CODORUS VALLEY BANCORP INC
Form 10-K
March 28, 2013
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UNITED STATES SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K

(Mark One)
x Annual Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934
For the fiscal year ended December 31, 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)

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

Securities registered pursuant to Section 12(b) of the Act:

Title of each class	Name of each exchange on which registered
Common Stock, $2.50 par value	**NASDAQ Stock Market LLC**

Securities registered pursuant to Section 12(g) of the Act: **None**

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.
o Yes x No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15 (d) of the Act.
o Yes x No

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. x Yes o No

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

Indicate by check mark if the disclosure of delinquent filers pursuant to Item 405 of Regulation S-K (§229.405 of this chapter) is not contained herein, and will not be contained, to the best of the registrant s knowledge, in the definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. x

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.
o Yes x No

The aggregate market value of Codorus Valley Bancorp, Inc. s voting stock held by non-affiliates was approximately $53,567,116 as of June 29, 2012.

As of March 6, 2013, Codorus Valley Bancorp, Inc. had 4,487,856 shares of common stock outstanding, par value $2.50 per share.

DOCUMENTS INCORPORATED BY REFERENCE

Part III incorporates certain information by reference to the registrant s Proxy Statement for the Annual Meeting of Shareholders to be held May 21, 2013.

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PART I

Item 1: Business

Codorus Valley Bancorp, Inc. (Codorus Valley or the Corporation) is a Pennsylvania business corporation, incorporated on October 7, 1986. On March 2, 1987, Codorus Valley became a bank holding company under the Bank Holding Company Act of 1956. PeoplesBank, A Codorus Valley Company (PeoplesBank) is its wholly owned bank subsidiary. SYC Realty Co., Inc. is its wholly owned nonbank subsidiary. Codorus Valley s business consists primarily of managing PeoplesBank, and its principal source of income is dividends received from PeoplesBank. On December 31, 2012, Codorus Valley had total consolidated assets of $1.06 billion, total deposits and other liabilities of $958.4 million, and total shareholders equity of $101.3 million.

Bank subsidiary

PeoplesBank, organized in 1934, is a Pennsylvania chartered bank that offers a full range of business and consumer banking services through eighteen financial centers located throughout York County, Pennsylvania and in Hunt Valley, Bel Air and Westminster, Maryland. PeoplesBank, with origins dating back to 1864, is focused on acquiring and nurturing financial relationships with small and mid-sized businesses. It also provides personal banking, mortgage banking, wealth management and real estate settlement services. The Federal Deposit Insurance Corporation insures the deposits of PeoplesBank to the maximum extent provided by law. On December 31, 2012, PeoplesBank had total gross loans of $738 million, excluding loans held for sale, and total deposits of $902 million. PeoplesBank had the second largest share of deposits in York County, PA with deposits totaling 13.1 percent of the market as of June 30, 2012, the latest available measurement date.

PeoplesBank is not dependent on deposits of, or exposed to a loan concentration to, a single customer, or a small group of customers. Therefore, the loss of a single customer, or a small customer group, would not have a material adverse effect on the financial condition of PeoplesBank. At year-end 2012, the largest indebtedness of a single PeoplesBank customer was $12,932,000, or 1.8 percent of the total loan portfolio, which was within PeoplesBank s regulatory lending limit.

Most of the Corporation s business is with customers in York County, Pennsylvania and northern Maryland. Although this limited market area may pose a concentration risk geographically, we believe that the diverse local economy and our detailed knowledge of the customer base lessens this risk. At year-end 2012 and 2011, the Corporation had two industry concentrations that exceeded 10 percent of the total loan portfolio: builder and developer were 13.2 percent and 14.9 percent of the portfolio at December 31, 2012 and 2011, respectively; and commercial real estate investor was 16.6 percent and 17.0 percent of the portfolio, respectively. Loans to borrowers within these industries are usually collateralized by real estate.

Nonbank subsidiaries of PeoplesBank

Codorus Valley Financial Advisors, Inc. is a wholly owned subsidiary of PeoplesBank that sells non-deposit investment products. This subsidiary began operations in January 2000 and, prior to a name change in December 2005, operated under the name SYC Insurance Services, Inc. SYC Settlement Services, Inc. is a wholly owned subsidiary of PeoplesBank that has provided real estate settlement services since January 1999. Periodically, PeoplesBank creates nonbank subsidiaries for the purpose of temporarily holding foreclosed properties pending liquidation. On December 31, 2012, only one of these subsidiaries was active. The operations of nonbank subsidiaries are consolidated for financial reporting purposes.

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Nonbank subsidiaries of Codorus Valley Bancorp, Inc.

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 100 percent of the common stock of these nonbank subsidiaries, which are not consolidated for financial reporting purposes. These obligations are reported as junior subordinated debt on the Corporation s balance sheet.

On June 20, 1991, SYC Realty was incorporated as a wholly owned subsidiary of Codorus Valley. Codorus Valley created this nonbank subsidiary primarily for the purpose of holding foreclosed properties obtained by PeoplesBank pending liquidation of those properties. SYC Realty commenced business operations in October 1995.

Employees

At year-end 2012, PeoplesBank employed 200 full-time employees and 36 part-time employees, which equated to approximately 219 full-time equivalent employees. Employees are not covered by a collective bargaining agreement, and PeoplesBank considers its relations with employees to be satisfactory.

Segment reporting

Management has determined that it operates in only one segment, community banking. The Corporation s non-banking activities are insignificant to the consolidated financial statements.

Competition

The banking industry in PeoplesBank s service area, principally York County, Pennsylvania, and northern Maryland, specifically, Baltimore, Harford and Carroll counties, is extremely competitive. PeoplesBank competes through service and price and by leveraging its hometown image. It competes with commercial banks and other financial service providers, such as thrifts, credit unions, consumer finance companies, investment firms and mortgage companies. Some financial service providers operating in PeoplesBank s service area operate on a national and regional scale and possess resources that are greater than PeoplesBank s.

Supervision and regulation

Federal Reserve System

Codorus Valley is registered as a bank holding company, and is subject to regulation by the Board of Governors of the Federal Reserve System (Federal Reserve), under the Bank Holding Company Act of 1956, as amended. The Bank Holding Company Act requires bank holding companies to file periodic reports with, and subjects them to examination by, the Federal Reserve. The Federal Reserve has issued regulations under the Bank Holding Company Act that require a bank holding company to serve as a source of financial and managerial strength to its subsidiary banks. As a result, the Federal Reserve may require Codorus Valley to use its resources to provide adequate capital funds to PeoplesBank during periods of financial stress or adversity.

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The Bank Holding Company Act prohibits Codorus Valley from acquiring direct or indirect control of more than 5 percent of the outstanding voting stock of any bank, or substantially all of the assets of any bank, or merging with another bank holding company, without the prior approval of the Federal Reserve. The Pennsylvania Department of Banking must also approve certain similar transactions. Pennsylvania law permits Pennsylvania bank holding companies to control an unlimited number of banks.

The Bank Holding Company Act restricts Codorus Valley to activities that the Federal Reserve has found to be closely related to banking, and which are expected to produce benefits for the public that will outweigh any potentially adverse effects. Therefore, the Bank Holding Company Act prohibits Codorus Valley from engaging in most nonbanking businesses, or acquiring ownership or control of more than 5 percent of the outstanding voting stock of any company engaged in a nonbanking business, unless the Federal Reserve has determined that the nonbanking business is closely related to banking. Under the Bank Holding Company Act, the Federal Reserve may require a bank holding company to end a nonbanking business if it constitutes a serious risk to the financial soundness and stability of any bank subsidiary of the bank holding company.

The Federal Reserve Act imposes restrictions on a subsidiary bank of a bank holding company, such as PeoplesBank. The restrictions affect extensions of credit to the bank holding company and its subsidiaries, investments in the stock or other securities of the bank holding company and its subsidiaries, and taking such stock or securities as collateral for loans. The Federal Reserve Act and Federal Reserve regulations also place limitations and reporting requirements on extensions of credit by a bank to the principal shareholders of its parent holding company, among others, and to related interests of such principal shareholders. In addition, such legislation and regulation may affect the terms upon which any person becoming a principal shareholder of a holding company may obtain credit from banks with which the subsidiary bank maintains a correspondent relationship.

PeoplesBank and the banking industry, in general, are affected by the monetary and fiscal policies of the U.S. Treasury and government agencies, including the Federal Reserve. Through open market securities transactions, changes in its federal funds and discount rates and reserve requirements, the Federal Reserve exerts considerable influence over the cost and availability of funds for lending and investment.

U.S. Department of the Treasury

The U.S. Department of the Treasury (Treasury) has a capital investment in the Corporation pursuant to the Corporation s participation in the Treasury s Small Business Lending Funding Program (SBLF Program). In August 2011, the Corporation sold to the Treasury, for an aggregate purchase price of $25 million, 25,000 shares of non-cumulative, perpetual preferred stock, Series B, $1,000 liquidation value, $2.50 par value. Proceeds from the SBLF Program were used in part to redeem $16.5 million of outstanding Series A preferred stock previously issued to the Treasury under its Capital Purchase Program (CPP) and to repurchase a related CPP common stock warrant. These transactions were previously disclosed in filings with the SEC. The terms of the SBLF Preferred Stock Agreement impose limits on the ability of the Corporation to pay dividends and repurchase shares of common stock, as disclosed within Note 10 Shareholders Equity to the consolidated financial statements.

Pennsylvania Department of Banking

The operations of PeoplesBank are subject to state statutes applicable to banks chartered under the banking laws of the Commonwealth of Pennsylvania. Pennsylvania business and banking laws restrict dividend payments if such payment would render the Corporation insolvent or result in negative net worth, and the Corporation and PeoplesBank are subject to regulatory capital requirements. More information about dividend restrictions and capital requirements can be found in Note 9 Regulatory Matters in the notes to the consolidated financial statements.

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State and federal banking laws and regulations govern such things as: the scope of a bank s business; permissible investments; the reserves against deposits a bank must maintain; the types and terms of loans a bank may make and the collateral it may take; the activities of a bank with respect to mergers and consolidations; the establishment of branches; and the sale of non-deposit investment products by the bank and its insurance subsidiary. The Pennsylvania Insurance Department, the Securities and Exchange Commission (SEC) and the Financial Industry Regulatory Authority (FINRA) control and supervise the licensing and activities of employees engaged in the sale of non-deposit investment products.

Federal Deposit Insurance Corporation (FDIC)

The FDIC is the primary federal regulator of PeoplesBank. It regularly examines banks in such areas as capital, asset quality, management, earnings, liquidity and sensitivity to market risk and other aspects of operations and requires that PeoplesBank furnish annual and quarterly reports. Examinations by the FDIC are designed for the protection of PeoplesBank s depositors rather than Codorus Valley s shareholders. The FDIC provides deposit insurance to banks, which covers all deposit accounts. The standard maximum insurance amount is $250,000 per depositor.

PeoplesBank pays deposit insurance premiums to the FDIC based on a risk-based assessment formula established by the FDIC for Deposit Insurance Fund (DIF) member institutions. Institutions are classified into one of four risk categories and pay premiums according to perceived risk to the FDIC s DIF. PeoplesBank has consistently been a risk category I institution, the least risky category. Institutions in risk categories II, III and IV are assessed premiums at progressively higher rates.

As a means of funding the FDIC s DIF, banks were required to prepay several years of deposit insurance premiums. In accordance with the FDIC s final rule in November 2009 pertaining to prepaid assessments for the banking industry, PeoplesBank prepaid approximately $4.4 million to the FDIC on December 30, 2009. This prepaid amount represented an accumulation of regular quarterly assessments projected by the FDIC through the year 2012. Insured institutions recorded the entire prepaid assessment as a prepaid asset subject to amortization of an appropriate amount to expense each quarter to coincide with quarterly FDIC assessment notices. At December 31, 2012, the Corporation had a prepaid asset balance of approximately $1.3 million, which is expected to be returned to the Corporation by the FDIC in June 2013. Beginning in the year 2013, the Corporation will accrue the cost of FDIC premiums in anticipation of quarterly assessments by the FDIC.

In February 2011, the FDIC announced its final rule pertaining to, among other things, changes in the computation of risk-based insurance premiums as mandated by the Dodd-Frank Wall Street Reform and Consumer Protection Act. The final rule, which took effect April 1, 2011, changed the assessment base from domestic deposits to average assets minus average tangible equity, i.e., Tier 1 capital, and lowered assessment rates. For insured member institutions below $10 billion in total assets, the four risk categories framework mentioned earlier continues to apply. For the least risky category I institutions, such as PeoplesBank, the assessment rate range of 7 to 24 basis points on domestic deposits decreased to 2.5 to 9 basis points on total average assets minus average tangible equity. The final rule eliminated risk categories for large institutions with total assets of $10 billion or more. Instead, their assessment rates are now calculated using a scorecard that combines regulatory ratings and certain forward financial measures to assess the risk a large institution poses to the DIF. Generally, the change in the assessment methodology by the FDIC lowered deposit insurance premiums for community banks like PeoplesBank.

Effective January 1, 2012, PeoplesBank became subject to FDIC regulation 363.3(b), which requires depository institutions with total assets of $1 billion or more to engage an independent public accountant to examine, attest to, and report on the assertion of management concerning the institution s internal control structure and procedures for financial reporting.

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Requirements of federal agencies that affect the Corporation and PeoplesBank

Small Business Jobs and Credit Act of 2010 In September 2010, President Obama signed into law the Small Business Jobs and Credit Act of 2010, which created the Small Business Lending Fund (SBLF). Under the SBLF the U.S. Treasury (Treasury) was authorized to make a capital investment of up to $30 billion by purchasing securities in participating community banks, principally in the form of senior preferred stock, that agree to use the funds to increase small-business lending. The SBLF limits the investment by the Treasury to 5 percent of risk-weighted assets for participating banks with total assets of $1 billion or less, and to 3 percent of risk-weighted assets for participating banks with more than $1 billion but less than $10 billion of total assets. Although the dividend rate was initially set at 5 percent, a participating community bank can decrease the dividend rate to as low as 1 percent by increasing its qualifying small business lending portfolio balance by at least 10 percent above a baseline portfolio balance. However, four and a half years after issuance, the dividend rate on SBLF securities will increase to 9 percent regardless of the level of small business lending. The SBLF provides community banks with a relatively inexpensive form of Tier 1 capital and also provides an attractive option for community banks to refinance preferred stock issued to the Treasury pursuant to its Capital Purchase Program. Accordingly, the Corporation participated in the SBLF program during the year 2011 and continues to participate in this program as discussed within the Shareholders Equity and Capital Adequacy section of this report.

Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) In July 2010, the Dodd-Frank Act was enacted to improve accountability and transparency in the financial system, to attempt to end too big to fail pertaining to large, troubled financial institutions, to protect the American taxpayer by ending governmental bailouts, to protect consumers from abusive financial services practices and for other purposes. The Dodd-Frank Act is broad and complex legislation that puts in place a sweeping new financial services regime that will have significant regulatory and legal consequences for banks now and for years to come. The effects of the Dodd-Frank Act on the financial services industry will depend, in large part, upon the extent to which regulators exercise the authority granted to them under the Dodd-Frank Act and the approaches taken in implementing regulations. Additional uncertainty regarding the effect of the Dodd-Frank Act exists due to the potential for additional legislative changes to the Dodd-Frank Act. The Corporation, as well as the broader financial services industry, is continuing to assess the potential impact of the Dodd-Frank Act on its business and operations, but at this stage, the extent of the impact cannot be determined with any degree of certainty. However, the Corporation is likely to be impacted by the Dodd-Frank Act in the areas of corporate governance, deposit insurance assessments, capital requirements, risk management, stress testing, and regulation under consumer protection laws. The Dodd-Frank Act:

- Provides extensive authorities to the federal bank regulatory agencies and, in particular, the Board of Governors of the Federal Reserve, to take proactive steps to reduce or eliminate threats to the safety of the financial system, impose strict controls on large bank holding companies ($50 billion or more) and nonbank financial companies to limit their risk, and take direct control of troubled financial companies considered systemically significant;

- Increases bank supervision by restructuring the supervision of holding companies and depository institutions. Establishes the equivalent of a prompt corrective action program for large bank holding companies. Requires that capital requirements for holding companies be at least as strict as capital requirements for depository institutions. Disallows new issuances of preferred securities to qualify for Tier 1 capital treatment. Directs federal bank regulators to develop specific capital requirements for holding companies and depository institutions that address activities that pose risk to the financial system, such as significant activities in higher risk areas, or concentrations in assets whose reported values are based on models;

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Establishes the Bureau of Consumer Financial Protection (Bureau) as an independent entity within the Federal Reserve System that will assume responsibility for most consumer protection laws. The Bureau will have authority to supervise, examine and take enforcement action with respect to depository institutions with more than $10 billion in assets and nonbank mortgage industry participants and other designated nonbank providers of consumer financial services;

Places certain limitations on investment and other activities by depository institutions, holding companies and their affiliates. Banks and their affiliates face strict limits on investment in, and sponsoring of, hedge funds and private equity funds. The coverage of Section 23A of the Federal Reserve Act is expanded to include the credit exposure related to additional transactions, including derivatives. New restrictions are imposed on acquisitions that would result in a financial services company controlling more than 10 percent of the consolidated aggregate liabilities of all financial companies; and

Significantly increases the regulation of mortgage lending and servicing by banks and nonbanks. Requires mortgage originators to ensure that the consumer will have the capacity to repay the loan and mandates loan related disclosures. Requires mortgage loan securitizers to retain a certain amount of risk, unless the mortgages conform to the new regulatory standards as qualified residential mortgages.

American Recovery and Reinvestment Act of 2009 (ARRA) In February 2009, the ARRA was enacted by the U.S. Congress in response to the recent financial crisis. The basic intent behind the ARRA was to preserve jobs and promote economic recovery, to assist those most impacted by the recession, to provide investments needed to increase efficiency by spurring technological advances in science and health, to invest in transportation and environmental protection and other infrastructure that will provide long-term economic benefits, and to stabilize state and local government budgets, in order to minimize and avoid reductions in essential services and counterproductive state and local taxes.

Emergency Economic Stabilization Act of 2008 (EESA) In October of 2008, the EESA, also known as the Troubled Asset Relief Act (TARP), was enacted. Under TARP, the U.S. Department of the Treasury initiated a Capital Purchase Program (CPP), which allowed qualified financial institutions to issue preferred stock to the Treasury, subject to certain limitations and terms. The EESA was developed to attract broad participation by strong financial institutions to stabilize the financial system and increase lending to benefit the national economy and U.S. citizens. As previously reported, in January 2009, the Corporation sold 16,500 shares of nonvoting Series A perpetual preferred stock and a common stock warrant to the Treasury and received $16.5 million in capital funds. Also as previously reported in August 2011 the Corporation redeemed all outstanding shares of Series A CPP preferred stock, and in September 2011 it repurchased the outstanding CPP common stock warrant. More information about this capital transaction is provided within the Shareholders Equity and Capital Adequacy section of this report.

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Sarbanes-Oxley Act of 2002 The Sarbanes-Oxley Act (SOA) was signed into law in July 2002 and applies to all companies, both U.S. and non-U.S, that file periodic reports under the Securities Exchange Act of 1934. The stated goals of the SOA were to increase corporate responsibility, to provide for enhanced penalties for accounting and auditing improprieties at publicly traded companies and to protect investors by improving the accuracy and reliability of corporate disclosures pursuant to the securities laws. The SEC is responsible for establishing rules to implement various provisions of the SOA. The SOA includes specific disclosure requirements and corporate governance rules, requires the SEC and securities exchanges to adopt extensive additional disclosure, corporate governance and other related rules and mandates further studies of certain issues by the SEC. The SOA represents significant regulation of the accounting profession and corporate governance practices, such as the relationship between a board of directors and management and between a board of directors and its committees. Section 404 of the SOA became effective for the year ended December 31, 2004, for companies whose public float (i.e., the product of outstanding common shares held by non-affiliates times the share price as of the last business day of the registrant s most recently completed second fiscal quarter) was above $75 million. For smaller companies (non-accelerated and smaller reporting company filers), including Codorus Valley, the effective date was the fiscal year ending on or after December 15, 2007. Section 404 requires publicly held companies to document, test and certify that their internal control systems over financial reporting are effective. During 2010, the Dodd-Frank Act permanently exempted public companies with common stock capitalization of less than $75 million from the independent auditor attestation requirements of the SOA. Effective December 31, 2012, PeoplesBank became subject to independent auditor attestation under FDIC regulation 363.3(b) due to its asset size, which is essentially equivalent to the SEC s independent attestation requirement under Section 404 of the SOA.

USA Patriot Act of 2001 In October of 2001, the USA Patriot Act of 2001 was enacted to strengthen U.S. law enforcement s and the intelligence communities abilities to work cohesively to combat terrorism on a variety of fronts. The Patriot Act contains sweeping anti-money laundering and financial transparency laws and imposes various regulations on financial institutions, including standards for verifying client identification at account opening, and rules to promote cooperation among financial institutions, regulators and law enforcement entities in identifying parties that may be involved in terrorism or money laundering.

Periodically, various types of federal and state legislation are proposed that could result in additional regulation of, and restrictions on, the business of Codorus Valley and PeoplesBank. It cannot be predicted whether such legislation will be adopted or, if adopted, how such legislation would affect the business of Codorus Valley and its subsidiaries. As a consequence of the extensive regulation of commercial banking activities in the United States of America, Codorus Valley and PeoplesBank s business is particularly susceptible to being affected by federal legislation and regulations. The general cost of compliance with numerous and multiple federal and state laws and regulations does have, and in the future may have, a negative impact on Codorus Valley s results of operations.

Other information

This Annual Report on Form 10-K is filed with the Securities and Exchange Commission (SEC). Copies of this document, the Quarterly Report on Form 10-Q, Current Reports on Form 8-K, amendments to those reports and other SEC filings by Codorus Valley Bancorp, Inc. may be obtained electronically at PeoplesBank s website at www.peoplesbanknet.com (select Investor Relations, then select SEC filings, then select Documents), or the SEC s website at www.sec.gov/edgarhp.htm. Copies can also be obtained without charge by writing to: Treasurer, Codorus Valley Bancorp, Inc., P.O. Box 2887, York, PA 17405-2887.

Item 1A: Risk factors

Not applicable to smaller reporting companies.

Item 1B: Unresolved staff comments

Not applicable.

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Item 2: Properties

Codorus Valley Bancorp, Inc. owns the Codorus Valley Corporate Center (Corporate Center), subject to a $1.2 million lien held by its wholly owned subsidiary, PeoplesBank. The Corporate Center is located at 105 Leader Heights Road, York Township, York, PA. This facility serves as the corporate headquarters and is approximately 40,000 square feet, a portion of which is leased to third-parties. The Corporate Center is adjacent to PeoplesBank s Data Operations Center and the Leader Heights banking office.

PeoplesBank operates 18 branch banking offices. Of this total, 6 are owned by PeoplesBank without liens and located in York County, PA, and 12 are leased by PeoplesBank and are located in York County, PA, and in Baltimore, Carroll and Harford Counties in Maryland.

Plans call for the construction of a full-service branch office in Dover, PA on a building lot purchased by PeoplesBank in October 2012. The new office has all necessary regulatory approvals and is expected to be operational by the fall of 2013. Additionally, management is seeking regulatory approval to establish a full-service branch office in Hanover, PA. The branch will be operated out of leased office space and, subject to regulatory approval, is scheduled to be operational in May 2013.

We believe that the above properties owned and leased by the Corporation and its subsidiary are adequate for present levels of operation.

Item 3: 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 financial position and/or operating results of the Corporation. Management is not aware of any proceedings known or contemplated by governmental authorities.

Item 4: Mine safety disclosures

Not applicable.

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PART II

Item 5: Market for registrant s common equity, related shareholder matters and issuer purchases of equity securities

Market information

The common shares of Codorus Valley Bancorp, Inc. are traded on the NASDAQ Global Market under the symbol CVLY. Codorus Valley had approximately 1,991 holders of record as of March 6, 2013. The closing price per share of Codorus Valley s common stock on March 6, 2013, was $16.37. The following table sets forth high and low sales prices and dividends paid per common share for Codorus Valley as reported by NASDAQ during the periods indicated. All amounts reflect the impact of the 5 percent common stock dividend distributed by the Corporation on December 11, 2012.

	2012			2011		
Quarter	High	Low	Dividends per share	High	Low	Dividends per share
First	$ 10.67	$ 7.89	$ 0.086	$ 10.70	$ 8.86	$ 0.076
Second	13.22	10.26	$ 0.086	10.71	9.54	$ 0.086
Third	15.39	12.62	$ 0.105	10.48	8.33	$ 0.086
Fourth	16.00	13.52	$ 0.105	9.29	7.84	$ 0.086

Dividend policy

Codorus Valley has a long history of paying quarterly cash dividends on its common stock. Codorus Valley presently expects to pay future cash dividends; however, the payment of such dividends will depend primarily upon the earnings of its subsidiary, PeoplesBank. Management anticipates that substantially all of the funds available for the payment of cash dividends by Codorus Valley will be derived from dividends paid to it by PeoplesBank. The payment of cash dividends is also subject to restrictions on dividends and capital requirements as reported in Note 9-Regulatory Matters in the notes to the consolidated financial statements.

The Corporation s participation in the U.S. Department of the Treasury s Small Business Lending Fund Program, previously disclosed in filings with the SEC, requires the payment of non-cumulative dividends quarterly on each January 1, April 1, July 1 and October 1 on the $25 million of Series B preferred stock issued to the Treasury on August 18, 2011, under its SBLF Program. The dividend rate can fluctuate on a quarterly basis for 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 under which the SBLF preferred stock was purchased by the Treasury) 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 to between one percent and five percent per annum to reflect the amount of change in the Bank s level of QSBL. If the level of the Bank s qualified small business loans declines so that the percentage increase in QSBL as compared to the baseline level is less than 10 percent, then the dividend rate payable on the SBLF Preferred Stock would increase. For the tenth calendar quarter through four and one-half years after issuance, the dividend rate will be fixed at between one percent and seven percent 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 percent (including a quarterly lending incentive fee of 0.5 percent). The terms of the SBLF Preferred Stock Agreement impose limits on the ability of the Corporation to pay dividends and repurchase shares of common stock, as discussed in Note 10-Shareholders Equity in the notes to the consolidated financial statements.

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Prior to August 18, 2011, the Corporation paid quarterly cash dividends of 5 percent per annum on $16.5 million of Series A preferred stock that it sold to the Treasury on January 9, 2009, under Treasury s Capital Purchase Program. The Series A preferred stock was subsequently redeemed on August 18, 2011 to coincide with the issuance of Series B preferred stock under the SBLF Program, as required by the Treasury.

Securities authorized for issuance under equity compensation plans

The following table provides information about options outstanding and securities available for future issuance under the Corporation s 2000 Stock Incentive Plan, 2001 Employee Stock Bonus Plan, 2007 Long Term Incentive Plan and 2007 Employee Stock Purchase Plan.

Equity Compensation Plan Information

Plan Category	Number of securities to be issued upon exercise of outstanding options, warrants and rights	Weighted-average exercise price of outstanding options, warrants and rights	Number of securities remaining available for future issuance under equity compensation plans (excluding securities reflected in the first column)
Equity compensation plans approved by security holders	254,184	$ 10.70	402,162(1)
Equity compensation plans not approved by security holders	0	0	15,007(2)
Total	254,184	$ 10.70	417,169

(1) Includes 172,668 shares available for issuance under the 2007 Employee Stock Purchase Plan.
(2) Shares available for issuance under the 2001 Employee Stock Bonus Plan that provides for shares of common stock to employees as performance-based compensation.

Purchases of equity securities by the issuer and affiliated purchasers

For the years ended December 31, 2012 and 2011, the Corporation did not acquire any of its common stock under the current repurchase program.

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Item 6: Selected financial data

Codorus Valley Bancorp, Inc.

	2012	2011	2010	2009	2008
Summary of operations *(in thousands)*					
Interest income	$ 46,512	$ 45,411	$ 44,027	$ 40,310	$ 36,732
Interest expense	10,527	12,359	13,154	16,358	15,809
Net interest income	35,985	33,052	30,873	23,952	20,923
Provision for loan losses	1,750	4,935	2,990	3,715	1,870
Noninterest income	8,190	7,358	7,574	7,497	6,665
Noninterest expense	29,928	27,079	28,116	24,491	20,044
Income before income taxes	12,497	8,396	7,341	3,243	5,674
Provision (benefit) for income taxes	3,103	1,617	1,133	(191)	1,209
Net income	9,394	6,779	6,208	3,434	4,465
Preferred stock dividends and discount accretion	384	1,460	980	957	0
Net income available to common shareholders	$ 9,010	$ 5,319	$ 5,228	$ 2,477	$ 4,465
Per common share *(adjusted for stock dividends)*					
Net income, basic	$ 2.03	$ 1.22	$ 1.22	$ 0.58	$ 1.07
Net income, diluted	$ 2.00	$ 1.21	$ 1.21	$ 0.58	$ 1.07
Cash dividends paid	$ 0.382	$ 0.334	$ 0.238	$ 0.248	$ 0.488
Stock dividends distributed	5%				5%
Book value	$ 17.03	$ 15.46	$ 13.81	$ 12.95	$ 12.37
Tangible book value	$ 17.03	$ 15.42	$ 13.75	$ 12.87	$ 12.29
Cash dividend payout ratio	18.8%	27.3%	19.6%	42.3%	45.1%
Weighted average shares outstanding	4,441,498	4,366,478	4,297,852	4,245,056	4,164,296
Weighted average diluted shares outstanding	4,502,153	4,394,258	4,304,449	4,245,056	4,190,504
Profitability ratios					
Return on average shareholders equity (ROE)	9.55%	8.04%	8.12%	4.88%	8.91%
Return on average assets (ROA)	0.90%	0.69%	0.67%	0.41%	0.71%
Net interest margin	3.81%	3.73%	3.72%	3.18%	3.63%
Efficiency ratio	65.65%	64.20%	69.87%	74.63%	70.59%
Net overhead ratio	2.13%	2.02%	2.24%	2.07%	2.14%
Capital ratios					
Tier 1 risk-based capital	13.59%	13.35%	12.51%	11.83%	10.03%
Total risk-based capital	14.79%	14.55%	13.64%	12.90%	10.80%
Average shareholders equity to average assets	9.45%	8.56%	8.29%	8.43%	7.94%
Summary of financial condition at year-end *(in thousands)*					
Investment securities	$ 236,925	$ 237,496	$ 226,603	$ 178,454	$ 77,287
Loans	740,225	696,384	645,839	647,143	580,451
Assets	1,059,737	1,012,132	957,332	892,831	702,766
Deposits	901,307	854,399	806,110	722,957	598,129
Borrowings	50,171	56,885	68,805	92,748	47,779
Equity	101,331	93,242	76,539	72,012	52,181
Other data					
Number of bank offices	18	18	17	17	17
Number of employees (*full-time equivalents*)	219	203	198	201	200
Wealth Management assets, market value (*in thousands*)	$ 329,626	$ 277,505	$ 368,985	$ 325,482	$ 261,153

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Item 7: 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 Annual Report on Form 10-K. These forward-looking statements may be 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 are used in this Form 10-K, 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-K. 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, 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 analyses 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 estimates

Disclosure of Codorus Valley s significant accounting policies is included in Note 1 in the notes to the consolidated financial statements of this Form 10-K. Some of these policies require management to make significant judgments, estimates and assumptions that have a material impact on the carrying value of certain assets and liabilities.

Management makes significant estimates in determining the allowance for loan losses, valuation of foreclosed real estate, and evaluation of other-than-temporary impairment losses of securities. Management considers a variety of factors in establishing allowance for loan losses such as current economic conditions, diversification of the loan portfolio, delinquency statistics, results of internal loan reviews, financial and managerial strength of borrowers, adequacy of collateral, (if collateral dependent, or present value of future cash flows) and other relevant factors. There is also the potential for adjustment to the allowance for loan losses as a result of regulatory examinations. Foreclosed real estate is initially recorded at fair value minus estimated costs to sell at the date of foreclosure, establishing a new cost basis. Appraisals are generally used to determine fair value. After foreclosure, management reviews valuations at least quarterly and adjusts the asset to the lower of cost or fair value minus estimated costs to sell. Estimates related to the value of collateral can have a significant impact on whether or not management continues to accrue income on delinquent and impaired loans and on the amounts at which foreclosed real estate is recorded on the statement of financial condition.

The Corporation records its available-for-sale securities portfolio at fair value. Fair values for these securities are determined based on methodologies in accordance with FASB Accounting Standards Codification (ASC) Topic 820. Fair values for debt securities are volatile and may be influenced by any number of factors, including market interest rates, prepayment speeds, discount rates, credit ratings and yield curves. Fair values for debt securities are based on quoted market prices, where available. If quoted market prices are not available, fair values are based on the quoted prices of similar instruments or an estimate of fair value by using a range of fair value estimates in the market place as a result of the illiquid market specific to the type of security. When the fair value of a debt security is below its amortized cost and depending on the length of time the condition exists and the extent the fair value is below amortized cost, additional analysis is performed to determine whether an other-than-temporary impairment condition exists. Debt securities are analyzed quarterly for possible other-than-temporary impairment. The analysis considers whether the Corporation has the intent to sell its debt securities prior to market recovery or maturity and whether it is more likely than not that the Corporation will be required to sell its debt securities prior to market recovery or maturity. Often, information available to conduct these assessments is limited and rapidly changing, making estimates of fair value subject to judgment. If actual information or conditions are different than estimated, the extent of the impairment of the debt security may be different than previously estimated, which could have a material effect on the Corporation s results of operations and financial condition.

Management discussed the development and selection of critical accounting estimates and related Management Discussion and Analysis disclosure with the Audit Committee. There were no material changes made to the critical accounting estimates during the periods presented within this report. Additional information is contained in Management s Discussion and Analysis regarding critical accounting estimates, including the provision and allowance for loan losses, located on pages 22 and 39 of this report.

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OVERVIEW

Executive summary

Net income available to common shareholders (earnings) for the year 2012 increased $3,691,000 or 69 percent above the year 2011, driven primarily by a decrease in the provision for loan losses and an increase in net interest income. The $3,185,000 or 65 percent pretax decrease in the provision for loan losses for the year 2012 reflected improved credit quality and a decrease in loan impairment charges compared to the year 2011. The $2,933,000 or 9 percent pretax increase in net interest income resulted from an increase in the average volume of earnings assets, principally commercial loans, as the Corporation leveraged its capital addition in 2011. A decrease in funding costs, resulting from the unusually low level of market interest rates and from a larger proportion of low cost core deposits to total deposits, also contributed significantly to the increase in net interest income. The level of core deposits, which for internal purposes includes repurchase agreements but excludes certificates of deposit, has trended up over the years and at December 31, 2012 comprised approximately 55 percent of total deposits. Given the low interest rate environment, the economy and the relatively high level of unemployment, our depositors have shown a preference for liquidity. A challenge for the Corporation and the financial industry will be the retention of low-cost core deposits when market interest rates eventually ramp up. According to recent pronouncements by the Federal Reserve s Federal Open Market Committee, market interest rates could begin to rise in 2015.

Given the economy, the level of unemployment and general declines in housing prices there has been little demand for consumer loans. In contrast, residential mortgage loan refinancings increased significantly as homeowners took advantage of historically low market interest rates. Refinanced residential mortgage loans were sold to investors thereby generating a record level of income gains for the year 2012. Given the long duration of low market interest rates, refinancing activity is expected to reach a saturation level resulting in decreased residential mortgage loan production and revenue therefrom at some point in the future.

Plans call for the construction of a full-service branch office in Dover, PA on a building lot purchased by PeoplesBank in October of 2012. The new office has all necessary regulatory approvals and is expected to be operational by the fall of 2013. Additionally, management is seeking regulatory approval to establish a full-service branch office in Hanover, PA. The branch will be operated out of leased office space and, subject to regulatory approval, is scheduled to be operational in May 2013.

For 2012, the Corporation paid cash dividends totaling $0.382 per common share, an increase of $0.048 or 14 percent above the year 2011 and distributed a 5 percent common stock dividend. The market price of the Corporation s common stock ended the year 2012 at $15.05 per share, a $7.15 increase per share over year-end 2011.

In the periods ahead, we will remain focused on profitable balance sheet growth, acquiring and nurturing client relationships, instilling a client centric culture, managing risk and expanding the banking franchise. We anticipate a continuation of economic weakness, both nationally and locally, through 2014 and possibly beyond. Risks and uncertainties include prolonged weakness in economic and business conditions, which could increase credit-related losses, possible declines in the market value of investment securities considered to be other-than-temporary, a relatively high level of unemployment, erosion of real estate values and possible adverse economic impacts caused by global events.

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Financial highlights

The Selected Financial Data schedule, located on page 13 of this report, provides a summary of operations and performance metrics for the past five years in a comparative format.

2012 vs. 2011

The Corporation earned net income available to common shareholders (earnings) totaling $9,010,000 or $2.03 per share basic, $2.00 per share diluted, compared to $5,319, 000 or $1.22 per share basic, $1.21 per share diluted for the year 2011. Per share amounts, for all periods, were adjusted for the 5 percent common stock dividend distributed in December 2012. The $3,691,000 or 69 percent increase in earnings was primarily the result of increases in interest and noninterest income and decreases in the provision for loan losses and preferred stock dividends, which more than offset increases in noninterest expense and provision for income taxes.

The $2,933,000 or 9 percent increase in net interest income for the year 2012, compared to the year 2011, resulted from an increase in the average volume of 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. Net interest income (tax equivalent basis) as a percentage of interest earning assets, i.e., net interest margin, was 3.81 percent for the year 2012, compared to 3.73 percent for the year 2011.

The $3,185,000 or 65 percent decrease in the provision for loan losses for the year 2012 reflected improved credit quality and a decrease in loan impairment charges compared to the year 2011.

The $832,000 or 11 percent increase in noninterest income for the year 2012, compared to the year 2011, resulted primarily from a $550,000 or 71 percent increase in gains from the sale of loans held for sale (i.e., residential mortgage loans). Market interest rates decreased to record low levels during the year 2012, leading to an increase in residential mortgage loan refinancings. A $302,000 or 29 percent increase in pretax gains from the sale of investment securities also contributed to the increase in noninterest income. U.S. agency mortgage-backed securities (MBS) were selectively sold at a gain to remove relatively low yielding instruments that were prepaying principal faster than anticipated and small odd-lot securities from the MBS portfolio.

The $2,849,000 or 11 percent increase in noninterest expense for the year 2012, compared to the year 2011, was due primarily to increases in personnel expenses and foreclosed real estate costs. The $1,564,000 or 11 percent increase in personnel expense was due to normal business growth, which included the impact of franchise expansion in September 2011, and the recognition of annual performance incentives. The $1,129,000 or 66 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.

The $1,486,000 or 92 percent increase in the provision for income taxes for the year 2012, compared to the year 2011, was a result of the 49 percent increase in income before income taxes.

The $1,076,000 or 74 percent decrease in preferred stock dividends and discount accretion for the year 2012, compared to the year 2011, reflected a decrease in the dividend rate and the redemption of preferred stock and a related warrant under the U.S. Treasury s Capital Purchase Program in the third quarter of 2011.

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On December 31, 2012, total assets were approximately $1.06 billion representing a $48 million or 5 percent increase above December 31, 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.

Cash dividends on common shares for the year 2012 totaled $0.382 per share, representing an increase of $0.048 or 14 percent above 2011. Additionally, a 5% common stock dividend was distributed on December 11, 2012. Comparatively, no stock dividends on the Corporation s common stock were distributed in the prior two years.

The Corporation has traditionally maintained a capital level well above minimum regulatory quantitative requirements. Currently, there are three federal regulatory definitions of capital that take the form of minimum ratios. Table 9 Capital Ratios, shows that the Corporation and PeoplesBank were well capitalized for all three years presented.

2011 vs. 2010

The Corporation earned net income available to common shareholders of $5,319,000 or $1.22 per share, $1.21 diluted, for the year 2011, compared to $5,228,000 or $1.22 per share, $1.21 diluted, for the year 2010. The $91,000 or 2 percent increase in annual earnings for the year 2011, compared to the year 2010 was the result of an increase in net interest income and a decrease in total noninterest expense, which more than offset a decrease in noninterest income and increases in the provision for loan losses, the provision for income taxes and preferred stock dividends and discount accretion.

The $2,179,000 or 7 percent increase in net interest income for 2011 resulted primarily from a larger volume of earning assets, principally commercial loans and investment securities, and a decrease in funding costs. The decrease in funding costs resulted from a lower volume of borrowings, a larger proportion of low cost core deposits to total deposits and lower rates generally paid on all deposit products, which reflected unusually low market interest rates. Net interest income (tax equivalent basis) as a percentage of interest earning assets, i.e., net interest margin, was 3.73 percent for the year 2011, compared to 3.72 percent for the year 2010.

The $1,945,000 or 65 percent increase in the provision for loan losses for the year 2011 reflected an increase in losses on various commercial loan relationships. During September 2011, the Corporation recorded losses totaling $3,175,000 on two unrelated commercial loan relationships which it disclosed in a Form 8-K filed on October 3, 2011, as amended by Form 8-K/A filed on November 10, 2011. The provision for the years 2011 and 2010 remained elevated in comparison to the Corporation s historic levels (pre-2008) and was reflective of 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.

Total noninterest income decreased $216,000 or 3 percent for the year 2011 primarily as a result of a decrease in income from mutual fund, annuity and insurance sales due to the resignation of four registered representatives who left in February. Total noninterest expense decreased $1,037,000 or 4 percent for the year 2011 primarily as a result of a decrease in net costs and losses attributable to foreclosed real estate and impaired loans.

The provision for income tax expense for the year 2011, compared to the year 2010, increased $484,000 or 43 percent due primarily to the 14 percent increase in the level of income before income taxes.

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The $480,000 or 49 percent increase in preferred stock dividends and discount accretion for the year 2011, compared to the year 2010, was primarily attributable to a non-recurring $379,000 transaction to remove unamortized discount caused by the redemption of all outstanding preferred stock issued to the U.S. Department of the Treasury (Treasury) under its Capital Purchase Program. The increase in dividends was caused by an increase in outstanding preferred stock, which reflected the Corporation s participation in the Treasury s Small Business Lending Fund Program (SBLF Program) commencing in August 2011, as previously reported on Form 8-K.

Total assets were approximately $1.01 billion at December 31, 2011, an increase of $55 million or 6 percent above December 31, 2010. Asset growth occurred primarily in the commercial loan portfolio and, to a lesser degree, the investment securities portfolio. Asset growth was funded by an increase in core deposits and, to a lesser degree, an $8 million addition, net of the redemption of the CPP Series A preferred stock and warrant, to capital obtained from the SBLF Program.

Annual cash dividends per common share totaled $0.334, as adjusted, for 2011, compared to $0.238, as adjusted, for 2010.

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

INCOME STATEMENT ANALYSIS

Net Interest Income

The Corporation s principal source of revenue is net interest income, which is the difference between interest income earned on loans and investment securities, and interest expense incurred on deposits and borrowed funds. Fluctuations in net interest income are caused by changes in interest rates, volumes and the composition or mix of interest rate sensitive assets and liabilities. Unless otherwise noted, the discussion that follows is based on interest income and interest expense as reported in the consolidated statements of income, not on a tax equivalent basis.

Net interest income for the year 2012 totaled $35,985,000, an increase of $2,933,000 or 9 percent above the year 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 year 2012, compared to 3.73 percent for the year 2011.

The $1,101,000 or 2 percent increase in total interest income for the year 2012, compared to the year 2011, was due primarily to an increase in the average volume of interest earning assets. Interest earning assets averaged $981 million and yielded 4.89 percent (tax equivalent basis) for 2012, compared to $925 million and 5.07 percent, respectively, for the year 2011. The $56 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 $1,832,000 or 15 percent decrease in total interest expense for the year 2012, compared to the year 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 $854 million at an average rate of 1.23 percent for 2012, compared to $824 million and 1.50 percent, respectively, for the year 2011. The $30 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 $10 million or 15 percent for 2012, compared to the year 2011. The Corporation defines core deposits as all deposits except certificates of deposit (i.e., time deposits).

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Comparatively, for 2011, net interest income totaled $33,052,000, an increase of $2,179,000 or 7 percent above 2010. The increase was primarily the result of an increase in the average volume of interest earning assets, a decrease in the average volume of long-term debt and a decrease in the average rate paid on deposits. The net interest margin was 3.73 percent for 2011, compared to 3.72 percent for 2010.

Interest earning assets averaged $925 million and yielded 5.07 percent (tax equivalent basis) for 2011, compared to $868 million and 5.24 percent, respectively, for 2010. The $57 million or 7 percent increase in average interest earning assets was due primarily to an increase in investment securities and secondarily to an increase in commercial loans. The increase in the average volume of earning assets more than offset the decrease in the average yield, which reflected the low level of market interest rates.

Total interest bearing liabilities averaged $824 million at an average rate of 1.50 percent for 2011, compared to $779 million and 1.69 percent, respectively, for 2010. The $45 million or 6 percent increase in average interest bearing liabilities reflected growth in all deposit categories, which more than offset a decrease in long-term debt. Interest expense on deposits for 2011 was $241 million or 2 percent below 2010 as the favorable impact of low product rates and deposit mix largely offset the effect of the increase in average volume. Interest expense on long-term debt decreased for 2011, compared to 2010, due primarily to volume as maturing Federal Home Loan Bank loans, with relatively high interest rates, were selectively not refinanced.

Tables 1 and 2 are presented on a tax equivalent basis to make it easier to compare taxable and tax-exempt assets. Income from tax-exempt assets, primarily loans to or securities issued by state and local governments, is increased by the amount of federal income taxes which would have been incurred if the income was taxable at the rate of 34 percent.

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

	2012			2011			2010		
(dollars in thousands)	**Average Balance**	**Interest**	**Yield/ Rate**	**Average Balance**	**Interest**	**Yield/ Rate**	**Average Balance**	**Interest**	**Yield/ Rate**
Assets									
Interest bearing deposits with banks	$ 37,101	$ 94	0.25%	$ 27,297	$ 66	0.24%	$ 24,452	$ 64	0.26%
Federal funds sold	0	0	0.00	674	2	0.30	2,935	9	0.31
Investment securities:									
Taxable	145,357	3,381	2.33	150,529	3,830	2.54	117,439	3,361	2.86
Tax-exempt	84,357	3,587	4.25	79,577	3,581	4.50	75,217	3,590	4.77
Total investment securities	229,714	6,968	3.03	230,106	7,411	3.22	192,656	6,951	3.61
Loans:									
Taxable (1)	700,915	40,096	5.72	651,604	38,485	5.91	633,192	37,540	5.93
Tax-exempt	13,150	770	5.86	14,891	887	5.96	14,647	905	6.18
Total loans	714,065	40,866	5.72	666,495	39,372	5.91	647,839	38,445	5.93
Total earning assets	980,880	47,928	4.89	924,572	46,851	5.07	867,882	45,469	5.24
Other assets (2)	60,431			60,143			53,870		
Total assets	$ 1,041,311			$ 984,715			$ 921,752		
Liabilities and Shareholders Equity									
Deposits:									
Interest bearing demand	$ 336,077	1,335	0.40%	$ 305,982	1,937	0.63%	$ 263,381	2,015	0.77%
Savings	33,516	84	0.25	29,442	108	0.37	26,870	107	0.40
Time	427,536	8,196	1.92	429,213	9,111	2.12	413,752	9,275	2.24
Total interest bearing deposits	797,129	9,615	1.21	764,637	11,156	1.46	704,003	11,397	1.62
Short-term borrowings	20,843	122	0.59	11,553	114	0.99	8,803	88	1.00
Long-term and junior subordinated debt	36,212	790	2.18	47,459	1,089	2.29	66,421	1,669	2.51
Total interest bearing liabilities	854,184	10,527	1.23	823,649	12,359	1.50	779,227	13,154	1.69
Noninterest bearing deposits	82,008			71,621			61,372		
Other liabilities	6,727			5,137			4,731		
Shareholders equity	98,392			84,308			76,422		
Total liabilities and shareholders equity	$ 1,041,311			$ 984,715			$ 921,752		
Net interest income		$ 37,401			$ 34,492			$ 32,315	
Net interest margin (3)			3.81%			3.73%			3.72%

(1) Average balance includes average nonaccrual loans of $11,538,000 in 2012, $16,550,000 in 2011, and $17,242,000 in 2010. Interest includes net loan fees of $1,060,000 in 2012, $941,000 in 2011, and $1,060,000 in 2010.

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

(3) Net interest income 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)

	2012 vs. 2011 Increase (decrease) due To change in			2011 vs. 2010 Increase (decrease) due To change in		
(dollars in thousands)	**Volume**	**Rate**	**Net**	**Volume**	**Rate**	**Net**
Interest Income						
Interest bearing deposits with banks	$ 23	$ 5	$ 28	$ 7	$ (5)	$ 2
Federal funds sold	(2)	0	(2)	(7)	0	(7)
Investment securities:						
Taxable	(118)	(331)	(449)	947	(478)	469
Tax-exempt	215	(209)	6	208	(217)	(9)
Loans:						
Taxable	3,455	(1,844)	1,611	1,092	(147)	945
Tax-exempt	(104)	(13)	(117)	15	(33)	(18)
Total interest income	3,469	(2,392)	1,077	2,262	(880)	1,382
Interest Expense						
Deposits:						
Interest bearing demand	188	(790)	(602)	326	(404)	(78)
Savings	15	(39)	(24)	10	(9)	1
Time	(36)	(879)	(915)	347	(511)	(164)
Short-term borrowings	92	(84)	8	27	(1)	26
Long-term and junior subordinated debt	(267)	(32)	(299)	(476)	(104)	(580)
Total interest expense	(8)	(1,824)	(1,832)	234	(1,029)	(795)
Net interest income	$ 3,477	$ (568)	$ 2,909	$ 2,028	$ 149	$ 2,177

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

The provision for loan losses is an expense charged to earnings to cover estimated losses attributable to uncollectible loans. The provision reflects management s judgment of an appropriate level for the allowance for loan and lease losses. The Risk Management section of this report, including Tables 10 Nonperforming Assets, 11 Analysis of Allowance for Loan and Lease Losses, and 12 Allocation of Allowance for Loan and Lease Losses, provides detailed information about the allowance, provision and credit risk.

For 2012, the provision for loan losses was $1,750,000, compared to $4,935,000 for 2011 and $2,990,000 for 2010. The decrease in the provision for the year 2012 reflected improved credit quality and a decrease in net charge-offs on loans compared to the prior two years. The provision for the year 2011 was unusually high, the result of two unrelated partial loan charge-offs 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. The provision for loan losses for all three periods presented remained elevated in comparison to the Corporation s historic levels and was reflective of 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. These factors can adversely affect our borrowers ability to service their loans.

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Noninterest income

The following table presents the components of total noninterest income for each of the past three years.

Table 3-Noninterest Income

(dollars in thousands)	**2012**	**2011**	**2010**
Trust and investment services fees	$ 1,702	$ 1,510	$ 1,420
Income from mutual fund, annuity and insurance sales	896	1,103	1,477
Service charges on deposit accounts	2,560	2,583	2,471
Income from bank owned life insurance including death benefits	633	647	637
Other income	645	613	601
Net gain on sales of loans held for sale	1,327	777	860
Net gain on sales of securities	427	125	108
Total noninterest income	$ 8,190	$ 7,358	$ 7,574

For 2012, the overall $832,000 or 11 percent increase in total noninterest income, compared to 2011, was primarily the result of increases in net gain on sales of loans held for sale and trust and investment services fees. The increase in net gain on sales of securities also contributed to the increase in noninterest income. Core noninterest income, which excludes the net gain on sales of securities, increased $530,000 or 7 percent for the year 2012, compared to the year 2011. The discussion that follows addresses changes in selected categories of noninterest income.

Trust and investment services fees Increases in this category of noninterest income for 2012 and 2011 were primarily the result of 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 For 2012, the $207,000 or 19 percent decrease in income from mutual fund, annuity and insurance sales compared to 2011 was due to a decrease in sales, which reflected market uncertainty and the relative unattractiveness of variable annuities due to low rates and less favorable structures. The decrease in income for 2011, compared to 2010, was also the result of a decrease in sales which reflected the resignation of four registered representatives who left Codorus Valley Financial Advisors (CVFA), a subsidiary of PeoplesBank, in February 2011.

Service charges on deposit accounts For 2012, service charges on deposit accounts decreased slightly compared to the year 2011 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 guidance on July 1, 2011, which effectively restricted overdraft pricing policies. The increase in service charge income for 2011, compared to 2010, was primarily the result of an increase in debit card revenue, which reflected an increase in the volume of transactions.

Income from bank owned life insurance (BOLI) Income from BOLI for the three years presented was basically flat as low market interest rates depressed yields. This investment provides a competitive tax-free return to the Corporation while providing a life insurance benefit to the management team.

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Note: On February 6, 2013, PeoplesBank purchased $5.3 million of BOLI. Of this total $4.7 million was invested with Massachusetts Mutual Life Insurance Company and $0.6 million was invested with Midland National Life Insurance Company. The tax-exempt yield is approximately 3.77 percent or 5.71 percent on a taxable equivalent basis.

Other income Other income, comprised of many underlying fees, increased as a result of normal business growth over the three year period presented. The increase in 2012, compared to 2011, also reflected a $53,000 increase in revenue from loan settlement services provided by SYC Settlement Services, Inc., a PeoplesBank subsidiary. The other income category includes wire transfer fees, credit card merchant fees, automated teller machine fees, safe deposit box fees and miscellaneous fees, among others.

Net gain on sales of loans held for sale For 2012, the $550,000 or 71 percent increase in net gain on sales of loans held for sale, compared to the year 2011, was due primarily to an increase in the volume of residential mortgage loan sales. The unusually low level of market interest rates that prevailed throughout the year 2012, which were influenced by the Federal Reserve Bank to stimulate the U.S. economy, resulted in a sharp increase in residential mortgage loan refinancings. For 2011, the decrease in net gain compared to the year 2010 reflected a decrease in the volume of sales and a decrease in pricing from secondary market sources.

Net gain on sales of securities For 2012, the net gain totaling $427,000 was primarily the result of sales 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 securities from the MBS portfolio.

Noninterest expense

The following table presents the components of total noninterest expense for each of the past three years.

Table 4-Noninterest Expense

(dollars in thousands)	**2012**	**2011**	**2010**
Personnel	$ 15,312	$ 13,748	$ 13,276
Occupancy of premises, net	1,977	2,004	1,926
Furniture and equipment	1,896	1,730	1,670
Postage, stationery and supplies	508	519	516
Professional and legal	534	586	488
Marketing and advertising	907	840	700
FDIC insurance	733	1,004	1,297
Debit card processing	707	655	585
Charitable donations	640	396	523
Telephone	532	509	560
External data processing	560	462	431
Foreclosed real estate including (gains) losses on sales	2,830	1,701	3,275
Impaired loan carrying costs	299	620	972
Other	2,493	2,305	1,897
Total noninterest expense	$ 29,928	$ 27,079	$ 28,116

Total noninterest expense for the year 2012 increased $2,849,000 or 11 percent above the year 2011 due primarily to increases within the personnel and foreclosed real estate expense categories.

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Planned franchise expansion Plans call for the construction of a full-service branch office in Dover, PA on a building lot purchased by PeoplesBank in October of 2012. The new office with a planned staff size of five people has all necessary regulatory approvals and is expected to be operational by the fall of 2013. Additionally, management is seeking regulatory approval to establish a full-service branch office in Hanover, PA. The branch will be operated out of leased office space and, subject to regulatory approval, is scheduled to be operational in May 2013. Branch office expansion is expected to increase noninterest expenses such as personnel, occupancy, furniture and equipment, and marketing, among other expenses.

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

Personnel Personnel expense is comprised of wages, sales commissions, payroll taxes and employee benefits, such as medical insurance and 401K plans. The $1,564,000 or 11 percent increase in personnel expense for 2012, compared to 2011, was attributable to normal business growth, which included the full year s impact of a branch office addition in September 2011, increased sales commissions for mortgage originators which resulted from increased production, and the accrual of annual performance incentives. Comparatively, the $472,000 or 4 percent increase in personnel expense for 2011, compared to 2010, was also attributable to normal business growth, which included a partial year s impact for the aforementioned branch office addition. The rate of increase in personnel expense for the year 2011 was limited by the decrease in wages caused by the resignation of four registered representatives and an office manager who left PeoplesBank subsidiary CVFA in February 2011.

Effective August 1, 2010, PeoplesBank converted from a fully insured health care program to a self-insured program by joining a consortium of approximately 30 banks. Employees have customarily reimbursed the Corporation for approximately 30 percent of the cost of health insurance. For the year 2012, compared to the year 2011, the cost of the self-insured program decreased approximately $122,000 or 11 percent due to a decrease in claims expense and a decrease in the insured pool as a result of program changes.

Occupancy of premises, net Occupancy of premises expense is comprised of rent, depreciation, maintenance, insurance, real estate taxes and utilities. The level of expense can vary annually based upon franchise expansion, repairs and maintenance, and normal business growth. Examples of franchise expansion include the addition of a branch banking office in 2011 and the relocation of an existing branch banking office during 2010 to a more favorable site.

Furniture and equipment This category includes depreciation expense on furniture and equipment, including IT-related equipment, and the cost of computer hardware and software maintenance contracts among other expenses. The upward trend in this expense category reflects normal business growth, including price increases, IT initiatives such as CRM (described below) and the addition of a branch banking office in 2011.

During the third quarter of 2010, PeoplesBank began implementing a client relationship management (CRM) system, which, in addition to computer hardware, is comprised of two main components, sales and service software and teller software. Sales and service software, the primary component, became operational in December 2011, and began depreciation at that time over a five-year estimated useful life. The teller software component, which will be phased in by individual branch office, is expected to be fully operational by the fall of 2013. The capital outlay for this project is estimated at $625,000, which does not include staffing and other ancillary expenses. A properly managed CRM process is expected to improve the Corporation s competitiveness and client service and retention.

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Professional and legal The level of professional and legal expense can vary annually based on the varying needs for legal, accounting and consulting services, which is driven in part by the level of routine lawsuits in the ordinary course of business, the number and complexity of corporate initiatives, and changes in regulatory compliance requirements.

Marketing and advertising Expense for the three years presented shows an upward trend that reflects an increased operating budget to support normal business growth and increased corporate initiatives such as branding, product advertising and internal promotions.

FDIC insurance Expense for the three years presented shows a downward trend, which reflects a decrease in the assessment rate. The decrease in the assessment rate was due to PeoplesBank s improved financial performance and a change in the methodology for calculating insurance premiums by the FDIC. Effective April 1, 2011, the FDIC lowered assessment rates and applied them against average assets minus average tangible capital, instead of domestic deposits. More information about FDIC insurance assessments is available under the Supervision and Regulation section of this report (reference the subheading-FDIC).

Debit card processing Expense for the three years presented shows an upward trend, which reflects increases in the number of new accounts and transaction volume. This expense category also includes the cost of operating automated teller machines.

Charitable donations The level of charitable donations, principally educational and scholarship donations, is based, in part, upon whether or not PeoplesBank can obtain related state tax credits if available from nonprofit organizations. Accordingly, the level of charitable donations can vary from year to year. For example, the decrease in charitable donations for 2011 resulted from the denial or delay of tax credits by the state of Pennsylvania for educational donations due to budgetary constraints. PeoplesBank uses state tax credits from donations to reduce its Pennsylvania Shares Tax expense, included below in other expenses.

Foreclosed real estate including (gains) losses on sales Net foreclosed real estate expense is comprised of impairment losses, including losses on sales, and carrying costs, net of gains from sales and income generated by the real estate. Typical carrying costs include insurance, maintenance and repairs, real estate taxes, appraisals and legal fees. Net foreclosed real estate expense remained elevated for the three years presented due to the level of carrying costs and impairment losses from deterioration of property values associated with specific properties as well as the size of the portfolio, which was reflective of prolonged weakness in economic and business conditions and the erosion of real estate values. Real estate expense for the year 2012 increased $1,129,000 or 66 percent compared to the year 2011 as a result of 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. For the year 2011, foreclosed real estate expense decreased $1,574,000 or 48 percent, compared to the year 2010, due in part to the recognition of rental income totaling $868,000 from a real estate project and a decrease in the provision for real estate losses. For the year 2011, the provision for real estate losses totaled $829,000, compared to $1,566,000 for 2010.

Impaired loan carrying costs 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 underlying collateral and the timing of when and for how long loans are classified as impaired, among other factors, contribute to the variability of this expense from period to period. Carrying costs are the same as those described for foreclosed real estate.

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Other Other expense is comprised of many underlying expenses, including, but not limited to: Pennsylvania shares tax, memberships and subscriptions, director fees, liability insurance, third-party courier, correspondent banking expenses and miscellaneous operating losses. For the year 2012, the $188,000 or 8 percent increase in the other expense category above the year 2011 reflected a nonrecurring charge-off of the unamortized balance of an intangible asset totaling $163,000. Varying levels of Pennsylvania shares tax expense, which reflected varying levels of state tax credits that originated from charitable donations (as described earlier) can cause annual variances in the other expense category. For example, shares tax, net of credits, totaled $306,000 for 2012, compared to 392,000 for 2011 and $229,000 for 2010. The upward trend in the other expense category for the three year period presented also reflects normal business growth.

Provision for income taxes

The provision for income tax for year 2012 was $3,103,000, compared to a $1,617,000 for 2011. The increase in income tax was primarily the result of an increase in pretax income. For both periods, the Corporation s statutory federal income tax rate was 34 percent. The Corporation s effective income tax rate was approximately 24.8 percent for 2012, compared to 19.3 percent for 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.

Preferred stock dividends and discount accretion

Preferred stock dividends for the year 2012 totaled $384,000, compared to preferred stock dividends and discount accretion totaling $1,460,000 for the year 2011. The $1,076,000 or 74 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 the redemption of preferred stock issued under the Treasury s Capital Purchase Program in 2011. Information about U.S. Treasury capital programs is provided in Note 10 Shareholders Equity of this report.

BALANCE SHEET REVIEW

Interest bearing deposits with banks

Interest bearing deposits with banks totaled $35 million on December 31, 2012, compared to $20 million on December 31, 2011. The level of interest bearing deposits can vary significantly based on the timing and magnitude of investment opportunities and funding.

Securities, available-for-sale

The investment securities portfolio is an interest earning asset, second in size to the loan portfolio. Investment securities serve as an important source of revenue and liquidity. They also serve as collateral for public and trust deposits, securities sold under agreements to repurchase and to support borrowings. The investment securities portfolio is managed to comply with the Corporation s Investment Securities Policy, and accounted for in accordance with FASB ASC Topic 320. Decisions to purchase or sell securities are based on an assessment of current economic and financial conditions, including the interest rate environment, the demand for loans, and liquidity and income requirements. Table 5 Investment Securities, shows the amortized cost and fair value by type of security for three year-end periods.

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Table 5-Investment Securities

	2012		2011		2010	
(dollars in thousands)	**Amortized Cost**	**Fair Value**	**Amortized Cost**	**Fair Value**	**Amortized Cost**	**Fair Value**
Available-for-sale						
Debt securities:						
U.S. Treasury notes	$ 5,001	$ 5,032	$ 10,003	$ 10,134	$ 8,014	$ 8,140
U.S. agency	37,000	38,058	29,593	30,673	13,519	13,643
U.S. agency mortgage-backed, residential	84,630	88,233	103,017	106,444	108,967	110,353
State and municipal	98,744	102,739	82,272	86,610	88,796	90,400
Total	$ 225,375	$ 234,062	$ 224,885	$ 233,861	$ 219,296	$ 222,536

At December 31, 2012, the fair value of the securities, available-for-sale totaled $234 million, approximately the same level as December 31, 2011. Throughout the year 2012, cash inflows from maturities and repayments, and the proceeds from sales of securities were reinvested back into the investment securities portfolio. Approximately $17 million of U.S. agency mortgage-backed securities (MBS) were selectively sold to remove relatively low yielding instruments that were prepaying faster than anticipated and small odd-lot securities from the MBS portfolio. The sales of MBS during the year 2012 resulted in the realization of net gains totaling $427,000. During the year 2011, PeoplesBank took advantage of the low interest rate environment and sold selected securities, which generated net gains of $125,000 that were recognized in income. Included in the net gains for 2011 was an $18,000 loss associated with the sale of eleven municipal bonds totaling approximately $5 million (par value) that no longer met the Corporation s investment standards.

Securities, available-for-sale are generally comprised of high quality debt instruments. Included in Table 5 are investments in the obligations of states and municipalities. During the fourth quarter of 2010 bonds issued by states and municipalities received negative national press because of widespread budget deficits and, by implication, the possibility of default. We believe that selected investment in municipal bonds is a sound investment practice. Municipalities have many options for meeting their debt obligations, including decreasing costs and service levels, imposing taxes and selling assets. In many cases, municipal debt issues are insured or, in the case of school districts of selected states, backed by specific reserves, which provide a layer of protection to the investor. Access to the credit market and a good credit rating are high priorities of municipal management enabling it to meet its current and future funding needs at a reasonable interest cost. For these reasons, defaults on municipal bonds are very low, well below 1 percent. With the exception of an approximately $14 million portfolio (fair value) of Texas municipal utility district bonds, which has its own criteria for investment, the remaining municipal bonds are almost all rated A or above by at least one national statistical rating organization at December 31, 2012. The majority of bonds in our 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. Many of the municipal holdings are also insured or backed by specific school district loss reserves.

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

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Table 6 Securities Maturity Schedule, shows that the available-for-sale portfolio had a yield of 3.14 percent on December 31, 2012. Comparatively, the portfolio yield was 3.48 percent on December 31, 2011. The decrease in portfolio yield for 2012 was the result of security additions, including the reinvestment of cash inflows from scheduled maturities and repayments of mortgage-backed bonds, during a period of unusually low market interest rates and asset yields. More information about investment securities is provided in Note 3-Securities in the notes to the consolidated financial statements.

Table 6-Securities Maturity Schedule (amortized cost basis)

	December 31, 2012 Maturity Distribution					
(dollars in thousands)	One year or less	One through five years	Five through ten years	After ten years	Total Amount	Total Yield(1)
Available-for-sale						
Debt securities:						
U.S. Treasury notes	$ 5,001	$ 0	$ 0	$ 0	$ 5,001	1.30%
U.S. agency	2,000	32,882	2,118	0	37,000	1.58%
U.S. agency mortgage-backed, residential (2)	0	81,793	2,837	0	84,630	2.88%
State and municipal	10,500	63,050	21,373	3,821	98,744	4.04%
Total	$ 17,501	$ 177,725	$ 26,328	$ 3,821	$ 225,375	3.14%
Yield (1)	2.78%	3.03%	3.69%	6.18%	3.14%	

(1) Weighted average yields (tax equivalent basis) were calculated on the amortized cost basis.
(2) U.S. agency mortgage-backed securities are included in the maturity categories based on average expected life.

Restricted investment in bank stocks

At December 31, 2012, PeoplesBank held $2,863,000 in restricted common stock, compared to $3,635,000 at year-end 2011. Investment in restricted stock is a condition of obtaining credit from the Federal Home Loan Bank of Pittsburgh (FHLBP) and the Atlantic Central Bankers Bank (ACBB) organizations. Of the total, $2,788,000 consisted of stock issued by the FHLBP and $75,000 issued by the ACBB. Information about impairment considerations for restricted stock is provided in Note 1 Summary of Significant Accounting Policies in the notes to the consolidated financial statements.

The FHLBP resumed the payment of quarterly cash dividends in the fourth quarter of 2011 after a period of suspension since December 2008. The quarterly dividend rate is based on the average 3-month LIBOR. The annualized percentage for the fourth quarter of 2012 is 0.32 percent. The FHLBP reported that it will continue to monitor the condition of its private-label residential mortgage-back securities portfolio, its overall financial performance and retained earnings, developments in the mortgage and credit markets, and other relevant information as the basis for determining the status of dividends and excess capital stock repurchases in future quarters.

Loans held for sale

On December 31, 2012, loans held for sale were approximately $3.1 million, compared to $2.9 million at year-end 2011. For both years PeoplesBank s mortgage banking staff remained focused on originating and selling residential mortgages without retaining servicing rights. The unusually low level of market interest rates that prevailed throughout the year 2012, which were influenced by the Federal Reserve Bank in its continuous efforts to stimulate the U.S. economy, resulted in a sharp increase in residential mortgage loan refinancings and sales. As a result, the level of net gain on sales of loans held for sale for the year 2012 increased $550,000 or 71 percent above the year 2011.

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Loans

On December 31, 2012, total loans, net of deferred fees, totaled approximately $737 million, an increase of $44 million or 6 percent above year-end 2011. Most of the increase was due to a $42 million or 7 percent increase in commercial loans, which reflected increased demand, in spite of a continuation of adverse economic conditions and depressed real estate markets, and our ability to acquire business from competitors based on our reputation for client service and competitive prices. The composition of the Corporation s loan portfolio at December 31, 2012 and 2011 is provided in Note 4 Loans in the notes to the consolidated financial statements. The average yield (tax equivalent basis) earned on total loans was 5.72 percent for 2012, compared to 5.91 percent for 2011. Table 7 presents the composition of total loans for five year-end periods.

Table 7-Loan Portfolio Composition

	December 31,									
(dollars in thousands)	**2012**	**%**	**2011**	**%**	**2010**	**%**	**2009**	**%**	**2008**	**%**
Commercial, financial and agricultural	$ 510,544	69.2	$ 462,061	66.6	$ 419,649	65.5	$ 415,404	64.3	$ 348,111	60.7
Real estate - construction and land development	96,936	13.2	103,514	14.9	95,735	14.9	104,986	16.3	100,088	17.5
Total commercial related loans	607,480	82.4	565,575	81.5	515,384	80.4	520,390	80.6	448,199	78.2
Real estate - residential mortgages	23,511	3.2	21,324	3.1	20,357	3.2	22,270	3.4	18,154	3.2
Consumer and home equity	106,143	14.4	106,616	15.4	105,108	16.4	103,217	16.0	106,725	18.6
Total consumer related loans	129,654	17.6	127,940	18.5	125,465	19.6	125,487	19.4	124,879	21.8
Total loans	$ 737,134	100.0	$ 693,515	100.0	$ 640,849	100.0	$ 645,877	100.0	$ 573,078	100.0

Table 8 shows that, at December 31, 2012, the commercial loan portfolio was comprised of approximately $356 million or 59 percent in fixed rate loans and $252 million or 41 percent in floating rate loans, which was the same mix on December 31, 2011. Floating rate loans reprice periodically with changes in the Wall Street Journal (WSJ) prime rate or LIBOR. Additional loan information can be found in Note 4 Loans in the notes to the consolidated financial statements and within the Risk Management section of this report.

Table 8-Selected Loan Maturities and Interest Rate Sensitivity

	December 31, 2012 Maturity Distribution			
(dollars in thousands)	**One year or less**	**One through five years**	**After five years**	**Total**
Commercial, financial and agricultural	$ 86,098	$ 119,204	$ 305,242	$ 510,544
Real estate-construction and land development	47,041	39,380	10,515	96,936
Total commercial related loans	$ 133,139	$ 158,584	$ 315,757	$ 607,480
Fixed interest rates	$ 32,228	$ 82,450	$ 241,296	$ 355,974
Floating interest rates	100,911	76,134	74,461	251,506
Total commercial related loans	$ 133,139	$ 158,584	$ 315,757	$ 607,480

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Other assets

On December 31, 2012, other assets totaled approximately $31 million, compared to $44 million on December 31, 2011. Other assets were primarily comprised of foreclosed real estate and investments in bank owned life insurance (BOLI). Foreclosed real estate, net of allowance, totaled $3.6 million at year-end 2012, compared to $16.2 million at year-end 2011. Foreclosed real estate is discussed in the Nonperforming Assets section of this report. Investments in life insurance relates to a select group of employees and directors whereby PeoplesBank is the owner and beneficiary of the policies. These investments, carried at the cash surrender value of the underlying policies, totaled $15.5 million at year-end 2012, compared to $14.8 million at year-end 2011. Other assets also includes lesser amounts for interest receivable on loans and investment securities, net deferred tax assets, prepaid FDIC deposit insurance and an investment in a real estate partnership that provides low cost housing to income qualified families. Additional information about these assets can be found in Note 1 Summary of Significant Accounting Policies in the notes to the consolidated financial statements under the appropriate subheadings.

Note: As a revenue raising strategy, PeoplesBank purchased $5.3 million of BOLI on February 6, 2013. Of this total, $4.7 million was invested with Massachusetts Mutual Life Insurance Company and $0.6 million was invested with Midland National Life Insurance Company. The selection of these insurers was based on their high credit rating and reputation, competitive tax-exempt yield and to accomplish diversification among insurers for the BOLI portfolio. The level of BOLI investment, including the $5.3 million addition, is estimated at 20 percent of PeoplesBank s Tier 1 capital, excluding unrealized gains (losses) on available-for-sale securities, at December 31, 2012, which is well within PeoplesBank s investment limitation of 25 percent of Tier 1 capital.

Funding

Deposits

Deposits are the principal source of funding for earning assets. On December 31, 2012, total deposits were $901 million, an increase of $47 million or 5 percent over year-end 2011. The increase in total deposits occurred primarily within the money market and demand categories. In contrast, total time deposits decreased $16 million or 4 percent in response to our clients apparent preference for liquidity. The average rate paid on interest bearing deposits was 1.21 percent for 2012, compared to 1.46 percent for 2011, which reflected the historically low level of market interest rates. The composition of the Corporation s deposit portfolio at December 31, 2012 is provided in Note 7-Deposits in the notes to the consolidated financial statements. On December 31, 2012, the balance of certificates of deposit with a balance of $100,000 and above was $175 million. Of this total, $18 million mature within three months, $24 million mature after three months but within six months, $34 million mature after six months but within twelve months, and the remaining $99 million mature beyond twelve months.

Short-term borrowings

Short-term borrowings consist of securities sold under agreements to repurchase (repo agreements), federal funds purchased and other borrowings as described more fully in Note 8-Short-term borrowings and Long-term Debt to the consolidated financial statements. On December 31, 2012 and 2011, short-term borrowings, comprised solely of repo agreements, totaled $19.4 million and $10.3 million, respectively.

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Long-term debt

Long-term debt is a secondary funding source for asset growth. On December 31, 2012, long-term debt totaled $30.8 million, compared to $46.6 million at year-end 2011. The decrease was attributable to payments for maturing FHLBP loans throughout 2012 that were not refinanced. Generally, funds for the payment of long-term debt come from operations. On December 31, 2012, total unused credit with the FHLBP was approximately $166 million. Obligations to the FHLBP are secured by FHLBP stock and qualifying collateral, principally real estate secured loans and selected investment securities.

In June 2012, the Corporation restructured (i.e., extended) two outstanding $5 million FHLBP 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 FHLBP 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 FHLBP 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.

A listing of outstanding long-term debt obligations is provided in Note 8-Short-term Borrowings and Long-term Debt in the notes to the consolidated financial statements.

Shareholders equity and capital adequacy

Shareholders equity or capital enables the Corporation to maintain asset growth and absorb losses. Capital adequacy can be affected by a multitude of factors, including profitability, corporate expansion, balance sheet growth, dividend policy and regulatory mandates, among others. Total shareholders equity was $101.3 million on December 31, 2012, compared to $93.2 million at year-end 2011. The increase in equity was 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 Program). 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 annualized dividend rate in effect on December 31, 2012 was 1 percent, compared to 5 percent on December 31, 2011. At inception of the SBLF Program (August 18, 2011) the dividend rate was initially set at 5 percent, but can vary from 1 percent to 5 percent on a quarterly basis through September 30, 2013, to reflect the amount of change in qualified small business lending compared to a baseline amount. On September 30, 2013, the dividend rate becomes fixed at the then prevailing rate for the remaining two and one half years of the initial four and one half year phase of the SBLF Program. After four and one half years from issuance the dividend rate will increase to 9 percent.

Dividends on common stock

The Corporation typically pays cash dividends on its common stock on a quarterly basis. The Board of Directors determines the dividend rate after considering the Corporation s capital requirements, current and projected net income, and other factors. Annual cash dividends per common share totaled $0.382 for 2012, compared to $0.334 for 2011, as adjusted for the 5 percent common stock dividend described below. On January 8, 2013, the Board declared a regular cash dividend of $0.11 per common share, payable on February 12, 2013, to shareholders of record on January 22, 2013.

Periodically, the Corporation distributes stock dividends on its common stock. On October 9, 2012, the Corporation declared a 5 percent common stock dividend distributable on December 11, 2012, to shareholders of record at the close of business on October 23, 2012. Distribution of this common stock dividend resulted in the issuance of 211,564 additional common shares.

Compensation plans

As disclosed in this report, the Corporation maintains various employee, director and shareholder benefit plans that could result in the issuance of its common stock or affect its earnings. Information regarding these plans can be found in Note 11-Benefit Plans and Note 12-Stock-Based Compensation in the notes to the consolidated financial statements.

Preferred and common stock

Information pertaining to preferred and common stock issued by the Corporation is disclosed in Note 10 Shareholders Equity in the notes to the consolidated financial statements.

Capital ratios

The Corporation 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 Table 9. The table provides a comparison of the Corporation s and PeoplesBank s risk-based capital ratios and leverage ratios to the minimum regulatory requirement for the periods indicated.

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 standards set forth in the proposed rule would require bank holding companies and their bank subsidiaries to maintain substantially more capital, with a greater emphasis on common equity. Subsequent to the review and comment period on the proposal which ended October 22, 2012, the banking regulators announced that the project was being delayed. The timing for adoption of final rules to implement the Basel III capital framework is uncertain. Accordingly, final rules applicable to the Corporation and Bank may be substantially different from the Basel III framework initially proposed. The Corporation plans to monitor Basel III capital rules to ensure compliance, once finalized.

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Table 9-Capital Ratios

(dollars in thousands)	**Ratios at December 31, 2012**	**2011**	**Federal Minimum Required**	**Federal Well Capitalized**	**Capital * at December 31, 2012**	**2011**
Tier 1 risk-based capital (as a percentage of risk weighted assets)						
Codorus Valley Bancorp, Inc. (consolidated)	13.59%	13.35%	4.00%	n/a%	$ 105,597	$ 97,128
PeoplesBank	13.20	12.98	4.00	6.00	102,120	94,056
Total risk-based capital (as a percentage of risk weighted assets)						
Codorus Valley Bancorp, Inc. (consolidated)	14.79%	14.55%	8.00%	n/a%	$ 114,899	$ 105,830
PeoplesBank	14.40	14.19	8.00	10.00	111,422	102,758
Leverage (Tier 1 capital as a percentage of average total assets)						
Codorus Valley Bancorp, Inc. (consolidated)	10.02%	9.62%	4.00%	n/a%	$ 105,597	$ 97,128
PeoplesBank	9.72	9.35	4.00	5.00	102,120	94,056

* Net unrealized gains and losses on securities available-for-sale, net of taxes, are disregarded for capital ratio computation purposes in accordance with federal regulatory banking guidelines.

Risk Management

The Corporation s Risk Management Committee (Committee) meets at least quarterly and includes members of senior management and an independent director. The objective of the Committee is to identify and manage risk inherent in the operations of the Corporation and its affiliates. While the Committee s risk review is broad in scope, its primary responsibility is to develop, implement and monitor compliance with formal risk management policies and procedures.

Credit risk management

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 of loss to the Corporation. Accordingly, the Corporation emphasizes the management of credit risk. To support this objective a sound lending policy framework has been established. This framework includes seven basic policies that guide the lending process and minimize risk. First, the Corporation follows detailed written lending policies and procedures. Second, lending authority is granted commensurate with dollar amount, loan type, level of risk, and loan officer experience. Third, loan review committees function at both the senior lending officer level and the Board level to review and approve loans that exceed pre-established dollar thresholds and/or meet other criteria. Fourth, the Corporation lends mainly within its primary geographical market area, York County, Pennsylvania and northern-central Maryland. Although this focus may pose a geographical concentration risk, the diverse local economy and employee knowledge of customers lessens this risk. Fifth, the loan portfolio is diversified to prevent dependency upon a single customer or small group of related customers. Sixth, the Corporation does not participate in the subprime lending market, nor does it invest in securities backed by subprime mortgages. And seventh, the Corporation does not lend to foreign countries or persons residing therein.

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The Corporation uses loan-to-value ratios (LTV ratios), establishing generally acceptable ratios of the loan amount to the value of the collateral securing the loan, to minimize the risk of loss from the loan portfolio. At December 31, 2012, the LTV ratios listed below were in effect.

Loan type	LTV ratio %
Residential, owner occupied 1-4 units, tax assessment (MD)	90
Residential, owner occupied 1-4 units, tax assessment (York, PA)	80
Residential, owner occupied 1-4 units, certified appraisal	80
Residential, non-owner occupied 1-4 units, certified appraisal	75
Residential, 5 or more units	75
Agricultural	75
Commercial	70
Industrial	65
Vacant land (depending on improvements, approvals)	60-70
Special/limited use properties	50

An acceptable valuation is required on all real estate secured loans. Generally, an appraisal performed by an independent licensed appraiser is required for real estate secured loans where the amount is above $100,000, or is non-owner occupied, or if the LTV ratio is above 70 percent for commercial property or above the limits shown in the above schedule for valuations based on tax assessments for owner occupied residential property, or if an existing appraisal is more than two years old assuming that there has been no material change in market conditions or the physical aspects of the property. Exceptions to LTV ratios and the use of a licensed appraiser are sometimes made by management or the Board of Directors when there are compensating factors.

One component of the internal credit risk review is the identification and management of industry concentrations, defined as greater than 10 percent of the total loan portfolio. The Corporation had two industry concentrations that exceeded 10 percent of the total loan portfolio: builder & developer were 13.2 percent and 14.9 of the portfolio at December 31, 2012 and 2011, respectively; and commercial real estate investor was 16.6 and 17.0 percent of the portfolio, respectively. Loans to borrowers within these industries are usually collateralized by real estate.

In addition to a comprehensive lending policy, numerous internal reviews of loan and foreclosed real estate portfolios occur throughout the year. Loan portfolios are also reviewed by independent auditors in connection with their annual financial statement audit and are examined periodically by bank regulators.

Nonperforming assets

The following table presents a five-year history of 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 for December 31, 2012, compared to December 31, 2011.

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Nonperforming assets are reviewed by management on a monthly basis. 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 is less than the net carrying amount of the loan, 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 all of the loan balance will not be collected, that amount is charged off as loss against the allowance. Generally, a loan is returned to interest accruing status when we determine that circumstances have improved to the extent that all of the principal and interest amounts contractually due are current for at least six consecutive payments and future payments are reasonably assured.

Table 10-Nonperforming Assets

	December 31,				
(dollars in thousands)	**2012**	**2011**	**2010**	**2009**	**2008**
Nonaccrual loans	$ 6,232	$ 5,931	$ 14,844	$ 25,558	$ 8,396
Nonaccrual loans, troubled debt restructurings	2,110	5,770	3,680	0	0
Accruing loans that are contractually past due 90 days or more as to principal and interest	186	0	197	40	61
Total nonperforming loans	8,528	11,701	18,721	25,598	8,457
Foreclosed real estate, net of allowance	3,633	16,243	10,572	9,314	2,052
Total nonperforming assets	$ 12,161	$ 27,944	$ 29,293	$ 34,912	$ 10,509
Accruing troubled debt restructurings	$ 3,550	$ 3,272	$ 0	$ 0	$ 0

Ratios:					
Total period-end loans, net of deferred fees	$ 737,134	$ 693,515	$ 640,849	$ 645,877	$ 573,078
Allowance for loan losses (ALL)	$ 9,302	$ 8,702	$ 7,626	$ 7,175	$ 4,690
ALL as a % of total period-end loans	1.26%	1.25%	1.19%	1.11%	0.82%
Annualized net charge-offs (recoveries) as a % of average total loans	0.16%	0.58%	0.39%	0.20%	0.13%
ALL as a % of nonperforming loans	109.08%	74.38%	40.74%	28.03%	55.45%
Nonperforming loans as a % of total period-end loans	1.16%	1.69%	2.92%	3.96%	1.48%
Nonperforming assets as a % of total period-end loans and net foreclosed real estate	1.64%	3.94%	4.50%	5.33%	1.83%
Nonperforming assets as a % of total period-end assets	1.15%				