

CODORUS VALLEY BANCORP INC  
Form 10-Q  
August 10, 2011  
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**UNITED STATES SECURITIES AND EXCHANGE COMMISSION**  
Washington, D.C. 20549

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**FORM 10-Q**

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**Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**  
**For the quarterly period ended June 30, 2011**

or

**Transition Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**  
For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission file number: 0-15536

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**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.)

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

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Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

Yes  No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer or a smaller reporting company. See 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, 2011, 4,161,759 shares of common stock, par value \$2.50, were outstanding.

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Codorus Valley Bancorp, Inc.

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Consolidated Balance Sheets  
Unaudited

| <i>(dollars in thousands, except share and per share data)</i>  | <b>June 30,<br/>2011</b> | <b>December 31,<br/>2010</b> |
|---|--------------------------|------------------------------|
| <b>Assets</b>   |                          |                              |
| Interest bearing deposits with banks  | \$ 93                    | \$ 32,219                    |
| Cash and due from banks   | 11,435                   | 8,050                        |
| Federal funds sold  | 0                        | 3,000                        |
| Total cash and cash equivalents   | 11,528                   | 43,269                       |
| Securities, available-for-sale  | 235,968                  | 222,536                      |
| Restricted investment in bank stocks, at cost   | 3,677                    | 4,067                        |
| Loans held for sale   | 966                      | 4,990                        |
| Loans (net of deferred fees of \$723 - 2011 and \$713 - 2010)   | 680,069                  | 640,849                      |
| Less-allowance for loan losses  | (8,351)                  | (7,626)                      |
| Net loans   | 671,718                  | 633,223                      |
| Premises and equipment, net   | 10,633                   | 10,766                       |
| Other assets  | 42,755                   | 38,481                       |
| Total assets  | \$ 977,245               | \$ 957,332                   |
| <b>Liabilities</b>  |                          |                              |
| Deposits  |                          |                              |
| Noninterest bearing   | \$ 71,388                | \$ 65,642                    |
| Interest bearing  | 760,815                  | 740,468                      |
| Total deposits  | 832,203                  | 806,110                      |
| Short-term borrowings   | 10,796                   | 6,763                        |
| Long-term debt  | 33,830                   | 51,732                       |
| Junior subordinated debt  | 10,310                   | 10,310                       |
| Other liabilities   | 8,570                    | 5,878                        |
| Total liabilities   | 895,709                  | 880,793                      |
| <b>Shareholders equity</b>  |                          |                              |
| Preferred stock, par value \$2.50 per share; \$1,000 liquidation preference, 1,000,000 shares authorized;<br>16,500 shares issued and outstanding - 2011 and 2010 | 16,061                   | 15,983                       |
| Common stock, par value \$2.50 per share; 10,000,000 shares authorized; 4,162,627 shares issued and<br>outstanding - 2011 and 4,131,802 - 2010                    | 10,407                   | 10,330                       |
| Additional paid-in capital  | 37,662                   | 37,290                       |
| Retained earnings   | 12,986                   | 10,798                       |
| Accumulated other comprehensive income  | 4,420                    | 2,138                        |
| Total shareholders equity   | 81,536                   | 76,539                       |
| Total liabilities and shareholders equity   | \$ 977,245               | \$ 957,332                   |

See accompanying notes.

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Codorus Valley Bancorp, Inc.  
Consolidated Statements of Income  
Unaudited

| <i>(dollars in thousands, except per share data)</i>     | Three months ended<br>June 30, |          | Six months ended<br>June 30, |           |
|--|--------------------------------|----------|------------------------------|-----------|
|  | 2011                           | 2010     | 2011                         | 2010      |
| <b>Interest income</b>                                   |                                |          |                              |           |
| Loans, including fees                                    | \$ 9,600                       | \$ 9,517 | \$ 18,912                    | \$ 18,647 |
| Investment securities:                                   |                                |          |                              |           |
| Taxable  | 1,045                          | 799      | 1,987                        | 1,628     |
| Tax-exempt   | 606                            | 583      | 1,242                        | 1,168     |
| Dividends  | 2                              | 1        | 4                            | 4         |
| Other  | 10                             | 20       | 25                           | 28        |
| Total interest income                                    | 11,263                         | 10,920   | 22,170                       | 21,475    |
| <b>Interest expense</b>                                  |                                |          |                              |           |
| Deposits   | 2,839                          | 2,781    | 5,674                        | 5,610     |
| Federal funds purchased and other short-term borrowings  | 25                             | 22       | 53                           | 42        |
| Long-term and junior subordinated debt                   | 263                            | 429      | 543                          | 897       |
| Total interest expense                                   | 3,127                          | 3,232    | 6,270                        | 6,549     |
| Net interest income                                      | 8,136                          | 7,688    | 15,900                       | 14,926    |
| <b>Provision for loan losses</b>                         |                                |          |                              |           |
| Net interest income after provision for loan losses      | 550                            | 630      | 1,225                        | 1,350     |
|  | 7,586                          | 7,058    | 14,675                       | 13,576    |
| <b>Noninterest income</b>                                |                                |          |                              |           |
| Trust and investment services fees                       | 383                            | 373      | 740                          | 719       |
| Income from mutual fund, annuity and insurance sales     | 241                            | 443      | 583                          | 762       |
| Service charges on deposit accounts                      | 676                            | 649      | 1,277                        | 1,211     |
| Income from bank owned life insurance                    | 160                            | 161      | 325                          | 319       |
| Other income   | 159                            | 132      | 300                          | 286       |
| Gains on sales of loans held for sale                    | 120                            | 217      | 296                          | 361       |
| Gain (loss) on sales of securities                       | 0                              | 108      | (25)                         | 108       |
| Total noninterest income                                 | 1,739                          | 2,083    | 3,496                        | 3,766     |
| <b>Noninterest expense</b>                               |                                |          |                              |           |
| Personnel  | 3,433                          | 3,213    | 6,964                        | 6,419     |
| Occupancy of premises, net                               | 487                            | 493      | 984                          | 994       |
| Furniture and equipment                                  | 422                            | 419      | 871                          | 859       |
| Postage, stationery and supplies                         | 129                            | 162      | 269                          | 277       |
| Professional and legal                                   | 173                            | 138      | 275                          | 244       |
| Marketing and advertising                                | 233                            | 223      | 383                          | 350       |
| FDIC insurance   | 218                            | 316      | 562                          | 624       |
| Debit card processing                                    | 165                            | 145      | 319                          | 280       |
| Charitable donations                                     | 8                              | 27       | 235                          | 356       |
| Foreclosed real estate including (gains) losses on sales | 606                            | 911      | 1,091                        | 984       |
| Impaired loan carrying costs                             | 160                            | 387      | 426                          | 583       |
| Other  | 898                            | 808      | 1,591                        | 1,356     |
| Total noninterest expense                                | 6,932                          | 7,242    | 13,970                       | 13,326    |
| Income before income taxes                               | 2,393                          | 1,899    | 4,201                        | 4,016     |
| <b>Provision for income taxes</b>                        |                                |          |                              |           |
| Net income   | 521                            | 274      | 818                          | 680       |
| Preferred stock dividends and discount accretion         | 1,872                          | 1,625    | 3,383                        | 3,336     |
|  | 246                            | 245      | 491                          | 490       |
| Net income available to common shareholders              | \$ 1,626                       | \$ 1,380 | \$ 2,892                     | \$ 2,846  |
| Net income per common share, basic                       | \$ 0.39                        | \$ 0.34  | \$ 0.70                      | \$ 0.70   |
| Net income per common share, diluted                     | \$ 0.39                        | \$ 0.34  | \$ 0.69                      | \$ 0.70   |

See accompanying notes.



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

| <i>(dollars in thousands)</i>   | Six months ended<br>June 30, |           |
|---|------------------------------|-----------|
|   | 2011                         | 2010      |
| <b>Cash flows from operating activities</b>                             |                              |           |
| Net income  | \$ 3,383                     | \$ 3,336  |
| Adjustments to reconcile net income to net cash provided by operations: |                              |           |
| Depreciation/amortization   | 652                          | 689       |
| Net amortization of securities  | 724                          | 464       |
| Amortization of deferred loan origination fees and costs                | (132)                        | (166)     |
| Amortization of intangible assets                                       | 19                           | 20        |
| Provision for loan losses   | 1,225                        | 1,350     |
| Provision for losses on foreclosed real estate                          | 235                          | 722       |
| Deferred income tax expense (benefit)                                   | (21)                         | 34        |
| Amortization of investment in real estate partnership                   | 291                          | 281       |
| Increase in cash surrender value of life insurance investment           | (325)                        | (319)     |
| Originations of loans held for sale                                     | (16,266)                     | (21,036)  |
| Proceeds from sales of loans held for sale                              | 20,585                       | 20,994    |
| Net gain on sales of loans held for sale                                | (296)                        | (361)     |
| Loss on disposal of premises and equipment                              | 1                            | 8         |
| Net loss (gain) on sales of securities available-for-sale               | 25                           | (108)     |
| Gain on sales of held for sale assets                                   | 0                            | (35)      |
| Net gain on sales of foreclosed real estate                             | (45)                         | (110)     |
| Stock-based compensation expense  | 157                          | 67        |
| Decrease in accrued interest receivable                                 | 54                           | 165       |
| (Increase) decrease in other assets                                     | (242)                        | 399       |
| Decrease in accrued interest payable                                    | (25)                         | (50)      |
| Increase in other liabilities   | 2,722                        | 4,387     |
| Net cash provided by operating activities                               | 12,721                       | 10,731    |
| <b>Cash flows from investing activities</b>                             |                              |           |
| Securities, available-for-sale  |                              |           |
| Purchases   | (34,296)                     | (33,567)  |
| Maturities, repayments and calls  | 17,495                       | 18,246    |
| Sales   | 6,077                        | 4,845     |
| Redemption of restricted investment in bank stock                       | 390                          | 0         |
| Net increase in loans made to customers                                 | (41,281)                     | (9,626)   |
| Purchases of premises and equipment                                     | (520)                        | (420)     |
| Investment in foreclosed real estate                                    | (4,190)                      | (50)      |
| Proceeds from sales of foreclosed real estate                           | 464                          | 7,395     |
| Net cash used in investing activities                                   | (55,861)                     | (13,177)  |
| <b>Cash flows from financing activities</b>                             |                              |           |
| Net increase in demand and savings deposits                             | 29,412                       | 29,985    |
| Net (decrease) increase in time deposits                                | (3,319)                      | 4,955     |
| Net increase in short-term borrowings                                   | 4,033                        | 1,924     |
| Repayment of long-term debt   | (17,902)                     | (21,626)  |
| Cash dividends paid to preferred shareholders                           | (413)                        | (413)     |
| Cash dividends paid to common shareholders                              | (704)                        | (367)     |
| Issuance of common stock  | 292                          | 111       |
| Net cash provided by financing activities                               | 11,399                       | 14,569    |
| Net (decrease) increase in cash and cash equivalents                    | (31,741)                     | 12,123    |
| Cash and cash equivalents at beginning of year                          | 43,269                       | 26,179    |
| Cash and cash equivalents at end of period                              | \$ 11,528                    | \$ 38,302 |

See accompanying notes.



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

| <i>(dollars in thousands, except per share data)</i>              | Preferred<br>Stock | Common<br>Stock | Additional<br>Paid-in<br>Capital | Retained<br>Earnings | Accumulated<br>Other<br>Comprehensive<br>Income | Total     |
|---|--------------------|-----------------|----------------------------------|----------------------|---|-----------|
| Balance, January 1, 2011  | \$ 15,983          | \$ 10,330       | \$ 37,290                        | \$ 10,798            | \$ 2,138  | \$ 76,539 |
| Comprehensive income:   |                    |                 |                                  |                      |   |           |
| Net income  |                    |                 |                                  | 3,383                |   | 3,383     |
| Other comprehensive gain, net of tax:                             |                    |                 |                                  |                      |   |           |
| Unrealized gains on securities, net                               |                    |                 |                                  |                      | 2,282   | 2,282     |
| Total comprehensive income  |                    |                 |                                  |                      |   | 5,665     |
| Preferred stock discount accretion                                | 78                 |                 |                                  | (78)                 |   | 0         |
| Common stock cash dividends (\$0.17 per share)                    |                    |                 |                                  | (704)                |   | (704)     |
| Preferred stock dividends   |                    |                 |                                  | (413)                |   | (413)     |
| Stock-based compensation  |                    |                 | 157                              |                      |   | 157       |
| Issuance of common stock:   |                    |                 |                                  |                      |   |           |
| 12,853 shares under dividend reinvestment and stock purchase plan |                    | 32              | 105                              |                      |   | 137       |
| 12,642 shares under stock option plan                             |                    | 32              | 81                               |                      |   | 113       |
| 5,330 shares under employee stock purchase plan                   |                    | 13              | 29                               |                      |   | 42        |
| Balance, June 30, 2011  | \$ 16,061          | \$ 10,407       | \$ 37,662                        | \$ 12,986            | \$ 4,420  | \$ 81,536 |
| Balance, January 1, 2010  | \$ 15,828          | \$ 10,187       | \$ 37,004                        | \$ 6,592             | \$ 2,401  | \$ 72,012 |
| Comprehensive income:   |                    |                 |                                  |                      |   |           |
| Net income  |                    |                 |                                  | 3,336                |   | 3,336     |
| Other comprehensive gain, net of tax:                             |                    |                 |                                  |                      |   |           |
| Unrealized gains on securities, net                               |                    |                 |                                  |                      | 1,728   | 1,728     |
| Total comprehensive income  |                    |                 |                                  |                      |   | 5,064     |
| Preferred stock discount accretion                                | 77                 |                 |                                  | (77)                 |   | 0         |
| Common stock cash dividends (\$0.09 per share)                    |                    |                 |                                  | (367)                |   | (367)     |
| Preferred stock dividends   |                    |                 |                                  | (413)                |   | (413)     |
| Stock-based compensation  |                    |                 | 67                               |                      |   | 67        |
| Issuance of common stock:   |                    |                 |                                  |                      |   |           |
| 10,627 shares under dividend reinvestment and stock purchase plan |                    | 26              | 48                               |                      |   | 74        |
| 7,930 shares under employee stock purchase plan                   |                    | 20              | 17                               |                      |   | 37        |
| Balance, June 30, 2010  | \$ 15,905          | \$ 10,233       | \$ 37,136                        | \$ 9,071             | \$ 4,129  | \$ 76,474 |

See accompanying notes.

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**Notes to Consolidated Financial Statements (Unaudited)**

**Note 1 Basis of Presentation**

The accompanying consolidated balance sheet at December 31, 2010 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 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, 2010.

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. and 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 six-month period ended June 30, 2011 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, 2011, and through the date these financial statements were issued for potential recognition or disclosure.

**Note 2 Significant Accounting Policies**

*Loans*

Loans 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 loan 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, 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 adequately 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 is determined based on contractual due dates for loan payments.

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*Allowance for Loan Losses*

The allowance for loan losses represents our 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 are charged off to the allowance as soon as it is determined that the repayment of all, or part, of the principal balance is unlikely. Because all identified losses are immediately charged off, no portion of the allowance for loan losses is restricted to any individual loan or groups of loans, and the entire allowance is available to absorb any and all loan losses.

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 and general allocations and an unallocated component. The specific allocation 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 allocation 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.

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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 loans 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 increased 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.

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. Commercial loans that are collateral dependent and deemed impaired are generally evaluated for impairment loss based on the fair value of the collateral. For commercial loans that are not collateral dependent, we rely on the present value of expected future cash flows, discounted at the loan's effective interest rate, to determine any impairment loss. Large groups of smaller balance homogeneous loans are collectively evaluated for impairment. Accordingly, the Corporation does not separately identify individual residential mortgage loans, home equity loans and other consumer loans for impairment disclosures, unless such loans are the subject of a troubled debt restructuring agreement.

An allowance for loan losses is established for an impaired loan if its carrying value exceeds its estimated fair value less estimated selling costs (i.e., net realizable value). For commercial loans secured by real estate, estimated fair values are determined primarily through third-party appraisals. 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 original appraisal and the condition of the property. Appraised values 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.

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 a reduction of the debt, accrued interest or interest rate, or extension of the maturity date at an interest rate lower than the current market rate for new debt with similar risk. 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. Loans classified as troubled debt restructurings are designated as impaired.

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Federal 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 current level of the allowance for loan losses is adequate.

*Foreclosed Real Estate*

Foreclosed real estate, included in other assets, is comprised of property acquired through a foreclosure proceeding, property that is acquired through acceptance of a deed-in-lieu of foreclosure and property that has not yet been acquired but which is classified as an insubstantial 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. Appraisals 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. Costs related to the improvement of foreclosed real estate are generally capitalized until the real estate reaches a saleable condition. Revenue and expense from operations and changes in the valuation allowance are included in 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, 2011, foreclosed real estate, net of allowance was \$15,801,000, compared to \$10,572,000 for December 31, 2010.

*Per Common Share Computations*

The weighted average number of shares of common stock outstanding used for basic and diluted calculations are provided below:

| <i>(in thousands, except per share data)</i>  | <b>Three months ended<br/>June 30,</b> |             | <b>Six months ended<br/>June 30,</b> |             |
|---|--|-------------|--------------------------------------|-------------|
|   | <b>2011</b>                            | <b>2010</b> | <b>2011</b>                          | <b>2010</b> |
| Net income available to common shareholders   | \$ 1,626                               | \$ 1,380    | \$ 2,892                             | \$ 2,846    |
| Weighted average shares outstanding (basic)   | 4,150                                  | 4,083       | 4,144                                | 4,080       |
| Effect of dilutive stock options  | 58                                     | 11          | 51                                   | 2           |
| Weighted average shares outstanding (diluted)   | 4,208                                  | 4,094       | 4,195                                | 4,082       |
| Basic earnings per common share   | \$ 0.39                                | \$ 0.34     | \$ 0.70                              | \$ 0.70     |
| Diluted earnings per common share   | \$ 0.39                                | \$ 0.34     | \$ 0.69                              | \$ 0.70     |
| Anti-dilutive stock options and common stock warrants excluded from the computation of earnings per share | 83                                     | 421         | 83                                   | 421         |

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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 equity section of the balance sheet, such items, along with net income, are components of comprehensive income. The components of other comprehensive income and related tax effects are presented in the following table:

| <i>(dollars in thousands)</i>                                     | Three months ended<br>June 30, |          | Six months ended<br>June 30, |          |
|---|--------------------------------|----------|------------------------------|----------|
|   | 2011                           | 2010     | 2011                         | 2010     |
| Unrealized holding gains arising during the period                | \$ 3,066                       | \$ 2,034 | \$ 3,432                     | \$ 2,726 |
| Reclassification adjustment for (gains) losses included in income | 0                              | (108)    | 25                           | (108)    |
| Net unrealized gains  | 3,066                          | 1,926    | 3,457                        | 2,618    |
| Tax effect  | (1,042)                        | (655)    | (1,175)                      | (890)    |
| Net of tax amount   | \$ 2,024                       | \$ 1,271 | \$ 2,282                     | \$ 1,728 |

*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. Noncash items for the six-month period ended June 30, 2011 consisted of the transfer of loans to foreclosed real estate in the amount of \$1,693,000. The increase in other liabilities includes pre-funded client ACH disbursements of \$1,883,000 and accounts payable for investment in foreclosed real estate of \$545,000. Comparatively, for the six-month period ended June 30, 2010, non-cash items consisted of the transfer of loans to foreclosed real estate in the amount of \$8,291,000 and the transfer of loans held for sale to investment in the amount of \$160,000.

*Recent Accounting Pronouncements*

The FASB issued ASU No. 2011-05, *Presentation of Comprehensive Income*. The provisions of this Update amend FASB ASC Topic 220, *Comprehensive Income*, to facilitate the continued alignment of U.S. GAAP with International Accounting Standards. The Update prohibits the presentation of the components of comprehensive income in the statement of shareholders' equity. Reporting entities are allowed to present either: a statement of comprehensive income, which reports both net income and other comprehensive income; or separate, but consecutive, statements of net income and other comprehensive income. Under previous GAAP, all 3 presentations were acceptable. Regardless of the presentation selected, the reporting entity is required to present all reclassifications between other comprehensive and net income on the face of the new statement or statements. The provisions of this Update are effective for fiscal years and interim periods beginning after December 31, 2011 for public entities. As the two remaining options for presentation existed prior to the issuance of this Update, early adoption is permitted. The Corporation is evaluating the impact of the Update on its consolidated financial statements.

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The FASB issued ASU No. 2011-04, *Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs*. This Update amends FASB ASC Topic 820, *Fair Value Measurements*, to bring U.S. GAAP for fair value measurements in line with International Accounting Standards. The Update clarifies existing guidance for items such as: the application of the highest and best use concept to non-financial assets and liabilities; the application of fair value measurement to financial instruments classified in a reporting entity's stockholder's equity; and disclosure requirements regarding quantitative information about unobservable inputs used in the fair value measurements of level 3 assets. The Update also creates an exception to Topic 820 for entities which carry financial instruments within a portfolio or group, under which the entity is now permitted to base the price used for fair valuation upon a price that would be received to sell the net asset position or transfer a net liability position in an orderly transaction. The Update also allows for the application of premiums and discounts in a fair value measurement if the financial instrument is categorized in level 2 or 3 of the fair value hierarchy. Lastly, the ASU contains new disclosure requirements regarding fair value amounts categorized as level 3 in the fair value hierarchy such as: disclosure of the valuation process used; effects of and relationships between unobservable inputs; usage of nonfinancial assets for purposes other than their highest and best use when that is the basis of the disclosed fair value; and categorization by level of items disclosed at fair value, but not measured at fair value for financial statement purposes. This Update is effective for interim and annual periods beginning after December 15, 2011. Early adoption is not permitted. The Corporation is evaluating the impact of this Update on its consolidated financial statements.

The FASB issued ASU No. 2011-02, *Receivables (Topic 310) – A Creditor's Determination of Whether a Restructuring Is a Troubled Debt Restructuring* to clarify the accounting principles applied to loan modifications as defined by FASB ASC Subtopic 310-40, *Receivables Troubled Debt Restructurings by Creditors*. This guidance was prompted by the increased volume of loan modifications prompted by the prolonged economic downturn. The Update clarifies guidance on a creditor's evaluation of whether or not a concession has been granted, with an emphasis on evaluating all aspects of the modification rather than a focus on specific criteria, such as the effective interest rate test, to determine a concession. The Update goes on to provide guidance on specific types of modifications such as changes in the interest rate of the borrowing, and insignificant delays in payments, as well as guidance on the creditor's evaluation of whether or not a debtor is experiencing financial difficulties. For public entities, the amendments in the Update are effective for the first interim or annual periods beginning on or after June 15, 2011, and should be applied retrospectively to the beginning of the annual period of adoption. The entity should also disclose related information required by ASU 2010-20. The requirements of this ASU will expand disclosures related to troubled debt restructurings and is not expected to have a material impact on the Corporation's consolidated financial statements.

In November 2008, the Securities and Exchange Commission (SEC) released a proposed roadmap regarding the potential use by U.S. issuers of financial statements prepared in accordance with International Financial Reporting Standards (IFRS). IFRS is a comprehensive series of accounting standards published by the International Accounting Standards Board (IASB). Under the proposed roadmap, the Corporation may be required to prepare financial statements in accordance with IFRS as early as 2015. The SEC has indicated it will make a determination in 2011 regarding the mandatory adoption of IFRS. The Corporation is currently assessing the impact that this potential change would have on its consolidated financial statements, and it will continue to monitor the development of the potential implementation of IFRS.

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A summary of securities, available-for-sale at June 30, 2011 and December 31, 2010 is provided below:

| <i>(dollars in thousands)</i>            | Amortized<br>Cost | Gross Unrealized |            | Estimated<br>Fair<br>Value |
|--|-------------------|------------------|------------|----------------------------|
|  |                   | Gains            | Losses     |                            |
| <b>June 30, 2011</b>                     |                   |                  |            |                            |
| Debt securities:                         |                   |                  |            |                            |
| U.S. Treasury notes                      | \$ 10,006         | \$ 146           | \$ 0       | \$ 10,152                  |
| U.S. agency                              | 29,631            | 513              | 0          | 30,144                     |
| U.S. agency mortgage-backed, residential | 107,088           | 3,061            | (104)      | 110,045                    |
| State and municipal                      | 82,546            | 3,115            | (34)       | 85,627                     |
| Total debt securities                    | \$ 229,271        | \$ 6,835         | \$ (138)   | \$ 235,968                 |
| <b>December 31, 2010</b>                 |                   |                  |            |                            |
| Debt securities:                         |                   |                  |            |                            |
| U.S. Treasury notes                      | \$ 8,014          | \$ 126           | \$ 0       | \$ 8,140                   |
| U.S. agency                              | 13,519            | 155              | (31)       | 13,643                     |
| U.S. agency mortgage-backed, residential | 108,967           | 2,213            | (827)      | 110,353                    |
| State and municipal                      | 88,796            | 2,079            | (475)      | 90,400                     |
| Total debt securities                    | \$ 219,296        | \$ 4,573         | \$ (1,333) | \$ 222,536                 |

The amortized cost and estimated fair value of debt securities at June 30, 2011 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>          | Available-for-sale |               |
|--|--------------------|---------------|
|  | Amortized<br>Cost  | Fair<br>Value |
| Due in one year or less                | \$ 11,575          | \$ 11,700     |
| Due after one year through five years  | 138,283            | 143,349       |
| Due after five years through ten years | 75,590             | 77,065        |
| Due after ten years                    | 3,823              | 3,854         |
| Total debt securities                  | \$ 229,271         | \$ 235,968    |

Gross realized gains and losses on sales of securities are shown below.

| <i>(dollars in thousands)</i> | Three months ended<br>June 30, |        | Six months ended<br>June 30, |        |
|-------------------------------|--------------------------------|--------|------------------------------|--------|
|                               | 2011                           | 2010   | 2011                         | 2010   |
| Realized gains                | \$ 0                           | \$ 108 | \$ 79                        | \$ 108 |
| Realized losses               | 0                              | 0      | (104)                        | 0      |
| Net gains (losses)            | \$ 0                           | \$ 108 | \$ (25)                      | \$ 108 |



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Realized gains and losses from the sale of securities, available-for-sale 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.

Securities, issued by agencies of the federal government, with a carrying value of \$120,581,000 and \$125,785,000 on June 30, 2011 and December 31, 2010, respectively, were pledged to secure public and trust deposits, repurchase agreements, other short-term borrowings and Federal Home Loan Bank debt.

The table below shows gross unrealized losses and fair value, aggregated by investment category and length of time, for securities, available-for-sale that have been in a continuous unrealized loss position, at June 30, 2011 and December 31, 2010.

| <i>(dollars in thousands)</i>              | Less than 12 months |                   | 12 months or more |                   | Total      |                   |
|--|---------------------|-------------------|-------------------|-------------------|------------|-------------------|
|  | Fair Value          | Unrealized Losses | Fair Value        | Unrealized Losses | Fair Value | Unrealized Losses |
| <b>June 30, 2011</b>                       |                     |                   |                   |                   |            |                   |
| Debt securities:                           |                     |                   |                   |                   |            |                   |
| U.S. agency mortgage-backed, residential   | \$ 34,449           | \$ 104            | \$ 0              | \$ 0              | \$ 34,449  | \$ 104            |
| State and municipal                        | 3,243               | 20                | 381               | 14                | 3,624      | 34                |
| Total temporarily impaired debt securities | \$ 37,692           | \$ 124            | \$ 381            | \$ 14             | \$ 38,073  | \$ 138            |
| <b>December 31, 2010</b>                   |                     |                   |                   |                   |            |                   |
| Debt securities:                           |                     |                   |                   |                   |            |                   |
| U.S. agencies                              | \$ 4,969            | \$ 31             | \$ 0              | \$ 0              | \$ 4,969   | \$ 31             |
| U.S. agency mortgage-backed, residential   | 50,982              | 827               | 0                 | 0                 | 50,982     | 827               |
| State and municipal                        | 20,382              | 429               | 350               | 46                | 20,732     | 475               |
| Total temporarily impaired debt securities | \$ 76,333           | \$ 1,287          | \$ 350            | \$ 46             | \$ 76,683  | \$ 1,333          |

At June 30, 2011, the unrealized losses within the less than 12 months category of \$124,000 were attributable to seven U.S. agency securities rated AAA and seven different municipal issues rated AA by the Standard and Poor rating service. Unrealized losses of \$14,000 in the 12 months or more category was attributed to a single municipal security rated Aa2 by the Moody's 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, 2011 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. To date, 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.

**Note 4 Restricted Investment in Bank Stocks**

Restricted stock represents required investments in the common stock of correspondent banks, consisting primarily of the common stock of Federal Home Loan Bank of Pittsburgh (FHLB) and, to a lesser degree, Atlantic Central Bankers Bank (ACBB) and is carried at cost as of June 30, 2011 and December 31, 2010. Under the FHLB'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 borrowing from the FHLB. In December 2008, the FHLB notified member banks that it was suspending dividend payments and the repurchase of capital stock as strategies to preserve its capital. During 2010, the FHLB partially lifted its restriction on capital stock repurchases.

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The Corporation evaluates the restricted stock for impairment in accordance with FASB ASC Topic 942. The determination of whether these investments are impaired is based on an assessment of the ultimate recoverability of their cost rather than by recognizing temporary declines in value. The determination of whether a decline affects the ultimate recoverability of their cost is influenced by criteria such as: (1) the significance of the decline in net assets of the issuer as compared to the capital stock amount for the issuer and the length of time this situation has persisted, (2) commitments by the issuer to make payments required by law or regulation and the level of such payments in relation to the operating performance of the issuer, and (3) the impact of legislative and regulatory changes on institutions and, accordingly, on the customer base of the issuer. We believe that no impairment charge was necessary related to the restricted stock during the periods ended June 30, 2011 and 2010.

**Note 5 Loans**

The table below provides the composition of the loan portfolio at June 30, 2011 and December 31, 2010. The portfolio is comprised of two segments, commercial and consumer loans. The commercial loan segment is disaggregated by industry class which allows us 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 does not engage in sub-prime residential mortgage originations.

| <i>(dollars in thousands)</i>    | <b>June 30,<br/>2011</b> | <b>December 31,<br/>2010</b> |
|----------------------------------|--------------------------|------------------------------|
| Builder & developer              | \$ 104,188               | \$ 95,735                    |
| Commercial real estate investor  | 108,121                  | 95,281                       |
| Residential real estate investor | 59,792                   | 55,930                       |
| Hotel/Motel                      | 49,931                   | 48,041                       |
| Wholesale & retail               | 50,589                   | 44,963                       |
| Manufacturing                    | 25,202                   | 24,989                       |
| Agriculture                      | 16,675                   | 14,247                       |
| Other                            | 134,154                  | 136,198                      |
| Total commercial related loans   | 548,652                  | 515,384                      |
| Residential mortgage             | 21,697                   | 20,357                       |
| Home equity                      | 57,838                   | 56,294                       |
| Other                            | 51,882                   | 48,814                       |
| Total consumer related loans     | 131,417                  | 125,465                      |
| Total loans                      | \$ 680,069               | \$ 640,849                   |

**Note 6 Loan Quality**

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.

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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 and 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 loan losses.

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The table below presents a summary of loan risk ratings by loan class at June 30, 2011 and December 31, 2010.

| <i>(dollars in thousands)</i>    | Pass       | Special<br>Mention | Substandard | Nonaccrual | Total      |
|----------------------------------|------------|--------------------|-------------|------------|------------|
| <b>June 30, 2011</b>             |            |                    |             |            |            |
| Builder & developer              | \$ 94,477  | \$ 1,522           | \$ 460      | \$ 7,729   | \$ 104,188 |
| Commercial real estate investor  | 95,449     | 10,484             | 365         | 1,823      | 108,121    |
| Residential real estate investor | 57,107     | 2,109              | 73          | 503        | 59,792     |
| Hotel/Motel                      | 49,931     | 0                  | 0           | 0          | 49,931     |
| Wholesale & retail               | 42,005     | 2,323              | 1,419       | 4,842      | 50,589     |
| Manufacturing                    | 24,472     | 730                | 0           | 0          | 25,202     |
| Agriculture                      | 16,177     | 0                  | 498         | 0          | 16,675     |
| Other                            | 118,290    | 9,087              | 2,805       | 3,972      | 134,154    |
| Total commercial related loans   | 497,908    | 26,255             | 5,620       | 18,869     | 548,652    |
| Residential mortgage             | 21,382     | 0                  | 42          | 273        | 21,697     |
| Home equity                      | 57,549     | 81                 | 188         | 20         | 57,838     |
| Other                            | 50,747     | 417                | 313         | 405        | 51,882     |
| Total consumer related loans     | 129,678    | 498                | 543         | 698        | 131,417    |
| Total loans                      | \$ 627,586 | \$ 26,753          | \$ 6,163    | \$ 19,567  | \$ 680,069 |
| <b>December 31, 2010</b>         |            |                    |             |            |            |
| Builder & developer              | \$ 84,409  | \$ 2,647           | \$ 453      | \$ 8,226   | \$ 95,735  |
| Commercial real estate investor  | 85,420     | 9,534              | 148         | 179        | 95,281     |
| Residential real estate investor | 55,346     | 94                 | 0           | 490        | 55,930     |
| Hotel/Motel                      | 48,041     | 0                  | 0           | 0          | 48,041     |
| Wholesale & retail               | 37,252     | 1,850              | 1,019       | 4,842      | 44,963     |
| Manufacturing                    | 24,989     | 0                  | 0           | 0          | 24,989     |
| Agriculture                      | 13,747     | 0                  | 500         | 0          | 14,247     |
| Other                            | 123,965    | 6,300              | 1,913       | 4,020      | 136,198    |
| Total commercial related loans   | 473,169    | 20,425             | 4,033       | 17,757     | 515,384    |
| Residential mortgage             | 20,109     | 0                  | 43          | 205        | 20,357     |
| Home equity                      | 56,183     | 12                 | 0           | 99         | 56,294     |
| Other                            | 47,933     | 418                | 0           | 463        | 48,814     |
| Total consumer related loans     | 124,225    | 430                | 43          | 767        | 125,465    |
| Total loans                      | \$ 597,394 | \$ 20,855          | \$ 4,076    | \$ 18,524  | \$ 640,849 |

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The table below presents a summary of impaired loans at June 30, 2011 and December 31, 2010. Generally, impaired loans are loans risk rated substandard and nonaccrual. An allowance is established for those individual loans where the Corporation has doubt as to full recovery of the outstanding principal balance. The recorded investment represents outstanding unpaid principal loan balances adjusted for charge-offs.

| <i>(dollars in thousands)</i>                         | June 30, 2011       |                          |                   | December 31, 2010   |                          |                   |
|---|---------------------|--------------------------|-------------------|---------------------|--------------------------|-------------------|
|   | Recorded Investment | Unpaid Principal Balance | Related Allowance | Recorded Investment | Unpaid Principal Balance | Related Allowance |
| <b>Impaired loans with no related allowance:</b>      |                     |                          |                   |                     |                          |                   |
| Builder & developer                                   | \$ 5,721            | \$ 5,721                 | \$ 0              | \$ 8,260            | \$ 8,260                 | \$ 0              |
| Commercial real estate investor                       | 2,020               | 2,020                    | 0                 | 0                   | 0                        | 0                 |
| Residential real estate investor                      | 483                 | 483                      | 0                 | 394                 | 394                      | 0                 |
| Hotel/Motel   | 0                   | 0                        | 0                 | 0                   | 0                        | 0                 |
| Wholesale & retail                                    | 1,419               | 1,419                    | 0                 | 1,019               | 1,019                    | 0                 |
| Manufacturing   | 0                   | 0                        | 0                 | 0                   | 0                        | 0                 |
| Agriculture   | 0                   | 0                        | 0                 | 0                   | 0                        | 0                 |
| Other commercial                                      | 6,075               | 6,091                    | 0                 | 5,219               | 5,219                    | 0                 |
| Residential mortgage                                  | 315                 | 385                      | 0                 | 248                 | 294                      | 0                 |
| Home equity   | 208                 | 208                      | 0                 | 99                  | 99                       | 0                 |
| Other consumer  | 718                 | 718                      | 0                 | 463                 | 463                      | 0                 |
| <b>Total impaired loans with no related allowance</b> | <b>\$ 16,959</b>    | <b>\$ 17,045</b>         | <b>\$ 0</b>       | <b>\$ 15,702</b>    | <b>\$ 15,748</b>         | <b>\$ 0</b>       |
| <b>Impaired loans with a related allowance:</b>       |                     |                          |                   |                     |                          |                   |
| Builder & developer                                   | \$ 2,468            | \$ 2,468                 | \$ 672            | \$ 419              | \$ 419                   | \$ 25             |
| Commercial real estate investor                       | 168                 | 268                      | 25                | 327                 | 427                      | 185               |
| Residential real estate investor                      | 93                  | 93                       | 30                | 96                  | 96                       | 10                |
| Hotel/Motel   | 0                   | 0                        | 0                 | 0                   | 0                        | 0                 |
| Wholesale & retail                                    | 4,842               | 4,842                    | 675               | 4,842               | 4,842                    | 675               |
| Manufacturing   | 0                   | 0                        | 0                 | 0                   | 0                        | 0                 |
| Agriculture   | 498                 | 498                      | 100               | 500                 | 500                      | 100               |
| Other commercial                                      | 702                 | 702                      | 200               | 714                 | 714                      | 200               |
| Residential mortgage                                  | 0                   | 0                        | 0                 | 0                   | 0                        | 0                 |
| Home equity   | 0                   | 0                        | 0                 | 0                   | 0                        | 0                 |
| Other consumer  | 0                   | 0                        | 0                 | 0                   | 0                        | 0                 |
| <b>Total impaired loans with a related allowance</b>  | <b>\$ 8,771</b>     | <b>\$ 8,871</b>          | <b>\$ 1,702</b>   | <b>\$ 6,898</b>     | <b>\$ 6,998</b>          | <b>\$ 1,195</b>   |
| <b>Total impaired loans:</b>                          |                     |                          |                   |                     |                          |                   |
| Builder & developer                                   | \$ 8,189            | \$ 8,189                 | \$ 672            | \$ 8,679            | \$ 8,679                 | \$ 25             |
| Commercial real estate investor                       | 2,188               | 2,288                    | 25                | 327                 | 427                      | 185               |
| Residential real estate investor                      | 576                 | 576                      | 30                | 490                 | 490                      | 10                |
| Hotel/Motel   | 0                   | 0                        | 0                 | 0                   | 0                        | 0                 |
| Wholesale & retail                                    | 6,261               | 6,261                    | 675               | 5,861               | 5,861                    | 675               |
| Manufacturing   | 0                   | 0                        | 0                 | 0                   | 0                        | 0                 |
| Agriculture   | 498                 | 498                      | 100               | 500                 | 500                      | 100               |
| Other commercial                                      | 6,777               | 6,793                    | 200               | 5,933               | 5,933                    | 200               |
| Residential mortgage                                  | 315                 | 385                      | 0                 | 248                 | 294                      | 0                 |
| Home equity   | 208                 | 208                      | 0                 | 99                  | 99                       | 0                 |
| Other consumer  | 718                 | 718                      | 0                 | 463                 | 463                      | 0                 |
| <b>Total impaired loans</b>                           | <b>\$ 25,730</b>    | <b>\$ 25,916</b>         | <b>\$ 1,702</b>   | <b>\$ 22,600</b>    | <b>\$ 22,746</b>         | <b>\$ 1,195</b>   |

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The table below presents a summary of average impaired loans and related interest income for three and six months ended June 30, 2011.

| <i>(dollars in thousands)</i>                         | Three months ended<br>June 30, 2011 |                    |               | Six months ended<br>June 30, 2011 |                    |               |
|---|-------------------------------------|--------------------|---------------|-----------------------------------|--------------------|---------------|
|   | Average<br>Recorded<br>Investment   | Interest<br>Income | Cash Basis    | Average<br>Recorded<br>Investment | Interest<br>Income | Cash Basis    |
| <b>Impaired loans with no related allowance:</b>      |                                     |                    |               |                                   |                    |               |
| Builder & developer                                   | \$ 6,081                            | \$ 156             | \$ 150        | \$ 6,807                          | \$ 232             | \$ 220        |
| Commercial real estate investor                       | 1,010                               | 15                 | 12            | 673                               | 14                 | 12            |
| Residential real estate investor                      | 438                                 | 0                  | 0             | 423                               | 0                  | 0             |
| Hotel/Motel   | 0                                   | 0                  | 0             | 0                                 | 0                  | 0             |
| Wholesale & retail                                    | 1,219                               | 22                 | 0             | 1,152                             | 40                 | 0             |
| Manufacturing   | 0                                   | 0                  | 0             | 0                                 | 0                  | 0             |
| Agriculture   | 0                                   | 0                  | 0             | 0                                 | 0                  | 0             |
| Other commercial                                      | 5,658                               | 111                | 89            | 5,512                             | 237                | 199           |
| Residential mortgage                                  | 316                                 | 5                  | 4             | 293                               | 10                 | 9             |
| Home equity   | 114                                 | 0                  | 0             | 109                               | 0                  | 0             |
| Other consumer  | 616                                 | 8                  | 3             | 565                               | 19                 | 10            |
| <b>Total impaired loans with no related allowance</b> | <b>\$ 15,452</b>                    | <b>\$ 317</b>      | <b>\$ 258</b> | <b>\$ 15,534</b>                  | <b>\$ 552</b>      | <b>\$ 450</b> |
| <b>Impaired loans with a related allowance:</b>       |                                     |                    |               |                                   |                    |               |
| Builder & developer                                   | \$ 1,517                            | \$ 7               | \$ 7          | \$ 1,151                          | \$ 12              | \$ 12         |
| Commercial real estate investor                       | 171                                 | 0                  | 0             | 223                               | 0                  | 0             |
| Residential real estate investor                      | 94                                  | 0                  | 0             | 95                                | 0                  | 0             |
| Hotel/Motel   | 0                                   | 0                  | 0             | 0                                 | 0                  | 0             |
| Wholesale & retail                                    | 4,842                               | 0                  | 0             | 4,842                             | 0                  | 0             |
| Manufacturing   | 0                                   | 0                  | 0             | 0                                 | 0                  | 0             |
| Agriculture   | 499                                 | 9                  | 0             | 499                               | 18                 | 0             |
| Other commercial                                      | 705                                 | 8                  | 0             | 708                               | 15                 | 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             |
| <b>Total impaired loans with a related allowance</b>  | <b>\$ 7,828</b>                     | <b>\$ 24</b>       | <b>\$ 7</b>   | <b>\$ 7,518</b>                   | <b>\$ 45</b>       | <b>\$ 12</b>  |
| <b>Total impaired loans:</b>                          |                                     |                    |               |                                   |                    |               |
| Builder & developer                                   | \$ 7,598                            | \$ 163             | \$ 157        | \$ 7,958                          | \$ 244             | \$ 232        |
| Commercial real estate investor                       | 1,181                               | 15                 | 12            | 896                               | 14                 | 12            |
| Residential real estate investor                      | 532                                 | 0                  | 0             | 518                               | 0                  | 0             |
| Hotel/Motel   | 0                                   | 0                  | 0             | 0                                 | 0                  | 0             |
| Wholesale & retail                                    | 6,061                               | 22                 | 0             | 5,994                             | 40                 | 0             |
| Manufacturing   | 0                                   | 0                  | 0             | 0                                 | 0                  | 0             |
| Agriculture   | 499                                 | 9                  | 0             | 499                               | 18                 | 0             |
| Other commercial                                      | 6,363                               | 119                | 89            | 6,220                             | 252                | 199           |
| Residential mortgage                                  | 316                                 | 5                  | 4             | 293                               | 10                 | 9             |
| Home equity   | 114                                 | 0                  | 0             | 109                               | 0                  | 0             |
| Other consumer  | 616                                 | 8                  | 3             | 565                               | 19                 | 10            |
| <b>Total impaired loans</b>                           | <b>\$ 23,280</b>                    | <b>\$ 341</b>      | <b>\$ 265</b> | <b>\$ 23,052</b>                  | <b>\$ 597</b>      | <b>\$ 462</b> |

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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, current loans and nonaccrual loans by loan segment and class at June 30, 2011 and December 31, 2010. Both periods include one troubled debt restructuring which is included in nonaccrual loans within the other commercial related loans class.

| <i>(dollars in thousands)</i>    | <b>30-59<br/>Days Past<br/>Due</b> | <b>60-89<br/>Days<br/>Past Due</b> | <b>Greater<br/>than 90<br/>Days</b> | <b>Total<br/>Past<br/>Due</b> | <b>Nonaccrual</b> | <b>Current</b> | <b>Total Loans</b> |
|----------------------------------|------------------------------------|------------------------------------|-------------------------------------|-------------------------------|-------------------|----------------|--------------------|
| <b>June 30, 2011</b>             |                                    |                                    |                                     |                               |                   |                |                    |
| Builder & developer              | \$ 2,030                           | \$ 2,289                           | \$ 0                                | \$ 4,319                      | \$ 7,729          | \$ 92,140      | \$ 104,188         |
| Commercial real estate investor  | 0                                  | 0                                  | 0                                   | 0                             | 1,823             | 106,298        | 108,121            |
| Residential real estate investor | 0                                  | 56                                 | 0                                   | 56                            | 503               | 59,233         | 59,792             |
| Hotel/Motel                      | 0                                  | 0                                  | 0                                   | 0                             | 0                 | 49,931         | 49,931             |
| Wholesale & retail               | 0                                  | 1,016                              | 0                                   | 1,016                         | 4,842             | 44,731         | 50,589             |
| Manufacturing                    | 0                                  | 0                                  | 0                                   | 0                             | 0                 | 25,202         | 25,202             |
| Agriculture                      | 0                                  | 0                                  | 0                                   | 0                             | 0                 | 16,675         | 16,675             |
| Other                            | 10                                 | 501                                | 0                                   | 511                           | 3,972             | 129,671        | 134,154            |
| Total commercial related loans   | 2,040                              | 3,862                              | 0                                   | 5,902                         | 18,869            | 523,881        | 548,652            |
| Residential mortgage             | 0                                  | 0                                  | 0                                   | 0                             | 273               | 21,424         | 21,697             |
| Home equity                      | 0                                  | 15                                 | 0                                   | 15                            | 20                | 57,803         | 57,838             |
| Other                            | 530                                | 78                                 | 168                                 | 776                           | 405               | 50,701         | 51,882             |
| Total consumer related loans     | 530                                | 93                                 | 168                                 | 791                           | 698               | 129,928        | 131,417            |
| Total loans                      | \$ 2,570                           | \$ 3,955                           | \$ 168                              | \$ 6,693                      | \$ 19,567         | \$ 653,809     | \$ 680,069         |

|                                  |        |          |        |          |           |            |            |
|----------------------------------|--------|----------|--------|----------|-----------|------------|------------|
| <b>December 31, 2010</b>         |        |          |        |          |           |            |            |
| Builder & developer              | \$ 33  | \$ 370   | \$ 0   | \$ 403   | \$ 8,226  | \$ 87,106  | \$ 95,735  |
| Commercial real estate investor  | 0      | 0        | 0      | 0        | 179       | 95,102     | 95,281     |
| Residential real estate investor | 212    | 0        | 0      | 212      | 490       | 55,228     | 55,930     |
| Hotel/Motel                      | 0      | 0        | 0      | 0        | 0         | 48,041     | 48,041     |
| Wholesale & retail               | 0      | 0        | 0      | 0        | 4,842     | 40,121     | 44,963     |
| Manufacturing                    | 0      | 0        | 0      | 0        | 0         | 24,989     | 24,989     |
| Agriculture                      | 0      | 0        | 0      | 0        | 0         | 14,247     | 14,247     |
| Other                            | 0      | 392      | 0      | 392      | 4,020     | 131,786    | 136,198    |
| Total commercial related loans   | 245    | 762      | 0      | 1,007    | 17,757    | 496,620    | 515,384    |
| Residential mortgage             | 0      | 409      | 0      | 409      | 205       | 19,743     | 20,357     |
| Home equity                      | 264    | 50       | 0      | 314      | 99        | 55,881     | 56,294     |
| Other                            | 304    | 43       | 197    | 544      | 463       | 47,807     | 48,814     |
| Total consumer related loans     | 568    | 502      | 197    | 1,267    | 767       | 123,431    | 125,465    |
| Total loans                      | \$ 813 | \$ 1,264 | \$ 197 | \$ 2,274 | \$ 18,524 | \$ 620,051 | \$ 640,849 |

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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 three and six months ended June 30, 2011 and in summary fashion for the same periods of 2010.

| <i>(dollars in thousands)</i>     | <b>Builder &amp; developer</b> | <b>Commercial real estate investor</b> | <b>Residential real estate investor</b> | <b>Hotel/Motel</b> | <b>Wholesale &amp; retail</b> | <b>Manufacturing</b> | <b>Agriculture</b> | <b>Other</b> | <b>Total commercial related</b> |
|-----------------------------------|--------------------------------|--|---|--------------------|-------------------------------|----------------------|--------------------|--------------|---------------------------------|
| <b>Allowance for loan losses:</b> |                                |  |   |                    |                               |                      |                    |              |                                 |
| Balance, April 1,                 | \$ 1,801                       | \$ 1,705                               | \$ 700                                  | \$ 345             | \$ 1,011                      | \$ 150               | \$ 167             | \$ 1,014     | \$ 6,893                        |
| Charge-offs                       | (25)                           | 0                                      | 0                                       | 0                  | 0                             | 0                    | 0                  | 0            | (25)                            |
| Recoveries                        | 0                              | 0                                      | 0                                       | 0                  | 1                             | 0                    | 0                  | 1            | 2                               |
| Provisions                        | 600                            | 192                                    | (112)                                   | 52                 | (74)                          | 1                    | 22                 | 144          | 825                             |
| Balance, June 30,                 | \$ 2,376                       | \$ 1,897                               | \$ 588                                  | \$ 397             | \$ 938                        | \$ 151               | \$ 189             | \$ 1,159     | \$ 7,695                        |

| <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>2011</b> | <b>2010</b> |
|-----------------------------------|-----------------------------|--------------------|--------------|-------------------------------|--------------------|-------------|-------------|
| <b>Allowance for loan losses:</b> |                             |                    |              |                               |                    |             |             |
| Balance, April 1,                 | \$ 130                      | \$ 244             | \$ 262       | \$ 636                        | \$ 327             | \$ 7,856    | \$ 7,711    |
| Charge-offs                       | 0                           | 0                  | (42)         | (42)                          | 0                  | (67)        | (2,041)     |
| Recoveries                        | 0                           | 7                  | 3            | 10                            | 0                  | 12          | 66          |
| Provisions                        | (57)                        | (96)               | (39)         | (192)                         | (83)               | 550         | 630         |
| Balance, June 30,                 | \$ 73                       | \$ 155             | \$ 184       | \$ 412                        | \$ 244             | \$ 8,351    | \$ 6,366    |

| <i>(dollars in thousands)</i>     | <b>Builder &amp; developer</b> | <b>Commercial real estate investor</b> | <b>Residential real estate investor</b> | <b>Hotel/Motel</b> | <b>Wholesale &amp; retail</b> | <b>Manufacturing</b> | <b>Agriculture</b> | <b>Other</b> | <b>Total commercial related</b> |
|-----------------------------------|--------------------------------|--|---|--------------------|-------------------------------|----------------------|--------------------|--------------|---------------------------------|
| <b>Allowance for loan losses:</b> |                                |  |   |                    |                               |                      |                    |              |                                 |
| Balance, January 1,               | \$ 1,561                       | \$ 1,887                               | \$ 698                                  | \$ 345             | \$ 843                        | \$ 155               | \$ 175             | \$ 1,123     | \$ 6,787                        |
| Charge-offs                       | (33)                           | 0                                      | 0                                       | 0                  | (146)                         | 0                    | 0                  | (39)         | (218)                           |
| Recoveries                        | 0                              | 0                                      | 0                                       | 0                  | 1                             | 0                    | 0                  | 1            | 2                               |
| Provisions                        | 848                            | 10                                     | (110)                                   | 52                 | 240                           | (4)                  | 14                 | 74           | 1,124                           |
| Balance, June 30,                 | \$ 2,376                       | \$ 1,897                               | \$ 588                                  | \$ 397             | \$ 938                        | \$ 151               | \$ 189             | \$ 1,159     | \$ 7,695                        |

| <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>2011</b> | <b>2010</b> |
|-----------------------------------|-----------------------------|--------------------|--------------|-------------------------------|--------------------|-------------|-------------|
| <b>Allowance for loan losses:</b> |                             |                    |              |                               |                    |             |             |
| Balance, January 1,               | \$ 30                       | \$ 83              | \$ 201       | \$ 314                        | \$ 525             | \$ 7,626    | \$ 7,175    |
| Charge-offs                       | (56)                        | (164)              | (75)         | (295)                         | 0                  | (513)       | (2,249)     |
| Recoveries                        | 0                           | 7                  | 4            | 11                            | 0                  | 13          | 90          |
| Provisions                        | 99                          | 229                | 54           | 382                           | (281)              | 1,225       | 1,350       |
| Balance, June 30,                 | \$ 73                       | \$ 155             | \$ 184       | \$ 412                        | \$ 244             | \$ 8,351    | \$ 6,366    |



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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, 2011 and December 31, 2010.

| <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>     |                     |                                 |                                  |             |                    |               |             |          |                          |
| Individually evaluated for impairment | \$ 672              | \$ 25                           | \$ 30                            | \$ 0        | \$ 675             | \$ 0          | \$ 100      | \$ 200   | \$ 1,702                 |
| Collectively evaluated for impairment | 1,704               | 1,872                           | 558                              | 397         | 263                | 151           | 89          | 959      | 5,993                    |
| Balance, June 30, 2011                | \$ 2,376            | \$ 1,897                        | \$ 588                           | \$ 397      | \$ 938             | \$ 151        | \$ 189      | \$ 1,159 | \$ 7,695                 |

**Loans:**

|                                       |            |            |           |           |           |           |           |            |            |
|---------------------------------------|------------|------------|-----------|-----------|-----------|-----------|-----------|------------|------------|
| Individually evaluated for impairment | \$ 8,189   | \$ 2,188   | \$ 576    | \$ 0      | \$ 6,261  | \$ 0      | \$ 498    | \$ 6,777   | \$ 24,489  |
| Collectively evaluated for impairment | 95,999     | 105,933    | 59,216    | 49,931    | 44,328    | 25,202    | 16,177    | 127,377    | 524,163    |
| Balance, June 30, 2011                | \$ 104,188 | \$ 108,121 | \$ 59,792 | \$ 49,931 | \$ 50,589 | \$ 25,202 | \$ 16,675 | \$ 134,154 | \$ 548,652 |

| <i>(dollars in thousands)</i>         | 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        | \$ 1,702 |
| Collectively evaluated for impairment | 73                   | 155         | 184    | 412                    | 244         | 6,649    |
| Balance, June 30, 2011                | \$ 73                | \$ 155      | \$ 184 | \$ 412                 | \$ 244      | \$ 8,351 |

**Loans:**

|                                       |           |           |           |            |            |
|---------------------------------------|-----------|-----------|-----------|------------|------------|
| Individually evaluated for impairment | \$ 0      | \$ 188    | \$ 0      | \$ 188     | \$ 24,677  |
| Collectively evaluated for impairment | 21,697    | 57,650    | 51,882    | 131,229    | 655,392    |
| Balance, June 30, 2011                | \$ 21,697 | \$ 57,838 | \$ 51,882 | \$ 131,417 | \$ 680,069 |

| <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>     |                     |                                 |                                  |             |                    |               |             |          |                          |
| Individually evaluated for impairment | \$ 25               | \$ 185                          | \$ 10                            | \$ 0        | \$ 675             | \$ 0          | \$ 100      | \$ 200   | \$ 1,195                 |
| Collectively evaluated for impairment | 1,536               | 1,702                           | 688                              | 345         | 168                | 155           | 75          | 923      | 5,592                    |
| Balance, December 31, 2010            | \$ 1,561            | \$ 1,887                        | \$ 698                           | \$ 345      | \$ 843             | \$ 155        | \$ 175      | \$ 1,123 | \$ 6,787                 |

**Loans:**

|                                       |           |           |           |           |           |           |           |            |            |
|---------------------------------------|-----------|-----------|-----------|-----------|-----------|-----------|-----------|------------|------------|
| Individually evaluated for impairment | \$ 8,679  | \$ 327    | \$ 490    | \$ 0      | \$ 5,861  | \$ 0      | \$ 500    | \$ 5,933   | \$ 21,790  |
| Collectively evaluated for impairment | 87,056    | 94,954    | 55,440    | 48,041    | 39,102    | 24,989    | 13,747    | 130,265    | 493,594    |
| Balance, December 31, 2010            | \$ 95,735 | \$ 95,281 | \$ 55,930 | \$ 48,041 | \$ 44,963 | \$ 24,989 | \$ 14,247 | \$ 136,198 | \$ 515,384 |

| <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>     |                             |                    |              |                               |                    |              |
| Individually evaluated for impairment | \$ 0                        | \$ 0               | \$ 0         | \$ 0                          | \$ 0               | \$ 1,195     |
| Collectively evaluated for impairment | 30                          | 83                 | 201          | 314                           | 525                | 6,431        |
| Balance, December 31, 2010            | \$ 30                       | \$ 83              | \$ 201       | \$ 314                        | \$ 525             | \$ 7,626     |
| <b>Loans:</b>                         |                             |                    |              |                               |                    |              |
| Individually evaluated for impairment | \$ 0                        | \$ 0               | \$ 0         | \$ 0                          |                    | \$ 21,790    |
| Collectively evaluated for impairment | 20,357                      | 56,294             | 48,814       | 125,465                       |                    | 619,059      |
| Balance, December 31, 2010            | \$ 20,357                   | \$ 56,294          | \$ 48,814    | \$ 125,465                    |                    | \$ 640,849   |

Table of Contents**Note 7 Deposits**

The composition of deposits was as follows:

| <i>(dollars in thousands)</i>     | <b>June 30,<br/>2011</b> | <b>December 31,<br/>2010</b> |
|-----------------------------------|--------------------------|------------------------------|
| Noninterest bearing demand        | \$ 71,388                | \$ 65,642                    |
| NOW                               | 67,606                   | 61,398                       |
| Money market                      | 235,339                  | 220,923                      |
| Savings                           | 30,079                   | 27,037                       |
| Time deposits less than \$100,000 | 250,334                  | 255,674                      |
| Time deposits \$100,000 or more   | 177,457                  | 175,436                      |
| Total deposits                    | \$ 832,203               | \$ 806,110                   |

**Note 8 Long-term Debt**

PeoplesBank's long-term debt obligations to FHLB are primarily fixed rate instruments, which are secured by FHLB stock, U.S. agency mortgage backed securities and under a blanket collateral agreement, qualifying loan receivables, principally mortgage loans. A summary of long-term debt at June 30, 2011 and December 31, 2010, is provided below.

| <i>(dollars in thousands)</i>       | <b>June 30,<br/>2011</b> | <b>December 31,<br/>2010</b> |
|-------------------------------------|--------------------------|------------------------------|
| PeoplesBank's obligations to FHLB:  |                          |                              |
| Due January 2011, 2.06%             | \$ 0                     | \$ 14,000                    |
| Due January 2011, 4.30%, amortizing | 0                        | 3,401                        |
| Due August 2011, 2.42%              | 12,000                   | 12,000                       |
| Due January 2012, 2.34%             | 10,000                   | 10,000                       |
| Due June 2012, 4.25%, amortizing    | 371                      | 567                          |
| Due December 2012, 1.91%            | 5,000                    | 5,000                        |
| Due May 2013, 3.46%, amortizing     | 1,097                    | 1,371                        |
| Due December 2013, 2.39%            | 5,000                    | 5,000                        |
|                                     | 33,468                   | 51,339                       |
| Capital lease obligation            | 362                      | 393                          |
| Total long-term debt                | \$ 33,830                | \$ 51,732                    |

**Note 9 Regulatory Matters**

Codorus Valley and PeoplesBank are subject to various regulatory capital requirements administered by banking regulators. Failure to meet minimum capital requirements can initiate certain mandatory and possible additional discretionary actions by regulators that, if undertaken, 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, 2011 based on regulatory capital guidelines.

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| <i>(dollars in thousands)</i>                      | Actual    |        | Minimum for<br>Capital Adequacy |       | Well Capitalized<br>Minimum* |       |
|--|-----------|--------|---------------------------------|-------|------------------------------|-------|
|  | Amount    | Ratio  | Amount                          | Ratio | Amount                       | Ratio |
| <b>Codorus Valley Bancorp, Inc. (consolidated)</b> |           |        |                                 |       |                              |       |
| <b>at June 30, 2011</b>                            |           |        |                                 |       |                              |       |
| Capital ratios:                                    |           |        |                                 |       |                              |       |
| Tier 1 risk based                                  | \$ 86,850 | 12.18% | \$ 28,533                       | 4.00% | n/a                          | n/a   |
| Total risk based                                   | 95,202    | 13.35  | 57,066                          | 8.00  | n/a                          | n/a   |
| Leverage   | 86,850    | 9.03   | 38,477                          | 4.00  | n/a                          | n/a   |
| <b>at December 31, 2010</b>                        |           |        |                                 |       |                              |       |
| Capital ratios:                                    |           |        |                                 |       |                              |       |
| Tier 1 risk based                                  | \$ 84,116 | 12.51% | \$ 26,905                       | 4.00% | n/a                          | n/a   |
| Total risk based                                   | 91,742    | 13.64  | 53,811                          | 8.00  | n/a                          | n/a   |
| Leverage   | 84,116    | 8.81   | 38,194                          | 4.00  | n/a                          | n/a   |
| <b>PeoplesBank, A Codorus Valley Company</b>       |           |        |                                 |       |                              |       |
| <b>at June 30, 2011</b>                            |           |        |                                 |       |                              |       |
| Capital ratios:                                    |           |        |                                 |       |                              |       |
| Tier 1 risk based                                  | \$ 83,867 | 11.80% | \$ 28,429                       | 4.00% | \$ 42,643                    | 6.00% |
| Total risk based                                   | 92,219    | 12.98  | 56,858                          | 8.00  | 71,072                       | 10.00 |
| Leverage   | 83,867    | 8.74   | 38,372                          | 4.00  | 47,966                       | 5.00  |
| <b>at December 31, 2010</b>                        |           |        |                                 |       |                              |       |
| Capital ratios:                                    |           |        |                                 |       |                              |       |
| Tier 1 risk based                                  | \$ 81,292 | 12.13% | \$ 26,805                       | 4.00% | \$ 40,207                    | 6.00% |
| Total risk based                                   | 88,918    | 13.27  | 53,610                          | 8.00  | 67,012                       | 10.00 |
| Leverage   | 81,292    | 8.54   | 38,079                          | 4.00  | 47,599                       | 5.00  |

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

**Note 10 Shareholders Equity***Preferred Stock Issued to the United States Department of the Treasury*

In connection with the Emergency Economic Stabilization Act of 2008 (EESA), the U.S. Treasury Department (Treasury) initiated a Capital Purchase Program (CPP) which allowed for qualifying financial institutions to issue preferred stock to the Treasury, subject to certain limitations and terms. The EESA was developed to attract broad participation by strong financial institutions, to stabilize the financial system and increase lending to benefit the national economy and citizens of the United States.

On January 9, 2009, the Corporation entered into a Securities Purchase Agreement with the Treasury pursuant to which the Corporation sold to the Treasury, for an aggregate purchase price of \$16.5 million, 16,500 shares of non-voting cumulative perpetual preferred stock, \$1,000 liquidation value, \$2.50 par value, and warrants to purchase up to 263,859 shares of common stock, par value \$2.50 per share, with an exercise price of \$9.38 per share. As a condition under the CPP, without the consent of the Treasury, the Corporation's share repurchases are limited to purchases in connection with the administration of any employee benefit plan, including purchases to offset share dilution in connection with any such plans. This restriction is effective until January 9, 2012 or until the Treasury no longer owns any of the Corporation's preferred shares issued under the CPP. The Corporation's preferred stock is included as a component of Tier 1 capital in accordance with regulatory capital requirements. See Note 9, Regulatory Matters for details of the Corporation's regulatory capital.

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The preferred stock ranks senior to the Corporation's common shares and pays a compounded cumulative dividend at a rate of 5 percent per year for the first five years, and 9 percent per year thereafter. Dividends are payable quarterly on February 15th, May 15th, August 15th and November 15th. The Corporation is prohibited from paying any dividend with respect to shares of common stock or repurchasing or redeeming any shares of the Corporation's common shares in any quarter unless all accrued and unpaid dividends are paid on the preferred stock for all past dividend periods (including the latest completed dividend period), subject to certain limited exceptions. In addition, without the prior consent of the Treasury, the Corporation is prohibited from declaring or paying quarterly cash dividends on common shares in excess of \$0.12 per share, which was the last quarterly cash dividend per share declared prior to October 14, 2008. The CPP also places restrictions on incentive compensation to senior executives. The preferred stock is non-voting, other than class voting rights on matters that could adversely affect the preferred stock, and is generally redeemable at the liquidation value at any time in whole or in part (i.e., a minimum of 25 percent of the issue price) with regulatory permission.

*Common Stock Warrants*

The 263,859 shares of common stock warrants issued to the Treasury have a term of 10 years (expiring January 9, 2019) and are exercisable at any time, in whole or in part, at an exercise price of \$9.38 per share (subject to certain anti-dilution adjustments). The \$16.5 million of proceeds was allocated to the preferred stock and the warrants based on their relative fair values at issuance (\$15.7 million was allocated to the preferred stock and \$783,000 to the warrants). The fair value of the preferred stock was based on a 10 percent assumed market discount rate. The fair value of the stock warrants was calculated by a third-party software model based on many financial assumptions, including market price of the stock, stock price volatility and risk free interest rate. The difference between the initial value allocated to the preferred stock of approximately \$15.7 million and the liquidation value of \$16.5 million, i.e., the preferred stock discount, will be charged to retained earnings over the first five years of the life of the preferred stock as an adjustment to the dividend yield using the effective yield method.

**Note 11 Contingent Liabilities**

The Corporation is not aware of any material contingent liabilities as of June 30, 2011.

**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 \$10,738,000 of standby letters of credit outstanding on June 30, 2011, compared to \$8,793,000 on December 31, 2010. 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, 2011 and December 31, 2010, 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.

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**Note 13 Fair Value Measurements and Fair Values of Financial Instruments**

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 measurement guidance defines fair value as the price that would be received to sell the asset or transfer the liability in an orderly transaction (that is, not a forced liquidation or distressed sale) between market participants at the measurement date under current market conditions. Additional guidance is provided on determining when the volume and level of activity for the asset or liability has significantly decreased and on identifying circumstances when a transaction may not be considered orderly.

Fair value measurement and disclosure guidance provides a list of factors that a reporting entity should evaluate to determine whether there has been a significant decrease in the volume and level of activity for the asset or liability in relation to normal market activity for the asset or liability. When the reporting entity concludes there has been a significant decrease in the volume and level of activity for the asset or liability, further analysis of the information from that market is needed, and significant adjustments to the related prices may be necessary to estimate fair value in accordance with fair value measurement and disclosure guidance.

This guidance further clarifies that, when there has been a significant decrease in the volume and level of activity for the asset or liability, some transactions may not be orderly. In those situations, the entity must evaluate the weight of the evidence to determine whether the transaction is orderly. The guidance provides a list of circumstances that may indicate that a transaction is not orderly. A transaction price that is not associated with an orderly transaction is given little, if any, weight when estimating fair value.

Fair value and disclosure guidance establishes a fair value hierarchy that prioritizes the inputs to valuation methods used to measure fair value. The hierarchy gives the highest priority to unadjusted quoted prices in active markets for identical assets or liabilities (Level 1 measurements) and the lowest priority to unobservable inputs (Level 3 measurements). The three levels of the fair value hierarchy are as follows:

Level 1: Unadjusted quoted prices in active markets that are accessible at the measurement date for identical, unrestricted assets or liabilities.

Level 2: Quoted prices in markets that are not active, or inputs that are observable either directly or indirectly, for substantially the full term of the asset or liability.

Level 3: Prices or valuation techniques that require inputs that are both significant to the fair value measurement and unobservable (i.e. supported with little or no market activity).

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.

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For financial assets measured at fair value, the fair value measurements by level within the fair value hierarchy are as follows:

| <i>(dollars in thousands)</i>                   | Total     | (Level 1)<br>Quoted Prices in<br>Active Markets for<br>Identical Assets | (Level 2)<br>Significant Other<br>Observable<br>Inputs | (Level 3)<br>Significant Other<br>Unobservable<br>Inputs |
|---|-----------|---|--|--|
| <b>June 30, 2011</b>                            |           |   |  |  |
| Measured at fair value on a recurring basis:    |           |   |  |  |
| Securities available-for-sale:                  |           |   |  |  |
| U.S. Treasury notes                             | \$ 10,152 | \$ 10,152   | \$ 0   | \$ 0   |
| U.S. agency                                     | 30,144    | 0   | 30,144   | 0  |
| U.S. agency mortgage-backed, residential        | 110,045   | 0   | 110,045  | 0  |
| State and municipal                             | 85,627    | 0   | 85,627   | 0  |
| Measured at fair value on a nonrecurring basis: |           |   |  |  |
| Impaired loans                                  | 7,069     | 0   | 0  | 7,069  |
| Foreclosed real estate                          | 12,895    | 0   | 0  | 12,895   |
| <b>December 31, 2010</b>                        |           |   |  |  |
| Measured at fair value on a recurring basis:    |           |   |  |  |
| Securities available-for-sale:                  |           |   |  |  |
| U.S. Treasury notes                             | \$ 8,140  | \$ 8,140  | \$ 0   | \$ 0   |
| U.S. agency                                     | 13,643    | 0   | 13,643   | 0  |
| U.S. agency mortgage-backed, residential        | 110,353   | 0   | 110,353  | 0  |
| State and municipal                             | 90,400    | 0   | 90,400   | 0  |
| Measured at fair value on a nonrecurring basis: |           |   |  |  |
| Impaired loans                                  | 5,703     | 0   | 0  | 5,703  |
| Foreclosed real estate                          | 4,447     | 0   | 0  | 4,447  |

The following information should not be interpreted as an estimate of the fair value of the entire Corporation since a fair value calculation is only provided for a limited portion of the Corporation's assets and liabilities. Due to a wide range of valuation techniques and the degree of subjectivity used in making the estimates, comparisons between the Corporation's disclosures and those of other companies may not be meaningful. The following methods and assumptions were used to estimate the fair values of certain assets and liabilities at June 30, 2011 and December 31, 2010:

**Cash and cash equivalents** (carried at cost)

The carrying amounts reported in the balance sheet for cash and short-term instruments approximate those assets' fair values.

**Securities, available-for-sale** (carried at fair value)

The fair values of securities available-for-sale are determined by obtaining 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.

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**Restricted investment in bank stocks** (carried at cost)

The carrying amount of restricted investment in bank stocks approximates fair value, and considers the limited marketability of such securities.

**Loans held for sale** (carried at lower of cost or fair value)

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. At June 30, 2011 and December 31, 2010, the fair value of loans held for sale exceeded their cost basis.

**Loans** (carried at cost)

Generally, for variable and adjustable rate loans that reprice frequently and with no significant change in credit risk, fair value is based on carrying value. Fair values for other loans in the portfolio are estimated using discounted cash flow analyses, using market rates at the balance sheet date that reflect the credit and interest rate-risk inherent in the loans. Projected future cash flows are calculated based upon contractual maturity or call dates, projected repayments and prepayments of principal.

**Impaired loans** (generally carried at fair value)

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. A portion of the allowance for loan losses is allocated to impaired loans if the value of the collateral supporting such loans is deemed to be less than the unpaid balance. If these allocations cause the allowance for loan losses to require an increase, such increase is reported as a component of the provision for loan losses. Loan losses are charged against the allowance when it is believed that the uncollectability of a loan is confirmed. 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, 2011, the fair value of loan balances with a specific reserve allowance was \$8,771,000, net of a valuation allowance of \$1,702,000, compared to \$6,898,000, net of a valuation allowance of \$1,195,000 at December 31, 2010.

**Foreclosed Real Estate** (carried at lower of cost or fair value)

Real estate acquired through foreclosure is initially recorded at fair value of the property at the transfer date less estimated selling cost, which becomes the cost basis. Subsequently, foreclosed real estate 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, 2011, the carrying value of foreclosed real estate with a valuation allowance was \$12,895,000 (\$14,696,000 less a \$1,801,000 allowance). At December 31, 2010, the carrying value of foreclosed real estate with a valuation allowance was \$4,447,000 (\$6,013,000 less a \$1,566,000 allowance).

**Interest receivable and payable** (carried at cost)

The carrying amount of interest receivable and interest payable approximates its fair value.

**Deposit liabilities** (carried at cost)

The fair values disclosed for demand deposits (e.g., noninterest and interest bearing checking, money market and savings accounts) are, by definition, equal to the amount payable on demand at the reporting date (i.e., their carrying amounts). Fair values for variable rate time deposits that reprice frequently are based on carrying value. Fair values for fixed rate time deposits are estimated using a discounted cash flow calculation that applies interest rates currently being offered in the market on certificates to a schedule of aggregated expected monthly maturities of time deposits.



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The carrying amount of short-term borrowings approximates their fair value.

**Long-term debt** (carried at cost)

Fair values 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.

**Junior subordinated debt** (carried at cost)

The fair value of junior subordinated debt is estimated using discounted cash flow analysis, based on market rates and spread characteristics currently offered on such debt with similar credit risk characteristics, terms and remaining maturity.

**Off-balance sheet financial instruments** (disclosed at cost)

Fair values for the Corporation's off-balance sheet financial instruments (lending commitments and letters of credit) are based on fees currently charged in the market to enter into similar agreements, taking into account the remaining terms of the agreements and the counterparties' credit standing. These amounts were not considered to be material at June 30, 2011 and December 31, 2010.

The estimated fair values of the Corporation's financial instruments were as follows at June 30, 2011 and December 31, 2010.

|  | June 30, 2011      |                            | December 31, 2010  |                            |
|--|--------------------|----------------------------|--------------------|----------------------------|
|  | Carrying<br>Amount | Estimated<br>Fair<br>Value | Carrying<br>Amount | Estimated<br>Fair<br>Value |
| <i>(dollars in thousands)</i>                                      |                    |                            |                    |                            |
| <b>Financial assets</b>  |                    |                            |                    |                            |
| Cash and cash equivalents  | \$ 11,528          | \$ 11,528                  | \$ 43,269          | \$ 43,269                  |
| Securities, available-for-sale                                     | 235,968            | 235,968                    | 222,536            | 222,536                    |
| Restricted investment in bank stocks                               | 3,677              | 3,677                      | 4,067              | 4,067                      |
| Loans held for sale  | 966                | 989                        | 4,990              | 5,054                      |
| Loans, net   | 671,718            | 679,859                    | 633,223            | 637,896                    |
| Interest receivable  | 3,536              | 3,536                      | 3,590              | 3,590                      |
| <b>Financial liabilities</b>                                       |                    |                            |                    |                            |
| Noninterest bearing demand, NOW, money market and savings deposits | \$ 404,412         | \$ 404,412                 | \$ 375,000         | \$ 375,000                 |
| Time deposits  | 427,791            | 435,762                    | 431,110            | 438,907                    |
| Short-term borrowings  | 10,796             | 10,796                     | 6,763              | 6,763                      |
| Long-term debt   | 33,830             | 34,213                     | 51,732             | 52,294                     |
| Junior subordinated debt   | 10,310             | 4,040                      | 10,310             | 4,330                      |
| Interest payable   | 662                | 662                        | 687                | 687                        |

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