iShares Silver Trust
Form 10-Q
May 07, 2010
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

x **Quarterly report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**
For the quarterly period ended March 31, 2010

¨ **Transition report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**
For the transition period from ______ to ______

Commission file number: 001-32863

iShares® Silver Trust

(Exact name of registrant as specified in its charter)

New York	**13-7474456**
(State or other jurisdiction of incorporation or organization)	**(I.R.S. Employer Identification No.)**

c/o BlackRock Asset Management International Inc.

400 Howard Street

San Francisco, California 94105

Attn: Product Management Team

Intermediary Investor and Exchange-Traded Products Department

(Address of principal executive offices)

(415) 670-2000

(Registrant s telephone number, including area code)

N/A

(Former name, former address and former fiscal year, if changed since last report)

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes ¨ No ¨

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

Large accelerated filer	x	Accelerated filer	¨
Non-accelerated filer (Do not check if a smaller reporting company)	¨	Smaller reporting company	¨

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

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Part I Financial Information

Item 1. Financial Statements

iShares® Silver Trust

Balance Sheets

At March 31, 2010 (Unaudited) and December 31, 2009

(Dollar amounts in $000 s)	March 31, 2010	December 31, 2009
ASSETS		
Current assets		
Silver bullion inventory (fair value of $5,185,932 and $5,185,449, respectively)	$ 4,125,631	$ 4,210,142
Payable for capital shares redeemed	(27,127)	
TOTAL ASSETS	$ 4,098,504	$ 4,210,142
LIABILITIES, REDEEMABLE CAPITAL SHARES AND SHAREHOLDERS EQUITY (DEFICIT)		
Current liabilities		
Sponsor s fees payable	$ 2,177	$ 2,295
Total liabilities	2,177	2,295
Commitments and contingent liabilities (Note 5)		
Redeemable capital shares, no par value, unlimited amount authorized (at redemption value) 302,050,000 issued and outstanding at March 31, 2010 and 310,700,000 issued and outstanding at December 31, 2009	5,183,755	5,183,154
Shareholders equity (deficit)	(1,087,428)	(975,307)
TOTAL LIABILITIES, REDEEMABLE CAPITAL SHARES AND SHAREHOLDERS EQUITY (DEFICIT)	$ 4,098,504	$ 4,210,142

See notes to the financial statements.

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iShares® Silver Trust

Income Statements (Unaudited)

For the three months ended March 31, 2010 and 2009

(Dollar amounts in $000 s, except for per share amounts)	Three Months Ended March 31, 2010	Three Months Ended March 31, 2009
Revenue		
Proceeds from sales of silver to pay expenses	$ 6,400	$ 3,295
Cost of silver sold to pay expenses	(5,249)	(3,573)
Gain (loss) on sales of silver to pay expenses	1,151	(278)
Gain (loss) on silver distributed for the redemption of shares	53,427	(334)
Total gain (loss) on sales and distributions of silver	54,578	(612)
Market value recovery (Note 2B)		532,914
Total revenue	54,578	532,302
Expenses		
Sponsor s fees	(6,282)	(3,808)
Total expenses	(6,282)	(3,808)
NET INCOME	$ 48,296	$ 528,494
Net income per share	$ 0.16	$ 2.12
Weighted-average shares outstanding	307,343,333	249,623,333

See notes to the financial statements.

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iShares® Silver Trust

Statements of Changes in Shareholders Equity (Deficit)

For the three months ended March 31, 2010 (Unaudited)

and the year ended December 31, 2009

(Dollar amounts in $000 s)	Three Months Ended March 31, 2010	Year Ended December 31, 2009
Shareholders equity (deficit) - beginning of period	$ (975,307)	$
Net income	48,296	574,523
Adjustment of redeemable capital shares to redemption value	(160,417)	(1,549,830)
Shareholders equity (deficit) - end of period	$ (1,087,428)	$ (975,307)

See notes to the financial statements.

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iShares® Silver Trust

Statements of Cash Flows (Unaudited)

For the three months ended March 31, 2010 and 2009

(Dollar amounts in $000 s)	**Three Months Ended March 31, 2010**	**2009**
CASH FLOWS FROM OPERATING ACTIVITIES:		
Proceeds from sales of silver	$ 6,400	$ 3,295
Expenses Sponsor s fee paid	(6,400)	(3,295)
Net cash provided by operating activities		
Increase (decrease) in cash		
Cash, beginning of period		
Cash, end of period	$	$
RECONCILIATION OF NET INCOME TO NET CASH PROVIDED BY OPERATING ACTIVITIES:		
Net income	$ 48,296	$ 528,494
Adjustments to reconcile net income to net cash provided by operating activities:		
(Gain) loss on silver distributed for the redemption of shares	(53,427)	334
Cost of silver sold to pay expenses	5,249	3,573
Increase (decrease) in Sponsor s fees payable	(118)	513
Market value recovery (Note 2B)		(532,914)
Net cash provided by operating activities	$	$
Supplemental disclosure of non-cash information:		
Carrying value of silver received for creation of shares	$ 86,802	$ 730,272
Carrying value of silver distributed for redemption of shares, at average cost	$ (193,191)	$ (119,020)

See notes to the financial statements.

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iShares® Silver Trust

Notes to the Financial Statements (Unaudited)

March 31, 2010

1 - Organization

The iShares® Silver Trust (the Trust) was organized on April 21, 2006 as a New York trust. The trustee is The Bank of New York Mellon (the Trustee) and is responsible for the day to day administration of the Trust. The Trust s sponsor is BlackRock Asset Management International Inc. (the Sponsor), a Delaware corporation. The Trust is governed by the Depositary Trust Agreement (the Trust Agreement) executed at the time of organization of the Trust by the Trustee and the Sponsor.

The objective of the Trust is for the value of its shares to reflect, at any given time, the price of silver owned by the Trust at that time, less the Trust s expenses and liabilities. The Trust is designed to provide a vehicle for investors to own interests in silver bullion.

The accompanying unaudited financial statements were prepared in accordance with accounting principles generally accepted in the United States of America (U.S. GAAP) for interim financial information and with the instructions for Form 10-Q and the rules and regulations of the U.S. Securities and Exchange Commission (the SEC). In the opinion of management, all material adjustments, consisting only of normal recurring adjustments, considered necessary for a fair statement of the interim period financial statements have been made. Interim period results are not necessarily indicative of results for a full-year period. These financial statements and the notes thereto should be read in conjunction with the Trust s financial statements included in its Annual Report on Form 10-K for the year ended December 31, 2009 as filed with the SEC on February 26, 2010.

2 - Summary of Significant Accounting Policies

A. *Basis of Accounting*

The following is a summary of significant accounting policies consistently followed by the Trust in the preparation of its financial statements in conformity with U.S. GAAP. The preparation of financial statements in conformity with U.S. GAAP requires management to make certain estimates and assumptions that affect the reported amounts of assets and liabilities and disclosures of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenue and expenses during the reporting period. Actual results could differ from those estimates and these differences could be material.

B. *Silver Bullion*

JPMorgan Chase Bank N.A., acting through its London Branch (the Custodian), is responsible for safekeeping the silver owned by the Trust.

For financial statement purposes, the silver bullion held by the Trust is valued at the lower of cost or market, using the average cost method. Should the market value of the silver held be lower than its average cost during the interim periods of the same fiscal year, an adjustment of value below cost (market value reserve) is recorded by the Trust. Should the market value of the silver held increase subsequent to the market value reserve being recorded, a market value recovery is recorded by the Trust. Gain or loss on sales of silver bullion is calculated on a trade date basis. Fair value of the silver bullion is based on the price for an ounce of silver set each working day by three market making members of The London Bullion Market Association (The London Fix).

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The following table summarizes activity in silver bullion during the three months ended March 31, 2010 (all balances in 000 s):

	Ounces	Average Cost	Fair Value	Realized Gain (Loss)
Beginning balance	305,206.0	$ 4,210,142	$ 5,185,449	$
Silver contributed	5,495.5	86,802	86,802	
Silver distributed	(13,982.4)	(193,191)	(246,618)	53,427
Silver sold	(380.1)	(5,249)	(6,400)	1,151
Adjustment for realized gain			54,578	
Adjustment for unrealized gain on silver bullion			112,121	
Ending balance	296,339.0	$ 4,098,504	$ 5,185,932	$ 54,578

The following table summarizes activity in silver bullion for the year ended December 31, 2009 (all balances in 000 s):

	Ounces	Average Cost	Fair Value	Realized Gain (Loss)
Beginning balance	218,399.7	$ 2,356,533	$ 2,356,533	$
Silver contributed	108,877.6	1,575,673	1,575,673	
Silver distributed	(20,775.6)	(276,552)	(297,947)	21,395
Silver sold	(1,295.7)	(17,296)	(18,718)	1,422
Adjustment for realized gain			22,817	
Adjustment for unrealized gain on silver bullion			1,547,091	
Market value recovery		571,784		
Ending balance	305,206.0	$ 4,210,142	$ 5,185,449	$ 22,817

C. *Redeemable Capital Shares*

Shares of the Trust are classified as redeemable for balance sheet purposes, since they are subject to redemption. Trust shares are issued and redeemed continuously in aggregations of 50,000 shares in exchange for silver bullion rather than cash. Individual investors cannot purchase or redeem shares in direct transactions with the Trust. The Trust only transacts with registered broker-dealers eligible to settle securities transactions through the book-entry facilities of the Depository Trust Company and which have entered into a contractual arrangement with the Trust and the Sponsor governing, among other matters, the creation and redemption processes (such broker-dealers are the Authorized Participants). Holders of shares of the Trust may redeem their shares at any time acting through an Authorized Participant and in the prescribed aggregations of 50,000 shares; *provided,* that redemptions of shares may be suspended during any period while regular trading on NYSE Arca is suspended or restricted, or in which an emergency exists as a result of which delivery, disposal or evaluation of silver is not reasonably practicable.

The per-share amount of silver exchanged for a purchase or redemption is calculated daily by the Trustee, using The London Fix to calculate the silver amount in respect of any liabilities for which covering silver sales have not yet been made, and represents the per-share amount of silver held by the Trust, after giving effect to its liabilities, sales to cover expenses and liabilities and any losses that may have occurred.

When silver is exchanged in settlement of a redemption, it is considered a sale of silver for financial statement purposes.

Due to the expected continuing sales and redemption of capital stock and the three-day period for share settlement the Trust reflects capital shares sold as a receivable, rather than as contra equity. Shares redeemed are reflected as a contra asset on the trade date. Outstanding Trust shares are reflected at redemption value, which is the net asset value per share at the period ended date. Adjustments to redemption value are reflected in shareholders equity.

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Net asset value is computed by deducting all accrued fees, expenses and other liabilities of the Trust, including the Sponsor s fees, from the fair value of the silver bullion held by the Trust.

Activity in redeemable capital shares is as follows (all balances in 000 s):

	Three Months Ended March 31, 2010		Year Ended December 31, 2009	
	Shares	Amount	Shares	Amount
Beginning balance	310,700	$ 5,183,154	221,250	$ 2,355,598
Shares issued	5,600	86,802	110,550	1,575,673
Shares redeemed	(14,250)	(246,618)	(21,100)	(297,947)
Redemption value adjustment		160,417		1,549,830
Ending balance	302,050	$ 5,183,755	310,700	$ 5,183,154

D. *Federal Income Taxes*

The Trust is treated as a grantor trust for federal income tax purposes and, therefore, no provision for federal income taxes is required. Any interest and gains and losses are deemed passed through to the holders of shares of the Trust.

3 - Expenses

The Trust pays to the Sponsor a Sponsor s fee that accrues daily at an annualized rate equal to 0.50% of the adjusted daily net asset value of the Trust, paid monthly in arrears. The Sponsor has agreed to assume the following administrative and marketing expenses incurred by the Trust: the Trustee s fee, the Custodian s fee, NYSE Arca listing fees, SEC registration fees, printing and mailing costs, audit fees and expenses, and up to $100,000 per annum in legal fees and expenses.

4 - Related Parties

The Sponsor and the Trustee are considered to be related parties to the Trust. The Trustee s fee is paid by the Sponsor and is not a separate expense of the Trust.

5 - Indemnification

Under the Trust s organizational documents, the Sponsor is indemnified against liabilities or expenses it incurs without negligence, bad faith or willful misconduct on its part. The Trust s maximum exposure under these arrangements is unknown as this would involve future claims that may be made against the Trust that have not yet occurred.

6 - Concentration Risk

Substantially all of the Trust s assets are holdings of silver bullion, which creates a concentration risk associated with fluctuations in the price of silver. Accordingly, a decline in the price of silver will have an adverse effect on the value of the shares of the Trust. Factors that may have the effect of causing a decline in the price of silver include a change in economic conditions (such as a recession), an increase in the hedging activities of silver producers, and changes in the attitude towards silver of speculators, investors and other market participants.

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7 - Review for Subsequent Events

In connection with the preparation of the financial statements of the Trust as of and for the period ended March 31, 2010, management has evaluated the impact of all subsequent events through the date the financial statements were issued, and has determined that there were no subsequent events requiring adjustment or disclosure in the financial statements.

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Item 2. Management s Discussion and Analysis of Financial Condition and Results of Operations

This information should be read in conjunction with the financial statements and notes to the financial statements included in Item 1 of Part I of this Form 10-Q. The discussion and analysis that follows may contain statements that relate to future events or future performance. In some cases, such forward-looking statements can be identified by terminology such as may, should, expect, plan, anticipate, believe, estimate, predict, potential or the negative of these terms or other comparable terminology. Neither the Sponsor, nor any other person assumes responsibility for the accuracy or completeness of forward-looking statements. Neither the Trust nor the Sponsor is under a duty to update any of the forward-looking statements to conform such statements to actual results or to a change in the Sponsor s expectations or predictions.

Introduction

The iShares® Silver Trust (the Trust) is a grantor trust formed under the laws of the State of New York. The Trust does not have any officers, directors, or employees, and is administered by The Bank of New York Mellon (the Trustee) acting as trustee pursuant to the Depositary Trust Agreement (Trust Agreement) between the Trustee and BlackRock Asset Management International Inc., the sponsor of the Trust (the Sponsor) (formerly Barclays Global Investors International Inc.). The Trust issues shares representing fractional undivided beneficial interests in its net assets. The assets of the Trust consist primarily of silver bullion held by a custodian as an agent of the Trust and responsible only to the Trustee.

The Trust is a passive investment vehicle and the objective of the Trust is merely for the value of each share to approximately reflect, at any given time, the price of silver owned by the Trust less the Trust s liabilities (anticipated to be principally for accrued operating expenses) divided by the number of outstanding shares. The Trust does not engage in any activities designed to obtain a profit from, or ameliorate losses caused by, changes in the price of silver.

The Trust issues and redeems shares only in exchange for silver, only in aggregations of 50,000 shares or integral multiples thereof (each, a Basket), and only in transactions with registered broker-dealers that have previously entered into an agreement with the Trust governing the terms and conditions of such issuance (such dealers, the Authorized Participants). A list of current Authorized Participants is available from the Sponsor or the Trustee.

Shares of the Trust trade on NYSE Arca under the symbol SLV.

Valuation of Silver; Computation of Net Asset Value

On each business day, as soon as practicable after 4:00 p.m. (New York time), the Trustee evaluates the silver held by the Trust and determines the net asset value of the Trust and the net asset value per share. The Trustee values the silver held by the Trust using the announced price for an ounce of silver set each working day by three market making members of The London Bullion Market Association (The London Fix). Having valued the silver held by the Trust, the Trustee then subtracts all accrued fees (other than the fees to be computed by reference to the value of the Trust or its assets), expenses and other liabilities of the Trust from the value of the silver and other assets of the Trust. The result is the adjusted net asset value of the Trust, which is used to compute all fees (including the Sponsor s fee), which are calculated from the value of the Trust s assets. To determine the net asset value of the Trust, the Trustee subtracts from the adjusted net asset value of the Trust the amount of accrued fees computed from the value of the Trust s assets. The Trustee also computes the net asset value per share, by dividing the net asset value of the Trust by the number of shares outstanding on the date the computation is made.

Liquidity

The Trust is not aware of any trends, demands, conditions or events that are reasonably likely to result in material changes to its liquidity needs. In exchange for a fee, the Sponsor has agreed to assume most of the expenses incurred by the Trust. As a result, the only ordinary expense of the Trust during the period covered by this report was the Sponsor s fee. The Trust s only source of liquidity is its sales of silver.

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Critical Accounting Policies

The financial statements and accompanying notes are prepared in accordance with accounting principles generally accepted in the United States of America. The preparation of these financial statements relies on estimates and assumptions that impact the Trust s financial position and results of operations. These estimates and assumptions affect the Trust s application of accounting policies. Below we describe the valuation of silver bullion, a critical accounting policy that we believe is important to understanding our results of operations and financial position. In addition, please refer to Note 2 to the financial statements for further discussion of our accounting policies.

Valuation of Silver Bullion

Silver bullion held by the Trust is recorded at the lower of cost or market. For purposes of this calculation, market values are based on The London Fix. Should the market value of the silver bullion held be lower than its average cost, an adjustment of value below cost (market value reserve) is recorded by the Trust and The London Fix is used as the value for financial statement purposes. Should the market value of the silver held increase subsequent to the market value reserve being recorded, a market value recovery is recorded by the Trust. As indicated above, The London Fix is also used to value silver bullion held for purposes of calculating the net asset value of the Trust, which in turn is used for the calculation of the redemption value of outstanding Trust shares.

There are other indicators of the value of silver bullion that are available that could be different than that chosen by the Trust. The London Fix is used since it is commonly used by the U.S. silver market as an indicator of the value of silver, and is required by the Trust Agreement. The use of an indicator of value of silver bullion other than The London Fix could result in materially different fair value pricing of the silver in the Trust, and as such, could result in different lower of cost or market adjustments or in different redemption value adjustments of the outstanding redeemable capital shares.

Results of Operations

The Quarter Ended March 31, 2010

The Trust s net asset value grew from $5,183,153,950 at December 31, 2009 to $5,183,755,134 at March 31, 2010, a 0.01% increase. The increase in the Trust s net asset value resulted primarily from an increase in The London Fix price, which rose 3.00% from $16.99 at December 31, 2009 to $17.50 at March 31, 2010. The increase in the Trust s net asset value was partially offset by a decrease in outstanding shares, which fell from 310,700,000 shares at December 31, 2009 to 302,050,000 shares at March 31, 2010, a consequence of 5,600,000 shares (112 Baskets) being created and 14,250,000 shares (285 Baskets) being redeemed during the quarter.

The 3.00% rise in the London Fix price also directly related to the 2.88% increase in the Trust s net asset value per share from $16.68 at December 31, 2009 to $17.16 at March 31, 2010.

The Trust s net asset value per share increased slightly less than the price of silver on a percentage basis due to the Sponsor s fees, which were $6,281,756 for the quarter, or 0.12% of the Trust s average weighted assets of $5,094,965,443 during the quarter. The net asset value per share of $18.50 on January 11, 2010 was the highest during the quarter, compared with a low during the quarter of $14.86 on February 8, 2010. The net asset value of the Trust is obtained by subtracting the Trust s expenses and liabilities on any day from the value of the silver owned by the Trust on that day; the net asset value per share is obtained by dividing the net asset value of the Trust on a given day by the number of shares outstanding on that day.

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Net income for the quarter ended March 31, 2010 was $48,296,425, resulting from a net gain of $1,151,092 on the sale of silver to pay expenses, a net gain of $53,427,089 on silver distributed for the redemption of shares offset by Sponsor s fees of $6,281,756. Other than the Sponsor s fees the Trust had no expenses during the quarter.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

Not applicable.

Item 4. Controls and Procedures

The duly authorized officers of the Sponsor performing functions equivalent to those a principal executive officer and principal financial officer of the Trust would perform if the Trust had any officers, and with the participating of the Trustee, have evaluated the effectiveness of the Trust s disclosure controls and procedures, and have concluded that the disclosure controls and procedures of the Trust have been effective as of the end of the period covered by this quarterly report.

There were no changes in the Trust s internal control over financial reporting that occurred during the period covered by this report that have materially affected, or are reasonably likely to materially affect, the Trust s internal control over financial reporting.

Item 4T. Controls and Procedures

Not applicable.

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Part II Other Information

Item 1. Legal Proceedings

None.

Item 1A. Risk Factors

There have been no material changes to the Risk Factors last reported under Part I, Item 1A of the registrant s Annual Report on Form 10-K for the year ended December 31, 2009, filed with the Securities and Exchange Commission on February 26, 2010.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

a) None.

b) Not applicable.

c) 285 Baskets (14,250,000 shares) were redeemed during the quarter ended March 31, 2010.

Period	Total Number of Shares Redeemed	Average Ounces of Silver Per Share
01/01/10 to 01/31/10	5,850,000	0.9817
02/01/10 to 02/28/10		
03/01/10 to 03/31/10	8,400,000	0.9809
Total	14,250,000	0.9812

Item 3. Defaults Upon Senior Securities

None.

Item 5. Other Information

None.

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Item 6. Exhibits

Exhibit No.	Description
4.1	Depositary Trust Agreement is incorporated by reference to Exhibit 4.1 filed with Registration Statement No. 333-156506 on December 8, 2008
4.2	First Amendment to Depositary Trust Agreement is incorporated by reference to Exhibit 4.1 filed with Current Report on Form 8-K on December 2, 2009
4.3	Standard Terms for Authorized Participant Agreements is incorporated by reference to Exhibit 4.2 filed with Registration Statement No. 333-156506 on December 30, 2008
10.1	Custodian Agreement is incorporated by reference to Exhibit 10.1 filed with Registration Statement No. 333-156506 on December 30, 2008
10.2	Sub-license Agreement is incorporated by reference to Exhibit 10.2 filed with Registration Statement No. 333-156506 on December 30, 2008
10.3	Amendment No. 1 to Custodian Agreement is incorporated by reference to Exhibit 10.3 filed with Registration Statement No. 333-137621 on September 27, 2006
10.4	Second Amendment to Custodian Agreement is incorporated by reference to Exhibit 10.1 filed with Current Report on Form 8-K on February 10, 2010
31.1	Certification by Principal Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
31.2	Certification by Principal Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
32.1	Certification by Principal Executive Officer Pursuant to 18 U.S.C. Section 1350, As Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
32.2	Certification by Principal Financial Officer Pursuant to 18 U.S.C. Section 1350, As Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

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SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned in the capacities* indicated thereunto duly authorized.

BlackRock Asset Management International Inc.

Sponsor of the iShares® Silver Trust (Registrant)

/s/ Michael A. Latham
Michael A. Latham

Chief Executive Officer

(Principal executive officer)
Date: May 7, 2010

/s/ Geoffrey D. Flynn
Geoffrey D. Flynn

Chief Financial Officer

(Principal financial and accounting officer)
Date: May 7, 2010

* The Registrant is a trust and the persons are signing in their capacities as officers of BlackRock Asset Management International Inc., the Sponsor of the Registrant.

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The committee reviewed with J.H. Williams & Co., LLP, who are responsible for expressing an opinion on the conformity of those audited financial statements with generally accepted accounting principles, their judgments as to the quality, not just the acceptability, of the Corporation’s accounting principles and such other matters as are required to be discussed with the committee under generally accepted auditing standards. In addition, the committee has discussed with J.H. Williams & Co., LLP, their independence from management and the Corporation including the matters in written disclosures required by the statement on Auditing Standards No. 61, as amended, as adopted by the Public Company Accounting Oversight Board in Rule 3200T and considered the compatibility of non-audit services with the accountants’ independence.

The committee discussed the overall scope and plans for their audits with the Corporation's internal auditors and J.H. Williams & Co., LLP. The committee meets with the internal auditors and J.H. Williams & Co., LLP, with and without management present, to discuss the results of their examinations, their evaluations of the Corporation's internal controls and the overall quality of the Corporation's financial reporting. The Corporation believes that it has established appropriate policies and procedures to comply with requirements of the Sarbanes-Oxley Act of 2002. The committee held 4 meetings during fiscal year 2013.

The committee, among other things, discussed with J.H. Williams & Co., LLP matters relating to their independence, including their written disclosures made to the committee and their letter as required by applicable requirements of the Public Company Accounting Oversight Board regarding their communications with the Audit Committee concerning independence.

In reliance on the reviews and discussions referred to above, the committee recommended to the Board (and the Board has approved) that the audited financial statements be included in the Annual Report on Form 10-K for the year ended December 31, 2013 for filing with the SEC.

The committee and the Board have approved the selection of BDO USA, LLP as the Corporation's independent accountants for 2014 as detailed in Proposal No. 2: Ratification of Independent Registered Public Accounting Firm.

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Aggregate fees billed to the Corporation and the Bank by J.H. Williams & Co., LLP for services rendered during the years ended December 31, 2013 and 2012 were as follows:

	Year Ended December 31, 2013	2012
Audit fees[1]	$ 107,000	$ 106,908
Tax fees[2]	10,000	10,000
Total	$ 117,000	$ 116,908

[1]Audit Fees include fees billed for professional services rendered for the audit of annual financial statement and fees billed for the review of financial statements included in the Corporation's Forms 10-Q or services that are normally provided by J.H. Williams & Co., LLP in connection with statutory and regulatory filings or engagements.

[2]Tax Fees include fees billed for professional services rendered by J.H. Williams & Co., LLP for tax compliance. These services include preparation of Federal and State Annual Tax Returns for the Corporation and the Bank.

Audit Committee Pre-Approval of Audit and Permissible Non-Audit Services

The Audit Committee pre-approves all audit and permissible non-audit services provided to the Corporation. J.H. Williams & Co., LLP served as the Corporation's independent accountants for the year 2013. These services may include audit services, audit related services, tax services, and other services. The Audit Committee has adopted a policy for the pre-approval of services provided by the independent accountants. Under the policy, pre-approval is generally provided for up to one year and any pre-approval is detailed as to the particular service or category of services and is subject to a specific Board approved budget. In addition, the Audit Committee may also pre-approve particular services on a case by case basis. For each proposed service, the independent accountant is required to provide a detailed engagement letter.

The committee is comprised of four directors, all of whom are considered "independent" as defined by SEC Rules and NASDAQ listing standards, including Mr. Bazewicz as of October 1, 2013. The Board has determined that no member of the committee has a relationship with the Corporation that should interfere with his independence from the Corporation or its management.

The foregoing report has been furnished by the current members of the committee.

Members of the Audit Committee

David R. Saracino, Chairman
J. Gerald Bazewicz
Don E. Bower
Jerome F. Fabian

COMPENSATION DISCUSSION AND ANALYSIS

Introduction

The Board serves as the Compensation Committee for the Bank and develops the Bank's and the Corporation's executive compensation policy. The Board also determines the named executive officers' individual compensation. For the year 2013, the named executive officers were Matthew P. Prosseda, Kevin L. Miller, Diane C.A. Rosler, Elaine A. Woodland, and James S. Szewc. Mr. Miller resigned from the Corporation and the Bank on January 3, 2014.

Compensation Objectives and Program Design

For the fiscal year 2013, executive compensation included base salary, the opportunity for cash bonuses and the ability to participate in the Bank's health and welfare plans and the Bank's retirement plan.

The compensation program is designed to reward the named executive officers based on their level of assigned management responsibilities and individual performance levels.

The basic mission of the Corporation's executive compensation policy is to provide executives with a competitive compensation package that attracts and retains qualified executives while placing a portion of total pay at risk. The at risk element of compensation, the Management Incentive Compensation Plan, may have no value or may be worth less than the target value if goals are not met.

Executive Officers' Role in Determining Compensation

The Board, acting as the Compensation Committee, considers information provided by the Chief Executive Officer in determining the appropriate level of compensation for other named executive officers. Individual performance objectives are set by the Chief Executive Officer and a year-end appraisal on each named executive officer prepared by the Chief Executive Officer is reviewed by the Board. No named executive officer other than the Chief Executive Officer attends those portions of the Board meetings during which the performance of the other named executive officers is evaluated or their compensation is being determined.

The Chief Executive Officer is not present during the Compensation Committee's discussion of his performance and compensation.

Compensation Consultant

In 2013, a compensation consultant did not play a role in setting compensation or advising on specific compensation. The Compensation Committee reviewed the L. R. Webber Associates, Inc.'s 2013 Salary/Benefits for Financial Institutions Survey ("the Survey") to acquaint itself with current trends and practices in compensation.

Benchmarking

The Compensation Committee reviewed the data contained in the Survey. The Survey provides information in ranges by job position including certain executives. The peer group of financial institutions chosen by the Board for purposes of making a comparative analysis of executive compensation does include some of the same financial institutions incorporated in the peer group established to compare shareholder returns as indicated in the performance graph included in the Annual Report on Form 10-K.

The financial institutions chosen for the Survey included seventeen banks with assets generally between $600 million and $1 billion with headquarters located in Northeastern and Central Pennsylvania. They included:

- Citizens and Northern Bank (Wellsboro)
- Dime Bank (Honesdale)
- Ephrata National Bank (Ephrata)
- ESSA Bank & Trust (Stroudsburg)
- First Citizens Community Bank (Mansfield)
- First Columbia Bank and Trust Co. (Bloomsburg)
- First National Community Bank (Dunmore)
- Jersey Shore State Bank (Williamsport)
- Mid Penn Bank (Millersburg)
- Mifflinburg Bank and Trust Company (Mifflinburg)
- Muncy Bank and Trust Company (Muncy)
- National Penn Bank (Scranton)
- Northumberland National Bank (Northumberland)
- Penn Security Bank & Trust (Scranton)
- Peoples Neighborhood Bank (Hallstead)
- Peoples State Bank of Wyalusing (Wyalusing)
- Turbotville National Bank (Turbotville)

After reviewing the base salaries and benefits provided in the Survey, no adjustments to compensation were made in 2013, other than the normal annual salary increases. The goal of the Corporation is to compensate at approximately the average range mid-point for each job classification with the at risk portion of compensation to reward favorable overall bank earnings performance. The named executive officer positions were reviewed and three of the five fall below the mid-point range.

Shareholder Vote

The Compensation Committee reviewed and considered the shareholder response to the Say-On-Pay Vote at the 2011 Annual Meeting. For 2013, the Compensation Committee acknowledged and considered the shareholders' approval of the Corporation's and Bank's compensation policies and did not make any adjustments thereto.

Base Salary

The executive compensation established by the Compensation Committee is based upon its overall subjective assessment of the value of the services provided by each named executive officer with consideration given to performance factors and peer group compensation information.

For the base salary paid to named executive officers other than the Chief Executive Officer, the Compensation Committee considers information provided by the Chief Executive Officer as to each executive officer's level of individual performance, contribution to the organization, scope of responsibilities, salary history and general market levels gathered from the Survey.

For the base salary paid to the Chief Executive Officer, the Compensation Committee, with the Chief Executive Officer not being present, considers his performance level, the results of management decisions made by him and the earnings of the organization. The Compensation Committee reviews the return on assets and return on equity when making the subjective determination of whether or not the Chief Executive Officer's base pay should be at the median, below the median, or above the median provided in the compensation survey. No particular weight is assigned to any of the foregoing individual performance factors and no specific performance targets are used in determining whether an increase in base salary is warranted.

Decisions regarding base salary are made without consideration of other forms of compensation provided. Bonuses are intended to provide additional incentive to the named executive officers to achieve a higher level of success. Adjusting the base salary to correspond with the amount of the bonuses would defeat the purpose of having at risk compensation.

Cash Bonuses

The purpose of the Management Incentive Compensation Plan (the "Plan") is to provide incentives and awards to top management employees who, through high levels of performance, contribute to the success and profitability of the bank. Participation in the Plan is limited to the executive management team. This management team includes the following functional job titles: Chief Executive Officer, Chief Operating Officer, Senior Vice President and Chief Financial Officer, Executive Vice President and Director of Lending and effective January 1, 2013, the Vice President and Senior Trust Officer. The management incentive pool created after the achievement of a required budget net income is distributed to the executive management team as follows:

Chief Executive Officer	40	%
Chief Operating Officer	20	%
Senior Vice President and Chief Financial Officer	8	%
Executive Vice President and Director of Lending	8	%
Vice President and Senior Trust Officer	8	%

The Plan serves as a short-term incentive that aligns executive pay with the annual performance of the Corporation and is earned through the achievement of overall annual earnings objectives. It aligns management's interests with those of the shareholders because, generally, the higher the net income for the year, the larger the bonuses paid to management. The Plan is also designed to support organizational objectives and financial goals, as defined by the Bank's Strategic and Financial Plans, by making available additional, variable and contingent incentive compensation.

The Plan is also established to augment regular salary and benefits programs already in existence. It is not meant to be a substitute for salary increases, but as a supplement to salary, and, as stated earlier, as an incentive for performance that contributes to outstanding levels of achievement.

Under the Plan, the Board of Directors elected not to award bonuses for the year 2013.

Supplemental Employee Retirement Plan

The Supplemental Employee Retirement Plan (the "SERP") rewards certain named executive officers for their long-term contributions to the bank. To encourage Mr. Prosseda and Ms. Woodland to continue their employment with the Corporation until retirement, the Compensation Committee believed it to be in the best interests of the Corporation and Bank to enter into salary continuation agreements with them. The agreements were also established to reward them for past and future services to the Corporation. The Compensation Committee believes the income benefit amounts are reasonable and consistent with the compensation standards of Section 39 of the Federal Deposit Insurance Company Improvement Act of 1991 and the related implementing regulations. Another benefit to the Bank from providing the SERP is that it contains a restrictive covenant prohibiting the executive from competing with the Bank while receiving benefits under the SERP, except after a change of control.

Employee Benefits Provided to Eligible Employees

All named executive officers participate in the Bank's retirement plan and health and welfare plans that are offered to other eligible employees of the Bank. Retirement and health and welfare benefits are not tied to Corporation, Bank, or individual performance. The cost of providing such benefits is not taken into account when determining specific salaries of the named executive officers and is seen as a cost of doing business.

Retirement Plan

The Compensation Committee believes that it is essential for employees to save for retirement and as such has provided all employees a vehicle through which to do so by maintaining a 401(k) plan, which has a combined tax qualified savings feature and profit sharing feature.

Health and Welfare Plans

Group life insurance, group disability, vision benefits and health insurance are available to all employees, as well as an IRS Section 125 plan. Such plans are standard in the industry and in the geographic area for all industries and necessary to compete for talented employees at all levels of the Corporation. Named executive officers participate in these plans under the same terms and conditions as other employees.

Health insurance premiums are partially paid by employees through payroll deductions for the employee share of the health care cost.

Triggering Events In Contracts

Presently, there are no named executive officers who are parties to employment or consulting agreements with the Corporation.

Under the SERP to which both Mr. Prosseda and Ms. Woodland are parties, the triggering events are change of control, retirement, disability, involuntary termination and death.

The Compensation Committee believes that the triggering events in these agreements are appropriate in that they encourage executives to act in the best interests of the shareholders in evaluating any change of control opportunities and it keeps the executives focused on running the Corporation in the face of real or rumored corporate transactions. The Compensation Committee also believes that it is appropriate to provide the named executive officers a benefit under the SERP in the event the executive becomes disabled and a benefit to his or her beneficiaries in the event of his or her death as consideration for the executive's past employment with the Bank. Additionally, as the SERP is a benefit upon which the executive will rely upon for retirement income, the Compensation Committee understands that it is important to provide the executive with a reduced benefit under the SERP if the executive is terminated without cause before retirement age.

Accounting and Tax Treatments

Sections 162(m) of the Internal Revenue Code generally limits the tax deductibility of compensation paid in one year to highly compensated employees to $1 million. Given the current level of compensation, the Compensation Committee does not feel that it is necessary to have a formal policy with regard to Section 162(m). There were no accounting treatments which were considered in establishing the Compensation Policy.

Material Differences in Named Executive Officers' Compensation

The named executive officers are compensated based upon their respective position and longevity with the Bank. All named executive officers participate in the retirement and health insurance benefits provided to all employees on the same terms as all other employees. The difference in the named executive officers' base salary is premised upon their position, experience, and individual performance. Only Mr. Prosseda and Ms. Woodland are provided SERP agreements as a result of Mr. Prosseda's role as Chief Executive Officer and as a result of Ms. Woodland's role as Director of Lending of the Bank.

Conclusion

The Compensation Committee believes the amount and types of compensation provided to the named executive officers are competitive and appropriate for the Corporation to attain its short and long-term objectives and goals. The compensation programs are designed to provide an incentive to the named executive officers on both a short-term and long-term basis. The programs have been tailored by the Corporation so that the various elements of compensation align the interests of our shareholders and those of the named executive officers to maximize shareholder value.

Compensation Committee Report

The Board, acting as the Compensation Committee, has reviewed and discussed the Compensation Discussion and Analysis with management, and based on the review and discussions, the Board concluded that the Compensation Discussion and Analysis be included in the Corporation's Proxy Statement.

Board of Directors

Robert E. Bull, Chairman	Robert A. Bull
J. Gerald Bazewicz, Vice Chairman	Dr. Joseph B. Conahan, Jr.
Matthew P. Prosseda, President	Jerome F. Fabian
John E. Arndt, Secretary	John G. Gerlach
Don E. Bower	David R. Saracino

Compensation Committee Interlocks and Insider Participation

The Board, which includes Matthew P. Prosseda, President and Chief Executive Officer, functions as the Compensation Committee. For compensation paid to executive officers other than the Chief Executive Officer, the Board of Directors considers information provided by the Chief Executive Officer. For compensation paid to the Chief Executive Officer, the Board of Directors, with Mr. Prosseda not being present, determines his compensation, as outlined above under “Base Salary”.

None of the members of the Compensation Committee, with the exception of Matthew P. Prosseda, President and Chief Executive Officer, has served as an officer or employee of the Corporation or its subsidiary, nor did any of them have any relationship with the Corporation requiring disclosure under Item 404 of Regulation S-K of the SEC. In addition, none of our executive officers served as a director of another entity, or as a member of the Compensation Committee or other committee serving an equivalent function of another entity at any time during 2013.

Executive Compensation

During the beginning of 2013, the Board conducted a risk assessment of the Bank's compensation program. The Board concluded that the program is balanced, does not motivate imprudent risk taking, and is not reasonably likely to have a material adverse effect on the Bank.

The following table shows information concerning the annual and long-term compensation for services rendered in all capacities to the Corporation and the Bank for the fiscal year ended December 31, 2013 of those persons who were:

- all individuals who served as the Principal Executive Officer and Principal Financial Officer during 2013; and
- the other 3 most highly compensated named executive officers of the Corporation and the Bank at December 31, 2013 whose total compensation exceeded $100,000.

EXECUTIVE COMPENSATION

SUMMARY COMPENSATION TABLE

Name and Principal Position	Year	Salary ($)	Bonus ($)	Stock Awards ($)	Option Awards ($)	Change in Pension Value and Nonqualified Deferred Compensation Earnings ($)	All Other Compensation ($)		Total ($)
	2013	216,300				29,568	47,468	1	293,336
Matthew P. Prosseda	2012	210,000	30,060			27,850	38,175	1	306,085
Chief Executive Officer	2011	198,462	33,750			26,232	22,649	1	281,093
	2013	111,000					12,356	2	123,356
Diane C. A. Rosler	2012	108,000	6,680				11,550	2	126,230
Chief Financial Officer	2011	100,000	7,500				11,019	2	118,519
	2013	138,750					16,313	3	155,063
Kevin L. Miller	2012	134,640	16,700				15,339	3	166,679
Chief Operating Officer	2011	119,938	18,750				13,351	3	152,039
	2013	147,000				16,193	16,136	4	179,329
Elaine A. Woodland	2012	142,695	6,680			15,252	15,020	4	179,647
Director of Lending	2011	135,131	7,500			14,366	13,851	4	170,848
	2013	106,000					11,182	5	117,182
James S. Szewc	2012	101,920					10,292	5	112,212
Senior Trust Officer	2011	98,000					10,178	5	108,178

[1]Amounts shown for Mr. Prosseda in 2013 include $21,600 in director fees, $7,391 401(k) matching and $18,477 401(k) profit sharing award, in 2012 $13,800 in director fees, $7,313 401(k) matching contribution and $17,062 401(k) profit sharing award and in 2011 $6,629 401(k) matching contribution and $16,020 401(k) profit sharing award.

[2]Amounts shown for Ms. Rosler in 2013 include $3,530 401(k) matching and $8,826 401(k) profit sharing award, in 2012 $3,465 401(k) matching contribution and $8,085 401(k) profit sharing award and in 2011 $3,225 401(k) matching contribution and $7,794 401(k) profit sharing award.

[3]Amounts shown for Mr. Miller in 2013 include $4,661 401(k) matching and $11,652 401(k) profit sharing award, in 2012 $4,602 401(k) matching contribution and $10,737 401(k) profit sharing award and in 2011 $3,908 401(k) matching contribution and $9,443 401(k) profit sharing award.

[4]Amounts shown for Ms. Woodland in 2013 include $4,610 401(k) matching and $11,526 profit sharing award, in 2012 $4,506 401(k) matching contribution and $10,514 401(k) profit sharing award and in 2011 $4,054 401(k) matching contribution and $9,797 401(k) profit sharing award.

[5] Amounts shown for Mr. Szewc in 2013 include $3,195 401(k) matching and $7,987 401(k) profit sharing award, in 2012 $3,088 401(k) matching contribution and $7,204 401(k) profit sharing award and in 2011 $2,979 401(k) matching contribution and $7,199 401(k) profit sharing award.

401(k) Plan

The Bank maintains a 401(k) Plan which has a combined tax qualified savings feature and profit sharing feature. The plan provides benefits to employees who have completed at least one year of service and are at least 21 years of age. The plan agreement provides that the Bank will match employee deferrals to the plan up to 3% of their respective eligible compensations. Additionally, the Bank may make a discretionary profit sharing contribution annually to the plan. Contributions made by the Bank to the plan are allocated to participants in the same portion that each participant's compensation bears to the aggregate compensation of all participants. Each participant in the plan is 100% vested at all times. Benefits are payable under the plan upon termination of employment, disability, death or retirement.

Of the $763,888 total expenses during 2013, $81,855 was credited among the individual accounts of the 5 named executive officers of the Bank: Mr. Prosseda with $25,868, Ms. Rosler with $12,356, Mr. Miller with $16,313, Ms. Woodland with $16,136 and Mr. Szewc with $11,182. Mr. Prosseda has been a member of the plan for 8 years, Ms. Rosler for 22 years, Mr. Miller for 28 years, Ms. Woodland for 6 years and Mr. Szewc for 14 years.

Aggregated Options, Grants or Exercises in 2013 Year-End Option Values

There were no grants of stock options to the named executive officers under the 1998 Stock Incentive Plan in 2013. Diane C.A. Rosler exercised 787 options in 2013.

OUTSTANDING EQUITY AWARDS AT DECEMBER 31, 2013

The Corporation's 1998 Stock Option Plan expired in 2008. Under the terms of the plan, options were granted for shares of the Corporation's common stock based on the market value at the date of grant and may be exercised six months after date of grant. There are no plan provisions for reload or tax-reimbursement features. The closing price of the stock as of December 31, 2013 was $25.00.

Name	Option Awards Number of Securities Underlying Unrestricted Options (#) Exercisable	Number of Securities Underlying Unrestricted Options (#) Unexercisable	Equity Incentive Plan Awards: Number of Securities Underlying Unrestricted Unearned Options (#)	Option Exercise Price ($)	Option Expiration Date
Matthew P. Prosseda Chief Executive Officer					
Diane C. A. Rosler Chief Financial Officer					
Kevin L. Miller Chief Operating Officer	500			16.75	12/27/17
Elaine A. Woodland Director of Lending	500			16.75	12/27/17
James S. Szewc Senior Trust Officer	525 750			20.95 16.75	09/27/15 12/27/17

OPTION EXERCISES DURING 2013

Name	**Option Awards** **Number of Shares Acquired on Exercise (#)**	**Value Realized on Exercise ($)**
Matthew P. Prosseda Chief Executive Officer		
Diane C.A. Rosler Chief Financial Officer	787	3,691
Kevin L. Miller Chief Operating Officer		

Elaine A. Woodland

Director of Lending

James S. Szewc

Senior Trust Officer

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Supplemental Employee Retirement Plan

The Corporation maintains a Supplemental Employee Retirement Plan ("SERP") covering 2 of the Bank's named executive officers, Matthew P. Prosseda and Elaine A. Woodland. The SERP, which is a salary continuation agreement, provides that if the executive officer continues to serve as an officer of the Bank until a stated retirement age of 62 years for Mr. Prosseda and 63 years for Ms. Woodland, the Bank will pay 240 guaranteed consecutive monthly payments for Mr. Prosseda and 180 guaranteed consecutive monthly payments for Woodland commencing on the first day of the month following the officer's 62nd or 63rd birthday and the termination of employment in the amounts indicated below. The established retirement benefit under the SERP for Mr. Prosseda and Ms. Woodland will be $4,167 per month, and $2,083 per month, respectively, and is not subject to change.

If the executive officer attains their stated retirement age, but dies before receiving all of the guaranteed monthly payments, then the Bank will make the remaining payments to the officer's beneficiary. In the event the officer dies while serving as an officer, prior to his or her stated retirement age, the Bank will remit the guaranteed monthly payment to the officer's beneficiary commencing the month following the executive's death. In the event of a change of control and the termination of the officer's employment, the guaranteed monthly payments will commence the month following the executive's termination of service. Generally, no benefit will be paid if the executive officer voluntarily terminates employment prior to attaining the stated retirement age or is terminated for cause.

The SERP allows the executive officers to achieve a retirement income percentage that is more consistent with their experience and years of service to the Bank. The plan objective is to provide the executive officers with a final wage replacement ratio of approximately 75% of projected final salary including projected benefits from the Bank 401(k) Plan, social security, and salary continuation provided through the agreement.

PENSION BENEFITS

Name	**Plan Name**	**Number of Years Credited Service (#)**	**Present Value of Accumulated Benefit ($)**	**Payments During Last Fiscal Year ($)**
Matthew P. Prosseda Chief Executive Officer	SERP	8	167,454	
Elaine A. Woodland Director of Lending	SERP	6	79,177	

Post Termination Benefits

The following tables and discussion outlines the payments which would have been made to each named executive officer had a termination event occurred on December 31, 2013.

Matthew P. Prosseda

The Board may, in its sole discretion, award Mr. Prosseda a pro-rata amount in the event of his retirement, death or disability under the Management Incentive Compensation Plan.

Termination for Cause and Voluntary Termination. If Mr. Prosseda's employment is terminated for "Cause" as defined in the SERP or he voluntarily terminates his employment, the Corporation shall be obligated to make the following payment.

	Termination for Cause ($)	Voluntary Termination ($)
Supplemental Employee Retirement Plan		

Termination Without Cause - Before a Change of Control. If Mr. Prosseda's employment is terminated "Without Cause," as defined in the SERP, he would be entitled to receive the following payment.

	Termination Without Cause ($)
Supplemental Employee Retirement Plan	26,062* annual benefit

*SERP benefit would be paid in 12 equal monthly payments of approximately $2,172 for 240 months commencing the month following the officer's 62nd birthday.

Death or Disability. In the event of a termination of employment as a result of Mr. Prosseda's death or disability, his dependents, beneficiaries or estate, as the case may be, will receive the following payments.

	Death ($)	Disability ($)
Supplemental Employee Retirement Plan	50,000* annual benefit	167,454
Life Insurance Proceeds	433,000	

*SERP benefit under death would be paid to the beneficiary in monthly payments of approximately $4,167 for 240 months commencing the month following the executive’s death. The SERP benefit under disability shall be paid in a lump sum 60 days after the executive’s termination of employment.

Termination Upon or After a Change in Control. If a “Change of Control” as defined in the SERP occurs, Mr. Prosseda shall be entitled to the following payment.

	Change of Control ($)
Supplemental Employee Retirement Plan	50,000* annual benefit

*The SERP benefit under a change of control would be paid in monthly payments of approximately $4,167 for 240 months commencing the month following the executive’s termination of service.

Diane C. A. Rosler

The Board of Directors may, in its sole discretion, award Ms. Rosler a pro-rata amount in the event of her retirement, death or disability under the Management Incentive Compensation Plan.

Termination for Cause and Voluntary Termination. If Ms. Rosler’s employment is terminated for “Cause” or she voluntarily terminates her employment, the Corporation would not be obligated to make any payments.

Termination Without Cause - Before a Change of Control. If Ms. Rosler’s employment is terminated “Without Cause,” the Corporation would not be obligated to make any payments.

Death or Disability. In the event of a termination of employment as a result of Ms. Rosler’s death or disability, her dependents, beneficiaries or estate, as the case may be, will receive the following payment.

	Death ($)	Disability ($)
Life Insurance Proceeds	222,000	

Termination Upon or After a Change in Control. If a “Change of Control” occurs, the Corporation would not be obligated to make any payments to Ms. Rosler.

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Kevin L. Miller

The Board of Directors may, in its sole discretion, award Mr. Miller a pro-rata amount in the event of his retirement, death or disability under the Management Incentive Compensation Plan.

Termination for Cause and Voluntary Termination. If Mr. Miller's employment is terminated for "Cause" or he voluntarily terminates his employment, First Keystone Corporation shall be obligated to make the following payment.

	Termination for Cause ($)	Voluntary Termination ($)
1998 Stock Incentive Plan	4,125	4,125

Termination Without Cause - Before a Change of Control. If Mr. Miller's employment is terminated "Without Cause," he would be entitled to receive the following payment.

	Termination Without Cause ($)
1998 Stock Incentive Plan	4,125

Death or Disability. In the event of a termination of employment as a result of Mr. Miller's death or disability, his dependents, beneficiaries or estate, as the case may be, will receive the following payments.

	Death ($)	Disability ($)
1998 Stock Incentive Plan	4,125	4,125
Life Insurance Proceeds	278,000	

Termination Upon or After a Change in Control. If a "Change of Control" occurs, Mr. Miller shall be entitled to the following payment.

	Change of Control ($)

1998 Stock Incentive Plan	4,125

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Elaine A. Woodland

The Board may, in its sole discretion, award Ms. Woodland a pro-rata amount in the event of her retirement, death or disability under the Management Incentive Compensation Plan.

Termination for Cause and Voluntary Termination. If Ms. Woodland's employment is terminated for "Cause" as defined in the SERP or she voluntarily terminates her employment, the Corporation shall be obligated to make the following payments.

	Termination for Cause ($)	Voluntary Termination ($)
1998 Stock Incentive Plan	4,125	4,125
Supplemental Employee Retirement Plan		

Termination Without Cause - Before a Change of Control. If Ms. Woodland's employment is terminated "Without Cause" as defined in SERP, she would be entitled to receive the following payments.

	Termination Without Cause ($)
1998 Stock Incentive Plan	4,125
Supplemental Employee Retirement Plan	12,813* annual benefit

*SERP benefit would be paid in 12 equal monthly payments of approximately $1,068 for 180 months commencing the month following the officer's 63rd birthday.

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Death or Disability. In the event of a termination of employment as a result of Ms. Woodland's death or disability, her dependents, beneficiaries or estate, as the case may be, will receive the following payments.

	Death ($)	Disability ($)
1998 Stock Incentive Plan	4,125	4,125
Supplemental Employee Retirement Plan	25,000* annual benefit	79,177
Life Insurance Proceeds	294,000	

*SERP benefit under death would be paid to the beneficiary in monthly payments of approximately $2,083 for 180 months commencing the month following the executive's death. The SERP benefit under disability shall be paid in a lump sum 60 days after the executive's termination of employment.

Termination Upon or After a Change in Control. If a "Change of Control" as defined in the SERP occurs, Ms. Woodland shall be entitled to the following payments.

	Change of Control ($)
1998 Stock Incentive Plan	4,125
Supplemental Employee Retirement Plan	25,000* annual benefit

*The SERP benefit under a change of control would be paid in monthly payments of approximately $2,083 for 180 months commencing the month following the executive's termination of service.

James S. Szewc

The Board may, in its sole discretion, award Mr. Szewc a pro-rata amount in the event of his retirement, death or disability under the Management Incentive Compensation Plan.

Termination for Cause and Voluntary Termination. If Mr. Szewc's employment is terminated for "Cause" or he voluntarily terminates his employment, the Corporation shall be obligated to make the following payment.

	Termination for Cause ($)	Voluntary Termination ($)
1998 Stock Incentive Plan	8,314	8,314

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Termination Without Cause - Before a Change of Control. If Mr. Szewc's employment is terminated "Without Cause," he would be entitled to receive the following payment.

	Termination Without Cause ($)
1998 Stock Incentive Plan	8,314

Death or Disability. In the event of a termination of employment as a result of Mr. Szewc's death or disability, his dependents, beneficiaries or estate, as the case may be, will receive the following payments.

	Death ($)	Disability ($)
1998 Stock Incentive Plan	8,314	8,314
Life Insurance Proceeds	212,000	

Termination Upon or After a Change in Control. If a "Change of Control" occurs, Mr. Szewc shall be entitled to the following payment.

	Change of Control ($)
1998 Stock Incentive Plan	8,314

Related Person Transactions

Related person transactions are subject to approval by the Board of Directors.

In deciding whether to approve a related person transaction the following factors may be considered:

- information about the goods or services proposed to be or being provided by or to the related party or the nature of the transactions;
- the nature of the transactions and the costs to be incurred by the Corporation or payments to the Corporation;
- an analysis of the costs and benefits associated with the transaction and a comparison of comparable or alternative goods or services that are available to the Corporation from unrelated parties; and
- the business advantage the Corporation would gain by engaging in the transaction.

To receive approval, the related person transaction must be on terms that are fair and reasonable to the Corporation, and that are as favorable to the Corporation as would be available from non-related entities in comparable transactions.

There have been no material transactions between the Corporation or the Bank, nor any material transactions proposed, with any director or executive officer of the Corporation or the Bank, or any associate of these persons. The Corporation and the Bank have engaged in and intend to continue to engage in banking and financial transactions in the ordinary course of business with directors and officers of the Corporation and the Bank and their associates on comparable terms and with similar interest rates as those prevailing from time to time for other customers of the Corporation and the Bank.

Total loans outstanding and commitments from the Corporation and the Bank at December 31, 2013, to the Corporation's and the Bank's named executive officers and directors as a group and members of their immediate families and companies in which they had an ownership interest of 10% or more was $6,096,000, or approximately 6.3% the total equity capital. Loans to such persons were made in the ordinary course of business, were made on substantially the same terms, including interest rates and collateral, as those prevailing at the time for comparable transactions with other persons not related to the lender, and did not involve more than the normal risk of collectability or present other unfavorable features. All loans are current and being paid as agreed. The largest aggregate amount of indebtedness outstanding at any time during fiscal year 2013 to the named executive officers and directors of the Corporation and the Bank, and their affiliates as a group was $6,742,000. The aggregate amount of outstanding indebtedness as of the latest practicable date, March 3, 2014, to the above described group was $6,052,000.

PRINCIPAL OFFICERS OF THE BANK AND THE CORPORATION

The following table presents selected information as of March 3, 2014, about the executive officers of the Bank and Corporation, each of whom is elected by the Board and each of whom holds office at the discretion of the Board:

Name	Age as of March 3, 2014	Office and Position with the Bank	Office and Position with the Corporation
Robert E. Bull	91	Chairman of the Board since 1981	Chairman of the Board since 1983
J. Gerald Bazewicz	65	Vice Chairman of the Board since 2012	Vice Chairman of the Board since 2012
Matthew P. Prosseda	52	President and CEO since 2012	President and CEO since 2012
John E. Arndt	52	Secretary since 2006	Secretary since 2006
Diane C. A. Rosler	49	Chief Financial Officer since 2007	Chief Financial Officer since 2007

LEGAL PROCEEDINGS

In the opinion of the management of the Corporation and its banking subsidiary, there are no proceedings pending to which the Corporation or the Bank is a party to, or which their property is subject, which, if determined adversely to the Corporation or the Bank, would have a material effect on their undivided profits or financial condition. There are no proceedings pending other than routine litigation incident to the business of the Corporation and the Bank. In addition, to the Board’s knowledge, no government authorities have initiated, threatened to initiate, or contemplated any material proceedings against the Corporation or the Bank.

PROPOSAL NO. 2: RATIFICATION OF

INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

In 2013, all audit and tax fees associated with J.H. Williams & Co., LLP's services were approved by the Audit Committee.

J.H. Williams & Co., LLP served as the Corporation's independent accountants for the 2013 fiscal year, assisted the Corporation and the Bank with preparation of their federal and state annual tax returns, and provided assistance in connection with regulatory matters, charging the Bank for services at its customary hourly billing rates. Representatives of J.H. Williams & Co., LLP will attend the Annual Meeting of Shareholders, will have the opportunity to make a statement and are expected to be available to respond to any questions.

The Board has appointed BDO USA, LLP, Certified Public Accountants, located at 320 Market Street, 6th Floor, Harrisburg, Pennsylvania 17101, as the Corporation's independent registered public accounting firm for its 2014 fiscal year. The Board proposes that shareholders ratify this selection. BDO USA, LLP has advised the Corporation that none of its members has any financial interest in the Corporation. Ratification of BDO USA, LLP will require the affirmative vote of a majority of the votes cast in person or by proxy at the Annual Meeting by shareholders entitled to vote.

In the event that the shareholders do not ratify the selection of BDO USA, LLP as the Corporation's independent registered public accounting firm for the 2014 fiscal year, another accounting firm may be chosen to provide independent audit services for the 2014 fiscal year.

The Board of Directors recommends that the shareholders vote **FOR** the ratification of the selection of BDO USA, LLP as the independent registered public accounting firm for the Corporation for the year ending December 31, 2014.

CHANGES IN REGISTRANT'S CERTIFYING ACCOUNTANT

On February 11, 2014, the Audit Committee and the Board of Directors of the Corporation appointed BDO USA, LLP as the Corporation's new independent registered public accounting firm for and with respect to the year ending December 31, 2014 and dismissed J.H. Williams & Co., LLP from that role.

The reports of J.H. Williams & Co., LLP on the Corporation's financial statements as of and for the years ended December 31, 2012 and 2011 did not contain an adverse opinion or a disclaimer of an opinion and were not qualified or modified as to uncertainty, audit scope, or accounting principles.

During the Corporation's two most recent fiscal years and the subsequent interim period preceding J.H. Williams & Co., LLP's dismissal, there were: (i) no disagreements with J.H. Williams & Co., LLP on any matter of accounting principles or practices, financial statement disclosure, or auditing scope or procedure, which disagreements, if not resolved to the satisfaction of J.H. Williams & Co., LLP, would have caused it to make reference to the subject matter of the disagreements in its reports on the consolidated financial statements for the Corporation; and, (ii) no "reportable events", as such term is defined in Item 304(a)(1)(v) of Regulation S-K.

The Corporation provided J.H. Williams & Co., LLP with a copy of the above disclosures prior to filing a Form 8-K prior with the U.S. Securities and Exchange Commission and requested to furnish to the Corporation a letter addressed to the SEC stating that it agrees with the statements made above. A copy of J.H. Williams & Co., LLP's letter dated February 13, 2014 was attached as Exhibit 16.1 to the Form 8-K filed on February 14, 2014.

During the Corporation's two most recently completed fiscal years and through the date of the Corporation's appointment of BDO USA, LLP, the Corporation did not consult with BDO USA, LLP regarding: (i) the application of accounting principles to a specific completed or contemplated transaction, or the type of audit opinion that might be rendered on the Corporation's consolidated financial statements, and no written or oral advice was provided by BDO USA, LLP that was an important factor considered by the Corporation in reaching a decision as to accounting, auditing, or financial reporting issues; or, (ii) any matter that was either the subject of a disagreement or event, as set forth in Item 304(a)(1)(iv) or Item 304(a)(1)(v) of Regulation S-K.

PROPOSAL NO. 3: NON-BINDING VOTE ON EXECUTIVE COMPENSATION

In accordance with the requirements of Section 14A of the Securities Exchange Act of 1934, as amended (the "Exchange Act") (which was added by the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act")) and the related rules of the SEC, we are including in these proxy materials a separate resolution subject to shareholder vote to approve, in a non-binding vote, the compensation of our named executive officers.

As described in detail under the heading "Compensation Discussion and Analysis" and "Executive Compensation," our executive compensation programs are designed to attract, incentivize and retain our named executive officers, who are critical to our success. We are asking our shareholders to indicate their support for our named executive officer compensation as described in this Proxy Statement. This proposal, commonly known as a "say-on-pay" proposal, gives our shareholders the opportunity to express their views on our named executive officers' compensation. This vote is not intended to address any specific item of compensation, but rather the overall compensation of our named executive officers and the philosophy, policies and practices described in this Proxy Statement. Accordingly, we ask our shareholders to vote **FOR** the following resolution at the Annual Meeting:

"RESOLVED, that the Corporation's shareholders approve, on an advisory basis, the compensation of the named executive officers, as disclosed in the Corporation's Proxy Statement for the 2014 Annual Meeting of Shareholders pursuant to the compensation disclosure rules of the SEC, including the 2013 Summary Compensation Table and the other related tables and disclosure."

The say-on-pay vote is advisory, and therefore not binding on the Corporation or our Board of Directors. Our Board of Directors values the opinions of our shareholders and to the extent there is any significant vote against the named executive officer compensation as disclosed in this Proxy Statement, we will consider our shareholders' concerns and will evaluate whether any actions are necessary to address those concerns.

Vote Required; Recommendation of the Board of Directors

The approval of the compensation of the named executive officers as disclosed in this Proxy Statement will be approved if a majority of the votes cast at the Annual Meeting are voted "FOR" this proposal. Abstentions and "broker non-votes" will not be counted as votes cast and therefore will not affect the determination as to whether this proposal is approved.

The Board recommends a vote FOR the compensation of the named executive officers as disclosed in this Proxy Statement.

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SECTION 16(a) BENEFICIAL OWNERSHIP REPORTING COMPLIANCE

Section 16(a) of the Securities Exchange Act of 1934 requires the Corporation's directors, executive officers and shareholders who own more than 10% of the Corporation's outstanding equity stock to file initial reports of ownership and reports of changes in ownership of common stock and other equity securities of the Corporation with the SEC. Based solely on its review of copies of Section 16(a) forms received by it, or written representations from reporting persons that no Forms 5 were required for those persons, the Corporation believes that during the period January 1, 2013 through December 31, 2013, its officers, directors and reporting shareholders were in compliance with all filing requirements applicable to them.

INCORPORATION BY REFERENCE

The rules of the SEC permit us to "incorporate by reference" certain information we file with the SEC into this Proxy Statement. This means that we can disclose important information to shareholders by referring the shareholders to another document. Any information incorporated by reference into this Proxy Statement is considered to be part of this Proxy Statement from the date we file that information with the SEC. Any reports filed by us with the SEC after the date of this Proxy Statement will automatically update and, where applicable, supersede any information contained in this proxy statement or incorporated by reference into this Proxy Statement.

This Proxy Statement incorporates by reference the following items of Part II of the Corporation's Annual Report on Form 10-K filed with the SEC for the fiscal year ended December 31, 2013:

- Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations;
- Item 7A. Quantitative Disclosures About Market Risk;
- Item 8. Financial Statements and Supplementary Data; and
- Item 9. Changes in and Disagreements With Accountants on Accounting and Financial Disclosure.

All documents filed by the Corporation with the SEC subsequent to the date hereof and prior to the date of the Annual Meeting pursuant to Section 13(a), 13(c), 14 or 15(d) of the Securities Exchange Act of 1934, as amended, are incorporated herein by reference. Any statement contained in a document incorporated or deemed to be incorporated by reference herein shall be deemed to be modified or superseded for purposes of this Proxy Statement to the extent that a statement contained in another subsequently filed document which also is or is deemed to be incorporated by reference herein modifies or supersedes such statement.

The Corporation will file with the SEC an Annual Report on Form 10-K for 2013. The Corporation will provide a copy of that report on written request without charge to any person. Please address your request to Cheryl Wynings, Investor Relations, First Keystone Corporation, 111 West Front Street, P.O. Box 289, Berwick, Pennsylvania 18603, telephone: (570) 752-3671, extension 1175.

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OTHER MATTERS

The Board does not know of any matters to be presented for consideration other than the matters described in the accompanying Notice of Annual Meeting of Shareholders, but if any matters are properly presented, the persons named in the accompanying proxy intend to vote on the matters as they determine to be in the best interest of the Corporation.

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