

CODORUS VALLEY BANCORP INC
Form 10-Q
November 07, 2014
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UNITED STATES SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934
For the quarterly period ended September 30, 2014

or

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

Commission file number: 0-15536

CODORUS VALLEY BANCORP, INC.

(Exact name of registrant as specified in its charter)

Pennsylvania

(State or other jurisdiction of
incorporation or organization)

23-2428543

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

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

(Address of principal executive offices) (Zip code)

717-747-1519

(Registrant's telephone number, including area code)

Not Applicable

(Former name, former address and former fiscal year,
if changed since the last report.)

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

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Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer or a smaller reporting company. See definition of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer

Accelerated filer

Non-accelerated filer

Smaller reporting company

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

APPLICABLE ONLY TO CORPORATE ISSUERS

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date. On October 31, 2014, 5,804,749 shares of common stock, par value \$2.50, were outstanding, which includes the effect of the 5 percent common stock dividend declared October 14, 2014.

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Codorus Valley Bancorp, Inc.

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Consolidated Balance Sheets
Unaudited

| <i>(dollars in thousands, except share and per share data)</i> | September 30, 2014 | December 31, 2013 |
|---------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-----------------------|----------------------|
| Assets | | |
| Interest bearing deposits with banks | \$ 21,433 | \$ 1,947 |
| Cash and due from banks | 12,798 | 13,115 |
| Total cash and cash equivalents | 34,231 | 15,062 |
| Securities, available-for-sale | 228,803 | 228,741 |
| Restricted investment in bank stocks, at cost | 4,710 | 4,742 |
| Loans held for sale | 641 | 514 |
| Loans (net of deferred fees of \$2,144 - 2014 and \$1,963 - 2013) | 892,004 | 859,384 |
| Less-allowance for loan losses | (10,713) | (9,975) |
| Net loans | 881,291 | 849,409 |
| Premises and equipment, net | 15,173 | 14,599 |
| Other assets | 38,791 | 37,574 |
| Total assets | \$ 1,203,640 | \$ 1,150,641 |
| Liabilities | | |
| Deposits | | |
| Noninterest bearing | \$ 117,954 | \$ 107,921 |
| Interest bearing | 841,141 | 817,382 |
| Total deposits | 959,095 | 925,303 |
| Short-term borrowings | 41,377 | 40,363 |
| Long-term debt | 80,429 | 70,493 |
| Other liabilities | 6,883 | 6,833 |
| Total liabilities | 1,087,784 | 1,042,992 |
| Shareholders equity | | |
| Preferred stock, par value \$2.50 per share; \$1,000 liquidation preference, 1,000,000 shares authorized; Series B shares issued and outstanding: | | |
| 12,000 at September 30, 2014 and 25,000 at December 31, 2013 | 12,000 | 25,000 |
| Common stock, par value \$2.50 per share; 15,000,000 shares authorized; shares issued and outstanding: 5,804,749 at September 30, 2014 and 4,800,318 at December 31, 2013 | | |
| Additional paid-in capital | 62,423 | 45,399 |
| Retained earnings | 24,424 | 23,077 |
| Accumulated other comprehensive income | 2,496 | 2,172 |
| Total shareholders equity | 115,856 | 107,649 |
| Total liabilities and shareholders equity | \$ 1,203,640 | \$ 1,150,641 |
| See accompanying notes. | | |

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Codorus Valley Bancorp, Inc.
Consolidated Statements of Income
Unaudited

| <i>(dollars in thousands, except per share data)</i> | Three months ended September 30, | | Nine months ended September 30, | |
|----------------------------------------------------------|-------------------------------------|-----------|------------------------------------|-----------|
| | 2014 | 2013 | 2014 | 2013 |
| Interest income | | | | |
| Loans, including fees | \$ 11,272 | \$ 10,415 | \$ 33,157 | \$ 30,692 |
| Investment securities: | | | | |
| Taxable | 867 | 788 | 2,564 | 2,054 |
| Tax-exempt | 467 | 590 | 1,513 | 1,830 |
| Dividends | 48 | 9 | 171 | 18 |
| Other | 16 | 17 | 42 | 59 |
| Total interest income | 12,670 | 11,819 | 37,447 | 34,653 |
| Interest expense | | | | |
| Deposits | 1,682 | 1,889 | 5,094 | 5,849 |
| Federal funds purchased and other short-term borrowings | 43 | 34 | 116 | 91 |
| Long-term debt | 299 | 201 | 881 | 565 |
| Total interest expense | 2,024 | 2,124 | 6,091 | 6,505 |
| Net interest income | 10,646 | 9,695 | 31,356 | 28,148 |
| Provision for loan losses | 250 | 150 | 1,100 | 970 |
| Net interest income after provision for loan losses | 10,396 | 9,545 | 30,256 | 27,178 |
| Noninterest income | | | | |
| Trust and investment services fees | 592 | 510 | 1,644 | 1,447 |
| Income from mutual fund, annuity and insurance sales | 178 | 74 | 503 | 496 |
| Service charges on deposit accounts | 783 | 688 | 2,221 | 1,992 |
| Income from bank owned life insurance | 184 | 192 | 532 | 543 |
| Other income | 155 | 157 | 458 | 503 |
| Net gain on sales of loans held for sale | 124 | 233 | 306 | 874 |
| Gain on sales of securities | 146 | 0 | 146 | 44 |
| Total noninterest income | 2,162 | 1,854 | 5,810 | 5,899 |
| Noninterest expense | | | | |
| Personnel | 4,436 | 4,191 | 13,040 | 12,486 |
| Occupancy of premises, net | 505 | 496 | 1,586 | 1,519 |
| Furniture and equipment | 552 | 522 | 1,646 | 1,493 |
| Postage, stationery and supplies | 199 | 131 | 521 | 438 |
| Professional and legal | 380 | 187 | 819 | 489 |
| Marketing | 340 | 341 | 1,060 | 741 |
| FDIC insurance | 149 | 154 | 511 | 463 |
| Debit card processing | 199 | 204 | 592 | 577 |
| Charitable donations | 66 | 32 | 835 | 518 |
| Telephone | 141 | 130 | 432 | 396 |
| External data processing | 186 | 178 | 621 | 513 |
| Foreclosed real estate including (gains) losses on sales | 60 | 277 | 307 | 414 |
| Other | 789 | 889 | 1,666 | 2,095 |
| Total noninterest expense | 8,002 | 7,732 | 23,636 | 22,142 |
| Income before income taxes | 4,556 | 3,667 | 12,430 | 10,935 |
| Provision for income taxes | 1,377 | 990 | 3,441 | 2,951 |
| Net income | 3,179 | 2,677 | 8,989 | 7,984 |
| Preferred stock dividends | 30 | 62 | 144 | 187 |
| Net income available to common shareholders | \$ 3,149 | \$ 2,615 | \$ 8,845 | \$ 7,797 |
| Net income per common share, basic | \$ 0.54 | \$ 0.52 | \$ 1.60 | \$ 1.57 |
| Net income per common share, diluted | \$ 0.54 | \$ 0.51 | \$ 1.57 | \$ 1.54 |

See accompanying notes.

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

| <i>(dollars in thousands)</i> | Three months ended September 30, | |
|----------------------------------------------------------------------------------------------------------------------------------|---------------------------------------------|-----------------|
| | 2014 | 2013 |
| Net income | \$ 3,179 | \$ 2,677 |
| Other comprehensive income (loss): | | |
| Securities available for sale: | | |
| Net unrealized holding (losses) gains arising during the period (net of tax (benefit) expense of (\$420) and \$89, respectively) | (816) | 173 |
| Reclassification adjustment for gains included in net income (net of tax expense of \$50 and \$0, respectively) (a) (b) | (96) | 0 |
| Net unrealized (losses) gains | (912) | 173 |
| Comprehensive income | \$ 2,267 | \$ 2,850 |

| <i>(dollars in thousands)</i> | Nine months ended September 30, | |
|-------------------------------------------------------------------------------------------------------------------------------------|--------------------------------------------|-----------------|
| | 2014 | 2013 |
| Net income | \$ 8,989 | \$ 7,984 |
| Other comprehensive income (loss): | | |
| Securities available for sale: | | |
| Net unrealized holding gains (losses) arising during the period (net of tax expense (benefit) of \$217 and (\$1,410), respectively) | 420 | (2,738) |
| Reclassification adjustment for gains included in net income (net of tax expense of \$50 and \$15, respectively) (a) (b) | (96) | (29) |
| Net unrealized gains (losses) | 324 | (2,767) |
| Comprehensive income | \$ 9,313 | \$ 5,217 |

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

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

See accompanying notes.

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

| (dollars in thousands) | Nine months ended September 30, | |
|-------------------------------------------------------------------------|------------------------------------|-----------|
| | 2014 | 2013 |
| Cash flows from operating activities | | |
| Net income | \$ 8,989 | \$ 7,984 |
| Adjustments to reconcile net income to net cash provided by operations: | | |
| Depreciation/amortization | 1,311 | 1,116 |
| Net amortization of premiums on securities | 732 | 997 |
| Amortization of deferred loan origination fees and costs | (538) | (404) |
| Provision for loan losses | 1,100 | 970 |
| Provision for losses on foreclosed real estate | 0 | 125 |
| Deferred income tax benefit | (145) | 0 |
| Amortization of investment in real estate partnership | 208 | 242 |
| Increase in cash surrender of bank owned life insurance | (532) | (543) |
| Originations of loans held for sale | (14,795) | (46,719) |
| Proceeds from sales of loans held for sale | 14,974 | 48,600 |
| Net gain on sales of loans held for sale | (306) | (874) |
| Net loss on disposal of premises and equipment | 5 | 0 |
| Gain on sales of securities, available-for-sale | (146) | (44) |
| Net loss (gain) on sales of foreclosed real estate | 40 | (15) |
| Stock-based compensation | 229 | 236 |
| Decrease in interest receivable | 142 | 61 |
| (Increase) decrease in other assets | (1,100) | 1,270 |
| Decrease in interest payable | (6) | (94) |
| Increase (decrease) in other liabilities | 98 | (143) |
| Net cash provided by operating activities | 10,260 | 12,765 |
| Cash flows from investing activities | | |
| Purchases of securities, available-for-sale | (34,214) | (43,348) |
| Maturities, repayments and calls of securities, available-for-sale | 29,910 | 32,209 |
| Sales of securities, available-for-sale | 4,147 | 927 |
| Redemption (purchase) of restricted investment in bank stock | 32 | (745) |
| Net increase in loans made to customers | (34,014) | (77,240) |
| Purchases of premises and equipment | (1,890) | (3,912) |
| Investment in bank owned life insurance | (1,186) | (5,307) |
| Proceeds from sales of foreclosed real estate | 2,750 | 207 |
| Net cash used in investing activities | (34,465) | (97,209) |
| Cash flows from financing activities | | |
| Net increase in demand and savings deposits | 28,298 | 27,664 |
| Net increase (decrease) in time deposits | 5,494 | (6,656) |
| Net increase in short-term borrowings | 1,014 | 12,179 |
| Proceeds from issuance of long-term debt | 10,000 | 20,000 |
| Repayment of long-term debt | (64) | (302) |
| Tax benefit on vested restricted stock | 3 | 0 |
| Cash dividends paid to preferred shareholder | (177) | (187) |
| Cash dividends paid to common shareholders | (1,920) | (1,531) |
| Redemption of preferred stock | (13,000) | 0 |
| Issuance of common stock | 13,726 | 667 |
| Net cash provided by financing activities | 43,374 | 51,834 |
| Net increase (decrease) in cash and cash equivalents | 19,169 | (32,610) |
| Cash and cash equivalents at beginning of year | 15,062 | 49,757 |
| Cash and cash equivalents at end of period | \$ 34,231 | \$ 17,147 |

See accompanying notes.

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

| <i>(dollars in thousands, except per share data)</i> | Preferred Stock | Common Stock | Additional Paid-in Capital | Retained Earnings | Accumulated Other Comprehensive Income | Total |
|------------------------------------------------------------------------|--------------------|-----------------|----------------------------------|----------------------|-------------------------------------------------|------------|
| Balance, January 1, 2014 | \$ 25,000 | \$ 12,001 | \$ 45,399 | \$ 23,077 | \$ 2,172 | \$ 107,649 |
| Net income | | | | 8,989 | | 8,989 |
| Other comprehensive income, net of tax | | | | | 324 | 324 |
| Common stock cash dividends (\$0.347 per share, adjusted) | | | | (1,920) | | (1,920) |
| 5% common stock dividend, 276,417 shares at fair value | | 691 | 4,887 | (5,578) | | 0 |
| Preferred stock cash dividends | | | | (144) | | (144) |
| Redemption of preferred stock | (13,000) | | | | | (13,000) |
| Stock-based compensation including related tax benefit | | | 232 | | | 232 |
| Issuance and reissuance of common stock including related tax benefit: | | | | | | |
| 650,000 shares through private placement | | 1,625 | 10,885 | | | 12,510 |
| 13,219 shares under the dividend reinvestment and stock purchase plan | | 33 | 247 | | | 280 |
| 61,411 shares under the stock option plan | | 154 | 721 | | | 875 |
| 3,613 shares under employee stock purchase plan | | 9 | 52 | | | 61 |
| Balance, September 30, 2014 | \$ 12,000 | \$ 14,513 | \$ 62,423 | \$ 24,424 | \$ 2,496 | \$ 115,856 |
| Balance, January 1, 2013 | \$ 25,000 | \$ 11,206 | \$ 40,524 | \$ 18,868 | \$ 5,733 | \$ 101,331 |
| Net income | | | | 7,984 | | 7,984 |
| Other comprehensive loss, net of tax | | | | | (2,767) | (2,767) |
| Common stock cash dividends (\$0.309 per share, adjusted) | | | | (1,531) | | (1,531) |
| 5% common stock dividend, 226,451 shares at fair value | | 566 | 3,467 | (4,033) | | 0 |
| Preferred stock cash dividends | | | | (187) | | (187) |
| Stock-based compensation including related tax benefit | | | 236 | | | 236 |
| Issuance of common stock including related tax benefit: | | | | | | |
| 15,429 shares under the dividend reinvestment and stock purchase plan | | 38 | 229 | | | 267 |
| 27,031 shares under the stock option plan | | 68 | 278 | | | 346 |
| 4,246 shares under employee stock purchase plan | | 11 | 43 | | | 54 |
| Balance, September 30, 2013 | \$ 25,000 | \$ 11,889 | \$ 44,777 | \$ 21,101 | \$ 2,966 | \$ 105,733 |

See accompanying notes.

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Note 1 Basis of Presentation

The accompanying unaudited consolidated balance sheet at December 31, 2013 has been derived from audited financial statements, and the unaudited interim consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America for interim financial information, the instructions to Form 10-Q, and FASB Accounting Standards Codification (ASC) 270. Accordingly, the interim financial statements do not include all of the financial information and notes required by generally accepted accounting principles for complete financial statements. In the opinion of management, the interim consolidated financial statements include all adjustments necessary to present fairly the financial condition and results of operations for the reported periods, and all such adjustments are of a normal and recurring nature.

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

These consolidated statements should be read in conjunction with the notes to the audited consolidated financial statements contained in the Corporation's Annual Report on Form 10-K for the year ended December 31, 2013.

The results of operations for the three and nine months ended September 30, 2014 are not necessarily indicative of the results to be expected for the full year.

In accordance with FASB ASC 855, the Corporation evaluated the events and transactions that occurred after the balance sheet date of September 30, 2014 and through the date these consolidated financial statements were issued, for items of potential recognition or disclosure.

Note 2 Significant Accounting Policies

Loans

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

For all classes of loans receivable, the accrual of interest is discontinued when the contractual payment of principal or interest has become 90 days past due or management has serious doubts about further collectability of principal or interest, even though the loan is currently performing. A loan may remain on accrual status if it is in the process of collection and well secured. When a loan is placed on nonaccrual status, unpaid interest credited to income in the current year is reversed and unpaid interest accrued in prior years is charged against the allowance for loan losses. Interest received on nonaccrual loans, including impaired loans, generally is either applied against principal or reported as interest income, according to the Corporation's judgment as to the collectability of principal. Generally, loans are restored to accrual status when the obligation is brought current, has performed in accordance with the contractual terms for a reasonable period of time, generally six months, and the ultimate collectability of the total contractual principal and interest is no longer in doubt. The past due status of all classes of loans receivable is determined based on contractual due dates for loan payments.

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Allowance for Loan Losses

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

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

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

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

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

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

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

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

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

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Banking regulatory agencies, as an integral part of their examination process, periodically review the Corporation's allowance for loan losses and may require the Corporation to recognize additions to the allowance based on their judgments about information available to them at the time of their examination, which may not be currently available to the Corporation. Based on an analysis of the loan portfolio, the Corporation believes that the level of the allowance for loan losses at September 30, 2014 is adequate.

Foreclosed Real Estate

Foreclosed real estate, included in other assets, is comprised of property acquired through a foreclosure proceeding or property that is acquired through in-substance foreclosure. Foreclosed real estate is initially recorded at fair value minus estimated costs to sell at the date of foreclosure, establishing a new cost basis. Any difference between the carrying value and the new cost basis is charged against the allowance for loan losses. Appraisals, based upon an independent third party, are generally used to determine fair value. After foreclosure, management reviews valuations at least quarterly and adjusts the asset to the lower of cost or fair value minus estimated costs to sell through a valuation allowance or a charge-off. Costs related to the improvement of foreclosed real estate are generally capitalized until the real estate reaches a saleable condition subject to fair value limitations. Revenue and expense from operations and changes in the valuation allowance are included in noninterest expense. When a foreclosed real estate asset is ultimately sold, any gain or loss on the sale is included in the income statement as a component of noninterest expense. At September 30, 2014, foreclosed real estate, net of allowance, was \$2,805,000, compared to \$4,068,000 for December 31, 2013.

Per Common Share Computations

All per share computations include the effect of stock dividends declared, including a 5% common stock dividend declared October 14, 2014. The computation of net income per common share is provided in the table below.

| <i>(in thousands, except per share data)</i> | Three months ended September 30, | | Nine months ended September 30, | |
|---------------------------------------------------------------------------------|-------------------------------------|----------|------------------------------------|----------|
| | 2014 | 2013 | 2014 | 2013 |
| Net income available to common shareholders | \$ 3,149 | \$ 2,615 | \$ 8,845 | \$ 7,797 |
| Weighted average shares outstanding (basic) | 5,781 | 4,988 | 5,545 | 4,967 |
| Effect of dilutive stock options | 95 | 99 | 104 | 93 |
| Weighted average shares outstanding (diluted) | 5,876 | 5,087 | 5,649 | 5,060 |
| Basic earnings per common share | \$ 0.54 | \$ 0.52 | \$ 1.60 | \$ 1.57 |
| Diluted earnings per common share | \$ 0.54 | \$ 0.51 | \$ 1.57 | \$ 1.54 |
| Anti-dilutive stock options excluded from the computation of earnings per share | 23 | 4 | 28 | 35 |

Comprehensive Income

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

Table of Contents*Cash Flow Information*

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

Supplemental cash flow information is provided in the table below.

| <i>(dollars in thousands)</i> | Nine months ended September 30, | |
|-------------------------------------------------------------------|------------------------------------|----------|
| | 2014 | 2013 |
| Cash paid during the period for: | | |
| Income taxes | \$ 3,126 | \$ 2,490 |
| Interest | \$ 6,097 | \$ 6,599 |
| Noncash investing activities: | | |
| Transfer of loans to foreclosed real estate | \$ 1,570 | \$ 551 |
| Transfer of loans held for sale to the held-to-maturity portfolio | \$ 0 | \$ 258 |
| Charitable donation of foreclosed real estate | \$ 43 | \$ 0 |

Reclassification

Certain amounts in the 2013 consolidated financial statements have been reclassified to conform to the 2014 presentation, such reclassification did not impact net income or shareholders' equity.

Recent Accounting Pronouncements

In May 2014, the FASB issued ASU 2014-09, Revenue from Contracts with Customers (Topic 606). This standards update provides a framework that replaces most existing revenue recognition guidance. The guidance requires an entity to recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the company expects to be entitled in exchange for those goods or services. ASU 2014-09 is effective for interim and annual reporting periods beginning after December 15, 2016. Early adoption is not permitted. The Corporation is currently evaluating the impact of the adoption of this guidance on its consolidated financial statements.

Table of Contents**Note 3-Securities**

A summary of securities available-for-sale at September 30, 2014 and December 31, 2013 is provided below. The securities available-for-sale portfolio is generally comprised of high quality debt instruments, principally obligations of the United States government or agencies thereof and investments in the obligations of states and municipalities. The majority of municipal bonds in the portfolio are general obligation bonds, which can draw upon multiple sources of revenue, including taxes, for payment. Only a few bonds are revenue bonds, which are dependent upon a single revenue stream for payment, but they are for critical services such as water and sewer. In many cases, municipal debt issues are insured or, in the case of school districts of selected states, backed by specific loss reserves. At September 30, 2014, the fair value of the municipal bond portfolio was concentrated in the states of Pennsylvania at 42 percent and Texas at 16 percent.

| <i>(dollars in thousands)</i> | Amortized Cost | Gross Unrealized Gains | Losses | Fair Value |
|------------------------------------------|-------------------|---------------------------|------------|---------------|
| September 30, 2014 | | | | |
| Debt securities: | | | | |
| U.S. agency | \$ 29,211 | \$ 433 | \$ (144) | \$ 29,500 |
| U.S. agency mortgage-backed, residential | 124,601 | 1,688 | (234) | 126,055 |
| State and municipal | 71,209 | 2,051 | (12) | 73,248 |
| Total debt securities | \$ 225,021 | \$ 4,172 | \$ (390) | \$ 228,803 |
| December 31, 2013 | | | | |
| Debt securities: | | | | |
| U.S. agency | \$ 33,265 | \$ 695 | \$ (461) | \$ 33,499 |
| U.S. agency mortgage-backed, residential | 105,181 | 1,563 | (825) | 105,919 |
| State and municipal | 87,004 | 2,411 | (92) | 89,323 |
| Total debt securities | \$ 225,450 | \$ 4,669 | \$ (1,378) | \$ 228,741 |

The amortized cost and estimated fair value of debt securities at September 30, 2014 by contractual maturity are shown below. Actual maturities may differ from contractual maturities if call options on select debt issues are exercised in the future. Mortgage-backed securities are included in the maturity categories based on average expected life.

| <i>(dollars in thousands)</i> | Available-for-sale | |
|----------------------------------------|--------------------|---------------|
| | Amortized Cost | Fair Value |
| Due in one year or less | \$ 16,158 | \$ 16,362 |
| Due after one year through five years | 147,006 | 150,259 |
| Due after five years through ten years | 58,038 | 58,166 |
| Due after ten years | 3,819 | 4,016 |
| Total debt securities | \$ 225,021 | \$ 228,803 |

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

| <i>(dollars in thousands)</i> | Three months ended September 30, | | Nine months ended September 30, | |
|-------------------------------|-------------------------------------|------|------------------------------------|-------|
| | 2014 | 2013 | 2014 | 2013 |
| Realized gains | \$ 146 | \$ 0 | \$ 146 | \$ 44 |
| Realized losses | 0 | 0 | 0 | 0 |
| Net gains | \$ 146 | \$ 0 | \$ 146 | \$ 44 |

Securities, issued by agencies of the federal government, with a carrying value of \$176,709,000 and \$142,914,000 on September 30, 2014 and December 31, 2013, respectively, were pledged to secure public and trust deposits, repurchase agreements and other short-term borrowings.

The table below shows gross unrealized losses and fair value, aggregated by investment category and length of time, for securities that have been in a continuous unrealized loss position, at September 30, 2014 and December 31, 2013.

| <i>(dollars in thousands)</i> | Less than 12 months | | 12 months or more | | Total | |
|----------------------------------------------------------------|---------------------|-------------------|-------------------|-------------------|------------|-------------------|
| | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses |
| September 30, 2014 | | | | | | |
| Debt securities: | | | | | | |
| U.S. agency | \$ 0 | \$ 0 | \$ 10,980 | \$ (144) | \$ 10,980 | \$ (144) |
| U.S. agency mortgage-backed, residential | 48,509 | (193) | 4,219 | (41) | 52,728 | (234) |
| State and municipal | 1,237 | (1) | 1,697 | (11) | 2,934 | (12) |
| Total temporarily impaired debt securities, available-for-sale | \$ 49,746 | \$ (194) | \$ 16,896 | \$ (196) | \$ 66,642 | \$ (390) |
| December 31, 2013 | | | | | | |
| Debt securities: | | | | | | |
| U.S. agency | \$ 15,351 | \$ (461) | \$ 0 | \$ 0 | \$ 15,351 | \$ (461) |
| U.S. agency mortgage-backed, residential | 56,787 | (825) | 0 | 0 | 56,787 | (825) |
| State and municipal | 9,897 | (78) | 797 | (14) | 10,694 | (92) |
| Total temporarily impaired debt securities, available-for-sale | \$ 82,035 | \$ (1,364) | \$ 797 | \$ (14) | \$ 82,832 | \$ (1,378) |

The unrealized losses of \$194,000 at September 30, 2014 within the less than 12 months category were attributable to fourteen U.S. agency mortgage-backed securities and three state and municipal securities. The unrealized losses of \$196,000 within the 12 months or more category were attributable to four U.S. agency securities, two U.S. agency mortgage-backed securities, and four state and municipal securities. All of the securities with unrealized losses have been evaluated and determined to be investment grade.

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

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The Corporation believes that unrealized losses at September 30, 2014 were primarily the result of changes in market interest rates and that it has the ability to hold these investments for a time necessary to recover the amortized cost. Through September 30, 2014, the Corporation has collected all interest and principal on its investment securities as scheduled. The Corporation believes that collection of the contractual principal and interest is probable and, therefore, all impairment is considered to be temporary.

Note 4 Restricted Investment in Bank Stocks

Restricted stock, which represents required investments in the common stock of correspondent banks, is carried at cost and, as of September 30, 2014 and December 31, 2013, consisted primarily of the common stock of the Federal Home Loan Bank of Pittsburgh (FHLBP) and, to a lesser degree, Atlantic Community Bankers Bank (ACBB). Under the FHLBP's Capital Plan, PeoplesBank is required to maintain a minimum member stock investment, as a condition of remaining a member and as a condition of obtaining borrowings from the FHLBP. The FHLBP uses a formula to determine the minimum stock investment, which is based on the volume of loans outstanding, unused borrowing capacity and other factors.

The FHLBP paid dividends during the periods ended September 30, 2014 and 2013. FHLBP restricts the repurchase of the excess capital stock of member banks. The amount of excess capital stock that can be repurchased from any member is currently the lesser of five percent of the member's total capital stock outstanding or its excess capital stock outstanding.

Management evaluates the restricted stock for impairment in accordance with FASB ASC Topic 942. Management's determination of whether these investments are impaired is based on their assessment of the ultimate recoverability of their cost rather than by recognizing temporary declines in value. Using the FHLBP as an example, the determination of whether a decline affects the ultimate recoverability of cost is influenced by criteria such as: (1) the significance of the decline in net assets of the FHLBP as compared to the capital stock amount for the FHLBP and the length of time this situation has persisted; (2) commitments by the FHLBP to make payments required by law or regulation and the level of such payments in relation to the operating performance of the FHLBP; and (3) the impact of legislative and regulatory changes on institutions and, accordingly, on the customer base of the FHLBP. Management believes no impairment charge was necessary related to the restricted stock during the periods ended September 30, 2014 and 2013.

Table of Contents**Note 5 Loans***Loan Portfolio Composition*

The table below provides the composition of the loan portfolio at September 30, 2014 and December 31, 2013. The portfolio is comprised of two segments, commercial and consumer loans. The commercial loan segment is disaggregated by industry class which allows the Corporation to monitor risk and performance. Those industries representing the largest dollar investment and most risk are listed separately. The Other commercial loans category is comprised of various industries. The consumer related segment is comprised of residential mortgages, home equity and other consumer loans. The Corporation has not engaged in sub-prime residential mortgage originations.

| | September 30, 2014 | December 31, 2013 |
|----------------------------------|-----------------------------------|----------------------------------|
| <i>(dollars in thousands)</i> | | |
| Builder & developer | \$ 107,542 | \$ 106,436 |
| Commercial real estate investor | 151,462 | 141,372 |
| Residential real estate investor | 89,198 | 78,400 |
| Hotel/Motel | 75,371 | 70,324 |
| Wholesale & retail | 67,053 | 75,445 |
| Manufacturing | 35,532 | 36,872 |
| Agriculture | 40,242 | 38,041 |
| Other | 176,794 | 167,325 |
| Total commercial related loans | 743,194 | 714,215 |
| Residential mortgages | 32,676 | 25,695 |
| Home equity | 82,585 | 80,859 |
| Other | 33,549 | 38,615 |
| Total consumer related loans | 148,810 | 145,169 |
| Total loans | \$ 892,004 | \$ 859,384 |

Loan Risk Ratings

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

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

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The table below presents a summary of loan risk ratings by loan class at September 30, 2014 and December 31, 2013.

| <i>(dollars in thousands)</i> | Pass | Special Mention | Substandard | Nonaccrual | Total |
|----------------------------------|------------|--------------------|-------------|------------|------------|
| September 30, 2014 | | | | | |
| Builder & developer | \$ 94,626 | \$ 6,726 | \$ 4,074 | \$ 2,116 | \$ 107,542 |
| Commercial real estate investor | 140,572 | 4,293 | 3,389 | 3,208 | 151,462 |
| Residential real estate investor | 83,982 | 3,279 | 268 | 1,669 | 89,198 |
| Hotel/Motel | 74,806 | 0 | 565 | 0 | 75,371 |
| Wholesale & retail | 58,700 | 8,223 | 0 | 130 | 67,053 |
| Manufacturing | 31,336 | 3,533 | 663 | 0 | 35,532 |
| Agriculture | 37,055 | 2,751 | 436 | 0 | 40,242 |
| Other | 173,685 | 1,623 | 843 | 643 | 176,794 |
| Total commercial related loans | 694,762 | 30,428 | 10,238 | 7,766 | 743,194 |
| Residential mortgage | 32,530 | 0 | 28 | 118 | 32,676 |
| Home equity | 81,998 | 354 | 10 | 223 | 82,585 |
| Other | 33,024 | 82 | 0 | 443 | 33,549 |
| Total consumer related loans | 147,552 | 436 | 38 | 784 | 148,810 |
| Total loans | \$ 842,314 | \$ 30,864 | \$ 10,276 | \$ 8,550 | \$ 892,004 |
| December 31, 2013 | | | | | |
| Builder & developer | \$ 91,106 | \$ 4,879 | \$ 4,786 | \$ 5,665 | \$ 106,436 |
| Commercial real estate investor | 129,763 | 3,749 | 3,426 | 4,434 | 141,372 |
| Residential real estate investor | 74,626 | 1,790 | 187 | 1,797 | 78,400 |
| Hotel/Motel | 70,324 | 0 | 0 | 0 | 70,324 |
| Wholesale & retail | 73,425 | 892 | 0 | 1,128 | 75,445 |
| Manufacturing | 34,986 | 1,215 | 671 | 0 | 36,872 |
| Agriculture | 34,961 | 2,629 | 451 | 0 | 38,041 |
| Other | 164,621 | 880 | 482 | 1,342 | 167,325 |
| Total commercial related loans | 673,812 | 16,034 | 10,003 | 14,366 | 714,215 |
| Residential mortgage | 25,541 | 4 | 30 | 120 | 25,695 |
| Home equity | 80,271 | 357 | 11 | 220 | 80,859 |
| Other | 37,814 | 207 | 0 | 594 | 38,615 |
| Total consumer related loans | 143,626 | 568 | 41 | 934 | 145,169 |
| Total loans | \$ 817,438 | \$ 16,602 | \$ 10,044 | \$ 15,300 | \$ 859,384 |

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Table of Contents*Impaired Loans*

The table below presents a summary of impaired loans at September 30, 2014 and December 31, 2013. Generally, impaired loans are loans risk rated substandard and nonaccrual or classified as troubled debt restructurings. An allowance is established for individual commercial loans where the Corporation has doubt as to full recovery of the outstanding principal balance. Typically, impaired consumer loans are partially or fully charged off obviating the need for a specific allowance. The recorded investment represents outstanding unpaid principal loan balances adjusted for charge-offs.

| <i>(dollars in thousands)</i> | September 30, 2014 | | | December 31, 2013 | | |
|------------------------------------------------|---------------------|--------------------------|-------------------|---------------------|--------------------------|-------------------|
| | Recorded Investment | Unpaid Principal Balance | Related Allowance | Recorded Investment | Unpaid Principal Balance | Related Allowance |
| Impaired loans with no related allowance: | | | | | | |
| Builder & developer | \$ 4,145 | \$ 4,145 | | \$ 3,861 | \$ 3,861 | |
| Commercial real estate investor | 6,597 | 6,597 | | 7,860 | 7,860 | |
| Residential real estate investor | 411 | 411 | | 354 | 579 | |
| Hotel/Motel | 565 | 565 | | 0 | 0 | |
| Wholesale & retail | 402 | 402 | | 1,403 | 1,403 | |
| Manufacturing | 663 | 663 | | 671 | 671 | |
| Agriculture | 0 | 0 | | 0 | 0 | |
| Other commercial | 1,011 | 1,011 | | 1,498 | 1,498 | |
| Residential mortgage | 146 | 171 | | 150 | 176 | |
| Home equity | 233 | 233 | | 231 | 256 | |
| Other consumer | 443 | 443 | | 594 | 609 | |
| Total impaired loans with no related allowance | \$ 14,616 | \$ 14,641 | | \$ 16,622 | \$ 16,913 | |
| Impaired loans with a related allowance: | | | | | | |
| Builder & developer | \$ 2,045 | \$ 2,045 | \$ 953 | \$ 7,733 | \$ 7,733 | \$ 850 |
| Commercial real estate investor | 0 | 0 | 0 | 0 | 0 | 0 |
| Residential real estate investor | 1,526 | 1,526 | 559 | 1,630 | 1,630 | 650 |
| Hotel/Motel | 0 | 0 | 0 | 0 | 0 | 0 |
| Wholesale & retail | 0 | 0 | 0 | 0 | 0 | 0 |
| Manufacturing | 0 | 0 | 0 | 0 | 0 | 0 |
| Agriculture | 436 | 436 | 100 | 451 | 451 | 100 |
| Other commercial | 475 | 475 | 300 | 326 | 326 | 120 |
| Residential mortgage | 0 | 0 | 0 | 0 | 0 | 0 |
| Home equity | 0 | 0 | 0 | 0 | 0 | 0 |
| Other consumer | 0 | 0 | 0 | 0 | 0 | 0 |
| Total impaired loans with a related allowance | \$ 4,482 | \$ 4,482 | \$ 1,912 | \$ 10,140 | \$ 10,140 | \$ 1,720 |
| Total impaired loans: | | | | | | |
| Builder & developer | \$ 6,190 | \$ 6,190 | \$ 953 | \$ 11,594 | \$ 11,594 | \$ 850 |
| Commercial real estate investor | 6,597 | 6,597 | 0 | 7,860 | 7,860 | 0 |
| Residential real estate investor | 1,937 | 1,937 | 559 | 1,984 | 2,209 | 650 |
| Hotel/Motel | 565 | 565 | 0 | 0 | 0 | 0 |
| Wholesale & retail | 402 | 402 | 0 | 1,403 | 1,403 | 0 |
| Manufacturing | 663 | 663 | 0 | 671 | 671 | 0 |
| Agriculture | 436 | 436 | 100 | 451 | 451 | 100 |
| Other commercial | 1,486 | 1,486 | 300 | 1,824 | 1,824 | 120 |
| Residential mortgage | 146 | 171 | 0 | 150 | 176 | 0 |
| Home equity | 233 | 233 | 0 | 231 | 256 | 0 |
| Other consumer | 443 | 443 | 0 | 594 | 609 | 0 |
| Total impaired loans | \$ 19,098 | \$ 19,123 | \$ 1,912 | \$ 26,762 | \$ 27,053 | \$ 1,720 |

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The table below presents a summary of average impaired loans and related interest income that was included in net income for the three and nine months ended September 30, 2014 and 2013.

| <i>(dollars in thousands)</i> | For the three months ended | | | | | |
|------------------------------------------------|-----------------------------|---------------------------------------------|----------------------------|-----------------------------|---------------------------------------------|----------------------------|
| | Average Recorded Investment | September 30, 2014 Total Interest Income | Cash Basis Interest Income | Average Recorded Investment | September 30, 2013 Total Interest Income | Cash Basis Interest Income |
| Impaired loans with no related allowance: | | | | | | |
| Builder & developer | \$ 4,277 | \$ 64 | \$ 1 | \$ 9,094 | \$ 132 | \$ 0 |
| Commercial real estate investor | 6,620 | 76 | 26 | 6,182 | 61 | 23 |
| Residential real estate investor | 571 | 24 | 22 | 305 | 0 | 1 |
| Hotel/Motel | 582 | 5 | 0 | 0 | 0 | 0 |
| Wholesale & retail | 605 | 8 | 5 | 1,882 | 65 | 62 |
| Manufacturing | 665 | 10 | 0 | 679 | 11 | 0 |
| Agriculture | 0 | 0 | 0 | 0 | 0 | 0 |
| Other commercial | 1,151 | 5 | 0 | 1,563 | 4 | 0 |
| Residential mortgage | 146 | 0 | 0 | 152 | 3 | 2 |
| Home equity | 208 | 1 | 1 | 392 | 2 | 0 |
| Other consumer | 474 | 6 | 6 | 626 | 2 | 4 |
| Total impaired loans with no related allowance | \$ 15,299 | \$ 199 | \$ 61 | \$ 20,875 | \$ 280 | \$ 92 |
| Impaired loans with a related allowance: | | | | | | |
| Builder & developer | \$ 2,045 | \$ 5 | \$ 0 | \$ 0 | \$ 0 | \$ 0 |
| Commercial real estate investor | 0 | 0 | 0 | 0 | 0 | 0 |
| Residential real estate investor | 1,526 | 2 | 0 | 2,236 | 0 | 0 |
| Hotel/Motel | 0 | 0 | 0 | 0 | 0 | 0 |
| Wholesale & retail | 0 | 0 | 0 | 0 | 0 | 0 |
| Manufacturing | 0 | 0 | 0 | 0 | 0 | 0 |
| Agriculture | 439 | 8 | 0 | 460 | 8 | 0 |
| Other commercial | 475 | 7 | 0 | 602 | 0 | 0 |
| Residential mortgage | 0 | 0 | 0 | 0 | 0 | 0 |
| Home equity | 0 | 0 | 0 | 0 | 0 | 0 |
| Other consumer | 0 | 0 | 0 | 0 | 0 | 0 |
| Total impaired loans with a related allowance | \$ 4,485 | \$ 22 | \$ 0 | \$ 3,298 | \$ 8 | \$ 0 |
| Total impaired loans: | | | | | | |
| Builder & developer | \$ 6,322 | \$ 69 | \$ 1 | \$ 9,094 | \$ 132 | \$ 0 |
| Commercial real estate investor | 6,620 | 76 | 26 | 6,182 | 61 | 23 |
| Residential real estate investor | 2,097 | 26 | 22 | 2,541 | 0 | 1 |
| Hotel/Motel | 582 | 5 | 0 | 0 | 0 | 0 |
| Wholesale & retail | 605 | 8 | 5 | 1,882 | 65 | 62 |
| Manufacturing | 665 | 10 | 0 | 679 | 11 | 0 |
| Agriculture | 439 | 8 | 0 | 460 | 8 | 0 |
| Other commercial | 1,626 | 12 | 0 | 2,165 | 4 | 0 |
| Residential mortgage | 146 | 0 | 0 | 152 | 3 | 2 |
| Home equity | 208 | 1 | 1 | 392 | 2 | 0 |
| Other consumer | 474 | 6 | 6 | 626 | 2 | 4 |
| Total impaired loans | \$ 19,784 | \$ 221 | \$ 61 | \$ 24,173 | \$ 288 | \$ 92 |

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| <i>(dollars in thousands)</i> | For the nine months ended | | | | | |
|------------------------------------------------|-----------------------------|-----------------------|----------------------------|-----------------------------|-----------------------|----------------------------|
| | September 30, 2014 | | September 30, 2013 | | Cash Basis | |
| | Average Recorded Investment | Total Interest Income | Cash Basis Interest Income | Average Recorded Investment | Total Interest Income | Cash Basis Interest Income |
| Impaired loans with no related allowance: | | | | | | |
| Builder & developer | \$ 4,211 | \$ 228 | \$ 18 | \$ 9,913 | \$ 396 | \$ 5 |
| Commercial real estate investor | 7,229 | 226 | 78 | 5,953 | 195 | 92 |
| Residential real estate investor | 462 | 29 | 22 | 210 | 5 | 4 |
| Hotel/Motel | 449 | 15 | 0 | 0 | 0 | 0 |
| Wholesale & retail | 856 | 82 | 73 | 2,435 | 108 | 126 |
| Manufacturing | 667 | 32 | 0 | 686 | 33 | 0 |
| Agriculture | 0 | 0 | 0 | 0 | 0 | 0 |
| Other commercial | 1,202 | 36 | 21 | 1,589 | 10 | 4 |
| Residential mortgage | 148 | 4 | 3 | 118 | 7 | 5 |
| Home equity | 233 | 3 | 3 | 351 | 8 | 0 |
| Other consumer | 504 | 21 | 21 | 628 | 15 | 17 |
| Total impaired loans with no related allowance | \$ 15,961 | \$ 676 | \$ 239 | \$ 21,883 | \$ 777 | \$ 253 |
| Impaired loans with a related allowance: | | | | | | |
| Builder & developer | \$ 4,437 | \$ 18 | \$ 0 | \$ 97 | \$ 0 | \$ 0 |
| Commercial real estate investor | 0 | 0 | 0 | 0 | 0 | 0 |
| Residential real estate investor | 1,522 | 5 | 0 | 2,447 | (9) | 0 |
| Hotel/Motel | 0 | 0 | 0 | 0 | 0 | 0 |
| Wholesale & retail | 0 | 0 | 0 | 0 | 0 | 0 |
| Manufacturing | 0 | 0 | 0 | 0 | 0 | 0 |
| Agriculture | 444 | 24 | 0 | 465 | 24 | 0 |
| Other commercial | 369 | 14 | 0 | 786 | 0 | 0 |
| Residential mortgage | 0 | 0 | 0 | 0 | 0 | 0 |
| Home equity | 0 | 0 | 0 | 0 | 0 | 0 |
| Other consumer | 0 | 0 | 0 | 0 | 0 | 0 |
| Total impaired loans with a related allowance | \$ 6,772 | \$ 61 | \$ 0 | \$ 3,795 | \$ 15 | \$ 0 |
| Total impaired loans: | | | | | | |
| Builder & developer | \$ 8,648 | \$ 246 | \$ 18 | \$ 10,010 | \$ 396 | \$ 5 |
| Commercial real estate investor | 7,229 | 226 | 78 | 5,953 | 195 | 92 |
| Residential real estate investor | 1,984 | 34 | 22 | 2,657 | (4) | 4 |
| Hotel/Motel | 449 | 15 | 0 | 0 | 0 | 0 |
| Wholesale & retail | 856 | 82 | 73 | 2,435 | 108 | 126 |
| Manufacturing | 667 | 32 | 0 | 686 | 33 | 0 |
| Agriculture | 444 | 24 | 0 | 465 | 24 | 0 |
| Other commercial | 1,571 | 50 | 21 | 2,375 | 10 | 4 |
| Residential mortgage | 148 | 4 | 3 | 118 | 7 | 5 |
| Home equity | 233 | 3 | 3 | 351 | 8 | 0 |
| Other consumer | 504 | 21 | 21 | 628 | 15 | 17 |
| Total impaired loans | \$ 22,733 | \$ 737 | \$ 239 | \$ 25,678 | \$ 792 | \$ 253 |

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Table of Contents*Past Due and Nonaccrual*

The performance and credit quality of the loan portfolio is also monitored by using an aging schedule which shows the length of time a loan is past due. The table below presents a summary of past due loans, nonaccrual loans and current loans by loan segment and class at September 30, 2014 and December 31, 2013.

| <i>(dollars in thousands)</i> | 30-59 Days Past Due | 60-89 Days Past Due | ≥ 90 Days Past Due and Accruing | Nonaccrual | Total Past Due and Nonaccrual | Current | Total Loans |
|----------------------------------|---------------------------|---------------------------|------------------------------------------|------------|-------------------------------------|------------|----------------|
| September 30, 2014 | | | | | | | |
| Builder & developer | \$ 108 | \$ 0 | \$ 0 | \$ 2,116 | \$ 2,224 | \$ 105,318 | \$ 107,542 |
| Commercial real estate investor | 0 | 0 | 0 | 3,208 | 3,208 | 148,254 | 151,462 |
| Residential real estate investor | 508 | 69 | 0 | 1,669 | 2,246 | 86,952 | 89,198 |
| Hotel/Motel | 0 | 565 | 0 | 0 | 565 | 74,806 | 75,371 |
| Wholesale & retail | 348 | 0 | 0 | 130 | 478 | 66,575 | 67,053 |
| Manufacturing | 0 | 0 | 0 | 0 | 0 | 35,532 | 35,532 |
| Agriculture | 0 | 0 | 0 | 0 | 0 | 40,242 | 40,242 |
| Other | 130 | 0 | 0 | 643 | 773 | 176,021 | 176,794 |
| Total commercial related loans | 1,094 | 634 | 0 | 7,766 | 9,494 | 733,700 | 743,194 |
| Residential mortgage | 0 | 0 | 0 | 118 | 118 | 32,558 | 32,676 |
| Home equity | 394 | 150 | 0 | 223 | 767 | 81,818 | 82,585 |
| Other | 187 | 9 | 0 | 443 | 639 | 32,910 | 33,549 |
| Total consumer related loans | 581 | 159 | 0 | 784 | 1,524 | 147,286 | 148,810 |
| Total loans | \$ 1,675 | \$ 793 | \$ 0 | \$ 8,550 | \$ 11,018 | \$ 880,986 | \$ 892,004 |
| December 31, 2013 | | | | | | | |
| Builder & developer | \$ 220 | \$ 0 | \$ 0 | \$ 5,665 | \$ 5,885 | \$ 100,551 | \$ 106,436 |
| Commercial real estate investor | 0 | 0 | 0 | 4,434 | 4,434 | 136,938 | 141,372 |
| Residential real estate investor | 0 | 265 | 0 | 1,797 | 2,062 | 76,338 | 78,400 |
| Hotel/Motel | 0 | 0 | 0 | 0 | 0 | 70,324 | 70,324 |
| Wholesale & retail | 0 | 0 | 0 | 1,128 | 1,128 | 74,317 | 75,445 |
| Manufacturing | 0 | 0 | 0 | 0 | 0 | 36,872 | 36,872 |
| Agriculture | 0 | 0 | 0 | 0 | 0 | 38,041 | 38,041 |
| Other | 109 | 0 | 0 | 1,342 | 1,451 | 165,874 | 167,325 |
| Total commercial related loans | 329 | 265 | 0 | 14,366 | 14,960 | 699,255 | 714,215 |
| Residential mortgage | 0 | 0 | 0 | 120 | 120 | 25,575 | 25,695 |
| Home equity | 171 | 0 | 0 | 220 | 391 | 80,468 | 80,859 |
| Other | 118 | 161 | 0 | 594 | 873 | 37,742 | 38,615 |
| Total consumer related loans | 289 | 161 | 0 | 934 | 1,384 | 143,785 | 145,169 |
| Total loans | \$ 618 | \$ 426 | \$ 0 | \$ 15,300 | \$ 16,344 | \$ 843,040 | \$ 859,384 |

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Table of Contents*Troubled Debt Restructurings*

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

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

The table below shows loans whose terms have been modified under TDRs during the three and nine months ended September 30, 2014 and 2013. There was no impairment loss recognized on any of these TDRs. One commercial loan with a recorded investment of \$188,000 modified under a TDR during the nine months ended September 30, 2013, defaulted and was modified again, and subsequently defaulted under the terms of the new modification agreement during the nine months ended September 30, 2014.

| <i>(dollars in thousands)</i> | Number of Contracts | Modifications | | Recorded Investment at Period End |
|-------------------------------------|---------------------------|------------------------------------------------------------|-------------------------------------------------------------|-----------------------------------------|
| | | Pre-Modification Outstanding Recorded Investments | Post-Modification Outstanding Recorded Investments | |
| Three months ended: | | | | |
| September 30, 2014 | | | | |
| None | | | | |
| September 30, 2013 | | | | |
| Commercial related loans nonaccrual | 1 | 375 | 375 | 200 |
| Nine months ended: | | | | |
| September 30, 2014 | | | | |
| Commercial related loans accruing | 1 | \$ 194 | \$ 194 | \$ 188 |
| Consumer related loans nonaccrual | 1 | \$ 150 | \$ 120 | \$ 120 |
| September 30, 2013 | | | | |
| Commercial related loans accruing | 1 | \$ 208 | \$ 208 | \$ 206 |

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

The table below shows the activity in and the composition of the allowance for loan losses by loan segment and class detail as of and for the three and nine months ended September 30, 2014 and 2013.

| <i>(dollars in thousands)</i> | Commercial | | Residential | Wholesale | | | Total | | |
|------------------------------------|---------------------|----------------------|----------------------|---------------|---------------|---------------|---------------|-----------------|--------------------|
| | Builder & developer | real estate investor | real estate investor | Hotel/Motel | & retail | Manufacturing | Agriculture | Other | commercial related |
| Allowance for loan losses: | | | | | | | | | |
| Balance, July 1, 2014 | \$ 2,241 | \$ 1,592 | \$ 1,420 | \$ 655 | \$ 637 | \$ 212 | \$ 318 | \$ 1,513 | \$ 8,588 |
| Charge-offs | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| Recoveries | 0 | 0 | 0 | 0 | 3 | 0 | 0 | 0 | 3 |
| Provisions | (95) | 95 | (7) | (19) | (32) | (3) | 0 | (21) | (82) |
| Balance, September 30, 2014 | \$ 2,146 | \$ 1,687 | \$ 1,413 | \$ 636 | \$ 608 | \$ 209 | \$ 318 | \$ 1,492 | \$ 8,509 |
| Balance, July 1, 2013 | \$ 1,576 | \$ 1,213 | \$ 1,181 | \$ 505 | \$ 1,856 | \$ 201 | \$ 253 | \$ 1,151 | \$ 7,936 |
| Charge-offs | 0 | 0 | (85) | 0 | 0 | 0 | 0 | 0 | (85) |
| Recoveries | 0 | 0 | 0 | 0 | 25 | 0 | 0 | 16 | 41 |
| Provisions | (400) | 188 | 265 | (13) | (1,239) | 0 | 21 | 30 | (1,148) |
| Balance, September 30, 2013 | \$ 1,176 | \$ 1,401 | \$ 1,361 | \$ 492 | \$ 642 | \$ 201 | \$ 274 | \$ 1,197 | \$ 6,744 |

| <i>(dollars in thousands)</i> | Residential mortgage | Home equity | Other | Total consumer related | Unallocated | Total |
|------------------------------------|-----------------------------------|---------------|---------------|------------------------|-----------------|------------------|
| | Allowance for loan losses: | | | | | |
| Balance, July 1, 2014 | \$ 61 | \$ 157 | \$ 323 | \$ 541 | \$ 1,331 | \$ 10,460 |
| Charge-offs | 0 | 0 | (15) | (15) | 0 | (15) |
| Recoveries | 0 | 5 | 10 | 15 | 0 | 18 |
| Provisions | 1 | (2) | (66) | (67) | 399 | 250 |
| Balance, September 30, 2014 | \$ 62 | \$ 160 | \$ 252 | \$ 474 | \$ 1,730 | \$ 10,713 |
| Balance, July 1, 2013 | \$ 77 | \$ 236 | \$ 276 | \$ 589 | \$ 934 | \$ 9,459 |
| Charge-offs | 0 | (25) | (106) | (131) | 0 | (216) |
| Recoveries | 0 | 2 | 13 | 15 | 0 | 56 |
| Provisions | (8) | 24 | 124 | 140 | 1,158 | 150 |
| Balance, September 30, 2013 | \$ 69 | \$ 237 | \$ 307 | \$ 613 | \$ 2,092 | \$ 9,449 |

| <i>(dollars in thousands)</i> | Commercial | | Residential | Wholesale | | | Total | | |
|------------------------------------|---------------------|----------------------|----------------------|---------------|---------------|---------------|---------------|-----------------|--------------------|
| | Builder & developer | real estate investor | real estate investor | Hotel/Motel | & retail | Manufacturing | Agriculture | Other | commercial related |
| Allowance for loan losses: | | | | | | | | | |
| Balance, January 1, 2014 | \$ 2,073 | \$ 1,500 | \$ 1,482 | \$ 595 | \$ 637 | \$ 217 | \$ 307 | \$ 1,393 | \$ 8,204 |
| Charge-offs | 0 | (200) | (91) | 0 | (35) | 0 | 0 | 0 | (326) |
| Recoveries | 0 | 0 | 190 | 0 | 25 | 0 | 0 | 0 | 215 |
| Provisions | 73 | 387 | (168) | 41 | (19) | (8) | 11 | 99 | 416 |
| Balance, September 30, 2014 | \$ 2,146 | \$ 1,687 | \$ 1,413 | \$ 636 | \$ 608 | \$ 209 | \$ 318 | \$ 1,492 | \$ 8,509 |
| Balance, January 1, 2013 | \$ 1,571 | \$ 1,259 | \$ 1,195 | \$ 485 | \$ 1,913 | \$ 237 | \$ 202 | \$ 1,170 | \$ 8,032 |
| Charge-offs | (62) | 0 | (310) | 0 | (210) | 0 | 0 | 0 | (582) |
| Recoveries | 0 | 0 | 0 | 0 | 47 | 0 | 0 | 17 | 64 |
| Provisions | (333) | 142 | 476 | 7 | (1,108) | (36) | 72 | 10 | (770) |
| Balance, September 30, 2013 | \$ 1,176 | \$ 1,401 | \$ 1,361 | \$ 492 | \$ 642 | \$ 201 | \$ 274 | \$ 1,197 | \$ 6,744 |

Total

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(dollars in thousands)

| | Residential mortgage | Home equity | Other | consumer related | Unallocated | Total |
|------------------------------------|-------------------------|----------------|---------------|---------------------|-----------------|------------------|
| Allowance for loan losses: | | | | | | |
| Balance, January 1, 2014 | \$ 65 | \$ 237 | \$ 269 | \$ 571 | \$ 1,200 | \$ 9,975 |
| Charge-offs | (30) | (41) | (265) | (336) | 0 | (662) |
| Recoveries | 4 | 40 | 41 | 85 | 0 | 300 |
| Provisions | 23 | (76) | 207 | 154 | 530 | 1,100 |
| Balance, September 30, 2014 | \$ 62 | \$ 160 | \$ 252 | \$ 474 | \$ 1,730 | \$ 10,713 |
| Balance, January 1, 2013 | \$ 124 | \$ 237 | \$ 238 | \$ 599 | \$ 671 | \$ 9,302 |
| Charge-offs | (28) | (99) | (239) | (366) | 0 | (948) |
| Recoveries | 1 | 8 | 52 | 61 | 0 | 125 |
| Provisions | (28) | 91 | 256 | 319 | 1,421 | 970 |
| Balance, September 30, 2013 | \$ 69 | \$ 237 | \$ 307 | \$ 613 | \$ 2,092 | \$ 9,449 |

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The table below shows the allowance amount required for loans individually evaluated for impairment and the amount required for loans collectively evaluated for impairment at September 30, 2014 and 2013 and December 31, 2013.

| <i>(dollars in thousands)</i> | Commercial | | Residential | | Wholesale & retail | | | Agriculture | | Other | | Total |
|---------------------------------------------------------------------------------------------|----------------------|----------------------|----------------------|------------------------|--------------------|------------------|------------------|-------------------|-------------------|--------------------|--|-------|
| | Builder & developer | real estate investor | real estate investor | Hotel/Motel | Wholesale & retail | Manufacturing | Agriculture | Other | Other | commercial related | | |
| Allowance for loan losses: | | | | | | | | | | | | |
| Individually evaluated for impairment | \$ 953 | \$ 0 | \$ 559 | \$ 0 | \$ 0 | \$ 0 | \$ 100 | \$ 300 | \$ 1,912 | | | |
| Collectively evaluated for impairment | 1,193 | 1,687 | 854 | 636 | 608 | 209 | 218 | 1,192 | 6,597 | | | |
| Balance, September 30, 2014 | \$ 2,146 | \$ 1,687 | \$ 1,413 | \$ 636 | \$ 608 | \$ 209 | \$ 318 | \$ 1,492 | \$ 8,509 | | | |
| Individually evaluated for impairment | \$ 850 | \$ 0 | \$ 650 | \$ 0 | \$ 0 | \$ 0 | \$ 100 | \$ 120 | 1,720 | | | |
| Collectively evaluated for impairment | 1,223 | 1,500 | 832 | 595 | 637 | 217 | 207 | 1,273 | 6,484 | | | |
| Balance, December 31, 2013 | \$ 2,073 | \$ 1,500 | \$ 1,482 | \$ 595 | \$ 637 | \$ 217 | \$ 307 | \$ 1,393 | \$ 8,204 | | | |
| Individually evaluated for impairment | \$ 0 | \$ 0 | \$ 650 | \$ 0 | \$ 0 | \$ 0 | \$ 100 | \$ 120 | 870 | | | |
| Collectively evaluated for impairment | 1,176 | 1,401 | 711 | 492 | 642 | 201 | 174 | 1,077 | 5,874 | | | |
| Balance, September 30, 2013 | \$ 1,176 | \$ 1,401 | \$ 1,361 | \$ 492 | \$ 642 | \$ 201 | \$ 274 | \$ 1,197 | \$ 6,744 | | | |
| Loans: | | | | | | | | | | | | |
| Individually evaluated for impairment | \$ 6,190 | \$ 6,597 | \$ 1,937 | \$ 565 | \$ 402 | \$ 663 | \$ 436 | \$ 1,486 | 18,276 | | | |
| Collectively evaluated for impairment | 101,352 | 144,865 | 87,261 | 74,806 | 66,651 | 34,869 | 39,806 | 175,308 | 724,918 | | | |
| Balance, September 30, 2014 | \$ 107,542 | \$ 151,462 | \$ 89,198 | \$ 75,371 | \$ 67,053 | \$ 35,532 | \$ 40,242 | \$ 176,794 | \$ 743,194 | | | |
| Individually evaluated for impairment | \$ 11,594 | \$ 7,860 | \$ 1,984 | \$ 0 | \$ 1,403 | \$ 671 | \$ 451 | \$ 1,824 | 25,787 | | | |
| Collectively evaluated for impairment | 94,842 | 133,512 | 76,416 | 70,324 | 74,042 | 36,201 | 37,590 | 165,501 | 688,428 | | | |
| Balance, December 31, 2013 | \$ 106,436 | \$ 141,372 | \$ 78,400 | \$ 70,324 | \$ 75,445 | \$ 36,872 | \$ 38,041 | \$ 167,325 | \$ 714,215 | | | |
| Individually evaluated for impairment | \$ 9,020 | \$ 6,673 | \$ 2,510 | \$ 0 | \$ 1,616 | \$ 676 | \$ 458 | \$ 1,862 | 22,815 | | | |
| Collectively evaluated for impairment | 94,092 | 129,808 | 70,482 | 65,940 | 72,863 | 33,474 | 34,852 | 149,878 | 651,389 | | | |
| Balance, September 30, 2013 | \$ 103,112 | \$ 136,481 | \$ 72,992 | \$ 65,940 | \$ 74,479 | \$ 34,150 | \$ 35,310 | \$ 151,740 | \$ 674,204 | | | |
| Residential mortgage, Home equity, Other, Total consumer related, Unallocated, Total | | | | | | | | | | | | |
| <i>(dollars in thousands)</i> | Residential mortgage | Home equity | Other | Total consumer related | Unallocated | Total | | | | | | |
| Allowance for loan losses: | | | | | | | | | | | | |
| Individually evaluated for impairment | \$ 0 | \$ 0 | \$ 0 | \$ 0 | \$ 0 | 1,912 | | | | | | |
| Collectively evaluated for impairment | 62 | 160 | 252 | 474 | 1,730 | 8,801 | | | | | | |
| Balance, September 30, 2014 | \$ 62 | \$ 160 | \$ 252 | \$ 474 | \$ 1,730 | \$ 10,713 | | | | | | |
| Individually evaluated for impairment | \$ 0 | \$ 0 | \$ 0 | \$ 0 | \$ 0 | 1,720 | | | | | | |
| Collectively evaluated for impairment | 65 | 237 | 269 | 571 | 1,200 | 8,255 | | | | | | |
| Balance, December 31, 2013 | \$ 65 | \$ 237 | \$ 269 | \$ 571 | \$ 1,200 | \$ 9,975 | | | | | | |

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| | | | | | | | | | | | | |
|---------------------------------------|-----------|-----------|-----------|------------|-----------|------------|-----------|------------|-----------|--------------|-----------|--------------|
| Individually evaluated for impairment | \$ | 0 | \$ | 0 | \$ | 0 | \$ | 0 | \$ | 0 | \$ | 870 |
| Collectively evaluated for impairment | | 69 | | 237 | | 307 | | 613 | | 2,092 | | 8,579 |
| Balance, September 30, 2013 | \$ | 69 | \$ | 237 | \$ | 307 | \$ | 613 | \$ | 2,092 | \$ | 9,449 |

Loans:

| | | | | | | | | | | | | |
|---------------------------------------|-----------|---------------|-----------|---------------|-----------|---------------|-----------|----------------|-----------|--|-----------|----------------|
| Individually evaluated for impairment | \$ | 146 | \$ | 233 | \$ | 443 | \$ | 822 | \$ | | \$ | 19,098 |
| Collectively evaluated for impairment | | 32,530 | | 82,352 | | 33,106 | | 147,988 | | | | 872,906 |
| Balance, September 30, 2014 | \$ | 32,676 | \$ | 82,585 | \$ | 33,549 | \$ | 148,810 | \$ | | \$ | 892,004 |

| | | | | | | | | | | | | |
|---------------------------------------|-----------|---------------|-----------|---------------|-----------|---------------|-----------|----------------|-----------|--|-----------|----------------|
| Individually evaluated for impairment | \$ | 150 | \$ | 231 | \$ | 594 | \$ | 975 | \$ | | \$ | 26,762 |
| Collectively evaluated for impairment | | 25,545 | | 80,628 | | 38,021 | | 144,194 | | | | 832,622 |
| Balance, December 31, 2013 | \$ | 25,695 | \$ | 80,859 | \$ | 38,615 | \$ | 145,169 | \$ | | \$ | 859,384 |

| | | | | | | | | | | | | |
|---------------------------------------|-----------|---------------|-----------|---------------|-----------|---------------|-----------|----------------|-----------|--|-----------|----------------|
| Individually evaluated for impairment | \$ | 151 | \$ | 387 | \$ | 585 | \$ | 1,123 | \$ | | \$ | 23,938 |
| Collectively evaluated for impairment | | 24,974 | | 74,693 | | 38,667 | | 138,334 | | | | 789,723 |
| Balance, September 30, 2013 | \$ | 25,125 | \$ | 75,080 | \$ | 39,252 | \$ | 139,457 | \$ | | \$ | 813,661 |

Table of Contents**Note 7 Deposits**

The composition of deposits as of September 30, 2014 and December 31, 2013 is shown below.

| <i>(dollars in thousands)</i> | September 30, 2014 | December 31, 2013 |
|-----------------------------------|--------------------------|----------------------|
| Noninterest bearing demand | \$ 117,954 | \$ 107,921 |
| NOW | 86,401 | 83,949 |
| Money market | 306,479 | 292,870 |
| Savings | 41,726 | 39,522 |
| Time deposits less than \$100,000 | 232,406 | 230,641 |
| Time deposits \$100,000 or more | 174,129 | 170,400 |
| Total deposits | \$ 959,095 | \$ 925,303 |

Note 8 Short-Term Borrowings and Long-Term Debt

Short-term borrowings consist of securities sold under agreements to repurchase, federal funds purchased and other borrowings. At September 30, 2014, the balance of securities sold under agreements to repurchase was \$41,377,000 compared to \$24,597,000 at December 31, 2013. At September 30, 2014, there were no other short-term borrowings compared to \$15,766,000 at December 31, 2013.

The following table presents a summary of long-term debt as of September 30, 2014 and December 31, 2013.

| <i>(dollars in thousands)</i> | September 30, 2014 | December 31, 2013 |
|-----------------------------------------------------------------------------------------|--------------------------|----------------------|
| PeoplesBank s obligations: | | |
| Federal Home Loan Bank of Pittsburgh (FHLBP) | | |
| Due July 2015, 1.90% | \$ 5,000 | \$ 5,000 |
| Due July 2016, 2.35% | 5,000 | 5,000 |
| Due September 2016, 1.18% | 10,000 | 10,000 |
| Due October 2016, 1.06% | 10,000 | 10,000 |
| Due October 2016, 1.10% | 10,000 | 10,000 |
| Due April 2017, .97% | 10,000 | 0 |
| Due March 2018, 1.17% | 10,000 | 10,000 |
| Due June 2018, 1.87% | 5,000 | 5,000 |
| Due June 2019, 2.10% | 5,000 | 5,000 |
| Total FHLBP | 70,000 | 60,000 |
| Capital lease obligation | 119 | 183 |
| Codorus Valley Bancorp, Inc. obligations: | | |
| Junior subordinated debt | | |
| Due 2034, 2.25%, floating rate based on 3 month LIBOR plus 2.02%, callable quarterly | 3,093 | 3,093 |
| Due 2036, 1.77% floating rate based on 3 month LIBOR plus 1.54%, callable quarterly | 7,217 | 7,217 |
| Total long-term debt | \$ 80,429 | \$ 70,493 |

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

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

Note 9 Regulatory Matters

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

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Quantitative measures established by regulators to ensure capital adequacy require Codorus Valley and PeoplesBank to maintain minimum ratios, as set forth below, to total and Tier 1 capital as a percentage of risk-weighted assets, and of Tier 1 capital to quarter-to-date average assets (leverage ratio). Management believes that Codorus Valley and PeoplesBank were well capitalized on September 30, 2014 based on regulatory capital guidelines.

| | Actual | | Minimum for Capital Adequacy | | Well Capitalized Minimum* | |
|----------------------------------------------------|------------|--------|------------------------------|-------|---------------------------|-------|
| | Amount | Ratio | Amount | Ratio | Amount | Ratio |
| <i>(dollars in thousands)</i> | | | | | | |
| Codorus Valley Bancorp, Inc. (consolidated) | | | | | | |
| at September 30, 2014 | | | | | | |
| Capital ratios: | | | | | | |
| Tier 1 risk based | \$ 123,360 | 13.25% | \$ 37,231 | 4.00% | n/a | n/a |
| Total risk based | 134,073 | 14.40 | 74,462 | 8.00 | n/a | n/a |
| Leverage | 123,360 | 10.25 | 48,144 | 4.00 | n/a | n/a |
| at December 31, 2013 | | | | | | |
| Capital ratios: | | | | | | |
| Tier 1 risk based | \$ 115,477 | 12.79% | \$ 36,118 | 4.00% | n/a | n/a |
| Total risk based | 125,452 | 13.89 | 72,236 | 8.00 | n/a | n/a |
| Leverage | 115,477 | 10.18 | 45,371 | 4.00 | n/a | n/a |
| PeoplesBank, A Codorus Valley Company | | | | | | |
| at September 30, 2014 | | | | | | |
| Capital ratios: | | | | | | |
| Tier 1 risk based | \$ 119,349 | 12.87% | \$ 37,102 | 4.00% | \$ 55,653 | 6.00% |
| Total risk based | 130,062 | 14.02 | 74,204 | 8.00 | 92,755 | 10.00 |
| Leverage | 119,349 | 9.94 | 48,013 | 4.00 | 60,016 | 5.00 |
| at December 31, 2013 | | | | | | |
| Capital ratios: | | | | | | |
| Tier 1 risk based | \$ 111,713 | 12.42% | \$ 35,987 | 4.00% | \$ 53,981 | 6.00% |
| Total risk based | 121,688 | 13.53 | 71,975 | 8.00 | 89,968 | 10.00 |
| Leverage | 111,713 | 9.88 | 45,236 | 4.00 | 56,545 | 5.00 |

*To be well capitalized under prompt corrective action provisions.

Note 10 Shareholders Equity*Private Placement of Common Stock*

On March 26, 2014, the Corporation completed a private placement of 650,000 shares of its common stock, par value \$2.50 per share, pursuant to the terms of a Securities Purchase Agreement (Purchase Agreement) dated March 26, 2014, by and among the Corporation and seven accredited investors. Pursuant to the terms of the Purchase Agreement, the accredited investors also entered into a Registration Rights Agreement with the Corporation, under which the Corporation agreed to file with the Securities and Exchange Commission (the SEC) a registration statement covering the resale of the common stock issued pursuant to the Purchase Agreement. This registration statement was filed with the SEC on April 25, 2014. The full text and form of both the Purchase Agreement and the Registration Rights Agreement are attached to the Corporation s related Form 8-K filed on March 27, 2014.

The Corporation raised net proceeds of approximately \$12.5 million resulting from the gross amount of the private placement transaction of \$13 million, less related issuance costs of approximately \$0.5 million. The Corporation used the net proceeds from the private placement, and additional cash, to redeem \$13 million of the \$25 million in outstanding shares of the Corporation s preferred stock held by the United States Department of the Treasury.

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

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. On May 30, 2014, the Corporation redeemed 13,000 of the 25,000 outstanding shares of the Corporation's preferred stock that had been issued to the Treasury, leaving 12,000 outstanding shares and \$12 million of preferred stock as of September 30, 2014. The May 30, 2014 preferred stock redemption was funded primarily with the funds the Corporation raised in the March 26, 2014 private placement of its common stock.

The annualized dividend rate on the preferred stock issued under the SBLF Program was 1 percent for the three and nine months ended September 30, 2014 and 2013. Based on the increase in the qualified small business lending portfolio balance over the baseline level at September 30, 2013, the dividend rate will remain at 1 percent through February 18, 2016. Thereafter, under the provisions of the SBLF Program the dividend rate will increase to 9% (including a quarterly lending incentive fee of 0.5%). Additional information about SBLF preferred stock is disclosed in Note 10 Shareholders' Equity in the Corporation's Annual Report on Form 10-K for the year ended December 31, 2013.

Common stock dividend

Periodically, the Corporation distributes stock dividends on its common stock. On October 14, 2014, the Corporation declared a 5 percent common stock dividend payable on December 9, 2014, to shareholders of record at the close of business on October 28, 2014. Distribution of this stock dividend will result in the issuance of approximately 276,417 additional common shares. The Corporation distributed a 5 percent stock dividend on December 10, 2013 which resulted in the issuance of 225,937 additional common shares.

Note 11 Contingent Liabilities

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

Note 12 Guarantees

Codorus Valley does not issue any guarantees that would require liability recognition or disclosure, other than its standby letters of credit. Standby letters of credit are written conditional commitments issued by PeoplesBank to guarantee the performance of a customer to a third party. Generally, all letters of credit, when issued, have expiration dates within one year. The credit risk involved in issuing letters of credit is essentially the same as those that are involved in extending loan facilities to customers. The Corporation generally holds collateral and/or personal guarantees supporting these commitments. The Corporation had \$25,751,000 of standby letters of credit outstanding on September 30, 2014, compared to \$27,673,000 on December 31, 2013. Management believes that the proceeds obtained through a liquidation of collateral and the enforcement of guarantees would be sufficient to cover the potential amount of future payments required under the corresponding letters of credit. The amount of the liability as of September 30, 2014 and December 31, 2013, for guarantees under standby letters of credit issued, was not material. Many of the commitments are expected to expire without being drawn upon and, therefore, generally do not present significant liquidity risk to the Corporation or PeoplesBank.

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Note 13 Fair Value of Assets and Liabilities

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

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

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

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

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

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

Assets Measured at Fair Value on a Recurring Basis

Securities available-for-sale

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

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| | Total | Fair Value Measurements | | |
|------------------------------------------|-----------|----------------------------------------------------------------------------|-----------------------------------------------------------|-------------------------------------------------------------|
| | | (Level 1) Quoted Prices in Active Markets for Identical Assets | (Level 2) Significant Other Observable Inputs | (Level 3) Significant Other Unobservable Inputs |
| <i>(dollars in thousands)</i> | | | | |
| September 30, 2014 | | | | |
| Securities available-for-sale: | | | | |
| U.S. agency | \$ 29,500 | \$ 0 | \$ 29,500 | \$ 0 |
| U.S. agency mortgage-backed, residential | 126,055 | 0 | 126,055 | 0 |
| State and municipal | 73,248 | 0 | 73,248 | 0 |
| December 31, 2013 | | | | |
| Securities available-for-sale: | | | | |
| U.S. agency | \$ 33,499 | \$ 0 | \$ 33,499 | \$ 0 |
| U.S. agency mortgage-backed, residential | 105,919 | 0 | 105,919 | 0 |
| State and municipal | 89,323 | 0 | 89,323 | 0 |

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

Impaired loans are those that are accounted for under FASB ASC Topic 310, in which the Corporation has measured impairment generally based on the fair value of the loan's collateral. Fair value is generally determined based upon independent third-party appraisals of the properties, or discounted cash flows based upon the expected proceeds. These loans are included as Level 3 fair values, based on the lowest level of input that is significant to the fair value measurements. At September 30, 2014, the fair value of impaired loans with a valuation allowance or charge-off was of \$2,741,000, which is net of valuation allowances of \$1,912,000 and charge-offs of \$26,000. At December 31, 2013 the fair value of impaired loans with a valuation allowance or charge-off was \$8,669,000, which is net of valuation allowances of \$1,720,000 and charge-offs of \$291,000.

Foreclosed Real Estate

Other real estate property acquired through foreclosure is initially recorded at fair value of the property at the transfer date less estimated selling cost. Subsequently, other real estate owned is carried at the lower of its carrying value or the fair value less estimated selling cost. Fair value is usually determined based upon an independent third-party appraisal of the property or occasionally upon a recent sales offer. At September 30, 2014, the fair value of foreclosed real estate with a valuation allowance or charge-off was \$1,010,000, which is net of valuation allowances of \$1,627,000. At December 31, 2013, the carrying value of foreclosed real estate with a valuation allowance or charge-off was \$3,098,000, which is net of valuation allowances of \$3,954,000 and charge-offs of \$100,000.

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| <i>(dollars in thousands)</i> | Total | Fair Value Measurements | | |
|-------------------------------|----------|-------------------------------------------------------------------------|-----------------------------------------------------|----------------------------------------------------------|
| | | (Level 1) Quoted Prices in Active Markets for Identical Assets | (Level 2) Significant Other Observable Inputs | (Level 3) Significant Other Unobservable Inputs |
| September 30, 2014 | | | | |
| Impaired loans | \$ 2,741 | \$ 0 | \$ 0 | \$ 2,741 |
| Foreclosed real estate | 1,010 | 0 | 0 | 1,010 |
| December 31, 2013 | | | | |
| Impaired loans | \$ 8,669 | \$ 0 | \$ 0 | \$ 8,669 |
| Foreclosed real estate | 3,098 | 0 | 0 | 3,098 |

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

| <i>(dollars in thousands)</i> | Fair Value Estimate | Quantitative Information about Level 3 Fair Value Measurements | | | Weighted Average |
|-------------------------------|------------------------|----------------------------------------------------------------|---------------------------|-----------|---------------------|
| | | Valuation Techniques | Unobservable Input | Range | |
| September 30, 2014 | | | | | |
| Impaired loans | \$ 2,741 | Appraisal (1) | Appraisal adjustments (2) | 10% - 25% | 20% |
| Foreclosed real estate | 1,010 | Appraisal (1) | Appraisal adjustments (2) | 68% - 68% | 68% |
| December 31, 2013 | | | | | |
| Impaired loans | \$ 8,669 | Appraisal (1) | Appraisal adjustments (2) | 13% - 27% | 19% |
| Foreclosed real estate | 3,098 | Appraisal (1) | Appraisal adjustments (2) | 8% - 67% | 45% |

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

Disclosures about Fair Value of Financial Instruments

The following methods and assumptions were used to estimate the fair value of the Corporation's financial instruments as of September 30, 2014 and December 31, 2013:

Cash and cash equivalents

The carrying amount is a reasonable estimate of fair value.

Securities available for sale

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

Restricted investment in bank stocks

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

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Loans held for sale

The fair value of loans held for sale is determined, when possible, using quoted secondary-market prices. If quoted prices do not exist, quoted prices for a similar loan or loans, adjusted for the specific attributes of that loan, are used.

Loans, net

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

Interest receivable

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

Deposits

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

Short-term borrowings

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

Long-term debt

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

Interest payable

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

Off-balance sheet instruments

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

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The following presents the carrying amounts and estimated fair values of the Corporation's financial instruments as of September 30, 2014 and December 31, 2013.

| <i>(dollars in thousands)</i> | Carrying Amount | Estimated Fair Value | (Level 1) Quoted Prices in Active Markets for Identical Assets | Fair Value Estimates (Level 2) Significant Other Observable Inputs | (Level 3) Significant Other Unobservable Inputs |
|-------------------------------|--------------------|-------------------------|----------------------------------------------------------------------------|-----------------------------------------------------------------------------------|-------------------------------------------------------------|
| September 30, 2014 | | | | | |
| Financial assets | | | | | |
| Cash and cash equivalents | \$ 34,231 | \$ 34,231 | \$ 34,231 | \$ 0 | \$ 0 |
| Securities available-for-sale | 228,803 | 228,803 | 0 | 228,803 | 0 |
| Restricted investment in bank | | | | | |
| stocks | 4,710 | 4,710 | 0 | 4,710 | 0 |
| Loans held for sale | 641 | 659 | 0 | 659 | 0 |
| Loans, net | 881,291 | 894,266 | 0 | 0 | 894,266 |
| Interest receivable | 3,441 | 3,441 | 0 | 3,441 | 0 |
| Financial liabilities | | | | | |
| Deposits | \$ 959,095 | \$ 959,944 | \$ 0 | \$ 959,944 | \$ 0 |
| Short-term borrowings | 41,377 | 41,377 | 0 | 41,377 | 0 |
| Long-term debt | 80,429 | 78,018 | 0 | 70,355 | 7,663 |
| Interest payable | 385 | 385 | 0 | 385 | 0 |
| Off-balance sheet instruments | 0 | 0 | 0 | 0 | 0 |
| December 31, 2013 | | | | | |
| Financial assets | | | | | |
| Cash and cash equivalents | \$ 15,062 | \$ 15,062 | \$ 15,062 | \$ 0 | \$ 0 |
| Securities available-for-sale | 228,741 | 228,741 | 0 | 228,741 | 0 |
| Restricted investment in bank | | | | | |
| stocks | 4,742 | 4,742 | 0 | 4,742 | 0 |
| Loans held for sale | 514 | 524 | 0 | 524 | 0 |
| Loans, net | 849,409 | 868,413 | 0 | 0 | 868,413 |
| Interest receivable | 3,583 | 3,583 | 0 | 3,583 | 0 |
| Financial liabilities | | | | | |
| Deposits | \$ 925,303 | \$ 927,396 | \$ 0 | \$ 927,396 | \$ 0 |
| Short-term borrowings | 40,363 | 40,363 | 0 | 40,363 | 0 |
| Long-term debt | 70,493 | 68,604 | 0 | 60,417 | 8,187 |
| Interest payable | 391 | 391 | 0 | 391 | 0 |
| Off-balance sheet instruments | 0 | 0 | 0 | 0 | 0 |

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

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

| | | | Gross Amounts of Recognized Liabilities | Gross Amounts Offset in the Statements of Condition | Net Amounts of Liabilities Presented in the Statements of Condition | Gross amounts Not Offset in the Statements of Condition | | Net Amount | | | | | |
|-------------------------------|-----|----|--------------------------------------------------|-----------------------------------------------------------------|---------------------------------------------------------------------------------|------------------------------------------------------------|----------------------------|---------------|----------|----|---|----|---|
| | | | | | | Financial Instruments | Cash Collateral Pledged | | | | | | |
| <i>(dollars in thousands)</i> | | | | | | | | | | | | | |
| September 30, 2014 | | | | | | | | | | | | | |
| Repurchase Agreements | (1) | \$ | 41,377 | \$ | 0 | \$ | 41,377 | \$ | (41,377) | \$ | 0 | \$ | 0 |
| December 31, 2013 | | | | | | | | | | | | | |
| Repurchase Agreements | (1) | \$ | 24,597 | \$ | 0 | \$ | 24,597 | \$ | (24,597) | \$ | 0 | \$ | 0 |

(1) As of September 30, 2014 and December 31, 2013, the fair value of securities pledged in connection with repurchase agreements was \$43,746,000 and \$29,299,000, respectively.

Note 15 Pending Acquisition

On July 22, 2014, the Corporation entered into an Agreement and Plan of Merger (the Merger Agreement) with Madison Bancorp, Inc., a Maryland corporation (Madison), and CVLY Corp., a Pennsylvania corporation and wholly-owned subsidiary of the Corporation (Acquisition Subsidiary), pursuant to which the Corporation will acquire Madison through the merger of Acquisition Subsidiary with and into Madison (the Merger), with Madison being the surviving corporation in the Merger. In connection with the Merger, Madison will cause its wholly-owned subsidiary, Madison Square Federal Savings Bank (Madison Square), to merge with and into PeoplesBank (the Bank Merger), with PeoplesBank being the surviving bank in the Bank Merger.

Under the terms of the Merger Agreement, upon consummation of the Merger, each share of Madison common stock will be converted into the right to receive \$22.90 in cash, without interest, and each outstanding option to purchase Madison common stock will be converted into the right to receive cash based on a formula set forth in the Merger Agreement. The transaction is valued at approximately \$14.4 million.

As reported in a Form 8-K dated October 15, 2014, the merger transaction has been formally approved by Madison's shareholders. As reported in a Form 8-K dated November 3, 2014, the merger transaction has been approved by the various federal and state bank regulators. Consummation of the Merger is subject to the fulfillment of certain other terms and conditions.

It is expected that the acquisition will be completed in the first quarter of 2015.

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

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

Forward-looking statements

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

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

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

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

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Critical accounting policies

We have identified critical accounting policies for the Corporation to include the allowance for loan losses, valuation of foreclosed real estate, and evaluation of other-than-temporary impairment losses of securities. There were no material changes to the critical accounting policies disclosed in the Annual Report on Form 10-K for the year ended December 31, 2013 in regards to application or related judgments and estimates. A detailed disclosure pertaining to critical accounting estimates is provided in Item 7 of the Corporation's Annual Report on Form 10-K for the year ended December 31, 2013.

**Three months ended September 30, 2014,
compared to three months ended September 30, 2013**

FINANCIAL HIGHLIGHTS

The Corporation earned net income available to common shareholders (earnings) totaling \$3,149,000 for the quarter ended September 30, 2014, compared to \$2,615,000 for the quarter ended September 30, 2013. The \$534,000 or 20 percent increase in earnings was primarily the result of increases in net interest income and noninterest income, which more than offset increases in noninterest expense, the provision for loan losses, and the provision for income taxes, as described below.

Net interest income increased \$951,000 or 10 percent for the third quarter of 2014, compared to the third quarter of 2013, due primarily to an increase in the volume of interest-earning assets, principally commercial loans and U.S. agency mortgage-backed securities, and a decrease in the overall cost of deposits.

The provision for loan losses for the third quarter of 2014 increased \$100,000 or 67 percent compared to the third quarter of 2013. The increased provision supported growth in the commercial loan portfolio and maintained the adequacy of the allowance for loan losses.

The \$308,000 or 17 percent increase in total noninterest income for the third quarter of 2014, compared to the third quarter of 2013, was primarily the result of increases in trust fees, income from mutual fund and annuity sales, and gains on sales of securities, which collectively more than offset a decrease in net gain from sales of loans held for sale (i.e. residential mortgage loans), reflecting a decline in refinancing demand due to elevated mortgage market interest rates.

The \$270,000 or 3 percent increase in noninterest expense for the third quarter of 2014, compared to the third quarter of 2013, was driven by increases in personnel and professional and legal expenses, which more than offset a substantial decrease on foreclosed real estate expenses. Personnel expense increased \$245,000 or 6 percent as a result of expanding the banking franchise and normal business growth. The \$193,000 or 103 percent increase in professional and legal expense primarily was due to investment banking and legal fees associated with pre-merger activities related to the Corporation's planned acquisition of Madison Bancorp, Inc. as previously announced in a Form 8-K dated July 22, 2014 (see Note 15 - Pending Acquisition). Foreclosed real estate expenses decreased \$217,000 or 78 percent primarily as a result of the reversal of a \$50,000 allowance on a foreclosed real estate property during the third quarter of 2014 compared to a \$125,000 provision expense on a foreclosed real estate property during the third quarter of 2013.

The \$387,000 or 39 percent increase in the provision for income taxes for the third quarter of 2014, compared to the third quarter of 2013, was primarily the result of a higher level of pretax earnings, and to a lesser extent, a decrease in the amount of tax-exempt income for the third quarter of 2014 as compared to the same period in 2013.

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The schedule below presents selected performance metrics for the third quarter of both 2014 and 2013. All per share computations include the effect of stock dividends declared, including the 5 percent common stock dividend declared October 14, 2014.

| | Three months ended | | | |
|--------------------------------------------|--------------------|--------|----|--------|
| | September 30, | | | |
| | 2014 | | | 2013 |
| Basic earnings per common share | \$ | 0.54 | \$ | 0.52 |
| Diluted earnings per common share | \$ | 0.54 | \$ | 0.51 |
| Cash dividend payout ratio | | 21.80% | | 20.74% |
| Return on average assets | | 1.05% | | 0.97% |
| Return on average equity | | 11.03% | | 10.26% |
| Net interest margin (tax equivalent basis) | | 3.80% | | 3.78% |
| Net overhead ratio | | 1.98% | | 2.12% |
| Efficiency ratio | | 61.17% | | 64.39% |
| Average equity to average assets | | 9.56% | | 9.42% |

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

INCOME STATEMENT ANALYSIS**Net interest income**

Net interest income for the three month period ended September 30, 2014, was \$10,646,000, an increase of \$951,000 or 10 percent above the third quarter of 2013. The increase was due primarily to increased interest income from an increase in the average volume of interest earning assets, and a decrease in the cost of deposits, partially offset by an increase in long-term debt interest expense due to an increase in borrowings. Net interest income (tax equivalent basis) annualized as a percentage of average interest earning assets, i.e., net interest margin, was 3.80 percent for the third quarter of 2014, compared to 3.78 percent for the same period in 2013.

Interest income for the third quarter of 2014 totaled \$12,670,000, an increase of \$851,000 or 7 percent above the third quarter of 2013. The increase was driven primarily by an increase in the average volume of interest earning assets, principally commercial loans and U.S. agency mortgage-backed securities. Interest earning assets averaged \$1.14 billion and yielded 4.50 percent (tax equivalent basis) for the third quarter of 2014, compared to \$1.05 billion and 4.58 percent, respectively, for the third quarter of 2013. While the volume of earning assets increased, its effect on interest income was slightly muted by lower loan yields, a reflection of the continuing low interest rate environment.

Interest expense for the third quarter of 2014 totaled \$2,024,000, a decrease of \$100,000 or 5 percent below the third quarter of 2013. The decrease in total interest expense was driven primarily by a general decrease in deposit rates, due to the continuing low interest rate environment, and from a larger volume of low-cost core deposits. The Corporation defines core deposits as noninterest and interest bearing demand, savings and money market deposits. The average volume of these core demand and savings deposits was \$550 million for the third quarter of 2014, a \$32 million or 6 percent increase above the average volume for the third quarter of 2013. The growth of core deposits is a particular focus of the Corporation because of the lower cost of funds, fee income generated by certain transaction activity, and the relationship opportunity to cross-sell other financial products and services. Decreased interest expense on deposits was partially offset by higher interest expense on long-term debt, which increased \$98,000 or 49 percent due to an increase in the average volume of borrowings. Long-term debt averaged \$80 million for the third quarter of 2014, compared to a \$44 million average for the third quarter of 2013. The increase in long-term debt was comprised of advances from the Federal Home Loan Bank of Pittsburgh. These advances were low rate borrowings with intermediate term bullet maturities that supplement deposit funding and provide a hedge against rising market interest rates.

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

| <i>(dollars in thousands)</i> | Three months ended September 30, | | | | | |
|---------------------------------------------|----------------------------------|-----------|----------------|--------------------|-----------|----------------|
| | 2014 | | | 2013 | | |
| | Average Balance | Interest | Yield/ Rate | Average Balance | Interest | Yield/ Rate |
| Assets | | | | | | |
| Interest bearing deposits with banks | \$ 25,462 | \$ 16 | 0.25% | \$ 27,250 | \$ 17 | 0.25% |
| Investment securities: | | | | | | |
| Taxable | 154,871 | 915 | 2.34 | 144,238 | 797 | 2.19 |
| Tax-exempt | 71,364 | 697 | 3.87 | 89,713 | 876 | 3.87 |
| Total investment securities | 226,235 | 1,612 | 2.83 | 233,951 | 1,673 | 2.84 |
| Loans: | | | | | | |
| Taxable (1) | 872,908 | 11,110 | 5.05 | 778,944 | 10,308 | 5.25 |
| Tax-exempt | 19,039 | 241 | 5.02 | 12,001 | 161 | 5.32 |
| Total loans | 891,947 | 11,351 | 5.05 | 790,945 | 10,469 | 5.25 |
| Total earning assets | 1,143,644 | 12,979 | 4.50 | 1,052,146 | 12,159 | 4.58 |
| Other assets (2) | 62,999 | | | 56,668 | | |
| Total assets | \$ 1,206,643 | | | \$ 1,108,814 | | |
| Liabilities and Shareholders' Equity | | | | | | |
| Deposits: | | | | | | |
| Interest bearing demand | \$ 388,500 | \$ 325 | 0.33% | \$ 378,997 | \$ 361 | 0.38% |
| Savings | 41,945 | 15 | 0.14 | 38,728 | 24 | 0.25 |
| Time | 420,587 | 1,342 | 1.27 | 411,419 | 1,504 | 1.45 |
| Total interest bearing deposits | 851,032 | 1,682 | 0.78 | 829,144 | 1,889 | 0.90 |
| Short-term borrowings | 32,900 | 43 | 0.52 | 24,519 | 34 | 0.55 |
| Long-term debt | 80,442 | 299 | 1.47 | 43,568 | 201 | 1.83 |
| Total interest bearing liabilities | 964,374 | 2,024 | 0.83 | 897,231 | 2,124 | 0.94 |
| Noninterest bearing deposits | 119,633 | | | 100,505 | | |
| Other liabilities | 7,322 | | | 6,642 | | |
| Shareholders' equity | 115,314 | | | 104,436 | | |
| Total liabilities and shareholders' equity | \$ 1,206,643 | | | \$ 1,108,814 | | |
| Net interest income (tax equivalent basis) | | \$ 10,955 | | | \$ 10,035 | |
| Net interest margin (3) | | | 3.80% | | | 3.78% |
| Tax equivalent adjustment | | (309) | | | (340) | |
| Net interest income | | \$ 10,646 | | | \$ 9,695 | |

- (1) Average balance includes average nonaccrual loans of \$8,248,000 for 2014 and \$10,667,000 for 2013. Interest includes net loan fees of \$487,000 for 2014 and \$328,000 for 2013.
- (2) Average balance includes average bank owned life insurance, foreclosed real estate and unrealized holding gains (losses) on investment securities.
- (3) Net interest income (tax equivalent basis) annualized as a percentage of average interest earning assets.

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

| <i>(dollars in thousands)</i> | Three months ended September 30, 2014 vs. 2013 | | |
|--------------------------------------|---------------------------------------------------------------|-----------------|---------------|
| | Volume | Rate | Net |
| Interest Income | | | |
| Interest bearing deposits with banks | \$ (1) | \$ 0 | \$ (1) |
| Investment securities: | | | |
| Taxable | 56 | 62 | 118 |
| Tax-exempt | (178) | (1) | (179) |
| Loans: | | | |
| Taxable | 1,452 | (650) | 802 |
| Tax-exempt | 95 | (15) | 80 |
| Total interest income | 1,424 | (604) | 820 |
| Interest Expense | | | |
| Deposits: | | | |
| Interest bearing demand | 10 | (46) | (36) |
| Savings | 2 | (11) | (9) |
| Time | 34 | (196) | (162) |
| Short-term borrowings | 12 | (3) | 9 |
| Long-term debt | 166 | (68) | 98 |
| Total interest expense | 224 | (324) | (100) |
| Net interest income | \$ 1,200 | \$ (280) | \$ 920 |

*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 was \$250,000 for the third quarter of 2014, an increase of \$100,000 or 67 percent above the provision of \$150,000 for the third quarter of 2013. The increased provision supported growth in the commercial loan portfolio and maintained the adequacy of the allowance for loan losses. More information about the allowance for loan losses can be found in this report under the caption Allowance for Loan Losses on page 54.

Table of Contents**Noninterest income**

The following table presents the components of total noninterest income for the third quarter of 2014, compared to the third quarter of 2013.

Table 3 - Noninterest income

| <i>(dollars in thousands)</i> | Three months ended September 30, | | Change Increase (Decrease) | |
|------------------------------------------------------|-------------------------------------|----------|-------------------------------|------|
| | 2014 | 2013 | \$ | % |
| Trust and investment services fees | \$ 592 | \$ 510 | \$ 82 | 16% |
| Income from mutual fund, annuity and insurance sales | 178 | 74 | 104 | 141 |
| Service charges on deposit accounts | 783 | 688 | 95 | 14 |
| Income from bank owned life insurance | 184 | 192 | (8) | (4) |
| Other income | 155 | 157 | (2) | (1) |
| Net gain on sales of loans held for sale | 124 | 233 | (109) | (47) |
| Gain on sales of securities | 146 | 0 | 146 | nm* |
| Total noninterest income | \$ 2,162 | \$ 1,854 | \$ 308 | 17% |

*nm not meaningful

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

Trust and investment services fees The \$82,000 or 16 percent increase in trust and investment services fees was due to appreciation in the market value of managed accounts, upon which some fees are based, and growth in traditional trust business.

Income from mutual fund, annuity and insurance sales The \$104,000 or 141 percent increase in income from the sale of mutual fund, annuity and insurance products by Codorus Valley Financial Advisors (CVFA), a subsidiary of PeoplesBank, was a result of increased sales volume during the third quarter of 2014, while the third quarter of 2013 reflected the negative impact of the resignation of three registered representatives who left CVFA in 2013.

Service charges on deposit accounts The \$95,000 or 14 percent increase in service charge income on deposit accounts was due primarily to increases in overdraft fees and debit card revenue.

Net gain on sales of loans held for sale The \$109,000 or 47 percent decrease in gains from the sale of residential mortgage loans held for sale resulted from a decrease in mortgage originations, as refinancing demand and gains therefrom have declined significantly, and the higher level of mortgage interest rates has priced some borrowers out of the mortgage market.

Gain on sales of securities The third quarter of 2014 had \$146,000 in gains from the sale of approximately \$4 million of U.S. agency securities. Comparatively, there were no sales of investment securities in the third quarter of 2013.

Table of Contents**Noninterest expense**

The following table presents the components of total noninterest expense for the third quarter of 2014, compared to the third quarter of 2013.

Table 4 - Noninterest expense

| (dollars in thousands) | Three months ended September 30, | | Change Increase (Decrease) | |
|----------------------------------------------------------|-------------------------------------|----------|-------------------------------|------|
| | 2014 | 2013 | \$ | % |
| Personnel | \$ 4,436 | \$ 4,191 | \$ 245 | 6% |
| Occupancy of premises, net | 505 | 496 | 9 | 2 |
| Furniture and equipment | 552 | 522 | 30 | 6 |
| Postage, stationery and supplies | 199 | 131 | 68 | 52 |
| Professional and legal | 380 | 187 | 193 | 103 |
| Marketing | 340 | 341 | (1) | (0) |
| FDIC insurance | 149 | 154 | (5) | (3) |
| Debit card processing | 199 | 204 | (5) | (2) |
| Charitable donations | 66 | 32 | 34 | 106 |
| Telephone | 141 | 130 | 11 | 8 |
| External data processing | 186 | 178 | 8 | 4 |
| Foreclosed real estate including (gains) losses on sales | 60 | 277 | (217) | (78) |
| Other | 789 | 889 | (100) | (11) |
| Total noninterest expense | \$ 8,002 | \$ 7,732 | \$ 270 | 3% |

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

Personnel The \$245,000 or 6 percent increase in personnel expense was due largely to an increase in wage expense resulting from planned franchise expansion.

Postage, stationary and supplies The \$68,000 or 52 percent increase in postage, stationary and supplies was due primarily to franchise expansion, postage rate increases, and new stationary reflecting the Corporation's updated branding.

Professional and legal The \$193,000 or 103 percent increase in professional and legal expense primarily was due to investment banking and legal fees associated with pre-merger activities related to the Corporation's planned acquisition of Madison Bancorp, Inc. (see Note 15 Pending Acquisition).

Charitable donations The \$34,000 or 106 percent increase in charitable donations was the primarily the result of a charitable donation of a parcel of foreclosed real estate.

Foreclosed real estate The \$217,000 or 78 percent decrease in foreclosed real estate expenses was primarily the result of the reversal of a \$50,000 allowance on a foreclosed real estate property during the third quarter of 2014 compared to a \$125,000 provision expense on a foreclosed real estate property during the third quarter of 2013.

Other Other expense, comprised of many underlying expenses, decreased \$100,000 or 11 percent primarily due to decreased impaired loan costs as the lower volume of nonperforming assets in 2014 versus 2013 resulted in less carrying and collection costs.

Provision for income taxes

The provision for income tax for the third quarter of 2014 was \$1,377,000, compared to \$990,000 for the third quarter of 2013. The \$387,000 or 39 percent increase was primarily the result from a higher level of pretax earnings, and a decrease in the amount of tax-exempt income for the third quarter of 2014 as compared to the same period in 2013. For both periods, the Corporation's statutory federal income tax rate was 34 percent. The Corporation's effective income tax rate was 30 percent for the third quarter of 2014, compared to 27 percent for the third quarter of 2013 as a result of the lower tax-exempt income. The effective tax rate differs from the statutory tax rate due to the impact of low-income housing credits and tax-exempt income, including income from bank owned life insurance.

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Preferred stock dividends

Preferred stock dividends for the third quarter of 2014 totaled \$30,000 compared to \$62,000 for the third quarter of 2013. Though an annualized dividend rate of 1 percent applied to both periods, the amount of preferred stock dividends for the third quarter of 2014 decreased because, on May 30, 2014, as reported on a Form 8-K filed on the same date, the Corporation used the net proceeds from a private placement of common stock, and additional cash, to redeem \$13 million of the \$25 million in outstanding shares of the Corporation's preferred stock held by the United States Department of the Treasury. The Corporation is currently paying the lowest permissible dividend rate under the U.S. Treasury's Small Business Lending Fund Program (SBLF Program) as a result of originating loans that qualify for the SBLF Program in excess of a pre-determined loan portfolio baseline balance. Information about the SBLF Program is provided in this report at Note 10-Shareholders' Equity.

Nine months ended September 30, 2014, compared to the nine months ended September 30, 2013

FINANCIAL HIGHLIGHTS

The Corporation earned net income available to common shareholders (earnings) totaling \$8,845,000 for the first nine months of 2014, compared to \$7,797,000 for the same period of 2013. The \$1,048,000 or 13 percent increase in earnings was due primarily to an increase in net interest income, which more than offset increases in the provision for loan losses, noninterest expense and income taxes, as described below.

Net interest income increased \$3,208,000 or 11 percent for the first nine months of 2014, compared to the same period of 2013, due primarily to an increase in the average volume of interest-earning assets, principally commercial loans and U.S. agency mortgage-backed securities, and a decrease in the overall cost of deposits. The average balance of interest-earning assets increased \$104 million or 10 percent compared to the same period of 2013. Net interest income (tax equivalent basis) annualized as a percentage of average interest earning assets, i.e., net interest margin, was 3.83 percent for the first nine months of 2014, compared to 3.81 percent for the same period in 2013.

The provision for loan losses for the first nine months of 2014 was \$1,100,000 compared to \$970,000 for the same period in 2013, an increase of \$130,000 and 13 percent for 2014 year to date. The increased provision was required to support growth in the loan portfolio and to maintain the adequacy of the allowance for loan losses. The average balance of total loans for the first nine months of 2014 was \$879 million or 14% higher than the \$769 million of average total loans for the first nine months of 2013.

The \$89,000 or 2 percent decrease in total noninterest income for the first nine months of 2014, compared to the same period of 2013, was primarily the result of a sharp decrease in the net gain from sales of loans held for sale (i.e. residential mortgage loans). The decrease was offset by increases in trust fees, service charges on deposit accounts, and gains on sales of securities. The lower mortgage sale revenue reflects a decline in consumer mortgage demand and refinancing activity, primarily due to higher mortgage market interest rates that increased in mid-2013 and generally have persisted throughout 2014.

The \$1,494,000 or 7 percent increase in noninterest expense for the first nine months of 2014, compared to the same period of 2013, was due largely to an increase in personnel and facilities expenses, professional fees, marketing costs, and charitable donations.

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Personnel expense increased \$554,000 and occupancy and furniture and equipment expenses increased \$220,000 primarily as a result of expanding the banking franchise. Professional and legal expense increased \$330,000 due to investment banking and legal fees associated with pre-merger activities related to the Corporation's planned acquisition of Madison Bancorp, Inc. (see Note 15 Pending Acquisition), as well as increases in consulting expenses which supported corporate revenue growth initiatives. Marketing expense increased \$319,000 as a result of non-recurring costs to promote PeoplesBank's 150th year in business anniversary. An increase in charitable contributions of \$317,000 reflects increased donations to nonprofit organizations that qualify for state tax credits, which reduce future tax liabilities and effectively lowers the overall cost of the donations. External data processing increased \$108,000 reflecting greater reliance on outsourcing transaction processing to specialized vendors, expanded services offered to our client base, and higher transaction volume from normal business growth. Offsetting these overhead increases were reduced foreclosed real estate expenses, which decreased \$107,000 as sales of certain larger foreclosed properties during 2014 reduced related property holding costs. Additionally, the Corporation experienced favorable savings in certain other expense categories, including bank shares tax expense and impaired loan carrying costs.

The \$490,000 or 17 percent increase in the provision for income taxes for the first nine months of 2014, compared to the same period of 2013, primarily resulted from higher level of pretax earnings and a decrease in the amount of tax-exempt income.

The schedule below presents selected performance metrics for the first nine months of both 2014 and 2013. All per share computations include the effect of stock dividends declared, including the 5 percent common stock dividend distributed on December 10, 2013, and the 5 percent common stock dividend declared October 14, 2014.

| | Nine months ended | |
|--------------------------------------------|-------------------|---------|
| | September 30, | |
| | 2014 | 2013 |
| Basic earnings per common share | \$ 1.60 | \$ 1.57 |
| Diluted earnings per common share | \$ 1.57 | \$ 1.54 |
| Cash dividend payout ratio | 29.52% | 19.63% |
| Return on average assets | 1.01% | 0.98% |
| Return on average equity | 10.48% | 10.26% |
| Net interest margin (tax equivalent basis) | 3.83% | 3.81% |
| Net overhead ratio | 2.02% | 2.01% |
| Efficiency ratio | 61.70% | 62.57% |
| Average equity to average assets | 9.62% | 9.60% |

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

INCOME STATEMENT ANALYSIS**Net interest income**

Net interest income for the nine-month period ended September 30, 2014, was \$31,356,000, an increase of \$3,208,000 or 12 percent above the same period of 2013. The increase was due primarily to increased interest income from a 10 percent increase in the average volume of interest-earning assets for the first nine months of 2014 compared to the first nine months of 2013. A decrease in the cost of deposits, partially offset by increased long-term debt interest expense due to an increase in borrowings, also contributed to the increase in net interest income. Net interest income (tax equivalent basis) annualized as a percentage of average interest-earning assets, i.e., net interest margin, was 3.83 percent for the first nine months of 2014 compared to 3.81 percent for the same period in 2013.

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Interest income for the first nine months totaled \$37,447,000, an increase of \$2,794,000 or 8 percent above the same period of 2013. The increase was driven primarily by an increase in the average volume of interest earning assets, principally commercial loans and U.S. agency mortgage-backed securities. Interest earning assets averaged \$1.13 billion and yielded 4.55 percent (tax equivalent basis) for the first nine months of 2014, compared to \$1.02 billion and a yield of 4.66 percent, respectively, for the first nine months of 2013. While the volume of earning assets increased, its effect on interest income was slightly muted by the lower asset yields, a reflection of the continuing low interest rate environment.

Interest expense for the first nine months of 2014 totaled \$6,091,000, a decrease of \$414,000 or 6 percent below the same period of 2013. The decrease in total interest expense was driven primarily by a general decrease in deposit rates, due to the continuing low interest rate environment, and from a larger volume of low-cost core deposits. The Corporation defines core deposits as noninterest and interest bearing demand, savings and money market deposits. The average volume of these core demand and savings deposits was \$541 million for the nine-month period ending September 30, 2014, a \$42 million or 8 percent increase above the average volume for the same period of 2013. The growth of core deposits is a particular focus of the Corporation because of the lower cost of funds, fee income generated by certain transaction activity, and the relationship opportunity to cross-sell other financial products and services.

Decreased interest expense on deposits was offset by higher interest expense on long-term debt, which increased \$316,000 or 56 percent due to an increase in average borrowings. Long-term debt averaged \$79 million for the first nine months of 2014, compared to a \$39 million average for the same period of 2013. The increase in long-term debt was comprised of advances from the Federal Home Loan Bank of Pittsburgh. These advances were low rate borrowings with intermediate term bullet maturities that supplement deposit funding and provide a hedge against rising market interest rates.

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

| <i>(dollars in thousands)</i> | Nine months ended September 30, | | | | | |
|-------------------------------------------------------|---------------------------------|-----------|----------------|--------------------|-----------|----------------|
| | 2014 | | | 2013 | | |
| | Average Balance | Interest | Yield/ Rate | Average Balance | Interest | Yield/ Rate |
| Assets | | | | | | |
| Interest bearing deposits with banks | \$ 22,359 | \$ 42 | 0.25% | \$ 31,422 | \$ 59 | 0.25% |
| Investment securities: | | | | | | |
| Taxable | 149,634 | 2,735 | 2.44 | 131,037 | 2,072 | 2.11 |
| Tax-exempt | 76,889 | 2,253 | 3.92 | 92,495 | 2,717 | 3.93 |
| Total investment securities | 226,523 | 4,988 | 2.94 | 223,532 | 4,789 | 2.86 |
| Loans: | | | | | | |
| Taxable (1) | 860,963 | 32,707 | 5.08 | 757,499 | 30,379 | 5.36 |
| Tax-exempt | 17,978 | 672 | 5.00 | 11,254 | 468 | 5.56 |
| Total loans | 878,941 | 33,379 | 5.08 | 768,753 | 30,847 | 5.36 |
| Total earning assets | 1,127,823 | 38,409 | 4.55 | 1,023,707 | 35,695 | 4.66 |
| Other assets (2) | 60,489 | | | 57,289 | | |
| Total assets | \$ 1,188,312 | | | \$ 1,080,996 | | |
| Liabilities and Shareholders' Equity Deposits: | | | | | | |
| Interest bearing demand | \$ 386,581 | \$ 1,021 | 0.35% | \$ 369,193 | \$ 1,032 | 0.37% |
| Savings | 40,970 | 60 | 0.20 | 37,560 | 70 | 0.25 |
| Time | 416,642 | 4,013 | 1.29 | 409,470 | 4,747 | 1.55 |
| Total interest bearing deposits | 844,193 | 5,094 | 0.81 | 816,223 | 5,849 | 0.96 |
| Short-term borrowings | 29,467 | 116 | 0.53 | 21,914 | 91 | 0.56 |
| Long-term debt | 79,254 | 881 | 1.49 | 39,470 | 565 | 1.91 |
| Total interest bearing liabilities | 952,914 | 6,091 | 0.85 | 877,607 | 6,505 | 0.99 |
| Noninterest bearing deposits | 113,213 | | | 92,455 | | |
| Other liabilities | 7,866 | | | 7,133 | | |
| Shareholders' equity | 114,319 | | | 103,801 | | |
| Total liabilities and shareholders' equity | \$ 1,188,312 | | | \$ 1,080,996 | | |
| Net interest income (tax equivalent basis) | | \$ 32,318 | | | \$ 29,190 | |
| Net interest margin (3) | | | 3.83% | | | 3.81% |
| Tax equivalent adjustment | | (962) | | | (1,042) | |
| Net interest income | | \$ 31,356 | | | \$ 28,148 | |

- (1) Average balance includes average nonaccrual loans of \$11,418,000 for 2014 and \$10,388,000 for 2013. Interest includes net loan fees of \$1,308,000 for 2014 and \$1,049,000 for 2013.
- (2) Average balance includes average bank owned life insurance, foreclosed real estate and unrealized holding gains (losses) on investment securities.
- (3) Net interest income (tax equivalent basis) annualized as a percentage of average interest earning assets.

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

| <i>(dollars in thousands)</i> | Nine months ended September 30, 2014 vs. 2013 | | |
|--------------------------------------|-----------------------------------------------------|-----------------|-----------------|
| | Volume | Rate | Net |
| Interest Income | | | |
| Interest bearing deposits with banks | \$ (17) | \$ 0 | \$ (17) |
| Investment securities: | | | |
| Taxable | 284 | 379 | 663 |
| Tax-exempt | (459) | (5) | (464) |
| Loans: | | | |
| Taxable | 4,548 | (2,220) | 2,328 |
| Tax-exempt | 279 | (75) | 204 |
| Total interest income | 4,635 | (1,921) | 2,714 |
| Interest Expense | | | |
| Deposits: | | | |
| Interest bearing demand | 86 | (97) | (11) |
| Savings | 6 | (16) | (10) |
| Time | 83 | (817) | (734) |
| Short-term borrowings | 30 | (5) | 25 |
| Long-term debt | 561 | (245) | 316 |
| Total interest expense | 766 | (1,180) | (414) |
| Net interest income | \$ 3,869 | \$ (741) | \$ 3,128 |

*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 for the first nine months of 2014 was \$1,100,000, which was provided to support growth in the commercial loan portfolio and maintain the adequacy of the allowance for loan losses. The provision was \$130,000 or 13 percent higher compared to the first nine months of 2013. Average total loans for the first nine months of 2014 were \$879 million, a 14 percent increase as compared to the \$769 million of average total loans for the first nine months of 2013.

More information about the allowance for loan losses can be found in this report under the caption Allowance for Loan Losses on page 54.

Table of Contents**Noninterest income**

The following table presents the components of total noninterest income for the first nine months of 2014 compared to the first nine months of 2013.

Table 7 - Noninterest income

| <i>(dollars in thousands)</i> | Nine months ended September 30, | | Change Increase (Decrease) | |
|------------------------------------------------------|------------------------------------|----------|-------------------------------|------|
| | 2014 | 2013 | \$ | % |
| Trust and investment services fees | \$ 1,644 | \$ 1,447 | \$ 197 | 14% |
| Income from mutual fund, annuity and insurance sales | 503 | 496 | 7 | 1 |
| Service charges on deposit accounts | 2,221 | 1,992 | 229 | 11 |
| Income from bank owned life insurance | 532 | 543 | (11) | (2) |
| Other income | 458 | 503 | (45) | (9) |
| Net gain on sales of loans held for sale | 306 | 874 | (568) | (65) |
| Gain on sales of securities | 146 | 44 | 102 | 232 |
| Total noninterest income | \$ 5,810 | \$ 5,899 | \$ (89) | (2)% |

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

Trust and investment services fees The \$197,000 or 14 percent increase in trust and investment services fees was due to appreciation in the market value of managed accounts, upon which some fees are based, and growth in traditional trust business.

Service charges on deposit accounts The \$229,000 or 11 percent increase in service charge income was due primarily to increases in debit card revenue and overdraft fees.

Net gain on sales of loans held for sale The \$568,000 or 65 percent decrease in gains from the sale of residential mortgage loans held for sale resulted from a decrease in mortgage originations, as refinancing demand and gains therefrom have declined significantly, and the higher level of mortgage interest rates has priced some prospective borrowers out of the mortgage market.

Gain on sales of securities The \$102,000 increase in gains on sales of securities related to gains realized during the third quarter of 2014 from the sale of approximately \$4 million of U.S. agency securities.

Table of Contents**Noninterest expense**

The following table presents the components of total noninterest expense for the first nine months of 2014, compared to the first nine months of 2013.

Table 8 - Noninterest expense

| <i>(dollars in thousands)</i> | Nine months ended September 30, | | Change | |
|----------------------------------------------------------|------------------------------------|-----------|---------------------------|------|
| | 2014 | 2013 | Increase (Decrease) \$ | % |
| Personnel | \$ 13,040 | \$ 12,486 | \$ 554 | 4% |
| Occupancy of premises, net | 1,586 | 1,519 | 67 | 4 |
| Furniture and equipment | 1,646 | 1,493 | 153 | 10 |
| Postage, stationery and supplies | 521 | 438 | 83 | 19 |
| Professional and legal | 819 | 489 | 330 | 67 |
| Marketing | 1,060 | 741 | 319 | 43 |
| FDIC insurance | 511 | 463 | 48 | 10 |
| Debit card processing | 592 | 577 | 15 | 3 |
| Charitable donations | 835 | 518 | 317 | 61 |
| Telephone | 432 | 396 | 36 | 9 |
| External data processing | 621 | 513 | 108 | 21 |
| Foreclosed real estate including (gains) losses on sales | 307 | 414 | (107) | (26) |
| Other | 1,666 | 2,095 | (429) | (20) |
| Total noninterest expense | \$ 23,636 | \$ 22,142 | \$ 1,494 | 7% |

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

Personnel The \$554,000 or 4 percent increase in personnel expense was due largely to an increase in wage expense resulting from planned franchise expansion that occurred during the first nine months of 2014 and the latter half of 2013 that affect the current period.

Furniture and equipment The \$153,000 or 10 percent increase in furniture and equipment was due primarily to normal business growth, including expenses from the addition of two banking offices in the year 2013 that affect the current period, and related increased depreciation on computer hardware and software.

Professional and legal The \$330,000 or 67 percent increase in professional and legal expense was due to investment banking and legal fees associated with pre-merger activities related to the Corporation's planned acquisition of Madison Bancorp, Inc. (see Note 15 - Pending Acquisition), as well as increases in consulting expenses which supported corporate revenue growth initiatives.

Marketing The \$319,000 or 43 percent increase in marketing expense was primarily the result of non-recurring costs to promote PeoplesBank's 150th year in business anniversary.

FDIC insurance The \$48,000 or 10 percent increase in FDIC insurance expense related primarily to growth in the average balance of deposits for 2014, resulting in a higher deposit insurance assessment.

Charitable donations The \$317,000 or 61 percent increase in charitable donations was the result of an increase in donations to nonprofit organizations that qualify for related state tax credits. PeoplesBank uses state tax credits from donations to reduce its Pennsylvania shares tax expense, included in other expenses. State tax credits typically range from 55 to 90 percent of the amount donated, effectively lowering the cost of the donation.

External data processing The \$108,000 or 21 percent increase in external data processing reflects increased reliance on outsourcing transaction processing to specialized vendors, which is typically performed on their hosted and secure websites thereby increasing our processing efficiency. Expansion in the electronic banking services offered to our client base, and higher transaction volume from normal business growth, also contributed to the increase in this expense category.

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Foreclosed real estate The \$107,000 or 26 percent decrease in foreclosed real estate expenses was a result of sales of certain larger foreclosed properties in 2014. The sales reduced the volume of foreclosed assets held and the related year-over-year holding costs incurred, including real estate taxes, property maintenance, appraisal costs, and collection processing costs.

Other The \$429,000 or 20 percent decrease in other expense was primarily attributable to a substantial decrease in PA shares tax expense, a component of other expense. The decrease in shares tax expense reflected both (i) statutory changes in the formula for determining the shares tax which were favorable for the Corporation's tax basis, and (ii) changes in the volume of tax credits which originated from qualifying charitable donations described earlier. Additionally, impaired loan costs decreased as the lower volume of nonperforming assets in 2014 versus 2013 resulted in less carrying and collection costs.

Provision for income taxes

The provision for income tax for the first nine months of 2014 was \$3,441,000, compared to \$2,951,000 for the same period of 2013. The \$490,000 or 17 percent increase in the provision for income taxes was primarily the result of higher pretax earnings, and a decrease in the amount of tax-exempt income for the first nine months of 2014 as compared to the same period in 2013. For both periods, the Corporation's statutory federal income tax rate was 34 percent. The Corporation's effective income tax rate was 28 percent for the first nine months of 2014, compared to 27 percent for the first nine months of 2013. The effective tax rate differs from the statutory tax rate due to the impact of low-income housing credits and tax-exempt income, including income from bank owned life insurance.

Preferred stock dividends

Preferred stock dividends for the first nine months of 2014 totaled \$144,000 compared to \$187,000 for the same period of 2013. Though an annualized dividend rate of 1 percent applied to both periods, the amount of preferred stock dividends for the first nine months of 2014 decreased because, on May 30, 2014, as reported on a Form 8-K filed on the same date, the Corporation used the net proceeds from a private placement of common stock, and additional cash, to redeem \$13 million of the \$25 million in outstanding shares of the Corporation's preferred stock held by the United States Department of the Treasury. The Corporation is currently paying the lowest permissible dividend rate under the U.S. Treasury's Small Business Lending Fund Program (SBLF Program) as a result of originating loans that qualify for the SBLF Program in excess of a pre-determined loan portfolio baseline balance. Information about the SBLF Program is provided in this report at Note 10-Shareholders' Equity.

BALANCE SHEET REVIEW

Interest bearing deposits with banks

On September 30, 2014, interest bearing deposits with banks totaled \$21 million, compared to \$2 million at year-end 2013. The increase was the result of the growth in deposits, which outpaced the deployment of funds to the loan and investment security portfolios.

Securities available-for-sale

On September 30, 2014, the fair value of securities available-for-sale totaled \$229 million, which represented approximately the same total value of investments as compared year-end 2013. During 2014, cash inflows from U.S. agency mortgage-backed securities and state and municipal bond maturities (or bond calls) were reinvested in new investments in U.S. agency mortgage-backed securities. The overall composition of the Corporation's investment securities portfolio is provided in Note 3-Securities.

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Loans

On September 30, 2014, total loans, net of deferred fees, totaled \$892 million, which was \$33 million or 4 percent higher than the level at year-end 2013. The increase in volume was due primarily to increases in commercial loans within the commercial real estate investor and residential real estate investor sectors, and additional loan growth in other industry sectors (e.g., agriculture, hotel/motel, and transportation industries). The composition of the Corporation's loan portfolio is provided in Note 5 Loans.

Deposits

On September 30, 2014, deposits totaled \$959 million, which represented a \$34 million or 4 percent increase compared to the level at year-end 2013. Of the increase in total deposits, \$10 million was attributable to growth in noninterest bearing deposits, with an additional \$18 million related to growth in both interest bearing demand and savings deposits. Growth in time deposits of approximately \$6 million reflected new monies from a special rate promotion in early 2014 to celebrate PeoplesBank's 150th anniversary. The composition of the Corporation's deposit portfolio is provided in Note 7 Deposits.

Long-term debt

On September 30, 2014, long-term debt totaled \$80 million, which was \$10 million or 14 percent above the year-end 2013 level. The increase was the result of a \$10 million advance from the Federal Home Loan Bank of Pittsburgh that provides liquidity and acts as a hedge against rising market interest rates. A listing of outstanding long-term debt obligations is provided in Note 8 Short-Term Borrowing and Long-Term Debt.

Shareholders' equity and capital adequacy

Shareholders' equity, or capital, enables Codorus Valley to maintain asset growth and absorb losses. Total shareholders' equity was approximately \$116 million on September 30, 2014, an increase of approximately \$8 million or 8 percent, compared to the level at December 31, 2013. The increase in capital was primarily the result of retained earnings from profitable operations, less cash dividends paid during the first nine months of 2014. The composition of shareholders' equity reflects an increase in common equity and a decrease in preferred equity as a result of the net proceeds from a \$13 million private placement of common stock being used to redeem preferred stock, as discussed below.

Dividends on common stock

The Corporation has historically paid 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 relevant factors. As recently announced, the Board of Directors declared a quarterly cash dividend of \$0.125 per common share on October 14, 2014, payable on November 11, 2014, to shareholders of record at the close of business on October 28, 2014. This dividend follows a \$0.125 cash dividend distributed in August, and \$0.12 per common share of cash dividends distributed in May and February 2014. Also, on October 14, 2014, the Board of Directors declared a 5 percent common stock dividend, to be distributed on December 9, 2014, to shareholders of record at the close of business on October 28, 2014.

Private placement of common stock and redemption of preferred stock

As previously announced on the Form 8-K filed on March 27, 2014, the Corporation completed the private placement of 650,000 shares of its common stock to accredited investors at a purchase price of \$20 per share, pursuant to which the Corporation raised gross proceeds of \$13 million. After issuance costs, net proceeds from the private placement totaled approximately \$12.5 million. These net proceeds, in addition to \$0.5 million in cash, were used to redeem \$13 million of the \$25 million of outstanding preferred stock issued to the U.S. Treasury under its Small Business Lending Fund Program, as reported on the Form 8-K filed on May 30, 2014. More information about the private placement and the preferred stock can be found in this report at Note 10 Shareholders' Equity. For the nine month periods ended September 30, 2014 and 2013, accrued dividends equated to an annualized dividend rate of 1 percent on the preferred stock outstanding.

Table of Contents*Capital adequacy*

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 Note 9 Regulatory Matters to the financial statements. We believe that Codorus Valley and PeoplesBank were well capitalized on September 30, 2014, based on regulatory capital guidelines.

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

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

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

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

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

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

RISK MANAGEMENT**Credit risk management**

The Credit Risk Management section included in the Corporation's Form 10-K for year-end 2013 provides a general overview of the Corporation's credit risk management process and loan concentrations. Credit risk represents the possibility that a loan client, counterparty or issuer may not perform in accordance with contractual terms, posing one of the most significant risks to the Corporation.

Nonperforming assets

The following table presents asset categories posing the greatest risk of loss and related ratios. We generally place a loan on nonaccrual status and cease accruing interest income, i.e., recognize interest income on a cash basis, as long as the loan is sufficiently collateralized, when loan payment performance is unsatisfactory and the loan is past due 90 days or more. Loans past due 90 days or more and still accruing interest represent loans that are contractually past due, but are well collateralized and in the process of collection. Foreclosed real estate represents real estate acquired to satisfy debts owed to PeoplesBank. Troubled debt restructurings pertain 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 and table below address significant changes in the aforementioned categories as of September 30, 2014, compared to December 31, 2013.

Nonperforming assets are under the purview of in-house counsel, who continuously monitors and manages the collection of these accounts. Additionally, an internal asset quality control committee meets monthly to review nonperforming assets. We generally rely on appraisals performed by independent licensed appraisers to determine the value of collateral for impaired collateral-dependent loans. Generally, an appraisal is performed when: an account reaches 90 days past due, unless a certified appraisal was completed within the past twelve months; market values have changed significantly; the condition of the property has changed significantly; or the existing appraisal is outdated. In instances where the value of the collateral, net of costs to sell, is less than the net carrying amount for impaired commercial related loans, a specific loss allowance is established for the difference. When it is probable that some portion or an entire loan balance will not be collected, that amount is charged off as loss against the allowance.

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

| <i>(dollars in thousands)</i> | September 30, 2014 | December 31, 2013 |
|--------------------------------------------------------------------------------------|-----------------------|----------------------|
| Nonaccrual loans | \$ 6,273 | \$ 13,231 |
| Nonaccrual loans, troubled debt restructurings | 2,277 | 2,069 |
| Total nonperforming loans | 8,550 | 15,300 |
| Foreclosed real estate, net of allowance | 2,805 | 4,068 |
| Total nonperforming assets | \$ 11,355 | \$ 19,368 |
| Accruing troubled debt restructurings | \$ 1,997 | \$ 3,342 |
| | | |
| Total period-end loans, net of deferred fees | \$ 892,004 | \$ 859,384 |
| Allowance for loan losses (ALL) | \$ 10,713 | \$ 9,975 |
| ALL as a % of total period-end loans | 1.20% | 1.16% |
| Annualized net charge-offs as a % of average total loans | 0.05% | 0.10% |
| ALL as a % of nonperforming loans | 125.30% | 65.20% |
| Nonperforming loans as a % of total period-end loans | 0.96% | 1.78% |
| Nonperforming assets as a % of total period-end loans and net foreclosed real estate | 1.27% | 2.24% |
| Nonperforming assets as a % of total period-end assets | 0.94% | 1.68% |
| Nonperforming assets as a % of total period-end shareholders' equity | 9.80% | 17.99% |

The level of nonperforming assets as of September 30, 2014, has decreased by approximately \$8.0 million or 41 percent when compared to year-end 2013. Significant transactions contributing to the decrease include sales of two foreclosed real estate properties in the third quarter of 2014 totaling \$1.9 million, a \$3.9 million payment received on a nonaccrual loan in the second quarter of 2014, and a \$1.05 million payoff of a nonaccrual loan in the first quarter of 2014. Generally, we remain concerned about prolonged low economic growth, or a weakening economy, and the corresponding effects it has on our commercial borrowers.

Nonaccrual loans

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

As of September 30, 2014, the nonperforming loan portfolio balance totaled \$8,550,000, compared to \$15,300,000 at year-end 2013. Significant activity contributing to the decrease included (i) a \$3.9 million payment received on a nonaccrual commercial loan, (ii) a \$1.05 million payoff of a nonaccrual commercial loan, (iii) payments totaling \$679,000 from collateral sales and guarantees on a commercial loan relationship, and (iv) reclassifications to foreclosed real estate totaling \$1.6 million. For both periods the portfolio balance was comprised primarily of collateralized commercial loans. On September 30, 2014, the nonaccrual loan portfolio was comprised of twenty-four unrelated loan relationships with outstanding principal balances ranging in size from \$18,300 to \$1,969,000. Four unrelated commercial relationships, which represent 74 percent of the nonperforming loan portfolio balance, are described below.

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Loan no. 1 At September 30, 2014, the outstanding principal balance of the loan relationship was \$1,969,000, collateralized by commercial rental properties with rents assigned to PeoplesBank. Based on a recent appraisal of the primary real estate collateralizing the relationship, we believe that the loans are adequately secured. The borrower is presently operating under a troubled debt restructuring agreement.

Loan no. 2 At September 30, 2014, the outstanding principal balance of this loan relationship was \$1,595,000. The balance outstanding was significantly reduced in 2014 due to a significant principal payment of \$3,879,000 received during the second quarter, funded by proceeds from the sale of the largest commercial property securing the loan. The remaining balance is collateralized by various smaller properties, some with prior lienholders. A \$750,000 allowance for probable loan losses was established for this relationship. Management is pursuing its legal remedies to recover the remaining amount due.

Loan no. 3 At September 30, 2014, the outstanding principal balance of the loan relationship was \$1,407,000, collateralized by various residential rental properties. A \$500,000 allowance for loan losses was established for this relationship. The Bank is presently pursuing its legal remedies to recover the amount due, including sales of underlying collateral.

Loan no. 4 At September 30, 2014, the outstanding principal balance of the loan relationship was \$1,349,000, collateralized by two commercial properties. Based on an independent appraisal of the real estate collateralizing the relationship, we believe that the loans are adequately collateralized. The Bank is presently pursuing its legal remedies to recover the amount due.

Foreclosed real estate

Foreclosed real estate is included in the Other Assets category on the Corporation's balance sheet. The carrying amount of foreclosed real estate on September 30, 2014, net of allowance, totaled \$2,805,000 and was comprised of seven unrelated accounts ranging in size from \$51,000 to \$1,010,000, net of allowance. Total foreclosed real estate decreased by 31% from December 31, 2013, to September 30, 2014, with the decrease primarily attributable to the sales of two foreclosed real estate assets with a combined carrying amount of \$1,827,000 during the third quarter of 2014 with minimal combined additional losses.

Two unrelated foreclosed real estate properties, which represent 68% of the foreclosed real estate portfolio balance, net of allowance, as of September 30, 2014, are described below. If a valuation allowance for probable loss has been established for a particular property, it is so noted in the property description below. Further valuation allowances may be required on any foreclosed property as additional information becomes available or conditions change.

Property no. 1 The carrying amount of this property at September 30, 2014 was \$1,010,000, which is net of a \$1,627,000 valuation allowance. The property is comprised of 132 approved residential building lots. Of this total, 27 lots are improved. The property has been listed for sale with a property broker.

Property no. 2 The carrying amount of this property at September 30, 2014 is \$910,000. The property is comprised of an 8 acre parcel improved for commercially developable sites. Management is evaluating its disposition options with regard to this property.

Allowance for loan losses

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

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

The following table presents an analysis of the activity in the allowance for loan losses for the nine months ended September 30, 2014 and 2013:

Table 10 - Analysis of Allowance for Loan Losses

| <i>(dollars in thousands)</i> | 2014 | 2013 |
|------------------------------------------------------------|-------------|-------------|
| Balance-January 1, | \$ 9,975 | \$ 9,302 |
| Provision charged to operating expense | 1,100 | 970 |
| Loans charged off: | | |
| Commercial, financial and agricultural | 326 | 582 |
| Real estate - residential mortgages | 30 | 28 |
| Consumer and home equity | 306 | 338 |
| Total loans charged off | 662 | 948 |
| Recoveries: | | |
| Commercial, financial and agricultural | 215 | 64 |
| Real estate - residential mortgages | 4 | 1 |
| Consumer and home equity | 81 | 60 |
| Total recoveries | 300 | 125 |
| Net charge-offs | 362 | 823 |
| Balance-September 30, | \$ 10,713 | \$ 9,449 |
| Ratios: | | |
| Allowance for loan losses as a % of total period-end loans | 1.20% | 1.16% |
| Annualized net charge-offs as a % of average total loans | 0.05% | 0.14% |
| Allowance for loan losses as a % of nonperforming loans | 125.30% | 96.61% |

The \$1,264,000 or 13 percent increase in the allowance from September 30, 2013 to September 30, 2014, generally supported the \$78 million increase in loans, net of deferred fees, over the same 12 month period. The provision for loan losses for the first nine months of 2014 was \$1,100,000 or 13 percent higher compared to the provision of \$970,000 for the first nine months of 2013. The increased provision was required to support the larger commercial loan portfolio and to maintain the adequacy of the allowance for loan losses.

Net charge-offs for the first nine months of 2014 were \$362,000 compared to \$823,000 of net charge-offs for the same period of 2013. During 2014, the Corporation realized a recovery of \$190,000 of a previous partial charge-off of an impaired commercial loan due to updated appraisals of underlying collateral resulting in a favorable fair value adjustment prior to the asset being transferred to foreclosed real estate. The risks and uncertainties associated with prolonged low growth, or weak economic and business conditions, or the erosion of real estate values, can adversely affect our borrowers' ability to service their loans, causing significant fluctuations in the level of charge-offs and provision expense from one period to another. The unallocated portion of the allowance for loan losses decreased to \$1,730,000 or 16 percent of the total allowance as of September 30, 2014, as compared to \$2,092,000 or 22 percent of the total allowance as of September 30, 2013. Despite the comparatively favorable net charge off activity for 2014, the unallocated portion of the allowance was not further reduced in consideration of both continued loan growth, principally commercial loans, and the inherent imprecision in the methodology for estimating specific and general loan losses, including the unpredictable timing and amounts of charge-offs and related historical loss averages, and economic and real estate market value uncertainties which could negatively impact unimpaired portfolio loss factors. Based on a comprehensive analysis of the loan portfolio, we believe that the allowance for loan losses was adequate at September 30, 2014.

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Liquidity risk management

Maintaining adequate liquidity provides the Corporation with the ability to meet financial obligations to depositors, loan customers, employees, and shareholders on a timely and cost effective basis in the normal course of business. Additionally, it provides funds for growth and business opportunities as they arise. Liquidity is generated from transactions relating to both the Corporation's assets and liabilities. The primary sources of asset liquidity are scheduled investment security maturities and cash inflows, funds received from customer loan payments, and asset sales. The primary sources of liability liquidity are deposit growth, short-term borrowings and long-term debt. The Consolidated Statements of Cash Flows, included in this report, present the changes in cash from operating, investing and financing activities. At September 30, 2014, we believe that liquidity was adequate based upon the potential liquidation of unpledged available-for-sale securities with a fair value totaling approximately \$51 million and available credit from the Federal Home Loan Bank of Pittsburgh totaling approximately \$300 million. The Corporation's loan-to-deposit ratio was 93 percent at both September 30, 2014 and year-end 2013.

Off-balance sheet arrangements

The Corporation's financial statements do not reflect various commitments that are made in the normal course of business, which may involve some liquidity risk. These commitments consist primarily of commitments to grant new loans, unfunded commitments under existing loan facilities, and letters of credit issued under the same standards as on-balance sheet instruments. Unused commitments on September 30, 2014, totaled \$291 million and consisted of \$203 million in unfunded commitments under existing loan facilities, \$62 million to grant new loans and \$26 million in letters of credit. Normally these commitments have fixed expiration dates or termination clauses and are for specific purposes. Accordingly, many of the commitments are expected to expire without being drawn upon and, therefore, generally do not present significant liquidity risk to the Corporation or PeoplesBank.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

Not applicable to smaller reporting companies.

Item 4. Controls and Procedures

The Corporation carried out an evaluation, under the supervision and with the participation of the Corporation's management, including the Corporation's Chief Executive Officer and Chief Financial Officer, of the effectiveness of its disclosure controls and procedures, as defined in Exchange Act Rules 13a-15(e) and 15d-15(e). Based upon the evaluation, the Corporation's Chief Executive Officer and Chief Financial Officer concluded that, as of September 30, 2014, the Corporation's disclosure controls and procedures are effective. The Corporation's disclosure controls and procedures are designed to provide reasonable, not absolute, assurance that information required to be disclosed in the Corporation's reports filed or submitted under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission's rules and forms. A control system, no matter how well conceived and operated, must reflect the fact that there are resource constraints and that the benefits of controls must be considered relative to their costs, and no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, within a company have been detected.

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There has been no change in the Corporation's internal control over financial reporting that occurred during the quarter ended September 30, 2014, that has materially affected or is reasonably likely to materially affect, the Corporation's internal control over financial reporting.

Part II OTHER INFORMATION

Item 1. Legal proceedings

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

Item 1A. Risk factors

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

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

The Corporation relies on its subsidiary PeoplesBank, A Codorus Valley Company, for dividend distributions, which are subject to restrictions as reported in Note 9 Regulatory Matters of the Corporation's Annual Report on Form 10-K for the year ended December 31, 2013.

The Corporation has a Share Repurchase Program (Program), which was authorized in 1995, and has been periodically amended, to permit the purchase of up to a maximum of 4.9 percent of the outstanding shares of the Corporation's common stock at a price per share no greater than 200 percent of the latest quarterly published book value. For the nine month period ended September 30, 2014 and the year ended December 31, 2013, the Corporation had not acquired any of its common stock under the Program. The U.S. Treasury's Small Business Lending Fund (SBLF) agreement imposes limits on the ability of the Corporation to repurchase shares of common stock if it fails to declare and pay quarterly dividends on the SBLF preferred stock.

Item 3. Defaults upon senior securities

None

Item 4. Mine safety disclosures

This Item 4 is not applicable to the Corporation.

Item 5. Other information

None

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Item 6. Exhibits

| Exhibit Number | Description of Exhibit |
|----------------|-----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| 3.1 | Amended Articles of Incorporation (Incorporated by reference to Exhibit 3(i) to the Registrant's Quarterly Report on Form 10-Q for September 30, 2012, filed with the Commission on November 13, 2012) |
| 3.2 | Amended By-laws (Incorporated by reference to Exhibit 3(ii) to the Registrant's Current Report on Form 8-K, filed with the Commission on February 17, 2012) |
| 3.3 | Certificate of Designation of Senior Non-Cumulative Perpetual Preferred Stock, Series B (Incorporated by reference to Exhibit 3.1 to the Registrant's Current Report on Form 8-K, filed with the Commission on August 24, 2011) |
| 4.1 | Rights Agreement dated as of November 4, 2005 (Incorporated by reference to Exhibit 4 to the Registrant's Quarterly Report on Form 10-Q for September 30, 2010, filed with Commission on November 15, 2010), as amended January 9, 2009 (Incorporated by reference to Exhibit 4.1 to the Registrant's Quarterly Report on Form 10-Q for September 30, 2010, filed with the Commission on November 15, 2010), as further amended August 18, 2011 (Incorporated by reference to Exhibit 4.1 to the Registrant's Current Report on Form 8-K, filed with the Commission on August 24, 2011) |
| 4.2 | Specimen Certificate for Senior Non-Cumulative Perpetual Preferred Stock, Series B (Incorporated by reference to Exhibit 4.2 to Registrant's Registration Statement on Form S-3 filed with the Commission on November 21, 2013) |
| 4.3 | Registration Rights Agreement dated March 26, 2014 (Incorporated by reference to Exhibit 10.2 to the Registrant's Current Report on Form 8-K filed with the Commission on March 26, 2014) |
| 31.1 | Certification of Principal Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 |
| 31.2 | Certification of Principal Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 |
| 32 | Certification of Principal Executive Officer and Principal Financial Officer Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 |
| 101 | Financial statements from the Quarterly Report on Form 10-Q of Codorus Valley Bancorp, Inc. for the quarter ended September 30, 2014, formatted in XBRL: (i) the Consolidated Balance Sheets, (ii) the Consolidated Statements of Income (iii) the Consolidated Statements of Comprehensive Income (iv) the Consolidated Statements of Cash Flows, (v) the Consolidated Statements of Changes in Shareholder's Equity, and (vi) the Notes to Consolidated Financial Statements filed herewith. |

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Signatures

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

Codorus Valley Bancorp, Inc.
(Registrant)

November 7, 2014
Date

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

November 7, 2014
Date

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

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