	%		(26)	%
Total Loans (Including Fees)(3)	**$ 276,616**	**$ 19,163**	**6.93%**	$ 244,655	$ 16,566	6.77%	$ 232,658	$ 14,920	6.41%
Investment Securities:									
Taxable	**$ 179,431**	**$ 9,894**	**5.51%**	$ 156,109	$ 8,488	5.44%	$ 158,749	$ 7,638	4.81%
Tax Exempt(1)	**66,844**	**4,124**	**6.17%**	82,669	5,188	6.28%	87,564	5,635	6.44%
Total Investment Securities	**$ 246,275**	**$ 14,018**	**5.69%**	$ 238,778	$ 13,676	5.73%	$ 246,313	$ 13,273	5.39%
Interest Bearing Deposits in Banks	**1,086**	**66**	**6.05%**	606	31	5.12%	1,784	51	2.85%
Federal Funds Sold	**688**	**31**	**4.56%**			%	90	3	3.04%
Total Other Interest-Earning Assets	**1,774**	**97**	**5.47%**	606	31	5.12%	1,874	54	2.86%
Total Interest-Earning Assets	**$ 524,665**	**$ 33,278**	**6.34%**	$ 484,039	$ 30,273	6.25%	$ 480,845	$ 28,247	5.87%
Non-Interest Earning Assets:									
Cash and Due From Banks	**$ 8,132**			$ 7,437			$ 7,006		
Allowance for Loan Losses	**(3,960)**			(3,662)			(3,738)		
Premises and Equipment	**5,519**			4,991			5,230		
Foreclosed Assets Held for Sale				229			150		
Other Assets	**29,741**			23,707			17,028		
Total Non-Interest Earning Assets	**39,432**			32,702			25,676		
Total Assets	**$ 564,097**			$ 516,741			$ 506,521		
Interest-Bearing Liabilities:									
Savings, NOW Accounts, and Money Markets	**$ 154,200**	**$ 3,681**	**2.39%**	$ 136,481	$ 2,921	2.14%	$ 137,134	$ 1,711	1.25%
Time Deposits	**214,232**	**9,876**	**4.61%**	202,780	8,263	4.07%	191,455	6,394	3.34%
Short-Term Borrowings	**14,551**	**735**	**5.05%**	6,909	352	5.09%	5,039	179	3.56%
Long-Term Borrowings	**58,345**	**2,901**	**4.97%**	62,376	2,895	4.64%	66,305	3,017	4.55%
Fed Funds Purchased	**11**		**4.65%**			%			%
Securities Sold U/A to Repurchase	**14,553**	**592**	**4.07%**	13,411	542	4.04%	10,770	320	2.97%
Total Interest-Bearing Liabilities	**$ 455,892**	**$ 17,785**	**3.90%**	$ 421,957	$ 14,973	3.55%	$ 410,703	$ 11,621	2.83%
Non-Interest Bearing Liabilities:									
Demand Deposits	**$ 43,795**			$ 39,076			$ 38,177		
Other Liabilities	**5,940**			3,074			3,511		
Stockholders Equity	**58,470**			52,634			54,130		
Total Liabilities/Stockholders Equity	**$ 564,097**			$ 516,741			$ 506,521		
Net Interest Income Tax Equivalent		**$ 15,493**			$ 15,300			$ 16,626	
Net Interest Spread			**2.44%**			2.70%			3.04%
Net Interest Margin			**2.95%**			3.16%			3.46%

(1)Tax-exempt income has been adjusted to a tax equivalent basis using an incremental rate of 34%, and statutory interest expense disallowance.

(2)Installment loans are stated net of unearned interest.

(3)Average loan balances include non-accrual loans. Interest income on non-accrual loans is not included.

NET INTEREST INCOME

The major source of operating income for the Corporation is net interest income. Net interest income is the difference between interest income on earning assets, such as loans and securities, and the interest expense on liabilities used to fund those assets, including deposits and other borrowings. The amount of interest income is dependent upon both the volume of earning assets and the level of interest rates. In addition, the volume of non-performing loans affects interest income. The amount of interest expense varies with the amount of funds needed to support earning assets, interest rates paid on deposits and borrowed funds, and finally, the level of interest free deposits.

Table 2 on the preceding pages provides a summary of average outstanding balances of earning assets and interest bearing liabilities with the associated interest income and interest expense as well as average tax equivalent rates earned and paid as of year-end 2007, 2006, and 2005.

The yield on earning assets was 6.34% in 2007, 6.25% in 2006, and 5.87% in 2005. The rate paid on interest bearing liabilities was 3.90% in 2007, 3.55% in 2006, and 2.83% in 2005. This resulted in a decrease in our net interest spread to 2.44% in 2007, as compared to 2.70% in 2006 and 3.04% in 2005.

As Table 2 illustrates, the net interest margin, which is interest income less interest expenses divided by average earnings assets, was 2.95% in 2007 as compared to 3.16% in 2006 and 3.46% in 2005. The net interest margins are presented on a tax-equivalent basis. The decreases in net interest margin in 2007 and 2006 were due primarily to the increased interest paid on interest bearing liabilities. This was a result of more interest bearing liabilities repricing than earning assets.

In an effort to maintain or try to increase our net interest margin, we look to higher earning asset yields and lower funding costs in 2008. We feel it is apparent that interest margin expansion will be experienced if the yield curve returns to its more normal upward sloping environment.

Table 3 sets forth changes in interest income and interest expense for the periods indicated for each category of interest earning assets and interest bearing liabilities. Information is provided on changes attributable to (I) changes in volume (changes in average volume multiplied by prior rate); (ii) changes in rate (changes in average rate multiplied by prior average volume); and, (iii) changes in rate and volume (changes in average volume multiplied by change in average rate).

Interest income exempt from federal tax was $3,118,000 in 2007, $3,755,000 in 2006, and $4,043,000 in 2005. Tax-exempt income has been adjusted to a tax-equivalent basis using an incremental rate of 34%.

In 2007, the increase in net interest income of $193,000 resulted from an increase in volume of $1,405,000 and a decrease of $1,212,000 due to changes in rate. In 2006, the decrease in net interest income of $1,326,000 resulted from a decrease in volume of $45,000 and a decrease of $1,281,000 due to changes in rate.

Table 3 Changes in Income and Expense, 2007 and 2006

(Amounts in thousands)	2007 COMPARED TO 2006 VOLUME	RATE	NET	2006 COMPARED TO 2005 VOLUME	RATE	NET
Interest Income:						
Loans, Net	**$ 2,164**	**$ 433**	**$ 2,597**	$ 769	$ 877	$ 1,646
Taxable Investment Securities	**1,268**	**138**	**1,406**	(127)	977	850
Tax-Exempt Investment Securities	**(993)**	**(71)**	**(1,064)**	(315)	(132)	(447)
Other Short-Term Investments	**60**	**6**	**66**	(37)	14	(23)
Total Interest Income	**$ 2,499**	**$ 506**	**$ 3,005**	$ 290	$ 1,736	$ 2,026
Interest Expense:						
Savings, Now, and Money Markets	**$ 379**	**$ 381**	**$ 760**	$ (8)	$ 1,218	$ 1,210
Time Deposits	**467**	**1,146**	**1,613**	378	1,491	1,869
Short-Term Borrowings	**389**	**(6)**	**383**	66	107	173
Long-Term Borrowings	**(187)**	**193**	**6**	(179)	57	(122)
Securities Sold U/A to Repurchase	**46**	**4**	**50**	78	144	222
Total Interest Expense	**$ 1,094**	**$ 1,718**	**$ 2,812**	$ 335	$ 3,017	$ 3,352
Net Interest Income	**$ 1,405**	**$ (1,212)**	**$ 193**	$ (45)	$ (1,281)	$ (1,326)

The change in interest due to both volume and yield/rate has been allocated to change due to volume and change due to yield/rate in proportion to the absolute value of the change in each.

Balance on non-accrual loans are included for computational purposes. Interest income on non-accrual loans is not included.

PROVISION FOR LOAN LOSSES

For the year ended December 31, 2007, the provision for loan losses was $150,000 as compared to $500,000 as of December 31, 2006 and $750,000 as of December 31, 2005. The provision in 2007, decreased primarily because of the reduced net charge-offs and improved loan quality. Net charge-offs by the Corporation for the fiscal year end December 31, 2007, 2006, and 2005, were $57,000, $505,000, and $902,000, respectively.

The allowance for loan losses as a percentage of loans, net of unearned interest, was 1.34% as of December 31, 2007, 1.46% as of December 31, 2006, 1.57% as of December 31, 2005.

On a quarterly basis, the Corporation s Board of Directors and management performs a detailed analysis of the adequacy of the allowance for loan losses. This analysis includes an evaluation of credit risk concentration, delinquency trends, past loss experience, current economic conditions, composition of the loan portfolio, classified loans and other relevant factors.

The Corporation will continue to monitor its allowance for loan losses and make future adjustments to the allowance through the provision for loan losses as conditions warrant. Although the Corporation believes that the allowance for loan losses is adequate to provide for losses inherent in the loan portfolio, there can be no assurance that future losses will not exceed the estimated amounts or that additional provisions will not be required in the future.

The Bank is subject to periodic regulatory examination by the Office of the Comptroller of the Currency (OCC). As part of the examination, the OCC will assess the adequacy of the bank s allowance for loan losses and may include factors not considered by the Bank. In the event that an OCC examination results in a conclusion that the Bank s allowance for loan losses is not adequate, the Bank may be required to increase its provision for loan losses.

NON-INTEREST INCOME

Non-interest income is derived primarily from trust department revenue, service charges and fees, income on bank owned life insurance, other miscellaneous revenue and the gain on the sale of mortgage loans. In addition, investment securities gains or losses also impact total non-interest income.

For the year ended December 31, 2007, non-interest income amounted to $4,199,000, an increase of $411,000, or 10.9% as compared to an increase of $6,000, or 0.2% for the year ended December 31, 2006. Table 4 provides the major categories of non-interest income and each respective change comparing the past three years.

Excluding investment securities gains, non-interest income in 2007 increased $309,000, or 9.1% to $3,716,000. This compares to a increase of $45,000, or 1.3% in 2006 before investment securities gains. Income from the trust department, which consists of fees generated from individual and corporate accounts, increased in 2007 by $74,000, or 14.6% after increasing by $30,000, or 6.3% in 2006. Increased income from the trust department in 2007 and 2006 was due primarily to an increase in account volume and increased fees from estate settlements.

Service charges and fees, consisting primarily of service charges on deposit accounts, was the largest source of non-interest income in 2007 and 2006. Service charges and fees increased by $34,000, or 1.6% in 2007 compared to a decrease of $14,000, or 0.6% in 2006.

Income on Bank Owned Life Insurance (BOLI) increased $86,000 to $558,000 in 2007 as compared to an increase of $35,000 to $472,000 in 2006. The income from BOLI represents the increase in the cash surrender value of BOLI and is intended to partially cover the costs of the Bank s employee benefit plan, including group life, disability, and health insurance.

The gain on sale of mortgages provided $89,000 in 2007 as compared to $39,000 in 2006. The increase in gains on sale of mortgages was largely a function of the increased originations and subsequent mortgage sales in the secondary market during the past year. The Corporation continues to service the mortgages which are sold, this servicing income provides an additional source of non-interest income on an ongoing basis.

Other income, consisting primarily of safe deposit box rentals, income from the sale of non-deposit products, and miscellaneous fees amounted to $305,000 for 2007, an increase of $65,000 or 27.1% over the $240,000 other income reported in 2006. The increased sale of non-deposit products, especially annuities, accounts for the majority of the increase in 2007.

Table 4 Non-Interest Income

		2007/2006 Increase/(Decrease)			2006/2005 Increase/(Decrease)		
(Amounts in thousands)	**2007**	**Amount**	**%**	**2006**	**Amount**	**%**	**2005**
Trust Department	**$ 581**	**$ 74**	**14.6**	$ 507	$ 30	6.3	$ 477
Service Charges and Fees	**2,183**	**34**	**1.6**	2,149	(14)	(0.6)	2,163
Income on Bank Owned Life Insurance	**558**	**86**	**18.2**	472	35	8.0	437
Gain on Sale of Mortgages	**89**	**50**	**128.2**	39	(24)	(38.1)	63
Other	**305**	**65**	**27.1**	240	18	8.1	222
Subtotal	**$ 3,716**	**$ 309**	**9.1**	$ 3,407	$ 45	1.3	$ 3,362
Investment Securities Gains	**483**	**102**	**26.8**	381	(39)	(9.3)	420
Total	**$ 4,199**	**$ 411**	**10.9**	$ 3,788	$ 6	0.2	$ 3,782

NON-INTEREST EXPENSE

Non-interest expense consists of salaries and benefits, occupancy, furniture and equipment, and other miscellaneous expenses. Table 5 provides the yearly non-interest expense by category, along with the amount, dollar changes, and percentage of change.

Total non-interest expense amounted to $10,645,000, an increase of $1,130,000, or 11.9% in 2007 compared to a decrease of $68,000, or 0.7% in 2006. Expenses associated with employees (salaries and employee benefits) continue to be the largest non-interest expenditure. Salaries and employee benefits amounted to 52.4% of total non-interest expense in 2007 and 54.5% in 2006. Salaries and employee benefits increased $391,000, or 7.5% in 2007 and $111,000, or 2.2% in 2006. The increases in both years largely reflect normal salary adjustments and increased benefit costs. The number of full time equivalent employees was 167 as of December 31, 2007, and 128 as of December 31, 2006, relating primarily to the Pocono acquisition.

Net occupancy expense increased $150,000, or 24.7% in 2007 as compared to an increase of $30,000, or 5.2% in 2006. Furniture and equipment expense increased $13,000, or 1.7% in 2007 compared to a increase of $67,000, or 9.8% in 2006. The increases in occupancy and furniture and equipment expense in 2007 relate to the Pocono acquisition and to increases in rent and lease payments and new equipment purchases. Other operating expenses increased $576,000, or 19.4% in 2007 as compared to a decrease of $276,000, or 8.5% in 2006. Increases in professional fees, marketing, advertising, and miscellaneous expense associated with both our name change from The First National Bank of Berwick to First Keystone National Bank and the Pocono acquisition account for much of the increase in other operating expenses in 2007.

The overall level of non-interest expense remains low, relative to our peers. In fact, our total non-interest expense was less than 2% of average assets in both 2007 and 2006. Non-interest expense as a percentage of average assets under 2% places us among the leaders in our peer financial institution categories in controlling non-interest expense.

Table 5 Non-Interest Expense

		2007/2006 Increase/(Decrease)			2006/2005 Increase/(Decrease)		
(Amounts in thousands)	**2007**	**Amount**	**%**	**2006**	**Amount**	**%**	**2005**
Salaries and Employee Benefits	**$ 5,576**	**$ 391**	**7.5**	**$ 5,185**	$ 111	2.2	$ 5,074
Occupancy, Net	**758**	**150**	**24.7**	**608**	30	5.2	578
Furniture and Equipment	**764**	**13**	**1.7**	**751**	67	9.8	684
Other, Shares Tax, and Professional Service	**3,547**	**576**	**19.4**	**2,971**	(276)	(8.5)	3,247
Total	**$ 10,645**	**$ 1,130**	**11.9**	**$ 9,515**	$ (68)	(0.7)	$ 9,583

INCOME TAX EXPENSE

Income tax expense for the year ended December 31, 2007, was $1,391,000 as compared to $1,188,000 and $1,363,000 for the years ended December 31, 2006, and December 31, 2005, respectively. In 2007, our income tax expense increased because income before taxes increased $140,000 to $7,518,000 from $7,378,000 in 2006. In 2005, our income before taxes amounted to $8,210,000. The corporation looks to maximize its tax-exempt interest derived from both tax-free loans and tax-free municipal investments without triggering alternative minimum tax. The effective income tax rate was 18.5% in 2007, 16.1% in 2006, and 16.6% in 2005. The limited availability of tax-free municipal investments at attractive interest rates may result in a higher effective tax rate in future years.

FINANCIAL CONDITION

GENERAL

Total assets increased to $681,207,000, at year-end 2007, an increase of 29.5% over year-end 2006. As of December 31, 2007, total deposits amounted to $493,041,000, an increase of 28.4% over 2006. Assets as of December 31, 2006, were $525,920,000, an increase of 2.6% over 2005, while total deposits as of year-end 2006 amounted to $384,020,000, an increase of 5.9% from 2005.

In both 2007 and 2006, deposit growth was used principally to fund loan growth. The Corporation continues to maintain and manage its asset growth. Our strong equity capital position provides us an opportunity to further leverage our asset growth. Borrowings increased in 2007 by $27,810,000 after decreasing in 2006 by $7,972,000. Increased borrowings in 2007 helped fund loan growth and other asset growth on the balance sheet. Decreased borrowings in 2006 resulted in a reduction in investment securities. Core deposits, which include demand deposits and interest bearing demand deposits (NOWs), money market accounts, savings accounts, and time deposits of individuals continues to be our most significant source of funds. In 2007 and 2006, several successful sales campaigns attracted new customers and generated growth in retail certificates of deposit (time deposits of individuals) as well as savings and money market accounts.

EARNING ASSETS

Earning assets are defined as those assets that produce interest income. By maintaining a healthy asset utilization rate, i.e., the volume of earning assets as a percentage of total assets, the Corporation maximizes income. The earning asset ratio (average interest earning assets divided by average total assets) equaled 93.0% for 2007, compared to 93.7% for 2006 and 94.9% for 2005. This indicates that the management of earning assets is a priority and non-earning assets, primarily cash and due from banks, fixed assets and other assets, are maintained at minimal levels. The primary earning assets are loans and investment securities.

LOANS

Total loans, net of unearned income, increased to $376,603,000 as of December 31, 2007, as compared to a balance of $251,757,000 as of December 31, 2006. Table 6 provides data relating to the composition of the Corporation s loan portfolio on the dates indicated. Total loans, net of unearned income increased $124,846,000, or 49.6% in 2007 compared to an increase of $17,164,000, or 7.3% in 2006.

The loan portfolio is well diversified and increases in the portfolio in 2007 were primarily in commercial loans secured by commercial real estate other, tax exempt, and real estate loans. In 2006, the increase in loans was also entirely in commercial real estate. Outstanding balances in all categories, except consumer loans, increased in 2007. The Corporation continues to originate and sell certain long-term fixed rate residential mortgage loans which conform to secondary market requirements. The Corporation derives ongoing income from the servicing of mortgages sold in the secondary market.

The Corporation continues to internally underwrite each of its loans to comply with prescribed policies and approval levels established by its Board of Directors.

Table 6 Loans Outstanding, Net of Unearned Income

(Amounts in thousands)		2007		2006		December 31, 2005		2004		2003
Commercial, financial and agricultural:										
Commercial secured by real estate	**$**	**190,803**	$	123,673	$	92,930	$	86,735	$	73,433
Commercial - other		**29,129**		22,169		29,284		33,470		33,890
Tax exempt		**10,899**		3,264		3,840		3,629		3,930
Real estate (primarily residential mortgage loans)		**130,865**		86,208		92,840		92,408		96,422
Consumer loans		**16,712**		18,728		18,467		20,823		25,626
Total Gross Loans	**$**	**378,408**	$	254,042	$	237,361	$	237,065	$	233,301
Less:Unearned income and unamortized loan fees net of costs		**1,805**		2,285		2,768		3,265		4,228
Total Loans, net of unearned income	**$**	**376,603**	$	251,757	$	234,593	$	233,800	$	229,073

INVESTMENT SECURITIES

The Corporation uses investment securities to not only generate interest and dividend revenue, but also to help manage interest rate risk and to provide liquidity to meet operating cash needs.

The investment portfolio has been allocated between securities available for sale and securities held to maturity. No investment securities were established in a trading account. Available for sale securities increased $4,512,000, or 1.9% to $241,521,000 after declining to $237,009,000 in 2006, a 4.2% decrease from 2005. At December 31, 2007 the net unrealized loss, net of the tax effect, on these securities was $166,000 and is included in stockholders equity as accumulated other comprehensive loss. At December 31, 2006, accumulated other comprehensive income, net of tax effect, amounted to a loss of $126,000. In 2007, held to maturity securities decreased $2,391,000, or 34.5% to $4,538,000 after increasing $2,681,000, or 63.1% in 2006. Table 7 provides data on the carrying value of our investment portfolio on the dates indicated. The vast majority of investment security purchases are allocated as available for sale. This provides the Corporation with increased flexibility should there be a need or desire to liquidate an investment security.

The investment portfolio includes U.S. Government Corporations and Agencies, corporate obligations, mortgage backed securities, state and municipal securities, and other debt securities. In addition, the investment portfolio includes restricted equity securities consisting primarily of common stock investments in the Federal Reserve Bank and the Federal Home Loan Bank. Marketable equity securities consists of common stock investments in other commercial banks and bank holding companies.

Securities available for sale may be sold as part of the overall asset and liability management process. Realized gains and losses are reflected in the results of operations on our statements of income. The investment portfolio does not contain any structured notes, step-up bonds, or any off-balance sheet derivatives.

During 2007, interest bearing deposits in other banks decreased to $89,000 from $4,307,000 in 2006. Interest bearing deposits in other banks are generally kept relatively low as funds were invested in marketable securities to maximize income while still addressing liquidity needs.

Table 7 Carrying Value of Investment Securities

	December 31,					
	2007		2006		2005	
(Amounts in thousands)	**Available for Sale**	**Held to Maturity**	**Available for Sale**	**Held to Maturity**	**Available for Sale**	**Held to Maturity**
U. S. Government Corporations and Agencies	**$ 149,607**	**$ 2,191**	$ 153,211	$ 4,205	$ 142,403	$ 1,524
State and Municipal	**74,359**	**2,347**	73,456	2,724	84,434	2,724
Corporate	**8,530**		2,019		12,698	
Marketable Equity Securities	**2,916**		3,711		2,966	
Restricted Equity Securities	**6,109**		4,612		4,787	
Total Investment Securities	**$ 241,521**	**$ 4,538**	$ 237,009	$ 6,929	$ 247,288	$ 4,248

ALLOWANCE FOR LOAN LOSSES

The allowance for loan losses constitutes the amount available to absorb losses within the loan portfolio. As of December 31, 2007, the allowance for loan losses was $5,046,000 as compared to $3,671,000 and $3,676,000 as of December 31, 2006 and 2005, respectively. The allowance for loan losses as of December 31, 2007 included $1,282,000 acquired through the Pocono Community Bank acquisition. The allowance for loan losses is established through a provision for loan losses charged to expenses. Loans are charged against the allowance for possible loan losses when management believes that the collectibility of the principal is unlikely. The risk characteristics of the loan portfolio are managed through the various control processes, including credit evaluations of individual borrowers, periodic reviews, and diversification by industry. Risk is further mitigated through the application of lending procedures such as the holding of adequate collateral and the establishment of contractual guarantees.

Management performs a quarterly analysis to determine the adequacy of the allowance for loan losses. The methodology in determining adequacy incorporates specific and general allocations together with a risk/loss analysis on various segments of the portfolio according to an internal loan review process. This assessment results in an allocated allowance. Management maintains its loan review and loan classification standards consistent with those of its regulatory supervisory authority.

Management feels based upon its methodology, that the allowance for loan losses is adequate to cover foreseeable future losses. Table 8 contains an analysis of our Allowance for Loan Losses indicating charge-offs and recoveries by the year and annual additional provisions charged to operations. In 2007, net charge-offs as a percentage of average loans were .02% compared to .21% in 2006 and .39% in 2005. Net charge-offs amounted to $57,000 in 2007 compared to $505,000 in 2006 and $902,000 in 2005, respectively. The decrease in net charge-offs in 2007 follows the decrease in net charge-offs in 2006 and 2005.

Table 8 Analysis of Allowance for Loan Losses

	Years Ended December 31,				
(Amounts in thousands)	**2007**	**2006**	**2005**	**2004**	**2003**
Balance at beginning of period	**$ 3,671**	$ 3,676	$ 3,828	$ 3,524	$ 3,174
Charge-offs:					
Commercial, financial, and agricultural	**12**	493	338	1,209	43
Real estate	**138**	183	497	132	22
Consumer	**86**	110	98	143	133
	236	786	933	1,484	198
Recoveries:					
Commercial, financial, and agricultural	**135**	228			1
Real estate	**11**	4	1	18	1
Consumer	**33**	49	30	20	46
	179	281	31	38	48
Net charge-offs	**57**	505	902	1,446	150
Additions charged to operations	**150**	500	750	1,750	500
Allowance purchased	**1,282**				
Balance at end of period	**$ 5,046**	$ 3,671	$ 3,676	$ 3,828	$ 3,524
Ratio of net charge-offs during the period to average loans outstanding during the period	**.02%**	.21%	.39%	.62%	.07%
Allowance for loan losses to average loans outstanding during the period	**1.82%**	1.50%	1.58%	1.64%	1.66%

It is the policy of management and the Corporation s Board of Directors to provide for losses on both identified and unidentified losses inherent in its loan portfolio. A provision for loan losses is charged to operations based upon an evaluation of the potential losses in the loan portfolio. This evaluation takes into account such factors as portfolio concentrations, delinquency, trends, trends of non-accrual and classified loans, economic conditions, and other relevant factors.

The loan review process which is conducted quarterly, is an integral part of our evaluation of the loan portfolio. A detailed quarterly analysis to determine the adequacy of the Corporation s allowance for loan losses is reviewed by our Board of Directors.

With our manageable level of net charge-offs and the additions to the reserve from our provision out of operations, the allowance for loan losses as a percentage of average loans amounted to 1.82% in 2007, 1.50% to 2006, and 1.58% in 2005.

Table 9 sets forth the allocation of the Bank s allowance for loan losses by loan category and the percentage of loans in each category to total loans receivable at the dates indicated. The portion of the allowance for loan losses allocated to each loan category does not represent the total available for future losses that may occur within the loan category, since the total loan loss allowance is a valuation reserve applicable to the entire loan portfolio.

Table 9 Allocation of Allowance for Loan Losses

	December 31,									
(Amounts in thousands)	**2007**	**%***	**2006**	**%***	**2005**	**%***	**2004**	**%***	**2003**	**%***
Commercial, financial, and agricultural	**$ 1,116**	**22.8**	$ 674	19.7	$ 906	25.2	$ 858	14.3	$ 775	15.4
Real estate - mortgage	**3,680**	**75.1**	2,613	76.1	2,521	70.2	2,594	77.1	2,106	72.6
Consumer and other loans	**103**	**2.1**	145	4.2	164	4.6	308	8.6	378	12.0
Unallocated	**147**	**N/A**	239	N/A	85	N/A	68	N/A	265	N/A
	$ 5,046	**100.0**	$ 3,671	100.0	$ 3,676	100.0	$ 3,828	100.0	$ 3,524	100.0

*Percentage of loans in each category to total loans.

NON-PERFORMING ASSETS

Table 10 details the Corporation s non-performing assets at the dates indicated.

Non-accrual loans are generally delinquent on which principal or interest is past-due approximately 90 days or more, depending upon the type of credit and the collateral. When a loan is placed on non-accrual status, any unpaid interest is charged against income. Restructured loans are loans where the borrower has been granted a concession in the interest rate or payment amount because of financial problems. Foreclosed assets held for sale represents property acquired through foreclosure, or considered to be an in-substance foreclosure.

The total of non-performing assets increased to $3,458,000 as of December 31, 2007, as compared to $2,880,000 as of December 31, 2006. Non-accrual and restructured loans increased to $3,208,000 in 2007 from $1,704,000 in 2006. Foreclosed assets increased to $65,000 in 2007 from $41,000 in 2006. Loans past-due 90 days or more and still accruing decreased to $185,000 in 2007 from $1,135,000 in 2006. During the fourth quarter of 2007, a borrower with two loans amounting to $1,758,000 and secured by commercial real estate was placed on non-accrual. The loans are well collateralized and repayment is expected from the sale of the commercial real estate. A specific allocation for potential loss on the two loans secured by commercial real estate has been identified in our allowance for loan losses. Our allowance for loan losses to total non-performing assets increased to 145.9% in 2007 from 127.5% in 2006. While asset quality is a priority, the corporation continues to retain an independent outside loan review consultant to closely tract and monitor overall loan quality.

Improving loan quality is a priority, and we actively work with borrowers to resolve credit problems. Excluding the assets disclosed in Table 10, management is not aware of any information about borrowers possible credit problems, which cause serious doubt as to their ability to comply with present loan repayment terms.

Should the economic climate no longer continue to be stable or begin to deteriorate, borrowers may experience difficulty, and the level of non-performing loans and assets, charge-offs and delinquencies could rise and possibly require additional increases in our allowance for loan losses.

In addition, regulatory authorities, as an integral part of their examinations, periodically review the allowance for possible loan and lease losses. They may require additions to allowances based upon their judgements about information available to them at the time of examination.

Interest income received on non-performing loans in 2007 and 2006 was $144,000 and $14,000, respectively. Interest income, which would have been recorded on these loans under the original terms in 2007 and 2006 was $175,000 and $133,000, respectively. At December 31, 2006, the Corporation had no outstanding commitments to advance additional funds with respect to these non-performing loans.

A concentration of credit exists when the total amount of loans to borrowers, who are engaged in similar activities that are similarly impacted by economic or other conditions, exceed 10% of total loans. As of December 31, 2007, 2006 and 2005, management is of the opinion that there were no loan concentrations exceeding 10% of total loans.

Table 10 Non-Performing Assets

(Amounts in thousands)	December 31, 2007	2006	2005	2004	2003
Non-accrual and restructured loans	**$ 3,208**	$ 1,704	$ 2,069	$ 3,405	$ 735
Foreclosed assets	**65**	41	397	6	
Loans past-due 90 days or more and still accruing	**185**	1,135	64	69	33
Total non-performing assets	**$ 3,458**	$ 2,880	$ 2,530	$ 3,480	$ 768
Non-performing assets to period-end loans and foreclosed assets	**0.92%**	1.14%	1.08%	1.49%	0.34%
Total non-performing assets to total assets	**0.51%**	0.55%	0.49%	0.70%	0.16%
Total allowance for loan losses to total non-performing assets	**145.9%**	127.5%	145.3%	110.0%	458.9%

Real estate mortgages comprise 85.4% of the loan portfolio as of December 31, 2007, up from 83.4% in 2006. Real estate mortgages consist of both residential and commercial real estate loans. The real estate loan portfolio is well diversified in terms of borrowers, collateral, interest rates, and maturities. Also, the real estate loan portfolio has a mix of both fixed rate and adjustable rate mortgages. The real estate loans are concentrated primarily in our marketing area and are subject to risks associated with the local economy.

DEPOSITS AND OTHER BORROWED FUNDS

Consumer and commercial retail deposits are attracted primarily by First Keystone s subsidiary bank s fourteen full service office locations. The Bank offers a broad selection of deposit products and continually evaluates its interest rates and fees on deposit products. The Bank regularly reviews competing financial institutions interest rates along with prevailing market rates, especially when establishing interest rates on certificates of deposit.

Deposits increased by $109,021,000, or a 28.4% increase when comparing December 31, 2007 to December 31, 2006. This increase compares to a deposit increase of 5.9% in 2006 and an increase of 1.4% in 2005. Much of the deposit increase in 2007 relates to the Pocono Community Bank acquisition.

During 2007, the Corporation experienced a deposit increase in both non-interest bearing and interest bearing deposits. Non-interest bearing deposits amounted to $58,844,000 as of December 31, 2007, an increase of $17,483,000 or 42.3% over 2006. Interest bearing deposits amounted to $434,197,000 as of December 31, 2007, an increase of $91,538,000, or 26.7% over 2006.

During 2007, the Corporation increased its reliance on borrowings. Short-term borrowings amounted to $47,349,000 as of year-end 2007, an increase of $19,170,000 from 2006. Long-term borrowings increased $8,640,000 in 2007 to $66,175,000 as of December 31, 2007. Total borrowings were $113,524,000 as of December 31, 2007, compared to $85,714,000 on December 31, 2006. Short-term borrowings are comprised of federal funds purchased, securities sold under agreements to repurchase, U.S. Treasury demand notes, and short-term borrowings from the Federal Home Loan Bank (FHLB).

Long-term borrowings are typically FHLB term borrowings with a maturity of one year or more. Short-term borrowings from the Federal Home Loan Bank are commonly used to offset seasonal fluctuations in deposits. In connection with FHLB borrowings and securities sold under agreements to repurchase, the Corporation maintains certain eligible assets as collateral.

CAPITAL STRENGTH

Normal increases in capital are generated by net income, less cash dividends paid out. Also, the net unrealized gains or losses on investment securities available-for-sale, net of taxes, referred to as accumulated other comprehensive income may increase or decrease total equity capital. The total net increase in capital was $17,537,000 in 2007 after an increase of $56,000 in 2006. Much of the increase in equity capital in 2007 relates to the Pocono Community Bank acquisition. The accumulated other comprehensive income amounted to $(166,000) in 2007 and $(126,000) in 2006. One factor which also decreased total equity capital in 2007 and 2006 relates to stock repurchase. The Corporation had 247,691 shares of common stock as of December 31, 2007, and 228,900 shares in 2006, at a cost of $6,242,000 and $5,910,000, respectively as treasury stock.

Return on equity (ROE) is computed by dividing net income by average stockholders equity. This ratio was 10.48% for 2007, 11.76% for 2006, and 12.65% for 2005. Refer to Performance Ratios on page 14 Selected Financial Data for a more expanded listing of the ROE.

Adequate capitalization of banks and bank holding companies is required and monitored by regulatory authorities. Table 11 reflects risk-based capital ratios and the leverage ratio for our Corporation and Bank. The Corporation s leverage ratio was 7.96% at December 31, 2007, and 9.94% at December 31, 2006.

The Corporation has consistently maintained regulatory capital ratios at or above the well capitalized standards. For additional information on capital ratios, see page 26 - Corporations Capital Ratios or Table 11 Capital Ratios. The risk-based capital ratios for both the Corporation and the Bank, remained very strong. The risk-based capital calculation assigns various levels of risk to different categories of bank assets, requiring higher levels of capital for assets with more risk. Also measured in the risk-based capital ratio is credit risk exposure associated with off-balance sheet contracts and commitments.

Table 11 Capital Ratios

	December 31, 2007		December 31, 2006	
	Corporation	Bank	Corporation	Bank
Risk-Based Capital:				
Tier I risk-based capital ratio	**11.86%**	**13.10%**	17.45%	16.17%
Total risk-based capital ratio (Tier 1 and Tier 2)	**13.06%**	**14.28%**	18.82%	17.41%
Leverage Ratio:				
Tier I capital to average assets	**7.96%**	**9.00%**	9.94%	9.19%

LIQUIDITY MANAGEMENT

Effective liquidity management ensures that the cash flow requirements of depositors and borrowers, as well as the operating cash needs of the Corporation, are met.

Liquidity is needed to provide the funding requirements of depositors withdrawals, loan growth, and other operational needs. Asset liquidity is provided by investment securities maturing in one year or less, other short-term investments, federal funds sold, and cash and due from banks. At year-end 2007, cash and due from banks and interest-bearing deposits in other banks totaled $9,975,000 as compared to $10,188,000 at year-end 2006. Additionally, maturing loans and repayment of loans are another source of asset liquidity.

Liability liquidity is accomplished by maintaining a core deposit base, acquired by attracting new deposits and retaining maturing deposits. Also, short-term borrowings provide funds to meet liquidity.

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

Finally, the Corporation s subsidiary bank does have access to funds on a short-term basis from the Federal Reserve Bank discount window. Also, Fed funds can be purchased by means of a borrowing line at the Atlantic Central Bankers Bank. The Corporation has indirect access to the capital markets through its membership in the Federal Home Loan Bank. Advances on borrowings, both short-term and long-term, are available to help address any liquidity needs.

FORWARD LOOKING STATEMENTS

The sections that follow, Market Risk and Asset/Liability Management contain certain forward looking statements. These forward looking statements involve significant risks and uncertainties, including changes in economic and financial market conditions. Although First Keystone Corporation believes that the expectations reflected in such forward looking statements are reasonable, actual results may differ materially.

MARKET RISK

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

Increases in the level of interest rates also may adversely affect the fair value of the Corporation s securities and other earning assets. Generally, the fair value of fixed-rate instruments fluctuates inversely with changes in interest rates. As a result, increases in interest rates could result in decreases in the fair value of the Corporation s interest-earning assets, which could adversely affect the Corporation s results of operations if sold, or, in the case of interest earning assets classified as available for sale, the Corporation s stockholders equity, if retained. Under The Financial Accounting Standards Board (FASB) Statement 115, changes in the unrealized gains and losses, net of taxes, on securities classified as available for sale will be reflected in the Corporation s stockholders equity. The Corporation does not own any trading assets.

Asset/Liability Management

The principal objective of asset liability management is to manage the sensitivity of the net interest margin to potential movements in interest rates and to enhance profitability through returns from managed levels of interest rate risk. The Corporation actively manages the interest rate sensitivity of its assets and liabilities. Table 12 presents an interest sensitivity analysis of assets and liabilities as of December 31, 2007. Several techniques are used for measuring interest rate sensitivity. Interest rate risk arises from the mismatches in the repricing of assets and liabilities within a given time period, referred to as a rate sensitivity gap. If more assets than liabilities mature or reprice within the time frame, the Corporation is asset sensitive. This position would contribute positively to net interest income in a rising rate environment. Conversely, if more liabilities mature or reprice, the Corporation is liability sensitive. This position would contribute positively to net interest income in a falling rate environment.

Limitations of interest rate sensitivity gap analysis as illustrated in Table 12 include: a) assets and liabilities which contractually reprice within the same period may not, in fact, reprice at the same time or to the same extent; b) changes in market interest rates do not affect all assets and liabilities to the same extent or at the same time, and c) interest rate sensitivity gaps reflect the Corporation s position on a single day (December 31, 2007 in the case of the following schedule) while the Corporation continually adjusts its interest sensitivity throughout the year. The Corporation s cumulative gap at one year indicates the Corporation is liability sensitive.

Table 12 Interest Rate Sensitivity Analysis

			December 31, 2007		
(Amounts in thousands)	**One Year**	**1 - 5 Years**	**Beyond 5 Years**	**Not Rate Sensitive**	**Total**
Assets	**$ 238,206**	**$ 211,253**	**$ 180,738**	**$ 51,010**	**$ 681,207**
Liabilities/Stockholders Equity	**266,204**	**248,617**	**92,304**	**74,082**	**681,207**
Interest Rate Sensitivity Gap	**(27,998)**	**(37,364)**	**88,434**	**(23,072)**	
Cumulative Gap	**(27,998)**	**(65,362)**	**23,072**		

Earnings at Risk

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

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

Earnings Simulation Modeling

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

Earnings simulation modeling is the primary mechanism used in assessing the impact of changes in interest rates on net interest income. The model reflects management s assumptions related to asset yields and rates paid on liabilities, deposit sensitivity, size and composition of the balance sheet. The assumptions are based on what management believes at that time to be the most likely interest rate environment. Earnings at risk is the change in net interest income from a base case scenario under an increase and decrease of 200 basis points in the interest rate earnings simulation model.

Table 13 presents an analysis of the changes in net-interest income and net present value of the balance sheet resulting from an increase or decrease of two percentage points (200 basis points) in the level of interest rates. The calculated estimates of change in net interest income and net present value of the balance sheet are compared to current limits approved by ALCO and the Board of Directors. The earnings simulation model projects net-interest income would decrease by approximately 6.5% if rates fell by two percentage points over one year. The model projects a decrease of approximately 15.0% in net-interest income if rates rise by two percentage points over one year. Both of these forecasts are within the one year policy guidelines.

Net Present Value Estimation

The net present value measures economic value at risk and is used for helping to determine levels of risk at a point in time present in the balance sheet that might not be taken into account in the earnings simulation model. The net present value of the balance sheet is defined as the discounted present value of asset cash flows minus the discounted present value of liability cash flows. At year-end 2007, a 200 basis point immediate decrease in rates is estimated to increase net present value by 6.0%. Additionally, net present value is projected to decrease by 46.0% if rates increase immediately by 200 basis points. The +2% scenario slightly exceeds policy limits of 40%.

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

Table 13 Effect of Change in Interest Rates

	Projected Change
Effect on Net Interest Income	
1-year Net Income simulation Projection	
200 bp Shock vs Stable Rate	(6.5)%
+200 bp Shock vs Stable Rate	(15.0)%
Effect on Net Present Value of Balance Sheet	
Static Net Present Value Change	
200 bp Shock vs Stable Rate	6.0%
+200 bp Shock vs Stable Rate	(46.0)%

MARKET PRICE/DIVIDEND HISTORY

As of December 31, 2007, the corporation had 5,440,076 shares of $2.00 par value common stock outstanding held by shareholders of record. First Keystone Corporation s common stock is quoted on the Over The Counter (OTC) Bulletin Board under the symbol FKYS.OB .

Table 14 reports the highest and lowest per share prices known to the Corporation and the dividends paid during the periods indicated. The market prices and dividend paid have been adjusted to reflect a 5% stock dividend paid December 5, 2006. These prices do not necessarily reflect any dealer or retail markup, markdown or commission.

Table 14 Market Price/Dividend History

	2007		2006		2005	
	Common Stock High/Low	Dividends Paid	Common Stock High/Low	Dividends Paid	Common Stock High/Low	Dividends Paid
First Quarter	**$19.00/$17.50**	**$ .22**	$19.91/$18.57	$ .21	$22.76/$20.48	$ .19
Second Quarter	**$21.75/$17.90**	**.22**	$19.05/$17.43	.21	$20.95/$18.81	.19
Third Quarter	**$19.25/$17.00**	**.22**	$19.33/$16.81	.21	$21.67/$19.14	.19
Fourth Quarter	**$18.25/$15.80**	**.22**	$19.20/$17.29	.22	$20.81/$19.05	.21

Table 15 Quarterly Results of Operations (Unaudited)

(Amounts in thousands, except per share)

	Three Months Ended			
2007	**March 31**	**June 30**	**September 30**	**December 31**
Interest income	**$ 7,407**	**$ 7,550**	**$ 7,830**	**$ 9,113**
Interest expense	**4,086**	**4,175**	**4,469**	**5,056**
Net interest income	**$ 3,321**	**$ 3,375**	**$ 3,361**	**$ 4,057**
Provision for loan losses	**50**	**75**	**25**	**0**
Other non-interest income	**953**	**1,042**	**973**	**1,201**
Non-interest expense	**2,491**	**2,669**	**2,430**	**3,025**
Income before income taxes	**$ 1,733**	**$ 1,673**	**$ 1,879**	**$ 2,233**
Income taxes	**299**			