

LUZERNE NATIONAL BANK CORPORATION
2010 Annual Report



LUZERNE NATIONAL BANK CORPORATION
SELECTED CONSOLIDATED FINANCIAL DATA

(Amounts in thousands, except per share data)

	At or for the Year Ended December 31,				
	2010	2009	2008	2007	2006
Selected Financial Condition Data:					
Total assets	\$ 280,313	\$ 267,835	\$ 233,148	\$ 207,330	\$ 184,039
Loans, net	203,078	197,067	176,549	144,152	103,599
Investment securities	24,473	25,750	27,763	42,332	56,443
Deposits	243,645	226,858	187,489	171,750	158,831
Borrowings and repurchase agreements	9,456	15,874	22,406	11,748	4,835
Shareholders' equity	25,155	23,270	21,318	20,175	18,774
Selected Operating Data:					
Interest and dividend income	\$ 12,344	\$ 11,682	\$ 11,713	\$ 11,003	\$ 9,947
Interest expense	2,369	3,169	3,799	3,938	3,033
Net interest income	9,975	8,513	7,914	7,065	6,914
Provision for loan losses	675	430	370	321	-375
Net interest income after provision for loan losses	9,300	8,083	7,544	6,744	7,289
Non-interest income	1,895	1,906	1,777	1,648	1,739
Other operating expenses	7,661	7,256	6,884	6,365	6,144
Income before income taxes	3,534	2,733	2,437	2,027	2,884
Income taxes	999	712	649	474	689
Net income	<u>\$ 2,535</u>	<u>\$ 2,021</u>	<u>\$ 1,788</u>	<u>\$ 1,553</u>	<u>\$ 2,195</u>
Earnings per share:					
Basic	\$ 3.75	\$ 2.98	\$ 2.64	\$ 2.29	\$ 3.24
Diluted	3.75	2.98	2.64	2.29	3.24
Selected Statistical Data:					
Return on Average Assets	.95	.84	.83	.80	1.22
	%	%	%	%	%
Return on Average Equity	10.45	9.06	8.60	8.00	12.55
Equity to total assets, end of period	8.97	8.69	9.14	9.73	10.20
Efficiency ratio	63.87	68.83	69.77	71.28	70.28
Allowance as a percentage of loans	1.19	1.06	.98	1.00	1.08
Net loan to deposit ratio	83.35	86.87	94.16	83.93	65.23
Book value per share	\$ 37.17	\$ 34.35	\$ 31.47	\$ 29.73	\$ 27.69
Cash dividends per share	0.75	0.70	0.70	0.70	0.70

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To our Shareholders:

This past year mirrored the year 2009 in several ways. It represented a year of uncertainty of our economy, uncertainty in politics, uncertainty regarding our industry, and perhaps the most important to us, another year of continued growth and record earnings. I am extremely pleased to announce the performance results of your bank for 2010. As you will see in the accompanying financial reports, the bank grew almost 5 % in assets, 3 % in net loans and over 7 % in deposits. The real story, however, is in the earnings and continued credit quality in the loan portfolio. Net income grew at a staggering 25 % while increasing the provision for loan losses 57 % from the prior year. We have seen evidence of deterioration in the ability of some customers to remain current with their obligations, an expected result of a poor economy. Yet our delinquencies remain low, and charged-off loans, while at a higher level than a year ago, were not at a level of concern. The main reason behind the increase in earnings is our margin. We have been blessed with a large share of non-interest bearing deposits, which, when invested in quality loans, give us results like we experienced in 2010.

Other noteworthy developments include the decision of management and the Board to vacate the Trust and Asset Management business. The volume was just too small to provide an adequate return to the bank. Our Trust Department Officers are working with potential trustees to take over this business, which we have targeted to conclude by midyear. We continue to investigate potential branch acquisitions in markets that make sense for us and have been on our radar. The opportunity to purchase an existing branch from a bank that is consolidating its market makes sense as opposed to starting from scratch. We have also recently made the decision to move into the Lackawanna County market through a Loan Production Office in Scranton. I am hopeful that by the time you are reading this report, that office will be staffed with quality lenders and be completely operational.

As you can see, the bank is on the move. These are exciting developments for the bank and demonstrate the Board's commitment to growth and long term value for our shareholders.

While we are not out of the woods with regard to the economic outlook, your bank continues to turn in a solid performance by any measure. We hope you agree that these are exciting times for your bank and that you continue to support the effort to make this bank one that is the envy of others.

We continue to appreciate your support of Luzerne National Bank Corporation.

Sincerely,

A handwritten signature in black ink, appearing to read "Robert C. Snyder".

Robert C. Snyder
President and CEO

Management's Discussion and Analysis of Financial Condition and Results of Operations

General

Luzerne National Bank Corporation (the "Corporation") was incorporated in November 1986 and became the holding company for Luzerne Bank (the "Bank"), Firststar Financial Corporation, Firststar Abstract, Inc., and Firststar Insurance Services, Inc. Currently, the Bank provides fiduciary services through its Trust Department.

The primary market area of the Bank, with seven full-service offices, consists primarily of Luzerne County and portions of Lackawanna and Wyoming Counties. Also, in the first quarter of 2011, the Bank opened a loan production office located in Scranton, Lackawanna County, Pennsylvania. The Bank is a community-oriented commercial bank engaged principally in attracting retail deposits from the general public and investing those deposits, together with funds generated from operations and borrowings, primarily in commercial business loans, commercial and residential real estate loans, consumer loans and various mortgage-backed, debt and equity securities.

Comparison of Financial Condition at December 31, 2010 and 2009

Total assets increased \$12.5 million from \$267.8 million at December 31, 2009 to \$280.3 million at December 31, 2010. The increase primarily reflects increases of \$8.5 million in federal funds sold, \$6.0 million in net loans and \$295 thousand in other assets, partially offset by decreases in cash and due from banks of \$966 thousand and investment securities of \$1.3 million. The increase in the Corporation's funding balances consisted primarily of increases in deposits of \$16.8 million, other liabilities of \$224 thousand and shareholders' equity of \$1.9 million offset by decreases in repurchase agreements of \$3.6 million and borrowed funds of \$2.8 million.

The \$1.3 million, or 4.9%, decrease in investment securities consisted of a decrease in mortgage-backed securities, \$2.5 million and a decrease of \$7 thousand in equity securities offset by increases in U.S. government and agencies securities, \$444 thousand and obligations of state and political subdivisions, \$822 thousand. The \$6.0 million increase in net loans consisted of an increase in commercial loans, \$2.1 million and real estate loans, \$4.6 million partially offset by decreases in consumer loans \$347 thousand and an increase in the allowance for loan losses, \$330 thousand.

Deposits increased \$16.8 million from \$226.9 million at December 31, 2009 to \$243.7 million at December 31, 2010. The increase in deposits was primarily reflected in changes to the following accounts: a \$23.5 million increase in demand deposits, a \$7.4 million increase in NOW accounts and a \$1.0 million increase in savings offset by a \$2.1 million decrease in money markets and a decrease of \$13.0 million in time deposits.

Total shareholders' equity increased \$1.9 million, or 8.2%, from \$23.3 million at December 31, 2009 to \$25.2 million at December 31, 2010. The increase was primarily attributable to net income of \$2.5 million partially offset by a decrease in comprehensive income of \$119 thousand and dividends declared of \$508 thousand. The ratio of shareholders' equity to total assets increased to 9.0% at December 31, 2010 as compared to 8.7% at December 31, 2009.

Comparison of Operating Results for the Years Ended December 31, 2010 and 2009

General. The Federal Reserve held the federal funds target rate throughout 2010 at 0% - .25% due to continued economic uncertainty. Luzerne Bank was able to maintain a net interest margin of 4.17% for 2010.

For the year ended December 31, 2010, the Corporation recognized net income of \$2.5 million, or \$3.75 per diluted share, compared to net income of \$2.0 million, or \$2.98 per diluted share, for the comparable period in 2009. The increase was primarily attributable to an increase in net interest income of \$1.5 million which was offset by a decrease in non-interest income, \$11 thousand and increases in the provision for loan losses, \$245 thousand, other operating expenses, \$405 thousand and income tax expense \$287 thousand. For the year ended December 31, 2010 return on average assets ("ROAA") and return on average equity ("ROAE") were .95% and 10.45%, respectively. The ROAA and ROAE for the corresponding period in 2009 were .84% and 9.06%, respectively.

Net Interest Income. Net interest income for the years ended December 31, 2010 and 2009 was \$10.0 million and \$8.5 million, respectively. The Corporation's taxable equivalent net interest margin (net interest income as a percentage of average earning assets) for the year ended December 31, 2010 was 4.17% as compared to 3.95% for the year ended December 31, 2009. The components of net interest income are interest and dividend income, which increased \$662 thousand, and interest expense, which decreased \$800 thousand.

Total interest income increased \$662 thousand, or 5.7%, from \$11.7 million for the year ended December 31, 2009 to \$12.3 million for the year ended December 31, 2010. The increase primarily reflects a 25 basis point decrease in the average yield on interest-earning assets, combined with a \$23.0 million increase in average interest-earning assets. The 25 basis point decrease in the average yield on interest-earning assets was caused primarily by a 71 basis point decrease in the average yield on investment securities, a 4 basis point decrease in the average yield on federal funds sold and a 12 basis point decrease in the yield earned on loans. The components of the increase in average interest-earning assets are federal funds sold, \$4.4 million and loans, \$19.5 million increase offset by decreases in securities, \$978 thousand.

Total interest expense decreased \$800 thousand, or 25.2%, from \$3.2 million for the year ended December 31, 2009 to \$2.4 million for the year ended December 31, 2010. The decrease primarily reflects a 49 basis point decrease in the rate paid on interest-bearing deposits and borrowings combined with a \$5.3 million increase in average interest-bearing deposits and borrowings.

Average interest-bearing deposits increased \$11.9 million, or 7.5%, from \$159.2 million for 2009 compared to \$171.1 million for 2010. The yield on average interest-bearing deposits decreased 47 basis points from 1.68% for the year ended December 31, 2009 to 1.21% for the year ended December 31, 2010. Year-to-date average interest-bearing borrowings and repurchase agreements decreased \$6.6 million from \$18.5 million for 2009 to \$11.9 million for 2010; in addition, the yield paid on interest-bearing borrowings and repurchase agreements decreased from 2.68% for the year ended December 31, 2009 to 2.57% for the year ended December 31, 2010.

Provision for Loan Losses. The provision for loan losses increased \$245 thousand from \$430 thousand for the year ended December 31, 2009 to a provision of \$675 thousand for the year ended December 31, 2010. The allowance for loan losses as a percentage of gross loans was 1.19% and 1.06% at December 31, 2010 and 2009, respectively.

Non-Interest Income. Non-interest income decreased \$11 thousand to \$1.89 million for the year ended December 31, 2010 from \$1.90 million for the year ended December 31, 2009. The decrease was caused by a \$44 thousand decrease in other service charges and fees, a \$6 thousand decrease in trust income and a \$6 thousand decrease in gain on sale of securities partially offset by a \$39 thousand increase in ATM fees and debit card income and a \$6 thousand increase in income on life insurance policies.

Other Operating Expenses. Other operating expenses increased \$405 thousand, or 5.6%, from the year ended December 31, 2009 to the year ended December 31, 2010. The largest portion of the increase is attributable to salaries and employee benefit expense which increased \$200 thousand from \$4.2 million for the year ended December 31, 2009 compared to \$4.4 million for the year ended December 31, 2010. Increased health care costs accounted for nearly half of the salary and employee benefit increase.

Income Tax Expense. Income tax expense increased \$287 thousand to \$999 thousand for the year ended December 31, 2010 from \$712 thousand for the year ended December 31, 2009. The increase was caused primarily by the \$801 thousand increase in pre-tax income to \$3.5 million for the year ended December 31, 2010 from \$2.7 million for the year ended December 31, 2009. The effective tax rates for the years ended December 31, 2010 and 2009 were 28.3% and 26.1%, respectively.



Independent Auditors' Report

Board of Directors and Shareholders
of Luzerne National Bank Corporation

We have audited the accompanying consolidated balance sheets of Luzerne National Bank Corporation and Subsidiaries as of December 31, 2010 and 2009, and the related consolidated statements of income, changes in shareholders' equity and cash flows for the years then ended. These consolidated financial statements are the responsibility of the Corporation's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of Luzerne National Bank Corporation and Subsidiaries as of December 31, 2010 and 2009, and the results of their operations and their cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

J. H. Williams & Co., LLP

February 11, 2011

LUZERNE NATIONAL BANK CORPORATION AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS
(Dollars in thousands, except per share data)

DECEMBER 31, 2010 AND 2009

	<u>ASSETS</u>	
	<u>2010</u>	<u>2009</u>
Cash and due from banks	\$ 15,747	\$ 16,713
Federal funds sold	21,235	12,747
Investment securities held to maturity (fair value of \$1,192 and \$1,566 in 2010 and 2009, respectively)	1,151	1,533
Investment securities available for sale	23,322	24,217
Restricted equity securities	1,574	1,647
Loans, net	203,078	197,067
Premises and equipment, net	5,111	5,194
Accrued interest receivable	808	867
Cash surrender value of life insurance	6,327	6,068
Foreclosed real estate	120	-
FDIC assessment prepayment	642	919
Other assets	1,198	863
	<u>280,313</u>	<u>267,835</u>
Total assets	<u>\$ 280,313</u>	<u>\$ 267,835</u>
	<u>LIABILITIES AND SHAREHOLDERS' EQUITY</u>	
Deposits:		
Demand	\$ 73,993	\$ 50,533
NOW accounts	22,724	15,366
Money market	28,805	30,912
Savings	41,690	40,641
Time deposits	76,433	89,406
Total deposits	<u>243,645</u>	<u>226,858</u>
Securities sold under agreements to repurchase	3,606	7,206
Borrowed funds	5,850	8,668
Accrued interest payable	214	294
Deferred compensation	1,151	872
Other liabilities	692	667
	<u>255,158</u>	<u>244,565</u>
Total liabilities	<u>255,158</u>	<u>244,565</u>
Preferred stock, par value \$2.50 per share, 1,000,000 shares authorized, none outstanding	-	-
Common stock, par value \$2.50 per share, 5,000,000 shares authorized, 678,884 shares issued	1,697	1,697
Additional paid in capital	232	232
Retained earnings	23,089	21,062
Accumulated other comprehensive income	223	342
	<u>25,241</u>	<u>23,333</u>
Less treasury stock at cost (2,190 shares in 2010 and 1,490 shares in 2009)	<u>(86)</u>	<u>(63)</u>
Total shareholders' equity	<u>25,155</u>	<u>23,270</u>
Total liabilities and shareholders' equity	<u>\$ 280,313</u>	<u>\$ 267,835</u>

See Notes to Consolidated Financial Statements

LUZERNE NATIONAL BANK CORPORATION AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF INCOME
(Dollars in thousands, except per share data)

YEARS ENDED DECEMBER 31, 2010 AND 2009

	2010	2009
Interest and dividend income:		
Interest and fees on loans	\$ 11,556	\$ 10,667
Interest and dividends on investments	781	1,011
Interest on federal funds sold	7	4
Total interest and dividend income	12,344	11,682
Interest expense:		
Deposits	2,063	2,673
Other	306	496
Total interest expense	2,369	3,169
Net interest income	9,975	8,513
Provision for loan losses	675	430
Net interest income after provision for loan losses	9,300	8,083
Non-interest income:		
ATM fees and debit card income	455	416
Trust department	186	192
Service and fee income	955	999
Income on life insurance policies	259	253
Gain on sale of securities	40	46
Total non-interest income	1,895	1,906
Other operating expenses:		
Salaries and employee benefits	4,358	4,158
Occupancy	1,121	1,099
Data processing	345	314
Professional fees	211	194
ATM and debit card processing fees	191	186
Directors' fees	133	99
FDIC assessments	316	356
State shares tax	178	170
Other	808	680
Total other operating expenses	7,661	7,256
Income before income taxes	3,534	2,733
Income taxes	999	712
Net income	\$ 2,535	\$ 2,021
Earnings per share:		
Basic	\$ 3.75	\$ 2.98
Diluted	\$ 3.75	\$ 2.98

See Notes to Consolidated Financial Statements

LUZERNE NATIONAL BANK CORPORATION AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY
(Dollars in thousands, except per share data)

YEARS ENDED DECEMBER 31, 2010 AND 2009

	Common Stock	Additional Paid in Capital	Treasury Stock	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Total Shareholders' Equity
Balance at December 31, 2008	1,697	232	(63)	19,515	(63)	\$ 21,318
Comprehensive income:						
Net income				2,021		2,021
Change in net unrealized gain on securities available for sale, net of reclassification adjustment and tax effects					405	405
Total comprehensive income						2,426
Dividends declared (\$.70 per share)				(474)		(474)
Balance at December 31, 2009	1,697	232	(63)	21,062	342	23,270
Comprehensive income:						
Net income				2,535		2,535
Change in net unrealized gain on securities available for sale, net of reclassification adjustment and tax effects					(119)	(119)
Total comprehensive income						2,416
Treasury stock acquired, 700 shares			(23)			(23)
Dividends declared (\$.75 per share)				(508)		(508)
Balance at December 31, 2010	<u>\$ 1,697</u>	<u>\$ 232</u>	<u>\$ (86)</u>	<u>\$ 23,089</u>	<u>\$ 223</u>	<u>\$ 25,155</u>

See Notes to Consolidated Financial Statements

LUZERNE NATIONAL BANK CORPORATION AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS
(Dollars in thousands)

YEARS ENDED DECEMBER 31, 2010 AND 2009

	2010	2009
Cash flows from operating activities:		
Net income	\$ 2,535	\$ 2,021
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation, amortization and accretion	497	468
Provision for loan losses	675	430
Income on life insurance policies	(259)	(253)
Net loss on sale of foreclosed real estate	-	8
Gain on sale of securities	(40)	(46)
Deferred income tax (benefit)	(217)	(194)
Change in:		
Accrued interest receivable	59	(59)
Other assets	(57)	(3)
FDIC assessment prepayment	277	(919)
Accrued interest payable	(80)	(129)
Deferred compensation	279	55
Other liabilities	(9)	(28)
Net cash provided by operating activities	3,660	1,351
Cash flows from investing activities:		
Net increase in loans receivable	(6,806)	(20,948)
Proceeds from maturities and calls of available for sale securities	11,950	2,265
Proceeds from maturities and calls of held to maturity securities	35	3,035
Proceeds from sales of available for sale securities	619	1,536
Proceeds from sales of held to maturity securities	-	2
Purchase of available for sale securities	(14,041)	(8,243)
Purchase of restricted equity securities	-	(4)
Proceeds from redemptions of restricted equity securities	53	50
Proceeds from principal paydowns of securities	2,527	3,982
Proceeds from sale of foreclosed assets held for sale	-	42
Purchase of premises and equipment	(347)	(171)
Net cash used in investing activities	(6,010)	(18,454)
Cash flows from financing activities:		
Net increase in deposit accounts	16,787	39,369
Net (decrease) increase in securities sold under agreements to repurchase	(3,600)	252
Payments on borrowed funds	(2,818)	(6,784)
Cash dividends	(474)	(474)
Purchase of treasury stock	(23)	-
Net cash provided by financing activities	9,872	32,363
Net increase in cash and cash equivalents	7,522	15,260
Cash and cash equivalents at beginning of year	29,460	14,200
Cash and cash equivalents at end of year	\$ 36,982	\$ 29,460
Supplement disclosures:		
Cash paid during the period for:		
Interest	\$ 2,449	\$ 3,298
Income taxes	\$ 1,321	\$ 731
Non cash items:		
Unrealized (gain) loss on securities available for sale, net	\$ 119	\$ (405)
Transfer of loans to foreclosed real estate	\$ 120	\$ -
Cash dividends declared but paid in the following year	\$ 203	\$ 169
Acquisition of available-for-sale securities from collateral on loan settlement	\$ -	\$ 4

See Notes to Consolidated Financial Statements

LUZERNE NATIONAL BANK CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Dollars in thousands, except per share data)

YEARS ENDED DECEMBER 31, 2010 AND 2009

1. Nature of operations and summary of significant accounting policies:

Luzerne National Bank Corporation, a bank holding company incorporated under the laws of Pennsylvania, provides a full range of financial services through its wholly-owned subsidiaries, Luzerne Bank (“the Bank”), Firststar Financial Corp., Firststar Abstract, Inc., and Firststar Insurance Services, Inc. (“the Corporation”). Firststar Financial Corp. is an investment holding company that is authorized to invest in stocks, bonds, certificates of deposit and other money market instruments. Firststar Abstract, Inc. is authorized to engage in the selling of title insurance to individuals and small businesses. Firststar Insurance Services, Inc. is authorized to engage in the selling of insurance products and services. The Bank services its individual and commercial customers through its seven offices located within Luzerne County, Pennsylvania. Also, in the first quarter of 2011, the Bank opened a loan production office located in Scranton, Lackawanna County, Pennsylvania. The Corporation is registered with and supervised by the Board of Governors of the Federal Reserve System.

The Bank is a state 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.

The Bank’s primary deposit products are savings accounts, checking accounts and certificates of deposit. Its primary lending products are business loans and single-family residential loans. In addition, the Bank currently provides fiduciary services through its Trust Division.

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

Basis of presentation:

The accounting principles followed by the Corporation and the methods of applying these principles conform with accounting principles generally accepted in the United States of America and with general practices of the banking industry. All significant intercompany balances and transactions have been eliminated in consolidation.

Use of estimates:

In preparing consolidated financial statements in conformity with accounting principles generally accepted in the United States of America, management is required to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities as of the date of the consolidated financial statements and the reported amounts of revenues and expenses during the reporting periods. Actual results could differ from those estimates.

LUZERNE NATIONAL BANK CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Dollars in thousands, except per share data)

YEARS ENDED DECEMBER 31, 2010 AND 2009

1. Nature of operations and summary of significant accounting policies (continued):

Significant group concentrations of investment and credit risk:

Most of the Bank's activities are with customers located within Luzerne County, Pennsylvania. Note 3 and the following paragraph discuss the types of securities that the Bank invests in. Note 4 discusses the types of lending the Bank engages in. The Bank does not have any significant loan concentrations in any one industry or customer; nor, except for U.S. government/agency obligations and mortgage-backed securities, are there any significant investment concentrations.

Securities:

Restricted equity securities, which consist of investments in the common stock of the Federal Reserve Bank, Federal Home Loan Bank and Atlantic Central Bankers Bank, are stated at cost. Debt securities that management has the positive intent and ability to hold to maturity are classified as "held to maturity" and recorded at amortized cost. Securities not classified as restricted equity securities or held to maturity are classified as "available for sale" and recorded at fair value, with unrealized gains and losses excluded from earnings and reported in other comprehensive income. Realized gains and losses are included in net investment securities gains. The cost of investment securities sold, redeemed, or matured is based on the specific identification method. Investment income includes amortization of purchase premiums and discounts. The Corporation has evaluated its holding of restricted stock for impairment and deemed the stock not to be impaired due to the expected recoverability of par value, which equals the value reflected within the Corporation's consolidated financial statements.

Cash and cash equivalents:

For the purposes of the consolidated statements of cash flows, the Corporation has defined cash and cash equivalents as those amounts included in the consolidated balance sheet captions cash and due from banks and federal funds sold.

Loans:

The Bank grants real estate, commercial and consumer loans to customers. A substantial portion of the loan portfolio is represented by loans throughout Luzerne County, Pennsylvania. The ability of the Bank's debtors to honor their contracts is dependent upon the general economic conditions in this area.

Loans are reported at their outstanding unpaid principal balances adjusted for charge-offs, the allowance for loan losses and any deferred fees or costs on originated loans. Interest income is accrued on the unpaid principal balance. Loan origination fees, net of certain direct origination costs, are deferred and recognized as an adjustment of the related loan yield using the interest method.

Generally, a loan is classified as a non-accrual, with the accrual of interest on such a loan discontinued when the contractual payment of principal or interest has become 90-

LUZERNE NATIONAL BANK CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Dollars in thousands, except per share data)

YEARS ENDED DECEMBER 31, 2010 AND 2009

1. Nature of operations and summary of significant accounting policies (continued):

days past due or management has serious doubts about further collectibility of principal or interest, even though the loan currently is performing. A loan may remain on accrual status if it is in the process of collection and is either guaranteed or well-secured. When a loan is placed on non-accrual status, unpaid interest credited to income in the current year is reversed, and unpaid interest accrued in prior years is charged against the allowance for loan losses. Certain non-accrual loans may continue to perform wherein payments are still being received with those payments generally applied to principal. Non-accrual loans remain under constant scrutiny and if performance continues, interest income may be recorded on a cash basis based on management's judgment as to collectability of principal.

A loan is considered impaired when, based on current information and events, it is probable that the Bank will be unable to collect the scheduled payments of principal or interest when due according to the contractual terms of the loan agreement. Factors considered by management in determining impairment include payment status, collateral value, and the probability of collecting scheduled principal and interest payments when due. Loans that experience insignificant payment delays and payment shortfalls generally are not classified as impaired. Management determines the significance of payment delays and payment shortfalls on a case-by-case basis, taking into consideration all of the circumstances surrounding the loan and the borrower, including the length of the delay, the reasons for the delay, the borrower's prior payment record, and the amount of the shortfall in relation to the principal and interest owed.

Impairment is measured on a loan by loan basis for commercial and commercial real estate loans by either the present value of expected future cash flows discounted at the loan's effective interest rate, the loan's obtainable market price, or the fair value of the collateral if the loan is collateral dependent.

Large groups of smaller balance homogeneous loans are evaluated for impairment collectively. Accordingly, the Bank does not separately identify individual consumer and residential real estate loans for impairment disclosures, unless such loans are the subject of a restructuring agreement.

Allowance for loan losses:

The allowance for loan losses is established as losses are estimated to have occurred through a provision for loan losses charged to earnings. Loan losses are charged against the allowance when management believes the uncollectibility of a loan balance is confirmed. Subsequent recoveries, if any, are credited to the allowance.

The allowance for loan losses is evaluated on a regular basis by management and is based upon management's periodic review of the collectibility of the loans in light of

LUZERNE NATIONAL BANK CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Dollars in thousands, except per share data)

YEARS ENDED DECEMBER 31, 2010 AND 2009

1. Nature of operations and summary of significant accounting policies (continued):

historical experience, the nature and volume of the portfolio, adverse situations that may affect the borrower's ability to repay, estimated value of any underlying collateral and prevailing economic conditions. This evaluation is inherently subjective as it requires estimates that are susceptible to significant revision as more information becomes available.

The allowance consists of specific, general and unallocated components. The specific component relates to loans that are classified as either doubtful, substandard or special mention. For such loans that are also classified as impaired, an allowance is established when the collateral value of the impaired loan is lower than the carrying value of that loan. The general component covers non-classified loans and is based on historical loss experience adjusted for qualitative factors. An unallocated component is maintained to cover uncertainties that could affect management's estimate of probable losses. The unallocated component of the allowance reflects the margin of imprecision inherent in the underlying assumptions used in the methodologies for estimating specific and general losses in the portfolio.

Off-balance sheet credit related financial instruments:

In the ordinary course of business, the Bank has entered into commitments to extend credit, including commitments under credit line arrangements and standby letters of credit. Such financial instruments are recorded when they are funded.

Premises and equipment:

Premises, improvements and equipment are stated at cost less accumulated depreciation computed principally on the straight-line method over the estimated useful lives of the assets. Long-lived assets are reviewed for impairment whenever events or changes in business circumstances indicate that the carrying value may not be recovered. Maintenance and minor repairs are charged to operations as incurred. The cost and accumulated depreciation of the premises and equipment retired or sold are eliminated from the property accounts at the time of retirement or sale, and the resulting gain or loss is reflected in current operations.

Foreclosed real estate:

Real estate acquired through, or in lieu of, loan foreclosure is held for sale and is initially recorded at fair value at the date of foreclosure, establishing a new cost basis. Subsequent to foreclosure, valuations are periodically performed by management and the real estate is carried at the lower of carrying amount or fair value less costs to sell. Expenses from operations are included in other expense.

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YEARS ENDED DECEMBER 31, 2010 AND 2009

1. Nature of operations and summary of significant accounting policies (continued):

Bank Owned Life Insurance:

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

Trust assets and income:

Assets held by the Bank in a fiduciary or agency capacity for its customers are not included in the accompanying consolidated financial statements since such items are not assets of the Bank. In accordance with banking industry practice, Trust Department income is recognized on the cash basis and is not materially different than if it was reported on the accrual basis. In late 2010, the Bank notified current Trust Department customers of its intent to vacate the trust and asset management business during 2011. Trust department officers continue to service the current customers during this transition.

Income taxes:

The provision for income taxes is based on the results of operations, adjusted primarily for tax-exempt income. Certain items of income and expense are reported in different periods for financial reporting and tax return purposes. Deferred tax assets and liabilities are determined based on the differences between the consolidated financial statement and income tax bases of assets and liabilities measured by using the enacted tax rates and laws expected to be in effect when the timing differences are expected to reverse. Deferred tax expense or benefit is based on the difference between deferred tax asset or liability from period to period.

Earnings per share:

FASB ASC Topic 260 (SFAS No. 128, "Earnings Per Share"), requires dual presentation of basic and fully diluted earnings per share. Basic earnings per share is calculated by dividing net income by the weighted average number of shares of common stock outstanding at the end of each period. Diluted earnings per share is calculated by increasing the denominator for the assumed conversion of all potentially dilutive securities. The Corporation does not have any dilutive securities. Basic and fully diluted earnings per share are the same. Earnings per share have been computed based on the following:

	INCOME NUMERATOR	COMMON SHARE DENOMINATOR	EPS
2010	<u>\$ 2,535</u>	<u>676,748</u>	<u>\$3.75</u>
2009	<u>\$ 2,021</u>	<u>677,394</u>	<u>\$2.98</u>

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1. Nature of operations and summary of significant accounting policies (continued):

Comprehensive income:

Accounting principles generally require that realized revenue, expenses, gains and losses be included in net income. Unrealized gains and losses on available for sale securities are reported as a separate component of the equity section of the consolidated balance sheet and, along with net income, are components of other comprehensive income.

The components of other comprehensive income and related tax effects for the years ended December 31, are as follows:

	<u>2010</u>	<u>2009</u>
Unrealized gains (losses) on investment securities available for sale	\$ (140)	\$ 660
Reclassification adjustment for gains included in net income	<u>40</u>	<u>46</u>
Change in unrealized gains (losses) before tax effect	(180)	614
Tax effect	<u>61</u>	<u>(209)</u>
Net change in unrealized gains (losses)	<u>\$ (119)</u>	<u>\$ 405</u>

The components of accumulated other comprehensive income, included in shareholders' equity at December 31 are as follows:

	<u>2010</u>	<u>2009</u>
Net unrealized gain on investment securities available for sale	\$ 338	\$ 519
Tax effect	<u>115</u>	<u>177</u>
Net-of-tax amount	<u>\$ 223</u>	<u>\$ 342</u>

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Dollars in thousands, except per share data)

YEARS ENDED DECEMBER 31, 2010 AND 2009

1. Nature of operations and summary of significant accounting policies (continued):

Advertising costs:

It is the Corporation's policy to expense advertising costs in the period in which they are incurred. Advertising expense for the years ended December 31, 2010 and 2009 was approximately \$87 and \$66, respectively.

Fair Value Measurements:

The Financial Accounting Standards Board's (FASB) fair value measurement and disclosure guidance for all nonrecurring fair value measurements of nonfinancial assets and liabilities became effective as of January 1, 2009.

In April 2009, the FASB issued authoritative guidance clarifying that fair value is defined as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants under current market conditions. This new guidance requires an evaluation of whether there has been a significant decrease in the volume and level of activity for the asset or liability in relation to normal market activity for the asset or liability. If there has, transactions or quoted prices may not be indicative of fair value and an adjustment may need to be made to those prices to estimate fair value. Additionally, an entity must consider whether the observed transaction was orderly (i.e., not distressed or forced). If the transaction was orderly, the obtained price can be considered a relevant observable input for determining fair value. If the transaction is not orderly, other valuation techniques must be used when estimating fair value. This guidance was adopted for the year ending December 31, 2009. The adoption of this guidance did not have a material impact on the Corporation's results of operations, cash flows or financial positions.

In August 2009, the FASB issued authoritative guidance clarifying the measurement of the fair value of a liability in circumstances when a quoted price in an active market for an identical liability is not available. The guidance emphasizes that entities should maximize the use of observable inputs in the absence of quoted prices when measuring the fair value of liabilities. This guidance became effective as of October 1, 2009 and did not have a material impact on the Corporation's results of operations, cash flows or financial positions.

Transfers of Financial Assets:

In June 2009, the FASB issued authoritative guidance amending the accounting for the transfers of financial assets. Key provisions include (i) the removal of the concept of qualifying special purpose entities, (ii) the introduction of the concept of a participating interest, in circumstances in which a portion of a financial asset has been transferred and (iii) the requirement that to qualify for sale accounting, the transferor must evaluate whether it maintains effective control over transferred financial assets either directly or indirectly. Furthermore, this guidance requires enhanced disclosures about

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1. Nature of operations and summary of significant accounting policies (continued):

transfers of financial assets and a transferor's continuing involvement. This guidance is effective beginning January 1, 2010 and is required to be applied prospectively. The adoption of this guidance did not have a material impact on the Corporation's results of operations, cash flows or financial position.

Accounting Standards Codification:

In June 2009, the FASB issued authoritative guidance which replaced the previous hierarchy of GAAP and establishes the FASB Codification as the single source of authoritative GAAP recognized by the FASB to be applied by nongovernmental entities. SEC rules and interpretive releases are also sources of authoritative GAAP for SEC registrants. This guidance modifies the GAAP hierarchy to include only two levels of GAAP: authoritative and nonauthoritative. This guidance was effective as of July 1, 2009. The adoption of this guidance did not impact results of operations, cash flows or financial positions since the FASB Codification is not intended to change or alter existing GAAP.

Recognition and Presentation of Other-Than-Temporary Impairments:

In April 2009, the FASB amended authoritative guidance related to accounting for certain investments in debt and equity securities and accounting for certain investments held by not-for-profit organizations. This revised guidance establishes a new method of recognizing and reporting other-than-temporary impairments of debt securities. If it is more likely than not that an impaired debt security will be sold before the recovery of its cost basis, either due to the investor's intent to sell or because it will be required to sell the security, the entire impairment is recognized in earnings. Otherwise, only the portion of the impaired debt security related to estimated credit losses is recognized in earnings, while the remainder of the impairment is recorded in other comprehensive income (OCI) and recognized over the remaining life of the debt security. In addition, the guidance expands the presentation and disclosure requirements for other-than-temporary impairments for both debt and equity securities. This guidance was adopted for the year ended December 31, 2009 and did not have a material impact on the Corporation's results of operations, cash flows or financial positions.

Subsequent Events:

In May 2009, the FASB issued authoritative guidance which incorporates the principles and accounting guidance for recognizing and disclosing subsequent events that originated as auditing standards into the body of authoritative literature issued by the FASB and prescribes disclosures regarding the date through which subsequent events have been evaluated. Management is required to evaluate subsequent events through the date the financial statements are issued. This guidance was effective for the year ended December 31, 2009. Since this guidance is not intended to significantly change the current practice of reporting subsequent events, it did not have an impact on the Corporation's results of operations, cash flows or financial position.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Dollars in thousands, except per share data)

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1. Nature of operations and summary of significant accounting policies (continued):

Fair Value Measurements Disclosures:

In January 2010, the FASB issued authoritative guidance intended to improve disclosures about fair value measurements. The guidance requires entities to disclose significant transfers in and out of fair value hierarchy levels and the reasons for the transfers and to present information about purchases, sales, issuances and settlements separately in the reconciliation of fair value measurements using significant unobservable inputs (Level 3). Additionally, the guidance clarifies that a reporting entity should provide fair value measurements for each class of assets and liabilities and disclose the inputs and valuation techniques used for fair value measurements using significant other observable inputs (Level 2) and significant unobservable inputs (Level 3). This guidance is effective for annual periods beginning after December 15, 2009 except for the disclosures about purchases, sales, issuances and settlements in the Level 3 reconciliation, which will be effective for annual periods beginning after December 15, 2010. As this guidance provides only disclosure requirements, the adoption of this standard will not impact the Corporation's results of operations, cash flows or financial positions.

ASU No. 2010-20, "Receivables (Topic 310) – Disclosures about the Credit Quality of Financing Receivables and the Allowance for Credit Losses" ASU 2010-20 requires entities to provide disclosures designed to facilitate financial statement users' evaluation of (i) the nature of credit risk inherent in the entity's portfolio of financing receivables, (ii) how that risk is analyzed and assessed in arriving at the allowance for credit losses and (iii) the changes and reasons for those changes in the allowance for credit losses. Disclosures must be disaggregated by portfolio segment, the level at which an entity develops and documents a systematic method for determining its allowance for credit losses, and class of financing receivable, which is generally a disaggregation of portfolio segment. The required disclosures include, among other things, a rollforward of the allowance for credit losses as well as information about modified, impaired, non-accrual and past due loans and credit quality indicators. ASU 2010-20 will become effective for the Corporation's financial statements as of December 31, 2011, as it relates to disclosures required as of the end of a reporting period. Disclosures that relate to activity during a reporting period will be required for the Corporation's financial statements that include periods beginning on or after January 1, 2011. ASU 2011-01, "Receivables (Topic 310) – Deferral of the Effective Date of Disclosures about Troubled Debt Restructurings in Update No. 2010-20," temporarily deferred the effective date for disclosures related to troubled debt restructurings to coincide with the effective date of a proposed accounting standards update related to troubled debt restructurings, which is currently expected to be effective for periods ending after June 15, 2011.

Reclassifications:

Certain amounts in the 2009 consolidated financial statements have been reclassified to conform with the presentation used in the 2010 consolidated financial statements. Such reclassification had no effect on the Corporation's consolidated financial position net income.

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**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Dollars in thousands, except per share data)**

YEARS ENDED DECEMBER 31, 2010 AND 2009

3. Investment securities (continued):

Investment securities with a carrying value of approximately \$12,806 and \$11,992 at December 31, 2010 and 2009, respectively, were pledged to secure governmental deposits, trust funds, and for other purposes as required by law.

A summary of the amortized cost and fair value of debt securities at December 31, 2010 by contractual maturity is shown below.

	Within 1 year	After 1 year through 5 years	After 5 year through 10 years	Over 10 years	Total
Securities held to maturity, at amortized cost:					
Obligations of state and political subdivisions	\$ 30				30
Mortgage-backed securities		13	118	\$ 990	1,121
Total	\$ 30	\$ 13	\$ 118	\$ 990	\$ 1,151
Securities available for sale, at fair value:					
Obligations of U.S. government, its corporations and agencies	\$	\$ 7,034	\$ 2,340		\$ 9,374
Obligations of state and political subdivisions		1,745	7,976	\$ 668	10,389
Mortgage-backed securities		690	42	2,827	3,559
Total	\$	\$ 9,469	\$ 10,358	\$ 3,495	\$ 23,322

Proceeds from sales, maturities and redemptions of investments in debt and equity securities classified as available-for-sale during 2010 and 2009 were \$12,569 and \$7,843, respectively. Gross gains realized on these transactions were \$40 and \$67, respectively. Gross losses realized on these transactions were \$0 and \$21, respectively.

Proceeds from sales, maturities and redemptions of investments in debt and equity securities classified as held-to-maturity during 2010 and 2009 were \$35 and \$3,037, respectively. There were no gross gains or losses on the 2010 and 2009 transactions.

Information pertaining to securities with gross unrealized losses at December 31, 2010 and 2009, aggregated by investment category and length of time that individual securities have been in a continuous loss position, follows:

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Dollars in thousands, except per share data)

YEARS ENDED DECEMBER 31, 2010 AND 2009

3. Investment securities (continued):

2010	LESS THAN TWELVE MONTHS		TWELVE MONTHS OR GREATER	
	GROSS UNREALIZED HOLDING LOSSES	FAIR VALUE	GROSS UNREALIZED HOLDING LOSSES	FAIR VALUE
There were no securities classified as held-to-maturity that were in an unrealized loss position at December 31, 2010.				
Securities available for sale:				
Obligations of U.S. government, its corporations and agencies	\$ 12	\$ 989		
Obligations of states and political subdivisions	57	2,485		
Mortgage-backed securities				
Total	<u>\$ 69</u>	<u>\$ 3,474</u>	<u>\$</u>	<u>\$</u>

2009	LESS THAN TWELVE MONTHS		TWELVE MONTHS OR GREATER	
	GROSS UNREALIZED HOLDING LOSSES	FAIR VALUE	GROSS UNREALIZED HOLDING LOSSES	FAIR VALUE
Securities held to maturity:				
Mortgage-backed securities	\$	\$	\$ 1	\$ 30
Total	<u>\$</u>	<u>\$</u>	<u>\$ 1</u>	<u>\$ 30</u>

There were no securities classified as available-for-sale that were in an unrealized loss position at December 31, 2009.

The Bank had 118 investment securities at December 31, 2010. There were 11 investment securities in an unrealized loss position at December 31, 2010. There were 2 mortgage-backed securities that have been in a continuous loss position for more than 12 months as of December 31, 2010. Deterioration in the value of these securities was attributable to changes in market interest rates and not the credit quality of the issuers. None of the investment securities in an unrealized loss position at December 31, 2010 represent an other-than-temporary impairment. Furthermore, as management has the ability to hold debt securities until maturity, or for the foreseeable future if classified as available for sale, no declines are deemed to be other than temporary.

Management evaluates securities for other-than-temporary impairment ("OTTI") at least on a quarterly basis, and more frequently when economic or market conditions warrant such an evaluation. Investment securities classified as available for sale or held-to-maturity are generally evaluated for OTTI under FASB ASC 320 (SFAS No. 115, Accounting for Certain Investments in Debt and Equity Securities). In determining OTTI under the FASB ASC 320 (SFAS No. 115) model, management considers many

LUZERNE NATIONAL BANK CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Dollars in thousands, except per share data)

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3. Investment securities (continued):

factors, including (1) the length of time and the extent to which the fair value has been less than cost, (2) the financial condition and near-term prospects of the issuer, (3) whether the market decline was affected by macroeconomic conditions, and (4) whether the entity has the intent to sell the debt security or more likely than not will be required to sell the debt security before its anticipated recovery. The assessment of whether an other-than-temporary decline exists involves a high degree of subjectivity and judgment and is based on the information available to management at a point in time.

When other-than-temporary impairment occurs, the amount of the other-than-temporary impairment recognized in earnings depends on whether an entity intends to sell the security or more likely than not will be required to sell the security before recovery of its amortized cost basis less any current-period credit loss. If an entity intends to sell or more likely than not will be required to sell the security before recovery of its amortized cost basis less any current-period credit loss, the other-than-temporary impairment shall be recognized in earnings equal to the entire difference between the investment's amortized cost basis and its fair value at the balance sheet date. If an entity does not intend to sell the security and it is not more likely than not that the entity will be required to sell the security before recovery of its amortized cost basis less any current-period loss, the other-than-temporary impairment shall be separated into the amount representing the credit loss and the amount related to all other factors. The amount of the total other-than-temporary impairment related to the credit loss is determined based on the present value of cash flows expected to be collected and is recognized in earnings. The amount of the total other-than-temporary impairment related to the other factor shall be recognized in other comprehensive income, net of applicable taxes.

The previous amortized cost basis less the other-than-temporary impairment recognized in earnings shall become the new amortized cost basis of the investment.

Assets Measured at Fair Value on a Recurring Basis:

The Bank measures certain assets at fair value on a recurring basis. Fair value is defined as a price that would be received to sell an asset in an orderly transaction between market participants at the measurement date. Authoritative guidance establishes a framework for measuring fair value that includes a hierarchy used to classify the inputs used in measuring fair value. The hierarchy prioritizes the inputs used in determining valuations into three levels. The level in the fair value hierarchy within which the fair value measurement falls is determined based on the lowest level input that is significant to the fair value measurement. The levels of the fair value hierarchy are as follows:

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Dollars in thousands, except per share data)

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3. Investment securities (continued):

- A. Level 1: Fair value is based on unadjusted quoted prices in active markets that are accessible to the Bank for identical assets. These generally provide the most reliable evidence and are used to measure fair value whenever available.
- B. Level 2: Fair value is based on significant inputs, other than Level 1 inputs, that are observable either directly or indirectly for substantially the full term of the asset through corroboration with observable market data. Level 2 inputs include quoted market prices in active markets for similar assets, quoted market prices that are not active for identical or similar assets and other observable inputs.
- C. Level 3: Fair value is based on significant unobservable inputs. Examples of valuation methodologies that would result in Level 3 classification include option pricing models, discounted cash flows and other similar techniques.

At December 31, 2010, investments measured at fair value on a recurring basis and the valuation methods used are as follows:

Available for Sale Securities	<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>	<u>Total</u>
Obligations of US Government Agencies		\$ 9,374		\$ 9,374
Obligations of state and political subdivisions		10,389		10,389
Mortgage-backed securities		3,559		3,559
Equity securities		-		-
	<u>\$</u>	<u>\$ 23,322</u>	<u>\$</u>	<u>\$23,322</u>

The estimated fair values for all available for sale securities are obtained from nationally-recognized third-party pricing agencies. The estimated fair values are derived primarily from cash flow models, which include assumptions for interest rates, credit losses, and prepayment speeds. The significant inputs utilized in the cash flow models are based on market data obtained from sources independent of the Bank (observable inputs), and are therefore classified as Level 2 within the fair value hierarchy.

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4. Loans:

Major classifications of loans are summarized at December 31 as follows:

	<u>2010</u>	<u>2009</u>
Commercial	\$ 54,969	\$ 52,853
Real estate	147,140	142,568
Consumer	<u>3,408</u>	<u>3,755</u>
Total	205,517	199,176
Less allowance for possible loan losses	<u>2,439</u>	<u>2,109</u>
Loans, net	<u>\$ 203,078</u>	<u>\$ 197,067</u>

Although the Bank has a diversified loan portfolio, loans outstanding to individuals and businesses are dependent upon the local economic conditions in its immediate trade area. The majority of loans are secured by real estate. The Bank has experienced minimal difficulty in accessing collateral when required.

The aggregate amount of all extensions of loans to directors, executive officers, principal shareholders or to their affiliates totaled \$5,879 and \$5,924 at December 31, 2010 and 2009, respectively. These loans are made during the ordinary course of business at the Bank's normal credit terms. There were no related party loans that were classified as nonaccrual, past due, restructured or considered a potential credit risk at December 31, 2010 and 2009.

At December 31, 2010 and 2009, net unamortized loan fees of \$100 and \$162, respectively, have been offset against the carrying value of loans.

Non-accrual loan information is as follows at December 31:

	<u>2010</u>	<u>2009</u>
Loans for which there is a related allowance for loan losses	\$ 0	\$ 0
Loans for which there is no related allowance for loan losses	<u>375</u>	<u>216</u>
Total non-accrual loans	<u>\$ 375</u>	<u>\$ 216</u>
Related allowance for loan losses	0	0
Average recorded balance of non-accrual loans	472	201

LUZERNE NATIONAL BANK CORPORATION AND SUBSIDIARIES

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4. Loans (continued):

The gross interest that would have been recorded if these loans had been current in accordance with their original terms and the amounts actually recorded in income were as follows:

	<u>2010</u>	<u>2009</u>
Gross interest due under terms	\$ 42	\$ 13
Amount included in income	<u>-</u>	<u>-</u>
Interest income not recognized	<u>\$ 42</u>	<u>\$ 13</u>

At December 31, 2010 there were no significant commitments to lend additional funds with respect to non-accrual loans.

Transactions in the allowance for possible loan losses are summarized for the years ended December 31 as follows:

	<u>2010</u>	<u>2009</u>
Balance, beginning of period	\$ 2,109	\$ 1,746
Provision for loan losses	675	430
Recovery of loans previously charged off	52	23
Loans charged off	<u>(397)</u>	<u>(90)</u>
Balance, end of period	<u>\$ 2,439</u>	<u>\$ 2,109</u>

From time to time, the Bank may agree to modify the contractual terms of a borrower's loan. In cases where such modifications represent a concession to a borrower experiencing financial difficulty, the modification is considered a troubled debt restructuring. Loans modified in a troubled debt restructuring are placed on non-accrual status until the Bank determines the future collection of principal and interest is reasonably assured, which generally requires that the borrower demonstrate a period of performance according to the restructured terms of six months. At December 31, 2010, there were no significant loans modified in troubled debt restructurings.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
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5. Premises and equipment:

A summary of premises and equipment at December 31 is as follows:

	<u>2010</u>	<u>2009</u>
Land	\$ 1,605	\$ 1,605
Buildings and improvements	5,728	5,586
Leasehold improvements	267	286
Furniture and equipment	<u>3,633</u>	<u>3,497</u>
	11,233	10,974
Less accumulated depreciation	<u>6,122</u>	<u>5,780</u>
Net	<u>\$ 5,111</u>	<u>\$ 5,194</u>

Depreciation on premises and equipment amounted to \$430 and \$409 in 2010 and 2009, respectively.

6. Deposits:

The aggregate amount of time deposits issued in amounts of \$100,000 or more was approximately \$24,965 and \$39,622 at December 31, 2010 and 2009, respectively.

At December 31, 2010, the scheduled maturities of time deposits are as follows:

2010	\$ 44,172
2011-2012	18,044
2013 and thereafter	<u>14,217</u>
	<u>\$ 76,433</u>

The Bank accepts deposits of its directors, executive officers, principal shareholders or their affiliates on the same terms and at the prevailing interest rates offered at the time of deposit for comparable transactions with unrelated parties. The amount of related party deposits totaled \$6,503 and \$6,050 at December 31, 2010 and 2009, respectively.

At December 31, 2010, one depositor in the real estate management business had aggregate deposits amounting to \$14,930,000.

7. Securities sold under agreements to repurchase:

Securities sold under agreements to repurchase, which are classified as secured borrowings, mature within one day from the transaction date. Securities sold under agreements to repurchase are reflected at the amount of cash received in connection with the transaction.

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8. Lines of Credit:

The Bank has an \$11,000 available line of credit with the Federal Home Loan Bank (FHLB), secured by loans and investments. The interest rate fluctuates daily and interest is payable weekly. The line expires December 2011. The Bank had no borrowings under this line of credit agreement at December 31, 2010 and 2009.

The Bank also has an unsecured line of credit available with the Atlantic Central Bankers Bank (ACBB) in the amount of \$6,000. The interest rate fluctuates daily. Borrowings are due and payable in full on the next business day after the day of the borrowing. The line expires on June 30, 2011. The Bank had no outstanding borrowings under this line of credit agreement at December 31, 2010 and 2009.

9. Borrowed funds:

The Bank's fixed-rate, long-term borrowed funds with the FHLB of \$5,850 at December 31, 2010, matures through 2016 and are secured by loans and investments. At December 31, 2010, the interest rates on borrowed funds ranged from 3.83% to 6.28%. The weighted average of these borrowings at December 31, 2010 was 4.22%

The contractual maturities of long-term borrowed funds at December 31, 2010 are as follows:

2011	\$ 852
2012	2,888
2013	840
2014	856
2015	392
Thereafter	<u>22</u>
	<u>\$ 5,850</u>

10. Deferred compensation:

The Bank has entered into deferred compensation agreements with certain directors and officers. The total present value of the future payments recorded under these agreements was \$1,151 and \$872 as of December 31, 2010 and 2009, respectively. Life insurance policies with cash surrender values of \$6,327 and \$6,068 at December 31, 2010 and 2009, respectively, have been acquired with the intention of funding these agreements. The related expenses for these agreements amounted to \$164 and \$138 for the years ended December 31, 2010 and 2009, respectively.

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11. Retirement plan:

The Bank maintains a 401(k) profit-sharing plan covering substantially all employees. Participants may make voluntary contributions up to 100% of their compensation, subject to limitations of the Internal Revenue Service, and the Bank currently makes discretionary matching contributions of 50% up to 6% of their compensation. Bank contributions were \$57 and \$62 for the years ended December 31, 2010 and 2009, respectively.

12. Income taxes:

The following temporary differences gave rise to the net deferred tax asset, included in other assets, at December 31:

	<u>2010</u>	<u>2009</u>
Deferred tax assets:		
Allowance for loan losses	\$ 727	\$ 569
Deferred compensation plan	391	297
Investment securities available for sale		
Other	<u>5</u>	<u>22</u>
	<u>1,123</u>	<u>888</u>
Deferred tax liabilities:		
Loan fees and costs	104	106
Premises and equipment	93	69
Prepaid expenses	114	116
Investment securities available for sale	<u>115</u>	<u>176</u>
	<u>426</u>	<u>467</u>
Deferred tax asset, net	<u>\$ 697</u>	<u>\$ 421</u>

It is anticipated that all deferred tax assets are to be realized and, accordingly, no valuation allowance has been provided. The Corporation and its subsidiaries file a consolidated federal income tax return.

The provision for income taxes is comprised of the following components for the years ended December 31:

	<u>2010</u>	<u>2009</u>
Current	\$ 1,216	\$ 906
Deferred benefit	<u>(217)</u>	<u>(194)</u>
Provision for income taxes	<u>\$ 999</u>	<u>\$ 712</u>

The effective federal income tax rates were 28.3% and 26.1% for the years ended December 31, 2010 and 2009, respectively.

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12. Income taxes (continued):

A reconciliation between the expected statutory income tax rates and the effective income tax rates on income before income taxes for the years ended December 31 follows:

	2010		2009	
	AMOUNT	%	AMOUNT	%
Provision at statutory rate	\$ 1,202	34.0	\$ 929	34.0
Tax-exempt income	(125)	(3.5)	(128)	(4.7)
Income on life insurance policies	(88)	(2.5)	(86)	(3.1)
Other, net	10	.3	(3)	(.1)
Effective income tax and rates	\$ 999	28.3	\$ 712	26.1

The corporation and its wholly owned subsidiaries file a consolidated federal income tax return. The Corporation is no longer subject to U.S. federal income tax examinations by tax authorities for years before 2007.

13. Financial instruments with off-balance-sheet risk:

The Bank is a party to financial instruments with off-balance-sheet risk in the normal course of business to meet the financing needs of its customers. These financial instruments consist of commitments to extend credit and standby letters of credit. Those instruments involve to varying degrees elements of credit, interest rate or liquidity risk in excess of the amount recognized in the consolidated balance sheet.

Bank exposure to credit loss from nonperformance by the other party to the financial instruments for commitments to extend credit and standby letters of credit is represented by the contractual amount of those instruments. The Bank uses the same credit policies in making commitments as it does for on-balance-sheet instruments.

Off-balance sheet financial instruments at December 31 are as follows:

	2010	2009
Commitments to extend credit	\$ 41,556	\$ 41,444
Standby letters of credit	2,062	1,121

Commitments to extend credit are legally binding agreements to lend to customers. Commitments generally have fixed expiration dates or other termination clauses and may require payment of fees.

Standby letters of credit are conditional commitments issued by the Bank guaranteeing performance by a customer to a third party.

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13. Financial instruments with off-balance-sheet risk (continued):

The credit risk involved in issuing commitments and letters of credit is essentially the same as that involved in extending loan facilities to customers.

Since many of the commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future liquidity requirements. The Bank evaluates each customer's creditworthiness on a case-by-case basis. The amount of collateral obtained if deemed necessary by the Bank on extension of credit is based on management's credit assessment of the counterparty.

14. Regulatory matters:

Capital requirements:

The Corporation, on a consolidated basis, and the Bank are subject to various regulatory capital requirements administered by the federal and state banking agencies. Failure to meet minimum capital requirements can initiate certain mandatory and possibly additional discretionary actions by regulators that, if undertaken, could have a direct material effect on the Corporation and Bank's financial statements.

Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the Corporation and Bank must meet specific capital guidelines that involve quantitative measures of the assets, liabilities, and certain off-balance-sheet items as calculated under regulatory accounting practices. The capital amounts and classification are also subject to qualitative judgments by the regulators about components, risk weightings, and other factors.

Quantitative measures established by regulation to ensure capital adequacy require the Corporation and Bank to maintain minimum amounts and ratios of total and Tier I capital (as defined in the regulations) to risk-weighted assets (as defined), and of Tier I capital (as defined) to average assets (as defined). Management believes, as of December 31, 2010 and 2009 that the Corporation and Bank meets all capital adequacy requirements to which they are subject.

As of December 31, 2010, the most recent notification from the Federal Deposit Insurance Corporation categorized the Bank as well capitalized under the regulatory framework for prompt corrective action. To be categorized as well-capitalized, the Bank must maintain minimum ratios as set forth in the table.

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14. Regulatory matters (continued):

Capital requirements (continued):

	<u>Actual</u>		<u>Minimum capital requirement</u>		<u>To be well-capitalized under prompt corrective action provisions</u>	
	<u>Amount</u>	<u>Ratio</u>	<u>Amount</u>	<u>Ratio</u>	<u>Amount</u>	<u>Ratio</u>
As of December 31, 2010:						
Total capital (to risk weighted assets)	\$ 27,306	12.71%	\$ 17,183	8.00%	\$21,479	10.00%
Tier I capital (to risk weighted assets)	24,867	11.58	8,592	4.00	12,888	6.00
Tier I capital (to average assets)	24,867	9.38	10,609	4.00	13,261	5.00
As of December 31, 2009:						
Total capital (to risk weighted assets)	\$ 24,937	12.11%	\$ 16,475	8.00%	\$20,594	10.00%
Tier I capital (to risk weighted assets)	22,828	11.08	8,238	4.00	12,357	6.00
Tier I capital (to average assets)	22,828	9.09	10,051	4.00	12,564	5.00

The Corporation's capital ratios are not materially different from those of the Bank.

There are no conditions or events subsequent to December 31, 2010 that management believes have significantly changed the "actual" amounts disclosed above.

15. Employee stock purchase plan:

In 2001, the Corporation's board of directors approved an employee stock purchase plan wherein employees may purchase shares of the Corporation's stock subject to limitations based on compensation. Employees purchased 356 and 288 shares in 2010 and 2009, respectively.

16. Fair values of financial instruments:

The fair value of a financial instrument is the current amount that would be exchanged between willing parties, other than in a forced liquidation. Fair value is best determined based upon quoted market prices. However, in many instances, there are no quoted market prices for the Corporation's various financial instruments. In cases where quoted market prices are not available, fair values are based on estimates using

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16. Fair values of financial instruments (continued):

present value or other valuation techniques. Those techniques are significantly affected by the assumptions used, including the discount rate and estimates of future cash flows. Accordingly, the fair value estimates may not be realized in an immediate settlement of the instrument. Certain financial instruments and all nonfinancial instruments are excluded from disclosure requirements. Accordingly, the fair value amounts presented do not necessarily represent the underlying fair value of the Corporation.

The following methods and assumptions were used by the Corporation in estimating fair value disclosures for financial instruments:

Cash and due from banks and federal funds sold:

The carrying amounts of these instruments approximate fair values.

Securities:

Securities classified as available for sale are reported as fair value utilizing Level 2 inputs.

For these securities, the Corporation obtains fair value measurements from an independent pricing service. The fair value measurements consider observable data that may include dealer quotes, market spreads, cash flows, the U.S. Treasury yield curve, live trading levels, trade execution data, market consensus prepayment speeds, credit information and the bond's terms and conditions, among other things.

Loans:

For variable rate loans that reprice frequently and with no significant change in credit risk, fair values are based on carrying values. Fair values for fixed rate real estate loans (e.g., one-to-four family residential) and consumer loans are based on quoted market prices of similar loans sold in conjunction with securitization transactions, adjusted for differences in loan characteristics.

Fair values for fixed rate commercial loans are estimated using discounted cash flow analyses using interest rates currently being offered for loans with similar terms to borrowers of similar credit quality. Fair values for impaired loans are estimated using underlying collateral values.

Deposit liabilities:

The fair values for demand deposits are, by definition, equal to the amount payable on demand at the reporting date (e.g. carrying amounts). The carrying amounts of variable-rate, fixed-term NOW accounts, money market accounts, savings accounts and time deposits approximate their fair values at the reporting date.

Fair values for fixed-rate time deposits are estimated using a discounted cash flow calculation that applies interest rates currently being offered on time deposits to a

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16. Fair values of financial instruments (continued):

schedule of aggregated expected monthly maturities of these deposits.

Securities sold under agreements to repurchase:

The carrying amounts of securities sold under agreements to repurchase approximate their fair values.

Borrowed funds:

The fair values of the Bank's borrowed funds are estimated using discounted cash flow analyses based on the Bank's current incremental borrowing rates for similar types of borrowing arrangements.

Accrued interest:

The carrying amounts of accrued interest approximate fair value.

The carrying amount and estimated fair values of the Corporation's financial instruments are as follows at December 31:

	<u>2010</u>		<u>2009</u>	
	<u>CARRYING</u>	<u>FAIR</u>	<u>CARRYING</u>	<u>FAIR</u>
	<u>AMOUNT</u>	<u>VALUE</u>	<u>AMOUNT</u>	<u>VALUE</u>
FINANCIAL ASSETS:				
Cash and due from banks	\$ 15,747	\$ 15,747	\$ 16,713	\$ 16,713
Federal funds sold	21,235	21,235	12,747	12,747
Securities held-to-maturity	1,151	1,192	1,533	1,566
Securities available-for-sale and restricted equity securities	24,896	24,896	25,864	25,864
Loans, net of allowance	203,078	213,356	197,067	206,055
Accrued interest receivable	808	808	867	867
FINANCIAL LIABILITIES:				
Deposits	243,645	245,135	226,858	228,447
Federal funds purchased				
Securities sold under agreements to repurchase	3,606	3,606	7,206	7,206
Borrowed funds	5,850	6,239	8,668	9,177
Accrued interest payable	214	214	294	294

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17. Restrictions on dividends, loans and advances:

Federal and state banking regulations place certain restrictions on dividends paid and loans or advances made by the Bank to the Luzerne National Bank Corporation (“the Corporation”). The total amount of dividends which may be paid at any date is generally limited to the retained earnings of the Bank, and loans or advances are limited to 10% of the Bank’s capital stock and surplus on a secured basis.

At December 31, 2010, the Bank’s retained earnings available for the payment of dividends was \$21,614. Further, in a given year, the Bank cannot, without prior regulatory approval, pay a dividend to the Corporation in excess of the current year’s net earnings plus the retained net income of the prior two calendar years. Accordingly, in 2011, without prior regulatory approval, the Bank may declare dividends to the Corporation in the amount of \$3,596 plus additional amounts equal to the net income earned in 2011 for the period from January 1, 2011 through the date of declaration, less any dividends which may have already been paid in 2011. Funds available for loans or advances by the Bank to the Corporation amounted to \$325.

In addition, dividends paid by the Bank to the Corporation would be prohibited if the effect thereof would cause the Bank’s capital to be reduced below applicable minimum capital requirements.

18. Subsequent Events:

Management has evaluated subsequent events through February 11, 2011 which is the date that the Corporation’s consolidated financial statements were available to be issued. No material subsequent events have occurred since December 31, 2010 that required recognition or disclosure in the accompanying consolidated financial statements.

*The following firms have agreed to provide a market for
Luzerne National Bank Corporation Stock*

The stock trades under the symbol "LUZR"

Stifel Nicolaus & Company, Inc.
c/o Mark Ingold
2000 Oxford Drive
Suite 605
Bethel Park, PA 15102
Phone: (412) 854-7514
Toll Free: (866) 253-0500
Fax: (412) 831-3670

Boenning & Scattergood
c/o William R. Wagner
Institutional Equity Sales
2025 Greentree Road
Pittsburgh, PA 15220
Phone: (412) 254-2210
Toll Free: (800) 889-6440
Fax: (412) 344-2930

Janney Montgomery Scott LLC
c/o Phil Stevens
72 Glenmaura National Boulevard
Suite 103
Moosic, PA 18507
Toll Free: (800) 638-4417
Fax: (570) 963-5841



Dallas, PA



Harvey's Lake, PA



Luzerne, PA



Plains, PA



Swoyersville, PA



Wilkes-Barre, PA



Wyoming, PA

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Plains Office

1492 Highway 315
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Swoyersville Office

801 Main Street
Swoyersville, PA 18704
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324 Wyoming Avenue
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