

CODORUS VALLEY BANCORP INC

Form 10-Q

August 13, 2013

[Table of Contents](#)

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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 June 30, 2013**

**or**

**o 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: 0-15536

**CODORUS VALLEY BANCORP, INC.**

(Exact name of registrant as specified in its charter)

**Pennsylvania**

(State or other jurisdiction of  
incorporation or organization)

**23-2428543**

(I.R.S. Employer  
Identification No.)

**105 Leader Heights Road, P.O. Box 2887, York, Pennsylvania 17405**

(Address of principal executive offices) (Zip code)

**717-747-1519**

(Registrant's telephone number, including area code)

**Not Applicable**

(Former name, former address and former fiscal year,  
if changed since the 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 o

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

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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 definition of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer ☐

Accelerated filer ☐

Non-accelerated filer ☐

Smaller reporting company ☒

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

### APPLICABLE ONLY TO CORPORATE ISSUERS

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date. On August 1, 2013, 4,520,123 shares of common stock, par value \$2.50, were outstanding.

- 1 -

Edgar Filing: CODORUS VALLEY BANCORP INC - Form 10-Q

Codorus Valley Bancorp, Inc.

**Form 10-Q Index**

**PART I FINANCIAL INFORMATION**

Page #

<u>Item 1.</u>	<u>Financial statements (unaudited):</u>	
	<u>Consolidated balance sheets</u>	3
	<u>Consolidated statements of income</u>	4
	<u>Consolidated statements of comprehensive income</u>	5
	<u>Consolidated statements of cash flows</u>	6
	<u>Consolidated statements of changes in shareholders' equity</u>	7
	<u>Notes to consolidated financial statements</u>	8
<u>Item 2.</u>	<u>Management's discussion and analysis of financial condition and results of operations</u>	34
<u>Item 3.</u>	<u>Quantitative and qualitative disclosures about market risk</u>	56
<u>Item 4.</u>	<u>Controls and procedures</u>	56

**PART II OTHER INFORMATION**

<u>Item 1.</u>	<u>Legal proceedings</u>	56
<u>Item 1A.</u>	<u>Risk factors</u>	56
<u>Item 2.</u>	<u>Unregistered sales of equity securities and use of proceeds</u>	56
<u>Item 3.</u>	<u>Defaults upon senior securities</u>	56
<u>Item 4.</u>	<u>Mine safety disclosures</u>	57
<u>Item 5.</u>	<u>Other information</u>	57
<u>Item 6.</u>	<u>Exhibits</u>	57

**SIGNATURES**

58

Table of Contents**PART I - FINANCIAL INFORMATION****Item 1. Financial Statements**

Codorus Valley Bancorp, Inc.  
Consolidated Balance Sheets  
Unaudited

<i>(dollars in thousands, except share and per share data)</i>	<b>June 30, 2013</b>	<b>December 31, 2012</b>
<b>Assets</b>		
Interest bearing deposits with banks	\$ 53,695	\$ 34,866
Cash and due from banks	11,121	14,891
Total cash and cash equivalents	64,816	49,757
Securities, available-for-sale	221,184	234,062
Restricted investment in bank stocks, at cost	3,093	2,863
Loans held for sale	1,144	3,091
Loans (net of deferred fees of \$1,609 - 2013 and \$1,186 - 2012)	768,600	737,134
Less-allowance for loan losses	(9,459)	(9,302)
Net loans	759,141	727,832
Premises and equipment, net	13,029	11,493
Other assets	36,643	30,639
Total assets	\$ 1,099,050	\$ 1,059,737
<b>Liabilities</b>		
Deposits		
Noninterest bearing	\$ 102,977	\$ 88,476
Interest bearing	821,873	812,831
Total deposits	924,850	901,307
Short-term borrowings	23,130	19,356
Long-term debt	40,533	30,815
Other liabilities	7,281	6,928
Total liabilities	995,794	958,406
<b>Shareholders' equity</b>		
Preferred stock, par value \$2.50 per share; \$1,000 liquidation preference, 1,000,000 shares authorized; 25,000 Series B shares issued and outstanding - 2013 and 2012	25,000	25,000
Common stock, par value \$2.50 per share; 15,000,000 shares authorized; shares issued and outstanding: 4,520,123 at June 30, 2013 and 4,482,319 at December 31, 2012	11,300	11,206
Additional paid-in capital	41,101	40,524
Retained earnings	23,062	18,868
Accumulated other comprehensive income	2,793	5,733
Total shareholders' equity	103,256	101,331
Total liabilities and shareholders' equity	\$ 1,099,050	\$ 1,059,737
See accompanying notes.		

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Table of Contents

Codorus Valley Bancorp, Inc.  
Consolidated Statements of Income  
Unaudited

(dollars in thousands, except per share data)	Three months ended June 30,		Six months ended June 30,	
	2013	2012	2013	2012
<b>Interest income</b>				
Loans, including fees	\$ 10,209	\$ 10,164	\$ 20,277	\$ 20,034
Investment securities:				
Taxable	621	910	1,266	1,817
Tax-exempt	612	592	1,240	1,189
Dividends	3	3	9	7
Other	28	23	42	38
Total interest income	11,473	11,692	22,834	23,085
<b>Interest expense</b>				
Deposits	1,951	2,415	3,960	4,871
Federal funds purchased and other short-term borrowings	29	29	57	53
Long-term debt	192	196	364	407
Total interest expense	2,172	2,640	4,381	5,331
Net interest income	9,301	9,052	18,453	17,754
<b>Provision for loan losses</b>	560	250	820	500
Net interest income after provision for loan losses	8,741	8,802	17,633	17,254
<b>Noninterest income</b>				
Trust and investment services fees	464	405	937	813
Income from mutual fund, annuity and insurance sales	173	243	422	431
Service charges on deposit accounts	670	633	1,304	1,244
Income from bank owned life insurance	185	174	351	330
Other income	180	170	346	332
Net gain on sales of loans held for sale	322	281	641	540
Net gain on sales of securities	44	0	44	49
Total noninterest income	2,038	1,906	4,045	3,739
<b>Noninterest expense</b>				
Personnel	4,115	3,761	8,295	7,439
Occupancy of premises, net	512	504	1,023	1,012
Furniture and equipment	489	461	1,005	924
Postage, stationery and supplies	157	134	307	268
Professional and legal	165	150	302	309
Marketing and advertising	254	197	400	407
FDIC insurance	138	189	309	408
Debit card processing	195	178	373	355
Charitable donations	11	34	486	481
External data processing	157	142	304	270
Foreclosed real estate including (gains) losses on sales	74	211	137	804
Impaired loan carrying costs	36	185	115	230
Other	854	806	1,354	1,315
Total noninterest expense	7,157	6,952	14,410	14,222
Income before income taxes	3,622	3,756	7,268	6,771
<b>Provision for income taxes</b>	977	977	1,961	1,702
Net income	2,645	2,779	5,307	5,069
Preferred stock dividends	62	71	125	259
Net income available to common shareholders	\$ 2,583	\$ 2,708	\$ 5,182	\$ 4,810
Net income per common share, basic	\$ 0.57	\$ 0.61	\$ 1.15	\$ 1.09
Net income per common share, diluted	\$ 0.56	\$ 0.60	\$ 1.13	\$ 1.08

See accompanying notes.



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## Table of Contents

### Codorus Valley Bancorp, Inc. Consolidated Statements of Comprehensive Income Unaudited

	Three months ended June 30,	
	2013	2012
<i>(dollars in thousands)</i>		
<b>Net income</b>	\$ 2,645	\$ 2,779
<b>Other comprehensive (loss) income:</b>		
Securities available for sale:		
Net unrealized holding (losses) gains arising during the period (net of tax (benefit) expense of \$(1,283) and \$110, respectively)	(2,489)	214
Reclassification adjustment for (gains) included in net income (net of tax expense of \$15 and \$0, respectively) (a) (b)	(29)	0
Net unrealized (losses) gains	(2,518)	214
Comprehensive income	\$ 127	\$ 2,993
	Six months ended June 30,	
	2013	2012
<i>(dollars in thousands)</i>		
<b>Net income</b>	\$ 5,307	\$ 5,069
<b>Other comprehensive (loss) income:</b>		
Securities available for sale:		
Net unrealized holding (losses) gains arising during the period (net of tax (benefit) expense of \$(1,500) and \$171, respectively)	(2,911)	331
Reclassification adjustment for (gains) included in net income (net of tax expense of \$15 and \$17, respectively) (a) (b)	(29)	(32)
Net unrealized (losses) gains	(2,940)	299
Comprehensive income	\$ 2,367	\$ 5,368

(a) Amounts are included in net gain on sales of securities on the Consolidated Statements of Income within noninterest income.

(b) Income tax amounts are included in provision for income taxes on the Consolidated Statements of Income.

See accompanying notes.

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Table of Contents

Codorus Valley Bancorp, Inc.  
Consolidated Statements of Cash Flows  
Unaudited

	Six months ended June 30,	
	2013	2012
<i>(dollars in thousands)</i>		
<b>Cash flows from operating activities</b>		
Net income	\$ 5,307	\$ 5,069
Adjustments to reconcile net income to net cash provided by operations:		
Depreciation/amortization	729	682
Net amortization of premiums on securities	722	670
Amortization of deferred loan origination fees and costs	(277)	(122)
Amortization of intangible assets	0	15
Provision for loan losses	820	500
Provision for losses on foreclosed real estate	0	1,088
Amortization of investment in real estate partnership	161	172
Increase in cash surrender value and death benefit on bank owned life insurance	(351)	(330)
Originations of loans held for sale	(33,537)	(31,487)
Proceeds from sales of loans held for sale	36,125	33,102
Net gain on sales of loans held for sale	(641)	(540)
Gain on disposal of premises and equipment	0	7
Net gain on sales of securities available-for-sale	(44)	(49)
Net (gain) loss on sales of foreclosed real estate	(15)	8
Stock-based compensation	157	201
Decrease in interest receivable	181	286
Decrease in other assets	621	19
Decrease in interest payable	(79)	(43)
Increase (decrease) in other liabilities	439	(398)
Net cash provided by operating activities	10,318	8,850
<b>Cash flows from investing activities</b>		
Purchases of securities, available-for-sale	(14,143)	(31,488)
Maturities, repayments and calls of securities, available-for-sale	20,961	21,929
Sales of securities, available-for-sale	927	8,047
(Purchase) redemption of restricted investment in bank stock	(230)	347
Net increase in loans made to customers	(31,852)	(13,276)
Purchases of premises and equipment	(2,265)	(486)
Investment in bank owned life insurance	(5,300)	(230)
Proceeds from bank owned life insurance	0	206
Investment in foreclosed real estate	0	(17)
Proceeds from sales of foreclosed real estate	207	2,635
Net cash used in investing activities	(31,695)	(12,333)
<b>Cash flows from financing activities</b>		
Net increase in demand and savings deposits	19,877	20,510
Net increase in time deposits	3,666	3,134
Net increase in short-term borrowings	3,774	15,071
Proceeds from issuance of long-term debt	10,000	0
Repayment of long-term debt	(282)	(10,488)
Cash dividends paid to preferred shareholders	(125)	(501)
Cash dividends paid to common shareholders	(988)	(757)
Issuance of common stock	514	327
Net cash provided by financing activities	36,436	27,296
Net increase in cash and cash equivalents	15,059	23,813
Cash and cash equivalents at beginning of year	49,757	32,195
Cash and cash equivalents at end of period	\$ 64,816	\$ 56,008
See accompanying notes.		





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Table of Contents

Codorus Valley Bancorp, Inc.  
Consolidated Statements of Changes in Shareholders' Equity  
Unaudited

<i>(dollars in thousands, except per share data)</i>	Preferred Stock	Common Stock	Additional Paid-in Capital	Retained Earnings	Accumulated Other Comprehensive Income	Total
Balance, January 1, 2013	\$ 25,000	\$ 11,206	\$ 40,524	\$ 18,868	\$ 5,733	\$ 101,331
Net income				5,307		5,307
Other comprehensive loss, net of tax					(2,940)	(2,940)
Common stock cash dividends (\$0.22 per share)				(988)		(988)
Preferred stock cash dividends				(125)		(125)
Stock-based compensation			157			157
Issuance of common stock:						
10,453 shares under the dividend reinvestment and stock purchase plan		26	151			177
23,105 shares under the stock option plan		58	226			284
4,246 shares under employee stock purchase plan		10	43			53
Balance, June 30, 2013	\$ 25,000	\$ 11,300	\$ 41,101	\$ 23,062	\$ 2,793	\$ 103,256
Balance, January 1, 2012	\$ 25,000	\$ 10,507	\$ 37,253	\$ 14,558	\$ 5,924	\$ 93,242
Net income				5,069		5,069
Other comprehensive income, net of tax					299	299
Common stock cash dividends (\$0.0172 per share, adjusted)				(757)		(757)
Preferred stock cash dividends				(259)		(259)
Stock-based compensation			201			201
Issuance of common stock:						
11,673 shares under the dividend reinvestment and stock purchase plan		29	107			136
13,602 shares under the stock option plan		34	114			148
5,330 shares under employee stock purchase plan		15	28			43
Balance, June 30, 2012	\$ 25,000	\$ 10,585	\$ 37,703	\$ 18,611	\$ 6,223	\$ 98,122
See accompanying notes.						

Table of Contents

**Note 1 Basis of Presentation**

The accompanying unaudited consolidated balance sheet at December 31, 2012 has been derived from audited financial statements, and the unaudited interim consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America for interim financial information, the instructions to Form 10-Q, and FASB Accounting Standards Codification (ASC) 270. Accordingly, the interim financial statements do not include all of the financial information and notes required by generally accepted accounting principles for complete financial statements. In the opinion of management, the interim consolidated financial statements include all adjustments necessary to present fairly the financial condition and results of operations for the reported periods, and all such adjustments are of a normal and recurring nature.

These consolidated statements should be read in conjunction with the notes to the audited consolidated financial statements contained in the Corporation's Annual Report on Form 10-K for the year ended December 31, 2012.

The consolidated financial statements include the accounts of Codorus Valley Bancorp, Inc. and its wholly owned bank subsidiary, PeoplesBank, A Codorus Valley Company (PeoplesBank), and its wholly owned nonbank subsidiary, SYC Realty Company, Inc. (collectively referred to as Codorus Valley or the Corporation). PeoplesBank has four wholly-owned subsidiaries, Codorus Valley Financial Advisors, Inc., SYC Settlement Services, Inc. and two subsidiaries whose purpose is to temporarily hold foreclosed properties pending eventual liquidation. All significant intercompany account balances and transactions have been eliminated in consolidation. The combined results of operations of the nonbank subsidiaries are not material to the consolidated financial statements.

The results of operations for the three and six month periods ended June 30, 2013 are not necessarily indicative of the results to be expected for the full year.

In accordance with FASB ASC 855, the Corporation evaluated the events and transactions that occurred after the balance sheet date of June 30, 2013 and through the date these consolidated financial statements were issued, for items of potential recognition or disclosure.

**Note 2 Significant Accounting Policies**

*Loans*

Loans receivable that management has the intent and ability to hold for the foreseeable future or until maturity or payoff, are stated at their outstanding unpaid principal balances less amounts charged off, net of an allowance for loan losses and any deferred fees or costs. Interest income is accrued on the unpaid principal balance. Generally, loan origination fees, net of certain direct origination costs, are deferred and recognized as an adjustment of the yield (interest income) over the contractual life of the loan. The loans receivable portfolio is segmented into commercial and consumer loans. Commercial loans consist of the following industry classes: builder & developer, commercial real estate investor, residential real estate investor, hotel/motel, wholesale & retail, agriculture, manufacturing and all other. Consumer loans consist of the following classes: residential mortgage, home equity and all other.

For all classes of loans receivable, the accrual of interest is discontinued when the contractual payment of principal or interest has become 90 days past due or management has serious doubts about further collectability of principal or interest, even though the loan is currently 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 nonaccrual 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. Interest received on nonaccrual loans, including impaired loans, generally is either applied against principal or reported as interest income, according to the Corporation's judgment as to the collectability of principal. Generally, loans are restored to accrual status when the obligation is brought current, has performed in accordance with the contractual terms for a reasonable period of time, generally six months, and the ultimate collectability of the total contractual principal and interest is no longer in doubt. The past due status of all classes of loans receivable is determined based on contractual due dates for loan payments.

Table of Contents

*Allowance for Loan Losses*

The allowance for loan losses represents the Corporation's estimate of losses inherent in the loan portfolio as of the balance sheet date and is recorded as a reduction to loans. The allowance for loan losses is increased by the provision for loan losses, and decreased by charge-offs, net of recoveries. Loans deemed to be uncollectible are charged against the allowance for loan losses, and subsequent recoveries, if any, are credited to the allowance. All, or part, of the principal balance of loans receivable are charged off to the allowance as soon as it is determined that the repayment of all, or part, of the principal balance is highly unlikely. While the Corporation attributes a portion of the allowance to individual loans and groups of loans that it evaluates and determines to be impaired, the allowance is available to cover all charge-offs that arise from the loan portfolio.

The allowance for loan losses is maintained at a level considered adequate to provide for losses that can be reasonably anticipated. The Corporation performs a quarterly evaluation of the adequacy of the allowance. The allowance is based on the Corporation's past loan loss experience, known and inherent risks in the portfolio, adverse situations that may affect the borrower's ability to repay, the estimated value of any underlying collateral, composition of the loan portfolio, current economic conditions and other relevant factors. This evaluation is inherently subjective as it requires material estimates that may be 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 impaired, generally substandard and nonaccrual loans. For loans that are classified as impaired, an allowance is established when the collateral value (or discounted cash flows or observable market price) of the impaired loan is lower than the carrying value of that loan. The general component covers pools of loans by loan class including commercial loans not considered impaired, as well as smaller balance homogeneous loans, such as residential real estate, home equity and other consumer loans. These pools of loans are evaluated for loss exposure based upon historical loss rates for each of these classes of loans, adjusted for qualitative (environmental) risk factors. Historical loss rates are based on a two year rolling average of net charge-offs. Qualitative risk factors that supplement historical losses in the evaluation of loan pools include:

- Changes in national and local economies and business conditions
- Changes in the value of collateral for collateral dependent loans
- Changes in the level of concentrations of credit
- Changes in the volume and severity of classified and past due loans
- Changes in the nature and volume of the portfolio
- Changes in collection, charge-off, and recovery procedures
- Changes in underwriting standards and loan terms
- Changes in the quality of the loan review system
- Changes in the experience/ability of lending management and key lending staff
- Regulatory and legal regulations that could affect the level of credit losses
- Other pertinent environmental factors

Each factor is assigned a value to reflect improving, stable or declining conditions based on the Corporation's best judgment using relevant information available at the time of the evaluation. An unallocated component is maintained to cover uncertainties that could affect the Corporation'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 loan portfolio.

Table of Contents

As disclosed in Note 5-Loans, the Corporation engages in commercial and consumer lending. Loans are made within the Corporation's primary market area and surrounding areas, and include the purchase of whole loan or participation interests in loans from other financial institutions. Commercial related loans, which pose the greatest risk of loss to the Corporation, whether originated or purchased, are generally secured by real estate. Within the broad commercial loan segment, the builder & developer and commercial real estate investor loan classes generally present a higher level of risk than other commercial loan classifications. This greater risk is due to several factors, including the concentration of principal in a limited number of loans and borrowers, the effect of general economic conditions on income producing properties, unstable real estate prices and the dependency upon successful construction and sale or operation of the real estate project. Within the consumer loan segment, junior (i.e., second) liens present a slightly higher risk to the Corporation because economic and housing market conditions can adversely affect the underlying value of the collateral and the ability of some borrowers to service their debt.

A loan is considered impaired when, based on current information and events, it is probable that the Corporation 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 in determining impairment include payment status 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. The Corporation 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. Loans that are deemed impaired are evaluated for impairment loss based on the net realizable value of the collateral, as applicable. Loans that are not collateral dependent will rely on the present value of expected future cash flows discounted at the loan's effective interest rate to determine impairment loss. Large groups of smaller balance homogeneous loans such as residential mortgage loans, home equity loans and other consumer loans are collectively evaluated for impairment, unless they are considered to be a troubled debt restructuring.

An allowance for loan losses is established for an impaired commercial loan if its carrying value exceeds its estimated fair value. For commercial loans secured by real estate, estimated fair values are determined primarily through third-party appraisals of the underlying collateral. When a real estate secured loan becomes impaired, a decision is made regarding whether an updated certified appraisal of the real estate is necessary. This decision is based on various considerations, including the age of the most recent appraisal, the loan-to-value ratio based on the most recent appraisal and the condition of the property. Appraisals are generally discounted to provide for selling costs and other factors to determine an estimate of the net realizable value of the property. For commercial loans secured by non-real estate collateral, such as accounts receivable, inventory and equipment, estimated fair values are determined based on the borrower's financial statements, inventory reports, accounts receivable aging or equipment appraisals or invoices. Indications of value from these sources are generally discounted based on the age of the financial information or the quality of the assets. In instances when specific consumer related loans become impaired, they may be partially or fully charged off, which obviates the need for a specific allowance.

Loans whose terms are modified are classified as troubled debt restructurings if the Corporation grants borrowers experiencing financial difficulties concessions that it would not otherwise consider. Concessions granted under a troubled debt restructuring may involve an interest rate that is below the market rate given the associated credit risk of the loan or an extension of a loan's stated maturity date. Loans classified as troubled debt restructurings are designated as impaired. Non-accrual troubled debt restructurings are restored to accrual status if principal and interest payments, under the modified terms, are current for a reasonable period of time, generally six consecutive months after modification and future payments are reasonably assured.

Table of Contents

Banking regulatory agencies, as an integral part of their examination process, periodically review the Corporation's allowance for loan losses and may require the Corporation to recognize additions to the allowance based on their judgments about information available to them at the time of their examination, which may not be currently available to the Corporation. Based on a comprehensive analysis of the loan portfolio, the Corporation believes that the level of the allowance for loan losses at June 30, 2013 is adequate.

*Foreclosed Real Estate*

Foreclosed real estate, included in other assets, is comprised of property acquired through a foreclosure proceeding or property that is acquired through in substance foreclosure. Foreclosed real estate is initially recorded at fair value minus estimated costs to sell at the date of foreclosure, establishing a new cost basis. Any difference between the carrying value and the new cost basis is charged against the allowance for loan losses. Appraisals, based upon an independent third party, are generally used to determine fair value. After foreclosure, management reviews valuations at least quarterly and adjusts the asset to the lower of cost or fair value minus estimated costs to sell through a valuation allowance or a charge-off. Costs related to the improvement of foreclosed real estate are generally capitalized until the real estate reaches a saleable condition subject to fair value limitations. Revenue and expense from operations and changes in the valuation allowance are included in noninterest expense. When a foreclosed real estate asset is ultimately sold, any gain or loss on the sale is included in the income statement as a component of noninterest expense. At June 30, 2013, foreclosed real estate, net of allowance, was \$3,441,000, compared to \$3,633,000 for December 31, 2012.

*Per Common Share Computations*

All per share computations include the effect of stock dividends distributed. The computation of net income per common share is provided in the table below.

(in thousands, except per share data)	Three months ended June 30,		Six months ended June 30,	
	2013	2012	2013	2012
Net income available to common shareholders	\$ 2,583	\$ 2,708	\$ 5,182	\$ 4,810
Weighted average shares outstanding (basic)	4,506	4,432	4,495	4,425
Effect of dilutive stock options	83	63	83	47
Weighted average shares outstanding (diluted)	4,589	4,495	4,578	4,472
Basic earnings per common share	\$ 0.57	\$ 0.61	\$ 1.15	\$ 1.09
Diluted earnings per common share	\$ 0.56	\$ 0.60	\$ 1.13	\$ 1.08
Anti-dilutive stock options and common stock warrants excluded from the computation of earnings per share	28	79	28	79

- 11 -

Table of Contents*Comprehensive Income*

Accounting principles generally accepted in the United States of America require that recognized revenue, expenses, gains and losses be included in net income. Although certain changes in assets and liabilities, such as unrealized gains and losses on available-for-sale securities, are reported as a separate component of the shareholders' equity section of the balance sheet, such items, along with net income, are components of comprehensive income.

*Cash Flow Information*

For purposes of the statements of cash flows, the Corporation considers interest bearing deposits with banks, cash and due from banks, and federal funds sold to be cash and cash equivalents.

Supplemental cash flow information is provided in the table below.

<i>(dollars in thousands)</i>	Six months ended June 30,	
	2013	2012
Cash paid during the period for:		
Income taxes	\$ 1,965	\$ 1,882
Interest	\$ 4,460	\$ 5,374
Noncash investing activities:		
Transfer of loans to foreclosed real estate	\$ 0	\$ 156

*Reclassification*

Certain amounts in the 2012 consolidated financial statements have been reclassified to conform to the 2013 presentation, which did not impact net income or shareholders' equity.

*Recent Accounting Pronouncements*

There were no new accounting pronouncements affecting the Corporation during the reporting period that were not already adopted.

**Note 3-Securities**

A summary of securities available-for-sale at June 30, 2013 and December 31, 2012 is provided below. The securities available-for-sale portfolio is generally comprised of high quality debt instruments, principally obligations of the United States government or agencies thereof. Also included in the portfolio are investments in the obligations of states and municipalities. With the exception of an approximately \$13 million portfolio (fair value) of Texas municipal utility district bonds, which has its own criteria for investment (e.g., maximum debt to assessed valuation, minimum assessed valuation and district size, proximity to employment, etc.), the remaining municipal bonds were all rated A or above by a national rating service at June 30, 2013. The majority of municipal bonds in the portfolio are general obligation bonds, which can draw upon multiple sources of revenue, including taxes, for payment. Only a few bonds are revenue bonds, which are dependent upon a single revenue stream for payment, but they are for critical services such as water and sewer. In many cases, municipal debt issues are insured or, in the case of school districts of selected states, backed by specific loss reserves. At June 30, 2013, the fair value of the municipal bond portfolio was concentrated in the states of Pennsylvania at 42 percent and Texas at 18 percent.

Table of Contents

<i>(dollars in thousands)</i>	Amortized Cost	Gains	Gross Unrealized Losses	Fair Value
<b>June 30, 2013</b>				
Debt securities:				
U.S. Treasury notes	\$ 3,500	\$ 13	\$ 0	\$ 3,513
U.S. agency	40,135	763	(427)	40,471
U.S. agency mortgage-backed, residential	78,265	1,655	(204)	79,716
State and municipal	95,052	2,708	(276)	97,484
Total debt securities	\$ 216,952	\$ 5,139	\$ (907)	\$ 221,184

**December 31, 2012**

Debt securities:				
U.S. Treasury notes	\$ 5,001	\$ 31	\$ 0	\$ 5,032
U.S. agency	37,000	1,083	(25)	38,058
U.S. agency mortgage-backed, residential	84,630	3,603	0	88,233
State and municipal	98,744	4,053	(58)	102,739
Total debt securities	\$ 225,375	\$ 8,770	\$ (83)	\$ 234,062

The amortized cost and estimated fair value of debt securities at June 30, 2013 by contractual maturity are shown below. Actual maturities may differ from contractual maturities if call options on select debt issues are exercised in the future. Mortgage-backed securities are included in the maturity categories based on average expected life.

<i>(dollars in thousands)</i>	Amortized Cost	Available-for-sale Fair Value
Due in one year or less	\$ 14,449	\$ 14,545
Due after one year through five years	172,254	175,886
Due after five years through ten years	26,429	26,784
Due after ten years	3,820	3,969
Total debt securities	\$ 216,952	\$ 221,184

Gross realized gains and losses on sales of securities available-for-sale are shown below. Realized gains and losses are computed on the basis of specific identification of the adjusted cost of each security and are shown net as a separate line item in the income statement.

<i>(dollars in thousands)</i>	Three months ended June 30,		Six months ended June 30,	
	2013	2012	2013	2012
Realized gains	\$ 44	\$ 0	\$ 44	\$ 50
Realized losses	0	0	0	(1)
Net gains	\$ 44	\$ 0	\$ 44	\$ 49

Securities, issued by agencies of the federal government, with a carrying value of \$138,280,000 and \$135,348,000 on June 30, 2013 and December 31, 2012, respectively, were pledged to secure public and trust deposits, repurchase agreements and other short-term borrowings.



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## Table of Contents

The table below shows gross unrealized losses and fair value, aggregated by investment category and length of time, for securities that have been in a continuous unrealized loss position, at June 30, 2013 and December 31, 2012.

	Less than 12 months		12 months or more		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
<i>(dollars in thousands)</i>						
<b>June 30, 2013</b>						
Debt securities:						
U.S. agency	\$ 22,220	\$ (427)	\$ 0	\$ 0	\$ 22,220	\$ (427)
U.S. agency mortgage-backed, residential	23,957	(204)	0	0	23,957	(204)
State and municipal	19,549	(276)	0	0	19,549	(276)
Total temporarily impaired debt securities, available for sale	\$ 65,726	\$ (907)	\$ 0	\$ 0	\$ 65,726	\$ (907)
<b>December 31, 2012</b>						
Debt securities:						
U.S. agency	\$ 8,251	\$ (25)	\$ 0	\$ 0	\$ 8,251	\$ (25)
State and municipal	11,565	(58)	0	0	11,565	(58)
Total temporarily impaired debt securities, available for sale	\$ 19,816	\$ (83)	\$ 0	\$ 0	\$ 19,816	\$ (83)

The unrealized losses of \$907,000 at June 30, 2013 within the less than 12 months category were attributable to seven U.S. agency securities, eight U.S. agency mortgage-backed securities, and forty-five state and municipal securities, all rated A or above by a national rating service.

Securities available-for-sale are analyzed quarterly for possible other-than-temporary impairment. The analysis considers, among other factors: 1) whether the Corporation has the intent to sell its securities prior to market recovery or maturity; 2) whether it is more likely than not that the Corporation will be required to sell its securities prior to market recovery or maturity; 3) default rates/history by security type; 4) third-party securities ratings; 5) third-party guarantees; 6) subordination; 7) payment delinquencies; 8) nature of the issuer; and 9) current financial news.

The Corporation believes that unrealized losses at June 30, 2013 were primarily the result of changes in market interest rates and that it has the ability to hold these investments for a time necessary to recover the amortized cost. Through June 30, 2013 the Corporation has collected all interest and principal on its investment securities as scheduled. The Corporation believes that collection of the contractual principal and interest is probable and, therefore, all impairment is considered to be temporary.

Table of Contents

**Note 4 Restricted Investment in Bank Stocks**

Restricted stock, which represents required investments in the common stock of correspondent banks, is carried at cost and, as of June 30, 2013 and December 31, 2012, consisted primarily of the common stock of the Federal Home Loan Bank of Pittsburgh (FHLBP) and, to a lesser degree, Atlantic Community Bankers Bank (ACBB). Under the FHLBP's Capital Plan, PeoplesBank is required to maintain a minimum member stock investment, both as a condition of becoming and remaining a member and as a condition of obtaining borrowings from the FHLBP. The FHLBP uses a formula to determine the minimum stock investment, which is based on the volume of loans outstanding, unused borrowing capacity and other factors.

The FHLBP paid dividends during the periods ended June 30, 2013 and 2012 but reported that future dividends will be dependent upon the condition of its private-label residential mortgage-backed securities portfolio, its overall financial performance, retained earnings and other factors. The FHLBP restricts the repurchase of the excess capital stock of member banks. The amount of excess capital stock that can be repurchased from any member is currently the lesser of five percent of the member's total capital stock outstanding or its excess capital stock outstanding.

Management evaluates the restricted stock for impairment in accordance with FASB ASC Topic 942. Management's determination of whether these investments are impaired is based on their assessment of the ultimate recoverability of their cost rather than by recognizing temporary declines in value. Using the FHLBP as an example, the determination of whether a decline affects the ultimate recoverability of cost is influenced by criteria such as: (1) the significance of the decline in net assets of the FHLBP as compared to the capital stock amount for the FHLBP and the length of time this situation has persisted; (2) commitments by the FHLBP to make payments required by law or regulation and the level of such payments in relation to the operating performance of the FHLBP; and (3) the impact of legislative and regulatory changes on institutions and, accordingly, on the customer base of the FHLBP. Management believes no impairment charge was necessary related to the restricted stock during the periods ended June 30, 2013 and 2012.

Table of Contents**Note 5 Loans**

The table below provides the composition of the loan portfolio at June 30, 2013 and December 31, 2012. The portfolio is comprised of two segments, commercial and consumer loans. The commercial loan segment is disaggregated by industry class which allows the Corporation to monitor risk and performance. Those industries representing the largest dollar investment and most risk are listed separately. The other commercial loans category is comprised of a multitude of industries, including health services, professional services, public administration, restaurant, service, transportation, finance, natural resources, recreation and religious organizations. The consumer related segment is comprised of residential mortgages, home equity and other consumer loans. The Corporation has not engaged in sub-prime residential mortgage originations.

<i>(dollars in thousands)</i>	<b>June 30, 2013</b>	<b>December 31, 2012</b>
Builder & developer	\$ 101,911	\$ 96,936
Commercial real estate investor	118,085	122,714
Residential real estate investor	69,666	66,419
Hotel/Motel	67,668	64,948
Wholesale & retail	68,583	70,443
Manufacturing	34,142	40,258
Agriculture	31,153	20,928
Other	142,637	124,834
Total commercial related loans	633,845	607,480
Residential mortgages	24,428	23,511
Home equity	71,566	65,858
Other	38,761	40,285
Total consumer related loans	134,755	129,654
Total loans	\$ 768,600	\$ 737,134

The Corporation's internal risk rating system follows regulatory guidance as to risk classifications and definitions. Every approved loan is assigned a risk rating. Generally, risk ratings for commercial related loans and residential mortgages held for investment are determined by a formal evaluation of risk factors performed by the Corporation's underwriting staff. For consumer loans, and commercial loans up to \$750,000, the Corporation uses third-party credit scoring software models for risk rating purposes. The loan portfolio is monitored on a continuous basis by loan officers, loan review personnel and senior management. Adjustments of loan risk ratings are generally performed by the Special Asset Committee, which includes senior management. The Committee, which meets monthly, makes changes, as appropriate, to risk ratings when it becomes aware of credit events such as payment delinquency, cessation of a business or project, bankruptcy or death of the borrower, or changes in collateral value.

The Corporation uses ten risk ratings to grade loans. The first seven ratings, representing the lowest risk, are combined and given a pass rating. A pass rating is a satisfactory credit rating, which applies to a loan that is expected to perform in accordance with the loan agreement and has a low probability of loss. A loan rated special mention has a potential weakness which may, if not corrected, weaken the loan or inadequately protect the Corporation's position at some future date. A loan rated substandard is inadequately protected by the current net worth or paying capacity of the borrower or of the collateral pledged. A substandard loan has a well defined weakness or weaknesses that could jeopardize liquidation of the loan, which exposes the Corporation to loss if the deficiencies are not corrected. When circumstances indicate that collection of the loan is doubtful, the loan is risk rated nonaccrual, the accrual of interest income is discontinued, and any unpaid interest previously credited to income is reversed. Accordingly, the table below does not include the regulatory classification of doubtful, nor does it include the regulatory classification of loss because the Corporation promptly charges off known loan losses.

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## Table of Contents

The table below presents a summary of loan risk ratings by loan class at June 30, 2013 and December 31, 2012.

<i>(dollars in thousands)</i>	Pass	Special Mention	Substandard	Nonaccrual	Total
<b>June 30, 2013</b>					
Builder & developer	\$ 86,405	\$ 7,509	\$ 7,750	\$ 247	\$ 101,911
Commercial real estate investor	107,432	4,962	2,292	3,399	118,085
Residential real estate investor	66,784	311	85	2,486	69,666
Hotel/Motel	67,668	0	0	0	67,668
Wholesale & retail	65,386	1,326	0	1,871	68,583
Manufacturing	33,460	0	682	0	34,142
Agriculture	28,841	1,849	463	0	31,153
Other	138,711	1,458	253	2,215	142,637
Total commercial related loans	594,687	17,415	11,525	10,218	633,845
Residential mortgage	24,272	4	31	121	24,428
Home equity	71,052	117	188	209	71,566
Other	37,963	131	143	524	38,761
Total consumer related loans	133,287	252	362	854	134,755
Total loans	\$ 727,974	\$ 17,667	\$ 11,887	\$ 11,072	\$ 768,600
<b>December 31, 2012</b>					
Builder & developer	\$ 79,101	\$ 6,567	\$ 11,013	\$ 255	\$ 96,936
Commercial real estate investor	107,415	9,563	2,459	3,277	122,714
Residential real estate investor	62,327	1,361	2,044	687	66,419
Hotel/Motel	64,948	0	0	0	64,948
Wholesale & retail	66,155	1,521	983	1,784	70,443
Manufacturing	39,559	0	699	0	40,258
Agriculture	20,457	0	471	0	20,928
Other	121,223	1,156	612	1,843	124,834
Total commercial related loans	561,185	20,168	18,281	7,846	607,480
Residential mortgage	23,421	5	32	53	23,511
Home equity	65,406	112	188	152	65,858
Other	39,318	325	351	291	40,285
Total consumer related loans	128,145	442	571	496	129,654
Total loans	\$ 689,330	\$ 20,610	\$ 18,852	\$ 8,342	\$ 737,134

- 17 -

# Edgar Filing: CODORUS VALLEY BANCORP INC - Form 10-Q

## Table of Contents

The table below presents a summary of impaired loans at June 30, 2013 and December 31, 2012. Generally, impaired loans are loans risk rated substandard and nonaccrual or classified as troubled debt restructurings. An allowance is established for individual commercial related loans where the Corporation has doubt as to full recovery of the outstanding principal balance. Typically, impaired consumer related loans are partially or fully charged-off obviating the need for a specific allowance. The recorded investment represents outstanding unpaid principal loan balances adjusted for charge-offs.

	June 30, 2013			December 31, 2012		
	Recorded	Unpaid	Related	Recorded	Unpaid	Related
(dollars in thousands)	Investment	Principal	Allowance	Investment	Principal	Allowance
Impaired loans with no related allowance:						
Builder & developer	\$ 9,168	\$ 9,168		\$ 12,211	\$ 12,211	
Commercial real estate investor	5,691	5,791		5,736	5,836	
Residential real estate investor	322	547		72	72	
Hotel/Motel	0	0		0	0	
Wholesale & retail	2,149	4,634		3,048	5,323	
Manufacturing	682	682		699	699	
Agriculture	0	0		0	0	
Other commercial	1,590	1,718		1,483	1,611	
Residential mortgage	152	178		85	111	
Home equity	397	397		340	340	
Other consumer	667	725		642	718	
Total impaired loans with no related allowance	\$ 20,818	\$ 23,840		\$ 24,316	\$ 26,921	
Impaired loans with a related allowance:						
Builder & developer	\$ 0	\$ 0	\$ 0	\$ 256	\$ 256	\$ 147
Commercial real estate investor	0	0	0	0	0	0
Residential real estate investor	2,249	2,249	550	2,659	2,659	700
Hotel/Motel	0	0	0	0	0	0
Wholesale & retail	0	0	0	0	0	0
Manufacturing	0	0	0	0	0	0
Agriculture	463	463	100	471	471	100
Other commercial	878	878	120	972	972	215
Residential mortgage	0	0	0	0	0	0
Home equity	0	0	0	0	0	0
Other consumer	0	0	0	0	0	0
Total impaired loans with a related allowance	\$ 3,590	\$ 3,590	\$ 770	\$ 4,358	\$ 4,358	\$ 1,162
Total impaired loans:						
Builder & developer	\$ 9,168	\$ 9,168	\$ 0	\$ 12,467	\$ 12,467	\$ 147
Commercial real estate investor	5,691	5,791	0	5,736	5,836	0
Residential real estate investor	2,571	2,796	550	2,731	2,731	700
Hotel/Motel	0	0	0	0	0	0
Wholesale & retail	2,149	4,634	0	3,048	5,323	0
Manufacturing	682	682	0	699	699	0
Agriculture	463	463	100	471	471	100
Other commercial	2,468	2,596	120	2,455	2,583	215
Residential mortgage	152	178	0	85	111	0
Home equity	397	397	0	340	340	0
Other consumer	667	725	0	642	718	0
Total impaired loans	\$ 24,408	\$ 27,430	\$ 770	\$ 28,674	\$ 31,279	\$ 1,162

## Edgar Filing: CODORUS VALLEY BANCORP INC - Form 10-Q

Table of Contents

The tables below present a summary of average impaired loans and related interest income that was included in net income for the three and six months ended June 30, 2013 and 2012.

	For the three months ended					
	June 30, 2013			June 30, 2012		
	Average Recorded Investment	Total Interest Income	Cash Basis Interest Income	Average Recorded Investment	Total Interest Income	Cash Basis Interest Income
<i>(dollars in thousands)</i>						
Impaired loans with no related allowance:						
Builder & developer	\$ 9,211	\$ 135	\$ 3	\$ 8,070	\$ 117	\$ 11
Commercial real estate investor	5,702	67	33	4,546	76	39
Residential real estate investor	239	3	1	464	0	0
Hotel/Motel	0	0	0	0	0	0
Wholesale & retail	2,539	66	64	2,100	3	3
Manufacturing	685	11	0	710	10	0
Agriculture	0	0	0	0	0	0
Other commercial	1,667	7	2	5,443	102	101
Residential mortgage	118	2	2	144	1	1
Home equity	338	3	0	245	1	1
Other consumer	642	7	7	390	7	4
Total impaired loans with no related allowance	\$ 21,141	\$ 301	\$ 112	\$ 22,112	\$ 317	\$ 160
Impaired loans with a related allowance:						
Builder & developer	\$ 66	\$ 0	\$ 0	\$ 262	\$ 2	\$ 2
Commercial real estate investor	0	0	0	113	0	0
Residential real estate investor	2,453	0	0	1,114	2	0
Hotel/Motel	0	0	0	0	0	0
Wholesale & retail	0	0	0	0	0	0
Manufacturing	0	0	0	0	0	0
Agriculture	466	8	0	483	9	0
Other commercial	924	0	0	925	0	0
Residential mortgage	0	0	0	0	0	0
Home equity	0	0	0	0	0	0
Other consumer	0	0	0	0	0	0
Total impaired loans with a related allowance	\$ 3,909	\$ 8	\$ 0	\$ 2,897	\$ 13	\$ 2
Total impaired loans:						
Builder & developer	\$ 9,277	\$ 135	\$ 3	\$ 8,332	\$ 119	\$ 13
Commercial real estate investor	5,702	67	33	4,659	76	39
Residential real estate investor	2,692	3	1	1,578	2	0
Hotel/Motel	0	0	0	0	0	0
Wholesale & retail	2,539	66	64	2,100	3	3
Manufacturing	685	11	0	710	10	0
Agriculture	466	8	0	483	9	0
Other commercial	2,591	7	2	6,368	102	101
Residential mortgage	118	2	2	144	1	1
Home equity	338	3	0	245	1	1
Other consumer	642	7	7	390	7	4
Total impaired loans	\$ 25,050	\$ 309	\$ 112	\$ 25,009	\$ 330	\$ 162

- 19 -

Table of Contents

	June 30, 2013		For the six months ended		June 30, 2012	
	Average Recorded Investment	Total Interest Income	Cash Basis Interest Income	Average Recorded Investment	Total Interest Income	Cash Basis Interest Income
<i>(dollars in thousands)</i>						
Impaired loans with no related allowance:						
Builder & developer	\$ 10,211	\$ 264	\$ 5	\$ 6,256	\$ 234	\$ 54
Commercial real estate investor	5,713	134	69	4,352	136	73
Residential real estate investor	184	5	2	463	1	1
Hotel/Motel	0	0	0	0	0	0
Wholesale & retail	2,708	43	64	2,660	(1)	3
Manufacturing	690	22	0	711	21	0
Agriculture	0	0	0	0	0	0
Other commercial	1,606	6	4	4,835	79	125
Residential mortgage	107	4	3	164	4	3
Home equity	339	6	1	238	3	1
Other consumer	642	13	13	350	11	8
Total impaired loans with no related allowance	\$ 22,200	\$ 497	\$ 161	\$ 20,029	\$ 488	\$ 268
Impaired loans with a related allowance:						
Builder & developer	\$ 129	\$ 0	\$ 0	\$ 263	\$ 2	\$ 2
Commercial real estate investor	0	0	0	75	0	0
Residential real estate investor	2,522	(9)	0	773	2	0
Hotel/Motel	0	0	0	0	0	0
Wholesale & retail	0	0	0	0	0	0
Manufacturing	0	0	0	0	0	0
Agriculture	468	16	0	485	17	0
Other commercial	939	0	0	910	0	0
Residential mortgage	0	0	0	0	0	0
Home equity	0	0	0	0	0	0
Other consumer	0	0	0	0	0	0
Total impaired loans with a related allowance	\$ 4,058	\$ 7	\$ 0	\$ 2,506	\$ 21	\$ 2
Total impaired loans:						
Builder & developer	\$ 10,340	\$ 264	\$ 5	\$ 6,519	\$ 236	\$ 56
Commercial real estate investor	5,713	134	69	4,427	136	73
Residential real estate investor	2,706	(4)	2	1,236	3	1
Hotel/Motel	0	0	0	0	0	0
Wholesale & retail	2,708	43	64	2,660	(1)	3
Manufacturing	690	22	0	711	21	0
Agriculture	468	16	0	485	17	0
Other commercial	2,545	6	4	5,745	79	125
Residential mortgage	107	4	3	164	4	3
Home equity	339	6	1	238	3	1
Other consumer	642	13	13	350	11	8
Total impaired loans	\$ 26,258	\$ 504	\$ 161	\$ 22,535	\$ 509	\$ 270

- 20 -

## Edgar Filing: CODORUS VALLEY BANCORP INC - Form 10-Q

Table of Contents

The performance and credit quality of the loan portfolio is also monitored by using an aging schedule which shows the length of time a loan is past due. The table below presents a summary of past due loans, nonaccrual loans and current loans by loan segment and class at June 30, 2013 and December 31, 2012.

<i>(dollars in thousands)</i>	30-59 Days Past Due	60-89 Days Past Due	≥ 90 Days Past Due and Accruing	Nonaccrual	Total Past Due and Nonaccrual	Current	Total Loans
<b>June 30, 2013</b>							
Builder & developer	\$ 0	\$ 0	\$ 0	\$ 247	\$ 247	\$ 101,664	\$ 101,911
Commercial real estate investor	0	0	0	3,399	3,399	114,686	118,085
Residential real estate investor	134	0	0	2,486	2,620	67,046	69,666
Hotel/Motel	0	0	0	0	0	67,668	67,668
Wholesale & retail	0	0	0	1,871	1,871	66,712	68,583
Manufacturing	0	0	0	0	0	34,142	34,142
Agriculture	0	0	0	0	0	31,153	31,153
Other	130	0	0	2,215	2,345	140,292	142,637
Total commercial related loans	264	0	0	10,218	10,482	623,363	633,845
Residential mortgage	0	0	0	121	121	24,307	24,428
Home equity	0	17	0	209	226	71,340	71,566
Other	124	127	57	524	832	37,929	38,761
Total consumer related loans	124	144	57	854	1,179	133,576	134,755
Total loans	\$ 388	\$ 144	\$ 57	\$ 11,072	\$ 11,661	\$ 756,939	\$ 768,600
<b>December 31, 2012</b>							
Builder & developer	\$ 400	\$ 0	\$ 0	\$ 255	\$ 655	\$ 96,281	\$ 96,936
Commercial real estate investor	0	0	0	3,277	3,277	119,437	122,714
Residential real estate investor	2,044	0	0	687	2,731	63,688	66,419
Hotel/Motel	0	0	0	0	0	64,948	64,948
Wholesale & retail	1,067	0	0	1,784	2,851	67,592	70,443
Manufacturing	0	0	0	0	0	40,258	40,258
Agriculture	0	0	0	0	0	20,928	20,928
Other	456	0	0	1,843	2,299	122,535	124,834
Total commercial related loans	3,967	0	0	7,846	11,813	595,667	607,480
Residential mortgage	474	129	0	53	656	22,855	23,511
Home equity	62	0	0	152	214	65,644	65,858
Other	842	195	186	291	1,514	38,771	40,285
Total consumer related loans	1,378	324	186	496	2,384	127,270	129,654
Total loans	\$ 5,345	\$ 324	\$ 186	\$ 8,342	\$ 14,197	\$ 722,937	\$ 737,134

- 21 -



# Edgar Filing: CODORUS VALLEY BANCORP INC - Form 10-Q

## Table of Contents

Loans classified as troubled debt restructurings (TDRs) are designated impaired and arise when the Corporation grants borrowers experiencing financial difficulties concessions that it would not otherwise consider. Concessions granted with respect to these loans involve an extension of the maturity date or a below market interest rate relative to new debt with similar credit risk. Generally, these loans are secured by real estate. If repayment of the loan is determined to be collateral dependent, the loan is evaluated for impairment loss based on the fair value of the collateral. For loans that are not collateral dependent, the present value of expected future cash flows, discounted at the loan's effective interest rate, is used to determine any impairment loss.

A nonaccrual TDR represents a nonaccrual loan, as previously defined, which includes an economic concession. Nonaccrual TDRs are restored to accrual status if principal and interest payments, under the modified terms, are current for six consecutive payments after the modification and future principal and interest payments are reasonably assured. In contrast, an accruing TDR represents a loan that, at the time of the modification, has a demonstrated history of payments and with respect to which management believes that future loan payments are reasonably assured under the modified terms.

The table below shows loans whose terms have been modified under TDRs during the three months and six months ended June 30, 2013 and 2012. There was no impairment loss recognized on any of these TDRs, and they are all performing under their modified terms. There were no defaults during the three and six months ended June 30, 2013 and 2012 for TDRs entered into for the last 12 months.

	Number of Contracts	Modifications Pre-Modification Outstanding Recorded Investments	Post-Modification Outstanding Recorded Investments
<i>(dollars in thousands)</i>			
<b><u>Three months ended:</u></b>			
<b>June 30, 2013</b>			
None			
<b>June 30, 2012</b>			
None			
<b><u>Six months ended:</u></b>			
<b>June 30, 2013</b>			
Commercial related loans accruing	1	\$ 208	\$ 208
<b>June 30, 2012</b>			
Commercial related loans nonaccrual	1	\$ 286	\$ 286

- 22 -

## Edgar Filing: CODORUS VALLEY BANCORP INC - Form 10-Q

Table of Contents
**NOTE 6 Allowance for Loan Losses**

The table below shows the activity in and the composition of the allowance for loan losses by loan segment and class detail as of and for the three and six months ended June 30, 2013 and 2012.

<i>(dollars in thousands)</i>	Builder & developer	Commercial real estate investor	Residential real estate investor	Hotel/Motel	Wholesale & retail	Manufacturing	Agriculture	Other	Total commercial related
<b>Allowance for loan losses:</b>									
Balance, April 1, 2013	\$ 1,534	\$ 1,286	\$ 1,196	\$ 514	\$ 1,832	\$ 224	\$ 237	\$ 1,156	\$ 7,979
Charge-offs	(62)	0	(225)	0	(210)	0	0	0	(497)
Recoveries	0	0	0	0	18	0	0	0	18
Provisions	104	(73)	210	(9)	216	(23)	16	(5)	436
<b>Balance, June 30, 2013</b>	<b>\$ 1,576</b>	<b>\$ 1,213</b>	<b>\$ 1,181</b>	<b>\$ 505</b>	<b>\$ 1,856</b>	<b>\$ 201</b>	<b>\$ 253</b>	<b>\$ 1,151</b>	<b>\$ 7,936</b>
Balance, April 1, 2012	\$ 1,979	\$ 2,013	\$ 500	\$ 443	\$ 1,716	\$ 151	\$ 193	\$ 1,015	\$ 8,010
Charge-offs	(2)	(68)	0	0	0	0	0	(263)	(333)
Recoveries	0	0	0	0	5	0	0	0	5
Provisions	(297)	(706)	400	6	(31)	13	1	310	(304)
<b>Balance, June 30, 2012</b>	<b>\$ 1,680</b>	<b>\$ 1,239</b>	<b>\$ 900</b>	<b>\$ 449</b>	<b>\$ 1,690</b>	<b>\$ 164</b>	<b>\$ 194</b>	<b>\$ 1,062</b>	<b>\$ 7,378</b>

<i>(dollars in thousands)</i>	Residential mortgage	Home equity	Other	Total consumer related	Unallocated	Total
<b>Allowance for loan losses:</b>						
Balance, April 1, 2013	\$ 48	\$ 315	\$ 197	\$ 560	\$ 947	\$ 9,486
Charge-offs	(28)	0	(101)	(129)	0	(626)
Recoveries	2	6	13	21	0	39
Provisions	55	(85)	167	137	(13)	560
<b>Balance, June 30, 2013</b>	<b>\$ 77</b>	<b>\$ 236</b>	<b>\$ 276</b>	<b>\$ 589</b>	<b>\$ 934</b>	<b>\$ 9,459</b>
Balance, April 1, 2012	\$ 117	\$ 87	\$ 163	\$ 367	\$ 512	\$ 8,889
Charge-offs	0	(128)	(25)	(153)	0	(486)
Recoveries	24	0	8	32	0	37
Provisions	(63)	193	(9)	121	433	250
<b>Balance, June 30, 2012</b>	<b>\$ 78</b>	<b>\$ 152</b>	<b>\$ 137</b>	<b>\$ 367</b>	<b>\$ 945</b>	<b>\$ 8,690</b>

<i>(dollars in thousands)</i>	Builder & developer	Commercial real estate investor	Residential real estate investor	Hotel/Motel	Wholesale & retail	Manufacturing	Agriculture	Other	Total commercial related
<b>Allowance for loan losses:</b>									
Balance, January 1, 2013	\$ 1,571	\$ 1,259	\$ 1,195	\$ 485	\$ 1,913	\$ 237	\$ 202	\$ 1,170	\$ 8,032
Charge-offs	(62)	0	(225)	0	(210)	0	0	0	(497)
Recoveries	0	0	0	0	22	0	0	0	22
Provisions	67	(46)	211	20	131	(36)	51	(19)	379
<b>Balance, June 30, 2013</b>	<b>\$ 1,576</b>	<b>\$ 1,213</b>	<b>\$ 1,181</b>	<b>\$ 505</b>	<b>\$ 1,856</b>	<b>\$ 201</b>	<b>\$ 253</b>	<b>\$ 1,151</b>	<b>\$ 7,936</b>
Balance, January 1, 2012	\$ 2,170	\$ 2,003	\$ 505	\$ 394	\$ 1,806	\$ 151	\$ 184	\$ 907	\$ 8,120
Charge-offs	(2)	(68)	0	0	0	0	0	(263)	(333)
Recoveries	0	0	0	0	11	0	0	0	11
Provisions	(488)	(696)	395	55	(127)	13	10	418	(420)
<b>Balance, June 30, 2012</b>	<b>\$ 1,680</b>	<b>\$ 1,239</b>	<b>\$ 900</b>	<b>\$ 449</b>	<b>\$ 1,690</b>	<b>\$ 164</b>	<b>\$ 194</b>	<b>\$ 1,062</b>	<b>\$ 7,378</b>

<i>(dollars in thousands)</i>	<b>Residential mortgage</b>	<b>Home equity</b>	<b>Other</b>	<b>Total consumer related</b>	<b>Unallocated</b>	<b>Total</b>
<b>Allowance for loan losses:</b>						
Balance, January 1, 2013	\$ 124	\$ 237	\$ 238	\$ 599	\$ 671	\$ 9,302
Charge-offs	(28)	(75)	(133)	(236)	0	(733)
Recoveries	2	7	39	48	0	70
Provisions	(21)	67	132	178	263	820
<b>Balance, June 30, 2013</b>	<b>\$ 77</b>	<b>\$ 236</b>	<b>\$ 276</b>	<b>\$ 589</b>	<b>\$ 934</b>	<b>\$ 9,459</b>
Balance, January 1, 2012	\$ 88	\$ 86	\$ 171	\$ 345	\$ 237	\$ 8,702
Charge-offs	(39)	(128)	(76)	(243)	0	(576)
Recoveries	41	0	12	53	0	64
Provisions	(12)	194	30	212	708	500
<b>Balance, June 30, 2012</b>	<b>\$ 78</b>	<b>\$ 152</b>	<b>\$ 137</b>	<b>\$ 367</b>	<b>\$ 945</b>	<b>\$ 8,690</b>

- 23 -

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## Table of Contents

The table below shows the allowance amount required for loans individually evaluated for impairment and the amount required for loans collectively evaluated for impairment at June 30, 2013 and 2012 and December 31, 2012.

(dollars in thousands)	Builder & developer	Commercial real estate investor	Residential real estate investor	Hotel/Motel	Wholesale & retail	Manufacturing	Agriculture	Other	Total commercial related
<b>Allowance for loan losses:</b>									
Individually evaluated for impairment	\$ 0	\$ 0	\$ 550	\$ 0	\$ 0	\$ 0	\$ 100	\$ 120	\$ 770
Collectively evaluated for impairment	1,576	1,213	631	505	1,856	201	153	1,031	7,166
<b>Balance, June 30, 2013</b>	<b>\$ 1,576</b>	<b>\$ 1,213</b>	<b>\$ 1,181</b>	<b>\$ 505</b>	<b>\$ 1,856</b>	<b>\$ 201</b>	<b>\$ 253</b>	<b>\$ 1,151</b>	<b>\$ 7,936</b>
Individually evaluated for impairment	\$ 147	\$ 0	\$ 700	\$ 0	\$ 0	\$ 0	\$ 100	\$ 215	\$ 1,162
Collectively evaluated for impairment	1,424	1,259	495	485	1,913	237	102	955	6,870
<b>Balance, December 31, 2012</b>	<b>\$ 1,571</b>	<b>\$ 1,259</b>	<b>\$ 1,195</b>	<b>\$ 485</b>	<b>\$ 1,913</b>	<b>\$ 237</b>	<b>\$ 202</b>	<b>\$ 1,170</b>	<b>\$ 8,032</b>
Individually evaluated for impairment	\$ 147	\$ 0	\$ 430	\$ 0	\$ 0	\$ 0	\$ 100	\$ 120	\$ 797
Collectively evaluated for impairment	1,533	1,239	470	449	1,690	164	94	942	6,581
<b>Balance, June 30, 2012</b>	<b>\$ 1,680</b>	<b>\$ 1,239</b>	<b>\$ 900</b>	<b>\$ 449</b>	<b>\$ 1,690</b>	<b>\$ 164</b>	<b>\$ 194</b>	<b>\$ 1,062</b>	<b>\$ 7,378</b>
<b>Loans:</b>									
Individually evaluated for impairment	\$ 9,168	\$ 5,691	\$ 2,571	\$ 0	\$ 2,149	\$ 682	\$ 463	\$ 2,468	\$ 23,192
Collectively evaluated for impairment	92,743	112,394	67,095	67,668	66,434	33,460	30,690	140,169	610,653
<b>Balance, June 30, 2013</b>	<b>\$ 101,911</b>	<b>\$ 118,085</b>	<b>\$ 69,666</b>	<b>\$ 67,668</b>	<b>\$ 68,583</b>	<b>\$ 34,142</b>	<b>\$ 31,153</b>	<b>\$ 142,637</b>	<b>\$ 633,845</b>
Individually evaluated for impairment	\$ 12,467	\$ 5,736	\$ 2,731	\$ 0	\$ 3,048	\$ 699	\$ 471	\$ 2,455	\$ 27,607
Collectively evaluated for impairment	84,469	116,978	63,688	64,948	67,395	39,559	20,457	122,379	579,873
<b>Balance, December 31, 2012</b>	<b>\$ 96,936</b>	<b>\$ 122,714</b>	<b>\$ 66,419</b>	<b>\$ 64,948</b>	<b>\$ 70,443</b>	<b>\$ 40,258</b>	<b>\$ 20,928</b>	<b>\$ 124,834</b>	<b>\$ 607,480</b>
Individually evaluated for impairment	\$ 8,535	\$ 4,536	\$ 2,604	\$ 0	\$ 2,071	\$ 708	\$ 481	\$ 4,639	\$ 23,574
Collectively evaluated for impairment	90,693	114,799	61,006	60,176	56,040	27,712	18,901	124,097	553,424
<b>Balance, June 30, 2012</b>	<b>\$ 99,228</b>	<b>\$ 119,335</b>	<b>\$ 63,610</b>	<b>\$ 60,176</b>	<b>\$ 58,111</b>	<b>\$ 28,420</b>	<b>\$ 19,382</b>	<b>\$ 128,736</b>	<b>\$ 576,998</b>

(dollars in thousands)	Residential mortgage	Home equity	Other	Total consumer related	Unallocated	Total
<b>Allowance for loan losses:</b>						
Individually evaluated for impairment	\$ 0	\$ 0	\$ 0	\$ 0	\$ 0	\$ 770
Collectively evaluated for impairment	77	236	276	589	934	8,689

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<b>Balance, June 30, 2013</b>	\$	77	\$	236	\$	276	\$	589	\$	934	\$	9,459
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Individually evaluated for impairment	\$	0	\$	0	\$	0	\$	0	\$	0	\$	1,162
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Collectively evaluated for impairment		124		237		238		599		671		8,140
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<b>Balance, December 31, 2012</b>	\$	124	\$	237	\$	238	\$	599	\$	671	\$	9,302
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Individually evaluated for impairment	\$	0	\$	0	\$	0	\$	0	\$	0	\$	797
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Collectively evaluated for impairment		78		152		137		367		945		7,893
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<b>Balance, June 30, 2012</b>	\$	78	\$	152	\$	137	\$	367	\$	945	\$	8,690
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**Loans:**

Individually evaluated for impairment	\$	152	\$	397	\$	667	\$	1,216	\$		\$	24,408
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Collectively evaluated for impairment		24,276		71,169		38,094		133,539				744,192
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<b>Balance, June 30, 2013</b>	\$	24,428	\$	71,566	\$	38,761	\$	134,755	\$		\$	768,600
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Individually evaluated for impairment	\$	85	\$	340	\$	642	\$	1,067	\$		\$	28,674
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Collectively evaluated for impairment		23,426		65,518		39,643		128,587				708,460
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<b>Balance, December 31, 2012</b>	\$	23,511	\$	65,858	\$	40,285	\$	129,654	\$		\$	737,134
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Individually evaluated for impairment	\$	87	\$	222	\$	460	\$	769	\$		\$	24,343
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Collectively evaluated for impairment		22,339		60,270		45,868		128,477				681,901
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<b>Balance, June 30, 2012</b>	\$	22,426	\$	60,492	\$	46,328	\$	129,246	\$		\$	706,244
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Table of Contents**Note 7 Deposits**

The composition of deposits as of June 30, 2013 and December 31, 2012 is shown below.

<i>(dollars in thousands)</i>	<b>June 30, 2013</b>	<b>December 31, 2012</b>
Noninterest bearing demand	\$ 102,977	\$ 88,476
NOW	84,782	77,531
Money market	282,735	289,149
Savings	38,911	34,372
Time deposits less than \$100,000	236,604	236,683
Time deposits \$100,000 or more	178,841	175,096
Total deposits	\$ 924,850	\$ 901,307

**Note 8 Short Term Borrowings and Long-term Debt***Short-term borrowing*

During the second quarter of 2013, the Corporation opened a \$3 million line of credit with ACNB Bank to provide a source of liquidity. The line, renewable annually, is secured by a first lien on the Codorus Valley Corporate Center. The interest rate on the ACNB Bank line is Wall Street Journal Prime. No draws have been made on the line and on June 30, 2013, the balance was zero.

*Long-term debt*

A summary of long-term debt as of June 30, 2013 and December 31, 2012 is shown below.

<i>(dollars in thousands)</i>	<b>June 30, 2013</b>	<b>December 31, 2012</b>
PeoplesBank's obligations:		
FHLBP		
Due May 2013, 3.46%, amortizing	\$ 0	\$ 245
Due July 2015, 1.90%	5,000	5,000
Due July 2016, 2.35%	5,000	5,000
Due March 2018, 1.17%	10,000	0
Due June 2018, 1.87%	5,000	5,000
Due June 2019, 2.10%	5,000	5,000
Total FHLBP	30,000	20,245
Capital lease obligation	223	260
Codorus Valley Bancorp, Inc. obligations:		
Junior subordinated debt		
Due 2034, 2.29%, floating rate based on 3 month LIBOR plus 2.02%, callable quarterly	3,093	3,093
Due 2036, 1.82% floating rate based on 3 month LIBOR plus 1.54%, callable quarterly	7,217	7,217
Total long-term debt	\$ 40,533	\$ 30,815

Table of Contents

PeoplesBank's long-term debt obligations to the Federal Home Loan Bank of Pittsburgh (FHLBP) are fixed rate instruments. Under terms of a blanket collateral agreement with the FHLBP, the obligations are secured by FHLBP stock and qualifying loan receivables, principally real estate secured loans.

In June 2006, Codorus Valley formed CVB Statutory Trust No. 2, a wholly-owned special purpose subsidiary whose sole purpose was to facilitate a pooled trust preferred debt issuance of \$7,217,000. In November 2004, Codorus Valley formed CVB Statutory Trust No. 1 to facilitate a pooled trust preferred debt issuance of \$3,093,000. The Corporation owns all of the common stock of these nonbank subsidiaries, and the debentures are the sole assets of the Trusts. The accounts of both Trusts are not consolidated for financial reporting purposes in accordance with FASB ASC 810. For regulatory capital purposes, all of the Corporation's trust preferred securities qualified as Tier 1 capital for all reported periods. Trust preferred securities are subject to capital limitations under the FDIC's risk-based capital guidelines. The Corporation used the net proceeds from these offerings to fund its operations.

**Note 9 Regulatory Matters**

Codorus Valley and PeoplesBank are subject to various regulatory capital requirements. Failure to meet minimum capital requirements can initiate certain mandatory and possible additional discretionary actions by regulators that, if imposed, could have a material effect on Codorus Valley's financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, Codorus Valley and PeoplesBank must meet specific capital guidelines that involve quantitative measures of assets, liabilities, and certain off-balance sheet items as calculated under regulatory accounting practices. The capital amounts and classifications are also subject to qualitative judgments by the regulators.

Quantitative measures established by regulators to ensure capital adequacy require Codorus Valley and PeoplesBank to maintain minimum ratios, as set forth below, to total and Tier 1 capital as a percentage of risk-weighted assets, and of Tier 1 capital to quarter-to-date average assets (leverage ratio). Management believes that Codorus Valley and PeoplesBank were well capitalized on June 30, 2013 based on regulatory capital guidelines.

Table of Contents

(dollars in thousands)	Actual		Minimum for Capital Adequacy		Well Capitalized Minimum*	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
<b>Codorus Valley Bancorp, Inc. (consolidated)</b>						
<b>at June 30, 2013</b>						
Capital ratios:						
Tier 1 risk based	\$ 110,463	13.52%	\$ 32,685	4.00%	n/a	n/a
Total risk based	119,922	14.68	65,370	8.00	n/a	n/a
Leverage	110,463	10.28	42,985	4.00	n/a	n/a
<b>at December 31, 2012</b>						
Capital ratios:						
Tier 1 risk based	\$ 105,597	13.59%	\$ 31,074	4.00%	n/a	n/a
Total risk based	114,899	14.79	62,147	8.00	n/a	n/a
Leverage	105,597	10.02	42,143	4.00	n/a	n/a
<b>PeoplesBank, A Codorus Valley Company</b>						
<b>at June 30, 2013</b>						
Capital ratios:						
Tier 1 risk based	\$ 106,763	13.11%	\$ 32,563	4.00%	\$ 48,845	6.00%
Total risk based	116,222	14.28	65,126	8.00	81,408	10.00
Leverage	106,763	9.96	42,863	4.00	53,579	5.00
<b>at December 31, 2012</b>						
Capital ratios:						
Tier 1 risk based	\$ 102,120	13.20%	\$ 30,951	4.00%	\$ 46,427	6.00%
Total risk based	111,422	14.40	61,902	8.00	77,378	10.00
Leverage	102,120	9.72	42,020	4.00	52,526	5.00

\*To be well capitalized under prompt corrective action provisions.

**Note 10 Shareholders Equity***Preferred stock issued under the US Treasury's Small Business Lending Fund Program*

On August 18, 2011, as part of the Treasury Small Business Lending Fund (SBLF) program, the Corporation entered into a Securities Purchase Agreement (SBLF Purchase Agreement) with the United States Department of the Treasury (Treasury) pursuant to which the Corporation sold to the Treasury, for an aggregate purchase price of \$25 million, 25,000 shares of senior non-cumulative, perpetual preferred stock, Series B, \$1,000 liquidation value, \$2.50 par value. Generally, the preferred stock is non-voting and qualifies as Tier 1 regulatory capital. The SBLF agreement imposes limits on the ability of the Corporation to pay dividends and repurchase shares of common stock if it fails to declare and pay quarterly dividends on the SBLF preferred stock. The dividend rate can fluctuate on a quarterly basis during the first 10 quarters during which the SBLF preferred stock is outstanding, based upon changes in the level of Qualified Small Business Lending or QSBL (as defined in the Purchase Agreement) by the Bank. Based upon the increase in the Bank's level of QSBL over the baseline level calculated under the terms of the Purchase Agreement, the dividend rate for the initial dividend period was set at 5 percent. For the second through ninth calendar quarters, the dividend rate may be adjusted between one percent (1%) and five percent (5%) per annum to reflect the amount of change in the Bank's level of QSBL. The annualized dividend rate was 1 percent for the quarters ended June 30, 2013 and December 31, 2012, and 1.14 percent for the quarter ended June 30, 2012. For the tenth calendar quarter through four and one half years after issuance, the dividend rate will be fixed at between one percent (1%) and seven percent (7%) based upon the increase in QSBL as compared to the baseline. After four and one half years from issuance, the dividend rate will increase to 9% (including a quarterly lending incentive fee of 0.5%). Additional information about SBLF preferred stock is disclosed in Note 10 Shareholders Equity in the Corporation's Annual Report on Form 10-K for the year ended December 31, 2012.



Table of Contents

*Common stock dividend*

Periodically, the Corporation distributes stock dividends on its common stock. The Corporation distributed a 5 percent common stock dividend on December 11, 2012 which resulted in the issuance of 211,564 additional common shares.

**Note 11 Contingent Liabilities**

There are no legal proceedings pending against Codorus Valley Bancorp, Inc. or any of its subsidiaries which are expected to have a material impact upon the consolidated financial position and/or operating results of the Corporation other than routine litigation incidental to the business. Management is not aware of any proceedings known or contemplated by government authorities.

**Note 12 Guarantees**

Codorus Valley does not issue any guarantees that would require liability recognition or disclosure, other than its standby letters of credit. Standby letters of credit are written conditional commitments issued by PeoplesBank to guarantee the performance of a customer to a third party. Generally, all letters of credit, when issued, have expiration dates within one year. The credit risk involved in issuing letters of credit is essentially the same as those that are involved in extending loan facilities to customers. The Corporation generally holds collateral and/or personal guarantees supporting these commitments. The Corporation had \$20,110,000 of standby letters of credit outstanding on June 30, 2013, compared to \$17,064,000 on December 31, 2012. Management believes that the proceeds obtained through a liquidation of collateral and the enforcement of guarantees would be sufficient to cover the potential amount of future payments required under the corresponding letters of credit. The amount of the liability as of June 30, 2013 and December 31, 2012, for guarantees under standby letters of credit issued, was not material. Many of the commitments are expected to expire without being drawn upon and, therefore, generally do not present significant liquidity risk to the Corporation or PeoplesBank.

**Note 13 Fair Value of Assets and Liabilities**

The Corporation uses its best judgment in estimating the fair value of the Corporation's assets and liabilities; however, there are inherent weaknesses in any estimation technique. Therefore, the fair value estimates herein are not necessarily indicative of the amounts that could be realized in sales transactions on the dates indicated. The estimated fair value amounts have been measured as of their respective period-ends and have not been re-evaluated or updated for purposes of these financial statements subsequent to those respective dates. As such, the estimated fair values subsequent to the respective reporting dates may be different than the amounts reported at each period end.

Fair value is defined as the price that would be received to sell an asset or paid to transfer a liability in the principal or most advantageous market for an asset or liability in an orderly transaction (that is, not a forced liquidation or distressed sale) between market participants at the measurement date. GAAP establishes a fair value hierarchy that prioritizes the use of inputs used in valuation methodologies into the following three levels:

Level 1: Inputs to the valuation methodology are quoted prices, unadjusted, for identical assets or liabilities in active markets. A quoted price in an active market provides the most reliable evidence of fair value and shall be used to measure fair value whenever available.

Level 2: Inputs to the valuation methodology include quoted prices for similar assets or liabilities in active markets; inputs to the valuation methodology include quoted prices for identical or similar assets or liabilities in markets that are not active; or inputs to the valuation methodology that utilize model-based techniques for which all significant assumptions are observable in the market.

Table of Contents

Level 3: Inputs to the valuation methodology are unobservable and significant to the fair value measurement; inputs to the valuation methodology that utilize model-based techniques for which significant assumptions are not observable in the market; or inputs to the valuation methodology that require significant management judgment or estimation, some of which may be internally developed.

Since management maximizes the use of observable inputs and minimizes the use of unobservable inputs when determining fair value, an asset's or liability's level within the fair value hierarchy is based on the lowest level of input that is significant to the fair value measurement.

Management reviews and updates the fair value hierarchy classifications on a quarterly basis.

**Assets Measured at Fair Value on a Recurring Basis****Securities available-for-sale**

The fair values of investment securities were measured using information from a third-party pricing service. The pricing service uses quoted market prices on nationally recognized securities exchanges (Level 1), or matrix pricing (Level 2), which is a mathematical technique, used widely in the industry to value debt securities without relying exclusively on quoted market prices for the specific securities but rather by relying on the securities' relationship to other benchmark quoted prices. At least annually, the Corporation reviews a random sample of the pricing information received from the third-party pricing service by comparing it to price quotes from third-party brokers. Historically, price deviations have been immaterial.

		Fair Value Measurements		
		(Level 1) Quoted Prices in Active Markets for Identical Assets	(Level 2) Significant Other Observable Inputs	(Level 3) Significant Other Unobservable Inputs
<i>(dollars in thousands)</i>		Total		
<b>June 30, 2013</b>				
Securities available-for-sale:				
U.S. Treasury notes	\$	3,513	\$ 3,513	\$ 0
U.S. agency		40,471	0	40,471
U.S. agency mortgage-backed, residential		79,716	0	79,716
State and municipal		97,484	0	97,484
<b>December 31, 2012</b>				
Securities available-for-sale:				
U.S. Treasury notes	\$	5,032	\$ 5,032	\$ 0
U.S. agency		38,058	0	38,058
U.S. agency mortgage-backed, residential		88,233	0	88,233
State and municipal		102,739	0	102,739

**Assets Measured at Fair Value on a Nonrecurring Basis****Impaired loans**

Impaired loans are those that are accounted for under FASB ASC Topic 310, in which the Corporation has measured impairment generally based on the fair value of the loan's collateral. Fair value is generally determined based upon independent third-party appraisals of the properties, or discounted cash flows based upon the expected proceeds. These loans are included as Level 3 fair values, based on the lowest level of input that is significant to the fair value measurements. At June 30, 2013, the fair value of impaired loans with a valuation allowance or charge-off was of \$3,751,000, which is net of valuation allowances of \$770,000 and charge-offs of \$3,022,000. At December 31, 2012 the fair value of impaired loans with a valuation allowance or charge-off was \$4,493,000, which is net of valuation allowances of \$1,162,000 and charge-offs of \$2,605,000.

Table of Contents**Foreclosed Real Estate**

Other real estate property acquired through foreclosure is initially recorded at fair value of the property at the transfer date less estimated selling cost. Subsequently, other real estate owned is carried at the lower of its carrying value or the fair value less estimated selling cost. Fair value is usually determined based upon an independent third-party appraisal of the property or occasionally upon a recent sales offer. At June 30, 2013, the fair value of foreclosed real estate with a valuation allowance or charge-off was \$2,661,000, which is net of valuation allowances of \$3,611,000 and charge-offs of \$100,000. At December 31, 2012, the carrying value of foreclosed real estate with a valuation allowance or charge-off was \$2,779,000, which is net of valuation allowances of \$3,712,000 and no charge-offs.

(dollars in thousands)	Total	Fair Value Measurements		
		(Level 1) Quoted Prices in Active Markets for Identical Assets	(Level 2) Significant Other Observable Inputs	(Level 3) Significant Other Unobservable Inputs
<b>June 30, 2013</b>				
Impaired loans	\$ 3,751	\$ 0	\$ 0	\$ 3,751
Foreclosed real estate	2,661	0	0	2,661

**December 31, 2012**

Impaired loans	\$ 4,493	\$ 0	\$ 0	\$ 4,493
Foreclosed real estate	2,779	0	0	2,779

The following table presents additional quantitative information about assets measured at fair value on a nonrecurring basis and for which the Corporation has utilized Level 3 inputs to determine fair value:

(dollars in thousands)	Fair Value Estimate	Quantitative Information about Level 3 Fair Value Measurements			Weighted Average
		Valuation Techniques	Unobservable Input	Range	
<b>June 30, 2013</b>					
Impaired loans	\$ 3,751	Appraisal (1)	Appraisal adjustments (2)	20% - 30%	26%
Foreclosed real estate	2,661	Appraisal (1)	Appraisal adjustments (2)	5% - 16%	8%
<b>December 31, 2012</b>					
Impaired loans	\$ 4,493	Appraisal (1)	Appraisal adjustments (2)	10% - 100%	27%
Foreclosed real estate	2,779	Appraisal (1)	Appraisal adjustments (2)	5% - 100%	12%

- (1) Fair value is generally determined through independent appraisals, which generally include various level 3 inputs that are not identifiable.
- (2) Appraisals may be adjusted downward by the Corporation's management for qualitative factors such as economic conditions, and estimated liquidation expenses. The range of liquidation expenses and other appraisal adjustments are presented as a percent of the appraisal.

Table of Contents

**Disclosures about Fair Value of Financial Instruments**

The following methods and assumptions were used to estimate the fair value of the Corporation's financial instruments as of June 30, 2013 and December 31, 2012:

**Cash and cash equivalents**

The carrying amount is a reasonable estimate of fair value.

**Securities available for sale**

The fair value of securities available for sale is determined in accordance with the methods described under FASB ASC Topic 820 as described above.

**Restricted investment in bank stocks**

The carrying amount of restricted investment in bank stocks is a reasonable estimate of fair value. The Corporation is required to maintain minimum investment balances in these stocks, which are not actively traded and therefore have no readily determinable market value.

**Loans held for sale**

The fair value of loans held for sale is determined, when possible, using quoted secondary-market prices. If no such quoted prices exist, the fair value of a loan is determined using quoted prices for a similar loan or loans, adjusted for the specific attributes of that loan.

**Loans, net**

The fair value of loans, excluding all nonaccrual loans, is estimated using discounted cash flow analyses using the current interest rates at which similar loans would be made to borrowers with similar credit ratings and for the same remaining maturities. Loans were first segregated by type such as commercial, real estate, and consumer, and were then further segmented into fixed and variable rate. Projected future cash flows are calculated based upon contractual maturity or call dates. Generally, variable rate loans that reprice frequently have no significant change in credit risk; fair value is based on carrying value.

**Interest receivable**

The carrying value of interest receivable is a reasonable estimate of fair value.

**Deposits**

The fair value of demand deposits, savings accounts and money market deposits is the amount payable on demand at the reporting date. The fair values of time deposits are estimated using a discounted cash flow analyses. The discount rates used are based on rates currently offered for deposits with similar remaining maturities. The fair values of variable rate time deposits that reprice frequently are based on carrying value. The fair values of time deposit liabilities do not take into consideration the value of the Corporation's long-term relationships with depositors, which may have significant value.

**Short-term borrowings**

For these short-term instruments, the carrying amount is a reasonable estimate of fair value.

**Long-term debt**

Long-term debt includes FHLB advances (Level 2) and junior subordinated debt (Level 3). The fair value of FHLB advances are estimated using discounted cash flow analysis, based on quoted prices for new FHLB advances with similar credit risk characteristics, terms and remaining maturity. These prices are obtained from this active market and represent a market value that is deemed to represent the transfer price if the liability were assumed by a third party. The fair value of junior subordinated debt is estimated using discounted cash flow analysis, based on market rates and spread characteristics of similar debt with similar credit risk characteristics, terms and remaining maturity.

Table of Contents**Interest payable**

The carrying value of interest payable is a reasonable estimate of fair value.

**Off-balance sheet instruments**

Off-balance sheet instruments consist of lending commitments and letters of credit are based on fees currently charged in the market to enter into similar arrangements, taking into account the remaining terms of the agreements and counterparties' credit standing. These amounts were not considered material.

The following presents the carrying amounts and estimated fair values of the Corporation's financial instruments as of June 30, 2013 and December 31, 2012.

	Carrying Amount	Estimated Fair Value	(Level 1) Quoted Prices in Active Markets for Identical Assets	Fair Value Estimates (Level 2) Significant Other Observable Inputs	(Level 3) Significant Other Unobservable Inputs
<i>(dollars in thousands)</i>					
<b>June 30, 2013</b>					
Financial assets					
Cash and cash equivalents	\$ 64,816	\$ 64,816	\$ 64,816	\$ 0	\$ 0
Securities available-for-sale	221,184	221,184	3,513	217,671	0
Restricted investment in bank stocks	3,093	3,093	0	3,093	0
Loans held for sale	1,144	1,171	0	1,171	0
Loans, net	759,141	781,323	0	0	781,323
Interest receivable	3,398	3,398	0	3,398	0
Financial liabilities					
Deposits	\$ 924,850	\$ 927,386	\$ 0	\$ 927,386	\$ 0
Short-term borrowings	23,130	23,130	0	23,130	0
Long-term debt	40,533	35,989	0	30,127	5,862
Interest payable	391	391	0	391	0
Off-balance sheet instruments	0	0	0	0	0
<b>December 31, 2012</b>					
Financial assets					
Cash and cash equivalents	\$ 49,757	\$ 49,757	\$ 49,757	\$ 0	\$ 0
Securities available-for-sale	234,062	234,062	5,032	229,030	0
Restricted investment in bank stocks	2,863	2,863	0	2,863	0
Loans held for sale	3,091	3,151	0	3,151	0
Loans, net	727,832	753,299	0	0	753,299
Interest receivable	3,579	3,579	0	3,579	0
Financial liabilities					
Deposits	\$ 901,307	\$ 907,439	\$ 0	\$ 907,439	\$ 0
Short-term borrowings	19,356	19,356	0	19,356	0
Long-term debt	30,815	26,568	0	21,289	5,279
Interest payable	470	470	0	470	0
Off-balance sheet instruments	0	0	0	0	0

Table of Contents**Note 14 Assets and Liabilities Subject to Offsetting***Securities Sold Under Agreements to Repurchase ( Repurchase Agreements )*

PeoplesBank enters into agreements under which it sells securities subject to an obligation to repurchase the same securities the next business day. These repurchase agreements are accounted for as a collateralized financing arrangement (i.e. secured borrowings) and not as a sale and subsequent repurchase of securities. The obligation to repurchase the securities is reflected as a liability (short-term borrowings) in the Corporation's consolidated financial statements of condition, while the securities underlying the repurchase agreements remain in the respective securities asset accounts. In other words, there is no offsetting or netting of the securities with the repurchase agreement liabilities.

<i>dollars in thousands</i>										
		<b>Gross Amounts of Recognized Liabilities</b>		<b>Gross Amounts Offset in the Statements of Condition</b>		<b>Net Amounts of Liabilities Presented in the Statements of Condition</b>		<b>Gross amounts Not Offset in the Statements of Condition</b>		<b>Net Amount</b>
								<b>Financial Instruments</b>	<b>Cash Collateral Pledged</b>	
<b>June 30, 2013</b>										
Repurchase Agreements	(1)\$	23,130	\$	0	\$	23,130	\$	(23,130)	\$	0
<b>December 31, 2012</b>										
Repurchase Agreements	(1)\$	19,356	\$	0	\$	19,356	\$	(19,356)	\$	0

- (1) As of June 30, 2013 and December 31, 2012, the fair value of securities pledged in connection with repurchase agreements was \$28,171,000 and \$25,876,000, respectively.

Table of Contents

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

Management's discussion and analysis of the significant changes in the results of operations, capital resources and liquidity presented in the accompanying consolidated financial statements for Codorus Valley Bancorp, Inc. (Codorus Valley or the Corporation), a bank holding company, and its wholly owned subsidiary, PeoplesBank, A Codorus Valley Company (PeoplesBank), are provided below. Codorus Valley's consolidated financial condition and results of operations consist almost entirely of PeoplesBank's financial condition and results of operations. Current performance does not guarantee, and may not be indicative of, similar performance in the future.

**Forward-looking statements**

Management of the Corporation has made forward-looking statements in this Form 10-Q. These forward-looking statements are subject to risks and uncertainties. Forward-looking statements include information concerning possible or assumed future results of operations of the Corporation and its subsidiaries. When words such as believes, expects, anticipates or similar expressions occur in the Form 10-Q, management is making forward-looking statements.

Note that many factors, some of which are discussed elsewhere in this report and in the documents that are incorporated by reference, could affect the future financial results of the Corporation and its subsidiaries, both individually and collectively, and could cause those results to differ materially from those expressed in the forward-looking statements contained or incorporated by reference in this Form 10-Q. These factors include, but are not limited to, the following:

- operating, legal and regulatory risks;
- enacted financial reform legislation, e.g., Dodd-Frank Wall Street Reform and Consumer Protection Act, which may have a significant impact on the Corporation's business and results of operations;
- a prolonged economic downturn;
- an increase in nonperforming assets requiring loss provisions and the incurrence of carrying costs related to nonperforming assets;
- declines in the market value of investment securities considered to be other-than-temporary;
- the effects of and changes in the rate of FDIC premiums, including special assessments;
- interest rate fluctuations which could increase our cost of funds or decrease our yield on earning assets and therefore reduce our net interest income;
- future legislative or administrative changes to U.S. governmental capital programs;
- unavailability of capital when needed or availability at less than favorable terms;
- political and competitive forces affecting banking, securities, asset management and credit services businesses;
- unauthorized disclosure of sensitive or confidential client or customer information, whether through a breach of our computer systems or otherwise, may adversely affect the Corporation's operations, net income or reputation; and
- the risk that management's analysis of these risks and forces could be incorrect and/or that the strategies developed to address them could be unsuccessful.

The Corporation undertakes no obligation to publicly revise or update these forward-looking statements to reflect events or circumstances that arise after the date of this report.

Table of Contents

**Critical accounting policies**

We have identified critical accounting policies for the Corporation to include allowance for loan losses, valuation of foreclosed real estate and evaluation of other-than-temporary impairment losses of securities. There were no material changes made to the critical accounting policies disclosed in the 2012 Annual Report on Form 10-K in regards to application or related judgments and estimates used. A detailed disclosure pertaining to critical accounting estimates is provided in Item 7 of the Corporation's 2012 Annual Report on Form 10-K.

**Three months ended June 30, 2013,  
compared to three months ended June 30, 2012**

**FINANCIAL HIGHLIGHTS**

The Corporation earned net income available to common shareholders (earnings) totaling \$2,583,000 for the quarter ended June 30, 2013, compared to \$2,708,000 for the quarter ended June 30, 2012. The \$125,000 or 5 percent decrease in earnings for the second quarter of 2013, compared to the second quarter of 2012, was primarily the result of increases in the provision for loan losses and noninterest expense, which more than offset increases in net interest income and noninterest income, as described below.

The \$249,000 or 3 percent increase in net interest income for the second quarter of 2013, compared to the same quarter of 2012, was due primarily to a decrease in funding costs resulting from a larger proportion of low cost core deposits to total deposits and lower rates generally paid on all deposit products, which reflected unusually low market interest rates. The average balance of interest earning assets, principally commercial loans, increased approximately \$47 million or 5 percent for the second quarter of 2013, compared to the same quarter of 2012. While the volume of earning assets increased, its effect on interest income was more than offset by lower yields, a reflection of the low interest rate environment.

The \$310,000 or 124 percent increase in the provision for loan losses for the second quarter of 2013, compared to the same quarter of 2012, resulted from an increase in net charge-offs and to support a larger loan portfolio.

The \$132,000 or 7 percent increase in total noninterest income for the second quarter of 2013, compared to the same quarter of 2012, was primarily the result of increases in income from trust fees, service charges on deposit accounts and gains from the sale of loans held for sale (i.e., residential mortgage loans). The recognition of a \$44,000 gain on the sale of investment securities also contributed to the increase in total noninterest income.

Total noninterest expense for the second quarter of 2013 was \$7,157,000, an increase of \$205,000 or 3 percent, compared to the same quarter of 2012. Personnel expense during the current quarter increased \$354,000 or 9 percent above the second quarter of 2012 due primarily to increases in planned staff additions, employee benefits costs and normal business growth. For the same periods, impairment losses on foreclosed real estate and carrying costs on foreclosed real estate and impaired loans experienced substantial decreases.



Table of Contents

The schedule below presents selected performance metrics for the second quarter of 2013 and 2012.

		Three months ended June 30,	
	2013	2012	
Basic earnings per share	\$ 0.57	\$ 0.61	
Diluted earnings per share	\$ 0.56	\$ 0.60	
Cash dividend payout ratio	19.2%	14.0%	
Return on average assets	0.98%	1.07%	
Return on average equity	10.13%	11.43%	
Net interest margin (tax equivalent)	3.79%	3.88%	
Net overhead ratio	1.91%	1.95%	
Efficiency ratio	60.86%	60.88%	
Average equity to average assets	9.67%	9.38%	

A more detailed analysis of the factors and trends affecting corporate earnings follows.

**INCOME STATEMENT ANALYSIS****Net interest income**

Net interest income for the three-month period ended June 30, 2013, was \$9,301,000, an increase of \$249,000 or 3 percent above the second quarter of 2012. The increase in net interest income was due primarily to a decrease in funding costs resulting from a larger proportion of low cost core deposits to total deposits and lower rates generally paid on all deposit products, which reflected unusually low market interest rates. Net interest income (tax equivalent basis) as a percentage of interest earning assets, i.e., net interest margin, was 3.79 percent for the second quarter of 2013, compared to 3.88 percent for the second quarter of 2012.

The \$219,000 or 2 percent decrease in total interest income for the current quarter, compared to the second quarter of 2012, was due primarily to a decrease in yields on earning assets, which was reflective of the long duration of historically low market interest rates. Interest earning assets averaged \$1.02 billion and yielded 4.65 percent (tax equivalent basis) for the current quarter, compared to \$974 million and 4.97 percent, respectively, for the second quarter of 2012. The average balance of interest earning assets, principally commercial loans, increased approximately \$47 million or 5 percent for the second quarter of 2013, compared to the same quarter of 2012. While the volume of earning assets increased, its effect on interest income was largely offset by lower yields, a reflection of the low interest rate environment.

The \$468,000 or 18 percent decrease in total interest expense for the current quarter, compared to the second quarter of 2012 resulted from a larger proportion of low cost core deposits to total deposits and lower rates generally paid on all deposit products, which reflected historically low market interest rates. Total interest bearing liabilities averaged \$874 million at an average rate of 1 percent for the current quarter, compared to \$850 million and 1.25 percent, respectively, for the second quarter of 2012. The \$24 million or 3 percent increase in the average volume of interest bearing liabilities reflected growth in core deposits, principally demand and money market deposits and, to a lesser degree, savings deposits. The growth of core deposits is a particular focus of the Corporation because the rates are relatively low, are a source of fee income and provide the opportunity to cross-sell other financial products and services. The Corporation excludes time deposits in its definition of core deposits.

Table of Contents
**Table 1-Average Balances and Interest Rates (tax equivalent basis)**

(dollars in thousands)	Three months ended June 30,					
	Average Balance	2013 Interest	Yield/Rate	Average Balance	2012 Interest	Yield/Rate
Assets						
Interest bearing deposits with banks	\$ 44,315	\$ 28	0.25%	\$ 36,250	\$ 23	0.26%
Investment securities:						
Taxable	120,860	624	2.07	147,631	913	2.49
Tax-exempt	92,784	908	3.93	79,979	877	4.41
Total investment securities	213,644	1,532	2.88	227,610	1,790	3.16
Loans:						
Taxable (1)	751,554	10,105	5.39	696,587	10,036	5.79
Tax-exempt	11,111	155	5.60	13,064	192	5.91
Total loans	762,665	10,260	5.40	709,651	10,228	5.80
Total earning assets	1,020,624	11,820	4.65	973,511	12,041	4.97
Other assets (2)	58,939			63,174		
Total assets	\$ 1,079,563			\$ 1,036,685		
Liabilities and Shareholders Equity						
Deposits:						
Interest bearing demand	\$ 363,182	\$ 337	0.37%	\$ 329,317	\$ 323	0.39%
Savings	38,194	24	0.25	34,044	21	0.25
Time	410,682	1,590	1.55	430,024	2,071	1.94
Total interest bearing deposits	812,058	1,951	0.96	793,385	2,415	1.22
Short-term borrowings	21,051	29	0.55	20,045	29	0.58
Long-term debt	40,569	192	1.90	36,245	196	2.17
Total interest bearing liabilities	873,678	2,172	1.00	849,675	2,640	1.25
Noninterest bearing deposits	93,442			83,229		
Other liabilities	8,001			6,562		
Shareholders equity	104,442			97,219		
Total liabilities and shareholders equity	\$ 1,079,563			\$ 1,036,685		
Net interest income		\$ 9,648			\$ 9,401	
Net interest margin (3)			3.79%			3.88%

- (1) Average balance includes average nonaccrual loans of \$11,726,000 for 2013 and \$14,432,000 for 2012. Interest includes net loan fees of \$393,000 for 2013 and \$221,000 for 2012.
- (2) Average balance includes average bank owned life insurance, foreclosed real estate and unrealized holding gains (losses) on investment securities.
- (3) Net interest income annualized as a percentage of average earning assets.

Table of Contents**Table 2-Rate/Volume Analysis of Changes in Net Interest Income (tax equivalent basis)**

	Three months ended June 30, 2013 vs. 2012		
	Volume	Rate	Net
(dollars in thousands)			
Interest Income			
Interest bearing deposits with banks	\$ 5	\$ 0	\$ 5
Investment securities:			
Taxable	(151)	(138)	(289)
Tax-exempt	141	(110)	31
Loans:			
Taxable	993	(924)	69
Tax-exempt	(29)	(8)	(37)
Total interest income	959	(1,180)	(221)
Interest Expense			
Deposits:			
Interest bearing demand	30	(16)	14
Savings	3	0	3
Time	(93)	(388)	(481)
Short-term borrowings	1	(1)	0
Long-term debt	24	(28)	(4)
Total interest expense	(35)	(433)	(468)
Net interest income	\$ 994	\$ (747)	\$ 247
Changes which are due to both volume and rate are allocated in proportion to their relationship to the amount of change attributed directly to volume or rate.			

**Provision for loan losses**

For the three-month period ended June 30, 2013, the provision for loan losses was \$560,000, which was the level needed to maintain the adequacy of the allowance for loan losses. Comparatively, the provision was \$250,000 for the second quarter of 2012. More information about the allowance for loan losses can be found in this report under the caption Allowance for Loan Losses on page 54.

Table of Contents**Noninterest income**

The following table presents the components of total noninterest income for the second quarter of 2013, compared to the second quarter of 2012.

**Table 3 - Noninterest income**

(dollars in thousands)	Three months ended June 30,		Change Increase (Decrease)	
	2013	2012	\$	%
Trust and investment services fees	\$ 464	\$ 405	\$ 59	15%
Income from mutual fund, annuity and insurance sales	173	243	(70)	(29)
Service charges on deposit accounts	670	633	37	6
Income from bank owned life insurance	185	174	11	6
Other income	180	170	10	6
Net gain on sales of loans held for sale	322	281	41	15
Net gain on sales of securities	44	0	44	nm
Total noninterest income	\$ 2,038	\$ 1,906	\$ 132	7%
nm not meaningful				

The discussion that follows addresses changes in selected categories of noninterest income.

**Trust and investment services fees** The \$59,000 or 15 percent increase in trust and investment services fees was due in part to the periodic recognition of approximately \$32,000 in estate fees, appreciation in the market value of managed accounts, upon which some fees are based, and growth in traditional trust business.

**Income from mutual fund, annuity and insurance sales** The \$70,000 or 29 percent decrease in income from the sale of mutual fund, annuity and insurance products by Codorus Valley Financial Advisors (CVFA), a subsidiary of PeoplesBank, was a result of the resignation of three registered representatives who left CVFA in April 2013.

**Service charges on deposit accounts** The \$37,000 or 6 percent increase in service charge income was due primarily to an increase in debit card revenue as a result of normal business growth.

**Income from bank owned life insurance (BOLI)** The \$11,000 or 6 percent increase in income from BOLI was due to an additional investment totaling \$5.3 million in February 2013. More information about this transaction is provided under the year-to-date section of Noninterest Income.

**Net gain on sales of loans held for sale** The \$41,000 or 15 percent increase in gains from the sale of residential mortgage loans resulted from an increase in loan origination volumes due to increased refinancing activity. Mortgage loan refinancing, and income therefrom, is expected to decrease for the remainder of the year as a consequence of saturation and the possibility of rising market interest rates.

**Net gain on sales of securities** During the second quarter of 2013, PeoplesBank sold three municipal bonds with a combined par value of \$875,000 that no longer met its investment quality standards. The sale resulted in the recognition of a \$44,000 gain. The second quarter of 2012 had no comparable sale transaction.

Table of Contents**Noninterest expense**

The following table presents the components of total noninterest expense for the second quarter of 2013, compared to the second quarter of 2012.

**Table 4 - Noninterest expense**

(dollars in thousands)	Three months ended June 30,		Change Increase (Decrease)	
	2013	2012	\$	%
Personnel	\$ 4,115	\$ 3,761	\$ 354	9%
Occupancy of premises, net	512	504	8	2
Furniture and equipment	489	461	28	6
Postage, stationery and supplies	157	134	23	17
Professional and legal	165	150	15	10
Marketing and advertising	254	197	57	29
FDIC insurance	138	189	(51)	(27)
Debit card processing	195	178	17	10
Charitable donations	11	34	(23)	(68)
External data processing	157	142	15	11
Foreclosed real estate including (gains) losses on sales	74	211	(137)	(65)
Impaired loan carrying costs	36	185	(149)	(81)
Other	854	806	48	6
Total noninterest expense	\$ 7,157	\$ 6,952	\$ 205	(3)%

The discussion that follows addresses changes in selected categories of noninterest expense.

**Personnel** The \$354,000 or 9 percent increase in personnel expense was due largely to an increase in wage expense resulting from planned staff additions and normal business growth. An increase in employee benefit expenses also contributed, including increases in medical insurance, due to a greater level of claims, and employer paid 401K Plan costs.

**Furniture and equipment** The \$28,000 or 6 percent increase in furniture and equipment was due primarily normal business growth, which included increases in software license fees and maintenance and depreciation expense on computer hardware.

**Marketing and advertising** The \$57,000 or 29 percent increase in marketing expense was due to normal business growth and increased corporate initiatives such as branding, product advertising and internal promotions.

**FDIC insurance** The \$51,000 or 27 percent decrease in FDIC insurance premiums was due to a lower assessment rate, which resulted from improved financial performance by PeoplesBank. The FDIC uses various performance and risk metrics to classify financial institutions below \$10 billion in total assets into four risk categories (1-4) with progressively higher assessments.

**Foreclosed real estate including (gains) losses on sales** The \$137,000 or 65 percent decrease in foreclosed real estate costs for the current quarter reflected a decrease in provisioning for impairment losses compared to the second quarter of 2012, which included a \$308,000 provision associated with one property.

Table of Contents

**Impaired loan carrying costs** The \$149,000 or 81 percent decrease in impaired loan carrying costs is an example of the variability of this line item expense, which is affected by variables such as economic and business conditions, the number and size of the loans in the impaired loan portfolio, financial capacity of the borrower or guarantor, and the value and liquidity of underlying collateral, among other factors.

**Provision for income taxes**

The provision for income tax for the second quarter of 2013 was \$977,000, which was the same amount for the second quarter of 2012. For both periods, the Corporation's statutory federal income tax rate was 34 percent. The Corporation's effective income tax rate was 27 percent for the second quarter of 2013, compared to 26 percent for the second quarter of 2012. The effective tax rate differs from the statutory tax rate due to the impact of low-income housing credits and tax-exempt income, including income from bank owned life insurance.

**Preferred stock dividends**

Preferred stock dividends for the second quarter of 2013 totaled \$62,000, compared to \$71,000 for the second quarter of 2012, which equated to annualized dividend rates of 1 percent and 1.14 percent, respectively. The Corporation is currently paying the lowest permissible dividend rate under the U.S. Treasury's Small Business Lending Fund Program (SBLF Program) as a result of adding loans that qualify for the SBLF Program in excess of a pre-determined loan portfolio baseline balance. Information about the SBLF Program is provided in this report at Note 10-Shareholders' Equity.

**Six months ended June 30, 2013,  
compared to six months ended June 30, 2012  
FINANCIAL HIGHLIGHTS**

The Corporation earned net income available to common shareholders (earnings) totaling \$5,182,000 for the first six months of 2013, compared to \$4,810,000 for the same period of 2012. The \$372,000 or 8 percent increase in earnings was primarily the result of increases in net interest income and noninterest income, and a decrease in preferred stock dividends, which more than offset increases in the provision for loan losses, noninterest expense and provision for income taxes, as described below.

The \$699,000 or 4 percent pretax increase in net interest income for the first six months of 2013, compared to the same period of 2012, was due primarily to a decrease in funding costs resulting from a larger proportion of low cost core deposits to total deposits and lower rates generally paid on all deposit products, which reflected unusually low market interest rates. The average balance of interest earning assets, principally commercial loans, increased approximately \$49 million or 5 percent for the first six months of 2013, compared to the same period of 2012. While the volume of earning assets increased, its effect on interest income was largely offset by lower yields, a reflection of the low interest rate environment.

The \$320,000 or 64 percent increase in the provision for loan losses for the first six months of 2013, compared to the same period of 2012, was the amount needed to replenish the allowance for loan losses due to an increase in net charge-offs and to support a larger loan portfolio and thereby maintain the adequacy of the allowance for loan losses.

The \$306,000 or 8 percent increase in total noninterest income for the first six months of 2013, compared to the same period of 2012, was primarily the result of increases in income from trust and investment services fees, service fees on deposits and gains from the sale of residential mortgage loans. Mortgage loan refinancing, and income therefrom, is expected to decrease for the remainder of the year as a consequence of saturation and the possibility of rising market interest rates.

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### Table of Contents

The \$188,000 or 1 percent increase in total noninterest expense for the first six months of 2013, compared to the same period of 2012, was due primarily to an increase in personnel expense as a result of planned staff additions, an increase in sales commissions due to increased loan production and normal business growth. An increase in employee benefit expenses also contributed, including increases in medical insurance, due to a greater level of claims, and employer paid 401K Plan costs. During the current period, carrying costs and loss provisions on impaired loans and foreclosed real estate decreased significantly, compared to the first six months of 2012, which helped to reduce the overall level of noninterest expense.

The \$259,000 or 15 percent increase in the provision for income taxes for the first six months of 2013, compared to the same period of 2012, was primarily the result of the 7 percent increase in income before income taxes.

The \$134,000 or 52 percent decrease in preferred stock dividends was the result of a decrease in the dividend rate caused by the addition of loans that qualified for the U.S. Treasury's Small Business Lending Fund Program (SBLF Program). The annualized dividend rate in effect for the six month period ended June 30, 2013 was 1 percent, compared to approximately 2.07 percent for the same period in 2012.

The schedule below presents selected performance metrics for the six month periods ended June 30, 2013 and 2012.

	Six months ended June 30,	
	2013	2012
Basic earnings per share	\$ 1.15	\$ 1.09
Diluted earnings per share	\$ 1.13	\$ 1.08
Cash dividend payout ratio	19.1%	15.7%
Return on average assets	0.99%	0.99%
Return on average equity	10.26%	10.53%
Net interest margin (tax equivalent)	3.83%	3.87%
Net overhead ratio	1.95%	2.06%
Efficiency ratio	61.64%	63.58%
Average equity to average assets	9.70%	9.40%

A more detailed analysis of the factors and trends affecting corporate earnings follows.

### INCOME STATEMENT ANALYSIS

#### Net interest income

Net interest income for the six-month period ended June 30, 2013, was \$18,453,000, an increase of \$699,000 or 4 percent above the second quarter of 2012. The increase in net interest income was due primarily to a decrease in funding costs resulting from a larger proportion of low cost core deposits to total deposits and lower rates generally paid on all deposit products, which reflected unusually low market interest rates. Net interest income (tax equivalent basis) as a percentage of interest earning assets, i.e., net interest margin, was 3.83 percent for the first six months of 2013, compared to 3.87 percent for the same period of 2012.

Table of Contents

The \$251,000 or 1 percent decrease in total interest income for the current period, compared to the first six months of 2012, was due primarily to a decrease in yields on earning assets, which was reflective of the long duration of historically low market interest rates. Interest earning assets averaged \$1.01 billion and yielded 4.70 percent (tax equivalent basis) for the current period, compared to \$960 million and 4.98 percent, respectively, for the first six months of 2012. The average balance of interest earning assets, principally commercial loans, increased approximately \$49 million or 5 percent for the first six months of 2013, compared to the first six months of 2012. While the volume of earning assets generally increased, its effect on interest income was largely offset by lower yields, a reflection of the low interest rate environment. The \$498,000 decrease in interest income from investment securities was attributable to lower reinvestment yields and a decrease in the average volume invested.

The \$950,000 or 18 percent decrease in total interest expense for the current period, compared to the first six months of 2012 resulted from a larger proportion of low cost core deposits to total deposits and lower rates generally paid on all deposit products, which reflected historically low market interest rates. Total interest bearing liabilities averaged \$868 million at an average rate of 1.02 percent for the current period, compared to \$843 million and 1.27 percent, respectively, for the first six months of 2012. The \$25 million or 3 percent increase in the average volume of interest bearing liabilities reflected growth in core deposits, principally money market and demand deposits. The growth of core deposits is a particular focus of the Corporation because the rates are relatively low, are a source of fee income and provide the opportunity to cross-sell other financial products and services. The Corporation excludes time deposits in its definition of core deposits.



Table of Contents**Table 5-Average Balances and Interest Rates (tax equivalent basis)**

(dollars in thousands)	Six months ended June 30,					
	Average Balance	2013 Interest	Yield/ Rate	Average Balance	2012 Interest	Yield/ Rate
<b>Assets</b>						
Interest bearing deposits with banks	\$ 33,543	\$ 42	0.25%	\$ 30,308	\$ 38	0.25%
Investment securities:						
Taxable	124,327	1,275	2.07	147,754	1,824	2.48
Tax-exempt	93,908	1,840	3.95	79,433	1,760	4.46
Total investment securities	218,235	3,115	2.88	227,187	3,584	3.17
<b>Loans:</b>						
Taxable (1)	746,601	20,072	5.42	688,965	19,761	5.77
Tax-exempt	10,874	306	5.67	13,798	407	5.93
Total loans	757,475	20,378	5.43	702,763	20,168	5.77
Total earning assets	1,009,253	23,535	4.70	960,258	23,790	4.98
Other assets (2)	57,607			63,865		
Total assets	\$ 1,066,860			\$ 1,024,123		
<b>Liabilities and Shareholders' Equity Deposits:</b>						
Interest bearing demand	\$ 364,209	\$ 671	0.37%	\$ 326,904	\$ 651	0.40%
Savings	36,967	46	0.25	32,929	41	0.25
Time	408,478	3,243	1.60	428,334	4,179	1.96
Total interest bearing deposits	809,654	3,960	0.99	788,167	4,871	1.24
Short-term borrowings	20,592	57	0.56	17,302	53	0.62
Long-term debt	37,387	364	1.96	37,252	407	2.20
Total interest bearing liabilities	867,633	4,381	1.02	842,721	5,331	1.27
Noninterest bearing deposits	88,363			78,724		
Other liabilities	7,377			6,421		
Shareholders' equity	103,487			96,257		
Total liabilities and shareholders' equity	\$ 1,066,860			\$ 1,024,123		
Net interest income		\$ 19,154			\$ 18,459	
Net interest margin (3)			3.83%			3.87%

- (1) Average balance includes average nonaccrual loans of \$10,249,000 for 2013 and \$12,769,000 for 2012. Interest includes net loan fees of \$721,000 for 2013 and \$419,000 for 2012.
- (2) Average balance includes average bank owned life insurance, foreclosed real estate and unrealized holding gains (losses) on investment securities.
- (3) Net interest income annualized as a percentage of average earning assets.

Table of Contents**Table 6-Rate/Volume Analysis of Changes in Net Interest Income (tax equivalent basis)**

	Six months ended June 30, 2013 vs. 2012		
	Volume	Rate	Net
<i>(dollars in thousands)</i>			
Interest Income			
Interest bearing deposits with banks	\$ 4	\$ 0	\$ 4
Investment securities:			
Taxable	(257)	(292)	(549)
Tax-exempt	321	(241)	80
Loans:			
Taxable	1,990	(1,679)	311
Tax-exempt	(86)	(15)	(101)
Total interest income	1,972	(2,227)	(255)
Interest Expense			
Deposits:			
Interest bearing demand	65	(45)	20
Savings	5	0	5
Time	(194)	(742)	(936)
Short-term borrowings	10	(6)	4
Long-term debt	1	(44)	(43)
Total interest expense	(113)	(837)	(950)
Net interest income	\$ 2,085	\$ (1,390)	\$ 695
Changes which are due to both volume and rate are allocated in proportion to their relationship to the amount of change attributed directly to volume or rate.			

**Provision for loan losses**

For the six-month period ended June 30, 2013, the provision for loan losses was \$820,000, which was the level needed to replenish an increase in net charge-offs and to support a larger loan portfolio and thereby maintain the adequacy of the allowance for loan losses. Comparatively, the provision was \$500,000 for the first six months of 2012. More information about the allowance for loan losses can be found in this report under the caption Allowance for Loan Losses on page 54.

Table of Contents**Noninterest income**

The following table presents the components of total noninterest income for the six month periods ended June 30, 2013 and 2012.

**Table 7 - Noninterest income**

(dollars in thousands)	Six months ended June 30,		Change Increase (Decrease)	
	2013	2012	\$	%
Trust and investment services fees	\$ 937	\$ 813	\$ 124	15%
Income from mutual fund, annuity and insurance sales	422	431	(9)	(2)
Service charges on deposit accounts	1,304	1,244	60	5
Income from bank owned life insurance	351	330	21	6
Other income	346	332	14	4
Net gain on sales of loans held for sale	641	540	101	19
Net gain on sales of securities	44	49	(5)	(10)
Total noninterest income	\$ 4,045	\$ 3,739	\$ 306	8%

The discussion that follows addresses changes in selected categories of noninterest income.

**Trust and investment services fees** The \$124,000 or 15 percent increase in trust and investment services fees was due in part to the periodic recognition of approximately \$68,000 in estate fees, appreciation in the market value of managed accounts, upon which some fees are based, and growth in traditional trust business.

**Income from mutual fund, annuity and insurance sales** The \$9,000 or 2 percent decrease in income from the sale of mutual fund, annuity and insurance products by Codorus Valley Financial Advisors (CVFA), a subsidiary of PeoplesBank, was a result of the resignation of three registered representatives who left CVFA in April 2013.

**Service charges on deposit accounts** The \$60,000 or 5 percent increase in service charge income was due primarily to an increase in debit card revenue as a result of normal business growth.

**Income from bank owned life insurance (BOLI)** The \$21,000 or 6 percent increase in income from BOLI was due to an additional investment totaling \$5.3 million in February 2013. Of this total \$4.7 million was invested with Massachusetts Mutual Life Insurance Company and \$0.6 million was invested with Midland National Life Insurance Company. The initial tax-exempt yield on this investment was approximately 3.77 percent or 5.71 percent on a taxable equivalent basis.

**Net gain on sales of loans held for sale** The \$101,000 or 19 percent increase in gains from the sale of residential mortgage loans resulted from an increase in loan origination volumes due to increased refinancing activity. Mortgage loan refinancing, and income therefrom, is expected to decrease for the remainder of the year as a consequence of saturation and the possibility of rising market interest rates.

Table of Contents**Noninterest expense**

The following table presents the components of total noninterest expense for the six month periods ended June 30, 2013 and 2012.

**Table 8 - Noninterest expense**

(dollars in thousands)	Six months ended June 30,		Change Increase (Decrease)	
	2013	2012	\$	%
Personnel	\$ 8,295	\$ 7,439	\$ 856	12%
Occupancy of premises, net	1,023	1,012	11	1
Furniture and equipment	1,005	924	81	9
Postage, stationery and supplies	307	268	39	15
Professional and legal	302	309	(7)	(2)
Marketing and advertising	400	407	(7)	(2)
FDIC insurance	309	408	(99)	(24)
Debit card processing	373	355	18	5
Charitable donations	486	481	5	1
External data processing	304	270	34	13
Foreclosed real estate including (gains) losses on sales	137	804	(667)	(83)
Impaired loan carrying costs	115	230	(115)	(50)
Other	1,354	1,315	39	3
Total noninterest expense	\$ 14,410	\$ 14,222	\$ 188	1%

The discussion that follows addresses changes in selected categories of noninterest expense.

**Personnel** The \$856,000 or 12 percent increase in personnel expense was due largely to an increase in wage expense resulting from planned staff additions, an increase in sales commissions due to increased loan production and normal business growth. An increase in employee benefit expenses also contributed, including increases in medical insurance, due to a greater level of claims, and employer paid 401K Plan costs. Effective January 1, 2013, PeoplesBank increased 401K Plan matching contributions to 100 percent up to the first 4 percent of an employee's compensation contributed to the Plan, compared to a 50 percent match up to the first 6 percent contributed, for 2012.

**Furniture and equipment** The \$81,000 or 9 percent increase in furniture and equipment was due primarily normal business growth, which included increases in software license fees and maintenance and depreciation expense on computer hardware.

**FDIC insurance** The \$99,000 or 24 percent decrease in FDIC insurance premiums was due to a lower assessment rate, which resulted from improved financial performance by PeoplesBank. The FDIC uses various performance and risk metrics to classify financial institutions below \$10 billion in total assets into four risk categories (1-4) with progressively higher assessments.

**Foreclosed real estate including (gains) losses on sales** The \$667,000 or 83 percent decrease in foreclosed real estate costs for the current period reflected a decrease in provisioning for impairment losses compared to the first six months of 2012, which included provisions associated with three unrelated properties.

Table of Contents

**Impaired loan carrying costs** The \$115,000 or 50 percent decrease in impaired loan carrying costs is an example of the variability of this line item expense, which is affected by variables such as economic and business conditions, the number and size of the loans in the impaired loan portfolio, financial capacity of the borrower or guarantor, and the value and liquidity of underlying collateral, among other factors.

**Provision for income taxes**

The provision for income tax for the first six months of 2013 was \$1,961,000, compared to \$1,702,000 for the first six months of 2012. The \$259,000 increase in the provision for income taxes was primarily the result of the increase in taxable income as evidenced by the 7 percent increase in income before income taxes. For both periods, the Corporation's statutory federal income tax rate was 34 percent. The Corporation's effective income tax rate was 27 percent for the first six months of 2013, compared to 25 percent for the first six months of 2012. The effective tax rate differs from the statutory tax rate due to the impact of low-income housing credits and tax-exempt income, including income from bank owned life insurance.

**Preferred stock dividends**

Preferred stock dividends for the first six months of 2013 were \$125,000, compared to \$259,000 for the same period of 2012. The \$134,000 or 52 percent decrease was the result of a decrease in the dividend rate caused by the addition of loans that qualified for the U.S. Treasury's Small Business Lending Fund Program (SBLF Program). The annualized dividend rate in effect for the six month period ended June 30, 2013 was 1 percent, compared to approximately 2.07 percent for the same period in 2012. Information about the SBLF Program is provided in this report at Note 10-Shareholders' Equity.

**BALANCE SHEET REVIEW**

**Securities available-for-sale**

At June 30, 2013, the fair value of securities available-for-sale totaled \$221 million, which represented an approximate 6 percent decrease compared to the \$234 million value at year-end 2012. During the current period, investable funds were reserved for higher yielding lending opportunities. The composition of the Corporation's investment securities portfolio is provided in Note 3-Securities.

On January 1, 2013, provision 939(a) of the Dodd-Frank Act became effective changing the definition of investment grade by removing reliance on credit ratings by national statistical rating organizations. Investment grade under the revised definition requires an active review (i.e., pre-purchase and post-purchase credit risk analysis) of the obligor to determine that the obligor has an adequate capacity to meet its financial commitments and more specifically that the risk of default is low and that full and timely repayment of principal and interest is expected. Obligations of the U.S. government and U.S. government sponsored enterprises are not subject to the due diligence requirement; however, municipal and corporate obligations are subject to the new requirement.

**Loans**

On June 30, 2013, total loans, net of deferred fees, totaled \$769 million, which was \$31 million or 4 percent higher than the year-end 2012 level. The increase in volume was due primarily to an increase in other commercial loans, principally within the health and professional services and recreational sectors. An increase in home equity loans also contributed to the overall increase in loans. The composition of the Corporation's loan portfolio at June 30, 2013, compared to December 31, 2012, is provided in Note 5 - Loans.

Table of Contents

**Other assets**

On June 30, 2013, other assets totaled \$37 million, which was \$6 million or 20 percent higher than the year-end 2012 level as a result of an investment in bank owned life insurance (BOLI). As a revenue raising strategy, PeoplesBank purchased \$5.3 million of BOLI in February 2013. Of this total, \$4.7 million was invested with Massachusetts Mutual Life Insurance Company and \$0.6 million was invested with Midland National Life Insurance Company. The selection of these insurers was based on their high credit rating and reputation, competitive tax-exempt yield and to accomplish diversification among insurers for the BOLI portfolio. The level of BOLI investment, including the \$5.3 million addition, is estimated at 20 percent of PeoplesBank's Tier 1 capital at June 30, 2013, which is well within PeoplesBank's investment limitation of 25 percent of Tier 1 capital.

**Deposits**

On June 30, 2013, deposits totaled \$925 million, which represented a \$24 million or 3 percent increase compared to the level at year-end 2012. The increase in total deposits occurred primarily within the demand and savings categories, while money market deposits decreased as some depositors redeployed their funds to the capital markets seeking higher returns. The composition of the Corporation's deposit portfolio at June 30, 2013, is provided in Note 7 Deposits.

**Long-term debt**

On June 30, 2013, long-term debt totaled \$41 million, which was \$10 million or 32 percent above the year-end 2012 level. The increase reflected a \$10 million advance from the Federal Home Loan Bank of Pittsburgh that provides liquidity and acts as a hedge against rising market interest rates. The advance has a balloon maturity in March 2018 and a 1.17 percent fixed rate of interest. A listing of outstanding long-term debt obligations is provided in Note 8 Long-term Debt.

**Shareholders' equity and capital adequacy**

Shareholders' equity, or capital, enables Codorus Valley to maintain asset growth and absorb losses. Total shareholders' equity was approximately \$103 million on June 30, 2013, an increase of approximately \$2 million or 2 percent, compared to the level at December 31, 2012. The increase was primarily the result of an increase in retained earnings from profitable operations, which more than offset the decrease in accumulated other comprehensive income (OCI). The decrease in OCI reflected a decline in unrealized gains from the investment securities portfolio caused by an increase in market interest rates most likely the result of remarks made by the chairman of the Federal Reserve Bank about the timing of when the Federal Reserve might unwind its quantitative easing policy.

*Dividends on preferred stock*

As previously disclosed, the Corporation participates in the U.S. Department of the Treasury's Small Business Lending Fund Program (SBLF Program). Information about the SBLF Program can be found in this report at Note 10 Shareholders' Equity. For the quarter ended June 30 2013, accrued dividends equated to an annualized dividend rate of 1 percent on the \$25 million of preferred stock outstanding. Comparatively, for the quarters ended December 31 and June 30 of 2012, the annualized dividend rates were 1 percent and approximately 1.14 percent, respectively.

Table of Contents*Dividends on common stock*

The Corporation typically pays cash dividends on its common stock on a quarterly basis. The Board of Directors determines the dividend rate after considering the Corporation's capital requirements, current and projected net income, and other factors. On July 9, 2013, the Board of Directors declared a quarterly cash dividend of \$0.12 per common share payable on August 13, 2013, to shareholders of record at the close of business on July 23, 2013. This dividend represents an increase of \$0.01 or 9 percent above the \$0.11 per share dividend paid in May and February of 2013.

*Capital adequacy*

Codorus Valley and PeoplesBank are subject to various regulatory capital requirements administered by banking regulators that involve quantitative guidelines and qualitative judgments. Quantitative measures established by regulators pertain to minimum capital ratios, as set forth in Note 9 Regulatory Matters, to the financial statements. We believe that Codorus Valley and PeoplesBank were well capitalized on June 30, 2013, based on regulatory capital guidelines.

On July 2, 2013, the Board of Governors of the Federal Reserve System finalized its rule implementing the Basel III regulatory capital framework, which the FDIC adopted on July 9, 2013. Under the rule, minimum requirements will increase both the quantity and quality of capital held by banking organizations. Consistent with the international Basel framework, the rule includes a new minimum ratio of common equity tier 1 capital to risk-weighted assets of 4.5 percent and a common equity tier 1 conservation buffer of 2.5 percent of risk-weighted assets that will apply to all supervised financial institutions. The rule also raises the minimum ratio of tier 1 capital to risk-weighted assets from 4 percent to 6 percent and includes a minimum leverage ratio of 4 percent for all banking organizations. The new rule increases the risk weights for past-due loans, certain commercial real estate loans and some equity exposures, and makes selected other changes in risk weights and credit conversion factors. The rule for smaller, less complex institutions, which includes the Corporation, takes effect January 1, 2015.

The new rule provides that, in order to avoid limitations on capital distributions, including dividend payments and certain discretionary bonus payments to executive officers, a banking organization must hold the 2.5 percent capital conservation buffer, which is to be phased in over a four year period beginning January 1, 2016, with the full 2.5 percent required as of January 1, 2019. The transition schedule for new ratios, including the capital conservation buffer, is as follows:

	2015	2016	As of January 1: 2017	2018	2019
Minimum common equity tier 1 capital ratio	4.5%	4.5%	4.5%	4.5%	4.5%
Common equity tier 1 capital conservation buffer	N/A	0.625%	1.25%	1.875%	2.5%
Minimum common equity tier 1 capital ratio plus capital conservation buffer	4.5%	5.125%	5.75%	6.375%	7.0%
Phase-in of most deductions from common equity tier 1 capital	40%	60%	80%	100%	100%
Minimum tier 1 capital ratio	6.0%	6.0%	6.0%	6.0%	6.0%
Minimum tier 1 capital ratio plus capital conservation buffer	N/A	6.625%	7.25%	7.875%	8.5%
Minimum total capital ratio	8.0%	8.0%	8.0%	8.0%	8.0%
Minimum total capital ratio plus capital conservation buffer	N/A	8.625%	9.25%	9.875%	10.5%

- 50 -

Table of Contents

As fully phased in, a banking organization with a buffer greater than 2.5% would not be subject to limits on dividend payments or discretionary bonus payments; however, a banking organization with a buffer less than 2.5% would be subject to increasingly stringent limitations as the buffer approaches zero. The new rule also prohibits a banking organization from making dividend payments or discretionary bonus payments if its eligible retained income is negative in that quarter and its capital conservation buffer ratio was less than 2.5% as of the beginning of that quarter. Eligible net income is defined as net income for the 4 calendar quarters preceding the current calendar quarter, net of any distributions and associated tax effects not already reflected in net income. A summary of payout restrictions based on the capital conservation buffer is as follows:

Capital Conservation Buffer (as a % of risk-weighted assets)	Maximum Payout (as a % of eligible retained income)
Greater than 2.5%	No payout limitation applies
≤2.5% and >1.875%	60%
≤1.875% and >1.25%	40%
≤1.25% and >0.625%	20%
≤0.625%	0%

The Corporation plans to manage its capital to ensure compliance with the Basel III capital rules.

**RISK MANAGEMENT****Credit risk management**

The Credit Risk Management section included in the Corporation's Form 10-K for year-end 2012 provides a general overview of the Corporation's credit risk management process and loan concentrations. Credit risk represents the possibility that a loan client, counterparty or issuer may not perform in accordance with contractual terms, posing one of the most significant risks to the Corporation.

***Nonperforming assets***

The following table presents asset categories posing the greatest risk of loss and related ratios. We generally place a loan on nonaccrual status and cease accruing interest income, i.e., recognize interest income on a cash basis, as long as the loan is sufficiently collateralized, when loan payment performance is unsatisfactory and the loan is past due 90 days or more. Loans past due 90 days or more and still accruing interest represent loans that are contractually past due, but are well collateralized and in the process of collection. Foreclosed real estate represents real estate acquired to satisfy debts owed to PeoplesBank. The final category, troubled debt restructurings, pertains to loans whose terms have been modified to include a concession that we would not ordinarily consider due to the debtor's financial difficulties. Concessions granted under a troubled debt restructuring typically involve a reduction of interest rate lower than the current market rate for new debt with similar risk, the deferral of payments or extension of the stated maturity date. Troubled debt restructurings are evaluated for impairment if they have been restructured during the most recent calendar year, or if they cease to perform in accordance with the modified terms. The paragraphs below explain significant changes in the aforementioned categories as of June 30, 2013, compared to December 31, 2012. Nonperforming assets are under the purview of in-house counsel who continuously monitors and manages the collection of these accounts. Additionally, an internal asset quality control committee meets monthly to review nonperforming assets. We generally rely on appraisals performed by independent licensed appraisers to determine the value of collateral for impaired collateral-dependent loans. Generally, an appraisal is performed when: an account reaches 60 days past due, unless a certified appraisal was completed within the past six months; market values have changed significantly; the condition of the property has changed significantly; or the existing appraisal is outdated. In instances where the value of the collateral net of costs to sell is less than the net carrying amount for impaired commercial related loans, a specific loss allowance is established for the difference by recording a loss provision to the income statement. When it is probable that some portion or an entire loan balance will not be collected, that amount is charged off as loss against the allowance.



Table of Contents**Table 9-Nonperforming Assets**

(dollars in thousands)

	June 30, 2013	December 31, 2012
Nonaccrual loans	\$ 8,841	\$ 6,232
Nonaccrual loans, troubled debt restructurings	2,231	2,110
Accruing loans 90 days or more past due	57	186
Total nonperforming loans	11,129	8,528
Foreclosed real estate, net of allowance	3,441	3,633
Total nonperforming assets	\$ 14,570	\$ 12,161
Accruing troubled debt restructurings	\$ 3,571	\$ 3,550
Total period-end loans, net of deferred fees	\$ 768,600	\$ 737,134
Allowance for loan losses (ALL)	\$ 9,459	\$ 9,302
ALL as a % of total period-end loans	1.23%	1.26%
Annualized net charge-offs as a % of average total loans	0.18%	0.16%
ALL as a % of nonperforming loans	85.00%	109.08%
Nonperforming loans as a % of total period-end loans	1.45%	1.16%
Nonperforming assets as a % of total period-end loans and net foreclosed real estate	1.89%	1.64%
Nonperforming assets as a % of total period-end assets	1.33%	1.15%
Nonperforming assets as a % of total period-end shareholders' equity	14.11%	12.00%

The current level of nonperforming assets has increased by approximately \$2.4 million or 20 percent when compared to year-end 2012, primarily as a result of the addition of two unrelated commercial loans to nonaccrual status. Generally, we remain concerned about prolonged weak economic conditions and the corresponding effects it has on our commercial borrowers.

*Nonaccrual loans*

We evaluate the adequacy of the allowance for loan losses at least quarterly and have established a loss allowance for selected loan relationships where the net realizable value of the collateral is insufficient to repay the loan. In this regard, allowances, if applicable, are noted below within the description of the loan. Collection efforts, including modification of contractual terms for individual accounts based on prevailing market conditions and liquidation of collateral assets, are being employed to maximize recovery. Further provisions for loan losses may be required for nonaccrual loans as additional information becomes available or conditions change. There is also the potential for adjustment to the allowance as a result of regulatory examinations. A loan is returned to interest accruing status when we determine that circumstances have improved to the extent that all of the principal and interest amounts contractually due are current for at least six consecutive payments and future payments are reasonably assured.

Table of Contents

On June 30, 2013, the nonperforming loan portfolio balance totaled \$11,129,000 and was comprised primarily of collateralized commercial loans. Comparatively, nonperforming loans totaled \$8,528,000 at year-end 2012. During the quarter ended March 31, 2013, two unrelated commercial loans experiencing deteriorating financial condition were reclassified to nonaccrual status described as loan no. 2 and loan no. 3, below. On June 30, 2013, the nonaccrual loan portfolio was comprised of twenty-seven unrelated loan relationships with outstanding principal balances ranging in size from \$3,000 to \$2,073,000. Six unrelated commercial relationships, which represent 78 percent of the nonperforming loan portfolio balance, are described below.

Loan no. 1 At June 30, 2013, the outstanding principal balance of the loan relationship was \$2,073,000, collateralized by commercial rental properties whose rents are assigned to PeoplesBank. Based on a recent appraisal of the primary real estate collateralizing the relationship, we believe that the loans are adequately collateralized. The borrower is presently operating under a troubled debt restructuring agreement.

Loan no. 2 At June 30, 2013, the outstanding principal balance of the loan relationship was \$2,025,000, collateralized by a portfolio of investment properties. The Bank is presently pursuing its legal remedies to recover the amount due and the borrower is attempting to liquidate selected properties. A \$400,000 allowance for loan losses was established for this relationship in the year 2012.

Loan no. 3 At June 30, 2013, the outstanding principal balance of the loan relationship was \$1,551,000, collateralized by residential and commercial properties. We believe that the loan is adequately collateralized and are pursuing legal remedies to recover the amount due. Note: During July 2013, one of the properties was sold and the Bank recovered approximately \$322,000, which was applied to the principal balance.

Loan no. 4 At June 30, 2013, the outstanding principal balance of the loan relationship was \$1,349,000, collateralized by two commercial properties. Based on an independent appraisal of the real estate collateralizing the relationship, we believe that the loans are adequately collateralized. The Bank is presently pursuing its legal remedies to recover the amount due.

Loan no. 5 At June 30, 2013, the outstanding principal balance of the loan relationship was \$1,280,000, which represents three commercial loans guaranteed from 70% to 80%, depending upon the specific loan, by the U.S. Department of Agriculture. A \$120,000 allowance for loan losses was established in a prior period for this relationship. Several parcels of improved real estate provide collateral for the loans, which are presently listed for sale.

Loan no. 6 PeoplesBank owns a 62.5 percent participation interest in this loan relationship. The carrying value of the Bank's principal at June 30, 2013, was \$375,000, which reflects a \$210,000 charge-off recognized in the second quarter of 2013 and the reduction of approximately \$271,000 from recoveries by the guarantors since year-end 2012. The Bank anticipates collection in full of the outstanding balance based on a recent agreement with the guarantors.

*Foreclosed real estate*

On June 30, 2013, foreclosed real estate, net of allowance, totaled \$3,441,000, compared to \$3,633,000 at December 31, 2012. On June 30, 2013, the portfolio was comprised of four unrelated accounts ranging in size from \$259,000 to \$1,314,000 (net of allowance and charge-offs), which, with the exception of property no. 1, we are actively attempting to liquidate. If a valuation allowance for probable loss has been established for a particular property it is so noted in the property description below. Further valuation allowances may be required on any foreclosed property as additional information becomes available or conditions change. Foreclosed real estate is included in the other assets category on the Corporation's balance sheet. Three unrelated foreclosed real estate properties, which represent the majority of the foreclosed real estate portfolio balance, are described below.

Property no. 1 The carrying amount of this property at June 30, 2013 was \$1,314,000, which is net of a \$1,984,000 allowance for probable loss based on an independent appraisal less estimated selling costs. This account is collateralized by 266 acres of unimproved land that is zoned for residential development. Based on information obtained in 2012, plans to obtain a formal development plan were suspended with the intent to temporarily retain the property and investigate other development, disposition or income generating options at some future date.

Table of Contents

Property no. 2 The carrying amount of this property at June 30, 2013 was \$1,088,000, which is net of a \$1,627,000 allowance for probable loss based on the results of an independent appraisal less estimated selling costs. This account is collateralized by 136 approved residential building lots. Of this total, 29 lots are improved. Management is evaluating its disposition options with regard to this property.

Property no. 3 The carrying amount of this property at June 30, 2013 was \$780,000, which represents the value of the borrower's personal residence presently listed for sale less estimated selling costs.

*Allowance for loan losses*

Although the Corporation maintains sound credit policies, certain loans deteriorate and must be charged off as losses. The allowance for loan losses is maintained to absorb losses inherent in the portfolio. The allowance is increased by provisions charged to expense and is reduced by loan charge-offs, net of recoveries. The allowance is based upon management's continuous evaluation of the loan portfolio coupled with a formal review of adequacy on a quarterly basis, which is subject to review and approval by the Board.

The allowance for loan losses consists primarily of three components: specific allowances for individually impaired commercial loans; allowances calculated for pools of loans; and an unallocated component, which reflects the margin of imprecision inherent in the assumptions that underlie the evaluation of the adequacy of the allowance. The Corporation uses an internal risk rating system to evaluate individual loans. Loans are segmented into industry groups or pools with similar characteristics, and an allowance for loan losses is allocated to each segment based on quantitative factors such as recent loss history (two-year rolling average of net charge-offs) and qualitative factors, such as the results of internal and external credit reviews, changes in the size and composition of the loan portfolio, adequacy of collateral, general economic conditions and the local business outlook. Determining the level of the allowance for probable loan losses at any given period is difficult, particularly during deteriorating or uncertain economic periods. We must make estimates using assumptions and information which are often subjective and fluid. There is also the potential for adjustment to the allowance as a result of regulatory examinations.

The following table presents an analysis of the activity in the allowance for loan losses for the six months ended June 30, 2013 and 2012. The increase in the allowance was generally supported by an increase in the balance of the loan portfolio. The level of annualized net charge-offs for both periods was relatively consistent with prior periods. However, prolonged weakness in economic and business conditions, a relatively high level of unemployment and erosion of real estate values, which adversely affect our borrowers' ability to service their loans, remain and can cause significant fluctuations in the level of charge-offs and provision expense from one period to another. Based on a comprehensive analysis of the loan portfolio, we believe that the allowance for loan losses was adequate at June 30, 2013.

Table of Contents**Table 10 -Analysis of Allowance for Loan Losses**

<i>(dollars in thousands)</i>	2013	2012
Balance-January 1,	\$ 9,302	\$ 8,702
Provision charged to operating expense	820	500
Loans charged off:		
Commercial, financial and agricultural	497	331
Real estate - construction and land development	0	2
Real estate - residential mortgages	28	39
Consumer and home equity	208	204
Total loans charged off	733	576
Recoveries:		
Commercial, financial and agricultural	22	11
Real estate - residential mortgages	2	41
Consumer and home equity	46	12
Total recoveries	70	64
Net charge-offs	663	512
Balance-June 30,	\$ 9,459	\$ 8,690

Ratios:

Allowance for loan losses as a % of total period-end loans	1.23%	1.23%
Annualized net charge-offs as a % of average total loans	0.18%	0.15%
Allowance for loan losses as a % of nonperforming loans	85.00%	79.88%

**Liquidity risk management**

Maintaining adequate liquidity provides the Corporation with the ability to meet financial obligations to depositors, loan customers, employees, and shareholders on a timely and cost effective basis in the normal course of business. Additionally, it provides funds for growth and business opportunities as they arise. Liquidity is generated from transactions relating to both the Corporation's assets and liabilities. The primary sources of asset liquidity are scheduled investment security maturities and cash inflows, funds received from customer loan payments, and asset sales. The primary sources of liability liquidity are deposit growth, short-term borrowings and long-term debt. The Consolidated Statements of Cash Flows, included in this report, present the changes in cash from operating, investing and financing activities. At June 30, 2013, we believe that liquidity was adequate based upon the \$54 million level of interest bearing deposits with banks, the potential liquidation of unpledged available-for-sale securities with a fair value totaling approximately \$80 million and available credit from the Federal Home Loan Bank of Pittsburgh totaling approximately \$189 million. The Corporation's loan-to-deposit ratio was 83 percent at June 30, 2013, compared to 82 percent at year-end 2012.

**Off-balance sheet arrangements**

The Corporation's financial statements do not reflect various commitments that are made in the normal course of business, which may involve some liquidity risk. These commitments consist primarily of commitments to grant new loans, unfunded commitments under existing loan facilities, and letters of credit issued under the same standards as on-balance sheet instruments. Unused commitments on June 30, 2013, totaled \$322 million and consisted of \$188 million in unfunded commitments under existing loan facilities, \$114 million to grant new loans and \$20 million in letters of credit. Normally these commitments have fixed expiration dates or termination clauses and are for specific purposes. Accordingly, many of the commitments are expected to expire without being drawn upon and therefore, generally do not present significant liquidity risk to the Corporation or PeoplesBank.

Table of Contents

**Item 3. Quantitative and Qualitative Disclosures About Market Risk**

Not applicable to smaller reporting companies.

**Item 4. Controls and Procedures**

The Corporation carried out an evaluation, under the supervision and with the participation of the Corporation's management, including the Corporation's Chief Executive Officer and Chief Financial Officer, of the effectiveness of its disclosure controls and procedures, as defined in Exchange Act Rules 13a-15(e) and 15d-15(e). Based upon the evaluation, the Corporation's Chief Executive Officer and Chief Financial Officer concluded that, as of June 30, 2013, the Corporation's disclosure controls and procedures are effective. The Corporation's disclosure controls and procedures are designed to provide reasonable, not absolute, assurance that information required to be disclosed in the Corporation's reports filed or submitted under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission's rules and forms. A control system, no matter how well conceived and operated, must reflect the fact that there are resource constraints, that the benefits of controls must be considered relative to their costs, and inherent limitations that may not prevent fraud, particularly by collusion of two or more people or by management override of a control.

There has been no change in the Corporation's internal control over financial reporting that occurred during the quarter ended June 30, 2013, that has materially affected or is reasonably likely to materially affect, the Corporation's internal control over financial reporting.

**Part II OTHER INFORMATION**

**Item 1. Legal proceedings**

The Corporation and PeoplesBank are involved in routine litigation incidental to their business. There are no legal proceedings pending against the Corporation or any of its subsidiaries which are expected to have a material impact upon the consolidated financial position and/or operating results of the Corporation. Management is not aware of any proceedings known or contemplated by government authorities.

**Item 1A. Risk factors**

This Item 1A is not applicable to smaller reporting companies.

**Item 2. Unregistered sales of equity securities and use of proceeds**

The Corporation relies on its subsidiary PeoplesBank, A Codorus Valley Company, for dividend distributions, which are subject to restrictions as reported in Note 9 Regulatory Matters of the Corporation's Annual Report on Form 10-K for the year ended December 31, 2012.

The Corporation has a Share Repurchase Program (Program), which was authorized in 1995, and periodically amended, to permit the purchase of up to a maximum of 4.9 percent of the outstanding shares of the Corporation's common stock at a price per share no greater than 200 percent of the latest quarterly published book value. For the six month period ended June 30, 2013 and the year ended December 31, 2012, the Corporation had not acquired any of its common stock under the Program. The U.S. Treasury's Small Business Lending Fund (SBLF) agreement imposes limits on the ability of the Corporation to repurchase shares of common stock if it fails to declare and pay quarterly dividends on the SBLF preferred stock.

**Item 3. Defaults upon senior securities**

The Corporation has nothing to report under this Item 3.

Table of Contents

**Item 4. Mine safety disclosures**

This Item 4 is not applicable to the Corporation.

**Item 5. Other information**

The Corporation has nothing to report under this Item 5.

**Item 6. Exhibits**

Exhibit Number	Description of Exhibit
3.1	Amended Articles of Incorporation (Incorporated by reference to Exhibit 3(i) to the Registrant's Quarterly Report on Form 10-Q for September 30, 2012, filed with the Commission on November 13, 2012)
3.2	Amended By-laws (Incorporated by reference to Exhibit 3(ii) to the Registrant's Current Report on Form 8-K, filed with the Commission on February 17, 2012)
3.3	Certificate of Designations for the Series A Preferred Stock (Incorporated by reference to Exhibit 3.1 to the Registrant's Current Report on Form 8-K, filed with the Commission on January 15, 2009)
3.4	Certificate of Designation of Senior Non-Cumulative Perpetual Preferred Stock, Series B (Incorporated by reference to Exhibit 3.1 to the Registrant's Current Report on Form 8-K, filed with the Commission on August 24, 2011)
4	Rights Agreement dated as of November 4, 2005 (Incorporated by reference to Exhibit 4 to the Registrant's Quarterly Report on Form 10-Q for September 30, 2010, filed with Commission on November 15, 2010), as amended January 9, 2009 (Incorporated by reference to Exhibit 4.1 to the Registrant's Quarterly Report on Form 10-Q for September 30, 2010, filed with the Commission on November 15, 2010), as further amended August 18, 2011 (Incorporated by reference to Exhibit 4.1 to the Registrant's Current Report on Form 8-K, filed with the Commission on August 24, 2011)
4.1	Small Business Lending Fund- Securities Purchase Agreement, dated August 18, 2011, between Codorus Valley Bancorp, Inc. and the Secretary of the Treasury, with respect to the issuance and sale of the SBLF Preferred Stock (Incorporated by reference to Exhibit 10.1 to the Registrant's Current Report on Form 8-K, filed with the Commission on August 24, 2011)
31.1	Certification of Principal Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
31.2	Certification of Principal Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
32	Certification of Principal Executive Officer and Principal Financial Officer Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
101	Financial statements from the Quarterly Report on Form 10-Q of Codorus Valley Bancorp, Inc. for the quarter ended June 30, 2013, formatted in XBRL: (i) the Consolidated Balance Sheets, (ii) the Consolidated Statements of Income (iii) the Consolidated Statements of Comprehensive Income (iv) the Consolidated Statements of Cash Flows, (v) the Consolidated Statements of Changes in Shareholder's Equity, and (vi) the Notes to Consolidated Financial Statements filed herewith.

Table of Contents

**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 there unto duly authorized.

Codorus Valley Bancorp, Inc.  
(Registrant)

August 13, 2013

Date

/s/ Larry J. Miller  
Larry J. Miller  
President & CEO  
(Principal Executive Officer)

August 13, 2013

Date

/s/ Jann A. Weaver  
Jann A. Weaver  
Treasurer & Assistant Secretary  
(Principal Financial and Accounting Officer)

- 58 -

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