CODORUS VALLEY BANCORP INC
Form 10-Q
November 13, 2012

UNITED STATES SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

x Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934
For the quarterly period ended September 30, 2012
or

o Transition Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934
For the transition period from____________to______________
Commission file number: 0-15536

CODORUS VALLEY BANCORP, INC.

(Exact name of registrant as specified in its charter)

Pennsylvania	**23-2428543**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

105 Leader Heights Road, P.O. Box 2887, York, Pennsylvania 17405
(Address of principal executive offices) (Zip code)

717-747-1519
(Registrant s telephone number, including area code)

Not Applicable
(Former name, former address and former fiscal year, if changed since the last report.)

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

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

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

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

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 November 1, 2012, 4,461,106 shares of common stock, par value $2.50, were outstanding, which includes the effect of the 5 percent common stock dividend declared October 9, 2012.

Codorus Valley Bancorp, Inc.

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PART I - FINANCIAL INFORMATION

Item 1. Financial Statements

Codorus Valley Bancorp, Inc.
Consolidated Balance Sheets
Unaudited

(dollars in thousands, except share and per share data)		**September 30, 2012**		**December 31, 2011**
Assets				
Interest bearing deposits with banks	$	33,561	$	19,640
Cash and due from banks		17,698		12,555
Total cash and cash equivalents		51,259		32,195
Securities, available-for-sale		238,605		233,861
Restricted investment in bank stocks, at cost		2,980		3,635
Loans held for sale		3,853		2,869
Loans (net of deferred fees of $977 - 2012 and $692 - 2011)		732,638		693,515
Less-allowance for loan losses		(8,787)		(8,702)
Net loans		723,851		684,813
Premises and equipment, net		10,624		10,861
Other assets		33,186		43,898
Total assets	$	1,064,358	$	1,012,132
Liabilities				
Deposits				
Noninterest bearing	$	88,158	$	73,760
Interest bearing		807,296		780,639
Total deposits		895,454		854,399
Short-term borrowings		24,193		10,257
Long-term debt		35,978		46,628
Other liabilities		8,508		7,606
Total liabilities		964,133		918,890
Shareholders equity				
Preferred stock, par value $2.50 per share; $1,000 liquidation preference, 1,000,000 shares authorized; 25,000 Series B shares issued and outstanding - 2012 and 2011		25,000		25,000
Common stock, par value $2.50 per share; 15,000,000 shares authorized; 4,452,160 shares issued and outstanding - 2012 and 10,000,000 shares authorized; 4,202,606 shares issued and outstanding - 2011		11,130		10,507
Additional paid-in capital		40,312		37,253
Retained earnings		16,944		14,558
Accumulated other comprehensive income		6,839		5,924
Total shareholders equity		100,225		93,242
Total liabilities and shareholders equity	$	1,064,358	$	1,012,132

See accompanying notes.

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Codorus Valley Bancorp, Inc.
Consolidated Statements of Income
Unaudited

	Three months ended September 30,		Nine months ended September 30,	
(dollars in thousands, except per share data)	**2012**	**2011**	**2012**	**2011**
Interest income				
Loans, including fees	$ 10,129	$ 10,146	$ 30,163	$ 29,058
Investment securities:				
Taxable	834	975	2,651	2,962
Tax-exempt	608	598	1,797	1,840
Dividends	2	2	9	6
Other	35	17	73	42
Total interest income	11,608	11,738	34,693	33,908
Interest expense				
Deposits	2,444	2,817	7,315	8,491
Federal funds purchased and other short-term borrowings	36	29	89	82
Long-term debt	197	285	604	828
Total interest expense	2,677	3,131	8,008	9,401
Net interest income	8,931	8,607	26,685	24,507
Provision for loan losses	650	3,560	1,150	4,785
Net interest income after provision for loan losses	8,281	5,047	25,535	19,722
Noninterest income				
Trust and investment services fees	450	384	1,263	1,124
Income from mutual fund, annuity and insurance sales	227	308	658	891
Service charges on deposit accounts	635	657	1,879	1,934
Income from bank owned life insurance including death benefits	157	164	487	489
Other income	151	153	483	453
Net gain on sales of loans held for sale	293	126	833	422
Net gain (loss) on sales of securities	382	0	431	(25)
Total noninterest income	2,295	1,792	6,034	5,288
Noninterest expense				
Personnel	3,806	3,218	11,245	10,182
Occupancy of premises, net	485	501	1,497	1,485
Furniture and equipment	490	434	1,414	1,305
Postage, stationery and supplies	116	128	384	397
Professional and legal	155	205	464	480
Marketing and advertising	259	278	666	661
FDIC insurance	181	223	589	785
Debit card processing	181	169	536	488
Charitable donations	26	37	507	272
Telephone	127	128	394	383
External data processing	149	107	419	336
Foreclosed real estate including (gains) losses on sales	1,498	214	2,302	1,305
Impaired loan carrying costs	36	95	266	521
Other	685	580	1,733	1,687
Total noninterest expense	8,194	6,317	22,416	20,287
Income before income taxes	2,382	522	9,153	4,723
Provision (benefit) for income taxes	511	(139)	2,213	679
Net income	1,871	661	6,940	4,044

Preferred stock dividends and discount accretion		62		657		321		1,148
Net income available to common shareholders	$	1,809	$	4	$	6,619	$	2,896
Net income per common share, basic	$	0.41	$	0.00	$	1.49	$	0.66
Net income per common share, diluted	$	0.40	$	0.00	$	1.47	$	0.66

See accompanying notes.

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

(dollars in thousands)	Three months ended September 30, 2012	2011
Net income	$ 1,871	$ 661
Other comprehensive income:		
Securities available for sale:		
Net unrealized holding gains arising during the period (net of tax expense of $447 and $837, respectively)	868	1,624
Reclassification adjustment for (gains) losses included in net income (net of tax expense of $130 and $0, respectively)	(252)	0
Net unrealized gains	616	1,624
Comprehensive income	$ 2,487	$ 2,285

(dollars in thousands)	Nine months ended September 30, 2012	2011
Net income	$ 6,940	$ 4,044
Other comprehensive income:		
Securities available for sale:		
Net unrealized holding gains arising during the period (net of tax expense of $618 and $2,003, respectively)	1,199	3,890
Reclassification adjustment for (gains) losses included in net income (net of tax expense of $147 and tax benefit of $9, respectively)	(284)	16
Net unrealized gains	915	3,906
Comprehensive income	$ 7,855	$ 7,950

See accompanying notes.

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

(dollars in thousands)	Nine months ended September 30, 2012	2011
Cash flows from operating activities		
Net income	$ 6,940	$ 4,044
Adjustments to reconcile net income to net cash provided by operations:		
Depreciation/amortization	1,028	978
Net amortization of premiums on securities	1,049	1,060
Amortization of deferred loan origination fees and costs	(201)	(201)
Amortization of intangible assets	22	29
Provision for loan losses	1,150	4,785
Provision for losses on foreclosed real estate	2,273	388
Deferred income tax benefit	0	(198)
Amortization of investment in real estate partnership	258	436
Increase in cash surrender value and death benefit on bank owned life insurance	(487)	(489)
Originations of loans held for sale	(47,539)	(25,184)
Proceeds from sales of loans held for sale	47,388	27,630
Net gain on sales of loans held for sale	(833)	(422)
Loss on disposal of premises and equipment	7	0
Net (gain) loss on sales of securities available-for-sale	(431)	25
Net loss (gain) on sales of foreclosed real estate	167	(154)
Stock-based compensation	234	188
Decrease in accrued interest receivable	107	322
Increase in other assets	(229)	(1,592)
Decrease in accrued interest payable	(21)	(73)
Decrease in other liabilities	(1,020)	(203)
Net cash provided by operating activities	9,862	11,369
Cash flows from investing activities		
Purchases of securities, available-for-sale	(51,533)	(34,296)
Maturities, repayments and calls of securities, available-for-sale	32,272	26,150
Sales of securities, available-for-sale	15,920	6,077
Redemption of restricted investment in bank stock	655	245
Net increase in loans made to customers	(40,218)	(50,414)
Purchases of premises and equipment	(798)	(967)
Investment in bank owned life insurance	(237)	(7)
Proceeds from bank owned life insurance	206	0
Investment in foreclosed real estate	(17)	(3,767)
Proceeds from sales of foreclosed real estate	9,967	728
Net cash used in investing activities	(33,783)	(56,251)
Cash flows from financing activities		
Net increase in demand and savings deposits	38,842	54,435
Net increase (decrease) in time deposits	2,213	(2,797)
Net increase in short-term borrowings	13,936	5,216
Proceeds from issuance of long-term debt	0	15,000
Repayment of long-term debt	(10,650)	(30,156)
Tax benefit on vested restricted stock	27	0
Cash dividends paid to preferred shareholders	(571)	(775)
Cash dividends paid to common shareholders	(1,223)	(1,078)
Redemption of preferred stock and common stock warrant	0	(17,027)

Issuance of preferred stock		0		25,000
Issuance of common stock		411		369
Net cash provided by financing activities		42,985		48,187
Net increase in cash and cash equivalents		19,064		3,305
Cash and cash equivalents at beginning of year		32,195		43,269
Cash and cash equivalents at end of period	$	51,259	$	46,574

See accompanying notes.

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

(dollars in thousands, except per share data)	**Preferred Stock**	**Common Stock**	**Additional Paid-in Capital**	**Retained Earnings**	**Accumulated Other Comprehensive Income**	**Total**
Balance, January 1, 2012	$ 25,000	$ 10,507	$ 37,253	$ 14,558	$ 5,924	$ 93,242
Net income				6,940		6,940
Other comprehensive income, net of tax					915	915
Common stock cash dividends ($0.277 per share, adjusted)				(1,223)		(1,223)
5% common stock dividend, 212,008 shares at fair value		530	2,480	(3,010)		0
Preferred stock dividends				(321)		(321)
Stock-based compensation			261			261
Issuance of common stock:						
17,339 shares under the dividend reinvestment and stock purchase plan		43	180			223
14,241 shares under the stock option plan		35	110			145
5,966 shares under employee stock purchase plan		15	28			43
Balance, September 30, 2012	$ 25,000	$ 11,130	$ 40,312	$ 16,944	$ 6,839	$ 100,225
Balance, January 1, 2011	$ 15,983	$ 10,330	$ 37,290	$ 10,798	$ 2,138	$ 76,539
Net income				4,044		4,044
Other comprehensive income, net of tax					3,906	3,906
Preferred stock discount accretion	478			(478)		0
Common stock cash dividends ($0.248 per share, adjusted)				(1,078)		(1,078)
Preferred stock dividends				(775)		(775)
Redemption of preferred stock and repurchase of common stock warrant	(16,461)		(566)			(17,027)
Issuance of preferred stock	25,000					25,000
Stock-based compensation			188			188
Issuance of common stock:						
19,291 shares under the dividend reinvestment and stock purchase plan		48	153			201
14,682 shares under the stock option plan		37	89			126
5,330 shares under employee stock purchase plan		13	29			42
Balance, September 30, 2011	$ 25,000	$ 10,428	$ 37,183	$ 12,511	$ 6,044	$ 91,166

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, 2011 has been derived from audited financial statements, and the unaudited interim consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America for interim financial information, the instructions to Form 10-Q, and FASB Accounting Standards Codification (ASC) 270. Accordingly, the interim financial statements do not include all of the financial information and notes required by generally accepted accounting principles for complete financial statements. In the opinion of management, the interim consolidated financial statements include all adjustments necessary to present fairly the financial condition and results of operations for the reported periods, and all such adjustments are of a normal and recurring nature.

These consolidated statements should be read in conjunction with the notes to the audited consolidated financial statements contained in the Corporation s Annual Report on Form 10-K for the year ended December 31, 2011.

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

The results of operations for the three and nine month periods ended September 30, 2012 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 September 30, 2012, and through the date these consolidated financial statements were issued, for items of potential recognition or disclosure.

Note 2 Significant Accounting Policies

Loans

Loans receivable that management has the intent and ability to hold for the foreseeable future or until maturity or payoff are stated at their outstanding unpaid principal balances less amounts charged off, net of an allowance for loan losses and any deferred fees or costs. Interest income is accrued on the unpaid principal balance of loans. 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 receivable, the accrual of interest is discontinued when the contractual payment of principal or interest has become 90 days past due or management has serious doubts about further collectability of principal or interest, even though the loan is currently performing. A loan may remain on accrual status if it is in the process of collection and is either adequately guaranteed or well secured. Generally, 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 is reported as interest income or applied against principal, according to the Corporation s judgment as to the collectability of principal. Generally, loans are restored to accrual status when the obligation is brought current, has performed in accordance with the contractual terms for a reasonable period of time, generally six months, and the ultimate collectability of the total contractual principal and interest is no longer in doubt. The past due status of all classes of loans receivable is determined based on contractual due dates for loan payments.

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Allowance for Loan Losses

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

The allowance for loan losses is maintained at a level considered adequate to provide for losses that can be reasonably anticipated. The Corporation performs a quarterly evaluation of the adequacy of the allowance. The allowance is based on the Corporation s past loan loss experience, known and inherent risks in the portfolio, adverse situations that may affect the borrower s ability to repay, the estimated value of any underlying collateral, composition of the loan portfolio, current economic conditions and other relevant factors. This evaluation is inherently subjective as it requires material estimates that may be susceptible to significant revision as more information becomes available.

The allowance consists of specific, general, and unallocated components. The specific component relates to commercial loans that are classified as impaired, generally substandard and nonaccrual loans. For commercial loans that are classified as impaired, an allowance is established when the collateral value (or discounted cash flows or observable market price) of the impaired loan is lower than the carrying value of that loan. The general component covers pools of loans by loan class including commercial loans not considered impaired, as well as smaller balance homogeneous loans, such as residential real estate, home equity and other consumer loans. These pools of loans are evaluated for loss exposure based upon historical loss rates for each of these classes of loans, adjusted for qualitative (environmental) risk factors. Historical loss rates are based on a two year rolling average of net charge-offs. Qualitative risk factors that supplement historical losses in the evaluation of loan pools include:

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

Each factor is assigned a value to reflect improving, stable or declining conditions based on the Corporation s best judgment using relevant information available at the time of the evaluation. An unallocated component is maintained to cover uncertainties that could affect the Corporation s estimate of probable losses. The unallocated component of the allowance reflects the margin of imprecision inherent in the underlying assumptions used in the methodologies for estimating specific and general losses in the loan portfolio.

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

A loan is considered impaired when, based on current information and events, it is probable that the Corporation will be unable to collect the scheduled payments of principal or interest when due according to the contractual terms of the loan agreement. Factors considered in determining impairment include payment status and the probability of collecting scheduled principal and interest payments when due. Loans that experience insignificant payment delays and payment shortfalls generally are not classified as impaired. The Corporation determines the significance of payment delays and payment shortfalls on a case-by-case basis, taking into consideration all of the circumstances surrounding the loan and the borrower, including the length of the delay, the reasons for the delay, the borrower s prior payment record and the amount of the shortfall in relation to the principal and interest owed. Loans that are deemed impaired are evaluated for impairment loss based on the net realizable value of the collateral, as applicable. Loans that are not collateral dependent will rely on the present value of expected future cash flows discounted at the loan s effective interest rate to determine impairment loss. Large groups of smaller balance homogeneous loans such as residential mortgage loans, home equity loans and other consumer loans are collectively evaluated for impairment, unless they are considered to be a troubled debt restructuring.

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

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

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 level of the allowance for loan losses at September 30, 2012 is adequate.

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Foreclosed Real Estate

Foreclosed real estate, included in other assets, is comprised of property acquired through a foreclosure proceeding or property that is acquired through acceptance of a deed-in-lieu of foreclosure. Foreclosed real estate is initially recorded at fair value minus estimated costs to sell at the date of foreclosure, establishing a new cost basis. Any difference between the carrying value and the new cost basis is charged against the allowance for loan losses. Appraisals 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 subject to fair value limitations. 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 September 30, 2012, foreclosed real estate, net of allowance, was $4,084,000, compared to $16,243,000 for December 31, 2011. The $12,159,000 or 75 percent decrease was due primarily to the sale of real estate and secondarily to an increase in the allowance for real estate losses for selected properties.

Per Common Share Computations

All per share computations include the effect of the 5 percent common stock dividend declared October 9, 2012, payable on December 11, 2012, to shareholders of record as of October 23, 2012. The computation of net income per common share is provided in the table below.

	Three months ended September 30,		Nine months ended September 30,	
(in thousands, except per share data)	**2012**	**2011**	**2012**	**2011**
Net income available to common shareholders	$ 1,809	$ 4	$ 6,619	$ 2,896
Weighted average shares outstanding (basic)	4,449	4,375	4,432	4,359
Effect of dilutive stock options	73	41	57	48
Weighted average shares outstanding (diluted)	4,522	4,416	4,489	4,407
Basic earnings per common share	$ 0.41	$ 0.00	$ 1.49	$ 0.66
Diluted earnings per common share	$ 0.40	$ 0.00	$ 1.47	$ 0.66
Anti-dilutive stock options and common stock warrants	77	92	83	92

Comprehensive Income

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

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Cash Flow Information

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

Supplemental cash flow information is provided in the table below.

	Nine months ended September 30,	
(dollars in thousands)	**2012**	**2011**
Cash paid during the period for:		
Income taxes	$ 2,727	$ 1,860
Interest	$ 8,029	$ 9,474
Noncash investing and financing activities:		
Transfer of loans to foreclosed real estate	$ 231	$ 1,885
Increase in other liabilities for investment in foreclosed real estate	$ 0	$ 476
Increase in other liabilities for purchase of securities settling after quarter end	$ 2,201	$ 0
Increase in other assets for sale of securities settling after quarter end	$ 1,566	$ 0
Increase in other liabilities for preferred dividends declared	$ 63	$ 149

Reclassification

Certain amounts in the 2011 consolidated financial statements have been reclassified to conform to the 2012 presentation, which did not impact net income or shareholders equity.

Recent Accounting Pronouncements

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. The Corporation adopted the provisions of ASU No. 2011-04 effective January 1, 2012. The fair value measurement provisions of ASU No. 2011-04 had no impact on the Corporation s consolidated financial statements. See Note 13 to the consolidated financial statements for enhanced disclosures required by ASU No. 2011-04.

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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). On July 13, 2012, the SEC published their final report on IFRS, which included an analysis of the issues related to possible incorporation of IFRS into the U.S. financial reporting regime. The SEC report was designed to inform the SEC commissioners for when they would come to decide whether, and if so, how, IFRS should be applied to the U.S. The next step for the SEC is to develop a recommendation on IFRS, but no timetable has been disclosed for completing this work. The Corporation will continue to monitor the development of the potential implementation of IFRS.

Note 3 Securities

A summary of securities available-for-sale at September 30, 2012 and December 31, 2011 is provided below. The securities available-for-sale portfolio is generally comprised of high quality debt instruments, principally obligations of the United States government or agencies thereof. Also included in the portfolio are investments in the obligations of states and municipalities. With the exception of an approximately $15 million portfolio (fair value) of Texas municipal utility district bonds, which has its own criteria for investment (e.g., maximum debt to assessed valuation, minimum assessed valuation and district size, proximity to employment, etc.), the remaining municipal bonds were almost all rated A or above by a national rating service at September 30, 2012. The majority of municipal bonds in the portfolio are general obligation bonds, which can draw upon multiple sources of revenue, including taxes, for payment. Only a few bonds are revenue bonds, which are dependent upon a single revenue stream for payment, but they are for critical services such as water and sewer. In many cases, municipal debt issues are insured or, in the case of school districts of selected states, backed by specific loss reserves. At September 30, 2012, the fair value of the municipal bond portfolio was concentrated in the states of Pennsylvania at 40 percent and Texas at 19 percent.

(dollars in thousands)	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
September 30, 2012				
Debt securities:				
U.S. Treasury notes	$ 8,000	$ 52	$ 0	$ 8,052
U.S. agency	31,905	1,188	(1)	33,092
U.S. agency mortgage-backed, residential	92,803	4,488	0	97,291
State and municipal	95,535	4,641	(6)	100,170
Total debt securities	$ 228,243	$ 10,369	$ (7)	$ 238,605
December 31, 2011				
Debt securities:				
U.S. Treasury notes	$ 10,003	$ 131	$ 0	$ 10,134
U.S. agency	29,593	1,080	0	30,673
U.S. agency mortgage-backed, residential	103,017	3,456	(29)	106,444
State and municipal	82,272	4,340	(2)	86,610
Total debt securities	$ 224,885	$ 9,007	$ (31)	$ 233,861

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The amortized cost and estimated fair value of debt securities at September 30, 2012 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.

	Available-for-sale	
(dollars in thousands)	**Amortized Cost**	**Fair Value**
Due in one year or less	$ 16,095	$ 16,215
Due after one year through five years	164,410	172,169
Due after five years through ten years	43,916	46,065
Due after ten years	3,822	4,156
Total debt securities	$ 228,243	$ 238,605

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

	Three months ended September 30,		Nine months ended September 30,	
(dollars in thousands)	**2012**	**2011**	**2012**	**2011**
Realized gains	$ 382	$ 0	$ 431	$ 79
Realized losses	0	0	0	(104)
Net gains (losses)	$ 382	$ 0	$ 431	$ (25)

Securities, issued by agencies of the federal government, with a carrying value of $149,657,000 and $136,827,000 on September 30, 2012 and December 31, 2011, 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 that have been in a continuous unrealized loss position, at September 30, 2012 and December 31, 2011.

	Less than 12 months		12 months or more		Total	
(dollars in thousands)	**Fair Value**	**Unrealized Losses**	**Fair Value**	**Unrealized Losses**	**Fair Value**	**Unrealized Losses**
September 30, 2012						
Debt securities:						
U.S. agency	3,149	(1)	0	0	3,149	(1)
State and municipal	$ 2,930	$ (6)	$ 0	$ 0	$ 2,930	$ (6)
Total temporarily impaired debt securities, available for sale	$ 6,079	$ (7)	$ 0	$ 0	$ 6,079	$ (7)
December 31, 2011						
Debt securities:						
U.S. agency mortgage-backed, residential	$ 13,430	$ (29)	$ 0	$ 0	$ 13,430	$ (29)
State and municipal	856	(2)	0	0	856	(2)
Total temporarily impaired debt securities, available for sale	$ 14,286	$ (31)	$ 0	$ 0	$ 14,286	$ (31)

The unrealized losses of $7,000 at September 30, 2012 within the less than 12 months category were attributable to seven municipal securities and one U.S. agency security, all rated A or above by a national rating service.

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

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The Corporation believes that unrealized losses at September 30, 2012 were primarily the result of changes in market interest rates and that it has the ability to hold these investments for a time necessary to recover the amortized cost. Through September 30, 2012, 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, which represents required investments in the common stock of correspondent banks, is carried at cost and, as of September 30, 2012 and December 31, 2011, consisted primarily of the common stock of the Federal Home Loan Bank of Pittsburgh (FHLBP) and, to a lesser degree, Atlantic Central Bankers Bank (ACBB). Under the FHLBP s Capital Plan, PeoplesBank is required to maintain a minimum member stock investment, both as a condition of becoming and remaining a member and as a condition of obtaining borrowings from the FHLBP. The FHLBP uses a formula to determine the minimum stock investment, which is based on the volume of loans outstanding, unused borrowing capacity and other factors.

During the first quarter of 2012, the FHLBP began paying a quarterly cash dividend on its common stock. Prior to 2012, dividend payments had been suspended by the FHLBP since December 2008. The FHLBP reported that future dividends will be dependent upon the condition of its private-label residential mortgage-backed securities portfolio, its overall financial performance, retained earnings and other factors. The FHLBP restricts the repurchase of the excess capital stock of member banks. The amount of excess capital stock that can be repurchased from any member is currently the lesser of five percent of the member s total capital stock outstanding or its excess capital stock outstanding.

Management evaluates the restricted stock for impairment in accordance with FASB ASC Topic 942. Management s determination of whether these investments are impaired is based on their assessment of the ultimate recoverability of their cost rather than by recognizing temporary declines in value. Using the FHLBP as an example, the determination of whether a decline affects the ultimate recoverability of cost is influenced by criteria such as: (1) the significance of the decline in net assets of the FHLBP as compared to the capital stock amount for the FHLBP and the length of time this situation has persisted; (2) commitments by the FHLBP to make payments required by law or regulation and the level of such payments in relation to the operating performance of the FHLBP; and (3) the impact of legislative and regulatory changes on institutions and, accordingly, on the customer base of the FHLBP. Management believes no impairment charge was necessary related to the restricted stock during the periods ended September 30, 2012 and 2011.

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Note 5 Loans

The table below provides the composition of the loan portfolio at September 30, 2012 and December 31, 2011. The portfolio is comprised of two segments, commercial and consumer loans. The commercial loan segment is disaggregated by industry class which allows the Corporation to monitor risk and performance. Those industries representing the largest dollar investment and most risk are listed separately. The other commercial loans category is comprised of a multitude of industries, including health services, professional services, public administration, restaurant, service, transportation, finance, natural resources, recreation and religious organizations. The consumer related segment is comprised of residential mortgages, home equity and other consumer loans. The Corporation has not engaged in sub-prime residential mortgage originations.

(dollars in thousands)	**September 30, 2012**	**December 31, 2011**
Builder & developer	$ 99,186	$ 103,514
Commercial real estate investor	128,068	118,133
Residential real estate investor	63,578	62,564
Hotel/Motel	60,187	52,871
Wholesale & retail	68,151	60,328
Manufacturing	37,720	25,976
Agriculture	18,674	17,368
Other	128,825	124,821
Total commercial related loans	604,389	565,575
Residential mortgages	21,961	21,324
Home equity	63,598	58,390
Other	42,690	48,226
Total consumer related loans	128,249	127,940
Total loans	$ 732,638	$ 693,515

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

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

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The table below presents a summary of loan risk ratings by loan class at September 30, 2012 and December 31, 2011.

(dollars in thousands)	Pass	Special Mention	Substandard	Nonaccrual	Total
September 30, 2012					
Builder & developer	$ 79,701	$ 7,157	$ 11,020	$ 1,308	$ 99,186
Commercial real estate investor	112,651	9,662	2,465	3,290	128,068
Residential real estate investor	59,698	1,370	2,046	464	63,578
Hotel/Motel	60,187	0	0	0	60,187
Wholesale & retail	63,480	1,899	988	1,784	68,151
Manufacturing	37,015	0	705	0	37,720
Agriculture	18,197	0	477	0	18,674
Other	123,047	691	619	4,468	128,825
Total commercial related loans	553,976	20,779	18,320	11,314	604,389
Residential mortgage	21,869	6	33	53	21,961
Home equity	63,165	119	188	126	63,598
Other	41,758	447	354	131	42,690
Total consumer related loans	126,792	572	575	310	128,249
Total loans	$ 680,768	$ 21,351	$ 18,895	$ 11,624	$ 732,638
December 31, 2011					
Builder & developer	$ 90,429	$ 11,392	$ 533	$ 1,160	$ 103,514
Commercial real estate investor	102,374	13,519	161	2,079	118,133
Residential real estate investor	58,331	3,681	0	552	62,564
Hotel/Motel	52,871	0	0	0	52,871
Wholesale & retail	54,193	2,354	811	2,970	60,328
Manufacturing	25,262	0	714	0	25,976
Agriculture	16,879	0	489	0	17,368
Other	111,227	9,095	0	4,499	124,821
Total commercial related loans	511,566	40,041	2,708	11,260	565,575
Residential mortgage	21,113	7	34	170	21,324
Home equity	58,088	79	188	35	58,390
Other	47,359	597	34	236	48,226
Total consumer related loans	126,560	683	256	441	127,940
Total loans	$ 638,126	$ 40,724	$ 2,964	$ 11,701	$ 693,515

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The table below presents a summary of impaired loans at September 30, 2012 and December 31, 2011. Generally, impaired loans are loans risk rated substandard and nonaccrual or classified as troubled debt restructurings. An allowance is established for individual commercial related loans where the Corporation has doubt as to full recovery of the outstanding principal balance. Typically, impaired consumer related loans are partially or fully charged-off obviating the need for a specific allowance. The recorded investment represents outstanding unpaid principal loan balances adjusted for charge-offs.

	September 30, 2012			December 31, 2011		
(dollars in thousands)	Recorded Investment	Unpaid Principal Balance	Related Allowance	Recorded Investment	Unpaid Principal Balance	Related Allowance
Impaired loans with no related allowance:						
Builder & developer	$ 13,268	$ 13,268	$ 0	$ 2,627	$ 2,627	$ 0
Commercial real estate investor	5,755	5,855	0	3,965	4,065	0
Residential real estate investor	72	72	0	463	463	0
Hotel/Motel	0	0	0	0	0	0
Wholesale & retail	2,527	4,802	0	3,781	6,056	0
Manufacturing	705	705	0	714	714	0
Agriculture	0	0	0	0	0	0
Other commercial	4,111	4,239	0	3,619	3,619	0
Residential mortgage	86	112	0	204	314	0
Home equity	314	314	0	223	223	0
Other consumer	485	562	0	270	270	0
Total impaired loans with no related allowance	$ 27,323	$ 29,929	$ 0	$ 15,866	$ 18,351	$ 0
Impaired loans with a related allowance:						
Builder & developer	$ 258	$ 258	$ 147	$ 264	$ 264	$ 147
Commercial real estate investor	0	0	0	0	0	0
Residential real estate investor	2,438	2,438	550	89	89	30
Hotel/Motel	0	0	0	0	0	0
Wholesale & retail	525	525	150	0	0	0
Manufacturing	0	0	0	0	0	0
Agriculture	478	478	100	489	489	100
Other commercial	975	975	218	880	880	120
Residential mortgage	0	0	0	0	0	0
Home equity	0	0	0	0	0	0
Other consumer	0	0	0	0	0	0
Total impaired loans with a related allowance	$ 4,674	$ 4,674	$ 1,165	$ 1,722	$ 1,722	$ 397
Total impaired loans:						
Builder & developer	$ 13,526	$ 13,526	$ 147	$ 2,891	$ 2,891	$ 147
Commercial real estate investor	5,755	5,855	0	3,965	4,065	0
Residential real estate investor	2,510	2,510	550	552	552	30
Hotel/Motel	0	0	0	0	0	0
Wholesale & retail	3,052	5,327	150	3,781	6,056	0
Manufacturing	705	705	0	714	714	0
Agriculture	478	478	100	489	489	100
Other commercial	5,086	5,214	218	4,499	4,499	120
Residential mortgage	86	112	0	204	314	0
Home equity	314	314	0	223	223	0
Other consumer	485	562	0	270	270	0
Total impaired loans	$ 31,997	$ 34,603	$ 1,165	$ 17,588	$ 20,073	$ 397

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The tables below present a summary of average impaired loans and related interest income that was included in net income for the three and nine months ended September 30, 2012 and 2011.

	For the three months ended					
	September 30, 2012			September 30, 2011		
(dollars in thousands)	Average Recorded Investment	Interest Income	Cash Basis	Average Recorded Investment	Interest Income	Cash Basis
Impaired loans with no related allowance:						
Builder & developer	$ 10,771	$ 121	$ 11	$ 3,852	$ 172	$ 165
Commercial real estate investor	5,146	73	34	2,049	20	14
Residential real estate investor	268	1	1	483	1	0
Hotel/Motel	0	0	0	0	0	0
Wholesale & retail	2,299	3	1	2,695	25	0
Manufacturing	706	10	0	0	0	0
Agriculture	0	0	0	0	0	0
Other commercial	3,936	3	1	5,627	86	65
Residential mortgage	86	1	1	272	2	1
Home equity	268	1	0	208	1	0
Other consumer	473	7	4	664	10	5
Total impaired loans with no related allowance	$ 23,953	$ 220	$ 53	$ 15,850	$ 317	$ 250
Impaired loans with a related allowance:						
Builder & developer	$ 259	$ 2	$ 2	$ 1,366	0	0
Commercial real estate investor	0	0	0	166	0	0
Residential real estate investor	2,289	31	0	92	0	0
Hotel/Motel	0	0	0	0	0	0
Wholesale & retail	263	0	0	2,421	0	0
Manufacturing	0	0	0	0	0	0
Agriculture	479	9	0	496	9	0
Other commercial	927	0	0	791	18	0
Residential mortgage	0	0	0	0	0	0
Home equity	0	0	0	0	0	0
Other consumer	0	0	0	0	0	0
Total impaired loans with a related allowance	$ 4,217	$ 42	$ 2	$ 5,332	$ 27	$ 0
Total impaired loans:						
Builder & developer	$ 11,030	$ 123	$ 13	$ 5,218	$ 172	$ 165
Commercial real estate investor	5,146	73	34	2,215	20	14
Residential real estate investor	2,557	32	1	575	1	0
Hotel/Motel	0	0	0	0	0	0
Wholesale & retail	2,562	3	1	5,116	25	0
Manufacturing	706	10	0	0	0	0
Agriculture	479	9	0	496	9	0
Other commercial	4,863	3	1	6,418	104	65
Residential mortgage	86	1	1	272	2	1
Home equity	268	1	0	208	1	0
Other consumer	473	7	4	664	10	5
Total impaired loans	$ 28,170	$ 262	$ 55	$ 21,182	$ 344	$ 250

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	For the nine months ended					
	September 30, 2012			September 30, 2011		
(dollars in thousands)	Average Recorded Investment	Interest Income	Cash Basis	Average Recorded Investment	Interest Income	Cash Basis
Impaired loans with no related allowance:						
Builder & developer	$ 8,008	$ 355	$ 65	$ 5,601	$ 392	$ 374
Commercial real estate investor	4,703	209	108	1,025	36	26
Residential real estate investor	366	4	4	438	2	0
Hotel/Motel	0	0	0	0	0	0
Wholesale & retail	2,627	5	4	1,857	65	0
Manufacturing	709	31	0	0	0	0
Agriculture	0	0	0	0	0	0
Other commercial	4,654	93	138	5,428	332	264
Residential mortgage	145	5	4	277	12	11
Home equity	257	5	1	134	2	0
Other consumer	384	16	10	576	29	14
Total impaired loans with no related allowance	$ 21,853	$ 723	$ 334	$ 15,336	$ 870	$ 689
Impaired loans with a related allowance:						
Builder & developer	$ 261	$ 4	$ 4	$ 929	0	0
Commercial real estate investor	57	0	0	208	0	0
Residential real estate investor	1,189	33	0	94	0	0
Hotel/Motel	0	0	0	0	0	0
Wholesale & retail	131	(3)	0	3,632	0	0
Manufacturing	0	0	0	0	0	0
Agriculture	484	26	0	498	26	0
Other commercial	926	0	0	751	22	0
Residential mortgage	0	0	0	0	0	0
Home equity	0	0	0	0	0	0
Other consumer	0	0	0	0	0	0
Total impaired loans with a related allowance	$ 3,048	$ 60	$ 4	$ 6,112	$ 48	$ 0
Total impaired loans:						
Builder & developer	$ 8,269	$ 359	$ 69	$ 6,530	$ 392	$ 374
Commercial real estate investor	4,760	209	108	1,233	36	26
Residential real estate investor	1,555	37	4	532	2	0
Hotel/Motel	0	0	0	0	0	0
Wholesale & retail	2,758	2	4	5,489	65	0
Manufacturing	709	31	0	0	0	0
Agriculture	484	26	0	498	26	0
Other commercial	5,580	93	138	6,179	354	264
Residential mortgage	145	5	4	277	12	11
Home equity	257	5	1	134	2	0
Other consumer	384	16	10	576	29	14
Total impaired loans	$ 24,901	$ 783	$ 338	$ 21,448	$ 918	$ 689

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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, nonaccrual loans and current loans by loan segment and class at September 30, 2012 and December 31, 2011.

(dollars in thousands)	**30-59 Days Past Due**	**60-89 Days Past Due**	**90 Days and Greater Past Due**	**Total Past Due Accruing**	**Nonaccrual**	**Current**	**Total Loans**
September 30, 2012							
Builder & developer	$ 5,000	$ 1,741	$ 0	$ 6,741	$ 1,308	$ 91,137	$ 99,186
Commercial real estate investor	0	0	0	0	3,290	124,778	128,068
Residential real estate investor	0	0	0	0	464	63,114	63,578
Hotel/Motel	0	0	0	0	0	60,187	60,187
Wholesale & retail	0	0	0	0	1,784	66,367	68,151
Manufacturing	0	0	0	0	0	37,720	37,720
Agriculture	252	0	0	252	0	18,422	18,674
Other	0	83	0	83	4,468	124,274	128,825
Total commercial related loans	5,252	1,824	0	7,076	11,314	585,999	604,389
Residential mortgage	0	33	0	33	53	21,875	21,961
Home equity	67	0	0	67	126	63,405	63,598
Other	143	14	21	178	131	42,381	42,690
Total consumer related loans	210	47	21	278	310	127,661	128,249
Total loans	$ 5,462	$ 1,871	$ 21	$ 7,354	$ 11,624	$ 713,660	$ 732,638
December 31, 2011							
Builder & developer	$ 1,709	$ 0	$ 0	$ 1,709	$ 1,160	$ 100,645	$ 103,514
Commercial real estate investor	0	0	0	0	2,079	116,054	118,133
Residential real estate investor	0	0	0	0	552	62,012	62,564
Hotel/Motel	0	0	0	0	0	52,871	52,871
Wholesale & retail	525	0	0	525	2,970	56,833	60,328
Manufacturing	0	0	0	0	0	25,976	25,976
Agriculture	0	0	0	0	0	17,368	17,368
Other	109	0	0	109	4,499	120,213	124,821
Total commercial related loans	2,343	0	0	2,343	11,260	551,972	565,575
Residential mortgage	320	0	0	320	170	20,834	21,324
Home equity	236	0	0	236	35	58,119	58,390
Other	677	1	0	678	236	47,312	48,226
Total consumer related loans	1,233	1	0	1,234	441	126,265	127,940
Total loans	$ 3,576	$ 1	$ 0	$ 3,577	$ 11,701	$ 678,237	$ 693,515

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

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

The table below shows loans whose terms have been modified under TDRs during the three months and nine months ended September 30, 2012 and 2011. There was no impairment loss recognized on any of these TDRs, and they are all performing under their modified terms. There were no defaults during the nine months ended September 30, 2012 for TDRs entered into for the last 12 months.

(dollars in thousands)	**Number of Contracts**	**Pre-Modification Outstanding Recorded Investments**	**Post-Modification Outstanding Recorded Investments**
Three months ended:			
September 30, 2012			
None			
September 30, 2011			
Commercial related loans			
nonaccrual	1	$ 2,151	$ 2,151
accruing	2	$ 2,936	$ 2,936
Nine months ended:			
September 30, 2012			
Commercial related loans			
nonaccrual	1	$ 286	$ 286
September 30, 2011			
Commercial related loans			
nonaccrual	1	$ 2,151	$ 2,151
accruing	2	$ 2,936	$ 2,936
Consumer related loans			
accruing	1	$ 188	$ 188

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NOTE 6 Allowance for Loan Losses

The table below shows the activity in and the composition of the allowance for loan losses by loan segment and class detail as of and for the three and nine months ended September 30, 2012 and 2011.

(dollars in thousands)	Builder & developer	Commercial real estate investor	Residential real estate investor	Hotel/ Motel	Wholesale & retail	Manufacturing	Agriculture	Other	Total commercial related
Allowance for loan losses:									
Balance, July 1, 2012	$ 1,680	$ 1,239	$ 900	$ 449	$ 1,690	$ 164	$ 194	$ 1,062	$ 7,378
Charge-offs	(215)	0	(15)	0	0	0	0	(46)	(276)
Recoveries	0	0	0	0	3	0	0	0	3
Provisions	119	78	140	0	436	58	(3)	158	986
Balance, September 30, 2012	$ 1,584	$ 1,317	$ 1,025	$ 449	$ 2,129	$ 222	$ 191	$ 1,174	$ 8,091
Balance, July 1, 2011	$ 2,376	$ 1,897	$ 588	$ 397	$ 938	$ 151	$ 189	$ 1,159	$ 7,695
Charge-offs	(900)	0	0	0	(2,275)	0	0	0	(3,175)
Recoveries	0	0	0	0	1	0	0	2	3
Provisions	901	18	(109)	9	3,090	4	3	(238)	3,678
Balance, September 30, 2011	$ 2,377	$ 1,915	$ 479	$ 406	$ 1,754	$ 155	$ 192	$ 923	$ 8,201

(dollars in thousands)	Residential mortgage	Home equity	Other	Total consumer related	Unallocated	Total
Allowance for loan losses:						
Balance, July 1, 2012	$ 78	$ 152	$ 137	$ 367	$ 945	$ 8,690
Charge-offs	(76)	(42)	(165)	(283)	0	(559)
Recoveries	0	1	2	3	0	6
Provisions	133	77	236	446	(782)	650
Balance, September 30, 2012	$ 135	$ 188	$ 210	$ 533	$ 163	$ 8,787
Balance, July 1, 2011	$ 73	$ 155	$ 184	$ 412	$ 244	$ 8,351
Charge-offs	(85)	0	(81)	(166)	0	(3,341)

Recoveries	0	0	44	44	0	47
Provisions	127	(47)	42	122	(240)	3,560
Balance, September 30, 2011	$ 115	$ 108	$ 189	$ 412	$ 4	$ 8,617

(dollars in thousands)	**Builder & developer**	**Commercial real estate investor**	**Residential real estate investor**	**Hotel/ Motel**	**Wholesale & retail**	**Manufacturing**	**Agriculture**	**Other**	**Total commercial related**
Allowance for loan losses:									
Balance, January 1, 2012	$ 2,170	$ 2,003	$ 505	$ 394	$ 1,806	$ 151	$ 184	$ 907	$ 8,120
Charge-offs	(217)	(68)	(15)	0	0	0	0	(309)	(609)
Recoveries	0	0	0	0	14	0	0	0	14
Provisions	(369)	(618)	535	55	309	71	7	576	566
Balance, September 30, 2012	$ 1,584	$ 1,317	$ 1,025	$ 449	$ 2,129	$ 222	$ 191	$ 1,174	$ 8,091
Balance, January 1, 2011	$ 1,561	$ 1,887	$ 698	$ 345	$ 843	$ 155	$ 175	$ 1,123	$ 6,787
Charge-offs	(933)	0	0	0	(2,420)	0	0	(40)	(3,393)
Recoveries	0	0	0	0	3	0	0	2	5
Provisions	1,749	28	(219)	61	3,328	0	17	(162)	4,802
Balance, September 30, 2011	$ 2,377	$ 1,915	$ 479	$ 406	$ 1,754	$ 155	$ 192	$ 923	$ 8,201

(dollars in thousands)	**Residential mortgage**	**Home equity**	**Other**	**Total consumer related**	**Unallocated**	**Total**
Allowance for loan losses:						
Balance, January 1, 2012	$ 88	$ 86	$ 171	$ 345	$ 237	$ 8,702
Charge-offs	(115)	(170)	(241)	(526)	0	(1,135)
Recoveries	41	1	14	56	0	70
Provisions	121	271	266	658	(74)	1,150
Balance, September 30, 2012	$ 135	$ 188	$ 210	$ 533	$ 163	$ 8,787
Balance, January 1, 2011	$ 30	$ 83	$ 201	$ 314	$ 525	$ 7,626
Charge-offs	(141)	(144)	(176)	(461)	0	(3,854)
Recoveries	0	8	47	55	0	60
Provisions	226	161	117	504	(521)	4,785

Balance, September 30, 2011	$	115	$	108	$	189	$	412	$	4	$	8,617

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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 September 30, 2012 and 2011 and December 31, 2011.

(dollars in thousands)	Builder & developer	Commercial real estate investor	Residential real estate investor	Hotel/Motel	Wholesale & retail	Manufacturing	Agriculture	Other	Total commercial related
Allowance for loan losses:									
Individually evaluated for impairment	$ 147	$ 0	$ 550	$ 0	$ 150	$ 0	$ 100	$ 218	$ 1,165
Collectively evaluated for impairment	1,437	1,317	475	449	1,979	222	91	956	6,926
Balance, September 30, 2012	$ 1,584	$ 1,317	$ 1,025	$ 449	$ 2,129	$ 222	$ 191	$ 1,174	$ 8,091
Individually evaluated for impairment	$ 147	$ 0	$ 30	$ 0	$ 0	$ 0	$ 100	$ 120	$ 397
Collectively evaluated for impairment	2,023	2,003	475	394	1,806	151	84	787	7,723
Balance, December 31, 2011	$ 2,170	$ 2,003	$ 505	$ 394	$ 1,806	$ 151	$ 184	$ 907	$ 8,120
Individually evaluated for impairment	$ 147	$ 25	$ 30	$ 0	$ 0	$ 0	$ 100	$ 120	$ 422
Collectively evaluated for impairment	2,230	1,890	449	406	1,754	155	92	803	7,779
Balance, September 30, 2011	$ 2,377	$ 1,915	$ 479	$ 406	$ 1,754	$ 155	$ 192	$ 923	$ 8,201
Loans:									
Individually evaluated for impairment	$ 13,526	$ 5,755	$ 2,510	$ 0	$ 3,052	$ 705	$ 478	$ 5,086	$ 31,112
Collectively evaluated for impairment	85,660	122,313	61,068	60,187	65,099	37,015	18,196	123,739	573,277

Balance, September 30, 2012	$ 99,186	$ 128,068	$ 63,578	$ 60,187	$ 68,151	$ 37,720	$ 18,674	$ 128,825	$ 604,389
Individually evaluated for impairment	$ 2,891	$ 3,965	$ 552	$ 0	$ 3,781	$ 714	$ 489	$ 4,499	$ 16,891
Collectively evaluated for impairment	100,623	114,168	62,012	52,871	56,547	25,262	16,879	120,322	548,684
Balance, December 31, 2011	$ 103,514	$ 118,133	$ 62,564	$ 52,871	$ 60,328	$ 25,976	$ 17,368	$ 124,821	$ 565,575
Individually evaluated for impairment	$ 2,247	$ 2,241	$ 574	$ 0	$ 3,972	$ 0	$ 494	$ 6,060	$ 15,588
Collectively evaluated for impairment	100,358	108,431	59,985	51,034	52,778	25,857	16,727	123,681	538,851
Balance, September 30, 2011	$ 102,605	$ 110,672	$ 60,559	$ 51,034	$ 56,750	$ 25,857	$ 17,221	$ 129,741	$ 554,439

(dollars in thousands)	**Residential mortgage**	**Home equity**	**Other**	**Total consumer related**	**Unallocated**	**Total**
Allowance for loan losses:						
Individually evaluated for impairment	$ 0	$ 0	$ 0	$ 0	$ 0	$ 1,165
Collectively evaluated for impairment	135	188	210	533	163	7,622
Balance, September 30, 2012	$ 135	$ 188	$ 210	$ 533	$ 163	$ 8,787
Individually evaluated for impairment	$ 0	$ 0	$ 0	$ 0	$ 0	$ 397
Collectively evaluated for impairment	88	86	171	345	237	8,305
Balance, December 31, 2011	$ 88	$ 86	$ 171	$ 345	$ 237	$ 8,702
	$ 0	$ 0	$ 0	$ 0	$ 0	$ 422

Individually evaluated for impairment						
Collectively evaluated for impairment	115	108	189	412	4	8,195
Balance, September 30, 2011	$ 115	$ 108	$ 189	$ 412	$ 4	$ 8,617
Loans:						
Individually evaluated for impairment	$ 86	$ 314	$ 485	$ 885		$ 31,997
Collectively evaluated for impairment	21,875	63,284	42,205	127,364		700,641
Balance, September 30, 2012	$ 21,961	$ 63,598	$ 42,690	$ 128,249		$ 732,638
Individually evaluated for impairment	$ 204	$ 223	$ 270	$ 697		$ 17,588
Collectively evaluated for impairment	21,120	58,167	47,956	127,243		675,927
Balance, December 31, 2011	$ 21,324	$ 58,390	$ 48,226	$ 127,940		$ 693,515
Individually evaluated for impairment	$ 228	$ 208	$ 610	$ 1,046		$ 16,634
Collectively evaluated for impairment	22,244	58,158	49,898	130,300		669,151
Balance, September 30, 2011	$ 22,472	$ 58,366	$ 50,508	$ 131,346		$ 685,785

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Note 7 Deposits

The composition of deposits as of September 30, 2012 and December 31, 2011 is shown below.

(dollars in thousands)		**September 30, 2012**		**December 31, 2011**
Noninterest bearing demand	$	88,158	$	73,760
NOW		74,319		68,518
Money market		268,885		253,598
Savings		33,665		30,309
Time deposits less than $100,000		245,629		247,190
Time deposits $100,000 or more		184,798		181,024
Total deposits	$	895,454	$	854,399

Note 8 Long-term Debt

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

In June 2012, the Corporation restructured (i.e., extended) two outstanding $5 million FHLB advances ($10 million total) to lock in low rates as a hedge against the possibility of rising market interest rates in the future. This transaction resulted in a $235,000 prepayment penalty that, under accounting rules, was deferred and embedded in the rates on the restructured advances where it will be recognized as interest expense over their respective repayment terms. The $5 million FHLB advance originally maturing December 2013 with a fixed rate of interest of 2.39 percent was extended to June 2019 with a fixed rate of interest of 2.10 percent. The $5 million FHLB advance originally maturing July 2014 with a fixed rate of interest of 1.38 percent was extended to June 2018 with a fixed rate of interest of 1.87 percent. The impact of the debt restructure on current period earnings is immaterial.

In June 2006, Codorus Valley formed CVB Statutory Trust No. 2, a wholly-owned special purpose subsidiary whose sole purpose was to facilitate a pooled trust preferred debt issuance of $7,217,000. In November 2004, Codorus Valley formed CVB Statutory Trust No. 1 to facilitate a pooled trust preferred debt issuance of $3,093,000. The Corporation owns all of the common stock of these nonbank subsidiaries, and the debentures are the sole assets of the Trusts. The accounts of both Trusts are not consolidated for financial reporting purposes in accordance with FASB ASC 810. For regulatory capital purposes, all of the Corporation s trust preferred securities qualified as Tier 1 capital for all reported periods. Trust preferred securities are subject to capital limitations under the FDIC s risk-based capital guidelines, i.e., the portion that exceeds 25 percent of capital qualifies as Tier 2 capital. The Corporation used the net proceeds from these offerings to fund its operations. Under proposed Basel III capital rules, the Tier 1 capital status of trust preferred debt would be phased out at 10 percent per year over ten years. The amount of disqualified Tier I capital would qualify as Tier II capital for regulatory capital purposes.

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A summary of long-term debt as of September 30, 2012 and December 31, 2011 is shown below.

(dollars in thousands)	**September 30, 2012**	**December 31, 2011**
PeoplesBank s obligations:		
FHLBP		
Due January 2012, 2.34%	$ 0	$ 10,000
Due June 2012, 4.25%, amortizing	0	170
Due December 2012, 1.91%	5,000	5,000
Due May 2013, 3.46%, amortizing	390	818
Due December 2013, 2.39%	0	5,000
Due July 2014, 1.38%	0	5,000
Due July 2015, 1.90%	5,000	5,000
Due July 2016, 2.35%	5,000	5,000
Due June 2018, 1.87%	5,000	0
Due June 2019, 2.10%	5,000	0
Total FHLBP	25,390	35,988
Capital lease obligation	278	330
Codorus Valley Bancorp, Inc. obligations:		
Due 2034, 2.41%, floating rate based on 3 month		
LIBOR plus 2.02%, callable quarterly after December 2009	3,093	3,093
Due 2036, 2.00% floating rate based on 3 month		
LIBOR plus 1.54%, callable quarterly after July 2011	7,217	7,217
Total long-term debt	$ 35,978	$ 46,628

Note 9 Regulatory Matters

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

Quantitative measures established by regulators to ensure capital adequacy require Codorus Valley and PeoplesBank to maintain minimum ratios, as set forth below, to total and Tier 1 capital as a percentage of risk-weighted assets, and of Tier 1 capital to quarter-to-date average assets (leverage ratio). Management believes that Codorus Valley and PeoplesBank were well capitalized on September 30, 2012 based on regulatory capital guidelines.

	Actual		Minimum for Capital Adequacy		Well Capitalized Minimum*	
(dollars in thousands)	Amount	Ratio	Amount	Ratio	Amount	Ratio
Codorus Valley Bancorp, Inc. ***(consolidated)***						
at September 30, 2012						
Capital ratios:						
Tier 1 risk based	$ 103,218	13.41%	$ 30,799	4.00%	n/a	n/a
Total risk based	112,005	14.55	61,597	8.00	n/a	n/a
Leverage	103,218	9.83	41,995	4.00	n/a	n/a
at December 31, 2011						
Capital ratios:						
Tier 1 risk based	$ 97,128	13.35%	$ 29,097	4.00%	n/a	n/a
Total risk based	105,830	14.55	58,194	8.00	n/a	n/a
Leverage	97,128	9.62	40,379	4.00	n/a	n/a
PeoplesBank, A Codorus Valley Company						
at September 30, 2012						
Capital ratios:						
Tier 1 risk based	$ 99,842	13.02%	$ 30,683	4.00%	$ 46,024	6.00%
Total risk based	108,629	14.16	61,365	8.00	76,707	10.00
Leverage	99,842	9.54	41,881	4.00	52,352	5.00
at December 31, 2011						
Capital ratios:						
Tier 1 risk based	$ 94,056	12.98%	$ 28,975	4.00%	$ 43,463	6.00%
Total risk based	102,758	14.19	57,950	8.00	72,438	10.00
Leverage	94,056	9.35	40,239	4.00	50,299	5.00

* To be well capitalized under prompt corrective action provisions.

Note 10 Shareholders Equity

Preferred stock issued under the US Treasury s Small Business Lending Fund Program

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

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Preferred stock and common stock warrant issued under the US Treasury s Capital Purchase Program

On August 18, 2011, the Corporation entered into a repurchase letter agreement with the Treasury providing for the redemption of the CPP preferred stock. Pursuant to the SBLF Purchase Agreement, approximately $16,507,000 of the proceeds of the sale of the SBLF preferred stock was used to redeem the 16,500 shares of the Series A CPP preferred stock plus accrued and unpaid dividends. Upon redemption, the remaining $379,000 preferred stock discount was recorded as a reduction to third quarter 2011 net income available to common shareholders. Additionally, the additional paid-in-capital account was reduced by approximately $39,000 pertaining to issuance costs for the CPP preferred stock. As a result of the redemption, the Corporation is no longer subject to the restrictions imposed by the CPP. On September 28, 2011, the Corporation repurchased the outstanding CPP common stock warrant for $526,604 from the US Treasury which was recorded as a reduction to additional paid-in-capital. Information about the CPP preferred stock and common stock warrant is disclosed in Note 10 Shareholders Equity in the Corporation s Annual Report on Form 10-K for the year ended December 31, 2010.

Change in authorized shares of common stock

On May 15, 2012, as previously reported on Form 8-K, the Corporation s shareholders approved the Board of Directors proposal to amend the Corporation s Articles of Incorporation to increase the aggregate number of shares of common stock which the Corporation may issue from 10 million to 15 million shares. The increase in the number of authorized shares provides flexibility of action in the future and enables the Corporation to act promptly in connection with stock splits, stock dividends, acquisitions, financings and such other corporate matters involving the issuance of common stock as the Board of Directors may deem advisable. There are no present plans for the use of the additional shares.

Dividend Reinvestment and Stock Purchase Plan

The Corporation maintains a Dividend Reinvestment and Stock Purchase Plan (Plan). Shareholders of common stock may participate in the Plan, which allows additional shares of common stock to be purchased with reinvested dividends at prevailing market prices. The Plan also permits participants to make additional voluntary cash payments to purchase shares of the Corporation s common stock. Since August 2008, purchases have been made from the Corporation from its authorized, but unissued, common stock. All shares reserved for the Plan were issued as of December 31, 2011. On January 26, 2012, an additional 150,000 shares were reserved for issuance under the Plan.

Common stock dividend

Periodically, the Corporation distributes stock dividends on its common stock as an additional means of enhancing long-term shareholder value. On October 9, 2012, the Corporation declared a 5 percent common stock dividend payable on or before December 11, 2012, to shareholders of record at the close of business on October 23, 2012. Distribution of these stock dividends resulted in the issuance of approximately 212,008 additional common shares.

Note 11 Contingent Liabilities

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

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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 $15,982,000 of standby letters of credit outstanding on September 30, 2012, compared to $11,532,000 on December 31, 2011. 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 September 30, 2012 and December 31, 2011, for guarantees under standby letters of credit issued, was not material. Many of the commitments are expected to expire without being drawn upon and, therefore, generally do not present significant liquidity risk to the Corporation or PeoplesBank.

Note 13 Fair Value of Assets and Liabilities

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

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

> Level 1: Inputs to the valuation methodology are quoted prices, unadjusted, for identical assets or liabilities in active markets. A quoted price in an active market provides the most reliable evidence of fair value and shall be used to measure fair value whenever available.
>
> Level 2: Inputs to the valuation methodology include quoted prices for similar assets or liabilities in active markets; inputs to the valuation methodology include quoted prices for identical or similar assets or liabilities in markets that are not active; or inputs to the valuation methodology that utilize model-based techniques for which all significant assumptions are observable in the market.
>
> Level 3: Inputs to the valuation methodology are unobservable and significant to the fair value measurement; inputs to the valuation methodology that utilize model-based techniques for which significant assumptions are not observable in the market; or inputs to the valuation methodology that require significant management judgment or estimation, some of which may be internally developed.

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

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Assets Measured at Fair Value on a Recurring Basis

Securities available-for-sale

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

		Fair Value Measurements		
(dollars in thousands)	**Total**	**(Level 1) Quoted Prices in Active Markets for Identical Assets**	**(Level 2) Significant Other Observable Inputs**	**(Level 3) Significant Other Unobservable Inputs**
September 30, 2012				
Securities available-for-sale:				
U.S. Treasury notes	$ 8,052	$ 8,052	$ 0	$ 0
U.S. agency	33,092	0	33,092	0
U.S. agency mortgage-backed, residential	97,291	0	97,291	0
State and municipal	100,170	0	100,170	0
December 31, 2011				
Securities available-for-sale:				
U.S. Treasury notes	$ 10,134	$ 10,134	$ 0	$ 0
U.S. agency	30,673	0	30,673	0
U.S. agency mortgage-backed, residential	106,444	0	106,444	0
State and municipal	86,610	0	86,610	0

Assets Measured at Fair Value on a Nonrecurring Basis

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. 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 September 30, 2012, the fair value consists of loan balances of $4,810,000, net of a valuation allowance of $1,165,000 and charge-offs of $2,605,000, compared to loan balances of $4,222,000, net of a valuation allowance of $397,000 and charge-offs of $2,485,000, at December 31, 2011.

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Foreclosed Real Estate (carried at lower of cost or fair value)
Other real estate property acquired through foreclosure is initially recorded at fair value of the property at the transfer date less estimated selling cost. Subsequently, other real estate owned is carried at the lower of its carrying value or the fair value less estimated selling cost. Fair value is usually determined based upon an independent third-party appraisal of the property or occasionally upon a recent sales offer. At September 30, 2012, the carrying value of foreclosed real estate with a valuation allowance was $3,231,000 ($6,710,000 less a $3,479,000 allowance). At December 31, 2011, the carrying value of foreclosed real estate with a valuation allowance was $14,093,000 ($16,488,000 less a $2,395,000 allowance).

		Fair Value Measurements		
(dollars in thousands)	**Total**	**(Level 1) Quoted Prices in Active Markets for Identical Assets**	**(Level 2) Significant Other Observable Inputs**	**(Level 3) Significant Other Unobservable Inputs**
September 30, 2012				
Impaired loans	$ 4,810	$ 0	$ 0	$ 4,810
Foreclosed real estate	3,231	0	0	3,231
December 31, 2011				
Impaired loans	$ 4,222	$ 0	$ 0	$ 4,222
Foreclosed real estate	14,093	0	0	14,093

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

	Quantitative Information about Level 3 Fair Value Measurements			
(dollars in thousands)	**Fair Value Estimate**	**Valuation Techniques**	**Unobservable Input**	**Range**
September 30, 2012				
Impaired loans	$ 4,810	Appraisal (1)	Appraisal adjustments (2)	20% - 30%
Foreclosed real estate	3,231	Appraisal (1), (3)		

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

Disclosures about Fair Value of Financial Instruments

The following presents the carrying amount and estimated fair value of the Corporation s financial instruments as of September 30, 2012 and December 31, 2011 and placement in the fair value hierarchy at September 30, 2012. For short-term financial assets such as cash and cash equivalents, restricted investment in bank stocks, and interest receivable, the carrying amount is a reasonable estimate of the fair value due to the relatively short time between the origination of the instrument and its expected realization or in the case of restricted investments in bank stocks, the nature of the asset. For financial liabilities such noninterest bearing demand, interest bearing demand, savings deposits, interest payable, and short-term borrowings, the carrying amount is a reasonable estimate of the fair value since these products have no stated maturity. 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 counterparties credit standing. These amounts were not considered to be material.

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 September 30, 2012 and December 31, 2011, the fair value of loans held for sale exceeded their cost basis.

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

Time Deposits (carried at cost)
The fair values of fixed rate time deposits are estimated using a discounted cash flow analyses. The discount rates used are based on rates currently offered for deposits with similar remaining maturities. The fair values of variable rate time deposits that reprice frequently are based on carrying value. The fair values of time deposit liabilities do not take into consideration the value of the Company s long-term relationships with depositors, which may have significant value.

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

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(dollars in thousands)	Carrying Amount	Estimated Fair Value	Fair Value Estimates (Level 1) Quoted Prices in Active Markets for Identical Assets	(Level 2) Significant Other Observable Inputs	(Level 3) Significant Other Unobservable Inputs
September 30, 2012					
Financial assets					
Cash and cash equivalents	$ 51,259	$ 51,259	$ 51,259	$ 0	$ 0
Securities available-for-sale	238,605	238,605	8,052	230,553	0
Restricted investment in bank stocks	2,980	2,980	2,980	0	0
Loans held for sale	3,853	3,931	0	3,931	0
Loans, net	723,851	749,914	0	0	749,914
Interest receivable	3,545	3,545	3,545	0	0
Financial liabilities					
Noninterest bearing demand, NOW, money market and savings deposits	$ 465,027	$ 465,027	$ 465,027	$ 0	$ 0
Time deposits	430,427	437,477	0	437,477	0
Short-term borrowings	24,193	24,193	24,193	0	0
Long-term debt	35,978	33,070	0	26,517	6,553
Interest payable	500	500	500	0	0
Off-balance sheet instruments	0	0	0	0	0

(dollars in thousands)	Carrying Amount	Estimated Fair Value
December 31, 2011		
Financial assets		
Cash and cash equivalents	$ 32,195	$ 32,195
Securities available-for-sale	233,861	233,861
Restricted investment in bank stocks	3,635	3,635
Loans held for sale	2,869	2,926
Loans, net	684,813	694,260
Interest receivable	3,652	3,652
Financial liabilities		
Noninterest bearing demand, NOW, money market and savings deposits	$ 426,185	$ 426,185
Time deposits	428,214	436,716
Short-term borrowings	10,257	10,257
Long-term debt	46,628	41,529
Interest payable	521	521
Off-balance sheet instruments	0	0

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

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

Forward-looking statements

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

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

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

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

Critical accounting policies

We have identified critical accounting policies for the Corporation to include allowance for loan losses, valuation of foreclosed real estate and evaluation of other-than-temporary impairment losses of securities. There were no material changes made to the critical accounting policies disclosed in the 2011 Annual Report on Form 10-K in regards to application or related judgments and estimates used. A detailed disclosure pertaining to critical accounting estimates is provided in Item 7 of the Corporation s 2011 Annual Report on Form 10-K.

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Three months ended September 30, 2012,
compared to three months ended September 30, 2011

FINANCIAL HIGHLIGHTS

The Corporation earned net income available to common shareholders (earnings) totaling $1,809,000 for the quarter ended September 30, 2012, compared to $4,000 for the quarter ended September 30, 2011. The $1,805,000 increase in earnings for the third quarter of 2012, compared to the third quarter of 2011, was primarily the result of a decrease in the provision for loan losses, an increase in interest and noninterest income and a decrease in preferred stock dividends, which more than offset increases in noninterest expense and provision for income taxes.

The $2,910,000 or 82 percent decrease in the provision for loan losses for the third quarter of 2012, compared to the third quarter of 2011, reflected an unusually large provision in the third quarter of 2011 to replenish the allowance for loan losses for the partial charge-off of two unrelated loans totaling $3,175,000.

The $324,000 or 4 percent increase in net interest income for the third quarter of 2012, compared to the third quarter of 2011, resulted primarily from a larger proportion of low cost core deposits to total deposits and lower rates generally paid on all deposit products, which reflected unusually low market interest rates. The average volume of interest earning assets, principally commercial loans, increased $59 million or 6 percent, during the current quarter compared to the third quarter of 2011. Income from the increase in loan volume was offset by decreasing asset yields.

The $503,000 or 28 percent increase in total noninterest income for the third quarter of 2012, compared to the same quarter of 2011, was due in part to a $167,000 or 132 percent increase in gains from increased sales of residential mortgage loans, principally refinancings, stimulated by the low level of market interest rates. The infrequent recognition of gains from the sale of securities totaling $382,000 during the current quarter also contributed to the increase in noninterest income. Approximately $9 million of U.S agency mortgage-backed securities (MBS) were selectively sold to remove relatively low yielding instruments that were prepaying principal faster than anticipated and small odd-lot pieces from the MBS portfolio.

The $595,000 or 91 percent decrease in preferred stock dividends and discount accretion for the third quarter of 2012, compared to the third quarter of 2011, reflected the recognition of $379,000 of unamortized discount in the third quarter of 2011, which coincided with the full redemption of preferred stock under the U.S. Treasury s Capital Purchase Program. The decrease in preferred stock dividends also reflects a decrease in the dividend rate caused by the addition of loans above a predetermined baseline portfolio balance that qualified for the U.S. Treasury s Small Business Lending Fund Program.

The $1,877,000 or 30 percent increase in total noninterest expense for the third quarter of 2012, compared to the same quarter of 2011, was due primarily to increases in foreclosed real estate costs and personnel expenses. The $1,284,000 or 600 percent increase in foreclosed real estate costs reflected increased provisioning for impairment losses, including a $1,027,000 provision relating to a foreclosed property, as previously reported on Form 8-K dated August 30, 2012. The $588,000 or 18 percent increase in personnel expense was due to normal business growth, which included the impact of franchise expansion in September 2011, and the accrual of annual performance incentives.

The provision for income tax for the third quarter of 2012 was $511,000, compared to an income tax benefit of $139,000 for the third quarter of 2011. The increase in income taxes was primarily the result of the significant increase in income before income taxes.

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The schedule below presents selected performance metrics for the third quarter of 2012 and 2011.

	Three months ended September 30, 2012	2011
Basic earnings per share	$ 0.41	$ 0.00
Diluted earnings per share	$ 0.40	$ 0.00
Cash dividend payout ratio	25.7%	nm
Return on average assets	0.71%	0.26%
Return on average equity	7.50%	3.04%
Net interest margin (tax equivalent)	3.70%	3.79%
Net overhead ratio	2.38%	1.81%
Efficiency ratio	72.48%	58.13%
Average equity to average assets	9.44%	8.68%

nm - not meaningful

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

INCOME STATEMENT ANALYSIS

Net interest income

Net interest income for the three-month period ended September 30, 2012, was $8,931,000, an increase of $324,000 or 4 percent above the third quarter of 2011. The increase was primarily the result of a decrease in the average rate paid on deposits. Net interest income (tax equivalent basis) as a percentage of interest earning assets, i.e., net interest margin, was 3.70 percent for the third quarter of 2012, compared to 3.79 percent for the third quarter of 2011.

The $130,000 or 1 percent decrease in total interest income for the current quarter, compared to the third quarter of 2011, was due primarily to a decrease in yields on earning assets, which was reflective of the long duration of historically low market interest rates. Interest earning assets averaged $998 million and yielded 4.77 percent (tax equivalent basis) for the current quarter, compared to $939 million and 5.11 percent, respectively, for the third quarter of 2011. The $59 million or 6 percent increase in the average volume of interest earning assets, principally commercial loans, partially offset the decrease in the average yield.

The $454,000 or 15 percent decrease in total interest expense for the current quarter, compared to the third quarter of 2011 resulted from a larger proportion of low cost core deposits to total deposits and lower rates generally paid on all deposit products, which reflected historically low market interest rates. Total interest bearing liabilities averaged $865 million at an average rate of 1.23 percent for the current quarter, compared to $835 million and 1.49 percent, respectively, for the third quarter of 2011. The $30 million or 4 percent increase in the average volume of interest bearing liabilities reflected growth in core deposits, principally money market and demand deposits. The Corporation defines core deposits as all deposits except certificates of deposit.

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

	Three months ended September 30,					
	2012			2011		
(dollars in thousands)	Average Balance	Interest	Yield/ Rate	Average Balance	Interest	Yield/ Rate
Assets						
Interest bearing deposits with banks	$ 54,940	$ 35	0.25%	$ 25,187	$ 17	0.27%
Federal funds sold	0	0	0.00	0	0	0.00
Investment securities:						
Taxable	145,974	836	2.28	151,295	977	2.56
Tax-exempt	85,500	900	4.19	78,139	882	4.48
Total investment securities	231,474	1,736	2.98	229,434	1,859	3.21
Loans:						
Taxable (1)	698,606	10,000	5.69	669,875	10,001	5.92
Tax-exempt	13,257	193	5.79	14,411	215	5.92
Total loans	711,863	10,193	5.70	684,286	10,216	5.92
Total earning assets	998,277	11,964	4.77	938,907	12,092	5.11
Other assets (2)	58,406			62,076		
Total assets	$ 1,056,683			$ 1,000,983		
Liabilities and Shareholders Equity						
Deposits:						
Interest bearing demand	$ 338,046	$ 340	0.40%	$ 314,788	$ 511	0.64%
Savings	34,188	21	0.24	29,543	27	0.36
Time	431,089	2,083	1.92	428,168	2,279	2.11
Total interest bearing deposits	803,323	2,444	1.21	772,499	2,817	1.45
Short-term borrowings	25,438	36	0.56	11,724	29	0.98
Long-term debt	36,050	197	2.17	51,063	285	2.21
Total interest bearing liabilities	864,811	2,677	1.23	835,286	3,131	1.49
Noninterest bearing deposits	84,527			73,553		
Other liabilities	7,565			5,247		
Shareholders equity	99,780			86,897		
Total liabilities and shareholders equity	$ 1,056,683			$ 1,000,983		
Net interest income		$ 9,287			$ 8,961	
Net interest margin (3)			3.70%			3.79%

(1) Average balance includes average nonaccrual loans of $10,948,000 for 2012 and $19,080,000 for 2011. Interest includes net loan fees of $275,000 for 2012 and $231,000 for 2011.
(2) Average balance includes average bank owned life insurance, foreclosed real estate and unrealized holding gains (losses) on investment securities.
(3) Net interest income annualized as a percentage of average earning assets.

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

(dollars in thousands)	**Three months ended September 30, 2012 vs. 2011 Increase (decrease) due to change in Volume**	**Rate**	**Net**
Interest Income			
Interest bearing deposits with banks	$ 20	$ (2)	$ 18
Federal funds sold	0	0	0
Investment securities:			
Taxable	(27)	(114)	(141)
Tax-exempt	83	(65)	18
Loans:			
Taxable	639	(640)	(1)
Tax-exempt	(17)	(5)	(22)
Total interest income	698	(826)	(128)
Interest Expense			
Deposits:			
Interest bearing demand	34	(205)	(171)
Savings	4	(10)	(6)
Time	16	(212)	(196)
Short-term borrowings	35	(28)	7
Long-term debt	(86)	(2)	(88)
Total interest expense	3	(457)	(454)
Net interest income	$ 695	$ (369)	$ 326

Changes which are due to both volume and rate are allocated in proportion to their relationship to the amount of change attributed directly to volume or rate.

Provision for loan losses

For the three-month period ended September 30, 2012, the provision for loan losses was $650,000, which was the level needed to maintain the adequacy of the allowance for loan losses. Comparatively, the $3,560,000 provision recorded for the third quarter of 2011, which was unusually large, replenished the allowance for the partial charge-off of two unrelated loans totaling $3,175,000 as reported on a Form 8-K filed October 31, 2011 and a Form 8-K/A filed on November 10, 2011. Information about loan quality is provided in the Nonperforming Assets section of this report on page 50.

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Noninterest income

The following table presents the components of total noninterest income for the third quarter of 2012, compared to the third quarter of 2011.

Table 3 - Noninterest income

	Three months ended September 30,		Change Increase (Decrease)	
(dollars in thousands)	**2012**	**2011**	**$**	**%**
Trust and investment services fees	$ 450	$ 384	$ 66	17%
Income from mutual fund, annuity and insurance sales	227	308	(81)	(26)
Service charges on deposit accounts	635	657	(22)	(3)
Income from bank owned life insurance	157	164	(7)	(4)
Other income	151	153	(2)	(1)
Net gain on sales of loans held for sale	293	126	167	133
Net gain (loss) on sales of securities	382	0	382	nm
Total noninterest income	$ 2,295	$ 1,792	$ 503	28%

nm - not meaningful

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

Trust and investment services fees The $66,000 or 17 percent increase in trust and investment services fees was due to new business and to a lesser degree market appreciation.

Income from mutual fund, annuity and insurance sales The $81,000 or 26 percent decrease in income from mutual fund, annuity and insurance sales was due to a decrease in sales. The low interest rate environment has negatively affected the sale of annuity products and economic and political uncertainties have resulted in some investors maintaining larger cash positions.

Service charges on deposit accounts The $22,000 or 3 percent decrease in service charge income was due primarily to a decrease in overdraft fees. Overdraft fee income on consumer accounts enrolled in PeoplesBank s automated overdraft payment program, which is a significant component of service charges, decreased in response to the implementation of FDIC pricing restrictions that took effect July 1, 2011.

Net gain on sales of loans held for sale The $167,000 or 133 percent increase in gains from the sale of loans was due primarily to an increase in the volume of residential mortgage loan sales. The low level of market interest rates influenced by the Federal Reserve Bank to stimulate the U.S. economy continue to stimulate residential mortgage loan refinancings.

Net gain on sales of securities $382,000 in gains were recognized in the current quarter from the sale of approximately $9 million of U.S agency mortgage-backed securities (MBS) that were selectively sold to remove relatively low yielding instruments that were prepaying principal faster than anticipated and small odd-lot pieces from the MBS portfolio.

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Noninterest expense

The following table presents the components of total noninterest expense for the third quarter of 2012, compared to the third quarter of 2011.

Table 4 - Noninterest expense

(dollars in thousands)	Three months ended September 30, 2012	2011	Change Increase (Decrease) $	%
Personnel	$ 3,806	$ 3,218	$ 588	18%
Occupancy of premises, net	485	501	(16)	(3)
Furniture and equipment	490	434	56	13
Postage, stationery and supplies	116	128	(12)	(9)
Professional and legal	155	205	(50)	(24)
Marketing and advertising	259	278	(19)	(7)
FDIC insurance	181	223	(42)	(19)
Debit card processing	181	169	12	7
Charitable donations	26	37	(11)	(30)
Telephone	127	128	(1)	(1)
External data processing	149	107	42	39
Foreclosed real estate including (gains) losses on sales	1,498	214	1,284	600
Impaired loan carrying costs	36	95	(59)	(62)
Other	685	580	105	18
Total noninterest expense	$ 8,194	$ 6,317	$ 1,877	30%

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

Personnel The $588,000 or 18 percent increase in personnel expense was due to normal business growth, which included the impact of a branch office addition in September 2011, and the accrual of annual performance incentives.

Foreclosed real estate including (gains) losses on sales The $1,284,000 or 600 percent increase in foreclosed real estate costs reflected increased provisioning for impairment losses, including the $1,027,000 provision relating to a foreclosed property, as previously reported on Form 8-K filed on August 30, 2012.

Other The $105,000 or 18 percent increase in other expense, which is comprised of many underlying expenses, was primarily the result of timing and normal business growth.

Income taxes

The provision for income tax for the third quarter of 2012 was $511,000, compared to an income tax benefit of $139,000 for the third quarter of 2011. The increase in income taxes was primarily the result of the significant increase in income before income taxes. For both periods, the Corporation s statutory federal income tax rate was 34 percent. The Corporation s effective income tax rate was 22 percent for the third quarter of 2012, compared to a negative rate for the third quarter of 2011. The effective tax rate differs from the statutory tax rate due to the impact of low-income housing credits and tax-exempt income, including income from bank owned life insurance.

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Preferred stock dividends and discount accretion

Preferred stock dividends for the third quarter of 2012 were $62,000, compared to preferred stock dividends and discount accretion totaling $657,000 for the third quarter of 2011. The $595,000 or 91 percent decrease reflected the recognition of $379,000 of unamortized discount in the third quarter of 2011, which coincided with the full redemption of preferred stock under the U.S. Treasury s Capital Purchase Program. The decrease in preferred stock dividends also reflected a decrease in the dividend rate caused by the addition of loans above a predetermined baseline portfolio balance that qualified for a lower rate under the U.S. Treasury s Small Business Lending Fund Program. Information about U.S. Treasury capital programs is provided in Note 10-Shareholders Equity of this report.

Nine months ended September 30, 2012,
compared to nine months ended September 30, 2011
FINANCIAL HIGHLIGHTS

The Corporation earned net income available to common shareholders (earnings) totaling $6,619,000 for the nine month period ended September 30, 2012, compared to $2,896,000 for the same period of 2011. The $3,723,000 or 129 percent increase in earnings was primarily the result of a decrease in the provision for loan losses, an increase in interest and noninterest income and a decrease in preferred stock dividends, which more than offset increases in noninterest expense and provision for income taxes.

The $3,635,000 or 76 percent decrease in the provision for loan losses for the first nine months of 2012, compared to the same period of 2011, reflected an unusually large provision in the third quarter of 2011 to replenish the allowance for loan losses for the partial charge-off of two unrelated loans totaling $3,175,000.

The $2,178,000 or 9 percent increase in net interest income for the first nine months of 2012, compared to the same period of 2011, resulted primarily from a larger volume of interest earning assets, principally commercial loans, and a decrease in funding costs. The decrease in funding costs resulted from a larger proportion of low cost core deposits to total deposits and lower rates generally paid on all deposit products, which reflected historically low market interest rates.

The $746,000 or 14 percent increase in noninterest income for the first nine months of 2012, compared to the same period of 2011, resulted primarily from a $411,000 increase in gains from the sale of residential mortgage loans. Market interest rates decreased to record low levels during the current period, leading to an increase in residential mortgage loan refinancings. A $456,000 increase in pretax gains from the infrequent sale of investment securities during the current period also contributed to the increase in noninterest income.

The $827,000 or 72 percent decrease in preferred stock dividends and discount accretion for the first nine months of 2012, compared to the same period of 2011, was the result of a decrease in the dividend rate on preferred stock caused by the addition of loans above a predetermined baseline portfolio balance that qualified for the U.S. Treasury s Small Business Lending Program. Also, the accretion of discount is no longer applicable in 2012 as a result of last year s redemption of preferred stock issued under the Treasury s Capital Purchase Program.

The $2,129,000 or 10 percent increase in noninterest expense for the first nine months of 2012, compared to the same period of 2011, was due primarily to increases in personnel expenses and foreclosed real estate costs. The $1,063,000 or 10 percent increase in personnel expense was due to normal business growth, which included the impact of franchise expansion in September 2011, and the accrual of annual performance incentives. The $997,000 or 76 percent increase in foreclosed real estate costs reflected increased provisioning for impairment losses, including a $1,027,000 provision relating to a foreclosed property, as previously reported on Form 8-K filed on August 30, 2012.

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The $1,534,000 or 226 percent increase in the provision for income taxes for the first nine months of 2012, compared to the same period of 2011, was the result of a 94 percent increase in income before income taxes.

On September 30, 2012, total assets were approximately $1.06 billion representing a $52 million or 5 percent increase above September 30, 2011. Compared to one year ago, asset growth occurred primarily in the commercial loan portfolio and was funded primarily by an increase in core deposits.

The schedule below presents selected performance metrics for the nine months ended September 30, 2012 and 2011.

	Nine months ended September 30, 2012	Nine months ended September 30, 2011
Basic earnings per share	$ 1.49	$ 0.66
Diluted earnings per share	$ 1.47	$ 0.66
Cash dividend payout ratio	18.5%	37.2%
Return on average assets	0.89%	0.55%
Return on average equity	9.50%	6.60%
Net interest margin (tax equivalent)	3.81%	3.74%
Net overhead ratio	2.17%	2.05%
Efficiency ratio	66.57%	64.91%
Average equity to average assets	9.41%	8.38%

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

INCOME STATEMENT ANALYSIS

Net interest income

Net interest income for the nine-month period ended September 30, 2012, was $26,685,000, an increase of $2,178,000 or 9 percent above the same period of 2011. The increase was primarily the result of an increase in the average volume of interest earning assets and a decrease in the average rate paid on deposits. Net interest income (tax equivalent basis) as a percentage of interest earning assets, i.e., net interest margin, was 3.81 percent for the first nine months of 2012, compared to 3.74 percent for the first nine months of 2011.

The $785,000 or 2 percent increase in total interest income for the first nine months of 2012, compared to the same period of 2011, was due primarily to an increase in the average volume of interest earning assets. Interest earning assets averaged $973 million and yielded 4.91 percent (tax equivalent basis) for the current period, compared to $916 million and 5.11 percent, respectively, for the first nine months of 2011. The $57 million or 6 percent increase in the average volume of interest earning assets, which more than offset the decrease in the average yield, was due primarily to an increase in commercial loans.

The $1,393,000 or 15 percent decrease in total interest expense for the first nine months of 2012, compared to the same period of 2011, resulted from a larger proportion of low cost core deposits to total deposits and lower rates generally paid on all deposit products, which reflected historically low market interest rates. Total interest bearing liabilities averaged $850 million at an average rate of 1.26 percent for the current period, compared to $817 million and 1.54 percent, respectively, for the first nine months of 2011. The $33 million or 4 percent increase in the average volume of interest bearing liabilities reflected growth in core deposits, principally money market deposits. Additionally, the average volume of noninterest bearing demand deposits increased by $11 million or 15 percent for the current period, compared to the first nine months of 2011. The Corporation defines core deposits as all deposits except certificates of deposit (i.e., time deposits).

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

	Nine months ended September 30,					
	2012			2011		
(dollars in thousands)	Average Balance	Interest	Yield/ Rate	Average Balance	Interest	Yield/ Rate
Assets						
Interest bearing deposits with banks	$ 38,579	$ 73	0.25%	$ 22,549	$ 40	0.24%
Federal funds sold	0	0	0.00	901	2	0.30
Investment securities:						
Taxable	147,011	2,660	2.42	151,982	2,968	2.61
Tax-exempt	81,470	2,659	4.36	80,292	2,710	4.51
Total investment securities	228,481	5,319	3.11	232,274	5,678	3.27
Loans:						
Taxable (1)	692,203	29,760	5.74	645,087	28,607	5.93
Tax-exempt	13,616	600	5.89	14,979	670	5.98
Total loans	705,819	30,360	5.75	660,066	29,277	5.93
Total earning assets	972,879	35,752	4.91	915,790	34,997	5.11
Other assets (2)	62,176			58,670		
Total assets	$ 1,035,055			$ 974,460		
Liabilities and Shareholders Equity						
Deposits:						
Interest bearing demand	$ 330,645	$ 991	0.40%	$ 299,289	$ 1,485	0.66%
Savings	33,352	62	0.25	29,434	84	0.38
Time	429,258	6,262	1.95	429,738	6,922	2.15
Total interest bearing deposits	793,255	7,315	1.23	758,461	8,491	1.50
Short-term borrowings	20,034	89	0.59	11,069	82	0.99
Long-term debt	36,850	604	2.19	47,694	828	2.32
Total interest bearing liabilities	850,139	8,008	1.26	817,224	9,401	1.54
Noninterest bearing deposits	80,676			70,235		
Other liabilities	6,792			5,322		
Shareholders equity	97,448			81,679		
Total liabilities and shareholders equity	$ 1,035,055			$ 974,460		
Net interest income		$ 27,744			$ 25,596	
Net interest margin (3)			3.81%			3.74%

(1) Average balance includes average nonaccrual loans of $12,157,000 for 2012 and $18,290,000 for 2011. Interest includes net loan fees of $694,000 for 2012 and $682,000 for 2011.

(2) Average balance includes average bank owned life insurance, foreclosed real estate and unrealized holding gains (losses) on investment securities.

(3) Net interest income annualized as a percentage of average earning assets.

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

	Nine months ended September 30, 2012 vs. 2011		
	Increase (decrease) due to change in		
(dollars in thousands)	**Volume**	**Rate**	**Net**
Interest Income			
Interest bearing deposits with banks	$ 28	$ 5	$ 33
Federal funds sold	(2)	0	(2)
Investment securities:			
Taxable	(96)	(212)	(308)
Tax-exempt	39	(90)	(51)
Loans:			
Taxable	2,549	(1,396)	1,153
Tax-exempt	(61)	(9)	(70)
Total interest income	2,457	(1,702)	755
Interest Expense			
Deposits:			
Interest bearing demand	160	(654)	(494)
Savings	11	(33)	(22)
Time	(8)	(652)	(660)
Short-term borrowings	67	(60)	7
Long-term debt	(196)	(28)	(224)
Total interest expense	34	(1,427)	(1,393)
Net interest income	$ 2,423	$ (275)	$ 2,148

Changes which are due to both volume and rate are allocated in proportion to their relationship to the amount of change attributed directly to volume or rate.

Provision for loan losses

For the nine-month period ended September 30, 2012, the provision for loan losses was $1,150,000, which was the amount needed to replenish the allowance for loan losses and to provide for loan portfolio growth. Comparatively, the provision for the first nine months of 2011 totaled $4,785,000. The provision recorded for 2011 reflected an unusually large provision in the third quarter of that year to replenish the allowance for loan losses for the partial charge-off of two unrelated loans totaling $3,175,000 as reported on a Form 8-K filed October 3, 2011 and a Form 8-K/A filed on November 10, 2011. Information about loan quality is provided in the Nonperforming Assets section of this report on page 50.

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Noninterest income

The following table presents the components of total noninterest income for the first nine months of 2012, compared to the first nine months of 2011.

Table 7 - Noninterest income

	Nine months ended September 30,		Change Increase (Decrease)	
(dollars in thousands)	**2012**	**2011**	**$**	**%**
Trust and investment services fees	$ 1,263	$ 1,124	$ 139	12%
Income from mutual fund, annuity and insurance sales	658	891	(233)	(26)
Service charges on deposit accounts	1,879	1,934	(55)	(3)
Income from bank owned life insurance	487	489	(2)	(0)
Other income	483	453	30	7
Net gain on sales of loans held for sale	833	422	411	97
Net gain (loss) on sales of securities	431	(25)	456	nm
Total noninterest income	$ 6,034	$ 5,288	$ 746	14%

nm - not meaningful

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

Trust and investment services fees The $139,000 or 12 percent increase in income from trust and investment services fees was due to appreciation in market value of managed accounts, upon which some fees are based, and growth in traditional trust business.

Income from mutual fund, annuity and insurance sales The $233,000 or 26 percent decrease in income from the sale of mutual funds, annuities and insurance products by Codorus Valley Financial Advisors (CVFA), a subsidiary of PeoplesBank, was due primarily to a decrease in sales. The low interest rate environment has negatively affected the sale of annuity products and economic and political uncertainties have resulted in some investors maintaining larger cash positions. The decrease in income was also due in part to the resignation of four financial advisors who left CVFA in February 2011.

Service charges on deposit accounts The $55,000 or 3 percent decrease in service charge income was due primarily to a decrease in overdraft fees. Overdraft fee income on consumer accounts enrolled in PeoplesBank s automated overdraft payment program, which is a significant component of service charges, decreased in response to the implementation of FDIC pricing restrictions that took effect July 1, 2011.

Price restrictions imposed by the federal government under the Durbin Interchange Amendment may significantly reduce debit card revenue (i.e., interchange fees) for PeoplesBank in future periods. While the legislation targeted larger banks with total assets of $10 billion on more, market forces in the future may not make a distinction between large and small banks.

Other income The $30,000 or 7 percent increase in other income was due primarily to an increase in fees from loan settlement services provided by SYC Settlement Services, Inc., a subsidiary of PeoplesBank, which resulted from an increase in the refinancing of residential mortgage loans.

Net gain on sales of loans held for sale The $411,000 or 97 percent increase in gains from the sale of loans was due primarily to an increase in the volume of residential mortgage loan sales. Market interest rates decreased to record low levels during the current period, leading to an increase in residential mortgage loan refinancings.

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Net gain (loss) on sales of securities The net gain of $431,000 for the current nine month period was the result of two transactions. During the third quarter, a $382,000 gain was recognized from the sale of approximately $9 million of U.S agency mortgage-backed securities (MBS) that were selectively sold to remove relatively low yielding instruments that were prepaying principal faster than anticipated and small odd-lot pieces from the MBS portfolio. During the first quarter, a net gain of $49,000 was recognized from the sale of approximately $8 million of MBS that were also prepaying faster than anticipated. Prior year 2011 included a $25,000 net loss from the sale of municipal bonds that no longer met the Corporation s investment criteria.

Noninterest expense

The following table presents the components of total noninterest expense for the first nine months of 2012, compared to the first nine months of 2011.

Table 8 - Noninterest expense

	Nine months ended September 30,		Change Increase (Decrease)	
(dollars in thousands)	**2012**	**2011**	**$**	**%**
Personnel	$ 11,245	$ 10,182	$ 1,063	10%
Occupancy of premises, net	1,497	1,485	12	1
Furniture and equipment	1,414	1,305	109	8
Postage, stationery and supplies	384	397	(13)	3
Professional and legal	464	480	(16)	(3)
Marketing and advertising	666	661	5	1
FDIC insurance	589	785	(196)	(25)
Debit card processing	536	488	48	10
Charitable donations	507	272	235	86
Telephone	394	383	11	3
External data processing	419	336	83	25
Foreclosed real estate including (gains) losses on sales	2,302	1,305	997	76
Impaired loan carrying costs	266	521	(255)	(49)
Other	1,733	1,687	46	3
Total noninterest expense	$ 22,416	$ 20,287	$ 2,129	10%

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

Personnel The $1,063,000 or 10 percent increase in personnel expense was due to normal business growth, which included the impact of a branch office addition in September 2011, and the accrual of annual performance incentives.

Furniture and equipment The $109,000 or 8 percent increase in furniture and equipment was due to franchise expansion and normal business growth.

FDIC insurance The $196,000 or 25 percent decrease in FDIC insurance premiums was partially the result of a change by the FDIC in its assessment methodology in the prior year. Effective April 1, 2011, the FDIC lowered assessment rates and applied them against average assets minus average tangible capital, instead of domestic deposits. A decrease in the assessment rate, which reflected PeoplesBank s improved financial performance also contributed to the decrease in the cost of FDIC insurance.

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Debit card processing The $48,000 or 10 percent increase in debit card processing expense was primarily the result of increases in the number of new accounts and transaction volume.

Charitable donations The $235,000 or 86 percent increase in charitable donations was due primarily to an increase in donations that qualify for state tax credits, which lower Pennsylvania Shares Tax expense, included below under other expenses.

External data processing The $83,000 or 25 percent increase in external data processing was the result of new services, price increases and normal business growth.

Foreclosed real estate including (gains) losses on sales The $997,000 or 76 percent increase in foreclosed real estate costs reflected increased provisioning for impairment losses, including the $1,027,000 provision related to a foreclosed property, as previously reported on Form 8-K dated August 30, 2012 and filed with the SEC.

Impaired loan carrying costs The $255,000 or 49 percent decrease in carrying costs reflects, in part, an unusually large level of legal expense recognized in prior year 2011 for a particular impaired loan. The prolonged weakness in economic and business conditions may cause fluctuations in impaired loan carrying costs. Factors such as the number and size of the loans in the impaired loan portfolio, financial capacity of the borrower or guarantor, value and liquidity of the underlying collateral and the timing of when and how long loans are classified as impaired, among other factors, contribute to the variability of this expense from period to period. Typical carrying costs include insurance, maintenance and repairs, real estate taxes, appraisals and legal fees.

Income taxes

The provision for income tax for the first nine months of 2012 was $2,213,000, compared to a provision of $679,000 for the first nine months of 2011. The $1,534,000 or 226 percent increase in income taxes was primarily the result of a 94 percent increase in income before income taxes. For both periods, the Corporation s statutory federal income tax rate was 34 percent. The Corporation s effective income tax rate was 24 percent for the first nine months of 2012, compared to approximately 14 percent for the first nine months of 2011. The effective tax rate differs from the statutory tax rate due to the level of tax-exempt income and tax credits relative to the level of income before income taxes.

Preferred stock dividends and discount accretion

Preferred stock dividends for the first nine months of 2012 were $321,000, compared to preferred stock dividends and discount accretion totaling $1,148,000 for the same period of 2011. The $827,000 or 72 percent decrease was a result of a decrease in the dividend rate on preferred stock caused by the addition of loans above a predetermined baseline portfolio balance that qualified for the U.S. Treasury s Small Business Lending Program. Also, the accretion of discount is no longer applicable in 2012 as a result of last year s redemption of preferred stock issued under the Treasury s Capital Purchase Program. Information about U.S. Treasury capital programs is provided in Note 10 Shareholders Equity of this report.

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BALANCE SHEET REVIEW

Interest bearing deposits with banks

Overnight investments, comprised of interest bearing deposits with banks and federal funds sold, totaled approximately $34 million on September 30, 2012, compared to $20 million on December 31, 2011. The level of overnight investment at September 30, 2012, increased as funds from deposit growth temporarily outpaced the deployment of funds into loans and investment securities.

Securities available-for-sale

At September 30, 2012, the fair value of securities available-for-sale totaled approximately $239 million, which represented a 2 percent increase above the $234 million value at December 31, 2011. During the current year the portfolio of U.S. agency mortgage-backed instruments decreased due to selective sales, as previously discussed, and principal repayments. The addition of high grade municipal bonds during the current period increased the state and municipal bond portfolio. The composition of the Corporation s investment securities portfolio is provided in Note 3-Securities.

Loans

On September 30, 2012, total loans, net of deferred fees, totaled $733 million, which was $39 million or 6 percent higher than the year-end 2011 level due to an increase in commercial loans. The composition of the Corporation s loan portfolio at September 30, 2012, compared to December 31, 2011, is provided in Note 5 Loans.

Deposits

On September 30, 2012, deposits totaled $895 million, which was $41 million or 5 percent higher than the year-end 2011 level. The increase in total deposits occurred primarily within the demand, savings and money market categories while total time deposits increased slightly. The composition of the Corporation s deposit portfolio at September 30, 2012, is provided in Note 7 Deposits.

Long-term debt

On September 30, 2012, long-term debt totaled $36 million, which was $11 million or 23 percent below the year-end 2011 level. The decrease was primarily the result of a Federal Home Loan Bank of Pittsburgh advance that matured and was not refinanced. A listing of outstanding long-term debt obligations is provided in Note 8 Long-term Debt.

In June 2012, the Corporation restructured (i.e., extended) two outstanding $5 million FHLB advances ($10 million total) to lock in low rates as a hedge against the possibility of rising market interest rates in the future. This transaction resulted in a $235,000 prepayment penalty that has been deferred and embedded in the rates on the restructured advances where it will be recognized as interest expense over their respective repayment terms. The $5 million FHLB advance originally maturing December 2013 with a fixed rate of interest of 2.39 percent was extended to June 2019 with a fixed rate of interest of 2.10 percent. The $5 million FHLB advance originally maturing July 2014 with a fixed rate of interest of 1.38 percent was extended to June 2018 with a fixed rate of interest of 1.87 percent. The impact of the debt restructure on current period earnings is immaterial.

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Shareholders equity and capital adequacy

Shareholders equity, or capital, enables Codorus Valley to maintain asset growth and absorb losses. Total shareholders equity was approximately $100 million on September 30, 2012, an increase of approximately $7 million or 7 percent, compared to the level at December 31, 2011. The increase was primarily the result of an increase in retained earnings from profitable operations.

Dividends on preferred stock

As previously disclosed, the Corporation participates in the U.S. Department of the Treasury s (Treasury) Small Business Lending Fund Program (SBLF). Under this program, the Corporation issued $25 million, or 25,000 shares of non-cumulative, perpetual preferred stock, Series B, $1,000 liquidation value, $2.50 par value to the Treasury. The SBLF preferred stock qualifies as Tier 1 regulatory capital and requires the payment of non-cumulative cash dividends quarterly on each January 1, April 1, July 1 and October 1. The dividend rate was initially set at 5 percent, but can vary from 1 percent to 5 percent on a quarterly basis for a period of time to reflect the amount of change in qualified small business lending compared to a baseline amount. For the quarter ended September 30, 2012, accrued dividends totaled $62,000, which equated to an annualized dividend rate of 1.00 percent. Comparatively, for the quarters ended June 30 and March 31 of 2012, the annualized dividend rates were approximately 1.14 percent and 3.01 percent, respectively.

Dividends on common stock

The Corporation typically pays cash dividends on a quarterly basis. The Board of Directors determines the dividend rate after considering the Corporation s capital requirements, current and projected net income, and other factors. On October 9, 2012, the Board of Directors declared a quarterly cash dividend of $0.11 per common share payable on November 13, 2012, to shareholders of record at the close of business on October 23, 2012. This cash dividend follows an $0.11 per share cash dividend paid in August and a $0.09 per share cash dividend paid in May and February. Including the cash dividend that was just declared, cash dividends for 2012 will total $0.40 per share, representing an increase of $0.05 or 14 percent above the 2011 level. As adjusted for the 5 percent stock dividend that was recently declared (described below), cash dividends paid total $0.382 per share for 2012, compared to $0.334 per share for 2011.

Periodically, the Corporation distributes stock dividends on its common stock. On October 9, 2012, the Corporation declared a 5 percent common stock dividend payable on or before December 11, 2012, to shareholders of record at the close of business on October 23, 2012. Payment of this stock dividend is expected to result in the issuance of approximately 212,008 additional common shares.

Capital adequacy

Codorus Valley and PeoplesBank are subject to various regulatory capital requirements administered by banking regulators that involve quantitative guidelines and qualitative judgments. Quantitative measures established by regulators pertain to minimum capital ratios, as set forth in Note 9 Regulatory Matters, to the financial statements. We believe that Codorus Valley and PeoplesBank were well capitalized on September 30, 2012, based on regulatory capital guidelines.

On June 18, 2012, the federal regulatory agencies jointly issued a Notice of Proposed Rulemaking that would revise the general risk-based capital rules to incorporate certain revisions by the Basel Committee on Banking Supervision to the Basel capital framework (i.e., Basel III). Generally, the proposed rule revises the definition of regulatory capital components and related calculations, adds a new common equity tier 1 capital ratio, implements a new capital conservation buffer, increases the risk weighting for residential mortgages and past due loans, and provides a transition period for several aspects of the proposed rule. The proposed rule would become effective on January 1, 2013, with full implementation on January 1, 2019. The review and comment period on the proposal ended October 22, 2012. The Corporation plans to monitor the Basel III capital rule to ensure compliance, once finalized.

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RISK MANAGEMENT

Credit risk management

The Credit Risk Management section included in our 2011 Form 10-K provides a general overview of the Corporation s credit risk management process and loan concentrations. Credit risk represents the possibility that a loan client, counterparty or issuer may not perform in accordance with contractual terms, posing one of the most significant risks to the Corporation.

Nonperforming assets

The following table presents asset categories posing the greatest risk of loss and related ratios. We generally place a loan on nonaccrual status and cease accruing interest income, i.e., recognize interest income on a cash basis, as long as the loan is sufficiently collateralized, when loan payment performance is unsatisfactory and the loan is past due 90 days or more. Loans past due 90 days or more and still accruing interest represent loans that are contractually past due, but are well collateralized and in the process of collection. Foreclosed real estate represents real estate acquired to satisfy debts owed to PeoplesBank. The final category, troubled debt restructurings, pertains to loans whose terms have been modified to include a concession that we would not ordinarily consider due to the debtor s financial difficulties. Concessions granted under a troubled debt restructuring typically involve a reduction of interest rate lower than the current market rate for new debt with similar risk, the deferral of payments or extension of the stated maturity date. Troubled debt restructurings are evaluated for impairment if they have been restructured during the most recent calendar year, or if they cease to perform in accordance with the modified terms. The paragraphs below explain significant changes in the aforementioned categories as of September 30, 2012, compared to December 31, 2011.

An internal asset quality control committee meets monthly to review and manage nonperforming assets. Collection activity on these accounts is closely monitored and is managed by in-house legal counsel. We generally rely on appraisals performed by independent licensed appraisers to determine the value of collateral for impaired collateral-dependent loans. Generally, an appraisal is performed when: an account reaches 60 days past due, unless a certified appraisal was completed within the past six months; market values have changed significantly; the condition of the property has changed significantly; or the existing appraisal is outdated. In instances where the value of the collateral net of costs to sell is less than the net carrying amount for impaired commercial related loans, a specific loss allowance is established for the difference by recording a loss provision to the income statement. When it is probable that some portion or an entire loan balance will not be collected, that amount is charged off as loss against the allowance.

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Table 9 - Nonperforming Assets

(dollars in thousands)		**September 30, 2012**		**December 31, 2011**
Nonaccrual loans	$	9,501	$	5,931
Nonaccrual loans, troubled debt restructurings		2,123		5,770
Accruing loans 90 days or more past due		21		0
Total nonperforming loans		11,645		11,701
Foreclosed real estate, net of allowance		4,084		16,243
Total nonperforming assets	$	15,729	$	27,944
Accruing troubled debt restructurings	$	3,552	$	3,272
Total period-end loans, net of deferred fees	$	732,638	$	693,515
Allowance for loan losses (ALL)	$	8,787	$	8,702
ALL as a % of total period-end loans		1.20%		1.25%
Annualized net charge-offs as a % of average total loans		0.20%		0.58%
ALL as a % of nonperforming loans		75.46%		74.38%
Nonperforming loans as a % of total period-end loans		1.59%		1.69%
Nonperforming assets as a % of total period-end loans and net foreclosed real estate		2.14%		3.94%
Nonperforming assets as a % of total period-end assets		1.48%		2.76%
Nonperforming assets as a % of total period-end shareholders equity		15.69%		29.97%

The current level of nonperforming assets has decreased by approximately $12 million or 44 percent when compared to year-end 2011 as a result of recoveries from borrower payments and foreclosed real estate sales, loan charge-offs and the establishment of valuation allowances for selective accounts. While progress has been made in reducing nonperforming assets, we remain concerned about prolonged weak economic conditions and the corresponding effects it has on our commercial borrowers.

Nonaccrual loans

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

On September 30, 2012, the nonperforming loan portfolio balance totaled $11,645,000 and was comprised primarily of collateralized commercial loans. Comparatively, nonperforming loans totaled $11,701,000 at year-end 2011. During the quarter ended June 30, 2012, a nonaccrual troubled debt restructured loan totaling $3,557,000 paid off in full. During the quarter ended March 31, 2012, a commercial loan totaling $3,424,000 was reclassified to nonaccrual status described below as loan no. 1. On September 30, 2012, the nonaccrual loan portfolio was comprised of twenty unrelated loan relationships with outstanding principal balances ranging in size from $14,000 to $2,378,000. Five unrelated commercial relationships, which represent 69 percent of the nonperforming loan portfolio balance, are described below.

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Loan no. 1 At September 30, 2012, the outstanding principal balance of the loan relationship was $2,378,000 for a municipal development project, which reflects a payment totaling $1,046,000 received during the third quarter of 2012. During October 2012, the borrower paid off the principal balance of the loan in addition to $72,000 of interest income.

Loan no. 2 At September 30, 2012, the outstanding principal balance of the loan relationship was $2,124,000, collateralized by commercial rental properties whose rents are assigned to PeoplesBank. Based on a recent appraisal of the primary real estate collateralizing the relationship, we believe that the loans are adequately collateralized. The borrower is presently operating under a troubled debt restructuring agreement.

Loan no. 3 At September 30, 2012, the outstanding principal balance of the loan relationship was $1,349,000, collateralized by two commercial properties. Based on an independent appraisal of the real estate collateralizing the relationship, we believe that the loans are adequately collateralized. We are presently pursuing legal remedies to recover the amount due.

Loan no. 4 At September 30, 2012, the outstanding principal balance of the loan relationship was $1,280,000, which represents three commercial loans guaranteed from 70% to 80%, depending upon the specific loan, by the U.S. Department of Agriculture. A $120,000 allowance for loan losses was established for this relationship. Several parcels of improved real estate provide collateral for the loans. The Bank is working through the process to liquidate the real estate.

Loan no. 5 PeoplesBank owns a 62.5 percent participation interest in this loan relationship. The carrying value of the Bank s principal at September 30, 2012, was $856,000, which reflects a payment totaling $1,634,000 from the sale of collateral during January 2012. The Bank is pursuing its legal options against parties to the original loan agreement, including the liquidation of remaining collateral. As previously disclosed, PeoplesBank charged-off $2,275,000 as a loss in September 2011 due to deterioration in the value of the collateral.

Foreclosed real estate

On September 30, 2012, foreclosed real estate, net of allowance, totaled $4,084,000, compared to $16,243,000 at December 31, 2011. The $12,159,000 or 75 percent decrease was due primarily to the sale of real estate and secondarily to an increase in the allowance for real estate losses for selected properties. On September 30, 2012, the portfolio was comprised of five unrelated accounts ranging in size from $74,000 to $1,704,000, which we are actively attempting to liquidate, with the exception of property no. 2 below. If a valuation allowance for probable loss has been established for a particular property it is so noted in the property description below. Further valuation allowances may be required on any foreclosed property as additional information becomes available or conditions change. Foreclosed real estate is included in the other assets category on the Corporation s balance sheet. Four unrelated foreclosed real estate properties, which represent the majority of the foreclosed real estate portfolio balance, are described below.

Property no. 1 The carrying amount of this property at September 30, 2012 was $1,088,000, which is net of a $1,627,000 allowance for probable loss based on the results of an independent appraisal less estimated selling costs. During the third quarter of 2012, a $1,027,000 impairment loss and corresponding increase in the allowance were recognized as reported on Form 8-K filed on August 30, 2012. The impairment recorded in the third quarter follows a $308,000 impairment loss and corresponding increase in the allowance recorded in the second quarter of this year. This account is collateralized by 136 approved residential building lots. Of this total, 29 lots are improved. Management is evaluating its disposition options with regard to this property.

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Property no. 2 The carrying amount of this property at June 30, 2012 was $1,704,000, which is net of a $1,594,000 allowance for probable loss based on an independent appraisal less estimated selling costs. This account is collateralized by 266 acres of unimproved land that is zoned for residential development. Based on information obtained in 2012, plans to obtain a formal development plan were suspended with the intent to temporarily retain the property and investigate other development, disposition or income generating options at some future date. As a result, an impairment loss of approximately $320,000 and a corresponding increase to the allowance was recognized for this property in the first quarter of 2012.

Property no. 3 The carrying amount of this property at September 30, 2012 was $780,000, which represents the value of the borrower s personal residence presently listed for sale less estimated selling costs. In February 2012, the sale of unimproved land was completed and the Corporation received net proceeds totaling $837,000.

Property no. 4 PeoplesBank has a 64 percent interest in 42 improved lots within a 20.6 acre established residential subdivision, which represents the original collateral. The carrying value of PeoplesBank s interest at September 30, 2012 was $439,000, which is net of a $100,000 allowance for probable loss. During June 2010, a purchase agreement was executed which permitted the buyer to develop and sell the lots. Since inception of the agreement through September 30, 2012, 28 lots have been sold.

Allowance for loan losses

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

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

The following table presents an analysis of the activity in the allowance for loan losses for the nine months ended September 30, 2012 and 2011. The allowance was $8,787,000 or 1.20 percent of total loans on September 30, 2012, compared to $8,617,000 or 1.26 percent, on September 30, 2011. During the most recent nine-month period, net charge-offs totaled $1,065,000, which was well below the $3,794,000 for the first nine months of 2011. The level of charge-offs in the prior year were unusually high due to the inclusion of partial charge-offs for two unrelated loans totaling $3,175,000. The annualized net charge-off ratio was relatively low at 0.20 percent on September 30, 2012, compared to 0.77 percent on September 30, 2011. The risks and uncertainties associated with prolonged weakness in economic and business conditions, a relatively high level of unemployment and erosion of real estate values, which adversely affect our borrowers ability to service their loans, can cause significant fluctuations in the level of charge-offs and provision expense from one period to another. Based on a comprehensive analysis of the loan portfolio, we believe that the allowance for loan losses was adequate at September 30, 2012.

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Table 10 - Analysis of Allowance for Loan Losses

(dollars in thousands)	**2012**	**2011**
Balance-January 1,	$ 8,702	$ 7,626
Provision charged to operating expense	1,150	4,785
Loans charged off:		
Commercial, financial and agricultural	607	3,393
Real estate - construction and land development	2	0
Real estate - residential mortgages	115	141
Consumer and home equity	411	320
Total loans charged off	1,135	3,854
Recoveries:		
Commercial, financial and agricultural	14	5
Real estate - residential mortgages	41	0
Consumer and home equity	15	55
Total recoveries	70	60
Net charge-offs	1,065	3,794
Balance-September 30,	$ 8,787	$ 8,617
Ratios:		
Allowance for loan losses as a % of total period-end loans	1.20%	1.26%
Annualized net charge-offs as a % of average total loans	0.20%	0.77%
Allowance for loan losses as a % of nonperforming loans	75.46%	74.19%

Liquidity risk management

Maintaining adequate liquidity provides the Corporation with the ability to meet financial obligations to depositors, loan customers, employees, and shareholders on a timely and cost effective basis in the normal course of business. Additionally, it provides funds for growth and business opportunities as they arise. Liquidity is generated from transactions relating to both the Corporation s assets and liabilities. The primary sources of asset liquidity are scheduled investment security maturities and cash inflows, funds received from customer loan payments, and asset sales. The primary sources of liability liquidity are deposit growth, short-term borrowings and long-term debt. The Consolidated Statements of Cash Flows, included in this report, present the changes in cash from operating, investing and financing activities. At September 30, 2012, we believe that liquidity was adequate based upon the $34 million level of interest bearing deposits with banks, the potential liquidation of unpledged available-for-sale securities with a fair value totaling approximately $85 million and available credit from the Federal Home Loan Bank of Pittsburgh totaling approximately $159 million. The Corporation s loan-to-deposit ratio was 82 percent at September 30, 2012, compared to 81 percent for year-end 2011.

Off-balance sheet arrangements

The Corporation s financial statements do not reflect various commitments that are made in the normal course of business, which may involve some liquidity risk. These commitments consist primarily of commitments to grant new loans, unfunded commitments under existing loan facilities, and letters of credit issued under the same standards as on-balance sheet instruments. Unused commitments on September 30, 2012, totaled $203 million and consisted of $151 million in unfunded commitments under existing loan facilities, $36 million to grant new loans and $16 million in letters of credit. Normally these commitments have fixed expiration dates or termination clauses and are for specific purposes. Accordingly, many of the commitments are expected to expire without being drawn upon and therefore, generally do not present significant liquidity risk to the Corporation or PeoplesBank.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

Not applicable to smaller reporting companies.

Item 4. Controls and Procedures

The Corporation carried out an evaluation, under the supervision and with the participation of the Corporation s management, including the Corporation s Chief Executive Officer and Chief Financial Officer, of the effectiveness of its disclosure controls and procedures, as defined in Exchange Act Rules 13a-15(e) and 15d-15(e). Based upon the evaluation, the Corporation s Chief Executive Officer and Chief Financial Officer concluded that, as of September 30, 2012, the Corporation s disclosure controls and procedures are effective. The Corporation s disclosure controls and procedures are designed to provide reasonable, not absolute, assurance that information required to be disclosed in the Corporation s reports filed or submitted under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission s rules and forms. A control system, no matter how well conceived and operated, must reflect the fact that there are resource constraints, that the benefits of controls must be considered relative to their costs, and inherent limitations that may not prevent fraud, particularly by collusion of two or more people or by management override of a control.

There has been no change in the Corporation s internal control over financial reporting that occurred during the quarter ended September 30, 2012, that has materially affected or is reasonably likely to materially affect, the Corporation s internal control over financial reporting.

Part II OTHER INFORMATION

Item 1. Legal proceedings

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

Item 1A. Risk factors

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

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

The Corporation relies on its subsidiary PeoplesBank, A Codorus Valley Company, for dividend distributions, which are subject to restrictions as reported in Note 9 Regulatory Matters of the Corporation s Annual Report on Form 10-K for the year ended December 31, 2011.

Item 3. Defaults upon senior securities

The Corporation has nothing to report under this Item 3.

Item 4. Mine safety disclosures

This Item 4 is not applicable to the Corporation.

Item 5. Other information

The Corporation has nothing to report under this Item 5.

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Item 6. Exhibits

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

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Signatures

Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned there unto duly authorized.

	Codorus Valley Bancorp, Inc. (Registrant)
November 13, 2012 Date	/s/ Larry J. Miller Larry J. Miller President & CEO (Principal Executive Officer)
November 13, 2012 Date	/s/ Jann A. Weaver Jann A. Weaver Treasurer & Assistant Secretary (Principal Financial and Accounting Officer)